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[Document(page\_content=' \n \n \nFinancial reporting developments \nA comprehensive guide \nLease \naccounting \nAccounting Standards Codification 842, \nLeases \nAugust 202 3 \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 0}), Document(page\_content=' \n To our clients and other friends \nAccounting Standard Codification (ASC) 842, Leases , requires most leases to be recognized on the balance \nsheet and requires enhanced disclosures. The Financial Accounting Standards Board (FASB or Board) \nbelieves this result s in a faithful representation of lessees’ assets and liabilities and provides \ntransparency about the lessee’s obligations and leasing activities. \nThe FASB held joint deliberations with the International Accounting Standards Board (IASB), which issued \na sim ilar standard (IFRS 16 , Leases ). However, there are significant differences between the FASB and \nIASB standards ( e.g., lessees do not classify leases under IFRS ). Appendix D of this publication summarizes \ndifferences between US GAAP and IFRS. Under ASC 842, leases are accounted for based on what the \nFASB refers to as a “right -of-use model.” The model reflects that, at the commencement date, a lessee has \na financial obligation to make lease payments to the lessor for its right to use the underlying asset during the \nlease term. The lessor conveys that right to use the underlying asset at lease commencement, which is the \npoint in time when it makes the underlying asset available for use by the lessee. \nASC 842 was effective for public business entities (PBEs)1 and certain not -for-profit entities2 and employee \nbenefit plans3 for annual periods beginning after 15 December 2018 ( i.e., 1 January 2019 for a calendar -\nyear entity) and interim periods within those years. Certain n ot-for-profit entitie s2 that ha d not i ssued \n(or made available for issuance) financial statements that reflect the new standard as of 3 June 2020 \nwere required to adopt the standard for annual periods beginning after 15 December 2019 and interim \nperiods within those annual periods. Private com panies and other not -for-profit entities that ha d not issued \n(or made available for issuance) financial statements that reflect the new standard as of 3 June 2020 were \nrequired to adopt the new leases standard for annual periods beginning after 15 December 2021 and interim \nperiods in annual periods beginning after 15 December 2022. Early adoption was permitted for all entities. \nASC 842’s transition provisions are applied using a modified retrospective approach. Full retrospective \napplication is prohibited. An entity can choose to apply the provisions at the beginning of the earliest \ncomparative period presented in the financial state ments or at the beginning of the period of adoption. \nThe views we express in this publication represent our perspectives as of August 202 3. We have updated \nthis edition to provide questions and answers to clarify certain aspects of the guidance. We may ide ntify \nadditional issues as we analyze the standard and entities continue to interpret it, and our views may evolve \nduring that process. We expect to periodically update our guidance to provide the latest implementation \ninsights. Appendix E of this publicat ion summarizes significant changes since the previous edition. \n \nAugust 202 3\n \n1 Refer to the ASC Master Glossary for the definition of a public business entity. \n2 Not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, listed or quoted on an exchange \nor an over -the-counter market . \n3 Employ ee benefit plans that file or furnish financial statements with or to the S ecurities and Exchange Commission . \n', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 1}), Document(page\_content=' \nFinancial reporting developments Lease accounting | i Contents \n1 Scope and scope exceptions ................................ ................................ ....................... 1 \n1A Amendments to ASC 842 (updated August 2023) ................................ ................................ ... 1 \n1.1 Scope and scope exceptions 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H-1 \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 11}), Document(page\_content='Contents \nFinancial reporting developments Lease accounting | xi Notice to readers: \nThis publication includes excerpts from and references to the Financial Accounting Standards Board \n(FASB or Board) Accounting Standards Codification (Codification or ASC). The Codification uses a \nhierarchy that includes Topics, Subtopics, Sections and Paragraphs. Each Topic includes an Overall \nSubtopic that generally includes pervasive guidance for the Topic and additional Subtop ics, as needed, \nwith incremental or unique guidance. Each Subtopic includes Sections that in turn includ e numbered \nParagraphs. Thus, a C odification reference includes the Topic (XXX), Subtopic (YY ), Section (ZZ) and \nParagraph (PP). \nThroughout this publicat ion references to guidance in the Codification are shown using these reference \nnumbers. References are also made to certain pre -Codification standards (and specific sections or \nparagraphs of pre -Codification standards) in situations in which the content being discussed is excluded \nfrom the Codification. \nThis publication has been carefully prepared, but it necessarily contains information in summary form \nand is therefore intended for general guidan ce only; it is not intended to be a substitute for detailed \nresearch or the exercise of professional judgment. The information presented in this publication should \nnot be construed as legal, tax, accounting, or any other professional advice or service. Ern st & Young LLP \ncan accept no responsibility for loss occasioned to any person acting or refraining from action as a result \nof any material in this publication. You should consult with Ernst & Young LLP or other professional \nadvisors familiar with your part icular factual situation for advice concerning specific audit, tax or other \nmatters before making any decisions. \nPortions of FASB publications reprinted with permission. Copyright Financial Accounting Standards Board, 801 Main Avenue , \nP.O. Box 5116, Norwa lk, CT 06856 -5116, USA. Portions of AICPA Statements of Position, Technical Practice Aids and other AICPA \npublications reprinted with permission. Copyright American Institute of Certified Public Accountants, 1345 Avenue of the Americas, \n27th Floor , New Yor k, NY 10105 , USA. Copies of complete documents are available from the FASB and the AICPA. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 12}), Document(page\_content=' \nFinancial reporting developments Lease accounting | 1 1 Scope and scope exceptions \nA lease is a contract, or part of a contract, that conveys the right to control the use of identified property, \nplant or equipment for a period of time in exchange for consideration . Under a lease, the party obtaining \nthe right to use the underlying asset is referred to as a lessee, and the party conveying the right to use the \nproperty is referred to as a lessor. Account ing guidance discussed in this publication for lease arrangements \nfor both lessees and lessors under US GAAP is primarily contained in ASC 842 and is applicable to all entities. \n1A Amendments to ASC 842 (updated August 2023) \nLand easement practical expedient ( ASU 2018 -01) \nThe FASB issued a final Accounting Standards Update (ASU) to provide an optional transition practical \nexpedient that permits an entity to continue applying its ASC 840 policy for accounting for land easements \nthat existed as of, or expired before, the effective date of ASC 842. An entity that elects the practical \nexpedient is required to apply it to all of its existing or expired land easements that were not previously \naccounted for under ASC 840. The ASU clarifies that an entity will evaluate whether land easements \nentered into or modified on or after the effective date meet the definition of a lease under ASC 842 \nbefore applying the guidance in ASC 350-30, Intangibles — Goodwill and Other — General Intangibles \nOther Than Goodwill . Refer to section 1.1.3, Land easements . \nCodification improvements (ASU 2018 -10) \nThe FASB issued a final ASU to clarify how to apply certain aspects of the new leases standard. The \nclarifications address the following: \n• Lease term and purchase opti ons (refer to section 2.3) \n• Lessor reassessment of lease term and purchase option s (refer to sections 2.3.6.2, 5.2.4 and 5.3.4) \n• Variable lease payments that depend on an index or rate (refer to section 2.4.2) \n• Rate implicit in the lease (refer to sections 2. 5 and 2.5.1) \n• Investment tax credits (refer to section 3.4.6.1) \n• Lessee reassessment of lease classification (refer to section 3.5) \n• Impairment of net investment in the lease (refer to section 5.2.3) \n• Effect of initial direct costs on rate implicit in the lease (refer to section 5.5) \n• Unguaranteed residual asset (refer to section 5.7.1) \n• Failed sale and leaseback transaction (refer to section 7.4) \n• Certain transition adjustments (refer to sections 11.3 and 11.4) \n• Transition guidance for leases previously classified as capital leases under ASC 840 (refer to \nsection 11.3.1) \n• Transition guidance for modifications to leases previously classified as direct financing or sales -type \nleases under Topic 840 (refer to section 11.4.1) \n• Transition guidance for sale and leaseback transactions (refer to section 11.5.1) \n• Transition guidance for amounts previously recognized in business combinations (refer to section 11.5.2) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 13}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 2 Targeted improvements ( ASU 2018 -11) \nThe FASB issued a final ASU providing an optional transition method that allows entities to continue to \napply the guidance in ASC 840, including its disclosure requirements, in the comparative periods presented \nin the year that they adopt the new leases guidance in ASC 842. The Bo ard also amended ASC 842 to \nprovide a practical expedient that allows lessors to elect, by class of underlying asset, to not separate lease \nand associated non -lease components if certain criteria are met. Refer to sections 1.4.2.4, Practical expedient \nto not separate lease and non -lease components — lessors , and 11.2, Transition , for further discussion \nNarrow -Scope Improvements for Lessors ( ASU 2018 -20) \nThe FASB issued ASU 2018 -20, Narrow -Scope Improvements for Lessors , which amended ASC 842 to allow \nlessors to make an accounting policy election not to evaluate whether sales taxes and similar taxes imposed \nby a governmental authority on a specific lease revenue -producing transaction and collected by the lessor \nfrom the lessee are the prima ry obligation of the lessor as owner of the underlying leased asset. A lessor that \nmakes this election must exclude from the consideration in the contract and from variable payments not \nincluded in the consideration in the contract all taxes within the sco pe of the election and make additional \ndisclosures. The amendments also require a lessor to exclude lessor costs paid directly by a lessee to third \nparties on the lessor’s behalf from variable payments, but lessor costs that are paid by the lessor and \nreim bursed by the lessee are required to be included in variable payments. Refer to section 1.4.4, \nDetermining, allocating and reassessing the consideration in the contract — lessors , for further discussion. \nThe amendments also clarify that when lessors alloca te variable payments to lease and non -lease \ncomponents they are required to follow the recognition guidance in ASC 842 for the lease component \nand other applicable guidance, such as ASC 606, for the non -lease component. Refer to section 1.4.4.3, \nAllocating variable payments — lessors . \nCodification Improvements (ASU 2019-01) \nThe FASB issued ASU 2019 -01, Codification Improvements , which added guidance to ASC 842 that states \nthat, for lessors that are not manufacturers or dealers, the fair value of the underly ing asset is their cost, less \nany volume or trade discounts. However, if there is a significant amount of time between the acquisition \nof the underlying asset and lease commencement, a lessor would have to measure the fair value using \nthe guidance in ASC 820, Fair Value Measurement . Refer to section 2.8, Fair value , for further discussion. \nThe amendments also clarified that lessors in the scope of ASC 942, Financial Services — Depository and \nLending , must classify principal payments rec eived from sales -type and direct financing leases in investing \nactivities in the statement of cash flows. Refer to section 5.8, Presentation , for further discussion. \nLastly, the amendments clarified that entities are not subject to the transition disclosur e requirements in \nASC 250-10-50-3 related to the effect of an accounting change on certain interim period financial \ninformation. Refer to section 11.6.1, Interim disclosures in the year of adoption , for further discussion. \nReference Rate Reform (Topic 848) : Facilitation of the Effects of Reference Rate Reform on Financial \nReporting (ASU 2020 -04) \nThe FASB issued ASU 2020 -04, Reference Rate Reform (Topic 848): Facilitation of the Effects of \nReference Rate Reform on Financial Reporting , to provide temporary optional expedients and exceptions \nto the US GAAP guidance on contract modifications to ease the financial reporting burden related to the \nexpected market transition from the London Interbank Offered Rate ( LIBOR ) and other interbank of fered \nrates to alternative reference rates, such as the Secured Overnight Financing Rate (SOFR). Under the \nASU, if an entity elects the optional expedient to not apply modification accounting to contract \nmodifications that replace a reference rate due to r eference rate reform, it would not account for the \nchange as a lease modification if the modified contract meets certain criteria. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 14}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 3 Refer to section 4.6.3 .1, Lessee accounting for a modification due to reference rate reform , and section \n5.6.3 .4, Lessor acco unting for a modification due to reference rate reform , for further discussion. \nRevenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for \nCertain Entities (ASU 2020 -05) \nThe FASB issued ASU 2020 -05, Revenue from Contracts with Customers (Topic 606) and Leases \n(Topic 842): Effective Dates for Certain Entities , that deferred the effective date of the new leases \nstandard for private companies ; not-for-profit entities that ha ve issued or are conduit bond obligor s for \nsecurities traded, listed or quoted on an exchange or over -the-counter market and that ha d not issued (or \nmade available for issuance) financial statements that reflect the new standard as of 3 June 2020 ; and \nother not -for-profit entities that ha d not issued (or made available for issuance) financial statements that \nreflect the new standard as of 3 June 2020 . \nNot-for-profit entities that have issued or are conduit bond obligors for securities traded, listed or quoted \non an exchan ge or over -the-counter market and that ha d not issued (or made available for issuance) \nfinancial statements that reflect the new standard as of 3 June 2020 were required to adopt the standard \nfor annual reporting periods beginning after 15 December 2019 an d interim reporting periods within \nthose annual reporting periods. Private companies and other not-for-profit entities that ha d not issued \n(or made available for issuance) financial statements that reflect the new standard as of 3 June 2020 were \nrequired t o adopt the new leases standard for annual reporting periods beginning after 15 December \n2021 and interim reporting periods in annual reporting periods beginning after 15 December 2022. \nLessors — Certain Leases with Variable Lease Payments (ASU 2021 -05) \nThe FASB issued ASU 2021 -05, Leases (Topic 842): Lessors – Certain Leases with Variable Lease \nPayments , which amended ASC 842 to require lessors to classify leases as operating leases if they have \nvariable lease payments that do not depend on an index or rate and would result in selling losses if they \nwere classified as sales -type or direct financing leases. For lessors that ha d adopted ASC 842 as of \n19 July 2021, the date the amendments were issued, the amendments were effective for annual periods \nbeginni ng after 15 December 2021 and interim periods either within those years or within the following \nyear, depending on when they were required to adopt ASC 842. Early adoption is permitted. Entities that \nhad not adopted ASC 842 as of 19 July 2021 are required to apply the amendments when they adopt \nASC 842 and follow the transition requirements in ASC 842. Refer to section 3.2, Criteria for lease \nclassification — lessors , for further discussion . \nDiscount Rate for Lessees That Are Not Public Business Entities (ASU 2021 -09) \nThe FASB issued ASU 2021 -09, Leases (Topic 842): Discount Rate for Lessees That Are Not Public \nBusiness Entities , which amended ASC 842 to allow a lessee that is not a PBE to elect to use a risk -free \nrate as its discount rate by class of underlying asset, rather than for all leases as originally required by \nASC 842. A lessee that makes the election is required to disclose the class or clas ses of underlying assets \nto which it applied the risk -free rate . The amendments also require lessees to use the rate implicit in the \nlease when it is readily determinable, even if they make the risk -free rate election. Lessees that ha d not \nadopted ASC 842 as of 11 November 2021, the date the amendments were issued, are required to apply \nthe amendments when they adopt ASC 842 and follow the transition requirements in ASC 842. Lessees \nthat ha d adopted ASC 842 as of 11 November 2021 are required to apply the a mendments on a modified \nretrospective basis to leases that existed at the beginning of the year of adoption. The amendments were \neffective for annual periods beginning after 15 December 2021 and interim periods beginning the following \nyear. Early adoption is permitted. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 15}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 4 Common Control Arrangements (ASU 2023 -01) \nThe FASB issued ASU 2023 -01, Leases (Topic 842) : Common Control Arrangements , which amended \nASC 842 to allow entities other than public business entities, not -for-profit conduit bond obligors or \nemployee benefit plans that file or furnish financial statements with the Securities and Exchange \nCommission (i.e., private companies and certain not -for-profit entities) to elect a practical expedient to \nuse the written terms and conditions (rather than t he legally enforceable terms) of a common control \narrangement to determine whether a lease exists and to classify and account for the lease. The practical \nexpedient may be elected on an arrangement -by-arrangement basis. \nASU 2023 -01 also requires all lessees, including public business entities, to amortize leasehold \nimprovements associated with common control leases over their useful life to the common control group , \nas long as the lessee controls the use of the underlying asset thro ugh a lease. Lessees are also required \nto account for the leasehold improvements as a transfer of assets between entities under common \ncontrol through an adjustment to equity (or net assets for not -for-profit entities) when the lessee no \nlonger controls th e use of the underlying asset. \nThis guidance is effective for fiscal years beginning after 15 December 2023, including interim periods \nwithin those fiscal years. Early adoption is permitted for financial statements that have not been made \navailable for iss uance in any annual or interim period as of the beginning of the related fiscal year. \n1.1 Scope and scope exceptions \nExcerpt from Accounting Standards Codification \nLeases — Overall \nScope and Scope Exceptions \n842-10-15-1 \nAn entity shall apply this Topic to all leases , including subleases . Because a lease is defined as a \ncontract, or part of a contract , that conveys the right to control the use of identified property, plant, \nor equipment (an identified asset) for a period of time in exchange for consideratio n, this Topic does \nnot apply to any of the following: \na. Leases of intangible assets (see Topic 350, Intangibles — Goodwill and Other). \nb. Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources (see \nTopics 930, Extractive Activities — Mining, and 932, Extractive Activities — Oil and Gas). This includes \nthe intangible right to explore for those natural r esources and rights to use the land in which those \nnatural resources are contained (that is, unless those rights of use include more than the right to \nexplore for natural resources), but not equipment used to explore for the natural resources. \nc. Leases o f biological assets, including timber (see Topic 905, Agriculture). \nd. Leases of inventory (see Topic 330, Inventory). \ne. Leases of assets under construction (see Topic 360, Property, Plant, and Equipment). \nMaster Glossary \nInventory \nThe aggregate of thos e items of tangible personal property that have any of the following characteristics: \na. Held for sale in the ordinary course of business \nb. In process of production for such sale \nc. To be currently consumed in the production of goods or services to be available for sale. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 16}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 5 The term inventory embraces goods awaiting sale (the merchandise of a trading concern and the finished \ngoods of a manufacturer), goods in the course of production (work in process), and goods to be consumed \ndirectly or indirectly in pro duction (raw materials and supplies). This definition of inventories excludes long -\nterm assets subject to depreciation accounting, or goods which, when put into use, will be so classified. The \nfact that a depreciable asset is retired from regular use and h eld for sale does not indicate that the item \nshould be classified as part of the inventory. Raw materials and supplies purchased for production may be \nused or consumed for the construction of long -term assets or other purposes not related to production, bu t \nthe fact that inventory items representing a small portion of the total may not be absorbed ultimately in the \nproduction process does not require separate classification. By trade practice, operating materials and \nsupplies of certain types of entities su ch as oil producers are usually treated as inventory. \nThe scope of ASC 842 is limited to leases of property, plant and equipment ( i.e., land and depreciable assets), \nincluding subleases of those assets. ASC 842 does not apply to any of the following: \n• Leases of intangible assets \n• Leases to explore for or use minerals, oil, natural gas and similar non -regenerative resources, including \nthe intangible rights to explore for those natural resources and rights to use the land in which those \nnatural resources are contained (unless those rights of use include more than the right to explore for \nnatural resources), but not equipment used to explore for the natural resources \n• Leases of biological assets, including timber \n• Leases of inventory ( i.e., assets h eld for sale in the ordinary course of business, assets in the process \nof production for sale, and assets to be currently consumed in the production of goods or services to \nbe available for sale) \n• Leases of assets under construction (refer to section 7.7, Lessee involvement in asset construction \n(‘build -to-suit’ transactions) ) \n1.1.1 Service concession arrangements \nA service concession arrangement between a grantor and an operating entity lays out the terms (including \nthe time period) under which the operatin g entity will operate the grantor’s infrastructure ( e.g., an airport, \nroad, bridge, tunnel). Arrangements within the scope of ASC 853, Service Concession Arrangements , are \nexcluded from the scope of ASC 842. Entities should evaluate whether ASC 853 applies to an arrangement \nbefore evaluating whether an arrangement contains a lease. Refer to section 1.8, Service concession \narrangements, for further information. \n1.1.2 Applicability to state and local governmental units \nPrior to adopting Governmental Accountin g Standards Board (GASB) Statement No. 87, Leases , \ngovernmental units follow guidance on accounting for leases in National Council on Governmental \nAccounting (NCGA) Statement 5 and GASB Statement No. 13. NCGA Statement 5 requires governmental \nunits to follow the provisions of FASB Statement No. 13. Users of this guide should refer to the \nappropriate governmental literature for further details. \nGASB Statement No. 87 establishes a single approach for state and local governments to account for \nand report leases based on the principle that leases are financin gs of the right to use an underlying asset. \nThe guidance applies to lease contracts for nonfinancial assets, including vehicles, heavy equipment and \nbuildings, but does not apply to nonexchange transactions, such as donated assets, and leases of intangible \nassets, such as patents and software licenses. GASB Statement No. 87 was originally effective for reporting \nperiods beginning after 15 December 2019. In May 2020, the GASB issued Statement No. 95, Postponement ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 17}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounti ng | 6 of the Effective Dates of Certain Authoritati ve Guidance , that deferred the effective date of GASB \nStatement No. 87 by 18 months. GASB Statement No. 87 was effective for reporting periods beginning \nafter 15 June 2021. Earlier application is encouraged. \n1.1.3 Land easements \nLand easements are rights to use, access or cross another entity’s land for a specified purpose. For \nexample, a land easement might be acquired for the right to construct and operate a pipeline or other \nasset (e.g., telecommunication cables) over, under or through an existing area of land or body of water \nwhile allowing the landowner continued use of the land for other purposes ( e.g., farming), as long as the \nlandowner does not interfere with the rights conveyed in the land easement. A land easement may be \nperpetual or term based, provide for exclusive or nonexclusive use of the land, and may be prepaid or \npaid over a defined term. \nPerpetual easements are outside the scope of ASC 842, as the definition of a lease requires the contract \nto be for a period of time. Therefore, entities must carefully evaluate easement contracts to determine \nwhether the contract is perpetual or for a period of time. Examples of contracts that may appear perpetual \nbut are term based include: \n• Very long -term contracts ( e.g., the FASB indicated in the Background Information and Basis for \nConclusions (BC 113) of ASU 2016 -02 that very long -term leases of land ( e.g., 999 years) are in the \nscope of ASC 842) \n• Cont racts with a stated, noncancelable lease term that “automatically renews” if the lessee pays a \nperiodic renewal fee are in-substance fixed term contract s with optional renewal periods \nWhen determining whether a contract for a land easement is a lease, enti ties will need to assess whether there \nis an identified asset ( i.e., a distinct portion of land) and whether the customer has the right to direct the use of, \nand obtain substantially all of the economic benefits of, the identified asset throughout the peri od of use. \nIllustration 1 -1: Subsurface pipeline land easement \nScenario A \nMidstream Co. enters into a 20 -year contract with Land Owner for the right to bury a 10 -inch diameter \npipe three feet below the surface of the land. The contract specifies the exact location of the pipe and \nstates that the property subject to the easement is a 10 -foot-strip of land, extending five feet on either \nside of the center line of the pipe. Additionally, the contract provides access rights to Midstream Co. to \ninstal l and maintain the pipeline for the duration of the contract (20 years) . The terms of the contract \npermit Midstream Co. to use the property for a pipeline . However, Midstream Co. does not have the \nright to restrict access to the land. Land Owner has the su bstantive right to access the property above \nthe pipeline and use it for farming, livestock or other purposes as long as that usage does not interfere \nwith Midstream Co.’s use of the subsurface property. \nAnalysis : Midstream Co. determines that the contract includes a single unit of account ( i.e., the \nidentified asset is the property through which the pipeline passes ). Midstream Co. determines that \nwhile it has access rights to the property, it does not have the right to obtain substantially all of the \necono mic benefit of the identified asset, because Land Owner retains rights to economic benefits \nsubject to the identified asset . Therefore, this contract does not contain a lease. \nIf Land Owner contracts with another third party to use the surface area above t he pipeline, Land Owner \nand the third party would need to evaluate the contract under ASC 842. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 18}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 7 Scenario B \nAssume the same facts as Scenario A , except that the contract also grants Midstream Co. the right to \nrestrict access to the land easement that includes the surface area immediately above the pipeline . \nThis right allows Midstream Co. to restrict access to the surface area above Midstream Co.’s pipeline \nthrough any methods Midstre am Co. deems appropriate , including the use of sign age or fencing. \nAnalysis : Midstream Co. determines that the contract includes a single unit of account ( i.e., the \nidentified asset is the property through which the pipeline passes ). Midstream Co. determin es that it \nhas the right to obtain substantially all of the economic benefit of the identified asset . Additionally, \nMidstream Co. determines that it has the right to direct how and for what purpose the identified asset will \nbe used throughout the period of use. Therefore, this contract contains a lease. \nThe FASB issued a final ASU to provide an optional transition practical expedient discussed in section 11.2.2, \nTransition practical expedients , and a clarification that an entity will evaluate whether land easements \nentered into or modified on or after the effective date meet the definition of a lease under ASC 842 \nbefore applying the guidance in ASC 350-30. \n1.1.4 Sales with repurchase options \nSom e arrangements include repurchase provisions, either as a component of a sales contract or as a \nseparate contract that relates to the goods in the original agreement or similar goods. These provisions \naffect how an entity applies ASC 606’s guidance on cont rol to affected transactions. If the nature of a \nrepurchase provision results in control of a good not transferring to the customer ( e.g., a forward or call \noption that could require or provide the right to the seller to repurchase an asset), the arrangeme nt may \nbe a lease within the scope of ASC 842. Refer to section 7.3, Repurchase agreements, of our Financial \nreporting developments (FRD) publication, Revenue from contracts with customers ( ASC 606) , for further \ndiscussion of repurchase options that may result in an arrangement being accounted for as a lease rather \nthan a sale to a customer. \n1.2 Determining whether an arrangement contains a lease \nExcerpt from Accounting Standards Codification \nMaster Glossary \nLease \nA contract , or part of a contract, that conveys the right to control the use of identified property, plant, \nor equipment (an identified asset) for a period of time in exchange for consideration. \nContract \nAn agreement between two or more parties that creates enforcea ble rights and obligations . \nPeriod of Use \nThe total period of time that an asset is used to fulfill a contract with a customer (including the sum of \nany nonconsecutive periods of time). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 19}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 8 Leases — Overall \nScope and Scope Exceptions \n842-10-15-2 \nAt inception of a contract , an entity shall determine whether that contract is or contains a lease . \n842-10-15-3 \nA contract is or contains a lease if the contract conveys the right to control the use of identified property, \nplant, or equipment (an identifie d asset) for a period of time in exchange for consideration. A period of \ntime may be described in terms of the amount of use of an identified asset (for example, the number of \nproduction units that an item of equipment will be used to produce). \n842-10-15-4 \nTo determine whether a contract conveys the right to control the use of an identified asset (see \nparagraphs 842 -10-15-17 through 15 -26) for a period of time, an entity shall assess whether, \nthroughout the period of use , the customer has both of the follow ing: \na. The right to obtain substantially all of the economic benefits from use of the identified asset (see \nparagraphs 842 -10-15-17 through 15 -19) \nb. The right to direct the use of the identified asset (see paragraphs 842 -10-15-20 through 15 -26). \nIf the customer in the contract is a joint operation or a joint arrangement, an entity shall consider \nwhether the joint operation or joint arrangement has the right to control the use of an identified asset \nthroughout the period of use. \n842-10-15-5 \nIf the custom er has the right to control the use of an identified asset for only a portion of the term of \nthe contract, the contract contains a lease for that portion of the term. \n842-10-15-7 \nIn making the determination about whether a contract is or contains a lease, an entity shall consider all \nrelevant facts and circumstances. \nA lease is a contract ( i.e., an agreement between two or more parties that creates enforceable rights and \nobligations), or part of a contract, that conveys the right to control the use of identified property, plant or \nequipment ( i.e., an identified asset) for a period of time in exchange for consideration. \nASC 842 requires an entity to determine whether a contract is a lease or contains a lease at the inception \nof the contract, considering all relevant facts and circumstances. For example, the fact that a contract is \nlabeled a “transportation contract” or a “lease” does not necessarily mean the arrangement is or is not a \nlease. T herefore, the parties to the contract must carefully analyze the terms to determine whether the \narrangement conveys the right to control the use of an asset. Executory contracts for services that \ninvolve the use of equipment but do not convey the right to control the use of the equipment to the \ncustomer are not leases and should be accounted for as service agreements. \nRefer to section 9.1, Related -party leasing transactions , and section 9.1.1, Practical expedient to use the \nwritten terms and conditions of c ommon control arrangement , for further discussion of considerations \nassociated with related -party leases and or common control leases, respectively. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 20}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 9 The following flowchart is included in ASC 842’s implementation guidance (ASC 842-10-55-1) and \ndepicts the decision -making process for determining whether an arrangement is or contains a lease. \n \nASC 842’s lease model is described in the following sections, using excerpts from ASC 842. Also, refer to \nAppendix C, Illustrations from ASC 842 on the application of the definition of a lease , for comprehensive \nillustrations from ASC 842 of the application of the definition of a lease. \n1.2.1 Identified asset \nExcerpt from Accounting Standards Codification \nLeases — Overall \nScope and Scope Exceptions \n842-10-15-9 \nAn asset typically is identified by being explicitly specified in a contract . However, an asset also can be \nidentified by being implicitly specified at the time that the asset is made available for use by the customer. \nNo \nNo \nYes \nYes \nSupplier \n Customer \nNeither; how and for what purpose the asset \nwill be used is predetermined \n(refer to section 1.2.2.2, Right to direct the use \nof the identified asse t) \nNo \nNo \nYes \nYes \nThe contract does not \ncontain a lease. \nStart \nIs there an identified asset? \nConsider paragraphs 842 -10-15-9 through 15 -16. \n(refer to section 1.2.1, Identified asset ) \nDoes the customer have the right to obtain substantially all of the \neconomic benefits from use of the asset throughout the period of use? \nConsider paragraphs 842-10-15-17 through 15 -19. \n(refer to section 1.2.2. 1, Right to obtain substantially all of the \neconomic benefits from the use of the identified asset) \nDoes the customer or the supplier have the right to direct how and for \nwhat purpose the identified asset is used throughout the period of use? \nConsider paragraphs 842 -10-15-20(a) and 842 -10-15-24 through 15 -26. \n(refer to section 1.2.2.2, Right to direct the use of the identified asset ) \nDoes the customer have the right to operate the asset \nthroughout the period of use without the supplier having the \nright to change those operating instructions? \n(refer to section 1.2.2.2, Right to direct the use of the identified asset ) \nDid the customer design the asset (or specific aspects of the asset) \nin a way that predetermines how and for what purpose the asset \nwill be used throughout the period of use? \n(refer to section 1.2.2.2, Right to direct the use of the identified asset ) \nThe contract contains a lease. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 21}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 10 842-10-15-16 \nA capacity portion of an asset is an identified asset if it is physically distinct (for example, a floor of a building \nor a segment of a pipeline that connects a single customer to the larger pipeline). A capacity or other portion \nof an asset that is not physically distinct (for example, a capacity portion of a fiber optic cable) is not an \nidentified asset, unless it represents substantially all of the capacity of the asset and thereby provides \nthe custom er with the right to obtain substantially all of the economic benefits from use of the asset. \nThe requirement that there be an identified asset is fundamental to the definition of a lease. An identified \nasset can be either implicitly or explicitly specified in a contract. \nIllustration 1 -2: Implicitly specified asset \nCustomer X enters into a five -year contract with Supplier Y for the use of a railcar specifically designed \nfor Customer X. The railcar is designed to transport materials used in Customer X’s production process \nand is not suitable for use by other customers. The railcar is not explicitly specified in the contract, but \nSupplier Y owns only one railcar that is suitable for Customer X’s use. If the railcar does not operate \nproperly, the contract requires Supplier Y to repair or replace the railcar. Assume that Supplier Y does \nnot have a subs tantive substitution right (refer to section 1.2.1.1, Substantive substitution rights ). \nAnalysis : The railcar is an identified asset. While the railcar is not explicitly specified in the contract \n(e.g., by serial number), it is implicitly specified because Supplier Y must use it to fulfill the contract. \nIn another example, a power plant is an implicitly identified asset in a power purchase contract if the \nseller of the power is a special -purpose entity (SPE) that owns a single power plant. In this instance, the \npower plant is implicitly specified in the c ontract because it is unlikely that the SPE could obtain replacement \npower to fulfill its obligations under the contract because an SPE generally has limited capital resources. \nIn the case of a transportation contract, the supplier may have only a single p ipeline, and it might not be \neconomically feasible for the supplier to obtain access to a second pipeline. In that case, the seller’s \npipeline is implicitly identified in the contract. \nAn identified asset also can be a physically distinct portion of a larg er asset. Examples include the following: \n• A floor of a building \n• The “last mile” of a telecommunications network that connects a single customer to a larger network \n• A segment of a pipeline that connects a single customer to a larger pipeline ( i.e., the segment is used \nsolely by one customer) \n• A dedicated production line within a contract manufacturing facility \nHowever, a capacity portion or other portion of an asset tha t is not physically distinct (e.g., a capacity \nportion of a fiber optic cable) is not an identified asset u nless it represents substantially all of the \ncapacity of the asset and therefore provides the customer with the right to obtain substantially all of the \neconomic benefits from use of the asset. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 22}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 11 Illustration 1-3: Identified asset — physically distinct portion of a larger asset \nCustomer X enters into a 12 -year contract with Supplier Y for the right to use three fibers in a fiber optic \ncable between New York and London. The contract identifies three of the cable’s 20 fibers for use by \nCustomer X . The three fibers are dedicated solely to Customer X’s data for the duration of the contract \nterm. Assume that Supplier Y does not have a substantive substitution right (refer to section 1.2.1.1, \nSubstantive substitution rights ). \nAnalysis: The three fibers are identified assets because they are physically distinct and explicitly \nspecified in the contract. \n \nIllustration 1-4: Identified asset — capacity portion of an asset \nScenario A \nCustomer X enters into a five -year contract with Supplier Y for the right to transport oil from Country A \nto Country B through Supplier Y’s pipeline. The contract provides that C ustomer X will have the right \nto 95% of the pipeline’s capacity throughout the term of the arrangement. Supplier Y has no right \n(substantively or contractually) to connect additional branch lines from the identified pipeline for the \nbenefit of other custom ers. \nAnalysis : The capacity portion of the pipeline is an identified asset. While 95% of the pipeline’s capacity \nis not physically distinct from the remaining capacity of the pipeline, it represents substantially all of \nthe capacity of the pipeline and the reby provides Customer X with the right to obtain substantially all \nof the economic benefits from use of the pipeline. \nScenario B \nAssume the same facts as in Scenario A, except that Customer X has the right to use 60% of the \npipeline’s capacity throughout the term of the arrangement. \nAnalysis : The capacity portion of the pipeline is not an identified asset because 60% of the pipeline’s \ncapacity is less than substantially all of the capacity of the pipeline. Customer X does not have the \nright to obtain subst antially all of the economic benefits from use of the pipeline. \nSubstantially all \nThe term “substantially all” is not defined in ASC 842. However, entities might refer to the description in \nASC 842-10-55-2 of how “substantially all the fair value of the underlying asset” could be evaluated in \nthe context of lease classification. In that paragraph, the FASB states that “one reasonable approach” \nwould be to conclude that “[n]inety percent or more of the fair value of the underlying asset amounts to \nsubs tantially all the fair value of the underlying asset.” Refer to section 2.8, Fair value. \n1.2.1.1 Substantive substitution rights (updated August 2023) \nExcerpt from Accounting Standards Codification \nLeases — Overall \nScope and Scope Exceptions \n842-10-15-10 \nEven if an asset is specified, a customer does not have the right to use an identified asset if the supplier \nhas the substantive right to substitute the asset throughout the period of use. A supplier’s right to \nsubstitute an asset is substanti ve only if both of the following conditions exist: \na. The supplier has the practical ability to substitute alternative assets throughout the period of use (fo r \nexample, the customer cannot prevent the supplier from substituting an asset, and alternative as sets are \nreadily available to the supplier or could be sourced by the supplier within a reasonable period of time). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 23}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 12 b. The supplier would benefit economically from the exercise of its right to substitute the asset (that \nis, the economic benefits associated with substituting the asset are expected to exceed the costs \nassociated with substituting the asset). \n842-10-15-11 \nAn entity’s evaluation of whether a supplier’s substitution right is substantive is based on facts and \ncircumstances at inception of the con tract and shall exclude consideration of future events that, at \ninception, are not considered likely to occur. Examples of future events that, at inception of the \ncontract, would not be considered likely to occur and, thus, should be excluded from the eval uation \ninclude, but are not limited to, the following: \na. An agreement by a future customer to pay an above -market rate for use of the asset \nb. The introduction of new technology that is not substantially developed at inception of the contract \nc. A substantial difference between the customer’s use of the asset, or the performance of the asset \nand the use or performance considered likely at inception of the contract \nd. A substantial difference between the market price of the asset during the period of use and the \nmarket price considered likely at inception of the contract. \n842-10-15-12 \nIf the asset is located at the customer’s premises or elsewhere, the costs associated with substitution \nare generally higher than when located at the supplier’s premises and, therefore, are more likely to \nexceed the benefits associated with substituting the asset. \n842-10-15-13 \nIf the supplier has a right or an obligation to substitute the asset only on or after either a particular \ndate or the occurrence of a specified eve nt, the supplier does not have the practical ability to \nsubstitute alternative assets throughout the period of use. \n842-10-15-14 \nThe supplier’s right or obligation to substitute an asset for repairs or maintenance, if the asset is not \noperating properly, o r if a technical upgrade becomes available, does not preclude the customer from \nhaving the right to use an identified asset. \n842-10-15-15 \nIf the customer cannot readily determine whether the supplier has a substantive substitution right, the \ncustomer shall presume that any substitution right is not substantive. \nEven if an asset is specified, a customer does not have the right to use an identified asset if, at inception of the \ncontract, a supplier has the substantive right to substitute the asset throughout the period of use ( i.e., the total \nperiod of time that an asset is used to fulfill a contract with a customer, including the sum of any nonconsecutive \nperiods of time). A substitution right is substantive when both of the following conditions are met: \n• The supplier has the practical ability to substitute alternative assets throughout the period of use \n(e.g., the customer cannot prevent the supplier from substituting an asset, and alternative assets are \nreadily available to the supplier or could be sourced by the supplier within a reasonable peri od of time). \n• The supplier would benefit economically from the exercise of its right to substitute the asset ( i.e., the \neconomic benefits associated with substituting the asset are expected to exceed the costs associated \nwith substituting the asset). \nThe FA SB indicated in the Basis for Conclusions (BC 129) of ASU 2016 -02 that the conditions above are \nintended to differentiate between substitution rights that result in a supplier controlling the use of an \nasset, rather than the customer, and rights that do no t change the substance or character of the contract. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 24}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 13 An entity’s evaluation of whether a supplier’s substitution right is substantive is based on facts and \ncircumstances at inception of the contract. At inception of the contract, an entity should not consi der \nfuture events that are not likely to occur. ASC 842 provides the following examples of circumstances \nthat at inception of the contract are not likely to occur and thus are excluded from the evaluation of \nwhether a supplier’s substitution right is subst antive throughout the period of use: \n• An agreement by a future customer to pay an above -market rate for use of the asset \n• The introduction of new technology that is not substantially developed at inception of the contract \n• A substantial difference between the customer’s use of the asset, or the performance of the asset, \nand the use or performance considered likely at inception of the contract \n• A substantial difference between the market price of the asset during the period of use and the \nmarket price considered likely at inception of the contract \nThe requirement that a substitution right must benefit the supplier economically in order to be substantive \nis a new concept. The FASB indicated in the Basis for Conclusions (BC 130) of ASU 2016 -02 that, in many \ncases, it will be clear that the supplier will not benefit from the exercise of a substitution right because of \nthe costs associated with substituting an asset. The physical location of the asset may affect the costs \nassociated with substituting the asset. For ex ample, if an asset is located at the customer’s premises, the \ncost associated with substituting it is generally higher than the cost of substituting a similar asset located \nat the supplier’s premises. However, simply because the cost of substitution is not significant doesn’t \nmean that the supplier would benefit economically from the right of substitution. \nASC 842-10-15-15 further clarifies that a customer should presume that a supplier’s substitution right is not \nsubstantive if the customer cannot readily determine whether the supplier has a substantive substitution \nright. That is, the customer would conclude a substitution right is not substantive absent appropriate evidence \nto the contrary. This requirement is intended to clarify that a customer is not ex pected to exert undue effort \nto provide evidence that a substitution right is not substantive and that effectively there is a presumption it is \nnot substantive. We believe that the FASB did not include a similar provision for suppliers because they should \nhave sufficient information to make a determination of whether a substitution right is substantive. \nContract terms that allow or require a supplier to substitute alternative assets only when the underlying \nasset is not operating properly ( e.g., a normal wa rranty provision) or when a technical upgrade becomes \navailable do not create a substantive substitution right. \nA supplier’s right or obligation to substitute alternative assets only on or after a particular date or the \noccurrence of a specified event also does not create a substantive substitution right because the supplier \ndoes not have the practical ability to substitute alternative assets throughout the period of use. \nIllustration 1 -5: Substitution rights \nScenario A \nAssume that an electronic data storage provider (supplier) provides services, through a centralized \ndata center, that involve the use of a specified server (Server No. 9). The supplier maintains many \nidentical servers in a single, accessible location and d etermines, at inception of the contract, that it is \npermitted to and can easily substitute another server without the customer’s consent throughout the \nperiod of use. Further, the supplier would benefit economically from substituting an alternative asset, \nbecause doing this would allow the supplier to optimize the performance of its network at only a \nnominal cost. In addition, the supplier has made clear that it has negotiated this right of substitution as \nan important right in the arrangement, and the subs titution right affected the pricing of the arrangement. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 25}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 14 Analysis: The customer does not have the right to use an identified asset because, at the inception \nof the contract, the supplier has the practical ability to substitute the server and would benefit \neconomically from such a substitution. However, if the customer could not readily determine whether \nthe supplier had a substantive substitution right ( e.g., there is insufficient transparency into the \nsupplier’s operations), the customer would presume the s ubstitution right is not substantive and \nconclude that there is an identified asset. \nScenario B \nAssume the same facts as in Scenario A except that Server No. 9 is customized, and the supplier \ndoes not have the practical ability to substitute the customized asset throughout the period of use. \nAdditionally, it is unclear to the customer whether the supplier has the practical ability to substitute \nor whether it would benefit economically from sourcing a similar alternative asset. \nAnalysis : Because the supplier does not have the practical ability to substitute the asset, and there is \nno evidence of economic benefit to the supplier for substituting the asset, the substitution right is non -\nsubstantive from the perspective of both the lessee and the lessor. Therefo re, Server No. 9 would be \nan identified asset. In this case, neither of the conditions of a substantive substitution right is met. As a \nreminder, both conditions must be met for the supplier to have a substantive substitution right. \n \nQuestion 1 -1 Does a contract contain a lease when the supplier has substitution rights that are not substantive \nthroughout the entire period of use ? (added August 2023) \nSubstitution rights may exist in a contract but may not be substantive through the entire period of the \nuse. Consider a fact pattern in which a customer enters into a 10 -year contract with a supplier for 100 \nsimilar batteries used in electric buses. The supplier has the practical ability to substitute alternative \nassets throughout the contract term and w ould be required to compensate the customer for any revenue \nlost or costs incurred while the substitution takes place. At inception of the contract, it is expected that \nthe supplier would benefit economically from substituting the battery once it has been used for three \nyears or more but not before . \nThis fact pattern was submitted to the IFRS Interpretations Committee (IFRS IC) in March 2023. Although \nthis question was submitted to the IFRS IC under IFRS 16, Leases , the definition of a lease is the same \nunder IFRS 16 and ASC 842. We should expect a similar answer under ASC 842 in this fact pattern . The \nIFRS IC noted that the customer is able to benefit from the use of each battery together with a bus that is \nreadily available to it, and each battery is neither highly dependent on, nor highly interrelated with the \nother batteries in the contract. The supplier has the practical ability to substitu te alternative batteries \nthroughout the period of use. However, because the supplier is not expected to benefit economically \nfrom substituting a battery for at least the first three years of the contract, the supplier does not have a \nsubstantive substituti on right throughout the period of use. \nTherefore, in the fact pattern, the IFRS IC concluded that each battery is an identified asset. It follows \nthen, in evaluating whether the contract contains lease, the requirements in ASC 842 need to be applied \nto as sess whether, throughout the period of use, the customer has the right to obtain substantially all the \neconomic benefits from use, and direct the use, of each battery (and therefore has the right to control \nthe use of the underlying asset) . \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 26}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 15 1.2.2 Right to control the use of the identified asset \nA contract conveys the right to control the use of an identified asset for a period of time if, throughout \nthe period of use, the customer has both of the following: \n• The right to obtain substantially all of the e conomic benefits from the use of the identified asset \n(refer to section 1.2.2.1, Right to obtain substantially all of the economic benefits from the use of the \nidentified asset ) \n• The right to direct the use of the identified asset (refer to section 1.2.2.2, Right to direct the use of \nthe identified asset ) \nIf the customer has the right to control the use of an identified asset for only a portion of the term of the \ncontract, the contract contains a lease for that portion of the term in accordance with ASC 842-10-15-5. \nIllustration 1 -6: Right to control the use of the identified asset \nScenario A \nContractor X enters into a contract with Crane Co. for the exclusive right to use a specific tower crane \nthroughout a three -year period. Crane Co. also provides a crew to operate the crane. The contract does \nnot provide for any substitution rights. Crane Co. prohibits certain uses of the crane ( e.g., moving it, \nusing it unsafely) and modifications to the crane. \nAnalysis : Contractor X concludes that it has the right to substantially all of the economic benefits that \nresult from the use of the crane throughout the period of use. \nAlthough Crane Co. provides a crew to operate the crane, Contractor X concludes that it has the right \nto direct how and for what purpose the c rane will be used throughout the period of use ( e.g., it directs \nwhen the crane operates and what it will lift and can change such decisions). While Crane Co. has the \nright to prohibit certain uses of the crane and modifications to the crane, those rights are solely to \nprotect its interest in the crane and do not, by themselves, prevent Contractor X from having the right \nto direct the use of the identified asset. \nBecause Contractor X has the right to substantially all of the economic benefits from the crane and \nhas the right to direct the use of the crane, Contractor X concludes that it has the right to control the \nuse of the crane . \nScenario B \nConsumer products entity (CP) enters into a contract with Vendor for a dedicated production line to \nmanufacture one of its store -brand household products for a two -year period. The contract states that \nCP has the exclusive use of the production line (that is, Vendor cannot use the production line for \nother customer orders). \nThe type of household product is specified in the contract. CP issues instructions to Vendor about the \nquantity and timing of products to be delivered. If the production line is not producing the household \nproduct for CP, it does not operate. \nVendor operates and maintains the production line on a daily basis. \nAnalysis : This contract contains a lease. CP has the right to use the dedicated production line for \ntwo years. \nThere is an identified asset. The dedicated production line is an implicitly identified asset because \nVendor has only one line that can fulfill the contract, and Vendor does not have the right to substitute \nthe specified production line. \nCP has the right to control the use of the dedicated production line ( i.e., the identified asse t) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 27}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 16 throughout the two -year period of use because: \n• CP has the right to substantially all of the economic benefits from use of the dedicated production \nline over the two -year period of use. CP has exclusive use of the dedicated production line; it has \nrights to all the household product produced throughout the two -year period of use. \n• CP has the right to direct the use of the dedicated production line. CP makes the relevant \ndecisions about how and for what purpose the production line is used because it has the right to \ndetermine whether, when, and how much the production line will produce (that is, the timing and \nquantity, if any, of household products produced) throughout the period of use. Because Vendor is \nprevented from using the production line for another purpose, CP’s decision -making rights about \nthe timing and quantity of household products produced, in effect, determine when and whether \nthe production line produces product. \nAlthough the operation and maintenance of the production line are essential to i ts efficient use, \nVendor’s decisions in this regard do not give it the right to direct how and for what purpose the \nproduction line is used. Consequently, Vendor does not control the use of the production line during \nthe period of use. Instead, Vendor’s de cisions are dependent on CP’s decisions about how and for what \npurpose the production line is used. \nDetermining whether a customer has the right to direct the use of an asset throughout the period of use \nmay require significant judgment. Changes in facts a nd circumstances may result in a different conclusion. \n1.2.2.1 Right to obtain substantially all of the economic benefits from the use of the identified asset \nExcerpt from Accounting Standards Codification \nLeases — Overall \nScope and Scope Exceptions \n842-10-15-17 \nTo control the use of an identified asset, a customer is required to have the right to obtain substantially \nall of the economic benefits from use of the asset throughout the period of use (for example, by having \nexclusive use of the asset throughout that period). A customer can obtain economic benefits from use \nof an asset directly or indirectly in many ways, such as by using, holding, or subleasing the asset. The \neconomic benefits from use of an asset include its primary output and by-products (including potential \ncash flows derived from these items) and other economic benefits from using the asset that could be \nrealized from a commercial transaction with a third party. \n842-10-15-18 \nWhen assessing the right to obtain substantially al l of the economic benefits from use of an asset, an \nentity shall consider the economic benefits that result from use of the asset within the defined scope \nof a customer’s right to use the asset in the contract (see paragraph 842 -10-15-23). For example: \na. If a contract limits the use of a motor vehicle to only one particular territory during the period of \nuse, an entity shall consider only the economic benefits from use of the motor vehicle within that \nterritory and not beyond. \nb. If a contract specifies that a customer can drive a motor vehicle only up to a particular number of \nmiles during the period of use, an entity shall consider only the economic benefits from use of the \nmotor vehicle for the permitted mileage and not beyond. \n842-10-15-19 \nIf a contract requires a customer to pay the supplier or another party a portion of the cash flows derived \nfrom use of an asset as consideration, those cash flows paid as consideration shall be considered to be ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 28}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 17 part of the economic benefits that the custome r obtains from use of the asset. For example, if a \ncustomer is required to pay the supplier a percentage of sales from use of retail space as consideration \nfor that use, that requirement does not prevent the customer from having the right to obtain substan tially \nall of the economic benefits from use of the retail space. That is because the cash flows arising from \nthose sales are considered to be economic benefits that the customer obtains from use of the retail \nspace, a portion of which it then pays to the supplier as consideration for the right to use that space. \nA customer’s right to control the use of an identified asset depends on its right to obtain substantially all \nof the economic benefits from the use of the identified asset throughout the period of use. The term \n“substantially all” is not defined in ASC 842. Refer to section 1.2.1, Identified asset , for a discussion \nabout how an entity might evaluate this term. \nA customer can obtain economic benefits either directly or indirectly ( e.g., by using, ho lding or subleasing \nthe asset). Economic benefits include the asset’s primary outputs ( i.e., goods or services) and any by -products \n(e.g., renewable energy credits that are generated through the use of the asset), including potential cash \nflows derived fro m these items. Economic benefits also include benefits from using the asset that could be \nrealized from a commercial transaction with a third party. However, economic benefits arising from ownership \nof the identified asset ( e.g., tax benefits related to excess tax depreciation and investment tax credits) \nare not considered economic benefits derived from the use of the asset and therefore are not considered \nwhen assessing whether a customer has the right to obtain substantially all the economic benefits. \nWhen assessing whether the customer has the right to obtain substantially all the economic benefits from \nthe use of an asset, an entity must consider the economic benefits that result from the use of the asset \nwithin the defined scop e of the customer’s right to use the asset. A right that solely protects the supplier’s \ninterest in the underlying asset ( e.g., limits on the number of miles a customer can drive a supplier’s \nvehicle, limits on where the asset may be used) does not, in and of itself, prevent the customer from \nobtaining substantially all of the economic benefits from the use of the asset (refer to section 1.2.2.3, \nEffect of protective rights on the right to direct the use of the identified asset ). Instead, it simply limits t he \neconomic benefits that are to be evaluated. \nIf a contract requires a customer to pay the supplier or another party a portion of the cash flows derived \nfrom the use of an asset as consideration ( e.g., a percentage of sales from the use of retail space), those \ncash flows are considered to be economic benefits that the customer derives from the use of the asset. \n1.2.2.2 Right to direct the use of the identified asset \nExcerpt from Accounting Standards Codification \nMaster Glossary \nPeriod of Use \nThe total period of time that an asset is used to fulfill a contract with a customer (including the sum of \nany nonconsecutive periods of time). \nLeases — Overall \nScope and Scope Exceptions \n842-10-15-20 \nA customer has the right to direct the use of an identi fied asset throughout the period of use in either \nof the following situations: \na. The customer has the right to direct how and for what purpose the asset is used throughout the \nperiod of use (as described in paragraphs 842 -10-15-24 through 15 -26). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 29}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 18 b. The relevant decisions about how and for what purpose the asset is used are predetermined \n(see paragraph 842 -10-15-21) and at least one of the following conditions exists: \n1. The customer has the right to operate the asset (or to direct others to operate t he asset in \na manner that it determines) throughout the period of use without the supplier having the \nright to change those operating instructions. \n2. The customer designed the asset (or specific aspects of the asset) in a way that predetermines \nhow and fo r what purpose the asset will be used throughout the period of use. \n842-10-15-21 \nThe relevant decisions about how and for what purpose an asset is used can be predetermined in a number \nof ways. For example, the relevant decisions can be predetermined by th e design of the asset or by \ncontractual restrictions on the use of the asset. \nA customer has the right to direct the use of an identified asset throughout the period of use when either: \n• The customer has the right to direct how and for what purpose the asset is used throughout the \nperiod of use. \n• The relevant decisions about how and for what purpose the asset is used are predetermined and the \ncustomer either (1) has the right to operate the asset, or direct others to operate the asset in a \nmanner it determines, throughout the period of use without the supplier having the right to change \nthe operating instructions or (2) designed the asset, or specific aspects of the asset, in a way that \npredetermines how and for what purpose the asset will be used thr oughout the period of use. \nThe right to direct how and for what purpose an asset is used throughout the period of use \nExcerpt from Accounting Standards Codification \nLeases — Overall \nScope and Scope Exceptions \n842-10-15-24 \nA customer has the right to direc t how and for what purpose an asset is used throughout the period of \nuse if, within the scope of its right of use defined in the contract, it can change how and for what purpose \nthe asset is used throughout that period. In making this assessment, an entity considers the decision -\nmaking rights that are most relevant to changing how and for what purpose an asset is used throughout \nthe period of use. Decision -making rights are relevant when they affect the economic benefits to be \nderived from use. The decision -making rights that are most relevant are likely to be different for different \ncontracts, depending on the nature of the asset and the terms and conditions of the contract. \n842-10-15-25 \nExamples of decision -making rights that, depending on the circumstances, grant the right to direct \nhow and for what purpose an asset is used, within the defined scope of the customer’s right of use, \ninclude the following: \na. The right to change the type of output that is produced by the asset (for example, decid ing \nwhether to use a shipping container to transport goods or for storage, or deciding on the mix of \nproducts sold from a retail unit) \nb. The right to change when the output is produced (for example, deciding when an item of \nmachinery or a power plant wil l be used) \nc. The right to change where the output is produced (for example, deciding on the destination of a \ntruck or a ship or deciding where a piece of equipment is used or deployed) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 30}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 19 d. The right to change whether the output is produced and the quanti ty of that output (for example, \ndeciding whether to produce energy from a power plant and how much energy to produce from \nthat power plant). \n842-10-15-26 \nExamples of decision -making rights that do not grant the right to direct how and for what purpose an \nasset is used include rights that are limited to operating or maintaining the asset. Although rights such \nas those to operate or maintain an asset often are essential to the efficient use of an asset, they are \nnot rights to direct how and for what purpose t he asset is used and often are dependent on the decisions \nabout how and for what purpose the asset is used. Such rights (that is, to operate or maintain the \nasset) can be held by the customer or the supplier. The supplier often holds those rights to protec t its \ninvestment in the asset. However, rights to operate an asset may grant the customer the right to \ndirect the use of the asset if the relevant decisions about how and for what purpose the asset is used \nare predetermined (see paragraph 842 -10-15-20(b)(1 )). \nA customer has the right to direct the use of an identified asset whenever it has the right to direct how and \nfor what purpose the asset is used throughout the period of use ( i.e., it can change how and for what purpose \nthe asset is used throughout the period of use). How and for what purpose an asset is used is a single \nconcept ( i.e., “how” an asset is used is not assessed separately from “for what purpose” an asset is used). \nWhen evaluating whether a customer has the r ight to direct how and for what purpose the asset is used \nthroughout the period of use, the focus should be on whether the customer has the decision -making \nrights that will most affect the economic benefits that will be derived from the use of the asset. T he \ndecision -making rights that are most relevant are likely to depend on the nature of the asset and the \nterms and conditions of the contract. \nThe FASB indicated in the Basis for Conclusions (BC 137) of ASU 2016 -02 that decisions about how and \nfor what pur pose an asset is used can be viewed as similar to the decisions made by a board of directors. \nDecisions made by a board of directors about the operating and financing activities of an entity are \ngenerally the most relevant decisions rather than the actions of individuals in implementing those decisions. \nASC 842 provides the following examples of decision -making rights that grant the right to change how \nand for what purpose an asset is used: \n• The right to change what type of output is pro duced by the asset ( e.g., deciding whether to use a \nshipping container to transport goods or for storage, deciding on the mix of products sold from a \nretail unit) \n• The right to change when the output is produced ( e.g., deciding when an item of machinery or a \npower plant will be used) \n• The right to change where the output is produced ( e.g., deciding on the destination of a truck or a \nship, deciding where a piece of equipment is used or deployed) \n• The right to change whether the output is produced and the quantity of that ou tput ( e.g., deciding \nwhether to produce energy from a power plant and how much energy to produce from that power plant) \nASC 842 also provides the following examples of decision -making rights that do not grant the right to \nchange how and for what purpose an asset is used: \n• Maint aining the asset \n• Opera ting the asset ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 31}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 20 Although the decisions about maintaining and operating the asset are often essential to the efficient use \nof that asset, the right to make those decisions, in and of itself, does not result in the r ight to change how \nand for what purpose the asset is used throughout the period of use. \nThe customer does not need the right to operate the underlying asset to have the right to direct its use. \nThat is, the customer may direct the use of an asset that is o perated by the supplier’s personnel. However, \nas discussed below, the right to operate an asset will often provide the customer the right to direct the use \nof the asset if the relevant decisions about how and for what purpose the asset is used are predeter mined. \nWe believe that the assessment of whether a contract is or contains a lease will be straightforward in most \narrangements. However, judgment may be required in applying the definition of a lease to certain \narrangements. For example, in contracts that include significant services, we believe that determining whether \nthe contract conveys the right to direct the use of an identified asset may be more complex. Example s of such \ncontracts may include third -party manufacturing, warehousing, transportation, advertising or information \ntechnology arrangements . Evaluating whether these arrangements contain a lease may require judgment. \nThe relevant decisions about how and for what purp ose an asset is used are predetermined \nIn some cases, it will not be clear whether the customer has the right to direct the use of the identified \nasset. This could be the case when the most relevant decisions about how and for what purpose an asset \nis used are predetermined by contractual restrictions on the use of the asset ( e.g., the decisions about \nthe use of the asset are agreed to by the customer and the supplier in negotiating the contract, and \nthose decisions cannot be changed). This could also be th e case when the most relevant decisions about \nhow and for what purpose an asset is used are, in effect, predetermined by the design of the asset. The \nFASB indicated in the Basis for Conclusions (BC 138) of ASU 2016 -02 that it would expect decisions \nabout h ow and for what purpose an asset is used to be predetermined in few cases. When decisions \nabout how and for what purpose an asset is to be used are predetermined, a customer has the right to \ndirect the use of an identified asset throughout the period of us e when the customer either: \n• Has the right to operate the asset, or direct others to operate the asset in a manner it determines, \nthroughout the period of use without the supplier having the right to change those operating instructions \n• Designed the asset (o r specific aspects of the asset) in a way that predetermines how and for what \npurpose the asset will be used throughout the period of use \nSignificant judgment may be required to assess whether a customer designed the asset (or specific aspects \nof the asset ) in a way that predetermines how and for what purpose the asset will be used throughout the \nperiod of use. The following provides an example of the evaluation of whether a customer designed the asset \nin a way that predetermines how and for what purpose th e asset will be used throughout the period of use. \nExcerpt from Accounting Standards Codification \nExample 9 — Contract for Energy/Power \nCase A — Contract Contains a Lease \n842-10-55-108 \nA utility company (Customer) enters into a contract with a power company (Supplier) to purchase all of the \nelectricity produced by a new solar farm for 20 years. The solar farm is explicitly specified in the contract, \nand Supplier has no substitution rights. The solar farm is owned by Supplier, and the energy cannot be \nprovided to Customer from another asset. Customer designed the solar farm before it was constructed — \nCustomer hired experts in solar energy to assist in determining the location of the farm and the engineering \nof the equipment to be used. Supplier is responsible for building the solar farm to Customer’s specifications \nand then operating and maintaining it. There are no decisions to be made about whether, when, or how \nmuch electricity will be produced because the design of the asset has predetermined these decisions. \nSupplier will receive tax credits relating to the construction and ownership of the solar farm, while \nCustomer receives renewable energy credits that accrue from use of the solar farm. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 32}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 21 842-10-55-109 \nThe contract contains a lease. Customer has the right to use the solar farm for 20 years. \n842-10-55-110 \nThere is an identified asset because the solar farm is explicitly specified in the contract, and Supplier \ndoes not have the right to substitute the specified solar farm. \n842-10-55-111 \nCustomer has the right to control the use of the solar farm throughout the 20 -year period of use because: \na. Customer has the right to obtain substantially all of the economic benefits from use of the solar \nfarm over the 20 -year period of use. Customer has exclusive use of the solar farm; it takes all of \nthe electricity produced by the farm over the 20 -year period of use as well as the renewable \nenergy credits that are a by -product from use of the solar farm. Although Supplier will be \nreceiving economic benefits from the solar farm in the form of tax credits, those economic \nbenefits relate to the ownership of the solar farm rather than the use of the solar farm and, thus, \nare not considered in this assessment. \nb. Customer has the right to direct the use of the solar farm. Neither Customer nor Supplier decides \nhow and for what purpose the solar farm is used during the period of use because those decisions \nare predetermined by the design of the asset (that is, the design of the solar farm has , in effect, \nprogrammed into the asset any relevant decision -making rights about how and for what purpose \nthe solar farm is used throughout the period of use). Customer does not operate the solar farm; \nSupplier makes the decisions about the operation of th e solar farm. However, Customer’s design \nof the solar farm has given it the right to direct the use of the farm (as described in paragraph \n842-10-15-20(b)(2)). Because the design of the solar farm has predetermined how and for what \npurpose the asset will b e used throughout the period of use, Customer’s control over that design \nis substantively no different from Customer controlling those decisions. \nCase B — Contract Does Not Contain a Lease \n842-10-55-112 \nCustomer enters into a contract with Supplier to purc hase all of the power produced by an explicitly \nspecified power plant for three years. The power plant is owned and operated by Supplier. Supplier is \nunable to provide power to Customer from another plant. The contract sets out the quantity and \ntiming of p ower that the power plant will produce throughout the period of use, which cannot be \nchanged in the absence of extraordinary circumstances (for example, emergency situations). Supplier \noperates and maintains the plant on a daily basis in accordance with in dustry -approved operating \npractices. Supplier designed the power plant when it was constructed some years before entering into \nthe contract with Customer; Customer had no involvement in that design. \n842-10-55-113 \nThe contract does not contain a lease. \n842-10-55-114 \nThere is an identified asset because the power plant is explicitly specified in the contract, and Supplier \ndoes not have the right to substitute the specified plant. \n842-10-55-115 \nCustomer has the right to obtain substantially all of t he economic benefits from use of the identified \npower plant over the three -year period of use. Customer will take all of the power produced by the \npower plant over the three -year term of the contract. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 33}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 22 842-10-55-116 \nHowever, Customer does not have the right to control the use of the power plant because it does not \nhave the right to direct its use. Customer does not have the right to direct how and for what purpose \nthe plant is used. How and for what purpose the plant is used (that is, whether, when, and how much \npower the plant will produce) are predetermined in the contract. Customer has no right to change how \nand for what purpose the plant is used during the period of use, nor does it have any other decision -\nmaking rights about the use of the power plant du ring the period of use (for example, it does not \noperate the power plant) and did not design the plant. Supplier is the only party that can make \ndecisions about the plant during the period of use by making the decisions about how the plant is \noperated and maintained. Customer has the same rights regarding the use of the plant as if it were one \nof many customers obtaining power from the plant. \nCase C — Contract Contains a Lease \n842-10-55-117 \nCustomer enters into a contract with Supplier to purchase all of th e power produced by an explicitly \nspecified power plant for 10 years. The contract states that Customer has rights to all of the power \nproduced by the plant (that is, Supplier cannot use the plant to fulfill other contracts). \n842-10-55-118 \nCustomer issues instructions to Supplier about the quantity and timing of the delivery of power. If the \nplant is not producing power for Customer, it does not operate. \n842-10-55-119 \nSupplier operates and maintains the plant on a daily basis in accordance with industry -approved \noperating practices. \n842-10-55-120 \nThe contract contains a lease. Customer has the right to use the power plant for 10 years. \n842-10-55-121 \nThere is an identified asset. The power plant is explicitly specified in the contract, and Supplier does \nnot h ave the right to substitute the specified plant. \n842-10-55-122 \nCustomer has the right to control the use of the power plant throughout the 10 -year period of use because: \na. Customer has the right to obtain substantially all of the economic benefits from use of the power \nplant over the 10 -year period of use. Customer has exclusive use of the power plant; it has rights \nto all of the power produced by the power plant throughout the 10 -year period of use. \nb. Customer has the right to direct the use of the power plant. Customer makes the relevant \ndecisions about how and for what purpose the power plant is used because it has the right to \ndetermine whether, when, and how much power the plant will produce (that is, the timing and \nquantity, if any, of power produced) throughout the period of use. Because Supplier is prevented \nfrom using the power plant for another purpose, Customer’s decision making about the timing and \nquantity of po wer produced, in effect, determines when and whether the plant produces output. \n842-10-55-123 \nAlthough the operation and maintenance of the power plant are essential to its efficient use, Supplier’s \ndecisions in this regard do not give it the right to dire ct how and for what purpose the power plant is \nused. Consequently, Supplier does not control the use of the power plant during the period of use. \nInstead, Supplier’s decisions are dependent on Customer’s decisions about how and for what purpose \nthe power p lant is used. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 34}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease ac counting | 23 Specifying the output of an asset before the period of use \nExcerpt from Accounting Standards Codification \nLeases — Overall \nScope and Scope Exceptions \n842-10-15-22 \nIn assessing whether a customer has the right to direct the use of an asset, an entity shall consider only \nrights to make decisions about the use of the asset during the period of use unless the customer designed \nthe asset (or specific aspects of the asset) in accordance with paragraph 842 -10-15-20(b)(2). \nConsequently, unles s that condition exists, an entity shall not consider decisions that are predetermined \nbefore the period of use. For example, if a customer is able only to specify the output of an asset before the \nperiod of use, the customer does not have the right to dir ect the use of that asset. The ability to specify the \noutput in a contract before the period of use, without any other decision -making rights relating to the use of \nthe asset, gives a customer the same rights as any customer that purchases goods or service s. \nIf a customer can only specify the output from an asset before the beginning of the period of use and \ncannot change that output throughout the period of use, the customer does not have the right to direct \nthe use of that asset unless it designed the asset, or specific aspects of the asset, as contemplated in \nASC 842-10-15-20(b)(2). If the customer did not design the asset or aspects of it, the customer’s ability \nto specify the output in a contract that does not give it any other relevant decision -making rig hts relating \nto the use of the asset ( e.g., the ability to change when, whether and what output is produced) gives the \ncustomer the same rights as any customer that purchases goods or service s in a service arrangement \n(i.e., a contract that does not contai n a lease) . \n1.2.2.3 Effect of protective rights on the right to direct the use of the identified asset \nExcerpt from Accounting Standards Codification \nLeases — Overall \nScope and Scope Exceptions \n842-10-15-23 \nA contract may include terms and conditions designed to protect the supplier’s interest in the asset or \nother assets, to protect its personnel, or to ensure the supplier’s compliance with laws or regulations. \nThese are examples of protective rights. For ex ample, a contract may specify the maximum amount of \nuse of an asset or limit where or when the customer can use the asset, may require a customer to \nfollow particular operating practices, or may require a customer to inform the supplier of changes in \nhow a n asset will be used. Protective rights typically define the scope of the customer’s right of use \nbut do not, in isolation, prevent the customer from having the right to direct the use of an asset. \nA right that solely protects the supplier’s interest in t he underlying asset , in and of itself, does not prevent \nthe customer from having the right to direct the use of an identified asset. Protective rights typically define \nthe scope of the customer’s right to use the asset without removing the customer’s right to direct the use of \nthe asset. Protective rights are intended to protect a supplier’s interests ( e.g., interests in the asset, its \npersonnel, compliance with laws and regulations) and might take the form of a specified maximum amount \nof asset use (e.g., limits on the number of miles a customer can drive a supplier’s vehicle) , a restriction on \nwhere an asset may be used or a requirement to follow specific operating instructions. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 35}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 24 Illustration 1 -7: Right to direct the use of an asset \nCustomer X enters into a contract with Supplier Y to use a vehicle for a three -year period. The vehicle \nis identified in the contract. Supplier Y cannot substitute another vehicle unless the specified vehicle is \nnot operational ( e.g., it breaks down). \nUnde r the contract: \n• Customer X operates the vehicle ( i.e., drives the vehicle) or directs others to operate the vehicle \n(e.g., hires a driver). \n• Customer X decides how to use the vehicle (within contractual limitations, as discussed below). For \nexample, through out the period of use, Customer X decides where the vehicle goes as well as \nwhen or whether it is used and what it is used for. Customer X can also change these decisions \nthroughout the period of use. \n• Supplier Y prohibits certain uses of the vehicle ( e.g., moving it overseas) and modifications of the \nvehicle to protect its interest in the asset. \nAnalysis : Customer X has the right to direct the use of the identified vehicle throughout the period of use. \nCustomer X has the right to direct the use of the vehic le because it has the right to change how the vehicle \nis used, when or whether the vehicle is used, where the vehicle goes and what the vehicle is used for. \nSupplier Y’s limits on certain uses for the vehicle and modifications to it are considered protecti ve \nrights that define the scope of Customer X’s use of the asset but do not affect the assessment of \nwhether Customer X directs the use of the asset. \n1.2.3 Leases involving joint arrangements \nA customer , including a customer that is a joint operation or joint arrangement ( collectively referred to \nas a “joint arrangement” in this section ), and a supplier are required to consider whether the customer \nhas the right to control the use of an identified asset to determine whether an arrangement is or contains \na lease. Joint arrangements, which are generally not legal entities and are not defined by US GAAP, are \ncommon in extractive industries and may be p resent in other industries . \nIn a joint arrangement, an operator ( e.g., an operator of an oil and gas property) may agree with other \nparties ( i.e., nonoperators in the joint arrangement to which the operator is a party ) to perform certain \nactivities necessa ry to develop or operate the property. The contractual rights and obligations of each \nparty to the arrangements are typically documented through the use of a joint operating agreement. To \nfulfill its responsibilities, the operator often enters into contrac ts with third -party suppliers to obtain the \nuse of an asset (e.g., a drilling rig) to perform the activities. Less frequently, the joint arrangement (as a \ngroup) may enter into agreements directly with a supplier to use an asset . \nConsequently, the custome r (i.e., either the operator individually or the joint arrangement as if it were a \nsingle customer ) and the supplier to each contract will have to carefully evaluate these agreements to \ndetermine whether the customer controls the use of an identified asset throughout the period of use. \nThis assessment will often require two steps when a supplier enters into a contract directly with the \noperator to use a n identified asset, for example: \n• Step 1: The supplier and the operator would evaluate whether the operator controls the use of the \nidentified asset, and if so, a right -of-use (ROU) asset and lease liability would generally be recognized \nby the operator (refer to section 4, Lessee accounting ). \n• Step 2: Next, the operator and the joint arrangement should evaluate whether a sublease exists from \nthe operator to the joint arrangement (as if the joint arrangement were a single customer ). If the \njoint arrangement controls the use of the identified asset under the term o f an arrangement between ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 36}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 25 the operator and the joint arrangement , the operator would recognize a sublease to the joint \narrangement to the extent of the nonoperators’ interest . The nonoperators to the joint arrangement \nconsider other applicable GAAP to indiv idually account for their interest in the joint arrangement. \nSummary of assessment when a supplier enters into a contract directly with the operator to use an \nidentified asset \n \nSummary of assessment when a supplier enters into a contract directly with the joint arrangement to \nuse an identified asset \n \nDoes the operator have the right to control the use \nof the identified asset? \n(section 1.2.2, Right to control the use of the identified asset ) \nApply other GAAP \nA right -of-use asset and lease liability are \ngenerally recognized by the operator \n(section 3, Lease classification , and section 4, Lessee accounting ) \nSupplier applies lessor accounting based on lease classification \n(section 3 , Lease classification , and section 5 , Lessor accounting ) \nA sublease exists from the operator to the joint arrangement \n(section 6, Subleases ) \n•Operator recognizes a sublease to the joint arrangement \n•Nonoperators consider other applicable GAAP to individually \naccount for their interest in the joint arrangement \nYes \nDoes the joint arrangement have the right to control the use of \nthe identified asset under the terms of an arrangemen t \nbetween the operator and the joint arrangement? \n(section 1.2.2, Right to control the use of the identified asset ) \nThe operator and joint arrangement should evaluate whether \na sublease exists from the operator to the joint arrangement \n(as if it were a s ingle customer) (section 6, Subleases ) \nNo \nNo \nOperator and nonoperators apply \nother GAAP to account for the \narrangement between the \noperator and nonoperators \nYes \nDoes the joint arrangement (as if it were a single customer) \nhave the right to control the use of the identified asset? \n(section 1.2.2, Right to control the use of the identified asset ) \nApply other GAAP \nA lease exists from the supplier to the joint arrangement \n•Supplier applies lessor accounting based on lease \nclassification (section 3 , Lease classification , and section 5 , \nLessor accounting ) \n•Operator and nonoperators consider other applicable \nGAAP to individually account for their interest in the \njoint arrangement \nNo \nYes ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 37}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 26 Illustration 1-8: Joint operations \nUpstream Co. is designated as the operator for a series of oil and gas properties in the Gulf of Mexico \n(GOM properties), for which there are three nonoperators. Under the joint arrangement , the \nnonoperators are limited in their involvement to only making choices about participation in the \nexploration and development of the property. \nTo fulfill its responsibilities as operator, Upstream Co. contracts with Rig Co. to lease a fixed platform \ndrilling rig (Rig A) for five years. Upstream Co. enters into the contract with the intention of using Rig A \nto develop the GOM properties; however, Upstream Co. does not enter into a contract with the joint \narrangement (or parties to that operation) for the right to use the asset ( i.e., the nonoperators do not \nhave any legally enforceable rights or obligations with respect to Rig A). \nAnalysis \nUpstream Co. concludes that it has legally enforceable rights and obligations with Rig Co., and that the \ncontract represents a lease of Rig A. Therefore, Upstream Co. will recor d 100% of the right -of-use \nasset and lease liability relating to Rig A. \nUpstream Co. and the nonoperators further evaluate the arrangement, noting the following: \n• Upstream Co. is contractually permitted to use Rig A for projects unrelated to the joint \narran gement , provided Upstream Co. supplies another drilling rig to fulfill its obligation as \noperator on the GOM properties. \n• Because the nonoperators are limited in their involvement to making choices about participation in \nthe exploration and development of t he property rather than the use of the leased rig, the joint \narrangement cannot direct the use of Rig A. \nUpstream Co. determines that the agreement with the joint arrangement does not include a sublease \nof Rig A. Likewise, the nonoperators determine that t hey are not lessees with respect to Rig A and, \ntherefore, do not recognize any right -of-use asset or lease liability w ith respect to Rig A. \n1.3 Reassessment of the contract \nExcerpt from Accounting Standards Codification \nLeases — Overall \nScope and Scope Exceptions \n842-10-15-6 \nAn entity shall reassess whether a contract is or contains a lease only if the terms and conditions of \nthe contract are changed. \nUnder ASC 842, an entity reassesses whether a contract is or contains a lease only if the terms and \nconditions of the contract are changed ( e.g., a change in the scope or consideration of a contract, \naddition of a right to use an underlying asset). This reassessment requirement also applies to modifications \nof contracts that were not previously determined to be or contain a lease. \nA change that provides the supplier with a substitution right or that changes the extent of the supplier’s \nor customer’s decision -making authority related to the underlying asset a re examples of changes in the \nterms and conditions of a contract that would require an entity to reassess whether the contract is or \ncontains a lease. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 38}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 27 Refer to sections 4.6, Lease modifications , and 5.6, Lease modifications , for discussion of accounting by \nlessees and lessors, respectively, for a modified contract that continues to be a lease. \n1.4 Identifying and separating lease and non -lease components of a contract and \nallocating contract consideration \n1.4.1 Identifying and separating lease components of a contract \nExcerpt from Accounting Standards Codification \nLeases — Overall \nScope and Scope Exceptions \n842-10-15-28 \nAfter determining that a contract contains a lease in accordance with paragraphs 842 -10-15-2 \nthrough 15 -27, an entity shall identify the separate lease components within the contract. An entity \nshall consider the right to use an underlying asset to be a separate lease component (that is, separate \nfrom any other lease components of the contract) if both of the following criteria are met: \na. The lessee can benefit from the right of use either on its own or together with other resources \nthat are readily available to the lessee. Readily available resources are goods or services that are \nsold or leased separately (by the lessor or other suppliers) or resources that the lessee already \nhas obtained (from the lessor or from other transactions or events). \nb. The right of use is neither highly dependent on nor highly interrelated with the other right(s) to \nuse underlying assets in the contract. A lessee’s right to use an underlying asset is highly \ndependent on or highly interrelated with another right to use an underlying asset if each right of \nuse significantly affec ts the other. \n842-10-15-29 \nThe guidance in paragraph 842 -10-15-28 notwithstanding, to classify and account for a lease of land \nand other assets, an entity shall account for the right to use land as a separate lease component unless \nthe accounting effect of doing so would be insignif icant (for example, separating the land element would \nhave no effect on lease classification of any lease component or the amount recognized for the land \nlease component would be insignificant). \nFor contracts that contain the rights to use multiple assets but not land ( e.g., a lease of a building and \nequipment, multiple pieces of equipment), the right to use each asset is considered a separate lease \ncomponent if both of the following criteria are met: \n• The lessee can benefit from the right of use either on its own or together with other resources that \nare readily available to the lessee ( i.e., goods or services that are sold or leased separately, by the \nlessor or other suppliers, or that the lessee has already obtained from the lessor or in ot her \ntransactions or events). \n• The right of use is neither highly dependent on, nor highly interrelated with, the other right(s) to use \nunderlying assets in the contract. \nIf one or both of these criteria are not met, the right to use multiple assets is consi dered a single lease \ncomponent. The FASB indicated in the Basis for Conclusion s (BC 14 6) of ASU 2016 -02 that the guidance \non identifying and separating lease components is similar to the guidance on identifying and separating \nperformance obligations in a r evenue contract under ASC 606. Refer to section 4, Identify the performance \nobligations in the contract , of our FRD, Revenue from contracts with customers ( ASC 606) , for \nadditional details . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 39}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 28 For contracts that involve the right to use land and o ther assets ( e.g., land and a building), ASC 842 \nrequires an entity to classify (refer to section 3, Lease classification ) and account for the right to use land \nas a separate lease component, even if the criteria for separating lease components are not met , unless \nthe accounting effect of not separately accounting for the land is insignificant. In assessing whether the \neffect of not separately accounting for the land would be insignificant, entities should consider the \npotential differences in accounting, i ncluding: \n• Lease classification \n• The balance sheet presentation of right -of-use assets and lease liabilities \n• The timing and classification of expense or income recognition \n• The classification of lease payments in the statement of cash flows \n• Disclosure s in the notes to the financial statements (e.g., disclosure of lease costs, noncash \ninformation on lease liabilities, the weighted -average lease term , the discount rate) \nThe FASB indicated in the Basis for Conclusions (BC 147) of ASU 2016 -02 that since land, by virtue of its \nindefinite economic life, is substantively different from other assets, it should be assessed separately \nregardless of whether the separate lease component criteria are met. \nAn entity that leases an entire building ( i.e., 100% of the building) is inherently leasing the land underneath \nthe building and would potentially account for the land and the building as separate lease components. \nHowever, we believe this would not necessarily be the case when an entity only leases part of the building \n(e.g., one floor of a multistory building). \nAn entity may account for separate lease components (e.g., a group of identical data servers ) as a single \nlease component using a portfolio approach if the leases commence at the same date, the leases are co -\nterminus and the accounting for the separate lease components as a single lease component does not \nmaterially differ from accounting for the separate lease components as multiple lease components. For \nmore information on the portfolio approach, refer to section 4.8.4, Portfolio approach , for lessee \naccounting and section 5.7. 4.1, Portfolio approach , for lessor accounting. \nHowever, in some circumstances, an entity may need to account for the separa te lease components as \nmultiple lease components when : \n• Accounting for certain lease modifications (refer to section 4.6, Lease modifications , for lessee \naccounting and section 5.6, Lease modifications , for lessor accounting) \n• Accounting for asset abandonme nts (refer to section 4.2.5.3, Abandonment of ROU asset s, for \nabandonment of operating lease right -of-use assets and section 4.3.4.3 , Abandonment of ROU \nasset s, for abandonment of finance lease right -of-use assets) \nASC 842 includes the following example for separating lease components of a contract (refer to \nsection 1.4.5, Examples — identifying and separating components of a contract and determining and \nallocating the consideration in the contract, for additional examples). \nExcerpt from Accountin g Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \nExample 13 — Lease of a Turbine Plant \n842-10-55-146 \nLessor leases a gas -fired turbine plant to Lessee for eight years so that Lessee can produce electricity \nfor its customers. The plant consists of the turbine housed within a building together with the land on \nwhich the building sits. The building was desig ned specifically to house the turbine, has a similar ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 40}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 29 economic life as the turbine of approximately 15 years, and has no alternative use. The lease does not \ntransfer ownership of any of the underlying assets to Lessee or grant Lessee an option to purchase \nany of the underlying assets. Lessor does not obtain a residual value guarantee from Lessee or any \nother unrelated third party. The present value of the lease payments is not substantially all of the \naggregate fair value of the three underlying assets. \n842-10-55-147 \nWhile the lease of the plant includes the lease of multiple underlying assets, the leases of those \nunderlying assets do not meet the second criterion necessary to be separate lease components, which \nis that the right to use the underlying asset i s neither dependent on nor highly interrelated with the \nother rights of use in the contract. Therefore, the contract contains only one lease component. The \nrights to use the turbine, the building, and the land are highly interrelated because each is an inp ut to \nthe customized combined item for which Lessee has contracted (that is, the right to use a gas -fired \nturbine plant that can produce electricity for distribution to Lessee’s customers). \n842-10-55-148 \nHowever, because the contract contains the lease of land, Lessee and Lessor also must consider the \nguidance in paragraph 842 -10-15-29. Lessee and Lessor each conclude that the effect of accounting \nfor the right to use the land as a separate lease component would be insignificant because Lessee’s \nright to use the turbine, the building, and the land is coterminous and separating the right to use the \nland from the right to use the turbine and the building would not affect the lease classification of the \nturbine/building lease component. Lessee and Less or each conclude that a single lease component \ncomprising the turbine, the building, and the land would be classified as an operating lease, as would \ntwo separate lease components comprising the land and the turbine/building, respectively. \n842-10-55-149 \nThe predominant asset in the single lease component is the turbine. Lessee entered into the lease \nprimarily to obtain the power -generation capabilities of the turbine. The building and land enable \nLessee to obtain the benefits from use of the turbine. The la nd and building would have little, if any, \nuse or value to Lessee in this contract without the turbine. Therefore, the remaining economic life of \nthe turbine is considered in evaluating the classification of the single lease component. \n1.4.2 Identifying and separating lease from non -lease components of a contract \nExcerpt from Accounting Standards Codification \nLeases — Overall \nScope and Scope Exceptions \n842-10-15-30 \nThe consideration in the contract shall be allocated to each separate lease component and nonlease \ncomponent of the contract (see paragraphs 842 -10-15-33 through 15 -37 for lessee allocation \nguidance and paragraphs 842 -10-15-38 through 15 -42C for lessor allocation guidance). Components \nof a contract include only those items or activities that transfer a good or service to the lessee. \nConsequently, the following are not components of a contract and do not receive an allocation of the \nconsideration in the contract: \na. Administrative tasks to set up a contract or initiate the lease that do not transfer a good or \nservice to the lessee \nb. Reimbursement or payment of the lessor’s costs. For example, a lessor may incur various costs in \nits role as a lessor or as owner of the underlying asset. A req uirement for the lessee to pay those \ncosts, whether directly to a third party or as a reimbursement to the lessor, does not transfer a \ngood or service to the lessee separate from the right to use the underlying asset. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 41}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 30 842-10-15-31 \nAn entity shall account for each separate lease component separately from the nonlease components \nof the contract (that is, unless a lessee makes the accounting policy election described in paragraph \n842-10-15-37 or unless a lessor makes the accounting pol icy election in accordance with paragraph \n842-10-15-42A). Nonlease components are not within the scope of this Topic and shall be accounted \nfor in accordance with other Topics. \nMany contracts contain a lease coupled with an agreement to purchase or sell o ther goods or services \n(non -lease components). The non -lease components are identified and accounted for separately from the \nlease component in accordance with other US GAAP (except when a lessee or lessor applies the practical \nexpedient to not separate le ase and non -lease components as discussed in sections 1.4.2.3 , Practical \nexpedient to not separate lease and non -lease components — lessees , and 1.4.2.4, Practical expedient to \nnot separate lease and non -lease components — lessors , respectively ). For example, the non-lease \ncomponents may be accounted for as executory arrangements by lessees (customers) or as contracts \nsubject to ASC 606, Revenue from Contracts with Customers , by lessors (suppliers). When the respective \npractical expedient is not applied, n on-lease component s are accounted for separately from the lease \ncomponent s under ASC 842 even if they would not be treated separately from other promised goods and \nservices in a revenue contract with a customer . \nSome contracts contain items that do not relate to the transfer of goods or services by the lessor to the \nlessee ( e.g., fees or other administrative costs that a lessor charges a lessee). These items should not be \nconsidered separate lease or non -lease componen ts, and lessees and lessors do not allocate consideration \nin the contract to these items. Refer to sections 1.4.3.2, Allocating the consideration in the contract — \nlessees, on lessee allocation of consideration in the contract and 1.4.4.2, Allocating the c onsideration in \nthe contract — lessors , on lessor allocation of consideration in the contract. \nHowever, if the lessor provides services ( e.g., maintenance, including common area maintenance, supply \nof utilities) or operates the underlying asset ( e.g., vessel charter, aircraft wet lease), the contract would \ngenerally contain non -lease components. \n1.4.2.1 Executory costs \n“Executory costs” is not a defined term in GAAP, and in practice the term generally refers to costs related to \ninsurance, taxes and maintenance (and any profit thereon) that will be paid to the lessor. ASC 842 clarifies \nthe accounting for these costs by requiring entities to evaluate whether the costs represent payments for a \ncomponent of the contract. That is, entities must evalu ate whether the payments are for a good or service \ntransferred to the lessee that is separate from the right to use the underlying asset. \nUnder ASC 842, maintenance activities, including common area maintenance ( e.g., cleaning a lobby of a \nbuilding, removi ng snow from a parking lot), provided by the lessor are considered non -lease components \nbecause they represent goods or services transferred to the lessee separately from the right to use the \nunderlying asset . \nInsurance that protects the lessor’s interest in the underlying asset and taxes related to the underlying \nasset ( e.g., real estate taxes on the underlying asset) are not separate components of the contract because \nthey do not transfer a good or service to the lessee that is separate from the right to use the underlying \nasset. As a result, a lessee will allocate payments for these items to lease and non -lease components, \nassuming it doesn’t make the accounting policy election to combine the lease and associated non -lease \ncomponents (refer to section 1.4 .2.3, Practical expedient to not separate lease and non -lease components — \nlessees ). Lessees also should evaluate whether lease payments made for insurance that protects the \nlessor’s interest in the underlying asset and taxes relating to such asset are fixed (or in -substance fixed) \nlease payments or variable lease payments (refer to section 2.4, Lease payments ). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 42}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 31 For lessees, if an arrangement does not contain a non -lease component, fixed and variable payments for \ninsuring the lessor’s asset and real estate taxes associated with such asset are attributable to the lease \ncomponent. Refer to Example 12 — Activities or Costs That Are Not Components of a Contract, Case A — \nPayments for Taxes and Insurances are Variable, included below. If the same arrangement contains a \nlease and a non -lease component ( e.g., maintenance), fixed payments are included in the con sideration \nin the contract and allocated between the lease and non -lease components on a relative standalone price \nbasis, assuming the lessee does not make the accounting policy election to combine the lease and associated \nnon-lease components. Variable pa yments for insuring the lessor’s asset and real estate taxes are excluded \nfrom consideration in the contract and, when recognized, are allocated to the lease and non -lease components \non the same basis as the allocation of consideration in the contract dete rmined at lease commencement. Refer \nto Example 14 — Determining the Consideration in the Contract — Variable Payments, Case A — Variable \nPayments That Relate to the Lease Component and the Nonlease Component, in section 1.4.5, Examples — \nidentifying and se parating components of a contract and determining and allocating the consideration in the \ncontract . Also refer to section 1.4.3.2, Allocating the consideration in the contract — lessees . \nHow a lessor accounts for payments for insurance that protects its in terest in the underlying asset and \nreal estate taxes related to such asset depends on whether those payments are fixed or variable and \nwhether they are made by the lessee to the lessor as a reimbursement or made directly to a third party on \nbehalf of the lessor (refer to section s 2.4, Lease payments , and 1.4.4, Determining, allocating and \nreassessing the consideration in the contract — lessors ). \nWhether the payments are allocated by a lessor to lease and non -lease components also depends on whether \nit qualifies for and elects the practical expedient to not separate lease and non -lease components (refer to \nsection 1.4.2.4, Practical expedient to not separate lease and non -lease components — lessors , for further \nguidance on the accounting policy election to combine the lease and associated non -lease components for \nlessors). If a lessor does not qualify for or elect to apply the practical expedient to not separate lease and \nnon-lease components, it would follow the guidance in ASC 842-10-15-38 through 15-40, which incorporates \nASC 606’s allocation guidance. Refer to section 1.4.4.2, Allocating the consideration in the contract — lessors . \nThe FASB issued ASU 2018 -20, Narrow -Scope Improvements for L essors , which amended ASC 842, to \nallow lessors to make an accounting policy election not to evaluate whether sales taxes and similar taxes \nimposed by a governmental authority on a specific lease revenue -producing transaction and collected by \nthe lessor from the lessee are the prim ary obligation of the lessor as owner of the underlying leased \nasset. A lessor that makes this election must exclude from the consideration in the contract and from \nvariable payments not included in the consideration in the contract all taxes within the sc ope of the \nelection and make additional disclosures. \nThe amendments also require a lessor to exclude lessor costs paid directly by a lessee to third parties on \nthe lessor’s behalf from variable payments, but lessor costs that are paid by the lessor and re imbursed by \nthe lessee are required to be included in variable payments. Refer to the amendments to paragraph s 842-\n10-55-141 and 55 -142 below , which illustrate this concept in a net lease (e.g., the property tax and \ninsurance amounts are not included in the fixed lease payments specified in the contract) . Additionally, \nrefer to section 1.4.4, Determining, allocating and reassessing the consideration in the contract — lessors , \nfor further discussion. \nThe amendments also clarify that when lessors allocate var iable payments to lease and non -lease components \nthey are required to follow the recognition guidance in ASC 842 for the lease component and other applicable \nguidance, such as ASC 606, for the non -lease component. Refer to section 1.4.4.3, Allocating varia ble \npayments — lessors . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 43}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 32 ASC 842 provides the following examples of accounting for lease -related executory costs. \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \nExample 12 — Activities or Costs That Are Not Components of a Contract \nCase A — Payments for Taxes and Insurance Are Variable \n842-10-55-141 \nLessor and Lessee enter into a five -year lease of a building. The contract designates that Lessee is \nrequired to pay for the costs relating to the asset, including the real estate taxes and the insurance on \nthe building. The real estate taxes would be owed by Lessor regardless of whether it leased the \nbuilding and who the lessee is. Lessor is the named insured on the building insurance policy (th at is, \nthe insurance protects Lessor’s investment in the building, and Lessor will receive the proceeds from \nany claim). The annual lease payments are fixed at $10,000 per year, while the annual real estate \ntaxes and insurance premium will vary and be bill ed by Lessor to Lessee each year. \n842-10-55-142 \nThe real estate taxes and the building insurance are not components of the contract. The contract \nincludes a single lease component — the right to use the building. Lessee’s payments of those amounts \nsolely represent a reimbursement of Lessor’s costs and do not represent payments for goods or \nservices in addition to the right to use the building. However, because the real estate taxes an d \ninsurance premiums during the lease term are variable, those payments are variable lease payments \nthat do not depend on an index or a rate and are excluded from the measurement of the lease liability \nand recognized by Lessee in profit or loss in accordan ce with paragraph 842 -20-25-5 or 842 -20-25-6. \nLessor also recognizes those payments as variable lease payments in accordance with paragraph 842 -\n10-15-40A because the real estate taxes and insurance premiums are paid by Lessor to the taxing \njurisdiction and insurance company and reimbursed by Lessee to Lessor. However, if Lessee paid the \ncosts directly to the third parties, those lessor costs would not be recognized by Lessor as variable \npayments because of the requirement in paragraph 842 -10-15-40A. \nCase B — Payment for Taxes and Insurance are Fixed \n842-10-55-143 \nAssume the same facts and circumstances as in Case A (paragraphs 842 -10-55-141 through 55 -142), \nexcept that the fixed annual lease payment is $13,000. There are no additional payments for real \nestat e taxes or building insurance; however, the fixed payment is itemized in the contract (that is, \n$10,000 for rent, $2,000 for real estate taxes, and $1,000 for building insurance). Consistent with \nCase A, the taxes and insurance are not components of the co ntract. The contract includes a single \nlease component, the right to use the building. The $65,000 in payments Lessee will make over the \n5-year lease term are all lease payments for the single component of the contract and, therefore, are \nincluded in the m easurement of the lease liability. \nCase C — Common Area Maintenance \n842-10-55-144 \nAssume the same facts and circumstances as in Case B (paragraph 842 -10-55-143), except that the \nlease is of space within the building, rather than for the entire building, an d the fixed annual lease \npayment of $13,000 also covers Lessor’s performance of common area maintenance activities (for \nexample, cleaning of common areas, parking lot maintenance, and providing utilities to the building). \nConsistent with Case B, the taxes and insurance are not components of the contract. However, the \ncommon area maintenance is a component because Lessor’s activities transfer services to Lessee. \nThat is, Lessee receives a service from Lessor in the form of the common area maintenance activit ies ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 44}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 33 it would otherwise have to undertake itself or pay another party to provide (for example, cleaning the \nlobby for its customers, removing snow from the parking lot for its employees and customers, and \nproviding utilities). The common area maintenance is a single component in this contract rather than \nmultiple components, because Lessor performs the activities as needed (for example, plows snow or \nundertakes minor repairs when and as necessary) over the same period of time. \n842-10-55-145 \nTherefore, the co ntract in Case C includes two components — a lease component (that is, the right to \nuse the building) and a nonlease component. The consideration in the contract of $65,000 is allocated \nbetween those 2 components (unless Lessee elects the practical expedie nt in paragraph 842 -10-15-37 or \nLessor elects the practical expedient in paragraph 842 -10-15-42A when the conditions in that paragraph \nare met). The amount allocated to the lease component is the lease payments in accounting for the lease. \n1.4.2.2 Guarantees of performance of underlying asset \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \n842-10-55-32 \nParagraph 460 -10-15-4(c) states that, except as provided in paragraph 460-10-15-7, the provisions \nof Subtopic 460 -10 on guarantees apply to indemnification agreements ( contracts ) that contingently \nrequire an indemnifying party (guarantor) to make payments to an indemnified party (guaranteed \nparty) based on changes in an unde rlying that is related to an asset, a liability, or an equity security of \nthe indemnified party. Paragraph 460 -10-55-23A provides related implementation guidance for a tax \nindemnification provided to a lessor . \n842-10-55-33 \nA lessor should evaluate a commit ment to guarantee performance of the underlying asset or to \neffectively protect the lessee from obsolescence of the underlying asset in accordance with \nparagraphs 606 -10-55-30 through 55 -35 on warranties . If the lessor’s commitment is more extensive \nthan a typical product warranty, it might indicate that the commitment is providing a service to the \nlessee that should be accounted for as a nonlease component of the contract. \nEntities should carefully evaluate the terms of any performance guarantees provided by the lessor and \nthe provisions of ASC 606-10-55-30 through 55 -35 to determine whether the guarantee is a non -lease \ncomponent of the contract that should be separated ( e.g., if the lessor’s commitment is more extensive \nthan a typical product warranty). \n1.4.2.3 Practical expedient to not separate lease and non -lease components — lessees \n(updated August 2022) \nExcerpt from Accounting Standards Codification \nLeases — Overall \nScope and Scope Exceptions \n842-10-15-37 \nAs a practical expedient, a lessee may, as an accounting policy election by class of underlying asset, \nchoose not to separate nonlease components from lease components and instead to account for each \nseparate lease component and the nonlease components ass ociated with that lease component as a \nsingle lease component. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 45}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 34 ASC 842 provides a practical expedient that permits lessees to make an accounting policy election (by class \nof underlying asset) to account for each separate lease component of a contract and its associated non -lease \ncomponents as a single lease component. ASC 842 provides this expedient to alleviate concerns that the \ncosts and administrative burden of allocating consideration to separate lease and non -lease components \nmay not be justified by the benefit of more precisely reflecting the right -of-use asset and th e lease liability. \nFurthermore, as indicated in BC 150 of ASU 2016 -02, the FASB expects the practical expedient to most \noften be used when the non -lease components of a contract are not significant when compared to the \nlease components of a contract. The p ractical expedient does not allow lessees to account for multiple \nlease components of a contract (refer to section 1.4.1, Identifying and separating lease components of a \ncontract ) as a single lease component. Refer to section 4, Lessee accounting , for a d iscussion of \nmeasurement of right -of-use assets and lease liabilities. \nLessees that make the accounting policy election to account for a lease component of a contract and its \nassociated non -lease components as a single lease component must assess classific ation of the lease \nbased on the consideration in the contract for the combined component. A lessee that makes this \nelection would assess whether the present value of the sum of the lease payments for the combined \ncomponent and any residual value guaranteed by the lessee that is not already reflected in the lease \npayments equals or exceeds substantially all of the fair value of the underlying asset (refer to section 3.1, \nCriteria for lease classification — lessees ). \nWhen a lease includes a non -lease componen t related to the purchase of inventory, we believe an entity \nshould separate the purchase of inventory from other lease and non -lease components, even if it has \nelected to apply the practical expedient to the class of underlying asset to which the lease re lates. For \nexample, if a contract contains a lease as well as non -lease components related to a service and the \npurchase of sheet metal to be used in the construction of inventory, we believe the purchase of the sheet \nmetal should be accounted for as a com ponent of inventory rather than together with the lease component \nas the purchase of a physical good is not a “non -lease component associated with that lease component.” \nQuestions have arisen about whether this interpretation on purchases of inventory shou ld apply to a \ncontract manufacturing arrangement that contains a lease. It does not apply because in a contract \nmanufacturing arrangement that contains a lease, the lessee generally is not purchasing inventory . \nInstead, the lessee is producing inventory wi th the leased assets ( e.g., manufacturing facility, identified \nequipment) and the manufacturing service provided by the contract manufacturer (lessor) . \nTherefore , when a contract manufacturing arrangement contains a lease, the lessee can make an \naccounting policy election for that class of underlying asset to not separate the lease component of the \ncontract ( e.g., lease of a manufacturing facility, identified equipment) and its associated non -lease \ncomponents ( e.g., manufacturing services). See section 1.4.2.4 for considerations for applying the lessor \npractical expedient to a contract manufacturing arrangement. \nLessees that make the policy election to account for a lease component of a contract and its associated \nnon-lease components as a single l ease component allocate all of the contract consideration to the lease \ncomponent. Therefore, the initial and subsequent measurement of the lease liability and right -of-use \nasset is greater than if the policy election was not applied, which could have an ef fect on a lessee’s \nimpairment analysis (refer to section 4.2.5, Impairment of right -of-use assets in operating leases ). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 46}), Document(page\_content='1 Scope and scope ex ceptions \nFinancial reporting developments Lease accounting | 35 1.4.2.4 Practical expedient to not separate lease and non -lease components — lessors \n(updated August 2022) \nExcerpt from Accounting Stand ards Codification \nLeases — Overall \nScope and Scope Exceptions \n842-10-15-38 \nA lessor shall allocate (unless the lessor makes the accounting policy election in accordance with \nparagraph 842 -10-15-42A) the consideration in the contract to the separate lease components and \nthe nonlease components using the requirements in paragraphs 606 -10-32-28 through 32 -41. A \nlessor also shall allocate (unless the lessor makes the accounting policy election in accordance with \nparagraph 842 -10-15-42A) any capitalized costs (for example, initial direct costs or contract costs \ncapitalized in accordance with Subtopic 340 -40 on other assets and deferred costs — contracts with \ncustomers) to the separate lease components or nonlease components to which those costs relate. \n842-10-15-42A \nAs a practical expedient, a lessor may, as an accounting policy election, by class of underlying \nasset, choose to not separate nonl ease components from lease components and, instead, to \naccount for each separate lease component and the nonlease components associated with that \nlease component as a single component if the nonlease components otherwise would be accounted \nfor under Topic 606 on revenue from contracts with customers and both of the following are met: \na. The timing and pattern of transfer for the lease component and nonlease components associated \nwith that lease component are the same. \nb. The lease component, if accounted for separately, would be classified as an operating lease in \naccordance with paragraphs 842 -10-25-2 through 25 -3A. \n842-10-15-42B \nA lessor that elects the pr actical expedient in paragraph 842 -10-15-42A shall account for the \ncombined component: \na. As a single performance obligation entirely in accordance with Topic 606 if the nonlease \ncomponent or components are the predominant component(s) of the combined comp onent. In \napplying Topic 606, the entity shall do both of the following: \n1. Use the same measure of progress as used for applying paragraph 842 -10-15-42A(a) \n2. Account for all variable payments related to any good or service, including the lease, that is p art of \nthe combined component in accordance with the guidance on variable consideration in Topic 606. \nb. Otherwise, as an operating lease entirely in accordance with this Topic. In applying this Topic, the \nentity shall account for all variable payments rel ated to any good or service that is part of the \ncombined component as variable lease payments. \nIn determining whether a nonlease component or components are the predominant component(s) \nof a combined component, a lessor shall consider whether the lessee wo uld be reasonably expected \nto ascribe more value to the nonlease component(s) than to the lease component. \n842-10-15-42C \nA lessor that elects the practical expedient in paragraph 842 -10-15-42A shall combine all nonlease \ncomponents that qualify for the prac tical expedient with the associated lease component and shall \naccount for the combined component in accordance with paragraph 842 -10-15-42B. A lessor shall \nseparately account for nonlease components that do not qualify for the practical expedient. \nAccordin gly, a lessor shall apply paragraphs 842 -10-15-38 through 15 -42 to account for nonlease \ncomponents that do not qualify for the practical expedient. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 47}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 36 The FASB added an optional practical expedient that allows lessors to elect, by class of underlying asset, to \nnot separate lease and related non -lease components if the non -lease components otherwise would be \naccounted for in accordance with the revenue st andard and both of the following criteria are met: \n• The timing and pattern of transfer of the lease component and the associated non -lease \ncomponent(s) are the same. \n• The lease component would be classified as an operating lease if it were accounted for sepa rately.4 \nAfter the adoption of ASU 2021 -05, leases with variable lease payments that are not based on an index or rate \n(e.g., long-term leases of machinery where the consideration in the contracts is determined based on hours used \nby the lessee) are class ified as operating leases if they would have otherwise been classified as sales -type or \ndirect financing leases and the lessor would have recognized a selling loss at lease commencement. As a result, \nmore leases may qualify for the practical expedient in these situations . Refer to section 3.2, Criteria for \nlease classification — lessors , for further discussion on the classification of such leases . \nIf both of the criteria are met and a lessor elects to use the practi cal expedient, the lessor is required to \naccount for the combined component as a single performance obligation in accordance with ASC 606 if \nthe non -lease component is the predominant component. If the non -lease component is not the \npredominant component, a lessor applying this practical expedient is required to account for the \ncombined component as an operating lease in accordance with ASC 842. \nThe decision tree below summarizes the evaluation of whether a lessor can apply the practical expedient \nnot to s eparate lease and non -lease components: \n \n \n4 The Basis for Conclusions (BC 30) of ASU 2018 -11, Targeted Improvements , says , “the Board emphasized that determining \nwhether the lease componen t (if accounted for separately) would be classified as an operating lease generally should not require \na detailed quantitative analysis but, rather, can often be determined using a reasonable qualitative assessment.” \nNo \nYes \nYes \nYes \nNo \nYes \nYes \nYes \nYes \nNo \nNo \nNo \nWould the non -lease component(s) otherwise \nbe accounted for under ASC 606? \nIs the timing and pattern of transfer of the \nlease component(s) and the associated \nnon-lease component(s) the same? \nWould the lease component(s) be classified \nas an operating lease, in accordance with \nASC 842-10-25-2 through 25 -3A, if it were \naccounted for separately? \nIs the non -lease component(s) the predominant \ncomponent(s) in the combined component? \nThe lessor may not combine the \nlease and non-lease component(s) \nas a single component. \nAccount for the combined component as \na single performance obligation in \naccordance with ASC 606. \nAccount for the combined component as an \noperating lease in accordance with ASC 842. \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 48}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 37 ASC 842 does not provide detailed guidance on how to evaluate whether the predominant component is \nthe lease or non -lease component. Likewise, the Basis for Conclusions ( BC 35 ) of ASU 2018 -11, Leases \n(Topic 842): Targeted Improvements , says , “The Board concluded that an entity should be able to \nreasonably determine which Topic to apply (based on predominance) without having to perform a \ndetailed quantitative analysis or theoretical allocation to each component.” \nWe agree that, in some cases, a reasonable qualitative analysis may provide an adequate basis for \nconclusions. However, if it is not clear which component (the lease component or related non -lease \ncomponent(s)) is predominant, we believe some quantitative analysis may be necessary. The extent of \nthe quantitative evaluation would depend on facts and circumstances of each contract. \nThe practical expedient is elected by class of underlying assets (as an accounting policy election) and is \napplied to all arrangements in that class of underlying asset th at qualify for the expedient . That is, a \nlessor cannot pick and choose which arrangements to account for under the expedient. \nFor example, a lessor may have a portfolio of similar lease arrangements ( e.g., units in independent living \nfacilities) across mul tiple geographic areas. If the lessor elects the expedient for a class of underlying \nassets, it would analyze (qualitatively and/or quantitatively, as applicable) all contracts in that class of \nunderlying assets. This may result in the lease component bein g the predominant component in some \ncontracts while other contracts involving the same class of underlying assets have the revenue \ncomponent as the predominant component. \nIf a contract includes a lease and multiple associated non -lease components, a lessor must combine all \ncomponents that qualify for the practical expedient and separately account for the components that do not \nqualify ( i.e., those for which the timing and pattern of transfer of the lease and associated non -lease components \nare not the same) . In doing so, the lessor is required to apply the separation and allocation guidance described \nin section 1.4.4.2, Allocating the consideration in the contract — lessors , to the separate components. \nThe practical expedient does not allow lessors to accoun t for multiple lease components of a contract (refer to \nsection 1.4.1, Identifying and separating lease components of a contract ) as a single lease component. \nIllustration 1 -9: Lessor elects practical expedient to not separate non -lease and associated \nlease components in a gross lease \nLessor owns and operates a multifamily residential building with 12 units. On 1 January 20X8, Lessor \nand Tenant enter into a 15 -month operating lease of a single residential unit in the building. As part of \nthe contract, Lessor is responsible for maintaining the common areas in the building. \nThe terms of the lease require Tenant to make a fixed monthly payment of $3,000 for u se of the \nresidential unit. There are no additional payments for real estate taxes, building insurance or \nmaintenance of the common areas. \nAnalysis: Lessor determines that the contract contains two components: a lease component ( i.e., the \nright to use the residential unit) and a non -lease component ( i.e., CAM ). Under the new guidance, real \nestate taxes and insurance are not separate components of the contract. \nLessor evaluates whether it can apply the optional practical expedient to not separate the lease a nd \nnon-lease component in the contract. It first determines that the non -lease component ( i.e., CAM ) \notherwise would be accounted for under the revenue standard and then assesses the criteria for use \nof the practical expedient: \n• Lessor concludes that the timing and pattern of transfer of the right to use the residential space \nand the transfer of CAM are the same ( i.e., the right to use the residential space and CAM transfer \nto the tenant on a monthly basis over the term of the contract). \n• Lessor concludes t hat the right to use the residential space would be classified as an operating \nlease if it were accounted for separately . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 49}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 38 Lessor concludes that it meets the criteria to use the practical expedient. Lessor then evaluates whether \nCAM is the predominant compo nent in the arrangement. Lessor concludes that CAM is not the \npredominant component because Tenant is reasonably expected to ascribe more value to the right to \nuse the residential space. Accordingly, Lessor accounts for the combined component as an operati ng \nlease in accordance with ASC 842 and provides the required disclosures by class of underlying assets. \nLessor applies the expedient to all eligible arrangements in the same class of underlying asset ( i.e., all \nmultifamily residential units that it leases ). \nContract s that include the sale of consumables \nLessors may enter into arrangements to provide a lease of equipment along with non -lease components \n(e.g., training services, maintenance services, supply of consumable products to be used with the \nleased equipment). \nWhen the lessor recognizes revenue from sales of the consumable products at a point in time (in accordance \nwith ASC 606), the lease component and th e non-lease components ( i.e., sale of consumable products) \ndo not have the same timing and pattern of transfer. Therefore, if the entity has made an accounting \npolicy election to not separate the lease and non -lease components, the non -lease component relating to \nthe sale of the consumable products is n ot eligible to be combined with the lease component. \nNon-lease component in a contract manufacturing arrangement \nIn a contract manufacturing arrangement that contain s a lease , the contract manufacturer (lessor) is not \nselling inventory. Instead, it is providing a servi ce of manufactur ing goods for the customer (lessee) over \na period of time using the leased assets . As such , the associated non-lease component in the \narran gement is providing a manufac turing service , not selling inventory , which may affect whether and \nhow the practical expedient for lessors can be applied . See section 1.4.2.3 for considerations for \napplying the lessee practical expedient to a contract manufacturing arrangement . \n1.4.3 Determining, allocating and reassessing the consi deration in the contract — lessees \n1.4.3.1 Determining the consideration in the contract — lessees \nExcerpt from Accounting Standards Codification \nMaster Glossary \nConsideration in the Contract \nSee paragraph 842 -10-15-35 for what constitutes the consideration in the contract for lessees and \nparagraph 842 -10-15-39 for what constitutes consideration in the contract for lessors . \nLeases — Overall \nScope and Scope Exceptions \n842-10-15-35 \nThe consideration in the contract for a lessee includes all of the payments described in paragraph 842 -\n10-30-5, as well as all of the following payments that will be made during the lease term : \na. Any fixed payments (for example, monthly service charges) or in substance fixed payments, less \nany incentives paid or payable to the lessee, other than those included in paragraph 842 -10-30-5 \nb. Any other variable payments that depend on an index or a rate, initially measured using the index \nor rate at the commencement date . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 50}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 39 The consideration in the contract for a lessee includes all of the payments described as lease payments in \nsection 2.4, Lease payments , as well as any of the following payments made during the lease term: \n• Any fixed payments ( e.g., monthly service charges) or in -substance fixed payments, less any \nincentives paid or payable to the lessee (re fer to section 2.4.1, Fixed (including in -substance fixed) \nlease payments and lease incentives ), other than those included in lease payments \n• Any variable payments that depend on an index or a rate (refer to section 2.4.2, Variable lease payments \nthat depen d on an index or rate ), initially measured using the index or rate at the commencement \ndate (refer to section 2.2, Commencement date of the lease ) \n \n1.4.3.2 Allocating the consideration in the contract — lessees \nExcerpt from Accounting Standards Codification \nMaster Glossary \nStandalone Price \nThe price at which a customer would purchase a component of a contract separately. \nLeases — Overall \nScope and Scope Exceptions \n842-10-15-33 \nA lessee shall allocate (that is, unless the lessee makes the accounting policy election described in \nparagraph 842 -10-15-37) the consideration in the contract to the separate lease components determined \nin accordance with paragraphs 842 -10-15-28 through 15 -31 and the nonlease components as follows: \na. The lessee shall determine the relative standalone price of the separate lease components and \nthe nonlease components on the basis of their observable standalone prices. If observable \nstandalone prices are not readi ly available, the lessee shall estimate the standalone prices, \nmaximizing the use of observable information. A residual estimation approach may be \nappropriate if the standalone price for a component is highly variable or uncertain. \nb. The lessee shall all ocate the consideration in the contract on a relative standalone price basis to \nthe separate lease components and the nonlease components of the contract . \nInitial direct costs should be allocated to the separate lease components on the same basis as the \nlease payments . \n842-10-15-34 \nA price is observable if it is the price that either the lessor or similar suppliers sell similar lease or \nnonlease components on a standalone basis . \nThe payments described as l ease payments in section 2.4, Lease payments \n+ \nAny other fixed payments ( e.g., monthly service charges) or in -substance \nfixed payments made during the lease term, less any incentives paid or \npayable to the lessee \n+ \nAny other variable payments that depend on an index or a rate made during \nthe lease term and initial ly measured using the index or rate at the \ncommencement date \nConsideration \nin the contract \nfor a lessee \n(ASC 842-10-\n15-35) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 51}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 40 Lessees that do not make an accounting policy election (by class of underlying asset) to use the practical \nexpedient (refer to section 1.4.2.3, Practical expedient to not separate lease and non -lease components — \nlessees ) to account for each separate l ease component of a contract and its associated non -lease \ncomponents as a single lease component are required to allocate the consideration in the contract to the \nlease and non -lease components on a relative standalone price basis. The practical expedient does not \nallow lessees to account for multiple lease components of a contract as a single lease component. \nLessees are required to use observable standalone prices ( i.e., prices at which a customer would purchase \na component of a contract separately) when readily available. If observable standalone prices are not \nreadily available, lessees estimate standalone prices, maximizing the use of observable information. A \nresidual estimation approach may be appropriate when the standa lone price for a component is highly \nvariable or uncertain. \nWhen variable payments not included in consideration in the contract are recognized, lessees also \nallocate these amounts between lease and non -lease components on the same basis as the allocation of \nconsideration in the contract. These payments include variable payments not based on an index or rate \nor the changes in variable payments based on an index or rate after the commencement date of the \nlease. Refer to sections 4.2.3, Expense recognition — operating leases , and 4.3.3, Expense recognition — \nfinance leases , for discussion of the timing of recognition of variable lease payments. \nRefer to section 1.4.5, Examples — identifying and separating components of a contract and determining \nand allocating the consideration in the contract , for illustrations of how a lessee determines and allocates \nconsideration in a contract, including for arrangements that include variable payments. \nFor contracts that contain multiple lease components (refer to section 1. 4.1, Identifying and separating \nlease components of a contract ), lessees also allocate initial direct costs (refer to section 2.6, Initial direct \ncosts ) to the separate lease components on the same basis as the lease payments. \nIllustration 1 -10: Allocating contract consideration if a lessee does not elect the practical \nexpedient to combine the lease and non -lease components \nOn 1 January 20X0, Lessee enters into a three -year lease for office space with Lessor . Under the terms \nof the agreement, Le ssee agrees to pay the following for the right to use the office space: \n• A fixed payment payable on 31 December of each year starting at $300,000 and increasing 10% \neach year \n• A variable payment per year based on the actual costs Lessor incurs for Lessor’s p roperty taxes \nand insurance related to the underlying asset and common area maintenance ( CAM ). Amounts \nincurred are payable on 31 December of each year . \nIn this example, the right to use the office space for three years is a lease component, with a standalone \nprice of $800,000. The lease is classified as an operating lease. The CAM services are a non -lease \ncomponent, with a standalone price of $123,000. Le ssee’s payments for Lessor’s real estate taxes \nand insurance related to the underlying asset are not components of the contract because they do \nnot represent payment for goods or services, in addition to the right to use the space, transferred to \nthe lesse e. \nAssume that Lessee incurs no initial direct costs, and its incremental borrowing rate at lease \ncommencement is 4%. \nAlso, Lessee does not elect the practical expedient to combine the lease and non -lease components. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 52}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 41 In this example, Lessee allocates the f ixed consideration in the contract as follows: \nComponent Relative % Allocation of fixed consideration \n Year 1 Year 2 Year 3 Total \nLease 86.7% (a) $ 260,000 $ 286,000 $ 315,000 $ 861,000 \nCAM 13.3% (b) 40,000 44,000 48,000 132,000 \n 100% $ 300,000 $ 330,000 $ 363,000 $ 993,000 \n(a) 800,000 / (800,000 + 123,000) = 86.7% \n(b) 123,000 / (800,000 + 123,000) = 13.3% \nThe initial measurement of the right -of-use asset and lease liability is $794,000 using the allocated \nconsideration in the contract of $861,000 discounted using Lessee ’s incremental borrowing rate at \nlease commencement of 4%. Refer to section 4.2, Operatin g leases , for lessee accounting guidance on \nthe initial measurement of operating leases. \nAt the end of year one, Lessee pays the annual rental payment of $300,000, of which $260,000 is \nallocated to the lease component and $40,000 is allocated to CAM servic es. \nLessee prepares financial statements on an annual basis at the end of the year. At the end of year one, \nLessee records the following for the fixed consideration (refer to section 4.2.2, Subsequent \nmeasurement — Operating leases , for further guidance) : \nLease liability $ 228,000 (a) \nLease expense 287,000 (b) \nMaintenance expense 44,000 (c) \n Right -of-use asset $ 255,000 (d) \n Cash 300,000 (e) \n CAM accrual 4,000 (f) \n(a) Difference between the initial measurement of the lease liability (and right -of-use asset) at lease commencement ($794,000) \nand the present value of remaining lease payments at the end of year one ($566,000) \n(b) Payments allocated to the lease component recognized on a straight -line basis (total consideration in the contract of \n$861,000 over three years) \n(c) Expense attributable to the non -lease component (total CAM expense of $132,000 over three years) \n(d) Adjustment in (a) of $228,000 plus accrued rent of $27,000, which is the difference between the cash pa id for the lease \ncomponent of $260,000 and straight -line lease rent expense of $287,000 \n(e) Cash payment \n(f) CAM accrual for the difference between the straight -line expense allocated to the CAM component ($44,000) and the CAM \npayment ($40,000) \nLessee makes a variable payment of $50,000 at the end of year one based on Lessor’s costs incurred \nfor property taxes, property insurance and CAM services. Lessee allocates variable payments to the \nlease and non -lease component s (i.e., CAM) on the same basis as the initial allocation of the \nconsideration in the contract. \nIn this example, Lessee allocates the variable payment in the contract as follows: \nComponent Relative % Allocation of variable payment \nLease 86.7% $ 43,350 \nCAM 13.3 % 6,650 \n 100% $ 50,000 \nAt the end of year one, Lessee records the following for the variable payment: \nLease expense $ 43,350 \nMaintenance expense 6,650 \n Cash $ 50,000 \nImmaterial differences may arise in the recomputation of amounts in the example above due to rounding. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 53}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 42 Illustration 1-11: Allocating contract consideration if a lessee elects the practical expedient to \ncombine lease and non -lease components \nAssume the same facts as in Illustration 1-10 except Lessee elects the practical expedient to combine \nlease and non -lease components. Lessee has concluded that the lease is an operating lease. \nIn this example, Lessee allocates all of the consideration to the lease component. Therefore, it \nrecognizes all of the fix ed consideration in the contract ($993,000) as lease payments. \nThe initial measurement of the right -of-use asset and lease liability is $916,000 using Lessee ’s \nincremental borrowing rate at lease commencement of 4%. Refer to section 4.2, Operating leases , for \nlessee accounting guidance on the initial measurement of operating leases. \nAt the end of year one, Lessee pays the annual rental payment of $300,000 and makes a variable payment \nof $50,000 based on Lessor’s actual costs incurred for property taxes, property insurance and CAM. \nLessee prepares financial statements on an annual basis at the end of the year. At the end of year one, \nLessee records the following for the fixed and variable consideration (refer to section 4.2.2, \nSubsequent measurement — Operating leases , for further guidance) : \nLease liability $ 263,000 (a) \nLease expense 381,000 (b) \n Right -of-use asset $ 294,000 (c) \n Cash 350,000 (d) \n(a) Difference between the initial measurement of the lease liability (and the right -of-use asset) at lease commencement \n($916,000) and the present value of remaining lease payments at the end of year one ($653,000) \n(b) Fixed and variable payments allocated to the lease component; fixed payments recognized on a straight -line basis ( total \nconsideration in the contract of $993,000 over three years) plus the variable payment of $50,000 in year one \n(c) Adjustment in (a) of $263,000 plus accrued rent of $31,000, which is the difference between the cash paid of $350,000 and \nstraight -line lease rent expense of $381,000 \n(d) Cash payment \nImmaterial differences may arise in the recomputation of amounts in the example above due to rounding. \n1.4.3.3 Reassessment: determining and allocating the consideration in the contract — lessees \nExcerpt from Accounting Standards Codification \nLeases — Overall \nScope and Scope Exceptions \n842-10-15-36 \nA lessee shall remeasure and reallocate the consideration in the contract upon either of the following: \na. A remeasurement of the lease liability (for example, a remeasurement resulting from a change in \nthe lease term or a change in the assessment of whether a lessee is or is not reasonably certain to \nexercise an option to purchase the underlying asset ) (see pa ragraph 842 -20-35-4) \nb. The effective date of a contract modification that is not accounted for as a separate contract (see \nparagraph 842 -10-25-8). \nLessees are required to remeasure and reallocate the consideration in a contract when they remeasure \nthe lease liability, which occurs as a result of any of the following: \n• A change to the lease term ( e.g., a change resulting from a lessee’s determination that it is \nreasonably certain to exercise an existing option to extend a lease that it had previously deter mined \nit was not reasonably certain to exercise) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 54}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 43 • A change in the assessment of whether a lessee is reasonably certain to exercise an option to \npurchase the underlying asset \n• A change in the amount that it is probable the lessee will owe under a residual value guarantee \n• A resolution of a contingency that results in some or all of the payments allocated to the lease \ncomponent that were previously determined to be variable meeting the definition of lease payments \n(e.g., an event occurs that results in variable lease payments that were linked to the performance or \nuse of the underlying asset becoming fixed payments for the remainder of the lease term) \nRefer to section 4.5, Remeasurement of lease liabilities and right -of-use assets — operating and finance \nleases, for further discussion. Lessees are also required to remeasure and reallocate the consideration in \nthe contract on the effective date of a contract modification ( i.e., the date the lessor and lessee approve \na change to the terms and con ditions of the lease that results in a change in the scope of or the \nconsideration for the lease) if the modified contract is not accounted for as a separate contract. Refer to \nsection 4.6, Lease modifications . \nWhen remeasuring and reallocating the conside ration in a contract, we believe a lessee should update \nthe standalone prices upon any of the following: \n• A lease modification that is not accounted for as a separate contract \n• A change to the lease term \n• A change in the assessment of whether a lessee is rea sonably certain to exercise an option to \npurchase the underlying asset \nWe believe a lessee is not required to update to the standalone prices when there is (1) a change in the \namount that it is probable the lessee will owe under a residual value guarantee or (2) a resolution of a \ncontingency that results in some or all of the payments allocated to the lease component that were \npreviously determined to be variable meeting the definition of lease payments , unless these events are \ncombined with one of the othe r remeasurement and reallocation events listed above. Refer to section 3.5.1, \nSummary of lease reassessment and remeasurement requirements. \n1.4.4 Determining, allocating and reassessing the consideration in the contract — \nlessors \nExcerpt from Accounting Standards Codification \nMaster Glossary \nConsideration in the Contract \nSee paragraph 842 -10-15-35 for what constitutes the consideration in the contract for lessees and \nparagraph 842 -10-15-39 for what constitutes consideration in the contract for lessors . \nLeases — Overall \nScope and Scope Exceptions \n842-10-15-38 \nA lessor shall allocate (unless the lessor makes the accounting policy election in accordance with \nparagraph 842-10-15-42A) the consideration in the contract to the separate lease components and \nthe nonlease components using the requirements in paragraphs 606 -10-32-28 through 32 -41. A \nlessor also shall allocate (unless the lessor makes the accounting policy elec tion in accordance with \nparagraph 842 -10-15-42A) any capitalized costs (for example, initial direct costs or contract costs \ncapitalized in accordance with Subtopic 340 -40 on other assets and deferred costs —contracts with \ncustomers) to the separate lease co mponents or nonlease components to which those costs relate. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 55}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 44 842-10-15-39 \nThe consideration in the contract for a lessor includes all of the amounts described in paragraph 842 -\n10-15-35 and any other variable payment amounts that would be included in the tr ansaction price in \naccordance with the guidance on variable consideration in Topic 606 on revenue from contracts with \ncustomers that specifically relates to either of the following: \na. The lessor’s efforts to transfer one or more goods or services that are not leases \nb. An outcome from transferring one or more goods or services that are not leases. \nAny variable payment amounts accounted for as consideration in the contract shall be allocated \nentirely to the nonlease component(s) to which the variable paymen t specifically relates if doing so \nwould be consistent with the transaction price allocation objective in paragraph 606 -10-32-28. \n842-10-15-39A \nA lessor may make an accounting policy election to exclude from the consideration in the contract and \nfrom varia ble payments not included in the consideration in the contract all taxes assessed by a \ngovernmental authority that are both imposed on and concurrent with a specific lease revenue -\nproducing transaction and collected by the lessor from a lessee (for example , sales, use, value added, \nand some excise taxes). Taxes assessed on a lessor’s total gross receipts or on the lessor as owner of \nthe underlying asset shall be excluded from the scope of this election. A lessor that makes this election \nshall exclude from t he consideration in the contract and from variable payments not included in the \nconsideration in the contract all taxes within the scope of the election and shall comply with the \ndisclosure requirements in paragraph 842 -30-50-14. \n842-10-15-40 \nIf the terms of a variable payment amount other than those in paragraph 842 -10-15-35 relate to a \nlease component, even partially, the lessor shall recognize those payments before the changes in facts \nand circumstances on which the variable payment is based occur (for example, when the lessee’s sales \non which the amount of the variable payment depends occur). When the changes in facts and \ncircumstances on which the variable payment is based occur, the lessor shall allocate those payments to \nthe lease and nonlease components of the contract. The allocation shall be on the same basis as the \ninitial allocation of the consideration in the contract or the most recent modification not accounted for as \na separate contract unless the variable payment meets the criteria in paragraph 606 -10-32-40 to be \nallocated only to the lease component(s). Variable payment amounts all ocated to the lease component(s) \nshall be recognized as income in profit or loss in accordance with this Topic, while variable payment \namounts allocated to nonlease component(s) shall be recognized in accordance with other Topics (for \nexample, Topic 606 on revenue from contracts with customers). \n842-10-15-40A \nThe guidance in paragraph 842 -10-15-40 notwithstanding, a lessor shall exclude from variable payments \nlessor costs paid by a lessee directly to a third party. However, costs excluded from the considera tion in \nthe contract that are paid by a lessor directly to a third party and are reimbursed by a lessee are \nconsidered lessor costs that shall be accounted for by the lessor as variable payments (this requirement \ndoes not preclude a lessor from making the accounting policy election in paragraph 842 -10-15-39A). \n \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 56}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 45 The FASB issued ASU 2018 -20, Narrow -Scope Improvements for Lessors , which amended ASC 842, to \nhelp lessors apply the new standard. The amendments respond to concerns raised by lessors about the \ncosts and complexity of assessing tax laws on a jurisdiction -by-jurisdiction basis, particularly when the \nlessor operates across multiple jurisdictions. The amendments also respond to concerns raised by \nstakeholders about the difficulty of estimating certa in costs paid directly by lessees to third parties on \nthe lessor’s behalf and concerns about the guidance when a lessor recognizes variable payments that \nrelate to both a lease component and a non -lease component. \nSales taxes and other similar taxes collec ted from lessees \nPrior to issuing ASU 2018 -20, ASC 842 required lessors to analyze sales taxes and other similar taxes on \na jurisdiction -by-jurisdiction basis to determine whether these taxes are the primary obligation of the \nlessor as owner of the underly ing asset being leased or whether these taxes are costs of the lessee. If \nthese taxes were a lessor cost, the lessor would include the amount in the measurement of lease revenue \nand the associated expense. If these taxes were a lessee cost, the lessor woul d exclude these taxes from \nthe measurement of lease revenue and the associated expense. \nThe amendments in ASU 2018 -20 allow lessors to make an accounting policy election not to evaluate whether \nsales taxes and other similar taxes imposed by a governmental authority on a specific lease revenue -producing \ntransaction that are collected by the lessor from the lessee are the primary obligation of the lessor as owner of \nthe underlying leased asset. A lessor that makes this election will exclude these taxes from t he measurement of \nlease revenue and the associated expense. Taxes assessed on a lessor’s total gross receipts or on the lessor \nas owner of the underlying asset ( e.g., property taxes) are excluded from the scope of the policy election. \nA lessor must apply t he election to all taxes in the scope of the policy election and would provide certain \ndisclosures. This policy election is similar to one that exists in the revenue standard for sales contracts that \ninclude sales taxes and other similar taxes collected fr om customers (refer to section 5.1, Presentation of \nsales (and other similar) taxes , in our FRD, Revenue from contracts with customers ( ASC 606) ). \nCertain lessor costs \nPrior to issuing ASU 2018 -20, ASC 842 required a lessor to recognize as revenue and expense any \nlessor costs paid by a lessee, regardless of whether the lessee paid the third party directly on behalf of \nthe lessor or reimbursed the lessor. As a result, the lessor would have had to estimate the amounts paid \ndirectly by a lessee on the lessor’s behalf in many cases. \nThe amendments in ASU 2018 -20 require lessors to exclude lessor costs paid directly by lessees to third \nparties on the lessor’s behalf from variable payments and therefore variable lease revenue . The amendments \nalso require lessors to include lessor costs that are paid by the lessor and reimb ursed by the lessee in the \nmeasurement of variable lease revenue and the associated expense. \nClarification of variable payments allocated to lease and non -lease components \nPrior to issuing ASU 2018 -20, ASC 842 required lessors to recognize certain variable payment amounts \nin profit or loss in the period when the changes in facts and circumstances on which the variable payment \nis based occur red, regardless of whether the payment partially relate d to non -lease components. That \ncould have resulted in a lessor recognizing revenue allocated to the non -lease component before the period \nin which the non -lease component is satisfie d under other guidance, such as ASC 606. \nThe amendments in ASU 2018 -20 clarify that lessors are required to allocate (rather than recogni ze) certain \nvariable payments to the lease and non -lease components when changes in facts and circumstances on which \nthe variable payment is based occur. After the allocation, the amount of variable payments allocated to the \nlease component is recognized as income in profit or loss in accordance with ASC 842, and the amount \nallocated to the non -lease component is recogni zed in accordance with other guidance, such as ASC 606. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 57}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 46 1.4.4.1 Determining the consideration in the contract — lessors \nThis illustration shows the types of payments that a lessor includes as consideration in the contract. \nAlthough similar, consideration in a contract for lessees and lessors may differ because lessors include \ncertain other variable payments that do not relate to a lease component. \n \n1.4.4.2 Allocating the consideration in the contract — lessors \nLessors are required to apply the guidance in ASC 606-10-32-28 through 32-41 to allocate the \nconsideration in the contract to lease and separate non -lease components if they (1) do not make an \naccounting policy election (by class of underlying asset) to use the optional practical expedient to not \nseparate lease and associated non-lease components or (2) make the accounting policy election but have \nat least one non -lease component that does not qualify for the expedient. Refer to section 1.4.2.4, \nPractical expedient to not separate lease and non -lease components — lessors . The guidance in this section \nand section 1.4.4.3, Allocating variable payments — lessors , assumes the entity has separate lease and \nnon-lease components to which consideration must be allocated. \nLessors are required to allocate consideration in the contract on a relative standalone selling price basis, \nexcept when allocating certain discounts ( ASC 606-10-32-36 through 32 -38) and certain variable \nconsideration ( ASC 606-10-32-39 through 32 -41). Using the guidance in ASC 606, lessors may ultimately \nattribute all o r portions of the consideration in the contract to specific lease and non -lease components. \nThe standalone selling price is the price at which an entity would sell a promised good or service separately \nto a customer. The best evidence of standalone selling price is the observable price of a good or service \nwhen the entity sells that good or service separately in similar circumstances and to similar customers. \nWhen the standalone selling price is not directly observable, the lessor must estimate it. ASC 606-10-32-33 \nthrough 32 -35 provides guidance for estimating the standalone selling price. Refer to section 6.1, \nDetermining standalone selling prices , of our F RD, Revenue from contracts with customers ( ASC 606) , \nfor a discussion of determining the standalone selling price and estimation methods. \n•The payments described as lease payments in section 2.4, Lease payments \nConsideration in the \ncontract for a lessee \n(ASC 842-10-15-35) \n+ \n•Any other fixed payments ( e.g., monthly service charges) or in -substance fixed \npayments made during the lease term, less any incentives paid or payable to the lessee \n•Any other variable payments that depend on an index or a rate made during the \nlease term and initially measured using th e index or rate at the commencement date \n+ \n+ \n•Any other variable payment amounts that would be included in the transaction price \nin accordance with the guidance on variable consideration in ASC 606 that specifically \nrelate to either of the following: \n•The lessor’s efforts to transfer one or more goods or services that are not leases \n•An outcome fr om transferring one or more goods or services that are not leases \n= \nConsideration in the contract for a lessor ( ASC 842-10-15-39) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 58}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 47 Illustration 1 -12: Allocating the consideration in the contract (minimum purchase commitment \nof consumables ) \nMedCo enters into a three -year contract with Hospital Co to lease equipment ( e.g., an MRI machine) at \nno stated cost and to sell consumables that will be used specifically with the equipment for $3.50 per \nunit. Under the contract, Hospital Co has a minimum purchase commitment of 5,000 consumable \nproducts for each year of the three -year lease term . At lease commencement, Hospital Co estimates \nthat the total purchases of consumable products during the lease term are equal to the minimum \npurchase commitment . \nUnder the terms of the contract, Hospital Co cannot use the equipment without the consumable \nproducts purchased exclusively from MedCo. Additionally, MedCo expects Hospital Co to purchase and \nuse different amount s of consumable products each month. \nAt the lease commencement date, MedCo determines the following standalone selling prices for the lease \nand non -lease components in the contract based upon observable transactions in which Medco leases \nthe equipment and sells consumable products separately in similar circumstances to similar customers: \n$25,000 for the equipment for the three -year lease term and $2.50 per un it for the sale of consumables. \nAnalysis: MedCo determines that there is one lease component (for the medical equipment) and one \nnon-lease component (sales of consumable products) in the agreement. The lessor practical expedient \ndoes not apply in this example because the timing and pattern of transfer of the lease and non -lease \ncomponents are not the same. \nAt lease commencement, MedCo calculates the consideration in the contract to be $52,500 ($3.50 \nper unit x three -year lease term x 5,000 minimum required purchase of consumable units per year). \nMedCo a pplies the principles of ASC 606 to determine the standalone selling price of each component \nand the amount to allocate to each lease and non -lease component , as follows: \nComponent SSP Relative percentage Allocation of contract \nconsideration \nEquipment $ 25,000 40% $ 21,000 \nConsumable products 37,500(a) 60% 31,500 \n $ 62,5 00 100% $ 52,500 \n \n(a) $2.50/unit x 3 years x 5,000 units per year = $37,500 \nRefer to Illustration 1 -13 for a scenario in which the total purchases during the lease term are \nestimated to be greater than the minimum purchase commitment. \nRefer to our FRD, Revenue from contracts with customers ( ASC 606) , for additional details regarding \nrecognition and measurement of the non -lease components. \n \nIllustration 1 -13: Allocating the consideration in the contract (fixed payments and an option to \npurchase additional goods ) \nLessee and Lessor enter into a two -year lease of medical equipment. Lessee agrees to pay a fixed \npayment of $50,000 per year. There are no variable lease payments that do not depend on an index or \nrate, and the lease would not result in selling losses if it was classified as a sales -type or direct \nfinancing lease . Legal title of the equipment passes to Lessee at the end of the lease term. Accordingly, \nLessor classifies the lease as a sales -type lease. At lease commencement, the standalone price of a two -\nyear lease of the equipment is $125,000. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 59}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 48 Lessee also has the right, but not the obligation, to purchase disposables that are used with the \nmedical equipment for $10 per disposable. At lease commencement, Lessor estimates that Lessee \nwill purchase 20,000 disposables during the lease term. The price that Lessor charges Lessee for \nthe disposables is consistent with the price that it charges oth er customers with a similar volume of \npurchases. Lessor concludes that the purchases of disposables are optional purchases and are not a \nform of variable consideration. \nLessor determines that the arrangement does not qualify for use of the lessor practical expedient in \nASC 842-10-15-42A. That is, the lease of the medical equipment ( i.e., the lease component) is not \nclassified as an operating lease and the timing and pattern of transfer of the medical equipment and \ndisposables ( i.e., the non -lease components ) are not the same (refer to section 1.4.2.4, Practical \nexpedient to not separate lease and non -lease components — lessors ). Therefore, Lessor allocates the \npayments in the arrangement between the medical equipment and the disposables in a manner that is \nconsistent with the transaction price allocation objective in ASC 606-10-32-28. \nLessor concludes that allocating the fixed payments of $100,000 ($50,000 per year x two years) \nentirely to the medical equipment would meet the allocation objective in ASC 606 b ecause at lease \ncommencement there are no existing non -lease components to which the fixed payments could be \nallocated. Lessor’s allocation methodology also would not result in an overallocation of the fixed \npayments to the lease component ( i.e., $100,000 is less than the standalone price of $125,000) and, \ntherefore, is not inconsistent with the allocation objective in ASC 606. \nLessor will then allocate payments, if any, for optional future purchases of disposables between the medical \nequipment and the disposables on a relative standalone price basis determined at lease commencement. \nThis allocation methodology considers that the fixed payments were allocated entirely to the equipment. \nAssume at lease commencement that Lessor determines that the standalo ne price of the disposables \nis $200,000 based on the estimated purchases of disposables during the lease term. Lessor allocates \nthe fixed payments and the payments for the optional purchases as follows: \nComponent SSP Allocation of \nestimated \npayments(a) Allocation of fixed \npayment Allocation of \npayments for \noptional purchases Allocation of \npayments \nfor optional \npurchases - % \nEquipment $ 125,000 $ 115,385(b) $ 100,000 $ 15,385 8% (d) \nDisposables 200,000 184,615(c) – 184,615 92% (e) \n $ 325,000 $ 300,000 $ 100,000 $ 200,000 100% \n \n(a) $100,000 of fixed payments + $200,000 of estimated payments for disposables ($10 per disposable X 20,000 estimated disposable s to be purchased) \n(b) (125,000/325,000) x 300,000 \n(c) (200,000/325,000) x 300,000 \n(d) 15,385/200,000 \n(e) 184,615/200,000 \nDuring the first year of the lease, Lessee purchases disposables totaling $100,000. Lessor allocates \nthe pay ments to the lease and non -lease components as follows: \nLease component : (($100,0 00 fixed payments/two years) + ($100,000 x 8%)) = $58,000 \nNon-lease component s (disposables) : ($100,000 x 92%) = $92,000 \nNote: This allocation methodology would not be appropriate for Lessee. Further, while Lessor’s \nallocation methodology is consistent with the transaction price allocation objective in ASC 606, the \nuse of other allocation methodologies may also be appropriate if t hose methodologies are consistent \nwith the allocation objective in ASC 606. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 60}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 49 1.4.4.3 Allocating variable payments — lessors \nIf an arrangement includes variable payments, a lessor should carefully analyze the nature of the variable \npayments and the compone nts to which they relate to determine how to allocate those amounts. Refer to \nAppendix F for a flowchart illustrating how a lessor accounts for variable payments . \nVariable payments included as consideration in the contract \nUnder ASC 842, certain variable payments are included as consideration in the contract ( i.e., variable \npayments that depend on an index or rate and other variable payments that relate to the transfer of or the \noutcome from transferring one or more goods or services that are not leases ). Refer to section 1.4.4.1, \nDetermining the consideration in the contract — lessors . Variable payments included as consideration in the \ncontract are allocated entirely to the non -lease component(s) to which they specifically relate if doing so would \nbe consistent with the transaction price allocation objective in ASC 606-10-32-28 (i.e., the variable payment \nwould be allocated entirely to the non -lease component if doing so depicts the amount of consideration to \nwhich the lessor expects to be entitled in exchange for transferring the non -lease component). \nExcerpt from Accounting Standards Codification \nRevenue from Contracts with Customers — Overall \nMeasurement \n606-10-32-28 \nThe objective when allocating the transaction price is for an entity to allocate the transaction price to \neach performance obligation (or distinct good or service) in an amount that depicts the amount of \nconsideration to which the entity expects to be entitled in exchange for transferring the promised \ngoods or services to the customer . \nIf variable payments are not specifically related to the non -lease component(s) or if allocating the \nvariable payments entirely to the non -lease component (s) is not consistent with the transaction price \nallocation objective in ASC 606-10-32-28, the consideration in the contract is generally allocated \nbetween lease and non -lease components on a relative standalone selling price basis. \nThe following illustration on allocating variable payments included in the consideration in the contract is \nbased on Example 14, Determining the Consideration in the Contract — Variable Payments, Case B — \nVariable Payments That Relate Specifically to a Nonlease Component , in ASC 842 (refer to section 1.4.5, \nExamples — identifying and separating components of a contract and determining and allocating the \nconsideration in the contract ). \nIllustration 1 -14: Allocating the consideration in the contract: variable payments that \nspecifically relate to the non -lease component \nLessee and Lessor enter into a five -year lease of highly specialized equipment that includes specialized \nmaintenance services on the equipment throughout the lease term. Lessee agrees to pay: \n• A fixed payment of $200,000 per year; and \n• A variable payment each year that is based on the number of hours that the equipment is operating \nat specified performance metrics ( i.e., the equipment is not malfu nctioning or inoperable) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 61}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 50 Assume Lessor properly concludes that the variable payments relate specifically to the outcome of its \nperformance of the maintenance services ( i.e., the non -lease component). Lessor evaluates the \nvariable payments in accordance wit h the guidance on variable consideration in ASC 606 and \nestimates, using the expected value method, that it will be entitled to receive $50,000 in variable \npayments (subject to the constraint on variable consideration). Lessor measures the consideration in \nthe contract at $1,050,000 ($200,000 x 5 years + $50,000 of estimated variable payments that \nspecifically relate to the non -lease component). The standalone selling prices for the equipment and \nmaintenance services are $1,350,000 and $200,000, respectivel y. \nScenario 1 \nLessor concludes that allocating the variable payment of $50,000 entirely to the maintenance \nservices would reasonably depict the amount of consideration to which it expects to be entitled in \nexchange for providing the equipment and maintenan ce services ( i.e., this would result in an allocation \nthat is consistent with the transaction price allocation objective in ASC 606-10-32-28). In this case, \nLessor allocates the considerati on in the contract as follows: \nComponent Standalone Price Allocation of \nFixed Payment Allocation of \nVariable Payment Total Allocation \nEquipment lease $ 1,350,000 $ 870,968(a) – $ 870,968 \nMaintenance 200,000 129,032(b) 50,000 179,032 \n $ 1,550,000 $ 1,000,000 $ 50,000 $ 1,050,000 \n(a) (1,350,000/1,550,000) x 1,000,000 \n(b) (200,000/1,550,000) x 1,000,000 \nNote : If the consideration allocated to the maintenance services is significantly higher than the \nstandalone selling price, this may indicate that the allocation is not consistent with t he allocation \nobjective in ASC 606-10-32-28 (i.e., allocating the variable payment entirely to the non -lease \ncomponent may not depict the amount of consideration to which the lessor expects to be entitled in \nexchange for transferring the non -lease componen t). \nScenario 2 \nLessor concludes that allocating the variable payments entirely to the maintenance services would not \nresult in an allocation that is consistent with the allocation objective in ASC 606-10-32-28. In this \ncase, Lessor allocates the entire consideration in t he contract of $1,050,000 between the equipment \nlease ( i.e., lease component) and maintenance services ( i.e., non-lease component) on a relative \nstandalone selling price basis as follows: \nComponent Standalone Price Allocation of \nFixed Payment Allocation of \nVariable Payment Total Allocation \nEquipment lease $ 1,350,000 $ 870,968(a) $ 43,548(c) $ 914,516 \nMaintenance 200,000 129,032(b) 6,452(d) 135,484 \n $ 1,550,000 $ 1,000,000 $ 50,000 $ 1,050,000 \n(a) (1,350,000/1,550,000) x 1,000,000 \n(b) (200,000/1,550,000) x 1,000,000 \n(c) (1,350,000/1,550,000) x 50,000 \n(d) (200,000/1,550,000) x 50,000 ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 62}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 51 Variable payments not included as consideration in the contract \nVariable payments that do not depend on an index or rate ( e.g., performance - or usage -based payments) \nthat relate to the lease component, even partially, are excluded from the consideration in the contract. \nFor example, ASC 842-10-55-152 states that if the quality and condition of the underlying leased asse t \nsubstantively affects whether a lessor receives potential variable payments, such variable payments are \nnot solely related to the non -lease component ( i.e., the potential variable payments are related to the \nlease component, even partially) and are exclu ded from the consideration in the contract. However, \ndetermining whether variable payments relate to the lease component, even partially, may require \nsignificant judgment in many cases. \nWith the issuance of ASU 2018 -20, the FASB clarified that i f the terms of a variable payment amount other \nthan those in ASC 842-10-15-35 (refer to section 1.4.3.1, Determining the consideration in the contract — \nlessees ) relate to the lease component, even partially, lessors do not recognize those payments before the \nchanges in facts and circumstances on which the variable payment is based occur (e.g., when the lessee’s \nsales on which the amount of the variable payment depends occur) . When the changes in facts and \ncircumstances on which the variable payments are ba sed occur , lessors allocate those payments to the \nlease and non -lease components . The allocation is on the same basis as the initial allocation of the \nconsideration in the contract or on the same basis as the most recent reallocation if the contract was \npreviously modified ( ASC 842-10-15-40 and ASC 842-10-55-152) unless the variable payment meets \nthe criteria in ASC 606-10-32-40 to be allocated only to the lease component(s) . \nAfter allocati ng, the amount of variable payments allocated to the lease component is recognized as \nincome in profit or loss in accordance with ASC 842, and the amount allocated to the non -lease \ncomponent is recognized in accordance with other guidance, such as ASC 606. \nIllustration 1 -15: Allocating the consideration in the contract: va riable payments that relate to \nthe lease component even partially \nEntity A (lessee) and Entity B (lessor) enter into a three -year lease of retail space in a mall that \nincludes common area maintenance throughout the lease term. Entity A agrees to pay a fix ed \npayment of $100,000 per year and variable payments based on a percentage of sales. Entity B \nconcludes that variable payments relate, at least partially, to the lease component and, therefore, \nEntity B measures the consideration in the contract at $300,0 00, which excludes the variable \npayments. Entity B allocates the consideration in the contract between the lease and maintenance \nservices on the basis of relative standalone selling prices of each component, which, for purposes of \nthis example, are $350,00 0 and $50,000. \nComponent Standalone Price Allocation Calculation \nRetail lease $ 350,000 $ 262,500 ($350,000/400,000) x 300,000 \nMaintenance 50,000 37,500 ($50,000/400,000) x 300,000 \n $ 400,000 $ 300,000 \nEntity B subsequently allocates the income related to the variable payments between the lease and \nmaintenance services on the same basis as the initial allocation of consideration in the contract or on \nthe same basis as the most recent reallocation if the contract was previousl y modified. \n1.4.4.4 Initial direct costs or contract costs — lessors \nA lessor allocates any capitalized costs ( e.g., initial direct costs or contract costs capitalized in \naccordance with ASC 340-40, Other Assets and Deferred Costs — Contracts with Customers ) to the \nseparate lease components or non -lease components to which those costs relate , unless the lessor applies \nthe practical expedient to not separate lease and non -lease components as discussed in section 1.4.2.4, \nPractical expedient to not separate lease and non -lease components — lessors . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 63}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accoun ting | 52 1.4.4.5 Reassessment: determining and allocating the consideration in the contract — lessors \nExcerpt from Accounting Standards Codification \nLeases — Overall \nScope and Scope Exceptions \n842-10-15-41 \nA lessor shall remeasure and reallocate the remaining consideration in the contract when there is a \ncontract modification that is not accounted for as a separate contract in accordance with paragraph \n842-10-25-8. \n842-10-15-42 \nIf the consideration in the contract changes, a lessor shall allocate those changes in accordance with \nthe requirements in paragra phs 606 -10-32-42 through 32 -45. \n842-10-15-42A \nAs a practical expedient, a lessor may, as an accounting policy election, by class of underlying \nasset, choose to not separate nonlease components from lease components and, instead, to \naccount for each separat e lease component and the nonlease components associated with that \nlease component as a single component if the nonlease components otherwise would be accounted \nfor under Topic 606 on revenue from contracts with customers and both of the following are met: \na. The timing and pattern of transfer for the lease component and nonlease components associated \nwith that lease component are the same. \nb. The lease component, if accounted for separately, would be classified as an operating lease in \naccordance with pa ragraphs 842 -10-25-2 through 25 -3A. \n842-10-15-42B \nA lessor that elects the practical expedient in paragraph 842 -10-15-42A shall account for the \ncombined component: \na. As a single performance obligation entirely in accordance with Topic 606 if the nonlease \ncomponent or components are the predominant component(s) of the combined component. In \napplying Topic 606, the entity shall do both of the following: \n1. Use the same measure of progress as used for applying paragraph 842 -10-15-42A(a) \n2. Account for all variable payments related to any good or service, including the lease, that is \npart of the combined component in accordance with the guidance on variable consideration \nin Topic 606. \nb. Otherwise, as an operating lease entirely in accordance with this Topic. In applying this Topic, the \nentity shall account for all variable payments related to any good or service that is part of the \ncombined component as variable lease pa yments. \nIn determining whether a nonlease component or components are the predominant component(s) of a \ncombined component, a lessor shall consider whether the lessee would be reasonably expected to \nascribe more value to the nonlease component(s) than to t he lease component. \n842-10-15-42C \nA lessor that elects the practical expedient in paragraph 842 -10-15-42A shall combine all nonlease \ncomponents that qualify for the practical expedient with the associated lease component and shall \naccount for the combined component in accordance with paragraph 842 -10-15-42B. A lessor shall \nseparately account for nonlease components that do not qualify for the practical expedient. \nAccordingly, a lessor shall apply paragraphs 842 -10-15-38 through 15 -42 to account for nonlease \ncomponents that do not qualify for the practical expedient. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 64}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 53 Lessors will remeasure and reallocate the remaining consideration in the contract upon a contract \nmodification ( i.e., a change to the terms and conditions of the contract that results in a change in the \nscope of or the consideration for the lease) that is not accounted for as a separate contract. Refer to \nsection 5.6 , Lease modifications . We believe a lessor should update the standalone selling price s used to \nreallocate the consideration in the contract when there is a contract modification that is not accounted \nfor as a separate contract. \nLessors will apply the guidance in ASC 606-10-32-42 through 32 -45 to allocate changes in the consideration \nin the contract t hat are not the result of a modification ( e.g., the consideration in the contract changes if \na lessor concludes in applying ASC 606 that there is a change in the amount it will receive for variable \npayments related to services that are not leases). That gu idance generally requires lessors to allocate the \nsubsequent changes between lease and non -lease components on the same basis as the initial allocation \nof the consideration in the contract (or on the same basis as the most recent reallocation if the contra ct \nwas previously modified). Refer to section 6.5, Changes in transaction price after contract inception , of \nour FRD, Revenue from contracts with customers ( ASC 606) , for a discussion of changes in transaction \nprices after contract inception. Although not considered a change in the consideration in the contract, \nlessors recognize changes to index - and rate -based variable payment s in profit or loss in the period of the \nchange and allocate those changes between lease and non -lease components on the same basis as the \ninitial allocation (or most recent re-allocation) of consideration in the contract. \nRefer to section 3.5.1, Summary o f lease reassessment and remeasurement requirements . Refer to \nsection 1.4.2.4, Practical expedient to not separate lease and non -lease components — lessors , for a \ndiscussion of the lessor practical expedient to combine lease and associated non -lease compon ents. \n1.4.5 Examples — identifying and separating components of a contract and \ndetermining and allocating the consideration in the contract \nASC 842 provides the following examples to illustrate how lessees and lessors identify and separate lease \nand non -lease components of a contract and determine and allocate the consideration in the contract. \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementations Guidance and Illustrations \nExample 11 — Allocation of Consideration to Lease and Nonlease Components of a Contract \nCase A — Allocation of Consideration in the Contract \n842-10-55-132 \nLessor leases a bulldozer, a truck, and a crane to Lessee to be used in Lessee’s construction operations \nfor three years. Lessor also agrees to maintain each piece of equipment throughout the lease term. \nThe total consideration in the contract is $600,000, payable in $200,000 annual installments. \n842-10-55-133 \nLessee and Lessor both conclude that the leases of the bulldozer, the truck, and the crane are each \nseparate lease components because both of the criteria in paragraph 842 -10-15-28 are met. That is: \na. The criterion in paragraph 842 -10-15-28(a) is met because Lessee can benefit from each of the \nthree pieces of equipment on its own or together with other readily available resources (for example, \nLessee could readily lease or purchase an alternative truck or crane to use with the bulldozer). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 65}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 54 b. The criterion in paragraph 842 -10-15-28(b) is met because, despite the fact that Lessee is leasing \nall three machines for one purpose (that is, to engage in construction operations), the machines \nare not highly depe ndent on or highly interrelated with each other. The machines are not, in effect, \ninputs to a combined single item for which Lessee is contracting. Lessor can fulfill each of its \nobligations to lease one of the underlying assets independently of its fulfil lment of the other lease \nobligations, and Lessee’s ability to derive benefit from the lease of each piece of equipment is not \nsignificantly affected by its decision to lease or not lease the other equipment from Lessor. \n842-10-55-134 \nIn accordance with par agraph 842 -10-15-31, Lessee and Lessor will account for the nonlease \nmaintenance services components separate from the three separate lease components (unless \nLessee elects the practical expedient in paragraph 842 -10-15-37 or Lessor elects the practical \nexpedient in paragraph 842 -10-15-42A when the conditions in that paragraph are met — see Case B \n[paragraphs 842 -10-55-138 through 55 -140] for an example in which Lessee elects the practical \nexpedient ). In accordance with the identifying performance obligatio ns guidance in paragraphs 606 -\n10-25-19 through 25 -22, Lessor further concludes that its maintenance services for each piece of \nleased equipment are distinct and therefore separate performance obligations, resulting in the \nconclusion that there are three se parate lease components and three separate nonlease components \n(that is, three maintenance service performance obligations). \n842-10-55-135 \nLessor allocates the consideration in the contract to the separate lease components and nonlease \ncomponents by applyi ng the guidance in paragraphs 606 -10-32-28 through 32 -41. The consideration \nallocated to each separate lease component constitutes the lease payments for purposes of Lessor’s \naccounting for those components. \n842-10-55-136 \nLessee allocates the consideration in the contract to the separate lease and nonlease components. \nSeveral suppliers provide maintenance services that relate to similar equipment such that there are \nobservable standalone prices for the maintenance services for each piece of leased equipment . In \naddition, even though Lessor, who is the manufacturer of the equipment, requires that all leases of \nits equipment include maintenance services, Lessee is able to establish observable standalone prices \nfor the three lease components on the basis of the price other lessors lease similar equipment on a \nstandalone basis. The standalone prices for the separate lease and nonlease components are as follows. \n Lease Maintenance \nBulldozer $ 200,000 $ 50,000 \nTruck 120,000 20,000 \nCrane 240,000 70,000 \n $ 560,000 $ 140,000 \n842-10-55-137 \nLessee first allocates the consideration in the contract ($600,000) to the lease and nonlease \ncomponents on a relative basis, utilizing the observable standalone prices determined in paragraph \n842-10-55-136. Lessee then accounts for each separate lease component in accordance with \nSubtopic 842 -20, treating the allocated consideration as the lease payments for each lease component. \nThe nonlease components are accounted for by Lessee in accordance with other Topics. T he \nallocation of the consideration to the lease and nonlease components is as follows. \n Lease Maintenance \nBulldozer $ 171,429 $ 42,857 \nTruck 102,857 17,143 \nCrane 205,714 60,000 \n $ 480,000 $ 120,000 ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 66}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 55 The following example from ASC 842 assumes the same facts as Case A above except that the lessee has \nmade an accounting policy election to use the practical expedient to not separate non -lease components \nfrom their associated lease components. \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementations Guidance and Illustrations \nExample 11 — Allocation of Consideration to Lease and Nonlease Components of a Contract \nCase B — Lessee Elects Practical Expedient to Not Separate Lease from Nonlease Components \n842-10-55-138 \nAssume the same facts and circumstances as in Case A (paragraphs 842 -10-55-132 through 55 -137), \nexcept that Lessee has made an accounting policy election to use the practical expedient to not \nseparate nonlease from lease components for its leased construction equipment. Consequently, \nLessee does not separate the maintenance services from the related lease components but, instead, \naccounts for the contract as conta ining only three lease components. \n842-10-55-139 \nBecause Lessor regularly leases each piece of equipment bundled together with maintenance services on \na standalone basis, there are observable standalone prices for each of the three combined components, \neach of which includes the lease and the maintenance services. Because each of the three separate lease \ncomponents includes the lease of the equipment and the related maintenance services, the observable \nstandalone price for each component in this scenario is greater than the observable standalone price for \neach separate lease component that does not include the maintenance services in Case A. \n842-10-55-140 \nLessee allocates the consideration in the contract ($600,000) to the three separate lease \ncomponents on a relative basis utilizing the observable standalone selling price of each separate lease \ncomponent (inclusive of maintenance services) and then accounts for each separate lease component \nin accordance with the guidance in Subtopic 842 -20, treating the all ocated consideration as the lease \npayments for each separate lease component. The standalone prices for each of the three combined \nlease components is as follows. \n Relative \n Standalone Standalone \n Price Price \nBulldozer $ 230,000 $ 215,625 \nTruck 130,000 121,875 \nCrane 280,000 262,500 \n $ 640,000 $ 600,000 ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 67}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 56 ASC 842 provides the following examples to illustrate how lessees and lessors identify and separate lease \nand non -lease components of a contract and determine and allocate the consideration in the contract when \nthere are variable payments that relate to the le ase component and the non -lease component. \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementations Guidance and Illustrations \nExample 14 — Determining the Consideration in the Contract — Variable Payments \nCase A — Variable Payments That Relate to the Lease Component and the Nonlease Component \n842-10-55-150 \nLessee and Lessor enter into a three -year lease of equipment that includes maintenance services on the \nequipment throughout the three -year lease term. Lessee will pay Lessor $100,000 per year plus an \nadditional $7,000 each year that the equipment is operating a minimum number of hours at a specified \nlevel of productivity (that is, the equipment is not malfunctioning or inoperable). The potential $7,000 \npayment each year is variable because the payment depends on the equipment operating a minimum \nnumber of hours at a specified level of productivity. The lease is an operating lease. \n842-10-55-151 \nIn accordance with paragraph 842 -10-15-35, variable payments other than those that depend on an \nindex or a rate are not accounted for as consideration in the contract by Lessee. Therefore, the \nconsideration in the contract to be allocated by Lessee to the equipment lease and the maintenance \nservices at lease commencement inclu des only the fixed payments of $100,000 each year (or \n$300,000 in total). Lessee allocates the consideration in the contract to the equipment lease and the \nmaintenance services on the basis of the standalone prices of each, which, for purposes of this \nexam ple, are $285,000 and $45,000, respectively. \n Relative \n Standalone Standalone \n Price Price \n Lease $ 285,000 $ 259,091 \n Maintenance 45,000 40,909 \n $ 330,000 $ 300,000 \nEach $100,000 annual fixed payment and each variable payment are allocated to the equipment \nlease and the maintenance services on the same basis as the initial allocation of the consideration in \nthe contract (that is, 86.4 percent to the equipment lease and 13.6 percent to the maintenance \nservices). Therefore, annual le ase expense, excluding variable expense, is $86,364. Lessee \nrecognizes the expense related to the variable payments in accordance with paragraphs 842 -20-25-6 \nand 842 -20-55-1 through 55 -2. \n842-10-55-152 \nIn accordance with paragraphs 842 -10-15-39 through 15 -40, Lessor also concludes that the potential \nvariable payments should not be accounted for as consideration in the contract. That is because the \npotential variable payment each year is not solely related to performance of the nonlease maintenance \nservices; the quality and condition of the underlying asset also substantively affect whether Lessor will \nearn those amounts. Therefore, Lessor’s allocation of the consideration in the contract ($300,000) in \nthis Example is the same as Lessee. Lessor will allocate, in accordance with paragraph 842 -10-15-40, \nthe variable payments between the lease and nonlease maintenance services (on the same basis as the \ninitial allocation of the consideration in the contract), when and if the productivity targets are met. \nLessor w ill recognize the portion allocated to the lease at that time and will recognize the portion \nallocated to the nonlease maintenance services in accordance with the guidance on satisfaction of \nperformance obligations in Topic 606 on revenue from contracts wi th customers. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 68}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 57 The following example assumes the same facts as Case A above except that the variable payments relate \nspecifically to a non -lease component. \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementations Guidance and Illustrations \nExample 14 — Determining the Consideration in the Contract — Variable Payments \nCase B — Variable Payments That Relate Specifically to a Nonlease Component \n842-10-55-153 \nAssume the same facts and circumstances as in Case A (paragraphs 842 -10-55-150 through 55 -152), \nexcept in this scenario the maintenance services are highly specialized and no entity would expect the \nequipment to meet the performance metrics without the specialized maintenance services. \n842-10-55-154 \nLessee would account for the potential variable payments consistent with Case A. The rationale for this \naccounting also is consistent with that in Case A. \n842-10-55-155 \nIn contrast to Case A, Lessor concludes that the variable payments relate specifically to an outcome from \nLessor’s performance of its maintenance services. Therefore, Lessor evaluates the variable payments in \naccordance with the variable consideration guidance in paragraphs 606 -10-32-5 through 32 -13. If Lessor \nestimates, using the most likely amount method, that it wil l be entitled to receive the $21,000 in variable \npayments and that it is probable that including that amount in the transaction price for the maintenance \nservices would not result in a significant revenue reversal when the uncertainty of the performance bo nus \nis resolved, the $21,000 would be included in the consideration in the contract. Because allocating the \n$21,000 entirely to the maintenance services would not result in an allocation that is consistent with the \nallocation objective in paragraph 606 -10-32-28 (that is, it would result in allocating $61,909 to the \nmaintenance services and the remainder to the equipment lease, which would not reasonably depict the \nconsideration to which Lessor expects to be entitled for each component), the entire considera tion in the \ncontract of $321,000 is allocated on a relative standalone price basis as follows. \n Relative \n Standalone Standalone \n Price Price \n Lease $ 285,000 $ 277,227 \n Maintenance 45,000 43,773 \n $ 330,000 $ 321,000 \n842-10-55-156 \nThe $277,227 allocated to the equipment lease is the lease payment in accounting for the lease in \naccordance with Subtopic 842 -30. Lessor will recognize the consideration in the contract allocated to the \nmaintenance services in accordance wit h the guidance on the satisfaction of performance obligations in \nparagraphs 606 -10-25-23 through 25 -37. If the consideration in the contract changes (for example, \nbecause Lessor no longer estimates that it will receive the full $21,000 in potential variabl e payments), \nLessor will allocate the change in the transaction price on the same basis as was initially done. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 69}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Leas e accounting | 58 The following example assumes the same facts as Case B above except that the variable payments relate \nspecifically to a non -lease component. \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementations Guidance and Illustrations \nExample 14 — Determining the Consideration in the Contract — Variable Payments \nCase C — Allocating Variable Payments Entirely to a Nonlease Component \n842-10-55-157 \nAssume the same facts and circumstances as in Case B (paragraphs 842 -10-55-153 through 55 -156), \nexcept that in this scenario all of the following apply: \na. The potential variable payments are $14,000 per year ($42,000 in total), and the annual fixed \npayments are $93,000 per year ($279,000 in total). \nb. While Lessor’s estimate of the variable payments to which it will be entitled is $42,000, Lessor \nconcludes that it is not probable that including the full $42,000 in potential variable payments in \nthe consideration in the contract will not result in a significant revenue reversal (that is, the entity \napplies the constraint on variable consideration in paragraph 606 -10-32-11). Lessor concludes \nthat only $28,000 is probable of not resulting in a significant revenue reversal. Therefore, the \nconsideration in the contract is initially $307,000 ($279,000 + $28,000). \n842-10-55-158 \nIn contrast to Case B, Lessor concludes that allocating the variable payments entirely to the maintenance \nservices and the fixed payments entirely to the equipment lease is consistent with the allocation objective \nin paragraph 606 -10-32-28. This is because $42,000 (Lessor considers its estimate of th e variable \npayments to which it expects to be entitled exclusive of the constraint on variable consideration in \nTopic 606 on revenue recognition) and $279,000 approximate the standalone price of the maintenance \nservices ($45,000) and the equipment lease ($ 285,000), respectively. Because the variable payments \nare allocated entirely to the maintenance services, if the consideration in the contract changes (for \nexample, because Lessor concludes it is now probable that it will earn the full $42,000 in variable \npayments), that change is allocated entirely to the maintenance services component in the contract. \n1.5 Contract combinations \nExcerpt from Accounting Standards Codification \nLeases — Overall \nRecognition \n842-10-25-19 \nAn entity shall combine two or more contracts , at least one of which is or contains a lease , entered \ninto at or near the same time with the same counterparty (or related parties) and consider the \ncontracts as a single transaction if any of the following cr iteria are met: \na. The contracts are negotiated as a package with the same commercial objective(s). \nb. The amount of consideration to be paid in one contract depends on the price or performance of \nthe other contract. \nc. The rights to use underlying assets conveyed in the contracts (or some of the rights of use conveyed \nin the contracts) are a single lease component in accordance with paragraph 842 -10-15-28. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 70}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 59 ASC 842 requires that two or more contracts entered into at or near the same time with the same \ncoun terparty (or related party) be considered a single contract if at least one of the contracts is or \ncontains a lease and any one of the following criteria is met: \n• The contracts are negotiated as a package with the same commercial objective(s). \n• The amount of consideration to be paid in one contract depends on the price or performance of the \nother contract. \n• The rights to use the underlying assets conveyed in the contracts (or some of the rights of use \nconveyed in the contracts) are a single lease component (refer to section 1.4.1, Identifying and \nseparating lease components of a contract ). \nThe FASB indicated in the Basis for Conclusions (BC 165) of ASU 2016 -02 that it developed these \ncriteria to address concerns that separately accounting for multiple contracts may not result in a faithful \nrepresentation of the combined transaction. \n1.6 Lease broker transacti ons \nThe difficulty in accounting for lease broker transactions is often determining whether the broker transaction \nis in substance a lease. In certain leasing transactions, a lease broker acts as an intermediary between the \nlessor and the lessee. The lease broker fee arrangement can be a relatively simple one where a lump -sum \ncash payment is paid to the broker at closing (when all or substantially all of the services were rendered, and \nthe broker has no future service commitments or obligations associated w ith the lease). In certain more \ncomplex leasing transactions, lease brokers often assume additional risks, offer additional services and \nsometimes receive additional benefits and compensation in various forms. Lease broker participation in the \nterms of the lease may be so extensive that the broker appears to be a lessor or a lessee and not merely \nan intermediary. As a result, what is intended to be a lease broker transaction may in certain cases be \nconsidered a lease. Alternatively, a lease broker may merel y serve as an intermediary in substance. \n1.7 Acquisition of lease residual values \nThe following issues related to accounting for the purchase of lease interests or residual values are \ndiscussed in ASC 360, Property, Plant, and Equipment . \nExcerpt from Acco unting Standards Codification \nLeases — Lessor \nDerecognition \n842-30-40-4 \nFor guidance on the acquisition of the residual value of an underlying asset by a third party, see \nparagraph 360 -10-25-2. \nProperty, Plant, and Equipment — Overall \nRecognition \n360-10-25-2 \nThis Section provides guidance on how a third -party entity shall account for the following: \na. The acquisition from a lessor of the unconditional right to own and possess, at the end of the \nlease term, an asset subject to a lease \nb. The acquisition of the right to receive all, or a portion, of the proceeds from the sale of a leased \nasset at the end of the lease term. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 71}), Document(page\_content="1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 60 360-10-25-3 \nAt the date the rights in the preceding paragraph are acquired, both transactions involve a right to \nrecei ve, at the end of the lease term, all, or a portion, of any future benefit to be derived from the \nleased asset and shall be accounted for as the acquisition of an asset. Both transactions are referred \nto as the acquisition of an interest in the residual va lue of a leased asset. \n360-10-25-4 \nAn interest in the residual value of a leased asset shall be recorded as an asset at the date the right \nis acquired. \nInitial Measurement \n360-10-30-3 \nAn interest in the residual value of a leased asset recognized under par agraph 360 -10-25-4 shall be \nmeasured initially at the amount of cash disbursed, the fair value of other consideration given, and the \npresent value of liabilities assumed. \n360-10-30-4 \nThe fair value of the interest in the residual value of the leased asset at the date of the agreement shall \nbe used to measure its cost if that fair value is more clearly evident than the fair value of assets \nsurrendered, services rendered, or liabilities assumed. \nSubsequent Measurement \n360-10-35-13 \nThe following paragraph provides guidance on how an entity acquiring an interest in the residual value \nof a leased asset shall account for that asset during the lease term. \n360-10-35-14 \nAn entity acquiring an interest in the residual value of any leased asset, irrespect ive of the classification \nof the related lease by the lessor, shall not recognize increases to the asset's estimated value over the \nremaining term of the related lease, and the asset shall be reported at no more than its acquisition cost \nuntil sale or disp osition. If it is subsequently determined that the fair value of the residual value of a \nleased asset has declined below the carrying amount of the acquired interest and that decline is other \nthan temporary, the asset shall be written down to fair value, a nd the amount of the write -down shall be \nrecognized as a loss. That fair value becomes the asset's new carrying amount, and the asset shall not \nbe increased for any subsequent increase in its fair value before its sale or disposition. \nThe acquisition of t he unconditional right to own and possess, at the end of the lease term, an asset \nsubject to a lease or the right to receive all, or a portion, of the proceeds from the sale of a leased asset \nat the end of the lease are both transactions involving a right to receive all, or a portion, of any future \nbenefit to be derived from the leased asset and should be accounted for as the acquisition of an asset. \nFor the remainder of this section, both transactions are referred to as the acquisition of an interest in th e \nresidual value of a leased asset. \nAn interest in the residual value of a leased asset should be recorded as an asset at the amount of cash \ndisbursed, the fair value of other consideration given and the present value of liabilities assumed at the \ndate the right is acquired. The fair value of the interest in the residual value of the leased asset at the \ndate of the agreement should be used to measure its cost if that fair value is more clearly evident than \nthe fair value of assets surrendered, services rend ered or liabilities assumed. ", metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 72}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 61 An enterprise acquiring an interest in the residual value of any leased asset, irrespective of the \nclassification of the related lease by the lessor, should not recognize increases to the asset’s estimated \nvalue over the remain ing term of the related lease, and the asset should be reported at no more than its \nacquisition cost until sale or disposition. If it is subsequently determined that the fair value of the residual \nvalue of a leased asset has declined below the carrying amo unt of the acquired interest and that decline \nis other than temporary, the asset should be written down to fair value, and the amount of the write -\ndown should be recognized as a loss. That fair value becomes the asset’s new carrying amount, and the \nasset s hould not be increased for any subsequent increase in its fair value prior to its sale or disposition. \nAn interest in the residual value of a leased asset acquired by a lease broker for cash, liabilities assumed \nand the fair value of other consideration gi ven, including services rendered, should be accounted for \nunder this guidance. \n1.8 Service concession arrangements \nExcerpt from Accounting Standards Codification \nService Concession Arrangements — Overall \nOverview and Background \nGeneral \n853-10-05-1 \nA service concession arrangement is an arrangement between a grantor and an operating entity for \nwhich the terms provide that the operating entity will operate the grantor’s infrastructure (for \nexample, airports, roads, bridges, tunnels, prison s, and hospitals) for a specified period of time. The \noperating entity may also maintain the infrastructure. The infrastructure already may exist or may be \nconstructed by the operating entity during the period of the service concession arrangement. If the \ninfrastructure already exists, the operating entity may be required to provide significant upgrades as \npart of the arrangement. Service concession arrangements can take many different forms. \n853-10-05-2 \nIn a typical service concession arrangement, an opera ting entity operates and maintains for a period of \ntime the infrastructure of the grantor that will be used to provide a public service. In exchange, the \noperating entity may receive payments from the grantor to perform those services. Those payments may \nbe paid as the services are performed or over an extended period of time. Additionally, the operating \nentity may be given a right to charge the public (the third -party users) to use the infrastructure. The \narrangement also may contain an unconditional guara ntee from the grantor under which the grantor \nprovides a guaranteed minimum payment if the fees collected from the third -party users do not reach \na specified minimum threshold. This Topic provides guidance for reporting entities when they enter \ninto a serv ice concession arrangement with a public sector grantor who controls or has the ability to \nmodify or approve the services that the operating entity must provide with the infrastructure, to whom \nit must provide them, and at what price (which could be set wi thin a specified range). The grantor also \ncontrols, through ownership, beneficial entitlement, or otherwise, any residual interest in the \ninfrastructure at the end of the term of the arrangement. \nA service concession arrangement is an arrangement between a grantor and an operating entity that \noperates the grantor’s infrastructure for a specified period of time. Such arrangements may take various \nforms. A service concession arrangement within the sc ope of ASC 853 involves a public -sector entity \ngrantor contracting with an operating entity to provide a public service, and the arrangement meets two \nadditional criteria described in ASC 853-10-15-3 as discussed below. A public -sector entity grantor may \nbe a governmental body ( e.g., a municipal government, a state government) or another entity to which a \ngovernmental body has delegated responsibility for providing a public service ( e.g., a regional airport \nauthority, a municipal transportation authority). Under such arrangements, the operating entity generally ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 73}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 62 operates and maintains the public -sector entity’s infrastructure ( e.g., a highway, bridge, parking facility, \npower plant, hospital) that fulfills a public service for a period of time, in exchange for consideration \n(e.g., payments from the grantor, the right to charge third -party users of the assets). The operating entity \nmay also construct the public -sector entity’s infrastructure or upgrade the existing infrastructure. \nAlthough service concession arr angements historically have not been widely entered into either in the US \nor generally by US reporting entities, these arrangements are becoming more prevalent in certain \nindustries , particularly in the energy and construction sectors ( e.g., entities invol ved with assets such as \npower plants or bridges). However, all entities should evaluate each arrangement with a public -sector \nentity to determine whether the arrangement is in the scope of this guidance. Additionally, entities with \nequity method investees should also consider the accounting effects of their investees’ service \nconcession arrangements, if any. \nExcerpt from Accounting Standards Codification \nService Concession Arrangements — Overall \nScope and Scope Exceptions \nGeneral \n853-10-15-2 \nThe guidance in this Topic applies to the accounting by operating entities of a service concession \narrangement under which a public -sector entity grantor enters into a contract with an operating entity \nto operate the grantor’s infrastructure. The operating entity also may provide the construction, \nupgrading, or maintenance services of the grantor’s infrastructure. \nASC 853 applies only to an operating entity in a service concession arrangement that has the \nresponsibility to provide a public service and involves a public -sector entity grantor (grantor) that meets \nthe following two conditions: \n• The grantor controls or has the ability to modify or approve the services that the operating entity \nmust provide with the infrastructure, to wh om it must provide them and at what price. \n• The grantor controls, through ownership, beneficial entitlement or otherwise, any residual interest in \nthe infrastructure at the end of the term of the arrangement. \nPublic service \nA feature of a service concession arrangement is that an operating entity provides a public service on \nbehalf of a governmental entity. However, ASC 853 does not provide a framework for determining \nwhether an arrangement between a grantor and an operating entity provides a public service or is a \nnormal supplier -customer arrangement between two unrelated parties. \nIn some circumstances, it may be clear that the operating entity is providing a public service on behalf of \na governmental entity ( e.g., operating a highway used by the general pub lic). However, judgment may be \nrequired when determining the substance of the arrangement. \nASC 853 also does not provide a framework for evaluating whether the grantor controls or has the ability \nto modify or approve the public services that must be provid ed, to whom they must be provided and at \nwhat price. To be in the scope of ASC 853, we believe the grantor should have the substantive ability to \ncontrol, modify or approve: \n• The public services that the operator must provide, \n• To whom those public services must be provided, and \n• At what price those public services must be provided. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 74}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 63 All three conditions must be met. Therefore, the terms and conditions of each arrangement, including \nthe rights of the operating entity and grantor, should be evaluated ca refully. For example, even though \nthe operating entity may have certain managerial or day -to-day decision -making abilities in providing the \nrequired services ( e.g., constructing, operating and maintaining a toll road), the grantor may retain the \nunilateral ability to control, modify or approve the services that the operating entity must provide with \nthe infrastructure, to whom it must provide them, and at what price. \nImportantly, a grantor need only have the ability to control, modify or (emphasis added ) approve each of \nthe conditions above. For example, a grantor may not control each condition in a contract where such \nconditions are agreed to up front ( i.e., agreed to by both parties to the contract). However, the grantor may \nhave to approve any changes, in dicating the approval criteria would be met. \nWhen assessing whether the grantor controls or has the ability to set, modify or approve the price of the \nservice provided, the arrangement need not establish a specific price. As described in ASC 853-10-05-2, \nthe price in a service concession arrangement “could be set within a specified range.” Such \narrangements should be evaluated to determine if the grantor set or approved the initially established \nprice range and if it can also modify or must approve any subs equent price changes outside that range. \nControl of the residual interest \nThe contractual terms of the arrangement will generally specify whether the grantor or the operating \nentity controls through ownership (or other means) any residual interest in the i nfrastructure at the end \nof the term of the arrangement. We believe control of the residual interest is generally evidenced within \nthe contractual arrangements ( e.g., an automatic transfer; a substantive option allowing the government \nto purchase the asset ; circumstances when the governmental entity can determine how the asset will be \ndisposed of or transferred at the end of the arrangement). \nAccounting for a service concession arrangement \nFor service concession arrangements that are in the scope of ASC 853, the operating entity should not \naccount for the arrangement as a lease ( i.e., in accordance with ASC 842) and should not recognize the \ninfrastructure as property, plant and equipment ( i.e., in accordance with ASC 360). Instead, the \noperating entity in the scope of ASC 853 should account for revenue from service concession arrangements \nin accordance with ASC 606. The accounting under ASC 606 may be similar to other non -lease service \nand management contracts where a party manages property or equipment on behalf of the owner. \nThe operating entity sh ould refer to other US GAAP to account for the various other aspects of a service \nconcession arrangement. The FASB did not specify which other aspects of US GAAP should be applied to \nservice concession arrangements within the scope of ASC 853, except to say that service concession \narrangements in the scope of both ASC 853 and ASC 980, Regulated Operations , should be a ccounted \nfor using ASC 980 instead of ASC 853. Refer to section 1.8.1, Service concession arrangements in \nregulated operations , for additional information about service concession arrangements that may also be \nwithin the scope of ASC 980. \nArrangements not in the scope of ASC 853 should first be evaluated by the operating entity using the \ncriteria in ASC 842 to determine whether lease accounting is appropriate. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 75}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 64 The following example is provided to assist with the application of the service concession arrange ments \nscope guidance in ASC 853-10-15-1 through 15 -3: \nIllustration 1 -16: Accounting for a service concession arrangement \nCompany Q (Company Q or operating entity) enters into an arrangement with the State X Department of \nTransportation (referred to as the DOT), State X’s governmental entity responsible for its public highways. \nUnder the terms of the arrangement, Company Q will be required to perform the following services: \nconstruct, operate and maintain the DOT’s toll highway for a period of 20 years. The arrangement \ndoes not contain any renewal periods. \nThe DOT will control any residual interest in the highway at the end of the 20 -year contractual period. \nThe arrangement requ ires Company Q to operate the toll highway by allowing the public to access and \ntravel upon the constructed highway ( i.e., a public service) in exchange for a toll that will be collected \nfrom each vehicle. The arrangement does not provide Company Q with an y rights to unilaterally \nchange the services that it must provide with the highway ( e.g., roadway maintenance, emergency \naccess and services, rest area concessions) or to who m it must provide the services. \nThe arrangement initially sets the toll within a s pecified range, determined by the DOT, of $0.50 to \n$1.00 per vehicle. Future changes to the toll amount ( i.e., price changes outside the specified range) \nrequire the DOT’s approval. \nAnalysis : The arrangement is a service concession arrangement. The arrange ment involves an \noperating entity (Company Q) contracting with a public -sector entity grantor (the DOT) to provide a \npublic service, and the following two conditions are met: \nThe DOT controls or has the ability to modify or approve the services that the op erating entity must \nprovide with the toll highway, to whom it must provide them and at what price. \nThe DOT controls, through ownership, beneficial entitlement or otherwise, any residual interest in the \ntoll highway at the end of the term of the arrangement . \nBecause the arrangement meets both criteria above, it is in the scope of ASC 853. Therefore, Company Q \nshould not account for the service concession arrangement as a lease in accordance with ASC 842. \nAdditionally, Company Q should not recognize the highw ay as its property, plant and equipment in \naccordance with ASC 360. Instead, Company Q should refer to other US GAAP to account for the \naspects of the arrangement ( e.g., revenue recognition guidance to account for tolls collected). \n1.8.1 Service concession arrangements in regulated operations \nExcerpt from Accounting Standards Codification \nService Concession Arrangements — Overall \nScope and Scope Exceptions \nGeneral \n853-10-15-4 \nA service concession arrangement that meets the scope criteria in Topic 980 on regulated operations \nshall apply the guidance in that Topic and not follow the guidance in this Topic. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 76}), Document(page\_content='1 Scope and scope exceptions \nFinancial reporting developments Lease accounting | 65 A common characteristic between regulated operations and service concession arrangements is that the \ngrantor ( i.e., the regulator in the ca se of regulated operations) determines the price that can be charged for \nthe service. However, in regulated operations, the operating entity often controls the residual interest in the \ninfrastructure ( i.e., the infrastructure is often owned by the operatin g entity). Therefore, such arrangements \nin regulated operations generally would not be in the scope of ASC 853. In circumstances when the \narrangement would otherwise be in the scope of both ASC 853 and ASC 980 ( e.g., an arrangement with an \noperating entity where the grantor is a state -owned utility that retains control over any residual interest in \nthe infrastructure), the FASB specified that the service concession arrangement should be accounted for \nusing the guidance in ASC 980 ( i.e., the guidance in ASC 853 should not be applied to such arrangements). \nRefer to ASC 980 for additional information about determining whether an arrangement is in the scope of \nthat standard and for guidance about the recognition and measure ment of such arrangements. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 77}), Document(page\_content=' \nFinancial reporting developments Lease accounting | 66 2 Key concepts \nLessees and lessors generally apply the same key concepts for purposes of identifying, classifying, \nrecognizing and measuring lease contracts. \n2.1 Inception of a contract \nExcerpt from Accounting Standards Codification \nLeases — Overall \nScope and Scope Exce ptions \n842-10-15-2 \nAt inception of a contract , an entity shall determine whether that contract is or contains a lease . \nASC 842-10-15-2 requires customers and suppliers to determine, at contract inception, whether a \ncontract is a lease or contains a lease. Entities should consider other US GAAP to determine how to \naccount for and disclose the existence of rights or obligations created between the inception of a \ncontract that is or contains a lease and the commencement date of the lease ( e.g., disclosures required \nby ASC 440, Commitments , or ASC 460, Guarantees ). \n2.2 Commencement date of the lease \nExcerpt from Accounting Standards Codification \nMaster Glossary \nCommencement Date of the Lease (Commencement Date) \nThe date on which a lessor makes an underlying asset available for use by a lessee . See paragraphs \n842-10-55-19 through 55 -21 for implementation guidance on the commencement date. \nUnderlying Asset \nAn asset that is the subject of a lease for which a right t o use that asset has been conveyed to a \nlessee . The underlying asset could be a physically distinct portion of a single asset. \nLeases — Overall \nImplementation Guidance and Illustrations \n842-10-55-19 \nIn some lease arrangements, the lessor may make the underlying asset available for use by the lessee \n(for example, the lessee may take possession of or be given control over the use of the underlying \nasset) before it begins operations or makes lease payments under the terms of the lease. Durin g this \nperiod, the lessee has the right to use the underlying asset and does so for the purpose of constructing \na lessee asset (for example, leasehold improvements). \n842-10-55-20 \nThe contract may require the lessee to make lease payments only after constru ction is completed and \nthe lessee begins operations. Alternatively, some contracts require the lessee to make lease payments \nwhen it takes possession of or is given control over the use of the underlying asset. The timing of when \nlease payments begin under the contract does not affect the commencement date of the lease. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 78}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 67 The commencement date is the date on which the lessor makes an underlying asset ( i.e., the property, \nplant or equipment that is subject to the lease) available for use by the lessee. In som e cases, the \ncommencement date of the lease may be before the date stipulated in the lease agreement ( e.g., the \ndate rent becomes due and payable). This often occurs when the underlying asset is modified by the \nlessee prior to commencing operations with the underlying asset (e.g., during the period a lessee uses \nleased space to construct its own leasehold improvements). In making the assessment of lease \ncommencement, it will often be necessary to distinguish between lessee and lessor assets (refer to \nsectio n 2.11, Improvements to the underlying asset ). \nIf a lessee takes possession of, or is given control over, the use of the underlying asset before it begins \noperations or before it begins making lease payments under the terms of the lease, the lease term has \ncommenced even if the lessee is not required t o pay rent or the lease arrangement states the lease \ncommencement date is a later date. As a result, the straight -line rent computation for operating leases \nmust include the deemed rent holiday period (refer to section 4.2.2, Subsequent measurement — \nopera ting leases, for a discussion of the subsequent measurement of an operating lease by a lessee and \nsection 5.4.1, Time pattern of use of property in an operating lease , for a discussion of recognition of \nrevenue for an operating lease by a lessor). The timi ng of when lease payments begin under the contract \ndoes not affect the commencement date of the lease. For example, a lessee (except lessees applying the \nshort -term lease election discussed in section 4.1.1, Short -term leases ) initially recognizes a lease liability \nand related right -of-use asset on the commencement date, and a lessor (for direct financing and most \nsales -type leases) initially recognizes its net investment in the lease on the commencement date. \nIllustration 2 -1: Determinin g the lease commencement date \nScenario A \nAssume that Entity A (the lessee) leases existing office space from Entity B (the lessor) , and both parties \nexecute the lease on 1 December 20X6. Entity B provides Entity A with access to the space on 1 \nFebruary 2 0X7 so that Entity A can begin to construct its own leasehold improvements (i.e., the \nimprovements are lessee assets) . On 1 June 20X7, following substantial completion of construction of \nthe leasehold improvements, the office space is in a condition for Entity A to begin using it for its \noperations and makes its first rental payment to Entity B. \nAnalysis: The lease commencement date is 1 February 20X7, the date on which Entity B made the \nunderlying asset available for use by Entity A. On the commencement date ( i.e., 1 February 20X7), \nthe lessee would generally recognize a right -of-use asset and a lease liability (refer to section 4, \nLessee accounting ) and the lessor (for direct financing and most sales -type leases) recognizes its net \ninvestmen t in the lease. Additionally, the lease commencement date would be 1 February 20X7 \nregardless of who is con structing the lessee owned leasehold improvement s (i.e., the le ssee , the lessor \nor a third party) and whether the lessor is finishing minor construct ion activities on the underlying \nasset after the lessee is granted access . \nScenario B \nAssume the same facts as in Scenario A, except that the improvements being constructed by Entity A \nare lessor assets (i.e., they are not leasehold improvements of Entity A). \nAnalysis : The lease commencement date is 1 June 20X7, the date on which Entity B made the \nunderlying asset available for use by Entity A. On the commencement date ( i.e., 1 June 20X7), the \nlessee would generally recognize a right -of-use asset and a lease liability (refer to section 4, Lessee \naccounting ) and the lessor (for direct financing and most sales -type leases) recognizes its net \ninvestment in the lease. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 79}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 68 2.2.1 Lease commencement date for master lease agreements \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \n842-10-55-17 \nUnder a master lease agreement, the lessee may gain control over the use of additional underlying \nassets during the term of the agreement. If the agreement specifies a minimum number of units or \ndollar value of equipment, the lessee obtaining control over the use of those additional underlying \nassets is not a lease modification . Rather, the entity (whether a lessee or a lessor ) applies the \nguidance in paragraphs 842 -10-15-28 through 15 -42 when identifying the separate lease components \nand allocating the consideration in the contract to those compon ents. Paragraph 842 -10-55-22 \nexplains that a master lease agreement may, therefore, result in multiple commencement dates . \n842-10-55-22 \nThere may be multiple commencement dates resulting from a master lease agreement. That is \nbecause a master lease agreeme nt may cover a significant number of underlying assets , each of \nwhich are made available for use by the lessee on different dates. Although a master lease agreement \nmay specify that the lessee must take a minimum number of units or dollar value of equipmen t, there \nwill be multiple commencement dates unless all of the underlying assets subject to that minimum are \nmade available for use by the lessee on the same date. \nA master lease agreement is a lease under which a lessee may gain control over the use of a dditional \nunderlying assets during the term of the agreement. In certain cases, a master lease agreement specifies \nminimum and maximum equipment dollars or quantities that can be required to be leased. If the \nagreement specifies a minimum number of units o r dollar value of equipment, the lessee obtaining \ncontrol over the use of those additional underlying assets is not a lease modification. \nThere will be multiple commencement dates resulting from a master lease agreement unless all of the \nunderlying assets are made available for use by the lessee on the same date (refer to section 1.4.1, \nIdentifying and separating lease components of a contract , for discussion of when multiple assets may be \naccounted for as a single lease component). Entities would determine the commencement date for each \nunderlying asset subject to a master lease agreement based on the date each underlying asset is made \navailable for use by a lessee (refer to section 2.2, Commencement date of the lease ). \n2.3 Lease term and purchase options \n2.3.1 Lease term \nExcerpt from Accounting Standards Codification \nMaster Glossary \nLease Term \nThe noncancellable period for which a lessee has the right to use an underlying asset , together with \nall of the following: \na. Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise \nthat option \nb. Periods covered by an option to terminate the lease if the lessee is reasonably certain not to \nexercise that option \nc. Periods covered by an opt ion to extend (or not to terminate) the lease in which exercise of the ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 80}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 69 option is controlled by the lessor . \nLeases — Overall \nInitial Measurement \n842-10-30-1 \nAn entity shall determine the lease term as the noncancellable period of the lease , together with all of \nthe following: \na. Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise \nthat option \nb. Periods covered by an option to terminate the lease if the le ssee is reasonably certain not to \nexercise that option \nc. Periods covered by an option to extend (or not to terminate) the lease in which exercise of the \noption is controlled by the lessor . \n842-10-30-2 \nAt the commencement date , an entity shall include the periods described in paragraph 842 -10-30-1 in \nthe lease term having considered all relevant factors that create an economic incentive for the lessee \n(that is, contract -based, asset -based, entity -based, and market -based factors). Those factors shall be \ncons idered together, and the existence of any one factor does not necessarily signify that a lessee is \nreasonably certain to exercise or not to exercise an option. \nImplementation Guidance and Illustrations \n842-10-55-25 \nThe lease term begins at the commencement date and includes any rent -free periods provided to the \nlessee by the lessor. \n842-10-55-26 \nAt the commencement date , an entity assesses whether the lessee is reasonably certain to exercise \nor not to exercise an option by considering all economic factors r elevant to that assessment —contract -\nbased, asset -based, market -based, and entity -based factors. An entity’s assessment often will require \nthe consideration of a combination of those factors because they are interrelated. Examples of \neconomic factors to con sider include, but are not limited to, any of the following: \na. Contractual terms and conditions for the optional periods compared with current market rates, \nsuch as: \n1. The amount of lease payments in any optional period \n2. The amount of any variable leas e payments or other contingent payments, such as \npayments under termination penalties and residual value guarantees \n3. The terms and conditions of any options that are exercisable after initial optional periods (for \nexample, the terms and conditions of a purchase option that is exercisable at the end of an \nextension period at a rate that is currently below market rates). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 81}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 70 b. Significant leasehold improvements that are expected to have significant economic value for the \nlessee when the option to extend or terminate the lease or to purchase the underlying asset \nbecomes exercisable. \nc. Costs relating to the termination of the lea se and the signing of a new lease, such as negotiation \ncosts, relocation costs, costs of identifying another underlying asset suitable for the lessee’s \noperations, or costs associated with returning the underlying asset in a contractually specified \nconditi on or to a contractually specified location. \nd. The importance of that underlying asset to the lessee’s operations, considering, for example, \nwhether the underlying asset is a specialized asset and the location of the underlying asset. \n \nThe lease term begins at the lease commencement date and is determined on that date based on the \nnoncancelable term of the lease, together with all of the following: \n• Periods covered by an option to extend the lease if the lessee is reasonably certain to exerc ise that option \n• Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise \nthat option (that is, the lease term includes the period after the date of the termination option if the \nlessee is reasonably certain it will not exercise the option to terminate the lease) \n• Periods covered by an option to extend (or not terminate) the lease in which the exercise of the \noption is controlled by the lessor \nThe FASB indicated in the Basis for Conclusions (BC 195) of ASU 2016 -02 that the phrase “reasonably \ncertain” is generally interpreted as a high threshold . Refer to section 2.3.5, Evaluating lease term and \npurchase options , for further discussion on evaluating whether a lessee is reasonably certain to exercise \nan option to re new the lease, not terminate the lease or purchase the underlying asset. \n2.3.1.1 Nonconsecutive periods of time \nLessees may enter into lease contracts for nonconsecutive periods of time. These arrangements meet \nthe definition of a lease if the customer controls the right to use an identified asset throughout the \nagreed period of use in exchange for consideration. In these cases, the leas e term is the sum of the \nnonconsecutive periods of time. For example, a retailer may enter into a noncancelable lease to use the \nsame retail space for the months of October, November and December of each year for a period of five \nyears. In this example, th e lease term at the commencement date of the lease is 15 months (three \nmonths per year for the five annual periods specified in the contract). \nLease term \nAny noncancelable periods \nPeriods covered by an option to extend the lease \nif the lessee is reasonably certain to exercise that option \nPeriods covered by an option to terminate the lease if the lessee \nis reasonably certain not to exercise that option \nPeriods covered by an option to exte nd (or not terminate) the lease \nin which the exercise of the option is controlled by the lessor ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 82}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 71 2.3.2 Purchase options \nExcerpt from Accounting Standards Codification \nLeases — Overall \nInitial Measurement \n842-10-30-3 \nAt the commencement date, an entity shall assess an option to purchase the underlying asset on the \nsame basis as an option to extend or not to terminate a lease, as described in paragraph 842 -10-30-2. \nPurchase options should be assessed in the same way as options to extend the lease term or terminate \nthe lease. The FASB indicated in the Basis for Conclusions (BC 218) of ASU 2016 -02 that an option to \npurchase an underlying asset is economically similar t o an option to extend the lease term for the \nremaining economic life of the underlying asset. When a lease contains a purchase option and the lessee is \nreasonably certain to exercise that option, the lease is classified as a finance lease by a lessee and a sales -\ntype lease by a lessor. Refer to section 3.1 , Criteria for lease classification — lessees, or section 3.2, \nCriteria for lease classification — lessors . \n2.3.3 Cancelable leases \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \n842-10-55-23 \nAn entity should determine the noncancellable period of a lease when determining the lease term . \nWhen assessing the length of the noncancellable period of a lease, an entity should apply the definition \nof a contract and determine the period for which the contract is enforceable. A lease is no longer \nenforceable when both the lessee and the lessor each have the right to terminate the lease without \npermission from the other party with no more than an insignificant penalty . \n842-10-55-24 \nIf only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the \nlease available to the lessee that an entity considers when determining the lease term, as described in \nparagraph 842 -10-30-1(b). If only a lessor has the right to terminate a lease, the lease term includes the \nperiod covered by the option to terminate the lea se, as described in paragraph 842 -10-30-1(c). \nASC 842 applies to contracts that are referred to as “cancellable,” “month -to-month,” “at -will,” \n“evergreen,” “perpetual” or “rolling” if they create enforceable rights and obligations. An arrangement is \nnot e nforceable if both the lessee and the lessor each have the right to terminate the lease without \npermission from the other party and with no more than an insignificant penalty. \nAny noncancelable periods (by the lessee and the lessor) in contracts that meet the definition of a lease \nare considered part of the lease term. If only a lessor has the right to terminate a lease, the period \ncovered by the option to terminate the lease is included in the noncancelable period of the lease. The \nlikelihood of the lessor exercising the termination option is not considered in evaluating the potential \nimpact on the lease term. If only a lessee has the right to terminate a lease, that right is a termination \noption that is considered when determining the lease term. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 83}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 72 Illustrat ion 2 -2: Cancelable leases \nScenario A \nA lease has an initial noncancelable period of one year and will be exten ded for an additional year under \nterms specified in the contract if both the lessee and the lessor agree. There is no penalty1 if the lessee \nand the lessor do not agree to extend the term. \nAnalysis: The initial one -year noncancelable period meets the definition of a contract because it creates \nenforceable rights and ob ligations. However, the one -year extension period does not meet the \ndefinition of a contract because both the lessee and the lessor could unilaterally elect not to extend \nthe arrangement without a more than insignificant penalty . 1 \nScenario B \nA lease has a n initial period of five years but can be terminated at the end of the third year at the \noption of the lessor. The lessee’s consent is not required for the termination option to be exercised. \nAnalysis : The lease term consists of the initial five -year period because it creates enforceable rights \nand obligations that can only be terminated by the lessor. \nScenario C \nA lease has an ini tial noncancelable period of two year s. Neither the lessee nor the lessor can cancel \nthe contract before the end of the second year. At the end of the second year, the contract \nautomatically extends on a month -to-month basis for up to three years, unless either the lessor or the \nlessee exercises its unilateral right to terminate th e contract. That is, after the second year, both the \nlessee and lessor have a right to terminate the lease without permission from the other party . \nFurther, assume the following as of the lease commencement date: \n• The terms and conditions for the lease ( e.g., lease payments) for the monthly periods in years \nthree through five are included in the contract. \n• The lessor would not suffer a more than insignificant penalty1 if it terminated the contract at any \ntime after the initial two years. \n• Due to the unique purpose and location of the underlying asset and the significance of the lessee’s \nleasehold improvements, the lessee would suffer a more than insignificant pe nalty1 if it were to \nexercise its termination rights before the end of the third year . The lessee also concludes it is \nreasonably certain not to terminate the lease before the end of the third year. \nAnalysis: The initial two -year noncancelable period meets the definition of a contract. The first 12 monthly \nperiods in year three are also inc luded in the contract’s enforceable period because the lessee would suffer a \nmore than insignificant penalty1 if it were to terminate the lease before the end of the third year. Additionally, \nbecause both the lessee and the lessor have the right to termina te the contract without permission from \nthe other party without a more than an insignificant penalty after the third year, the agreement does not \ncreate enforceable rights and obligations beyond the three -year period and therefore would no longer \nmeet the definition of a contract. Consistent with ASC 842-10-55-24, the likelihood of the lessor \nexercising the termination option during year three is not considered in the evaluation of the lease term. \nIn this scenario, the lease term is three years because the lessee concludes it is reasonably certain not \nto terminate the lease during the third year. \nThe evaluation of whether a lessee is reasonably certain not to terminate a contract considers all facts \nand circumstances, including any more than insignificant pe nalty the lessee would incur at each \ntermination date. The more significant the penalty the lessee would incur, the greater the likelihood \nthat the lessee would be reasonably certain not to terminate the contract. \n1 Refer to section 2.3.4, Penalty , for a discussion of the definition of a penalty . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 84}), Document(page\_content="2 Key concepts \nFinancial reporting developments Lease accounting | 73 2.3.4 Penalty \nExcerpt from Accounting Standards Codification \nMaster Glossary \nPenalty \nAny requirement that is imposed or can be imposed on the lessee by the lease agreement or by \nfactors outside the lease agreement to do any of the following: \na. Disburse cash \nb. Incur or assume a liability \nc. Perform services \nd. Surrender or transfer an asset or rights to an asset or otherwise forego an economic benefit, or \nsuffer an economic detriment. Factors to consider in determining whether an economic detriment \nmay be incurred include, but are not limited to, all of the following: \n1. The uniqueness of purpose or location of the underlying asset \n2. The availability of a comparable replacement asset \n3. The relative importance or significance of the underlying asset to the continuation of the \nlessee's line of business or service to its customers \n4. The existence of leasehold improvements or other assets whose value would be impaired by \nthe lessee vacating or discontinuing use of the underlying asset \n5. Adverse tax consequences \n6. The ability or willingness of the lessee to bear the cost associated with relocation or \nreplacement of the underlying asset at market rental rates or to tolerate other parties using \nthe underlying asset. \nA penalty is any requirement that is imposed or can be imposed on the lessee by the lease agreement or \nfactors outside the lease agreement to distribute cash, incur or assume a liability, perform se rvices, surrender \nor transfer an asset (or rights to an asset), to forgo an economic benefit or suffer an economic detriment. \nA penalty may affect the assessment of lease term (refer to section 2.3.1, Lease term ), purchase options \nand lease payments. As de scribed in section 2.3.5.1, Renewal penalty , a penalty may be sufficiently large \nto make the exercise of a renewal option reasonably certain at lease commencement. Similarly, the \nexistence of a penalty can cause the exercise of a purchase option to be reas onably certain. In instances \nwhere a penalty is not sufficiently large, in and of itself, to make a renewal or purchase option reasonably \ncertain of exercise at lease commencement, the penalty (if payable to or on behalf of the lessor) is included \nin lease payments. For example, if a lease includes a penalty payable to the lessor for failure to renew, and \nthe lessee determines that the penalty and other factors indicate that the renewal of the lease is not \nreasonably certain at commencement of the lease, th e penalty should be included as a lease payment. \nIt is important to note that a penalty is not solely a payment to a lessor but may be a payment to a third party \nor a loss of future earnings by the lessee. For example, if a lessee leases equipment that is used to generate \noperating income and alternative equipment is not available, the loss of the ability to generate operating \nincome might represent a penalty associated with terminating the lease. In addition, if a lessee can generate \noperating income by su bleasing an underlying asset, the loss of the ability to generate sublease income \nmight also represent a penalty associated with terminating the lease (refer to section 2.3.5.2, The effect of a \nsublease on the lease term ). However, only penalties payable to or on behalf of the lessor are potentially lease \npayments (refer to section 2.4, Lease payments, for a discussion of items included in lease payments). ", metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 85}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 74 2.3.5 Evaluating lease term and purchase options \nWhen evaluating whether a lessee is reasonably certain to exercise an option to renew the lease, not \nterminate the lease or to purchase the underlying asset, lessees and lessors are required to assess all \nrelevant factors that create an economic incentive for the lessee t o exercise lease renewal, termination \nor purchase options ( i.e., contract -based , asset -based , entity -based and market -based factors), including: \n• The pricing of a purchase option or lease renewal option (e.g., fixed rates, discounted rates, \n“bargain” rates) \n• The amount of payments for termination or nonrenewal and the pricing of the continuing lease \n• Contingent amounts due under residual value guarantees and other variable lease payments \n• Costs of returning the asset in a contractually specified condition or to a contractually specified location \n• Significant customization ( e.g., leasehold improvements), installation costs or relocation costs \n• The importance of the underlying asset to the lessee’s operations, considering the potential business \ndisru ptions from not having the underlying asset and the availability of a replacement asset \n• A sublease term that extends beyond the noncancelable period of the head lease ( e.g., a head lease \nthat has a noncancelable term of five years with a two -year renewal o ption, and the sublease term is \nfor seven years) \n• A guarantee by the lessee of the lessor’s debt directly or indirectly related to the underlying asset \nThe term “reasonably certain” is generally considered to be a high threshold (refer to section 2.3.1, \nLease term ). \nThe longer the period from commencement of the lease (refer to section 2.2, Commencement date of the \nlease ) to the exercise date of an option, the more difficult it will be, in certain cases, to determine whether \nthe exercise of the option is re asonably certain. The difficulty arises from several factors. For example, a \nlessee’s estimates of its future needs for the underlying asset become less precise the further into the \nfuture the forecast goes. Also, the future fair value of certain assets, such as those involving technology, \nis more difficult to predict than the future fair value of a relatively stable asset, such as a fully lea sed \ncommercial office building located in a prime area. \nThe further into the future the option date is, the lower the option price must be in relation to the \nestimated future fair value to conclude that the lessee is reasonably certain to exercise the opti on simply \nbased on option pricing. The difference between the option price and the estimated future fair value of an \nasset that is subject to significant changes in value also should be greater than would be the case for an \nasset with a relatively stable v alue. \nAn artificially short lease term ( e.g., a lease of a corporate headquarters, distribution facility, \nmanufacturing plant or other key property with a four -year lease term) may effectively create a significant \neconomic incentive for the lessee to exerc ise a purchase or renewal option. This may be evidenced by the \nsignificance of the underlying asset to the lessee’s continuing operations and whether, absent the option, \nthe lessee would have entered into such a lease. \nSimilarly, the significance of the un derlying asset to the lessee’s operations may create a significant \neconomic disincentive that affects a lessee’s decisions about whether it is reasonably certain to exercise a \npurchase or renewal option. For example, a company that leases a specialized fac ility ( e.g., manufacturing \nplant, distribution facility, corporate headquarters) and does not exercise a purchase or renewal option \nwould face a significant economic penalty if an alternative facility is not readily available. This would \npotentially have a n adverse effect on the company while it searched for a replacement asset. \nConsistent with paragraph B40 of IFRS 16, we believe that a lessee’s past practice regarding the period over ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 86}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 75 which it typically has used particular types of assets (whether leased o r owned), and its economic incentives \nfor doing so, may provide information that is helpful in assessing whether the lessee is reasonably certain to \nexercise, or not to exercise, an option. For example, if a lessee has typically used particular types of as sets for \na particular period of time or if the lessee has a practice of frequently exercising options on leases of particular \ntypes of underlying assets, we believe the lessee should consider the economic incentives for that past \npractice in assessing whet her it is reasonably certain to exercise an option on leases of those assets. \nIllustration 2 -3: Determining the lease term \nScenario A \nAssume that Entity P enters into a lease for equipment that includes a noncancelable term of four years \nand a two -year fixed -price renewal option with future lease payments that are intended to approximate \nmarket rates at lease inception. There are no termination penalties or other facto rs indicating that Entity \nP is reasonably certain to exercise the renewal option. \nAnalysis: At the lease commencement date, the lease term is four years. \nScenario B \nAssume that Entity Q enters into a lease for a building that includes a noncancelable term of four years \nand a two -year, fixed -price renewal option with future lease payments that are intended to approximate \nmarket rates at lease inception. Before it takes possession of the building, Entity Q pays for leasehold \nimprovements. The leasehold improv ements are expected to have significant value at the end of four \nyears, and that value can only be realized through continued occupancy of the underlying asset . \nAnalysis: At lease commencement, Entity Q determines that it is reasonably certain to exercise the \nrenewal option because it would suffer a significant economic penalty if it abandoned the leasehold \nimprovements at the end of the initial noncancelable period. At lease commencement, Entity Q \nconcludes that the lease term is six years. \n2.3.5.1 Renewal penalty \nWhen a penalty for failure to renew a lease at the end of a lease term (prior to renewal term) is so \nsignificant that it is reasonably certain at the commencement date (refer to section 2.2, Commencement \ndate of the lease ) that the lease wi ll be renewed, the renewal period is included in the lease term for \npurposes of determining a lease’s classification. \nThe cancellation penalty must be sufficiently large to represent a significant economic deterrent to \ncancellation. Determining whether thi s is the case requires judgment about the particular circumstances. \nOther factors also should be considered, such as the expected availability of other assets to serve the lessee’s \nneeds, the practicality of surrendering the underlying asset and the attrac tiveness of the ongoing rental price. \n2.3.5.2 The effect of a sublease on the lease term \nIn situations where a lessee grants (or intends to grant) a sublessee an initial lease term or renewal rights \nextending beyond the initial term of the lessee’s head l ease arrangement, the head lessee would consider \nany penalty (refer to section 2.3.4, Penalty ) created by failure to renew the head lease as well as all \nother contract, asset and market -based factors that could potentially impact the head lease in evaluati ng \nwhether it is reasonably certain to exercise options to extend or terminate the lease or purchase the \nunderlying asset, which includes entering into a sublease (refer to section 2.3.5, Evaluating lease term \nand purchase options , and section 2.3.6, Reass essment of the lease term and purchase options ). \nWhen the lease term (including a renewal provision that the sublessee is reasonably certain to exercise) \non the sublease extends longer than the lease term on the head lease, the lessee would revise its head \nlease term by assuming it is reasonably certain to exercise the renewal option on the head lease to be at \nleast as long as the term on the sublease. If the lease term (including a renewal provision that the lessee \nis reasonably certain to exercise) on the sublease is shorter than the lease term on the head lease, the ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 87}), Document(page\_content="2 Key concepts \nFinancial reporting developments Lease accounting | 76 lessee may, after considering any penalties and all other contract, asset and market -based factors, \nconclude that the renewal provision on the head lease is not reasonably certain of exercise. That is, the \nexistence of the renewal provision in the sublease, in and of itself, does not automatically result in the \nlessee assuming the exercise of the renewal options in the head lease are reasonably certain of exercise. \nThe FASB staff, through a FAS B technical inquiry, agreed with this view. \nIllustration 2 -4: Evaluating a lessee's head lease term when a sublease exists \nAssume Entity A leases land (the head lease) for an initial five -year term followed by four successive \nfive-year renewal options. Entity A immediately constructs a radio tower on the land and enters into a \nlease (as sublessor) with Radio Station B for an i nitial term of 10 years followed by three successive \nfive-year renewals at Radio Station B’s option. Entity A concludes Radio Station B is reasonably certain \nto exercise the first of its five -year renewal options based on consideration of all contract, ass et and \nmarket -based factors, resulting in a total lease term on the sublease of 15 years. \nAnalysis: The lease term used by Entity A in its accounting for the head lease would be at least 15 years \n(i.e., the noncancelable term of the sublease plus the five -year renewal period that Entity A has concluded \nRadio Station B is reasonably certain to exercise). If Radio Station B exercises its extension options \nbeyond the 15 -year lease term, Entity A would reassess the lease term on the head lease consistent \nwith t he guidance in ASC 842-10-55-28. \n2.3.5.3 Guarantee of residual value at a point in time prior to expiration \nCertain lease agreements enable a lessee to terminate the lease early, but such a termination results in the \nlessee guaranteeing the residual value of the underlying asset at the date of early termination. However, if the \nlease runs through its full term, the lessee does not guarantee the underlying asset ’s residual value. In such \nlease agreements, an assessment of the guaranteed residual value is required to determine whether it provides \na significant incentive for the lessee to continue the lease for the full term. In certain cases, the guarantee of a \nresidual value at a point in time prior to the end of the le ase term may be considered an option to terminate \nthe lease for purposes of determining lease term and lease payments (refer to section 2.4, Lease payments ). \nIllustration 2 -5: Guarantee of residual value upon early termination \nAssume a lessee guarantees to a lessor that if the lessee terminates a five -year lease at the end of three \nyears, the residual value of the underlying asset at the end of three years will not be less than $3,000. \nAnalysis: The lessee and lessor would evaluate the $3,000 r esidual value guarantee, in light of other \nfactors, to determine whether it serves as a penalty such that the lessee is reasonably certain to not \nexercise its termination option due to the existence of the guarantee. If the lessee is reasonably \ncertain to not exercise its termination option, the lease term would be five years. \nRefer to section 2.4.6, Amounts it is probable that a lessee will owe under residual value guarantees — \nlessees only , for further discussion of evaluating residual value guarantees. \n2.3.5.4 Fiscal funding clause \nExcerpt from Accounting Standards Codification \nMaster Glossary \nFiscal Funding Clause \nA provision by which the lease is cancelable if the legislature or other funding authority does not appropriate \nthe funds necess ary for the governmental unit to fulfill its obligations under the lease agreement. \nLeases — Overall \nImplementation Guidance and Illustrations ", metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 88}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 77 Fiscal Funding Clauses \n842-10-55-27 \nThe existence of a fiscal funding clause in a lease agreement requires an assessment of the likelihood \nof lease cancellation through exercise of the fiscal funding clause. If it is more than remote that the \nfiscal funding clause will be exercised, the lease term should include only those periods for which \nfunding is reasonably certain. \nA fiscal funding clause is commonly found in a lease agreement in which the lessee is a governmental \nunit. A fiscal funding clause generally provides that the lease is cancelable if the legislature or other \nfunding authority does not appropriate the funds necessary for the governmental unit to fulfill its \nobligations under the lease agreement. \nThe existence of a fiscal funding clause in a lease agreement would necessitate an assessment of the \nlikelihood of lease cancellation through exercise of the fiscal funding clause. If the likelihood of exercise \nof the fiscal funding clause is assessed as being remote ( i.e., the chance of occurring is slight), a lease \nagreement containing such a clause would be considered a noncancelable lease. If the chance of exercise \nis assessed as being more than remote, the lease term should include only those periods for which the \nfunding is reasonably certain. Refer to section 2.3.3, Cancelable leases . \n2.3.6 Reassessment of the lease term and purch ase options \n2.3.6.1 Reassessment of the lease term and purchase options — lessees (updated August 2022) \nExcerpt from Accounting Standards Codification \nLeases — Overall \nSubsequent Measurement \n842-10-35-1 \nA lessee shall reassess the lease term or a lessee option to purchase the underlying asset only if and \nat the point in time that any of the following occurs: \na. There is a significant event or a significant change in circumstances that is within the control of \nthe lessee that directly affects whether the lessee is reasonably certain to exercise or not to \nexercise an option to extend or terminate the lease or to purchase the underlying asset. \nb. There is an event that is written into the contract that obliges the lessee to exercise (or not to \nexercise) an option to extend or terminate the lease. \nc. The lessee elects to exercise an option even though the entity had previously determined that the \nlessee was not reasonably certain to do so. \nd. The lessee elects not to exercise an option even though the entity had previously determined that \nthe lessee was reasonably certain to do so. \nImplementation Guidance and Illustrations \n842-10-55-28 \nExamples of significant events or significant changes in circumstances that a lessee should consider in \naccordance with paragraph 842 -10-35-1 include, but are not limited to, the following: \na. Constructing significant leasehold improvements that are expec ted to have significant economic \nvalue for the lessee when the option becomes exercisable \nb. Making significant modifications or customizations to the underlying asset \nc. Making a business decision that is directly relevant to the lessee’s ability to exe rcise or not to \nexercise an option (for example, extending the lease of a complementary asset or disposing of an ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 89}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 78 alternative asset) \nd. Subleasing the underlying asset for a period beyond the exercise date of the option. \n842-10-55-29 \nA change in market -based factors (such as market rates to lease or purchase a comparable asset) should \nnot, in isolation, trigger reassessment of the lease term or a lessee option to purchase the underlying asset. \nAfter lease commencement (refer to section 2.2, Commencement date of the lease ), ASC 842 requires \nlessees to monitor leases for significant changes that could trigger a change in the lease term. Lessees \nare required to reassess the lease term ( i.e., the li kelihood of exercising a renewal or termination option) \nor whether it is reasonably certain that they will exercise an option to purchase the underlying asset at \nthe point in time when any of the following occurs: \nEvent Description \nSignificant event \nor ch ange in \ncircumstance • There is a significant event or significant change in circumstances within the \nlessee’s control that directly affects whether the lessee is reasonably certain \nto (1) extend the lease, (2) not terminate the lease or (3) purchase the \nunderlying asset. \nContractual event • There is an event that is written into the contract that obliges the lessee to \nexercise or not to exercise an option to extend or terminate the lease. \nOption exercised • The lessee elects to exercise an option even though it had previously \ndetermined that it was not reasonably certain to do so. \nOption not \nexercised • The lessee elects not to exercise an option even though it had previously \ndetermined that it was reasonably certain to do so. \nExamples of significant ev ents or significant changes in circumstances within the lessee’s control include: \n• Constructing significant leasehold improvements that are expected to have significant economic \nvalue for the lessee when the option becomes exercisable \n• Making significant mod ifications or customizations to the underlying asset \n• Making a business decision that is directly relevant to the lessee’s ability to exercise or not exercise \nan option ( e.g., extending the lease of a complementary asset or disposing of an alternative asset) \n• Subleasing th e underlying asset for a period beyond the exercise date of the option \nChanges in market -based factors ( e.g., a change in market rates to lease or purchase a comparable \nasset) are not within the lessee’s control, and they th erefore do not trigger a reassessment by \nthemselves. Further, events or changes in circumstances that indicate the carrying amount of an ROU \nasset may not be recoverable in accordance with ASC 360-10 that do not occur or arise as a result of an \naction that is within the control of the lessee do not, in isolation, trigger a reassessment of the lease term or a \nlessee option to purchase the underlying asset. Refer to section 4.2.5 , Impairment of right -of-use assets in \noperating leases , and section 4.3.4 , Impai rment of right -of-use assets in finance leases . \nThe following examples illustrate changes in market -based factors that are not in the lessee’s control \nand, therefore, would not, by themselves, trigger a reassessment. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 90}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 79 Illustration 2 -6: Changes in market -based factors that are indicators of impairment in \naccordance with ASC 360-10 \nLessee experiences a decline in sales and negative cash flows at one of its leased stores due to the \neffects of inflation and rising interest rates . Lessee identified these factors as indicators of impairment \nunder ASC 360-10 and tested the related asset group for recoverability under ASC 360-10. \nAnalysis \nThe decline in sales and negative cash flows are market -based factors that are not within the lessee ’s \ncontr ol. While these indicators might trigger the requirement for Lessee to perform the recoverability \ntest in accordance with ASC 360-10, an impairment evaluation and any related impairment loss \nrecognized would not, by themselves, trigger a reassessment of th e lease term in accordance with \nASC 842-10-35-1(a). \n \nIllustration 2 -7: Changes in market -based factors that change a lessee’s assessment of \nwhether it is reasonably certain to terminate a lease early \nLessee enters into a 10 -year lease of a retail store with a n option to terminate the lease after seven \nyears. At lease commencement, Lessee is reasonably certain that it will not terminate the lease after \nseven years and concludes that the lease term is 10 years. \nAfter expe riencing declining market conditions during the first five years of the lease, Lessee believes \nthat it is no longer reasonably certain it will not terminate the lease after seven years. However, \nLessee decides to wait until it is contractually required to notify the landlord about whether it is \nelecting to terminate the lease. \nAnalysis \nAlthough Lessee now believes it is no longer reasonably certain to not terminate the lease after seven \nyears, Lessee would not reassess the lease term. That is, until there are significant events or significant \nchanges in circumstances within Lessee ’s control that direct ly affect whether it is reasonably certain to \nterminate the lease early ( e.g., communicating to employees they will be terminated, altering significant \nsupply contracts, announcing that the store will permanently close), then there is no reassessment \nevent in accordance with ASC 842. \nASC 842-10-25-1 requires a lessee to reassess lease classification when there is a change in its \nassessment of either the lease term or whether it is reasonably certain to exercise an option to purchase \nthe underlying asset. Refer to section 3.5, Reassessment of lease classification . \nAdditionally, if there is a change in a lessee’s assessment of either the lease term or whether it is \nreasonably certain to exercise an option to purchase the underlying asset, a lessee should remeasure the \nlease liability, using r evised inputs ( e.g., discount rate and its allocation of contract consideration, \ndiscussed in section 2.5, Discount rates, and section 1.4.3.2, Allocating the consideration in the contract — \nlessees, respectively) at the reassessment date, and adjust the r ight-of-use asset. However, if the right -\nof-use asset is reduced to zero, a lessee would recognize any remaining amount in profit or loss. Refer to \nsection 4.5, Remeasurement of lease liabilities and right -of-use assets — operating and finance leases . \nRefe r to section 3.5.1, Summary of lease reassessment and remeasurement requirements. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 91}), Document(page\_content='2 Key concepts \nFinancial reporting developments Leas e accounting | 80 2.3.6.2 Reassessment of the lease term and purchase options — lessors \nExcerpt from Accounting Standards Codification \nLeases — Overall \nSubsequent Measurement \n842-10-35-3 \nA lessor shall not reassess the lease term or a lessee option to purchase the underlying asset unless \nthe lease is modified and that modification is not accounted for as a separate contract in accordance \nwith paragraph 842 -10-25-8. When a lessee exercises an option to extend the lease or purchase the \nunderlying asset that the lessor previously determined the lessee was not rea sonably certain to \nexercise or exercises an option to terminate the lease that the lessor previously determined the lessee \nwas reasonably certain not to exercise, the lessor shall account for the exercise of that option in the \nsame manner as a lease modifi cation . \nA lessor does not reassess the lease term or a lessee’s option to purchase the underlying asset unless the \nlease is modified ( i.e., the terms and conditions of the contract are changed in a way that results in a \nchange in the scope of the lease or the consideration) and the modified lease is not accounted for as a \nseparate contract. Additionally, ASC 842-10-35-3 requires a lessor to account for a lessee’s exercise of \nan option to extend or terminate the lease or purchase the underlying asset in the same manner as a \nlease modification when the exercise is inconsistent with the lessor’s previous assumption about whether \nthe lessee would exercise the option. Refer to section 5.6, Lease modifications . For example, if a lessor \nexcluded an optional period to extend the lease from the lease term because it concluded that the lessee \nwas not reasonably certain to exercise that option, the exercise of the option by the lessee should be \naccounted for as a lease modification. \nRefer to section 3.5.1, Summary of l ease reassessment and remeasurement requirements. \n2.4 Lease payments \nExcerpt from Accounting Standards Codification \nMaster Glossary \nLease Payments \nSee paragraph 842 -10-30-5 for what constitutes lease payments from the perspective of a lessee and \na lessor . \nVariable Lease Payments \nPayments made by a lessee to a lessor for the right to use an underlying asset that vary because of \nchanges in facts or cir cumstances occurring after the commencement date , other than the passage \nof time. \nProbable (second definition) \nThe future event or events are likely to occur. \nResidual Value Guarantee \nA guarantee made to a lessor that the value of an underlying asset retur ned to the lessor at the end of \na lease will be at least a specified amount. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 92}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 81 Leases — Overall \nInitial Measurement \n842-10-30-5 \nAt the commencement date , the lease payments shall consist of the following payments relating to \nthe use of the underlying asset during the lease term : \na. Fixed payments, including in substance fixed payments, less any lease incentives paid or payable \nto the lessee (see paragraphs 842 -10-55-30 through 55-31). \nb. Variable lease payments that depend on an index or a rate (such as the Consumer Price Index or \na market interest rate), initially measured using the index or rate at the commencement date. \nc. The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain \nto exercise that option (assessed considering the factors in paragraph 842 -10-55-26). \nd. Payments for penalties for terminating the lease if the lease term (as determined in accordance \nwith paragraph 842 -10-30-1) reflects the lessee exercising an option to terminate the lease. \ne. Fees paid by the lessee to the owners of a special -purpose entity for structuring the transaction. \nHowever, such fe es shall not be included in the fair value of the underlying asset for purposes of \napplying paragraph 842 -10-25-2(d). \nf. For a lessee only, amounts probable of being owed by the lessee under residual value guarantees \n(see paragraphs 842 -10-55-34 through 55 -36). \n842-10-30-6 \nLease payments do not include any of the following: \na. Variable lease payments other than those in paragraph 842 -10-30-5(b) \nb. Any guarantee by the lessee of the lessor’s debt \nc. Amounts allocated to nonlease components in accordance with paragraphs 842-10-15-33 \nthrough 15 -42. \nPending Content: \nTransition Date : (P) December 16, 2023; (N) December 16, 2023 | Transition Guidance: 842-10-65-8 \nLease payments do not include any of the following: \na. Variable lease payments other than those in paragraph 842 -10-30-5(b) \nb. Any guarantee by the lessee of the lessor ’s debt \nc. Amounts allocated to nonlease components in accordance with paragraphs 842 -10-15-33 \nthrough 15 -42 \nd. Leasehold improvements recognized by a lessee and accounted for in accordance with \nparagraph 842 -20-35-12A. \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 93}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 82 Lease payments are payments, made by a lessee to a lessor (or a third party on behalf of the lessor ), \nrelating to the right to use an underlying asset during the lease term and include the following amounts: \nLease payments7, 8 \n \nFixed \n(including \nin-substance \nfixed) payments, \nless any lease \nincentives paid \nor payable to \nthe lessee1 Variable \npayments \nbased on an \nindex or rate2 Exercise \nprice of a \npurchase \noption3 Payments for \npenalties for \nterminating \nthe lease4 Fees paid by \nthe lessee to \nthe owners of a \nspecial -purpose \nentity for \nstructuring the \ntransaction5 Amounts it is \nprobable that \nthe lessee will \nowe under \nresidual value \nguarant ees \n(lessees only)6 \n \n1 Refer to section 2.4.1, Fixed (including in -substance fixed) lease payments and lease incentives . \n2 Refer to section 2.4.2, Variable lease payments that depend on an index or rate . \n3 Refer to section 2.4.3, The exercise price of a purchase option . Include only if reasonably certain of exercise. \n4 Refer to section 2.4.4, Payments for penalties for terminating a lease . Include only if the lease term reflects the lessee \nexercising an opti on to terminate the lease. \n5 Refer to section 2.4.5, Fees paid by the lessee to the owners of a special -purpose entity for structuring the transaction . \n6 Refer to section 2.4.6, Amounts it is probable that a lessee will owe under residual value guarantees — lessees only . \n7 Refer to section 2.4.7, Payments made by a lessee prior to the beginning of the lease term . \n8 In some cases, a lessee may incur costs or make payments (e.g., to the lessor or a third party) for lessor assets \n(e.g., improvements to the underlying asset ). These payments are treated in the same manner as making a cash payment to the \nlessor and are accounted for as either fixed or variable payments. Determining whether the payments are fixed or variable \ndepends on the terms and cond itions of the contract. Refer to section 2.4.1, Fixed (including in -substance fixed) lease payments \nand lease incentives , and section 2.4.2, Variable lease payments that depend on an index or rate . \nLease payments do not include consideration in the contract allocated to the non -lease components of a \ncontract. However, lease payments include amounts that would otherwise be allocable to the non -lease \ncomponents of a contract when the entity makes an ac counting policy election to not separate lease and \nassociated non -lease components and accounts for the combined component as a single lease \ncomponent. Refer to section 1.4, Identifying and separating lease and non -lease components of a \ncontract and alloca ting contract consideration . \nASC 842 does not specifically address noncash lease payments ( e.g., equity shares or stock options of \nthe lessee provided to the lessor, estimated costs to dismantle and remove a n underlying asset at the end \nof the lease term i mposed by the lease agreement as opposed to an asset retirement obligation (refer to \nsection 2.4.8, Lessee’s obligations for asset retirement obligations (AROs) )). We believe that unless a \nform of consideration is specifically excluded, noncash lease payme nts should be included in lease \npayments at their fair value . \nASC 842-10-30-6 does explicitly note that lessee’s guarantees of lessor’s debt are excluded from lease \npayments (refer to section 2.4.10 , Amounts not included in lease payments ). \nSimilarly, a pr ovision that requires lessee indemnifications for preexisting environmental contamination \nor environmental contamination caused by the lessee during its use of the underlying asset over the term \nof the lease does not affect classification of the lease. The refore, noncash payments in the form of such \nindemnities are excluded from lease payments but only for purposes of lease classification (refer to \nsection 3.4.8, Lessee indemnifications for environmental contamination ). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 94}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 83 2.4.1 Fixed (including in-substance fixed) lease payments and lease incentives \n2.4.1.1 In-substance fixed lease payments \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \n842-10-55-31 \nLease payments include in substance f ixed lease payments. In substance fixed payments are \npayments that may, in form, appear to contain variability but are, in effect, unavoidable. In substance \nfixed payments for a lessee or a lessor may include, for example, any of the following: \na. Payments that do not create genuine variability (such as those that result from clauses that do \nnot have economic substance) \nb. The lower of the payments to be made when a lessee has a choice about which set of payments it \nmakes, although it must make at l east one set of payments. \nSome lease agreements include payments that are described as variable or may appear to contain \nvariability but are in -substance fixed payments because the contract terms require the payment of a fixed \namount that is unavoidable ( e.g., a lease that requires a lessee to pay percentage rent equal to 1% of its \nsales, subject to a minimum sales figure to be used). Such payments are included in the lease payments at \nlease commencement and thus used to measure entities’ lease assets and lease liabilities. \nCertain lease agreements include lease payments that increase based on a multiple of a change in an index \n(e.g., the Consumer Price Index) with a cap. Questions arise as to whether this feature should be viewed as \nvariable lease payments, a derivative or included as in -substance fixed lease payments at the capped amount. \nAn example would be a lease of a retirement community where lease payments increase each year by the \nlesser of 3% or three times the annual increa se in the Consumer Price Index. As discussed in ASC 842-10-30-5 \n(refer to section 2.4.2, Variable lease payments that depend on an index or rate ), lease payments that depend \non an existing index, such as the Consumer Price Index ( CPI), should be included i n lease payments based \non the index at lease commencement, and any increases or decreases in lease payments that result from \nsubsequent changes in the index should be reflected as they occur. However, the function of an index \nmultiplier and a cap serves to significantly modify the arrangement from one in which the lease payments \nsimply vary based on an index rate. Often, the combination of the multiplier and cap is specifically designed to \nmake sure the cap is always reached. \nWe believe that lessees and les sors should evaluate provisions in lease arrangements that require an \nadjustment to lease payments based on a multiple of an index and a cap and determine whether these \nprovisions represent genuine variability or whether these provisions are in -substance f ixed lease payments. If \nthe contingent rent feature does not create genuine variability ( i.e., the increase in the index coupled with the \nmultiplier and cap are designed such that the cap will be reached each year), the capped payments should be \nconsidered lease payments. This accounting, which applies to both lessors and lessees, affects lease payments \nnot only for purposes of the lease classification test but also the lessee measurement of the right -of-use asset \nand lessor and lessee accounting for straig ht-line rent (subject to collectibility) under an operating lease. If \nthe lessee or lessor determines that the index multiplier and cap do not represent in -substance fixed lease \npayments, the lessee or lessor would apply the embedded derivative guidance of ASC 815-15 and would likely \nconclude that inflation -indexed rentals that are subject to a leverage factor ( e.g., three times the change in CPI) \ndo not qualify for the clearly and closely related exception and, as a result, the portion of the rent attribut ed to \nthe inflation index would be separated from the host contract (the lease) and accounted for as a derivative. \nThe initial fair value of such a derivative would be treated as a day -one lease payment with subsequent \nchanges in fair value accounted for u nder the applicable guidance in ASC 815, Derivatives and Hedging . \nSubsequent changes in the fair value of the derivative would be recognized in income at each reporting period. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 95}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 84 The following example illustrates the accounting for in -substance fixed lease p ayments: \nIllustration 2 -8: In-substance fixed lease payments \nCompany A leases a building for five years with a fair value of $100 from Lessor B. The lease \nagreement provides that the lease payments start at $10 annually. The annual adjustment is based on \nthree times the annual increase in the CPI, but the aggregate annual adjustment is limited to 3%. \nAnalysis: Company A concludes that in substance, it has agreed, at the commencement date of the \nlease, to pay Lessor B additional lease payments in t he amount of 3% per year. As a result, the 3% \nincrease represents an in -substance fixed lease payment that would be included in the measurement \nof the right -of-use asset. \nThe following would be the straight -line rent calculation for both the lessee and les sor: \nYear Lease payments Straight -line rental \nrevenue/expense1 \n1 $10.00 $ 10.62 \n2 $10.30 ($10.00 x 1.03) $ 10.62 \n3 $10.61 ($10.30 x 1.03) $ 10.62 \n4 $10.93 ($10.61 x 1.03) $ 10.62 \n5 $11.26 ($10.93 x 1.03) $ 10.62 \n1 If the multiplier of the CPI were considered a derivative instead of an in -substance lease payment (at the capped amount), the day -one \nfair value of the derivative would be included as a lease payment for purposes of determining straight -line rent (as well as ass essing \nlease classification). Subsequent changes in the fair value of the derivative would be recognized in income at each reporting period. \n2.4.1.2 Lease incentives (updated August 2023) \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \n842-10-55-30 \nLease incentives include both of the following: \na. Payments made to or on behalf of the lessee \nb. Losses incurred by the lessor as a result of assuming a lessee’s preexisting lease with a third \nparty. In that circumstance, the lessor and the lessee should independently estimate any loss \nattributable to that assumption. For example, the lessee’s estimate of the lease incentive could be \nbased on a comparison of the new lease with the market rental rate available for similar \nunderlying assets or the market rental rate from the same lessor without the lease assumption. \nThe lessor should estimate any loss on the basis of the total remaining costs reduced by the \nexpected benefits from the sublease for use of the assumed underlying asset. \nA lease agreement with a lessor might include incentives for the lessee to sign the lease, such as an up -\nfront cash payment to the lessee, payment of costs for the lessee (such as moving expenses) or the \nassumption by the lessor of the lessee’s preexisting lease with a third party. Refer to section 4. 7, Lease \nincentives and improvements , for further discussion of lease incentives . \nLessee \nFor lessees, lease incentives that are paid or payable to the lessee at lease commencement (or on the \neffective date of a lease modification) are deducted from lease payments , which affect s the lease \nclassification test and reduce s the initial measurement of a lessee’s right -of-use asset. Lease incentives \nthat are payable t o the lessee at lease commencement (or on the effective date of a lease modification) \nalso reduce a lessee’s lease liability. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 96}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 85 Illustration 2 -9: Lessee accounting for l ease incentives paid or payable at commencement \nOn 1 January 20X1 (the commencement date of the lease), a lessee (Retailer) leases retail space in a \nshopping center for 10 years. Retailer agrees to pay a fixed payment per year of $100,000, due on 31 \nDecember of each year . The present value of the lease payments is $772,000 us ing a discount rate of \n5%. Retailer incurs no initial direct costs. The lease is classified as an operating lease. \nScenario A \nTo incentivize Retailer to enter into the lease, the lessor pays Retailer $100,000 on the commencement \ndate of the lease. \nAnalysis : Retailer records the right -of-use asset, lease liability and lease incentive on the commencement \ndate as follows: \nRight -of-use asset $ 672,000 \nCash 100,000 \n Lease liability $ 772,000 \nThe following journal entries would be recorded in Year 1: \nLease expense $ 100,000 \n Cash $ 100,000 \nTo reco rd lease expense and cash paid. \nRight -of-use asset (amortization of lease incentive) $ 10,000 \n Lease expense (amortization of lease incentive) $ 10,000 \nTo record amortization of the lease incentive ($100,000 ÷ 10 years = $10,000) . \nLease liability $ 61,000 \n Right -of-use asset $ 61,000 \nTo adjust the lease liability to the present value of the remaining lease payments with an offset to the \nright -of-use ass et. The adjustment of $61,000 is calculated as the initially recognized lease liability \n($772,000) less the present value of the remaining lease payments ($711,000) at the end of Year 1. \nScenario B \nAssume the same facts as Scenario A . However , to incentivi ze Retailer to enter into the lease, the \nlessor agrees to pay Retailer $100,000 at the end of the first year of the lease (i.e., 31 December \n20X1) . There is no contingency associated with Retailer’s right to receive the payment. \nAnalysis: In this scenario, the lease incentive receivable reduces Retailer’s lease payments by the \n$100,000 when initially measuring the right -of-use asset and lease liability at lease commencement : \nRight -of-use asset $ 677,000 \n Lease liability $ 677,000 \nTo record the right -of-use asset and lease liability at commencement. The lease liability of $677,000 is \ncalculated as the 10 $100,000 payments less t he $100,000 receivable from the lessor due in one \nyear , discounted at 5% . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 97}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 86 The following journal entries would be recorde d in Year 1: \nLease expense $ 100,000 \n Cash $ 100,000 \nTo record lease expense and cash paid . \nCash $ 100,000 \n Lease liability $ 100,000 \nTo record the cash incentive received. \nRight -of-use asset (amortization of lease incentive) $ 10,000 \n Lease expense (amortization of lease incentive) $ 10,000 \nTo record amortization of the lease incentive ($100,000 ÷ 10 years = $10,000) . \nLease liability $ 66,000 \n Right -of-use asset $ 66,000 \nTo adjust the lease liability to the present value of the remaining lease payments with an offset to the \nright -of-use asset. The adjustment of $66, 000 is calculated as the initially recognized lease liability \n($677,000) plus the adjustment to the lease liability resulti ng from the cash receipt of the lease incentive \n($100,000) less the present value of the remaining lease payments ($711,000) at the end of Year 1. \nASC 842 does not provide guidance on how to recogni ze lease incentives that are neither paid nor payable \nat lease commencement or on the effective date of a lease modification . A lease incentive is neither paid \nnor payable at lease commencement or on the effective date of a lease modification if the timing and \namount of payment from the landlord depend on future events ( e.g., the timing and amount of the \nqualified costs a retailer incurs to construct leasehold improvements). We believe the following \napproaches would be acceptable: \n• Approach 1: If a lease specifies a maximum level of reimbursement (e.g., for constructing leasehold \nimprovements) and the lessee is reasonably certain to incur reimbursable costs equal to or exceeding \nthis level, the amount would be deemed payable by the lessor at the commencement date and it would be \nincluded in the measurement of the consideration in the contract at commencement. Therefore, the \namount would be recognized as a reduction in the right -of-use asset and lease liability. \n• Approach 2: Once a lessee has incurred costs and the amounts qualify for reimbursement by the lessor , \nthe lessee would reduce the right -of-use asset and lease liability by the costs incurred. The reduction \nto the right -of-use asset would be recognized prospectively over the remainder of the lease term. \n• Approach 3: Once a lessee has incurred costs and the amounts qualify for reimbursement by the \nlessor, the lessee would reduce the right -of-use asset and lease liability by the costs incurred , as in \nApproach 2 . But in this approach, t he reduction to the right -of-use asset would be recognized as a \ncumulative catch -up adjustment to expense, as if the incentive were paid or payable at the lease \ncommencement date. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 98}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 87 Illustration 2 -10: Lessee a ccounting for lease incentives not paid or payable at commencement \nusing Approach 1 \nOn 1 January 20X1 (the commencement date of the lease), Lessee leases retail space in a shopping \ncenter from Lessor for 10 years. Lessee agrees to pay a fixed payment per year of $850,000, due on \n31 December of each year. The present value of the lease payments is $6,563,000 usi ng a discount \nrate of 5%. Lessee incurs no initial direct costs. The lease is classified as an operating lease. \nLessor provides an incentive allowance to reimburse Lessee for the cost of leasehold improvements up \nto $1 00,000 . Lessee is required to provide proof of payment of qualified expenditures to receive the \nincentive from Lessor. Lessor will pay the incentive at the end of the year in which the Lessee submits \nproof of payment ( i.e., this may not be the year in which the costs are incurred) . \nAssume the following a t lease commencement : \n• Lessee has incurred $10,000 of reimbursable costs associated with design of the leasehold \nimprovements and has submitted a request for payment to Lessor ( i.e., the incentive will be paid \nat the end of year 1) . \n• Lessee has contracted for and is reasonably certain it will incur costs in excess of the maximum \nallowance of $100,000 to construct the remaining leasehold improvements by the end of the first \nyear of the lease term. \nAssume the following at the end of year 1: \n• Lessee receives the cash incentive of $10,000 for reimbursable costs incurred prior to lease \ncommencement and submitted to Lessor at lease commencement. \n• Lessee incurs the remaining reimbursable costs of $90,000 at a single point in time (at the end of \nthe f irst year of the lease term) and plans to submit the request for payment to Lessor in year 2 . \nAssume the following at the end of year 2: \n• Lessee receives the cash incentive of $90,000 for reimbursable costs incurred in year 1 that the \nLessee submitted to Lessor in year 2. \nJournal entries \nThe full lease incentive of $100,000 is deemed payable by the lessor at the commencement date \nbecause th e lease specifies a maximum level of reimbursement and the lessee is reasonably certain to \nincur costs equal to or exceeding this level. For simplicity, amounts separately capitalized by the lessee \nas leasehold improvements (in accordance with ASC 360-10) are not included in this illustration. \nAt lease commencement, the lease incentive reduces Lessee’s lease payments by the full amount of \nthe lease incentive when initially measuring the right -of-use asset and lease liability: \nRight -of-use asset $ 6,472,000 \n Lease liability $ 6,472,000 \nTo record the right -of-use asset and lease liability at lease commencement. The ROU asset and lease \nliability of $6,472,000 are calculated as the present value of ( 1) the 10 annual $850,000 payments \nless ( 2) the $10,000 lease incentive receivable from Lessor at the end of year 1 and less ( 3) the \n$90,000 lease incentive expected to be received from Lessor at the end of year 2. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 99}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 88 The following journal entries would be recorded in year 1: \nLease expense $ 850,000 \n Cash $ 850,000 \nTo record lease expense and cash paid. \nCash $ 10,000 \n Lease liability $ 10,000 \nTo record the cash incentive of $10,000 received for reimbursable costs submitted to Lessor at lease \ncommencement. \nRight -of-use asset (amortization of lease incentive ) $ 10,000 \n Lease expense (amortization of lease incentive) $ 10,000 \nTo record amortization of the lease incentive ($100,000 ÷ 10 years = $10,000). \nLease liability $ 526,000 \n Right -of-use asset $ 526,000 \nTo adjust the lease liability to the present val ue of the remaining lease payments with an offset to the \nright -of-use asset. The adjustment of $526,000 is calculated as the accretion of the lease liability \n($6,472,000 x 5% = $324,000) less the annual cash lease payment ($850,000) . \nThe following journal entries would be recorded in year 2: \nLease expense $ 850,000 \n Cash $ 850,000 \nTo record lease expense and cash paid. \nCash $ 90,000 \n Lease liability $ 90,000 \nTo record the cash incentive of $90,000 received for reimbursable costs submitted to Lessor at the \nend of year 1. \nRight -of-use asset (amortization of lease incentive) $ 10,000 \n Lease expense (amortization of lease incentive) $ 10,000 \nTo record amortization of the lease incentive ($100,000 ÷ 10 years = $10,000). \nLease liability $ 552,000 \n Right -of-use asset $ 552,000 \nTo adjust the lease liability to the present value of the remaining lease payments with an offset to the \nright -of-use asset. The adjustment o f $552,000 is calculated as the accretion of the lease liability \n($5,956,000 x 5% = $298,000) less the annual cash lease payment ($850,000). \nThe following journal entries would be recorded in year 3: \nLease expense $ 850,000 \n Cash $ 850,000 \nTo record lease expense and cash paid. \nRight -of-use asset (amortization of lease incentive) $ 10,000 \n Lease expense (amortization of lease incentive) $ 10,000 \nTo record amortization of the lease incentive ($100,000 ÷ 10 years = $10,000). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 100}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 89 Lease liability $ 575,000 \n Right -of-use asset $ 575,000 \nTo adjust the lease liability to the present value of the remaining lease payments with an offset to the \nright -of-use asset. The adjustment of $575,000 is calculated as the accretion of the lease liability \n($5,494,000 x 5% = $275,000) less the annual cash lease payment ($850,000). \nLessee would record similar entries in years 4 through 10. \nRefer to Illustration 2 -12 for a summary of the lease expense, ROU asset and leas e liability amounts at \nlease commenceme nt, the end of year 1, the end of year 2 and the end of year 3 under Approach 1 as \nwell as a comparison to Approaches 2 and 3. \n \nIllustration 2 -11: Lessee a ccounting for lease incentives not paid or payable at commencement \nusing Approaches 2 and 3 \nAssume the same facts as in Illustration 2 -10 above. For simplicity, a mounts capitalized by the lessee \nas leasehold improvements (in accordance with ASC 360-10) are not included in this illustration. \nJournal entries under Approach 2 \nThe lease incentive does not reduce the right -of-use asset or lease liability until Lessee has incurred \ncosts and the amounts qualify for reimbursement by Lessor. In this example, o nly the $10,000 in \ncosts incurred by the lessee that are receivable by the lessee reduce the right -of-use asset and lease \nliability at the lease c ommencement da te. \nThe following journal entry is recorded when Lessee measures its right -of-use asset and lease liability \nat lease commencement. \nRight -of-use asset $ 6,554,000 \n Lease liability $ 6,554,000 \nTo record the right -of-use asset and lease liability at lease commencement. The ROU asset and lease \nliability of $6,554,000 are calculated as the present value of ( 1) the 10 annual $850,000 payments \nless ( 2) the $10,000 lease incentive receivable from Lessor at the end of year 1. \nThe following journal entries would be recorded in year 1: \nLease expense $ 850,000 \n Cash $ 850,000 \nTo record lease expense and cash paid. \nCash $ 10,000 \n Lease liability $ 10,000 \nTo record the cash incentive of $10,000 received at the end of year 1 for reimbursable costs \nsubmitted to Lessor at lease commencement. \nRight -of-use asset (amortization of lease incentive) $ 1,000 \n Lease expense (amortization of lease incentive) $ 1,000 \nTo record amortization of the lease incentive ($10,000 ÷ 10 years = $1,000). \nLease liability $ 86,000 \n Right -of-use asset $ 86,000 \nTo reduce the lease liability when Lessee incurs the remaining reimbursable costs at the end of year 1 \nfor the present val ue of the $90,000 lease incentive receiv able from Lessor at the end of year 2. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 101}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 90 Lease liability $ 522,000 \n Right -of-use asset $ 522,000 \nTo adjust the lease liability to the present value of the remaining lease payments with an offset to the \nright -of-use asset. The adjustment of $5 22,000 is calculated as the accretion of the lease liability \n($6,554,000 x 5% = $328,000) less the annual cash lease payment ($850,000). \nThe following journal entries would be recorded in year 2: \nLease expense $ 850, 000 \n Cash $ 850,000 \nTo record lease expense and cash paid. \nCash $ 90,000 \n Lease liability $ 90,000 \nTo record the cash incentive of $90,000 received in year 2 for reimbursable costs submitted to Lessor \nat the end of year 1. \nRight -of-use asset (amortization of lease incentive) $ 11,000 \n Lease expense (amortization of lease incentive) $ 11,000 \nTo record amortization of the lease incentive. The remaining lease incentive of $99,000 ($90,000 plus \n$9,000 unamortized from year 1) is amortized over t he remaining lease term ($99,000 ÷ 9 years = \n$11,000). \nLease liability $ 552,000 \n Right -of-use asset $ 552,000 \nTo adjust the lease liability to the present value of the remaining lease payments with an offset to the \nright -of-use asset. The adjustment of $552,000 is calculated as the accretion of the lease liability \n($5,956,000 x 5% = $298,000) less the annual cash lease payment ($850,000). \nThe following journal entries would be recorded in year 3: \nThe journal entries under Approach 2 would be the same as under Approach 1 for year 3, except for \nthe incentive amortization, which would be recorded as follows under Approach 2 : \nRight -of-use asset (amortization of lease incentive) $ 11,000 \n Lease expense (amortization of lease incentive) $ 11,000 \nTo record amortization of the lease incentive. The remaining lease incentive of $ 88,000 is amortized \nover the remaining lease term ($ 88,000 ÷ 8 years = $11,000). \nLessee would record similar entries in years 4 through 10. \nJournal entries under Approach 3 \nThe journal entries under Approach 3 in years 1 and 2 would be the same as under Approach 2, except \nfor th e entry for incentive amortization in year 2, which would be recorded as follows under Approach 3: \nRight -of-use asset (amortization of lease incentive) $ 19,000 \n Lease expense (amortization of lease incentive) $ 19,000 \nTo record amortization of the lease incentive. Lessee would recognize annual amortization expense as \nif the incentive were paid or payable at the lease commencement date ( i.e., $100,000 ÷ 10 years = \n$10,000). This would require Lessee to recognize an additional $9,000 in amortization expense in \nyear 2 as a cumulative adjustment as though the full amount of the incentive was recognized at lease \ncomme ncement ( i.e., $10,000, minus the $1,000 already expensed in year 1). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 102}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 91 The journal entries under Approach 3 would be the same as under Approach 1 in years 3 through 10. \nRefer to Illustration 2 -12 for a summary of the lease expense, ROU asset and lease liability amounts at \nlease commencement, the end of year 1, the end of year 2 and the end of year 3 under Approaches 2 \nand 3 as well as a comparison to Approach 1. \n \nIllustration 2 -12: Summary of lessee accounting for lease incentives not paid or payable at \ncommencement under the three approaches \nBased on the journal entries depicted above in Illustration s 2-8 and 2 -9, Lessee would have the \nfollowing lease expense, ROU asset and lease liability amounts at lease commencement, the end of \nyear 1 , the end of year 2 and the end of year 3 under the three approaches. Immaterial differences \nmay arise in the recomputation of amounts due to rounding. \n Accounts Approach 1 Approach 2 Approach 3 \nLease \ncommencement Lease liability \nROU asset $ 6,472,000 \n $ 6,472,000 $ 6,554,000 \n $ 6,554,000 \nYear 1 Lease expense \nEnding l ease liability \nEnding ROU asset $ 840,000 \n $ 5,956,000 \n $ 5,956,000 $ 849,000 \n $ 5,956,000 \n $ 5,947,000 \nYear 2 Lease expense \nEnding l ease liability \nEnding ROU asset $ 840,000 \n $ 5,494 ,000 \n $ 5,414,000 $ 839,000 \n $ 5,494,000 \n $ 5,406,000 $ 831,000 \n $ 5,494,000 \n $ 5,414,000 \nYear 3 Lease expense \nEnding l ease liability \nEnding ROU asset $ 840,000 \n $ 4,919,000 \n $ 4,849,000 $ 839,000 \n $ 4,91 9,000 \n $ 4,842,000 $ 840,000 \n $ 4,91 9,000 \n $ 4,849,000 \n \nRefer to section 4.2.1.2, Initial measurement of right -of-use assets — operating l eases , or section 4.3.1.2, \nInitial measurement of right -of-use assets — finance l eases , for further discussion of initial measurement \nby lessees. \nLessor \nFor lessors, lease incentives that are paid or payable to the lessee also are deducted from lease payments \nand affect the lease classification test. Lease incentives that are payable to the lessee at commencement \nreduce the initial measurement of the lesso r’s net investment in the lease for sales -type and direct financing \nleases. \nHowever, if lease incentives have been paid to the lessee prior to the commencement date, we believe \nthat they affect the calculation of selling profit or loss for sales -type and direct financing leases (refer to \nsection 5.1.3, Selling profit or selling loss ). For operating leases, lessors should defer the cost of any lease \nincentives paid or payable to the lessee and recognize that cost as a reduction to lease income over the \nlease term (refer to section 5.4.2, Lease incentives in an operating lease ). \nASC 842 does not specifically address the recognition of lease incentives by lessors that are neither paid nor \npayable at lease commencement. We believe a lessor should initially reco gnize its contingent obligation at \nlease commencement, if probable (similar to the threshold used to recognize variable lease payments for \nlessees), and amortize the incentive as a reduction to lease income over the lease term for an operating \nlease . If th e lessor later determines that the incentive will not be paid, the lessor would derecognize the \nliability and associated unamortized incentive and either recognize a cumulative catch -up adjustment to \nrevenue to reverse the previously recognized amortizatio n or recognize the adjustment prospectively over \nthe remaining lease term. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 103}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 92 Illustration 2-13: Lessor accounting for a sales -type lease with a lease incentive paid at lease \ncommencement \nOn 1 January 20X1 (the commencement date of the lease), Lessor leases equipment for 10 years. \nLessee agrees to a fixed payment of $1 5,000 per year , due 31 December of each year. Lessee \nguarantees the residual value for $30,000. The unguaranteed residual value is $20,000. To \nincentivize Lessee to enter into the lease, Lessor pays Lessee $5,000 on the lease commencement date. \nAt lease commencement, the equipment has a carrying amount of $100,000 and a fair value of \n$106,000. The present value of t he lease payments , including the lease incentive, is $98,344, using a \nrate implicit in the lease of 10.078 %. Lessor incurs no initial direct costs. The lease is classified as a \nsales -type lease because the present value of the lease payments, including the residual value \nguaranteed by Lessee, exceeds substantially all of the fair value of the underlying asset . At lease \ncommencement, Lessor concludes it is probable it will collect the lease payments and any amount \nprobable of being owed under the residual va lue guarantee provided by Lessee. \nAnalysis: Lessor record s the net investment in the sales -type lease and lease incentive paid and \nderecognize s the underlying asset on the lease commencement date as follows: \nNet investment in the lease $ 111,000(a) \nCost of goods sold 92,344(b) \n Revenue $ 98,344(d) \n Property held for lease 100,000(e) \n Cash 5,000(c) \n(a) The net investment in the lease consists of (1) the present value of the 10 annual lease payments of $15,000 plus the present value \nof the gua ranteed residual value of $30,000, both discounted at the rate implicit in the lease, which equals $103,344 (i.e., the lease \nreceivable) and (2) the present value of the unguaranteed residual value of the asset of $20,000, which equals $7,656. Note that th e \nnet investment in the lease is subject to the same considerations as other assets when classifying its components as current or \nnoncurrent assets in a classified balance sheet. \n(b) Cost of goods sold is the carrying amount of the equipment of $100,000 less the present value of the unguaranteed residual \nasset of $7,656. \n(c) Lease incentive payment made to lessee in cash on the lease commencement date . \n(d) Revenue equals the lease receivable, which consists of (1) the present value of the 10 annu al lease payments of $15,000 plus (2) the \npresent value of the guaranteed residual value of $30,000, both discounted at the rate implicit in the lease, which equals $1 03,344, \nless (3) the $5,000 lease incentive payment. \n(e) $100,000 is the carrying amount of the underlying asset. \nAt lease commencement, Lessor recognizes selling profit of $ 6,000, which is calculated as (1) \nrevenue of $98,344 less (2) cost of goods sold of $92,344. \nThe following journal entries would be recorded in Year 1: \nCash $ 15,000(f) \n Net investment in the lease $ 3,313(g) \n Interest income 11,187(h) \nYear 1 journal en tries for the sales -type lease. \n(f) Receipt of annual lease payment at the end of the year. \n(g) Reduction of the net investment in the lease for lease payment receive d of $15,000 less interest income of $11,187 . \n(h) Interest income equals 10.078% multiplied by the net investment in the lease at the beginning of Year 1, $111,000 . \nImmaterial differences may arise in the recomputation of amounts in the example above due to rounding. \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 104}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 93 Illustration 2-14: Lessor accounting for a sales -type lease with a contingent lease incentive \npayment \nAssume the same facts as in Illustration 2 -13, only in this illustration Lessor will only pay Lessee the \n$5,000 lease incentive payment contingent upon certain events occurring after lease commencement \n(e.g., Lessee incurring $5,000 of costs to construct leasehol d improvements). Lessor determines the \npayment of this lease incentive is probable at the lease commencement date and is expected to be \nmade at the end of Year 3. Therefore, t he present value of the lease payments , including the lease \nincentive payable , is $98,500, using a rate implicit in the lease of 10.305 %. \nLessor incurs no initial direct costs. The lease is classified as a sales -type lease because the present \nvalue of the lease payments, including the residual value guaranteed by Lessee, exceeds subst antially \nall of the fair value of the underlying asset . At lease commencement, Lessor concludes that it is \nprobable it will collect the lease payments and any amount probable of being owed under the residual \nvalue guarantee provided by Lessee. \nAnalysis : Because payment of the lease incentive is probable at lease commencement, the lease \nincentive reduces the net investment in the lease. L essor record s the net investment in the sales -type \nlease and derecognize s the underlying asset on the commencement date as follows: \nNet investment in the lease $ 106,000(a) \nCost of goods sold 92,500(b) \n Revenue $ 98,500(c) \n Property held for lease 100,000(d) \nTo record the net investment in the sales -type lease and de recognize the underlying asset. \n(a) The net investment in the lease consists of (1) the present value of the 10 annual lease payments of $15,000 , plus the present value \nof the guaranteed residual value of $30,000, less the present value of the lease incentive expected to be paid a t the end of Year 3, all \ndiscounted at the rate implicit in the lease, which equals $ 98,500 (i.e., the lease receivable) and (2) the present value of the \nunguaranteed residual value of the asset of $20,000, which equals $7, 500. Note that the net investment in the lease is subject to the \nsame considerations as other assets when classifying its components as current or noncurrent assets in a classified balance s heet. \n(b) Cost of goods sold is the carrying amount of the equipment of $100,000 less the present value of the unguaranteed residual \nasset of $7, 500. \n(c) Revenue equals the lease receivable, which consists of (1) the present value of the 10 annual lease payments of $15,000 plus (2) the \npresent value of the guaranteed residual value of $30,000 less (3) the present value of the lease incentive expected to be paid at the \nend of Year 3, all discounted at the rate implicit in the lease, which equals $ 98,500. \n(d) $100,000 is the carrying amount of the underlying asset. \nAt the end of Year 1, Lessor de termines the payment of the contingent incentive payment remains \nprobable and records the following entry: \nCash $ 15,000(e) \n Net investment in the lease $ 4,077(f) \n Interest income 10,923(g) \nYear 1 journal en tries for the sales -type lease. \n(e) Receipt of annual lease payment at the end of the year . \n(f) Reduction of the net investment in the lease for lease payment received of $15,000 less interest income of $1 0,923. \n(g) Interest income equals 10.305% multiplied by the net investment in the lease at the beginning of Year 1, $106,000 . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 105}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 94 2.4.1.3 Deposits paid before the lease commencement date \nLease contracts may require the lessee to pay the lessor a deposit before the lease commencement date. \nIf the deposit is fully refundable, it represents c ollateral to the lessor. We believe that the fully refundable \ndeposit payment and any market -rate-based interest earned by the lessor on the refundable deposit are \nnot included as consideration in the contract. If the deposit payment is nonrefundable, it i s in substance a \nfixed lease payment made by the lessee and is included as consideration in the contract. We also believe, \nif the deposit bears interest at a rate other than a market -based rate, the off -market portion of the \ninterest is additional consider ation in the contract as a lease incentive for the lessee (if above market) or \nas a lease payment for the lessee (if below market). \n2.4.2 Variable lease payments that depend on an index or rate \nVariable lease payments that depend on an index or a rate ar e included in the lease payments and are \nmeasured using the prevailing index or rate at the measurement date ( e.g., lease commencement date for \ninitial measurement). The FASB indicated in the Basis for Conclusions (BC 211) of ASU 2016 -02 that despite \nthe m easurement uncertainty associated with changes to index or rate -based payments, the payments meet \nthe definition of an asset (lessor) and a liability (lessee) because they are unavoidable. Lessees and lessors \nrecognize changes to index and rate -based varia ble lease payments in profit or loss in the period of the \nchange ( i.e., similar to other variable lease payments). Common examples of indexes and rates are: \n• CPI \n• LIBOR \n• Secured Overnight Financing Rate ( SOFR ) \n• Prime interest rate \n• Treasury rates (with or without a spread) \n• Payments that depend on market rental rates \nASC 842-10-35-4(b) requires a lessee to remeasure lease payments when a contingency upon which some or \nall of the lease payments that will be paid over the remainder of the lease term is resolved (refer to section \n2.4.11.1, Subsequent remeasurement of lease pa yments — lessees ). However, that guidance is applicable only \nto variable lease payments not based on an index or rate. That is, it does not apply to variable payments based \non an index or rate. For example, assume that a lessee enters into a five -year leas e agreement with a fixed \nlease payment in year one that is then adjusted at the beginning of years two through five based on the \nincrease in CPI. In this case, the entity would not remeasure its lease payments at the beginning of each year \nand instead woul d recognize the effect of future increases in CPI as part of lease -related cost in each year. \nIn some instances , a lease agreement will include a renewal option in which the payments during the \nrenewal period are based on the market rental rates determined at or near the beginning of the renewal \nperiod. At lease commencement, i f a lessee is reasonably certain to exercise the renewal option (refer to \nsection 2.3.5, Evaluating lease term and purchase options ), the lessee should include the payments during \nthe renewal period in lease payments similar to other variable lease payments that depend on an index or \nrate. Those payments should be measured using the market rental rates at the date of measurement \n(e.g., lease commencement date for initial measurement or remeasurement date upon reassessment of \nwhether the lessee is reasonably certain to exercise the renewal option ) for a lease with a term similar to \nthe renewal period (e.g., a lessee should measure the payments during a three -year renewal pe riod using \nthe market rental rates for a three -year lease) . That is, entities should not anticipate future rent increases \n(or decreases) when measuring lease payments for the future renewal periods included in the lease term. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 106}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 95 Therefore , and similar to the discussion above on payments based on CPI, the lessee would not remeasure its \nlease payments when the lease payments are reset to market ; instead , the lessee would recognize the effect \nof the changes in market rental rates as part of lease -related cost in the appropriate period (and disclosed \nas a variable lease cost) . As a reminder, if the lease liability is reassessed for other reasons, the fixed lease \npayments are adjusted to the current index or rate. Refer to sections 2.4.11 , Subsequent remeasurement \nof lease payments , and 4.10 , Disclosure . Likewise, l essors should recognize the changes as income in the \nperiod they are earned. \nASC 842 includes the following example of accounting for variable lease payments that depend on an \nindex or rate : \nExcerpt from Accounting Standards Codification \nImplementation Guidance and Illustrations \nExample 25 — Variable Lease Payments That Depend on an Index or a Rate and Variable Lease \nPayments Linked to Performance \nCase A —Variable Lease Payments That Depend on an Index or a Rate \n842-10-55-226 \nLessee enters into a 10 -year lease of a building with annual lease payments of $100,000, payable at \nthe beginning of each year. The contract specifies that lease payments for each year will increase on \nthe basis of the increase in the Consumer Price Index for the preceding 12 months. The Consumer \nPrice Index at the commencement date is 125. This Example ignores any initial direct costs. The lease \nis classified as an operating lease. \n842-10-55-227 \nThe rate implicit in the lease is not readily determinable. Lessee’s incrementa l borrowing rate is 8 \npercent, which reflects the rate at which Lessee could borrow an amount equal to the lease payment in \nthe same currency, over a similar term, and with similar collateral as in the lease. \n842-10-55-228 \nAt the commencement date, Lessee makes the lease payment for the first year and measures the \nlease liability at $624,689 (the present value of 9 payments of $100,000 discounted at the rate of 8 \npercent). The right -of-use asset is equal to the lease liability plus the prepaid rent ( $724,689). \n842-10-55-229 \nLessee prepares financial statements on an annual basis. Lessee determines the cost of the lease to be \n$1 million (the total lease payments for the lease term). The annual lease expense to be recognized is \n$100,000 ($1 million ÷ 10 years). \n842-10-55-230 \nAt the end of the first year of the lease, the Consumer Price Index is 128. Lessee calculates the payment \nfor the second year, adjusted to the Consumer Price Index, to be $102,400 ($100,000 × 128 ÷ 125). \n842-10-55-231 \nBecause Lessee has not remeasured the lease liability for another reason, Lessee does not make an \nadjustment to the lease liability to reflect the Consumer Price Index at the end of the reporting period; \nthat is, the lease liability continues to reflect annual lease paym ents of $100,000 (8 remaining annual \npayments of $100,000, discounted at the rate of 8 percent is $574,664). However, the Year 2 payment \namount of $102,400 (the $100,000 annual fixed payment + $2,400 variable lease payment) will be \nrecognized in profit or loss for Year 2 of the lease and classified as cash flow from operations in Lessee’s \nstatement of cash flows. In its quantitative disclosures, Lessee will include $100,000 of the $102,400 \nin its disclosure of operating lease cost and $2,400 in its disclosu re of variable lease cost. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 107}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 96 In contrast, ASC 842 includes the following example of accounting for variable lease payments that do not \ndepend on an index or rate. Refer to section 2.9, Variable lease payments : \nExcerpt from Accounting Standards Codification \nImplementation Guidance and Illustrations \nCase B—Variable Lease Payments Linked to Performance \n842-10-55-232 \nLessee enters into a 10-year lease of a building with annual lease payments of $100,000, payable at the \nbeginning of each year. The contract specifies that Lessee also is required to make variable lease payments \neach year of the lease, which are determined as 2 percent of L essee’s sales generated from the building . \n842-10-55-233 \nAt the commencement date, Lessee measures the lease liability and right -of-use asset at the same amounts \nas in Case A (paragraphs 842-10-55-226 through 55 -231) because the 2 percent royalty that will be paid \neach year to Lessor under the lease is a variable lease payment, which means that paym ent is not included \nin the measurement of the lease liability (or the right -of-use asset) at any point during the lease. \n842-10-55-234 \nDuring the first year of the lease, Lessee generates sales of $1.2 million from the building and, \ntherefore, recognizes t otal lease cost of $124,000 ($100,000 + [2% × $1.2 million]). In its \nquantitative disclosures, Lessee will include $100,000 of the $124,000 in its disclosure of operating \nlease cost and $24,000 in its disclosure of variable lease cost. \n2.4.3 The exercise price of a purchase option \nIf the lessee is reasonably certain to exercise a purchase option, the exercise price is included as a lease \npayment. That is, entities consider the exercise price of asset purchase options included in lease contracts \nconsistently with the evaluation of lease renewal and termination options (refer to section 2.3.5, \nEvaluating lease term and purchase options ). \n2.4.4 Payments for penalties for terminating a lease \nIf it is reasonably certain that the lessee will not termi nate a lease, the lease term is determined assuming \nthat the termination option would not be exercised, and any termination penalty is excluded from the \nlease payments. Otherwise, the lease termination penalty is included as a lease payment, and the lease \nterm is determined accordingly. The determination of whether to include lease termination penalties as \nlease payments is similar to the evaluation of lease renewal options. \n2.4.5 Fees paid by the lessee to the owners of a special -purpose entity for \nstruct uring the transaction \nFees paid by a lessee to the owners of a special -purpose entity for structuring a transaction are included \nas lease payments. However, such fees are excluded from the fair value of the underlying asset for \npurposes of the lease classi fication test. Refer to section 3.4.6, Fair value of the underlying asset . \n2.4.6 Amounts it is probable that a lessee will owe under residual value \nguarantees — lessees only \nASC 842 requires a lessee to include the amount it is probable it will owe to a l essor under a residual \nvalue guarantee as lease payments. \nA lessee may provide a guarantee to the lessor that the value of the underlying asset it returns to the \nlessor at the end of the lease will be at least a specified amount. Such guarantees are enforc eable \nobligations that the lessee has assumed by entering into the lease. Uncertainty related to the amount \nthat a lessee will pay under a guarantee of a lessor’s residual value affects the measurement of the \nobligation rather than the existence of an obli gation. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 108}), Document(page\_content="2 Key concepts \nFinancial reporting developments Lease accounting | 97 A lessee is required to remeasure and reallocate the remaining consideration in the contract and \nremeasure finance and operating lease liabilities when it changes its assessment of the amount it is \nprobable that it will owe under a residual value g uarantee. Refer to section 4.5, Remeasurement of lease \nliabilities and right -of-use assets — operating and finance leases . \nIllustration 2 -15: Residual value guarantee included in lease payments \nLessee R enters into a lease and guarantees that Lessor S will realize $15,000 from selling the asset \nto another party at the end of the lease. At lease commencement, based on Lessee R’s estimate of the \nresidual value of the underlying asset, Lessee R determines that it is pr obable that it will owe $6,000 at \nthe end of the lease. \nAnalysis : In accordance with ASC 842-10-25-2, Lessee R and Lessor S will include the full guaranteed \nresidual value of $15,000 for purposes of evaluating lease classification (refer to section 3.1, Criteria for \nlease classification — lessees , and section 3.2, Criteria for lease classifica tion — lessors ). \nBecause it is probable that Entity R will owe the lessor $6,000 under the residual value guarantee, Entity \nR includes that amount as a lease payment. \nRefer to section 5.1.1, Net investment in the lease, for discussion of accounting for res idual value \nguarantees by lessors in sales -type or direct financing leases. \n2.4.6.1 Third -party insurance that guarantees the asset’s residual value \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \n842-10-55-36 \nA residual value guarantee obtained by the lessee from an unrelated third party for the benefit of the lessor \nshould not be used to reduce the amount of the lessee's lease payments under paragraph 842 -10-30-5(f) \nexcept to the ext ent that the lessor explicitly releases the lessee from obligation, including the secondary \nobligation, which is if the guarantor defaults, a residual value deficiency must be made up. Amounts \npaid in consideration for a guarantee by an unrelated third par ty are executory costs and are not \nincluded in the lessee's lease payments. \nLessees may guarantee the residual value to the lessor and obtain an offsetting guarantee from an \nunrelated third party ( e.g., an insurance company). A third -party guarantee can b e used as a basis to \nreduce the lessee’s lease payments (refer to section 2.4, Lease payments ) only when (and to the extent) \nthe lessor explicitly releases the lessee from the residual value guarantee (including any secondary \nobligation if the guarantor defaults). Amounts paid to the unrelated third party as consideration for the \nguarantee are executory costs and are not included in the lessee’s lease payments. \n2.4.6.2 Requirement for lessee to purchase the underlying asset \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \n842-10-55-35 \nIf the lessor has the right to require the lessee to purchase the underlying asset by the end of the lease \nterm, the stated purchase price is included in lease payments. That amount is, in effect, a guaranteed \nresidual value that the lessee is obligated to pay on the basis of circumstances outside its control. ", metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 109}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 98 A lease may contain a provision granting the lessor the right to require the lessee to purchase the \nunderlying asset by the end of the lease term. In these cases, the amount of the stated put option would \nbe included in lease payments as it is, in effect, a residual value guarantee that the lessee is required to pay. \n2.4.7 Payments made by a lessee prior to the beginning of the lease term \nPayments made prior to lease commencement (refer to section 2.2, Commencement date of the lease ) are \nconsidered lease p ayments (refer to section 2.4, Lease payments ) and included in the lease classification \ntest (refer to section 3.1, Criteria for lease classification — lessees , and section 3.2, Criteria for lease \nclassification — lessors ) and are included in the initial m easurement of the right -of-use asset (refer to \nsection 4.2.1.2, Initial measurement of right -of-use assets — operating l eases , or section 4.3.1.2, Initial \nmeasurement of right -of-use assets — finance l eases ). \n2.4.8 Lessee’s obligations for asset retiremen t obligations (AROs) \nExcerpt from Accounting Standards Codification \nLeases — Overall \nInitial Measurement \n842-10-30-7 \nParagraph 410 -20-15-3(e) addresses the scope application of Subtopic 410 -20 on asset retirement \nobligations to obligations of a lessee in connection with a lease (see paragraph 842 -10-55-37). \nImplementation Guidance and Illustrations \n842-10-55-37 \nObligations imposed by a lease agreement to return an underlying asset to its original condition if it \nhas been modified by the lessee (f or example, a requirement to remove a lessee -installed leasehold \nimprovement) generally would not meet the definition of lease payments or variable lease payments \nand would be accounted for in accordance with Subtopic 410 -20 on asset retirement and environ mental \nobligations. In contrast, costs to dismantle and remove an underlying asset at the end of the lease \nterm that are imposed by the lease agreement generally would be considered lease payments or \nvariable lease payments. \nAsset Retirement and Environmen tal Obligations — Asset Retirement Obligations \nScope and Scope Exceptions \n410-20-15-3 \nThe guidance in this Subtopic does not apply to the following transactions and activities: \ne. Obligations of a lessee in connection with an underlying asset , whether imposed by a lease or by \na party other than the lessor, that meet the definition of either lease payments or variable lease \npayments in Subtopic 842 -10. Those obligations shall be accounted for by the lessee in \naccordance with the requirements of Subtopic 842 -10. However, if obligations of a lessee in \nconnection with an underlying asset, whether imposed by a lease or by a party other than the \nlessor, meet the provisions in paragraph 410 -20-15-2 but do not meet the definition of either \nlease paymen ts or variable lease payments in Subtopic 842 -10, those obligations shall be \naccounted for by the lessee in accordance with the requirements of this Subtopic. \nIt is important to remember that the requirements of ASC 410-20, Asset Retirement Obligations , may \napply not only to long -lived assets owned by the entity but also to improvements made to underlying \nassets. The following is a discussion of the lessee’s obl igations for asset retirement obligations. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 110}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 99 Distinguishing an asset retirement obligation (ARO) from lease payments and variable lease payments \nThe provisions of ASC 410-20 do not apply to obligations of a lessee in connection with the underlying \nasset , whe ther imposed by a lease agreement or by a party other than the lessor, that meet the definition \nof either lease payments or variable lease payments. Instead, obligations that are considered either lease \npayments or variable lease payments should be account ed for in accordance with ASC 842. However, \nobligations imposed by a lease agreement that meet the definition of an ARO and do not meet the \ndefinition of lease payments or variable lease payments are accounted for by the lessee in accordance \nwith the requi rements of ASC 410-20. It should be noted that ASC 842 does not apply to leases to \nexplore or exploit natural resources; thus, any retirement obligations imposed by these types of \nagreements always are within the scope of ASC 410-20. \nThe estimated costs im posed by a lease that requires a lessee to dismantle and remove a lessor’s asset \nat the end of the lease term are recognized as a component of lease payments. Because the estimated \nremoval costs are included in lease payments (refer to section 2.4, Lease p ayments ), these removal \ncosts will be included in the measurement of the lease liability and right -of-use asset, and the related \nexpense will be recognized over the lease term. \nVariable lease payments are defined as payments made by a lessee to a lessor fo r the right to use an \nunderlying asset that vary because of changes in facts or circumstances occurring after the commencement \ndate, other than the passage of time (refer to section 2. 4.10, Amounts not included in lease payments ). \nLease payments that depen d on a factor directly related to the future use of the underlying asset , such \nas machine hours or sales volume during the lease term, are variable lease payments and, accordingly, \nare excluded from lease payments in their entirety. Increases or decreases in payments that result from \nvariable lease payments are included in income as accruable. \nObligations imposed by a lease agreement to return the underlying asset to its original condition (if it has \nbeen modified by the lessee by the installation of leaseh old improvements, such as a building constructed \non leased land) generally do not meet the definition of a lease payment or a variable lease payment and, \ntherefore, should be accounted for by the lessee as an ARO. Said another way, if an improvement to an \nunderlying asset has been recognized as an asset on the lessee’s balance sheet ( i.e., leasehold \nimprovements), any obligation to remove that lessee improvement on expiration of the lease should \ngenerally be accounted for as an ARO. For example, assume a le ssee that leases retail space and installs \nits own improvements ( e.g., customized build -out) has an obligation under the lease to remove the \nimprovements at the expiration of the lease. The obligation to remove the leasehold improvements does \nnot arise solely because of the lease but instead is a direct result of the lessee’s decision to modify the \nleased space. Such costs would be excluded fr om lease payments and variable lease payments. We \nbelieve the lessee’s estimate of its ARO at lease commencement would be included in the measurement \nof the leasehold improvement to which it relates and not as a component of a right -of-use asset . Refer to \nour FRD, Asset retirement obligations , for further discussion of the accounting for an ARO. \nIn certain circumstances, it may b e difficult to determine whether improvements are assets of the lessee \nor the lessor. In many cases, the conclusion, which can affect the determination as to whether removal \ncosts should be accounted for under the provisions for accounting for leases ( ASC 842) or the provision s \nfor AROs ( ASC 410-20), will be based on facts and circumstances. Guidance to assist in determining \nwhether improvements should be considered assets of the lessee or the lessor can be found in ASC 842-\n40-55-5. Sections 2.11 , Improveme nts to the underlying asset , and 7 .7, Lessee involvement in asset \nconstruction ( “build -to-suit” transactions) , also discuss factors to consider in making this determination. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 111}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 100 The following illustrations demonstrate the concepts discussed above. \nIllustration 2-16: Obligation as a result of lease contract \nLand with cellular tower \nEntity A (lessee) leases vacant land from Entity B (lessor). Entity A has the right but not the obligation \nto construct a cellular tower on the property. If Entity A constructs the cellular tower on the property, \nit is obligated to return the land to its original condition at the end of the lease term. In this case, it is \nthe construction of the cellular tower that imposes the liability on Entity A, not the lease of th e land. If \nEntity A does not construct the cellular tower, it has no obligation under the lease. If it does construct \nthe cellular tower, the tower would be recognized as a leasehold improvement, and the obligation to \nremove the tower would be an ARO. \nAlternatively, if Entity A leases land and an existing cellular tower from Entity B and is required to \ndemolish and remove the cellular tower at the end of the lease term, Entity A has assumed a direct \nobligation related to the underlying asset that arises upo n entering into the lease rather than an \nobligation created by a future action. As a result, the estimated demolition and removal costs should \nbe included in lease payments. By including the dismantling obligation in lease payments, the \nobligation will be included in the measurement of the lease liability and right -of-use asset, and the \nrelated expense will be recognized over the lease term. At the end of the lease term, a liability exists \nthat would be reduced by the payments made to demolish and remove th e cellular tower. \nLease of office space \nA lessee leases office space with preexisting improvements ( e.g., interior walls, carpeting) and is \ncontractually obligated to remove these preexisting improvements upon expiration of the lease. Because \nthe original condition of the underlying asset included the improvements and the lessee is leasing the \nspace and improvements, the estimated removal obligation should be included in lease payments. \nAlternatively, if the lessee pays to build out the space to configure it to its needs ( e.g., interior walls \nand carpeting accounted for by the lessee as leasehold improvements) and is required to remove the \nimprovements on expiration of the lease, it should account for the removal obligation as an ARO. The lessee \nis obligated to remove an asset that it constructed and recorded as an asset ( i.e., a leasehold improvement). \nIf the lessee leases office space with both preexisting improvements ( i.e., lessor assets) and additional \nlessee leasehold improvements, estimated costs to remove the improvements should be split between \nthe preexisting improvements and the lessee improvements. Estimated costs to remove the preexisting \nimprovements should be included in lease payments. The contractual obligation associated with the \nremoval of the leasehold improvements constructed and accounted for by the lessee should be accounted \nfor as an ARO. \n \nIllustration 2 -17: Obligation as a result of a legal obligation \nEntity A (lessor) owns a gas station that it leases to Entity B (lessee). The property includes preexisting \nunderground fuel storage tanks . \nScenario 1 \nAt lease commencement, there is a legal requirement to remove the preexisting underground fuel \nstorage tanks in 10 years. Even though Entity A leases the gas station to another party, it remains \nlegally obligated for removal of the underground storage tanks and must recognize an ARO. \nIf the lease agreement requires Entity B to remove the underground storage tanks at the end of the \nlease term, the estimated cost of removal would be included in the lease payments by Entity B and \nwould have no effect on the requirement for Entity A to recognize an ARO under ASC 410-20 for its \nlegal obligation to remove the storage tanks. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 112}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 101 Scenario 2 \nAt lease commencement , there is no legal requirement for removal of the underground storage tanks. \nHowever, the lease requires that if such a legal requirement is enacted during the lease term, Entity B \nis required to remove the underground storage tanks at the end of the lease. \nEntity B wo uld have to consider the facts and circumstances to determine whether to account for the \nestimated costs of removal of the underground storage tanks as a lease payment or variable lease \npayment. We believe that if the enactment of a law requiring removal o f the underground storage tanks \nduring the lease term is judged to be probable at lease commencement , the removal costs would be \nincluded in the lease payments and accounted for under the general provisions for accounting for \nleases under ASC 842. However, if the enactment of such a law is not judged to be probable at lease \ncommencement, the estimated removal costs would be accounted for as a variable lease payment. If a \nlegal requirement to remove the underground storage tanks is enacted during the lease t erm or it is \ndetermined that the enactment of such law is probable after lease commencement , Entity B would \naccrue the estimated costs of removal. \nAs noted above, an obligation to return an underlying asset ( i.e., the leased asset) to its original conditi on \n(if it has been modified by the lessee by the installation of leasehold improvements) is an ARO that should \nbe accounted for under ASC 410-20. In certain cases, settlement of the obligation may be planned prior to the \nend of the lease term. However, a p lan to voluntarily settle an ARO obligation prior to the end of the lease \nterm does not affect the requirement to record an ARO liability when l easehold improvements are made. \nIllustration 2 -18: Settlement of ARO prior to the end of the lease term \nA retailer signs a 10 -year lease for space in a shopping mall. The lease terms include a requirement for \nthe lessee to return the space to its original condition at the end of the lease. At commencement \nof the lease, the retailer modifies the space by constr ucting various leasehold improvements \n(e.g., merchandise displays, shelving to stock merchandise, flooring, checkout counters). The retailer \nestimates that the useful life of the improvements is five years, at which time they will all be replaced. \nThe obli gating event to remove these leasehold improvements occurs when they are made, regardless \nof whether settlement is planned at the end of the lease term or at an earlier point in time. The asset \nretirement cost should be amortized over the five -year estimat ed useful life of the improvements, and \nthe obligation should be accreted using the credit -adjusted risk -free rate over the same five -year term. \nIf the retailer replaces the original leasehold improvements after five years, a settlement of the \noriginal ARO obligation should be recognized, and a new ARO obligation should be recorded related to \nany newly constructed leasehold improvements. \nAccounting for an ARO \nEntities often plan to use leased equipment to perform asset retirement activities. If this is th e case, the \nestimate of the gross cash flows to satisfy the ARO liability includes anticipated lease costs for equipment the \nentity plans to lease to perform asset retirement activities in the future. Therefore, the cost assumptions used \nto measure the fai r value of the ARO asset and liability will include all anticipated lease costs and costs relating \nto the non -lease components of contracts the entity expects to enter into to perform the asset retirement \nactivities. Lease costs include lease payments as d efined by ASC 842 and other payments associated with the \nlease component of the contract such as variable payments that are not dependent on an index or a rate. \nUnder ASC 842, a lessee is generally required to recognize a lease liability and a right -of-use asset for \nunderlying assets, including underlying assets that are used in asset retirement activities, on the lease \ncommencement date ( i.e., the date the underlying asset is available for use by the lessee and not the date \non which the ARO is recognized). This lease liability is recognized separately from any ARO liability even \nthough the entity may have included an estimate of the lease costs in its measurement of the ARO \n(consistent with accounting for other obligations also included in the estimate of the ARO, such as ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 113}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 102 employee payroll costs). That is, the entity recognizes one obligation to retire a long-lived asset or assets \nin accordance with ASC 410-205 and at the le ase commencement date, a separate obligation to the \nlessor of the leased equipment in accordance with ASC 842. This is not a “double counting” of the lease \nobligation but instead reflects two separate obligations to different parties ( i.e., an obligation a ssociated \nwith the retirement of a long -lived asset and a separate lease obligation). \nAROs are generally settled in the periods the asset retirement activities are performed. As noted above, \nrecognition of an ARO liability and the lease obligation are sepa rately recognized obligations. Therefore, \nthe recording of the lease liability doesn’t change the existence of the ARO. However, an entity should \nrevise its estimates of lease costs used in measuring the ARO whenever indicators suggest that the \nassumptions regarding the future lease costs have changed, including at the commencement date of a \nlease contract for equipment that will be used to perform the asset retirement activities ( i.e., when the \nterms of the lease arrangement are known).6 \nIn the periods th at a lessee uses a n underlying asset for asset retirement activities, lease costs \n(i.e., operating lease cost or amortization associated with the lease of a finance lease) recognized in \naccordance with ASC 842 are recorded as a reduction to the ARO liability, rather than as lease expense. \nRefer to section 4 , Lessee accounting , for a further discussion of lease accounting. \nThe ASC 842 lessee disclosure requirements also apply once the lease has been entered into, even \nthough the lessee will recognize lease costs as a reduction of the ARO. Therefore, entities will need to \ntrack total lease costs, including amounts that relate to asset retirement activities. \nThe graphic below illustrates both the accounting at key points in time and the periodic accounti ng journal \nentries an entity would make when using a n underlying asset to perform asset retirement activities and \nassumes the lease commencement date occurs after the end of the useful life of the asset being retired. \nKey points in time \n \n• Recognize ARO asset and liability • ARO asset has been fully depreciated \n• ARO liability recognized based on accretion to date and any \nchanges in estimated cash flows \n• Separately recognize ROU asset and lease liability at lease \ncommencement date \nPeriodic journal entries \n \n• Recognize accretion expense associated with the \nARO liability \n• Record ARO asset depreciation expense over the asset’s \nuseful life \n• Reevaluate and remeasure ARO in accordance with ARO \nguidance, whenever assumptions change significantly • Subsequently measure lease liability and ROU asset in \naccordance with ASC 842 following lease commenc ement date \n• Reduce ARO liability by lease costs ( i.e., operating lease \nexpense or amortization expense associated with a finance \nlease) recognized in each period \n• Recognize accretion expense associated with the ARO liability \n• Reduce ARO liability for other amounts used to settle \nthe obligation \n• Recognize any gain or loss on settlement, as required by \nASC 410-20 \n \n5 ASC 410-20 does not apply to obligati ons of a lessee associated with the underlying asset as defined by ASC 842 ( e.g., owned \nland, buildings, equipment, leasehold improvements). \n6 Refer to section 5.2 , Changes in estimates , and Example 2 in Appendix A , Comprehensive examples , of our FRD, Asset \nretirement obligations , for a discussion of the settlement of an ARO obligation involving a change in estimated cash flows and \nexample journal entries. \nARO incurred \n Decommissioning work begins; lease commence s \nAccounting during the decommissioning period \n Accounting before the decommissioning period ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 114}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 103 The requirements of ASC 410-20 do not apply to obligations of a lessee that meet the definition of either \nlease payments or variable lease paym ents in connection with the underlying asset , whether imposed by \na lease agreement or by a party other than the lessor. \nThe following illustration shows the accounting considerations for an entity that leases equipment used in \nasset retirement activities. While the illustration shows the considerations for an operating lease, the \nprinciples of this example would also apply to finance leases. \nIllustration 2 -19: Using leased equipment for decommissioning activities \nAssume that an upstream oil and gas entity (Upstream Co.) begins production on an oil field with an \nexpected producing life of 10 years, followed by a three -year period of rehabilitation and decommissioning \nof the field that Upstream Co. is legally obligated to perform. Also, assume the following: \n• The production activities involve the use of land not in the scope of ASC 842 ( i.e., ASC 842 does \nnot apply to leases to explore for or use non -regenerative resources) . \n• On the date production begins, Upstre am Co. estimates and records an ARO liability.1 \n• At the end of the 10 -year field life, the reserves are fully depleted.2 \n• The ARO liability estimate includes expected payments of $21 million to a third -party lessor \nthat Upstream Co. expects to make to lease a specialized drilling rig it plans to use in the asset \nretirement activities. \n• At the end of year 10, Upstream Co. enters into a three -year lease, classified as an operating \nlease, with the third -party supplier for the right to use the specialized drilling rig exclusively in the \ndecommissioning process. For simplicity: \n• The terms of the lease are consistent with the assumptions used to measure the ARO liability. \n• The lease requires Upstream Co. to make a single lease payment of $21 million at the end of the \nthree -year term, and there are no variable lease payments, meaning annual lease cost is $7 million. \n• Upstream Co. incurred no initial direct costs in connection with the lease and concludes the \nlease is an operating lease. \n• Annual accretion of the lease liability will be $1 million per year. \n• Upstream Co. recognizes a lease liability at the lease commencement date of $18 million.3 \nAnalysis: The journal entries below illustrate select accounting implications of this fact pattern. Refer \nto Example 1 in Appendix A , Comprehensive examples, of our FRD, Asset retirement obligations , for \nan example of the applicable ARO journal entries and section 4, Lease accounting , for a discussion of \nlessee accounting . \nAt the lease commencement date, Upstream Co. recognizes the right -of-use asset and lease liability: \nRight -of-use asset $ 18,000,000 \n Lease liability $ 18,000,000 \nTo initially recognize the right -of-use asset and lease liability. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 115}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 104 The following journal entries, among others, would be recorded in the first year of decommissioning: \nLease e xpense $ 7,000,000 \n Right -of-use asset $ 6,000,000 \n Lease liability 1,000,000 \nTo recognize the lease cost of $7 million ($21 million over the three -year operating lease term, on a \nstraight -line basis) for the use of the underlying asset and to adjust the lease liability to the present \nvalue of the remaining lease payments. \nARO liabi lity $ 7,000,000 \n Lease expense $ 7,000,000 \nTo reclassify lease expense to the ARO liability due to the use of the underlying asset for retirement activities. \n \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \n1 Refer to Example 1 in Appendix A , Comprehensive example s, of our FRD, Asset retirement obligations , for an example of th e initial \nmeasurement of an ARO using the expected cash flow approach and subs equent measurements assuming there are no changes in \nthe expected cash flows. \n2 This liability will be accreted until settlement of the obligation (these subsequent accretion entries are not included for \npurposes of this illustration). \n3 Refer to section 4 .2.4, Example — lessee accounting for an operating lease, for an example of lease accounting journal entries \nfor an operating lease. \nRefer to our FRD, Asset retirement obligations , for further discussion on the accounting for asset \nretirement obligations, including further discu ssion regarding the effect of applying the provisions of \nASC 820, Fair Value Measurement , to the measurement of asset retirement obligations. \n2.4.9 Tax indemnifications in lease agreements \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \n842-10-55-38 \nSome leases contain indemnification clauses that indemnify lessors on an after -tax basis for certain tax \nbenefits that the lessor may lose if a change in the tax law precludes realization of those tax benefits. \nAlthough the indemnification payments may appear to meet the definition of variable lease payments, \nthose payments are not of the nature normally expected to arise under variable lease payment provisions. \n842-10-55-39 \nBecause of the close associa tion of the indemnification payments to specific aspects of the tax law, \nany payments should be accounted for in a manner that recognizes the tax law association. The lease \nclassification should not be changed. \n842-10-55-40 \nParagraph 842 -30-55-16 discusses a lessor’s accounting for guarantee payments received. \nLeases — Lessor \nImplementation Guidance and Illustrations \nGuarantee Payments Received \n842-30-55-16 \nIndemnification payments related to tax effects other than the investment tax credit should be reflec ted \nby the lessor in income consistent with the classification of the lease . That is, the payments should be \naccounted for as an adjustment of the lessor’s net investment in the lease if the lease is a sales -type lease \nor a direct financing lease or recogn ized ratably over the lease term if the lease is an operating lease . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 116}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 105 Indemnities for changes in tax laws \nSome leases contain indemnification clauses that indemnify lessors, on an after -tax basis, for certain tax \nbenefits a lessor may lose because of a change in tax law. Although the indemnification payments may \nappear to meet the definition of variable lease payments, such payments are not of the nature normally \nexpected to arise under variable lease payment provisions. Further, due to the close association of the \npayments to specific aspects of the tax law, the payments should be accounted for in a manner tha t \nrecognizes the tax law association. The lease classification should not be changed. \nLessors \nIndemnification payments received by lessors should be reflected in income consistent with the \nclassification of the lease. That is, the payments should be accoun ted for as an adjustment to the lessor’s \nnet investment in the lease if a direct financing or sales -type lease or recognized ratably over the lease \nterm if an operating lease. The lease classification is not affected by indemnification clauses or \nindemnifi cation payments received by the lessor. \nLessees \nA lessee’s indemnification of the lessor for any adverse tax consequences that may arise from a change in \nthe tax laws is generally subject to the provisions for guarantees under ASC 460. These types of \nindem nifications are not considered to be guarantees of the lessee’s own future performance because \nonly a legislative body can change the tax laws, and the lessee therefore has no control over whether \npayments will be required under that indemnification. In ad dition, while ASC 460-10-15-7(c) provides a \nscope exception for contracts that have the characteristics of a guarantee or indemnification, but are \naccounted for as variable lease payments, because ASC 842-10-55-38 indicates that indemnification \npayments sh ould not be accounted for as variable lease payments, the scope exception does not apply. \nTherefore, to the extent a general indemnity requires additional payments to the lessor due to adverse \nchanges in the tax law, regulations or ruling, the indemnificat ion would generally be subject to ASC 460. \nIllustration 2 -20: Accounting for indemnity for changes in tax laws \nAssume a lessor in an operating lease is a foreign entity that is not subject to tax withholding \nrequirements and the lessor requires the lessee to indemnify the lessor for any future change in the \ntax law, which would require the lessee to withhold income taxes from payments to the lessor. This \nmay occur if the lessor’s taxing authority enters into or modifies its tax treaty with the US. The effe ct \nof this indemnification would be to increase the lessee’s payments for the underlying asset for the \nrequired withholding tax (which would be remitted directly to the IRS). \nAnalysis: This arrangement meets the criteria of ASC 460-10-15-4(c), and therefore, the indemnity is \nsubject to the recognition and measurement provisions of ASC 460. Therefore, the lessee should \nrecord a liability for the guarantee based on its fair value, and the related expense should be recognized \nover the operating lease term. \nAs noted above, tax indemnities do not affect the lease classification. That is, the fair value of the guarantee \nand the related expense should not be included in the lease classification test per ASC 842-10-25-3(b)(1) \n(refer to section 3.2, Criteria for lease classification — lessors ). \nGeneral indemnity for increase in taxes \nMany leases include a general indemnification that the lessee will directly pay (or reimburse the lessor) \neither the entire amount due or a pro rata share of any increases in all sales, use or property taxes. As \nnoted in section 1.4.2.1, Executory costs , the payment of taxes by a lessee is not considered a separate \n(i.e., non-lease) component of a contract. Entities should evaluate whether lease payments made for \ntaxes are fixed (or in -substance fixed) lease payments or variable lease payments (refer to sec tion 2.4, \nLease payments ). These types of arrangements are generally not viewed as indemnifications under ASC 460. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 117}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 106 Indemnities for adverse tax consequences that result from actions of the lessee \nMany leases require the lessee to indemnify the lessor for an y adverse tax consequences that may arise \nfrom acts, omissions and misrepresentations of the lessee. These types of indemnifications are generally \nrelated to the anticipated use of the underlying asset and level of taxation (or deductibility) related to \nthat intended use. We believe these indemnities would be outside the scope of ASC 460 as they represent \na guarantee of an entity’s own performance. \n2.4.10 Amounts not included in lease payments (updated August 2023) \nExcerpt from Accounting Standards Codific ation \nLeases — Overall \nInitial Measurement \n842-10-30-6 \nLease payments do not include any of the following: \na. Variable lease payments other than those in paragraph 842 -10-30-5(b) \nb. Any guarantee by the lessee of the lessor’s debt \nc. Amounts allocated to nonlease components in accordance with paragraphs 842 -10-15-33 \nthrough 15 -42. \nPending Content: \nTransition Date : (P) December 16, 2023; (N) December 16, 2023 | Transition Guidance: 842-10-65-8 \nLease payments do not include any of the following: \na. Variable lease payments other than those in paragraph 842 -10-30-5(b) \nb. Any guarantee by the lessee of the lessor ’s debt \nc. Amounts allocated to nonlease components in accordance with paragraphs 842 -10-15-33 \nthrough 15 -42 \nd. Leasehold imp rovements recognized by a lessee and accounted for in accordance with \nparagraph 842 -20-35-12A. \n \nVariable lease payments that do not depend on an index or rate \nVariable lease payments that do not depend on an index or rate, such as those based on performance \n(e.g., a percentage of sales) or usage of the underlying asset ( e.g., the number of hours flown, the \nnumber of units produced), are not included as lease payments. Entities should carefully evaluate the \nprovisions of variable lease payments so that the payments are not in -substance fixed payments (refer to \nsection 2.4.1.1, In-substance fixed lease payments ). Lessees are required to remeasure lease payments \nwhen a contingency is resolved that results in some or all of the lease payments that were previously \ndetermined to be variable meeting the definition of lease payments (refer to section 2.4.11, Subsequent \nremeasurement of lease payments ). \nA lessee’s guarantee of a lessor’s debt \nLease payments do not include any guarantee by the lessee of the l essor’s debt (which is generally \naccounted for under ASC 460). However, we believe if the lessor’s debt is recourse only to the underlying \nasset either because the debt is non -recourse or the lessor has no significant assets other than the \nproperty under lease, a guarantee by the lessee of the lessor’s debt is tantamount to guaranteeing the \nunderlying asset’s residual value. The same would be true for a non -recourse loan made by the lessee to \nthe lessor. Accordingly, the probable shortfall between the outstanding debt balance and the value of the ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 118}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 107 residual asset at the end of the lease term should be included in lease payments. In addition, the \npresence of a lessee’s guarantee of the lessor’s debt may affect the evaluation of both lease term and lease \npayments (e.g., the evaluation of whether a purchase option is reasonably certain to be exercised). \nWhile “any guarantee by the lessee of the lessor’s debt” is excluded from lease payments, a guarantee of \na lessor’s debt would still need to be accounted for under ASC 460. \nAmounts allocated to non -lease components \nLease payments do not include payments al located to the non -lease components of a contract. However, \nlease payments include amounts that would otherwise be allocable to the non -lease components of a \ncontract when the lessee makes an accounting policy election to account for the lease and non -lease \ncomponents as a single lease component (this election is not available to lessors). Refer to sections 1.4.3.2, \nAllocating the consideration in the contract — lessees , and 1.4.4.2, Allocating the consideration in the \ncontract — lessors , for lessees and le ssors, respectively. \nLeasehold improvements recognized in a lease between entities under common control \nLease payments do not include leasehold improv ements that are expected to be transferred from the \nlessee to a lessor that is under common control when the lessee no longer controls the use of the \nunderlying asset (i.e., at the end of the lease ). Refer to section 4.7.3.4 , Lessee amortization of leas ehold \nimprovements associated with a lease between entities under common control , for further discussion. \n2.4.11 Subsequent remeasurement of lease payments \n2.4.11.1 Subsequent remeasurement of lease payments — lessees \nExcerpt from Accounting Standards Codification \nLeases — Overall \nSubsequent Measurement \n842-10-35-4 \nA lessee shall remeasure the lease payments if any of the following occur: \na. The lease is modified, and that modification is not accounted for as a separate contract in \naccordance with paragraph 842 -10-25-8. \nb. A contingency upon which some or all of the variable lease payments that will be paid over the \nremainder of the lease term are based is resolved such that those payments now meet the \ndefinition of lease payments. For example, an event occurs that results in variable lease payments \nthat were linked to the pe rformance or use of the underlying asset becoming fixed payments for \nthe remainder of the lease term. However, a change in a reference index or a rate upon which \nsome or all of the variable lease payments in the contract are based does not constitute the \nresolution of a contingency subject to (b) (see paragraph 842 -10-35-5 for guidance on the \nremeasurement of variable lease payments that depend on an index or a rate). \nc. There is a change in any of the following: \n1. The lease term, as described in paragraph 842-10-35-1. A lessee shall determine the revised \nlease payments on the basis of the revised lease term. \n2. The assessment of whether the lessee is reasonably certain to exercise or not to exercise an \noption to purchase the underlying asset, as described in paragraph 842 -10-35-1. A lessee \nshall determine the revised lease payments to reflect the change in the assessment of the \npurchase option. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 119}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 108 3. Amounts probable of being owed by the lessee under residual value guarantees . A lessee \nshall determine the revi sed lease payments to reflect the change in amounts probable of \nbeing owed by the lessee under residual value guarantees. \n842-10-35-5 \nWhen one or more of the events described in paragraph 842 -10-35-4(a) or (c) occur or when a \ncontingency unrelated to a cha nge in a reference index or rate under paragraph 842 -10-35-4(b) is \nresolved, variable lease payments that depend on an index or a rate shall be remeasured using the \nindex or rate as of the date the remeasurement is required. \nASC 842 requires lessees to remeasure lease payments when there is a lease modification ( i.e., a change \nto the terms and conditions of the contract that results in a change in the scope of or the consideration \nfor the lease) that is not accounted for as a separate contract . Refer to the section 4.6, Lease modifications . \nLessees are also required to remeasure lease payments if any of the following occur: \nTitle Description of remeasurement event Section r eference \nResolution of \ncontingency fixing \npreviously variable \nlease payments A resolution of a contingency that results in some \nor all of the lease payments that were previously \ndetermined to be variable meeting the definition of \nlease payments ( e.g., an event occurs that results \nin variable lease payments that were linked to the \nperformance or use of the underlying asset becoming \nfixed payments for the remainder of the lease term) \nThis provision does not apply to variable payments \nbased on an index or rate 2.4.1, Fixed (including \nin-substance fixed) \nlease payments an d \nlease incentives \n \n \n \n2.4.2, Variable \npayments that depend \non an index or rate \nLease term A change in the lease term 2.3.1, Lease term \nExercise of options A change in the assessment of whether the lessee \nis reasonably certain to exercise an option to \npurchase the underlying asset 2.3.2, Purchase \noptions \nResidual value \nguarantee A change in the amounts it is probable that the \nlessee will owe under residual value guarantees 2.4.6, Amounts it is \nprobable that a lessee \nwill owe under residual \nvalue guaran tees — \nlessees only \nWhen lease payments are remeasured for any of the reasons discussed above, lessees will also \nremeasure variable lease payments that depend on an index or rate using the index or rate at the \nremeasurement date and remeasure and realloca te the remaining consideration in the contract (refer to \nsection 1.4.3.2, Allocating the consideration in the contract — lessees ). \nLessees remeasure the lease liability upon a remeasurement event, with a corresponding adjustment to the \nright -of-use asset. However, if the right -of-use asset is reduced to zero, a lessee would recognize any remaining \namount in profit or loss. Refer to section 4.5, Remeasurement of lease liabilities and right -of-use assets — \noperating and finance leases . \nRefer to section 3.5.1, Summary of lease reassessment and remeasurement requirements. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 120}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 109 Co-tenancy clause \nA co-tenancy clause is a clause in a lease contract that could result in changes in a tenant’s lease payments \nif certain events involving other tenants occur ( e.g., if key tenants or a certain number of tenants leave a \nretail shopping center). A co -tenancy clause, if triggered, may temporarily reduce a lessee’s lease payments \nor contractually change the lease payments from fixed lease payments to variable lease payments \n(e.g., payments that were previously fixed are changed to a percentage of sales). Generally, when the \nco-tenancy clause is resolved ( e.g., the anchor tenant is replaced or occupancy levels return to a stated \npercentage), the lease payments will revert back to the previous amounts. \nIf after lease commencement a co -tenancy clause is triggered, we believe a lessee generally would not \nremeasure the lease payment s. ASC 842 requires a lessee to remeasure lease payments when a \ncontingency upon whi ch some or all of the variable lease payments that will be paid over the remainder \nof the lease term are based is resolved and those payments now meet the definition of lease payments. A \nco-tenancy clause would typically result in the inverse scenario beca use it would temporarily lower the \nlease payment or temporarily cause fixed payments to become variable. Therefore, we believe any \ntemporary change in lease payments that results from a co -tenancy clause being triggered should be \nrecognized as period lease cost similar to variable lease payments. \nHowever, in certain circumstances, when it is likely the co -tenancy clause will not be resolved ( e.g., the \nlease space is an aging strip mall with a low likelihood of locating replacement tenants that comply with \nthe clause), we believe a lessee may reasonably conclude it should remeasure the lease payments. In this \nexample , the lease payments would be reme asured , resulting in a reduction to the existing lease liability. \nThe effect of a co -tenancy clause when reassessing lease payments will depend on facts and circumstances. \n2.4.11.2 Subsequent remeasurement of lease payments — lessors \nExcerpt from Accounting Standards Codification \nLeases — Overall \nSubsequent Measurement \n842-10-35-6 \nA lessor shall not remeasure the lease payments unless the lease is modified and that modification is \nnot accounted for as a separate contract in accordance with paragra ph 842 -10-25-8. \nLessors remeasure the lease payments only upon a modification ( i.e., a change to the terms and conditions \nof the contract that results in a change in the scope of or the consideration for the lease) that is not \naccounted for as a separate contract. Refer to section 5.6, Lease modifications . \nRefer to section 3.5.1, Summary of lease reassessment and remeasurement requirements. \n2.5 Discount rates \nExcerpt from Accounting Standards Codification \nMaster Glossary \nDiscount Rate for the Lease \nFor a lessee , the discount rate for the lease is the rate implicit in the lease unless that rate cannot be \nreadily determined. In that case, the lessee is required to use its incremental borrowing rate . \nFor a lessor , the discount rate for the lease is the rate implicit in the lease. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 121}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 110 Rate Implicit in the Lease \nThe rate of interest tha t, at a given date, causes the aggregate present value of (a) the lease \npayments and (b) the amount that a lessor expects to derive from the underlying asset following the \nend of the lease term to equal the sum of (1) the fair value of the underlying asset minus any related \ninvestment tax credit retained and expected to be realized by the lessor and (2) any deferred initial \ndirect costs of the lessor. However, if the rate determined in accordance with the preceding sentence \nis less than zero, a rate implici t in the lease of zero shall be used. \nIncremental Borrowing Rate \nThe rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar \nterm an amount equal to the lease payments in a similar economic environment. \nLeases — Lessee \nInitial Measurement \n842-20-30-2 \nThe discount rate for the lease initially used to determine the present value of the lease payments for \na lessee is calculated on the basis of information available at the commencement date . \n842-20-30-3 \nA lessee should use the rate implicit in the lease whenever that rate is readily determinable. If the rate \nimplicit in the lease is not readily determinable, a lessee uses its incremental borrowing rate . A lessee \nthat is not a public business entity is per mitted to use a risk -free discount rate for the lease instead of its \nincremental borrowing rate , determined using a period comparable with that of the lease term , as an \naccounting policy election made by class of underlying asset . \nLeases — Overall \nRecognit ion \n842-10-25-4 \nA lessor shall assess the criteria in paragraphs 842 -10-25-2(d) and 842 -10-25-3(b)(1) using the rate \nimplicit in the lease . For purposes of assessing the criterion in paragraph 842 -10-25-2(d), a lessor shall \nassume that no initial direct co sts will be deferred if, at the commencement date, the fair value of the \nunderlying asset is different from its carrying amount. \nDiscount rates are used to determine the present value of the lease payments, determine lease classification \n(refer to section 3.3, Discount rates used to determine lease classification ) and to measure a lessor’s net \ninvestment in the lease for sales -type and direct financing leases and a lessee’s lease liability. \nFor a lessee, the discount rate for the lease is the “rate implicit in the lease” and, if that rate cannot be \nreadily determined, its incremental borrowing rate (or for a lessee that is not a PBE, the risk -free rate if \nthe lessee has made the risk -free rate election for that class of underlying asset) . For a lesso r, the \ndiscount rate for the lease is the rate implicit in the lease. The rate implicit in the lease is defined in a \nmanner similar to the definition in ASC 840 and reflects the nature and specific terms of the lease. The \nrate implicit in the lease should not be less than zero , and we believe the incremental borrowing rate also \nshould not be less than zero. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 122}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 111 2.5.1 Discount rate — lessors \nLessors use the rate implicit in the lease that causes the following: \n \nThe amount the lessor expects to derive from the underlying asset \nFor purposes of determining the present value of the amount the lessor expects to derive from the \nunderlying asset at the end of the lease, inflation generally is not considered. The estimated fair value of \nthe underlying asset at the end of the lease is based on price s and market conditions that exist at the \ncommencement of the lease. Therefore, w e believe the amount used to determine the rate implicit in the \nlease would not exceed the fair value at lease commencement. \nInitial direct costs — classification \nThe following table summarizes the discount rates used to determine lease classification by lessors. \n At le ase commencement, the fair value \nof the underlying asset does not equal its \ncarrying value At lease commencement, the fair value \nof the underlying asset is equal to its \ncarrying value \nSales -type lease \nclassification test \n(as described in \nASC 842-10-25-2(d)) Rate implicit in the lease, assuming that no \ninitial direct costs of the lessor will be deferred \n(i.e., exclude initial direct costs from the \ncalculation of the rate implicit in the lease) Rate implicit in the lease (including initial \ndirect costs of the lessor in the calculation \nof the rate) \nDirect financing lease \nclassification test \n(as described in \nASC 842-10-25-3(b)(1)) Rate implicit in the lease (including initial \ndirect costs of the lessor in the calculation \nof the rate) Rate implicit in the lease (including initial \ndirect costs of the lessor in the calculation \nof the rate) \nWhen a lessor is performing the sale s-type lease classification test, ASC 842-10-25-4 clarifies that the \nlessor should assume that no initial direct costs will be deferred when determining the rate implicit in the \nlease if, at lease commencement, the fair value of the asset does not equal its carrying value. That is, a \nlessor would exclude initial direct costs from the calculation of the rate implicit in the lease if the \nunderlying asset’s fair value differs from its carrying value. The direct financing lease classification test \ndescribed in ASC 842-10-25-3(b)(1) does not include a similar exception. As a result, the calculation of \nthe rate implicit in the lease for purposes of applying the direct financing lease classification test will \nalways include the lessor’s initial direct costs. \nInitia l direct costs — initial recognition and measurement \nFor purposes of the initial recognition and measurement of a direct financing lease or a sales -type lease, \nif the fair value of the underlying asset equals its carrying amount at lease commencement, any initial \ndirect costs are deferred and included in the computation of the rate implicit in the lease and, therefore, \nthe net investment in the lease (refer to sections 5.2.1, Initial recognition and measurement — sales -type \nleases , or 5.3.1, Initial recogni tion and measurement — direct financing leases ). The rate that was used in \nthe sales -type lease classification test can differ from the rate used in the direct financing lease \nclassification test and to initially measure the net investment in the lease bec ause of the lease \nclassification guidance above. \nThe present value \nof lease payments \nmade by the lessee \nfor the right to use \nthe underlying asset \n(refer to section 2.4, \nLease payments ) \nThe present value \nof the amount the \nlessor expects to \nderive from the \nunderlying asset \nfollowing the end \nof the lease term \n(see below) \nThe fair value of the \nunderlying asset \nminus any related \ninvestment tax \ncredit retained and \nexpected to be \nrealized by the lessor \n(refer to section 2.8, \nFair value ) \nAny deferred initial \ndirect costs of the \nlessor (see below \nand section 2.6, \nInitial direct costs ) \n+ \n + \n = ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 123}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 112 Selling profit — initial recognition and measurement (direct financing leases) \nFor purposes of the initial recognition and measurement of a direct financing lease, any selling profit is \ndeferred and reduces the lessor’s net investment in the lease (refer to section 5.3.1 , Initial recognition \nand measurement — direct financing leases ). Therefore, a lessor of a direct financing lease would exclude \nselling profit from the calculation of the rate implicit in the lease . That is, when calculating the rate \nimplicit in the lease, the sum of (1) t he present value of lease payments made by the lessee for the right \nto use the underlying asset and (2) t he present value of the amount the lessor expects to derive from the \nunderlying asset following the end of the lease term would be reduced by the selling profit. \nLeases with significant variable lease payments \nVariable payments that do not depend on an index or rate are not considered lease payments and are \nexcluded from the measurement of a lessor’s net investment in the lease. As a result, a lessor’s initial \nmeasurement of its net investment in certain sales -type or direct financing leases with significant variable \npayments may be lower than the carrying amount of the underlying asset that is derecognized at lease \ncommencement. In such situations, the rate implicit in the lease, which a lessor will use to disco unt the \nlease payments and unguaranteed residual asset when measuring its net investment in a sales -type or \ndirect financing lease, may result in a negative discount rate. However, ASC 842 is clear that the rate \nimplicit in the lease cannot be less than ze ro, and a lessor that calculates a rate less than zero must use \nzero as the rate implicit in the lease. Consequently, a lessor may recognize a selling loss at lease \ncommencement for certain sales -type or direct financing leases with significant variable pa yments. After \nthe adoption of ASU 2021 -05, the existence of a selling loss in such situations would require a lessor to \nclassify the lease as an operating lease. Refer to section s 3.2, Criteria for lease classification — lessors , \nand 5.1.2, Leases with significant variable lease payments , for further discussion. \n2.5.2 Discount rate — lessees (updated August 202 3) \nExcerpt from Accounting Standards Codification \nLeases — Lessee \nInitial Measurement \n842-20-30-3 \nA lessee should use the rate implicit in the lease whenever that rate is readily determinable. If the rate \nimplicit in the lease is not readily determinable, a lessee uses its incremental borrowing rate . A lessee \nthat is not a public business entity is per mitted to use a risk -free discount rate for the lease instead of its \nincremental borrowing rate , determined using a period comparable with that of the lease term , as an \naccounting policy election made by class of underlying asset . \nLessees are required to use the rate implicit in the lease as described above if that rate can be readily \ndetermined. The rate implicit in the lease would be considered readily determinable when all of the inputs used \nto calculate the rate are readily determinable. We believe tha t lessees often will not know the amount of the \nlessor’s initial direct costs or the amount the lessor expects to derive from the underlying asset following the \nend of the lease term and, therefore, will be unable to determine the rate implicit in the leas e. When the lessee \ncannot readily determine that rate, the lessee uses its incremental borrowing rate. The lessee’s incremental \nborrowing rate is the rate of interest that the lessee would have to pay to borrow on a collateralized basis \nover a similar term an amount equal to the lease payments in a similar economic environment. \nFor purposes of determining a lessee’s incremental borrowing rate, a collateralized borrowing should also \nassume the lender can seek recourse through other assets of the lessee borro wer. A lessee should start \nwith the general credit of the company and then adjust the rate to reflect the effect of collateral on the \nincremental borrowing rate. However, the borrowing generally should not be over collateralized. The \nincremental borrowing rate cannot be a risk -free rate, unless the entity is a non -PBE that elects to apply a \nrisk-free rate (refer to further discussion below). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 124}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 113 When an entity identifies a borrowing with a “similar term,” we be lieve the entity can either: \n• Evaluate the term relative to the lease term determined at the lease commencement date ( i.e., any options \nnot deemed reasonably certain of exercise at lease commencement, such as termination or extension \noptions, would not be c onsidered in the term of the debt). Under this approach, the incremental borrowing \nrate is not adjusted to consider purchase, renewal or termination options not included in the lease term. \n• Use the same approach as above; however, the incremental borrowing rate is adjusted to reflect the \nlessee’s option to extend or terminate the lease or to purchase the underlying asset not otherwise \nincluded in the lease term . This view is consistent with the guidance in ASC 842-20-35-5 on \nremeasuring the lease liability ( refer to section 4.5, Remeasurement of lease liabilities and right -of-\nuse assets — operating and finance leases ). \nNon-PBE accounting policy election \nA lessee that is not a public business entity (PBE) is permitted to make an accounting policy election to u se the \nrisk-free rate ( e.g., in the US, the rate of a zero -coupon US Treasury instrument) by class of underlying asset \nfor the initial and subsequent measurement of lease liabilities. Refer to section 1A, Amendments to ASC 842, \nfor a description of ASU 2021 -09, which allows non -PBE lessees to elect to use the risk -free rate by class of \nunderlying asset rather than for all leases. The risk -free rate is determined using a period comparable with the \nlease term. A lessee is still required to use the r ate implicit in the lease for any individual lease for which it i s \nreadily determinable, as described above, even if it has made the risk -free rate election for the associated \nclass of underlying asset . If a lessee makes this election, it is required to disclose the class or classes of \nunderlying assets to which it applied the risk -free rate in the notes to the financial statements. \nWhile using a risk -free rate might reduce complexity for eligible lessees, it would increase the likelihood \nthat the present value of the lease payments and any residual value guaranteed by the lessee would \nequal or exceed substantially all of the fair value of the underlying asset , potentially resulting in the lease \nbeing classified as a finance lease. Additionally, the use of a lower rate would increase the initial \nmeasurement of a lessee’s lease liability and right -of-use asset. This might dissuade some lessees that \nare not PBEs from making a policy election to use a risk -free rate. \nAt an October 2020 Center for Audit Quality (CAQ ) SEC Regulations Committee joint meeting with the \nSEC staff, the SEC staff stated that it would not object to a registrant calculating the significance of an \nacquisition of a non -PBE lessee that previously elected to use a risk -free rate as its discou nt rate using \nthe lessee’s pre-acquisition financial statements if the only difference between those financial statements \nand a set of PBE financial statements is the use of the risk -free rate. The SEC staff observed that the risk -\nfree rate may result in higher calculated significance. \nThe SEC staff also shared its view that the financial statements of a lessee that previously elected to use \nthe risk -free rate and is only considered to be a PBE now because its financial statements are included in \nanother entity’s SEC filing ( e.g., S-X Rule 3 -05 financial statements) must use the rate implicit in the \nlease , if readily determinable, or its IBR in th e financial statements included in the filing . That i s because \nentities considered PBEs for this reason are required to provide financial statements that reflect the \nrecognition and measurement principles applicable to PBEs. \nA lessee should consider its future plans, such as its potential to become a PBE, when deciding whether \nto elect to use the risk -free rate . Electing to use the risk -free rate could increase complexity for a lessee \nthat become s a PBE because th is election cannot be applied by a public compan y and would require the \nlessee to make a retrospective change in accounting policy in accordance with ASC 250. \n2.5.2.1 Incremental borrowing rate when the lessee is unable to obtain financing \nIf the lessee’s financial condition is such that third parties generally would be unwilling to provide debt \nfinancing, the incremental borrowing rate of the lessee might not be readily determinable. In these rare \ncases, the lessee should use the interest rate for the lowest grade of debt currently available in the \nmarketplace a s its incremental borrowing rate. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 125}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 114 2.5.2.2 Subsidiaries’ incremental borrowing rate \nThe FASB indicated in the Basis for Conclusions (BC 201) of ASU 2016 -02 that it might be appropriate in \nsome cases for a subsidiary to use its parent’s incremental borrowin g rate as the discount rate. Determining \nwhether it is appropriate to do so for a subsidiary’s lease will depend on the facts and circumstances. For \ninstance, if a subsidiary does not have a separate treasury function and the group’s funding is managed \ncentrally at the group level, the lease negotiation may result in the parent entity providing a guarantee of the \nlease. In this situation, it might be appropriate to use the parent’s incremental borrowing rate. In all cases \nthe subsidiary would need to carefu lly evaluate its relationship with its parent, including any guarantees , to \nsupport the use of the parent’s incremental borrowing rate. Refer to Example 2 in ASC 842-20-55-18 through \n55-20 in section 4.8.4, Portfolio approach , which illustrates the use of a parent’s IBR for a portfolio of leases. \n2.5.3 Reassessment of the discount rate \n2.5.3.1 Reassessment of the discount rate — lessors \nLessors reassess the discount rate, for purposes of lease classification, upon a modification ( i.e., a change \nto the terms and conditions of the contract that results in a change in the scope of or consideration for the \nlease) that is not accounted for as a separate contract. The discount rate that is used to account for the \nmodified lease depends on the classification o f the lease before and after the lease modification. \nLessors use a revised discount rate to account for the modified lease upon any of the following: \n• A modification (as described above) to an operating lease that is not accounted for as a separate \ncontract , if the modified lease is classified as either a direct financing or a sales -type lease \n• A modification (as described above) to a direct financing lease that is not accounted for as a separate \ncontract, if the modified lease is classified as either a direc t financing or a sales -type lease \n• A modification (as described above) to a sales -type lease that is not accounted for as a separate \ncontract, if the modified lease is classified as either a direct financing or a sales -type lease \nRefer to section 5.6, Lease modifications . Also refer to section 3.5.1, Summary of lease reassessment \nand remeasurement requirements. \n2.5.3.2 Reassessment of the discount rate — lessees \nLessees reassess the discount rate upon a change to the lease term or a change in the assessment of whether \nthe lessee is reasonably certain to exercise an option to purchase the underlying asset if the discount rate for \nthe lease liability ( e.g., the lessee’s incremental borrowing rate) does not already reflect the lessee’s option \nin the lease to ex tend or terminate the lease or to purchase the underlying asset. That is, in such cases, a \nchange in the discount rate is only required if the lessee had not accounted for the optionality in the \ncontract when determining the discount rate previously. The r eassessment is based on the remaining \nlease term and lease payments. \nLessees are also required to reassess the discount rate upon a modification ( i.e., a change to the terms \nand conditions of the contract that results in a change in the scope of or the consideration for the lease) \nthat is not accounted for as a separate contract. Refer to section 4.6, Lease modifications . \nIf a reassessment of the discount rate results in a change to the discount rate, lessees should remeasure \nthe lease liability using the r evised discount rate at the reassessment date and adjust the right -of-use \nasset. However, if the right -of-use asset is reduced to zero, a lessee should recognize any remaining \namount in profit or loss. \nRefer to section 3.5.1, Summary of lease reassessment and remeasurement requirements. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 126}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 115 2.6 Initial direct costs \nExcerpt from Accounting Standards Codification \nMaster Glossary \nInitial Direct Costs \nIncremental costs of a lease that would not have been incurred if the lease had not been obtained. \nLeases — Overall \nInitial Measurement \n842-10-30-9 \nInitial direct costs for a lessee or a lessor may include, for example, either of the following: \na. Commissions \nb. Payments made to an existing tenant to incentivize that tenant to terminate its lease . \n842-10-30-10 \nCosts to negotiate or arrange a lease that would have been incurred regardless of whet her the lease \nwas obtained, such as fixed employee salaries, are not initial direct costs. The following items are \nexamples of costs that are not initial direct costs: \na. General overheads, including, for example, depreciation, occupancy and equipment cost s, \nunsuccessful origination efforts, and idle time \nb. Costs related to activities performed by the lessor for advertising, soliciting potential lessees, \nservicing existing leases, or other ancillary activities \nc. Costs related to activities that occur befo re the lease is obtained, such as costs of obtaining tax \nor legal advice, negotiating lease terms and conditions, or evaluating a prospective lessee’s \nfinancial condition. \nUnder ASC 842, initial direct costs are incremental costs that would not have been incurred if the lease \nhad not been obtained ( e.g., commissions, payments made to an existing tenant to incentivize that \ntenant to terminate its lease). Lessees and lessors apply the same definition of initial direct costs. \nASC 842’s guidance on initial dir ect costs is consistent with the concept of incremental costs of obtaining \na contract in the revenue recognition standard. \nThe following illustrates costs that may qualify as initial direct costs and costs that may not qualify as \ninitial direct costs: \nCosts that may qualify as IDCs \n• Commissions paid to a salesperson when a \nlease agreement is obtained \n• Payments made to existing tenants to \nincentivize them to terminate the lease Costs that may not qualify as IDCs \n• Fees for general legal and tax advic e \n• Costs of evaluating a prospective lessee’s \nfinancial condition \n• Commissions paid to a salesperson for \nentering into lease negotiations that is paid \neven if the lease is not obtained \n• General overheads \nIn some cases, a lessee may receive a payment from a third party in connection with the execution of a \nlease agreement . Such payments should be evaluated carefully to determine whether other GAAP applies \nto the arrangement ( e.g., whether the payments received are in exchange for fulfillment of a performance ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 127}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 116 obligation under ASC 606; consideration received from a government grant). I f other GAAP does not \napply, we believe , in some circumstances , a lessee would recognize a payment received in connection \nwith the execution of a lease agreement as a negative init ial direct cost. For example, we believe this may \nbe appropriate when a lessee’s arrangement with its real estate broker requires the broker to share a \nportion of its fee from the lessor for executing the lease with the lessee. \nASC 842-10-15-33 requires l essees to allocate initial direct costs to the separate lease components of a \ncontract on the same basis as the lease payments ( i.e., on a relative standalone price basis). Refer to \nsection 1.4.3.2, Allocating the consideration in the contract — lessees . \nASC 842-10-15-38 also requires lessors to allocate any capitalized costs ( e.g., initial direct costs, contract \ncosts that are capitalizable in accordance with ASC 340-40, Other Assets and Deferred Costs — Contracts \nwith Customers ) to the separate lease and non -lease components to which the costs relate. Refer to \nsection 1.4.4.2, Allocating the consideration in the contract — lessors . \nThe following table summarizes how lessees and lessors account for initial direct costs ( i.e., incremental \ncosts of a lease that would not have been incurred if the lease had not been obtained) that are capitalized \nat the date the lease is obtained (which may be before lease commencement) and allocate them to the \nlease components of the contract. \n Leas e classification Accounting for capitalized initial direct costs (IDCs) \nLessees Operating lease Include IDCs in the initial and subsequent measurement of the right -\nof-use asset (refer to section s 4.2.1.2, Initial measurement of right -\nof-use assets — operating l eases , or 4.3.1.2, Initial measurement of \nright -of-use assets — finance l eases , and section s 4.2.2.2, Subsequent \nmeasurement of right -of-use assets — operating leases , or 4.3.2.2, \nSubsequent measurement of right -of-use assets — finance leases ). Finance lease \nLessors \* Sales -type lease if the fair \nvalue of the underlying asset \nis different from its carrying \namount at lease \ncommencement \*\* Expense IDCs at lease commencement. Refer to section 5.2.1, \nInitial recognition and measurement — sales -type leases . \nSales -type lease if the fair \nvalue equals the carrying \nvalue of the underlying asset \nat lease commencement \*\* Include IDCs in the initial and subsequent measurement of the net \ninvestment in the lease (refer to sections 5.2.1, Initial recognition \nand measurement — sales -type leases , and 5.3.1, Initial recognition \nand measurement — direct financing leases ). \nDirect financing lease \*\* \nOperating lease Recognize IDCs as an expense over the lease term on the same \nbasis as lease income. Refer to section 5.4, Operating leases . \n\* As discussed in section 2.5.1, Discount rate — lessors , for purposes of performing the sales -type lease classification test only, a \nlessor assumes that no initial direct costs will be deferred ( i.e., initial direct costs are excluded from the calculation of the rate \nimplicit in the lease) if, at the commencement date, the fair value of the underlying asset is different from its carrying amount. \nRefer to section 3.3, Discount rates used to determine lease classification, for further discussion. In certain circumstances, for \nlessors that are not manufacturers or dealers , the fair value of the underlying asset is their cost, less any volume or trade \ndiscounts. Refer to section 2.8, Fair value, for further discussion. \n\*\* The FASB indicated in the Basis for Conclusions (BC 306) of ASU 2016 -02 that its decisions on defining, allocating and accounting for \ninitial direct costs were intended to align the accounting for initial direct costs by a lessor with the accounting for costs to obtain a \ncontract by a seller of similar goods under ASC 340-40. Under ASC 340-40, an entity reco gnizes the contract cost asset into income \nwhen (or as) the related goods or services are transferred to the customer. When a lessor enters into a direct financing lease or a \nsales -type lease in which the fair value of the underlying asset is equal to its carrying amount, the good or service to which the asset \n(initial direct costs) relates is the lessor’s service of providing financ ing to the lessee. In contrast, in a sales -type lease in which the fair \nvalue of the underlying asset is different from its ca rrying amount, the lessor is generally a manufacturer or a dealer and leasing \nrepresents another means for the lessor to sell its products. The good or service to which the initial direct costs relate in those \ntransactions is the underlying asset; control of which is effectively transferred to the lessee at lease commencement. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 128}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 117 ASC 842 includes the following example of the accounting for initial direct costs. \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \n842-10-55-240 \nLessee and Lessor enter into an operating lease. The following costs are incurred in connection with \nthe lease: \nTravel costs related to lease proposal $ 7,000 \nExternal legal fees 22,000 \nAllocation of employee costs for time neg otiating lease terms and conditions 6,000 \nCommissions to brokers 10,000 \nTotal costs incurred by Lessor $ 45,000 \nExternal legal fees $ 15,000 \nAllocation of employee costs for time negotiating leases terms and conditions 7,000 \nPayments made to existing te nant to obtain the lease 20,000 \nTotal costs incurred by Lessee $ 42,000 \n842-10-55-241 \nLessor capitalizes initial direct costs of $10,000, which it recognizes ratably over the lease term, \nconsistent with its recognition of lease income. The $10,000 in broker commissions is an initial direct cost \nbecause that cost was incurred only as a direc t result of obtaining the lease (that is, only as a direct result \nof the lease being executed). None of the other costs incurred by Lessor meet the definition of initial direct \ncosts because they would have been incurred even if the lease had not been exec uted. For example, the \nemployee salaries are paid regardless of whether the lease is obtained, and Lessor would be required to \npay its attorneys for negotiating and drafting the lease even if Lessee did not execute the lease. \n842-10-55-242 \nLessee includes $20,000 of initial direct costs in the initial measurement of the right -of-use asset. \nLessee amortizes those costs ratably over the lease term as part of its total lease cost. Throughout the \nlease term, any unamortized amounts from the original $20,000 are included in the measurement of \nthe right -of-use asset. The $20,000 payment to the existing tenant is an initial direct cost because \nthat cost is only incurred upon obtaining the lease; it would not have been owed if the lease had not \nbeen executed. None o f the other costs incurred by Lessee meet the definition of initial direct costs \nbecause they would have been incurred even if the lease had not been executed (for example, the \nemployee salaries are paid regardless of whether the lease is obtained, and Les see would be required \nto pay its attorneys for negotiating and drafting the lease even if the lease was not executed). \n2.6.1 Initial direct costs in a lease modification \nExcerpt from Accounting Standards Codification \nLeases — Overall \nRecognition \n842-10-25-10 \nAn entity shall account for initial direct costs , lease incentives, and any other payments made to or by \nthe entity in connection with a modification to a lease in the same manner as those items would be \naccounted for in connection with a new lease. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 129}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 118 Lessees and lessors account for costs incurred in a lease modification ( i.e., a change to the terms and \nconditions of the contract that results in a change in the scope of or the consideration for the lease) that \nmeet the definition of initial direct costs in the same manner as those items are accounted for in \nconnection with a new lease. \nA lessee ’s initial direct costs in a lease modification are included in the measurement of the new right -of-\nuse asset ( i.e., for a modification that is accounted for as a separate contract) or the adjustment to the \nright -of-use asset ( i.e., for a modification that is not accounted for as a separate contract). \nA lessor accounts for initial direct costs in a lease modification based on the classification of the new \nlease as follows: \n• For sales -type leases if, at the commencement date, the fair value of the underlying asset is different \nfrom its carrying amount, expense initial direct costs allocated to the lease component on the \neffective date of the modification \n• For sales -type leases if, at the commencement date, the fair value of the underlying asset equals its \ncarry ing amount, and direct financing leases, initial direct costs allocated to the lease component are \nincluded in the measurement of the new net investment in the lease ( i.e., for a modification that is \naccounted for as a separate contract) or the adjustment to the net investment in the lease ( i.e., for a \nmodification that is not accounted for as a separate contract) \n• For operating leases, capitalize and expense initial direct costs allocated to the lease component over \nthe lease term on the same basis as lease income for those costs allocated to the lease component \nRefer to sections 2.6, Initial direct costs ; 2.8, Fair value ; 4.6, Lease modifications ; and 5.6, Lease modifications . \n2.7 Economic life \nExcerpt from Accounting Standards Codification \nMaster Glossary \nEconomic Life \nEither the period over which an asset is expected to be economically usable by one or more users or \nthe number of production or similar units expected to be obtained from an asset by one or more users. \nASC 842 defines the economic l ife of an asset as either: \n• The period over which an asset is expected to be economically usable by one or more users \n• The number of production or similar units expected to be obtained from the asset by one or more users \nThis definition of economic life, while not the same as the definition in ASC 840, is not expected to \nsignificantly change economic life estimates. \nWe believe that “economically usable” means that the asset is or is expected to be viable from an \neconomic p erspective. In addition, we believe that “one or more users” means the existing lessee plus \nany successor lessees or owners. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 130}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 119 2.8 Fair value \nExcerpt from Accounting Standards Codification \nMaster Glossary \nFair Value (second definition) \nThe price that woul d be received to sell an asset or paid to transfer a liability in an orderly transaction \nbetween market participants at the measurement date. \nOrderly Transaction \nA transaction that assumes exposure to the market for a period before the measurement date to allow \nfor marketing activities that are usual and customary for transactions involving such assets or \nliabilities; it is not a forced transaction (for example, a forced liquidation or distress sale). \nMarket Participants \nBuyers and sellers in the principal (or most advantageous) market for the asset or liability that have all \nof the following characteristics: \na. They are independent of each other, that is, they are not related parties , although the price in a \nrelated -party transaction may be used as an input to a fair value measurement if the reporting \nentity has evidence that the transaction was entered into at market terms \nb. They are knowledgeable, having a reasonable understanding about the asset or liability and the \ntransaction using all available information, including information that might be obtained through \ndue diligence efforts that are usual and customary \nc. They are able to enter into a transaction for the asset or liability \nd. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but \nnot forced or otherwise compelled to do so. \nLeases — Lessor \nImplementation Guidance and Illustrations \n842-30-55-17A \nNotwithstanding the definition of fair value , if a lessor is not a manufacturer or a dealer, the fair value \nof the underlying asset at lease commencement is its cost, reflecting any volume or trade discounts \nthat may apply. However, if there has been a significant lapse of time between the acquisiti on of the \nunderlying asset and lease commencement, the definition of fair value shall be applied . \nLessees and lessors determine the fair value of the underlying asset in a lease arrangement for purposes \nof lease classification and measurement under ASC 842 using the definition of fair value in ASC 820. \nThat is, the fair value of the underlying asset in a lease arrangement is the price that would be received to \nsell the asset in an orderly transaction between market participants at the measurement date. ASC 820 \nprovides a framework for measuring fair value and requires certain disclosures. \nWhile ASC 842 does not specifically prohibit lessees from recognizing a right -of-use asset that exceeds the \nfair value of the underlying asset, we believe that lessees should challenge the inputs and assumptions \nused to measure the right -of-use asset if the carrying amo unt of the right -of-use asset would exceed the \nfair value of the underlying asset. Inputs and assumptions that could be challenged include the identification \nof lease and non -lease components, the allocation of consideration in the contract to those components \nand the discount rate used. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 131}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 120 Fair value exception for lessors that are not manufacturers or dealers \nPrior to issuing ASU 2019 -01, ASC 842 require d lessors to determine the fair value of the underlying \nasset in a lease arrangement for purposes of lease classification and measurement using the definition of \nfair value in ASC 820. Certain lessors that are not manufacturers or dealers raised concerns that applying \nthe fair value guidance in ASC 820 would require them to expense acquisition costs ( e.g., sales taxes, \ndelivery charges) that they capitalize d under ASC 840 only to then “recover” the costs by recognizing \ninterest income for direct financing leases and sales -type leases. Th ose lessors had said this treatment \nwould not provide useful informati on to investors because it d id not represent their business model of \nfinancing the total cost of the underlying asset for the lessee. \nThe amendments in ASU 2019 -01 added guidance to ASC 842 that is similar to the fair value exception \nfor lessors that are n ot manufacturers or dealers in ASC 840-10-55-44. The amendments generally \napply to financial institutions and captive finance companies. \nUnder the amendments , these entities calculate the fair value of the underlying asset at lease \ncommencement at their co st, less any volume or trade discounts that may apply, for the purposes of \nlease classification and measurement. However, if there is a significant amount of time between the \nacquisition of the underlying asset and lease commencement, a lessor would have t o measure the fair \nvalue using the guidance in ASC 820. Refer to section 11.2, Transition . \n2.9 Variable lease payments \nExcerpt from Accounting Standards Codification \nMaster Glossary \nVariable Lease Payments \nPayments made by a lessee to a lessor for the right to use an underlying asset that vary because of changes \nin facts or circumstances occurring after the commencement date , other than the passage of time. \nCommon examples of variable lease payments include: \n• Payments that depend on a percentag e of sales of a lessee \n• Payments that increase based upon an index such as CPI (including payments that depend on market \nrental rates) \n2.9.1 Lessee accounting for variable lease payments (updated August 2023 ) \nExcerpt from Accounting Standards Codification \nLeases — Lessee \nImplementation Guidance and Illustrations \n842-20-55-1 \nA lessee should recognize costs from variable lease payments (in annual periods as well as in interim \nperiods) before the achievement of the specified target that triggers the variable lease payments, \nprovided the achievement of that target is considered probable . \n842-20-55-2 \nVariable lease costs recognized in accordance with paragraph 842 -20-55-1 should be reversed at such \ntime that it is probable that the specified target will not be m et. \nMaster Glossary \nProbable (second definition) \nThe future event or events are likely to occur. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 132}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 121 Some rental agreements provide for fixed lease payments plus variable lease payments based on the lessee’s \noperations. Often, the specified targets are not achieved until later periods . This may occur despite the \nfact that achievement of the targets is considered probable at some earlier point. A lessee should \nrecognize costs for variable lease payments in the period (annual as well as interim) in which the \nachievement of the specified target that triggers the variable leas e payments becomes probable . \nPreviously recognized variable lease costs should be reversed in the period it becomes probable that the \nspecified target will not be met. How these costs are reversed will depend on how they were previously \nrecognized ( i.e., in profit or loss or capitalized as part of the cost of another asset, such as inventory). \nProbable in this context means the future event or events that will trigger the payment are likely to occur. \nThis is the same threshold of probability that is used in ASC 450, Contingencies , with respect to the \nrecognition of liabilities. \nIllustration 2 -21: Lessee accounting for variable lease payments \nA rental agreement requires an additional payment of $1,000 if machine hours exceed 10,000 hours. \nAnalysis: The $1,000 annual payment should be accrued before the achievement of the specified \ntarget that triggers the variable lease payments if the achievement of that target, annual machine \nhours in excess of 10,000 hours, is considered probable. \nRefe r to section 2.4.2, Variable lease payments that depend on an index or rate , for an additional \nexample of lessee accounting for variable lease payments . \nRefer to sections 4.2.3, Expense recognition — operating leases , and 4.3.3, Expense recognition — finan ce \nleases , for further discussion of recognition of variable lease payments by lessees. \nIn some instances, a lease contra ct includes fixed payments, including in -substance fixed payments, with \nno variable lease payments for a portion of the lease term and variabl e payments , with no fixed payments, \nfor the remainder of the lease term . For example, a five-year lease may include fixed annual payments in \nyears 1 and 2 and variable payments (not based on an index or rate) only in years 3 through 5. \nThe following example illustrat es a lessee’s accounting for such a lease arrangement. \nIllustration 2-22: Lessee acc ounting: Fixed lease payments in the first year and variable lease \npayments there after \nEntity A (lessee) enter s into a three -year lease of a retail space . Entity A agrees to make a payment of \n$15,000 (i.e., a fixed payment) in Year 1. For Year 2 and Year 3, th e payment s will equal 5% of the lessee’s \ncurrent year retail sale s (i.e., variable payments not based on an index or rate) . The table below illustrates \nthe fixed and variable payments based on actual annual sale s over the lease term. For simplicity, assume \nthere are no non -lease components and the lease is classified as an operating lease by Entity A. \n Payment under lease agreement Actual \nannual sales Calculated lease payment \nYear 1 $15,000 $200,000 \nYear 2 5% of current year sale s $250,000 $12,500 = $250,000 x 5% \nYear 3 5% of current year sale s $300,000 $15,000 = $300,000 x 5% \nAs noted above, Entity A conclu des the lease is an operating lease . Therefore, the fixed lease \npayments are recognized as lease cost on a straight -line basis over the lease term, even though the \npayme nt may have been economically designed to co mpensate the lessor for the rent in Year 1. In \naddition, the variable lease pa yments are recognized in the period in which the achievement of the \nspecified target that triggers the variable lease payments becomes probable (i.e., in the year of the \nretail sales in this example) . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 133}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 122 A summary of total amounts recognized as lease cost each year is as follows: \n Recognition of \nYear 1 payment Recognition of \nYear 2 payment Recognition of \nYear 3 payment Total lease cost \nrecognized \nYear 1 $5,000 \n$5,000 \n($15,000/3) \nYear 2 $5,000 $12,500 \n$17,500 \n($15,000/3) \nYear 3 $5,000 \n$15,000 $20,000 \n($15,000/3) \n \n$42,500 \nLease cost is higher in the later years of the lease because the fixed payment is recognized on a \nstraight -line basis over the lease term , and the variable lease payments cannot be estimated at lease \ncommencement (i.e., they are recognized in the period in which the achievement of the specified \ntarget that triggers the variable lease payments becomes probable ). \n2.9.2 Lessor accounting for variable lease payments (updated August 2023) \nExcerpt from Accounting Standards Codification \nLeases — Lessor \nRecognition \nSales -Type Leases \n842-30-25-2 \nAfter the commencement date, a lessor shall recognize all of the following: \na. Interest income on the net investment in the lease, measured in accordance with paragraph \n842-30-35-1(a) \nb. Variable lease payments that are not included in the net investment in the lease as income in \nprofit or loss in the period when the changes in facts and circumstances on which the variable \nlease payments are based occur \nc. Impairment of the net investment in the lease (a s described in paragraph 842 -30-35-3). \nPending Content: \nTransition Date: (P) December 16, 2019; (N) December 16, 2022 | Transit ion Guidance: 326-10-65-1 \nAfter the commencement date, a lessor shall recognize all of the following: \na. Interest income on the net investment in the lease, measured in accordance with paragraph \n842-30-35-1(a) \nb. Variable lease payments that are not included in the net investment in the lease as income in \nprofit or loss in the period when the changes in facts and circumstances on which the variable \nlease payments are base d occur \nc. Credit losses on the net investment in the lease (as described in paragraph 842 -30-35-3). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 134}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 123 Direct Financing Leases \n842-30-25-9 \nAfter the commencement date, a lessor shall recognize all of the following: \na. Interest income on the net investment i n the lease, measured in accordance with paragraph \n842-30-35-1(a) \nb. Variable lease payments that are not included in the net investment in the lease as income in \nprofit or loss in the period when the changes in facts and circumstances on which the variable \nlease payments are based occur \nc. Impairment of the net investment in the lease (as descri bed in paragraph 842 -30-35-3). \nPending Content: \nTransition Date: (P) December 16, 2019; (N) December 16, 2022 | Transit ion Guidance: 326-10-65-1 \nAfter the commencement date, a lessor shall recognize all of the following: \na. Interest income on the net investment in the lease, measured in accordance with paragraph \n842-30-35-1(a) \nb. Variable lease payments that are not included in the net investment in the lease as income in \nprofit or loss in the period when the changes in facts and circumstances on which the variable \nlease payments are base d occur \nc. Credit losses on the net investment in the lease (as described in paragraph 842 -30-35-3). \nOperating Leases \n842-30-25-11 \nAfter the commencement date, a lessor shall recognize all of the following: \na. The lease payments as income in profit or loss over the lease term on a straight -line basis unless \nanother systematic and rational basis is more representative of the pattern in which benefit is \nexpected to be derived from the use of the underlying asset , subject to paragra ph 842 -30-25-12. \nb. Variable lease payments as income in profit or loss in the period in which the changes in facts \nand circumstances on which the variable lease payments are based occur \nc. Initial direct costs as an expense over the lease term on the same basis as lease income (as \ndescribed in (a)). \nA lessor should recognize income for variable lease payments in the period when changes in facts and \ncircumstances on which the variable lease payments are based occur. This applies to both interim and \nannual periods and applies regardless of lease classification ( i.e., applies to sales -type, direct financing \nand operating leases). For example, if a lessor receives contingent rent if the lessee’s sales exceed \n$2,000,000 during the year, the lessor cannot recogn ize the variable lease payments until sales exceed \nthis amount, regardless of probability. Consequently, it would be inappropriate to anticipate changes in \nthe factors on which variable lease payments are based and recognize rental income prior to the \noccu rrence of the change in factors on which variable lease payments are based. Refer to sections 5.2.2, \nSubsequent measurement — sales -type leases , 5.3.2, Subsequent measurement — direct financing leases , \nand 5.4, Operating leases , for further discussion of a ccounting for variable lease payments by a lessor , \nand refer to Appendix F for a flowchart illustrating how a lessor accounts for variable payments . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 135}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 124 In some instances, a lease agreement will include fixed payments, including in substance fixed payments, \nwith no variable lease payments for a portion of the lease term and variable lease payments , with no \nfixed lease payments, for the remainder of the lease term. \nThe following example illustrat es a lessor’s accounting for such a lease arrangement. \nIllustrati on 2-23: Lessor accounting: Fixed lease payments in the first year and variable lease \npayments there after \nEntity B (less or) enter s into a three -year lease of a retail space . Entity A (lessee) agrees to make a \npayment of $15,000 (i.e., a fixed payment) in Year 1 . For Year 2 and Year 3 , the payment s will equal \n5% of the lessee’s current year retail sale s (i.e., variable payments not based on an index or rate) . The \ntable below illustrates the fixed and variable payments based on actual annual sale s over the lease \nterm. For simplicity, assume there are no non -lease components , and the lease is classified as an \noperating lease by Entity B. \n Payment under lease agreement Actual \nannual sales Calculated lease payment \nYear 1 $15,000 $200,000 \nYear 2 5% of current year sale s $250,000 $12,500 = $250,000 x 5% \nYear 3 5% of current year sale s $300,000 $15,000 = $300,000 x 5% \nAs noted above, Entity B concludes the lease is an operating lease. Therefore, the fixed lease payments \nare recognized as lease income on a straight -line basis over the lease term, even though the payment \nmay have been economically designed to compensate the lessor for the rent in Year 1. In addition, the \nvariable lease payments are recognized in the period when changes in facts and circumstances on \nwhich the variable lease payments are based occur (i.e., in the year of the retail sales in this example) . \nA summary of total amounts recognized as lease income each year is as follows: \n Recognition of \nYear 1 payment Recognition of \nYear 2 payment Recognition of \nYear 3 payment Total lease income \nrecognized \nYear 1 $5,000 \n$5,000 \n($15,000/3) \nYear 2 $5,000 $12,500 \n$17,500 \n($15,000/3) \nYear 3 $5,000 \n$15,000 $20,000 \n($15,000/3) \n \n$42,500 \nLease income is higher in the later years of the lease because the fixed payment is recognized on a \nstraight -line basis over the lease term , and the variable payments, because they relate even partially \nto the lease, cannot be estimated at lease commencement (i.e., they are recognized in the period \nwhen changes in facts and circumstances on which the variable lease payments are based occur ). \n2.9.3 Embedded derivatives in variable lease payments (updated August 2022) \nDerivative versus variable lease payments \nArrangements with variable lease payments may also contain embedded derivatives (i.e., features within \nthe lease contract that would meet the definition of a derivative under ASC 815 on a standalone basis) \nthat must be evaluated either pursuant to the “clearly and closely related” criteria of ASC 815-15 or to \ndetermine whether the embedded feature meets a specific scope exception from derivative accounting . If \nthe embedded derivative is not considered to be “clearly and closely related” to the host contract \n(i.e., the lease agreement ) and there is not a specific scope exception that applies , ASC 815-15 requires ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 136}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 125 that the embedded derivative(s) be bifurcated and accounted for separately from the host contract. The \nfollowing examples illustrate the application of the “clearly and closely related” analysis or whether a \nspecific scope exception applies to variable lease payments: \n• Variable le ase payments that are based on an inflation index (e.g., rentals that vary based on \nincreases in the CPI) are generally considered to be clearly and closely related to the h ost contract. \nAs such, the inflation -related embedded derivative would not be separated from the host contract \nunless a significant leverage factor is involved (e.g., rent payments escalate at twice the rate of an \nincrease in the CPI). \n• Variable lease payme nts based on sales volume of the lessee would not result in separation of the \nvariable lease payment -related embedded derivative from the host contract. ASC 815-10-15-59 \nprovides an exception from the application of ASC 815 to non -exchange -traded contracts with an \nunderlying that is a specified volume of sales by one of the parties to the contract. \n• Variable lease payments based on a variable interest rate are generally considered to be clearly and \nclosely related to the host contract . Consequently, lease co ntracts that include variable lease \npayments based on changes in, for example, the prime rate , the LIBOR rate , or the SOFR rate would \nnot typically result in a separation of the variable lease payment -related embedded derivative from \nthe host contract, unl ess, for example, the rental formula permits a significant leverage factor. \n• Refer to section 2.4.1.1, In-substance fixed lease payments, for a discussion of whether certain \npayments are lease payments, variable lease payments or derivatives and section 2.9 .4, Embedded \nforeign currency derivatives, for a discussion of embedded foreign currency derivatives in lease \narrangements . Our FRD, Derivatives and hedging , provide s additional information and guidance \nabout the subsequent accounting for embedded derivatives in lease arrangements that are accounted \nfor separately pursuant to ASC 815-15. \n2.9.4 Embedded foreign currency derivatives \nExcerpt from Accounting Standards Codification \nDerivatives and Hedging — Embedded Derivatives \nScope and Scope Exceptions \n815-15-15-5 \nUnsettled foreign currency transactions, including financia l instruments , shall not be considered to \ncontain embedded foreign currency derivatives under this Subtopic if the transactions meet all of the \nfollowing criteria: \na. They are monetary items. \nb. They have their principal payments, interest payments, or bot h denominated in a foreign currency. \nc. They are subject to the requirement in Subtopic 830-20 to recognize any foreign currency \ntransaction gain or loss in earnings. \n815-15-15-10 \nAn embedded foreign currency derivative shall not be separated from the host contract and considered a \nderivative instrument under paragraph 815 -15-25-1 if all of the following criteria are met: \na. The host contract is not a financial instrument. \nb. The ho st contract requires payment(s) denominated in any of the following currencies: \n1. The functional currency of any substantial party to that contract ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 137}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 126 2. The currency in which the price of the related good or service that is acquired or delivered \nis routinel y denominated in international commerce (for example, the U.S. dollar for crude \noil transactions) \n3. The local currency of any substantial party to the contract \n4. The currency used by a substantial party to the contract as if it were the functional currency \nbecause the primary economic environment in which the party operates is highly inflationary \n(as discussed in paragraph 830 -10-45-11). \nc. Other aspects of the embedded foreign currency derivative are clearly and closely related to the \nhost contract. \nThe evaluation of whether a contract qualifies for the scope exception in this paragraph shall be \nperformed only at inception of the contract. \nLessees \nFor a finance lease denominated in a nonfunctional currency , the lessee’s lease liability is deemed to be a \nmonetary item governed by the provisions of ASC 830, Foreign Currency Matters , and therefore would not \nbe considered to contain an embedded foreign currency derivative , as the finance lease liability meets all of \nthe criteria in ASC 815-15-15-5. While the lessee’s lease liability for operating leases denominated in a \nnonfunctional foreig n currenc y meet s the criteria in ASC 815-15-15-5(a) and (c), it is unclear whether \npayments on an operating lease could be viewed as principal and interest payments ( ASC 815-15-15-5(b)). \nHowever, w e believe that, consistent with other monetary items that are remeasured under ASC 830, \nbifurcation of the foreign currency embedded derivative in an operating lease denominated in a \nnonfunctional currency would not be required. \nLessors \nFor s ales-type leases and direct financing leases denominated in a nonfunctional currency , the lessor’s \nnet investment in the lease is deemed a monet ary item governed by the provisions of ASC 830 \nand therefore would not be considered to contain an embedded foreign currency derivative , as the net \ninvestment in the lease meets all of the criteria in ASC 815-15-15-5. \nOperating leases denominated in a nonfunctional currency need to be evaluated under the embedded \nderivatives guidance in ASC 815-15. Specifically, a lessor in an operating lease a greement that includes \nlease payments denominated in a foreign currency needs to evaluate the guidance in ASC 815-15-15-10 \nin determin ing whether the embedded f oreign currency derivative should be separated from the host \ncontract and considered a derivative instrument under ASC 815. \nWhen the host contract is not a financial instrument, ASC 815-15-15-10 provides that the bifurcation \nrequirements do not apply ( i.e., there is no requirement to separately account for an embedded foreign \ncurrency derivative) if the lease payments are denominated in any of the following currencies: \n• The functional currency of any substantial party to the lease \n• The local currency of an y substantial party to the lease \n• The currency used by a substantial party to the lease as if it were the functional currency because \nthe primary economic environment in which that party operates is highly inflationary \n• The currency in which the price of the underlying asset is routinely stated in international commerce \n(e.g., if it is current international practice for commercial jet leases to be denominated in US dollars) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 138}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 127 In providing the fourth exception, the FASB rec ognized that it would be appropriate to consider the \ncurrency in which contracts for a given asset are routinely denominated internationally to be clearly and \nclosely related to those contracts, regardless of the functional currency of the parties to that contract \n(Paragraph 311 of Statement 133 ). The application of the phrase “routinely denominated in \ninternational commerce” should be based on how similar transactions are routinely structured around \nthe world, not just in one local area. Therefore, if simi lar leases for a certain asset are routinely \ndenominated in international commerce in various different currencies, the exception provided by \nASC 815-15-15-10 does not apply to any of those similar transactions. \nFor purposes of evaluating whether a n operating lease contains an embedded foreign currency \nderivative, a guarantor is not a substantial party to a two -party lease, even when it is a related party of \nthe lessee or the lessor ( e.g., a parent company guarantee provided to its subsidiary, even if the parent \ncompany consolidates the subsidiary). The substantial parties to a lease contract are the lessor and the \nlessee ( ASC 815-15-55-84 through 55 -86). \nGenerally , if lease payments are denominated in a currency other than the currency of the primary \neconomic environment in which any substantial party to the operating lease contract operates ( i.e., in \nmost lease arrangements, the functional or the local currency of the lessee or the lessor), the operating \nlease would be considered to include an embedd ed foreign currency swap arrangement that should be \nseparated from the host contract ( i.e., the operating lease agreement) and considered a derivative \ninstrument under ASC 815 (provided that a separate instrument with the same terms would meet the \ndefiniti on of a derivative instrument). \nThe evaluation of whether a n operating lease qualifies for the exception is performed only at the \ninception of the contract. \nFor more guidance about the subsequent accounting for embedded derivatives in lease arrangements t hat \nare accounted for separately pursuant to ASC 815-15, refer to our FRD, Derivatives and hedging . \n2.10 Other matters related to residual value guarantees \n2.10.1 Residual value guarantees as derivatives \nASC 842-10-15-43 addresses the interaction between ASC 842 and ASC 815, Derivatives and Hedging . \nExcerpt from Accounting Standards Codification \nLeases — Overall \nScope and Scope Exceptions \n842-10-15-43 \nParagraph 815 -10-15-79 explains that leases that are within the scope of this Topic are not derivative \ninstruments subject to Subtopic 815 -10 on derivatives and hedging although a derivative instrument \nembedded in a lease may be subject to the requirements of Section 815-15-25. Paragraph 815 -10-15-80 \nexplains that residual value guarantees that are subject to the guidance in this Topic are not subject \nto the guidance in Subtopic 815 -10. Paragraph 815 -10-15-81 requires that a third -party residual \nvalue guara ntor consider the guidance in Subtopic 815 -10 for all residual value guarantees that it \nprovides to determine whether they are derivative instruments and whether they qualify for any of the \nscope exceptions in that Subtopic. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 139}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 128 Derivatives and Hedging — Overa ll \nScope and Scope Exceptions \n815-10-15-80 \nResidual value guarantees that are subject to the requirements of Topic 842 on leases are not subject \nto the requirements of this Subtopic. \n815-10-15-81 \nA third -party residual value guarantor shall consider the gu idance in this Subtopic for all residual value \nguarantees that it provides to determine whether they are derivative instruments and whether they qualify \nfor any of the scope exceptions in this Subtopic. The guarantees described in paragraph 842 -10-15-43 for \nwhich the exceptions of paragraphs 460 -10-15-7(b) and 460 -10-25-1(a) do not apply are subject to \nthe initial recognition, initial measurement, and disclosure requirements of Topic 460. \nLeases are not considered derivatives and are not subject to the accounting for derivative instruments \nunder ASC 815-10. However, a lease may contain an embedded derivative, which could be subject to the \nrequirements of ASC 815-15-25. \nResidual value guaran tees that are subject to the guidance in ASC 842 are not subject to the requirements \nfor derivative instruments under ASC 815. This “exception” only applies to residual value guarantees within \nthe scope of ASC 842 (ASC 815-10-15-80). For example, a residua l value guarantee obtained by a lessor \nfrom a third party after lease commencement (refer to section 2.2, Commencement date of the lease ) would \nnot be subject to ASC 842 and thus would potentially be subject to derivative accounting under ASC 815 if it \nmeets the definition of a derivative (and does not qualify for any of the scope exceptions therein). \nAdditionally, a third -party re sidual value guarantor should evaluat e the guidance in ASC 815-10 for all \nresidual value guarantee s that i t provides to determine whether they are derivative instrument s and whether \nthey qualify for any of the scope exceptions in ASC 815-10. If such a guarantee is not in the scope of \nASC 815, then the recognition and measurement guidance in ASC 460 would apply . \n2.10.2 Residual value guarantee of deficiency that is attributable to damage, \nextraordinary wear and tear or excessive usage \nExcerpt from Accou nting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \n842-10-55-34 \nA lease provision requiring the lessee to make up a residual value deficiency that is attributable to \ndamage, extraordinary wear and tear, or excessive us age is similar to variable lease payments in that \nthe amount is not determinable at the commencement date. Such a provision does not constitute a \nlessee guarantee of the residual value. \nLease provisions often require the lessee to make up a residual value deficiency attributed to damage, \nextraordinary wear and tear, or excessive usage ( e.g., excessive mileage on a leased vehicle). These \nlease provisions do not constitute a guarantee of residual value by the lessee but are similar to variable \nlease payments in that the amount is not determinable at the commencement date of the lease. Thus, they \nare not included in lease payments (refer to section 2.4, Lease payments ) but instead would be accounted \nfor like variable lease payments (refer to sect ion 2.9.1, Lessee accounting for variable lease payments , \nand section 2.9.2, Lessor accounting for variable lease payments ). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 140}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 129 2.10.3 Residual value guarantee of a group of assets — lessees \nIn certain master lease agreements covering a group of assets, the lessee guarantees the residual value \nof the group of assets being leased as opposed to the residual value of each individual asset in the group. \nWhen evaluating the “substantially all” crit erion of the lease classification test , we believe i t would be \nacceptable in all cases for a lessee to include the full amount of the residual value guarantee for the \ngroup of underlying asset s for each individual asset within the group (i.e., the “all-in” approach) . \nWe also believe i t would be acceptable in some arrangements to allocate the amount it is probable a lessee \nwill owe under the residual value guarantee among all of the underlying asset s on a pro rata basis in relation \nto the expected residual value at the end of the lease term of each asset (i.e., the pro rata approach). For \nexample, if the amount probable of being owed under a group residual value guarantee is $180 and the total \nexpected residual value of all of the underlying asset s as of the end of the master lease term is $300, the \nresidual value guarantee would be allocated to each asset based on 60% of each underlying asset ’s expected \nresidual value. \nWe believe the pro rata approach is acceptable only if the lease s in the group are substantially the same . For \nexample, use of the pro rata approach may be appropriate when the individual leases in the group are \ncoterminous, the underlying asset s are physically similar , and the variability associated with the expected \nresidual values i s expected to be highly correlated ( i.e., one asset’s residual value is expected to be similar to \nthat of the other assets’ residual values ). \n2.10.4 Residual value guarantee of a group of assets — lessors \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \n842-10-55-9 \nLessors may obtain residual value guarantees for a portfolio of underlying assets for which settlement \nis not solely based on the residual value of the individual underlying assets. In such cases, the lessor is \neconomically assured of receiving a minimum residual value for a portfolio of assets that are subject to \nseparate leases but not for each individua l asset. Accordingly, when an asset has a residual value in \nexcess of the “guaranteed” amount, that excess is offset against shortfalls in residual value that exist \nin other assets in the portfolio. \n842-10-55-10 \nResidual value guarantees of a portfolio of underlying assets preclude a lessor from determining the \namount of the guaranteed residual value of any individual underlying asset within the portfolio. \nConsequently, no such amounts should be considered when evaluating the lease classification criteria \nin paragraphs 842 -10-25-2(d) and 842 -10-25-3(b)(1). \nIn some cases, the residual value insurance may be for a portfolio of assets rather than individual assets \nwithin the lease portfolio. Accordingly, when an asset has a residual value below the guaranteed amount, \nsuch a deficiency could be offset by assets that have residual values in excess of their guaranteed value. \nASC 842-10-55-9 through 55 -10 address a lessor’s accounting for residual value guarantees for a \nportfolio of underlying assets and state that residual value guarantees of a portfolio of underly ing asset s \npreclude a lessor from determining the amount of the guaranteed residual value of any individual \nunderlying asset within the portfolio at lease inception, due to the netting of the residual value gains and \nlosses. Therefore, ASC 842-10-55-10 sta tes no amounts should be considered when evaluating the lease \nclassification criteria . However, we believe if the assets in the portfolio are physically identical and have \nthe same lease term, and the variability related to the expected residual values is expected to be highly \ncorrelated, it would be acceptable for a lessor to include an allocated portion of the residual value ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 141}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 130 guarantee for the portfolio of underlying asset s to determine the lease classification of the individual \nunderlying assets . Refer to section 3.2, Criteria for lease classification — lessors , for further discussion of \nconsideration of residual value guarantees in evaluating lease classification. \n2.10.5 Lessee guarantee of lessor’s return \nCertain lease agreements include a provision that on early termination of a lease by a lessee, the lessee \nis required to make payments to the lessor, or a lender to the lessor, to guarantee a stated return on the \nunderlying asset . Any termination payments that could be required to be made would be considered a \ntermination penalty that would be used to determine the lease term (refer to section 2.3, Lease term and \npurchase options ) and might have to be included in lease payments. An obligation to only make u p any \nshortfall on the lessor’s return in the event of early termination also would be an early termination \npenalty that would be used to determine the lease term and might be included in lease payments (under \nthe assumption that the lessee would be respon sible for the full shortfall, regardless of the likelihood of \nthat assumption). \n2.10.6 Third -party guarantee of lease payments or residual value \nExcerpt from Accounting Standards Codification \nGuarantees — Overall \nRecognition \n460-10-25-1 \nThe following types of guarantees are not subject to the recognition provisions of this Subsection: \ne. A guarantee by an original lessee that has become secondarily liable under a new lease that \nrelieved the original lessee from being the primary obligor (that is, principal debtor) under the \noriginal lease, as discussed in paragraph 842 -20-40-3. This exception shall not be applied by \nanalogy to other secondary obligations . \nFor lessors, in addition to lessee guarantees of residual value (primary or secondary), the amount of any \nguarantee of the residual value or rental payments beyond the lease term (refer to section 2.3, Lease \nterm and purchase options) by a third party unrelated to the lessee or lessor is considered when \ndetermining the classification of a dir ect financing lease ( i.e., when determining whether the lease is a \ndirect financing lease but not a sales -type lease). As noted in section 2.4.6.1, Third -party insurance that \nguarantees the asset’s residual value , a lessee excludes third -party residual val ue guarantees from lease \npayments for purposes of determining lease classification, only if the lessor has released the lessee from \nprimary and secondary liability. As a result, the purchase of a third -party guarantee often results in \nlessors obtaining dir ect financing lease treatment when the lease would otherwise be classified as an \noperating lease (refer to section 3.2, Criteria for lease classification — lessors ). \nIn considering residual value guarantees, it is important to understand the contract’s ter ms prior to \nincluding the amount of the guaranteed residual value for purposes of determining the lessor’s lease \nclassification. In many cases, the guarantee will contain provisions that result in the exclusion of the \nguarantee for purposes of the lessor’s lease classification. Some of these provisions are described below. \nExclusion provisions \nIn some cases, third -party residual value insurance contracts contain exclusion provisions that the contract \ndoes not represent a guarantee of the lessor’s residual v alue (that is, the residual value guarantee is only \neffective in limited circumstances). Many of the customary exclusion provisions, such as excess wear and \ntear or damages (which are typically the lessee’s responsibility), would be acceptable and not prec lude \nconsideration of the guaranteed residual value for lease classification purposes ( i.e., whether the lease is a \ndirect financing lease). However, exclusion provisions that substantially curtail the lessor’s ability to receive ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 142}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 131 a payment from the guarant or on disposition of the underlying asset at the end of the lease term (refer to \nsection 2.3, Lease term and purchase options ) would prevent the lessor from considering the guaranteed \nresidual value. For example, a requirement that the lessee return the underlying asset to “like -new” \ncondition at the end of the lease would not represent an effective guarantee of the asset’s residual value. \nLikewise, a requirement that the underlying asset be returned to a location that is economically unfeasible \nbased on th e anticipated location of the underlying asset and transportation costs to the specified location \nat the end of the lease term, or other requirements that severely restrict the lessor’s ability to dispose of \nthe asset at or near market value at the end of the lease term, should be carefully evaluated. \nSelf-insurance and premiums based on loss experience — lessors \nThe residual value guarantee must be from a third party unrelated to the lessor. If the guarantee is from \na related party, the residual value is not guaranteed and should be excluded from the evaluation of lease \nclassification. In addition, if the lessor participates in the loss experience, whether directly or indirectly, \nas would be the case with many retrospective policies (that is, the lessor’s pre mium is adjusted at the end \nof the coverage period based on actual loss experience, or subsequent premiums are adjusted based on \nprior policy period losses), the residual values are not guaranteed and should be excluded from the \nlessor’s evaluation of leas e classification. \nAs further discussed in section 2.10.1, Residual value guarantees as derivatives , residual value guarantees \nthat are subject to ASC 842 are excluded from the scope of ASC 815, Derivatives and Hedging . \n2.11 Improvements to the underlying asset \nEntities should evaluate whether improvements made to the underlying asset are lessee or lessor assets \nbecause this conclusion may affect : \n• Which entity recognizes the asset. For example, lessee improvements are capital ized by the lessee as \nleasehold improvements , and lessor improvements are capitalized by the lessor. \n• Whether a lessor payment to the lessee for the improvements is a lease incentive or a reimbursement \nof the costs incurred by the lessee to build the improv ements on the lessor’s behalf . For example, if a \nretailer leases general purpose retail space and has its own contractor build specific lessee improvements \nto make the store look like the others it operates around the Country (i.e., the improvements are le ssee \nassets ), any amounts the lessor provides to pay a portion of the cost will generally be viewed as an \nincentive. Lease incentives that are paid or payable to the lessee are deducted from lease payments, \naffect the lease classification test and may affect the initial measurement and subsequent accounting \nfor the lease ( e.g., for lessees, lease incentives that are pai d or payable reduce the lessee’s ROU asset , \nand lease incentives that are payable to the lessee at lease commencement reduce a lessee’s lease \nliability ). Refer to section 2.4.1.2, Lease incentives , for more information. In contrast, if the lessee \nleases fu lly built -out space and incurs costs to construct the space on the lessors’ behalf ( e.g., a floor in \nan office building with interior walls and lighting) , a lessor’s payment to the lessee for lessor improvements \nmay be a reimbursement of the costs incurred by the lessee. If a lessee is not reimbursed for payments \nit makes or costs it incurs on a lessor’s behalf, those amounts are considered noncash lease payments \n(refer to section 2. 4, Lease payments , for more information on noncash lease payments ). \n• The lea se commencement date. For example, if the lessor provides the lessee with access to the \nleased space so that the lessee can begin to construct its own leasehold improvements (i.e., the \nimprovements are lessee assets) , the commencement date is the date the lessor made the underlying \nasset available for use by the lessee (refer to section 2.2, Commencement date of the lease ). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 143}), Document(page\_content='2 Key concepts \nFinancial reporting developments Lease accounting | 132 In many instances, judgment will be required to determine whether the lessee is constructing lessee \nimprovements ( i.e., leasehold improvements) or lessor improvements ( i.e., leasing built -out space ). \nExamples of factors that would be considered in making th e determination of whether improvements are \nlessee or lessor assets include: \n• What happens to the improvements at the end of the lease term ( i.e., whether they are removed or \npreserved for the landlord) \n• How the economic life of the improvements compare s to the lease term ( i.e., whether the lease term \nis for substantially all of the economic life of the improvements ) \n• Whether the improvements are unique ( e.g., they include the décor and logo of a national retail chain \nrather than general purpose improvements) \n• Which party is supervising construction (i.e., whether the lessee is acting as an agent during the \nconstruction period or is actively involved in the design of the improvements) \n• Which party bears all costs of the improvements (including the risk of cost overruns) \n• Which party owns the improvements \nWe note that it would be inconsistent with the unit of accounting concept for a lessee to recognize a \npartial asset in its financial statements ( e.g., lessor funds 60% of an asset and the lessee recognizes 40% \nas an asset in the lessee’s financial statements). \nIn addition, an entity’s determination about whether the improvements are lessee or lessor assets should \nbe consistent across the various aspects of the guidance affected ( e.g., which entity recognizes the \nasset, the accounting for lease incentives or reimbursement of costs , the determination of the \ncommencement date of the lease ). \n2.11.1 Leasehold improvements \nLeasehold improvements are lessee assets that are capitalizable changes made to a n underlying asset to \ncustomize it for a particular use or need of a lessee ( e.g., a lessee that is leasing a commercial office \nspace may construct its own interior walls or install its own carpeting). Amounts capitalized as attributable \nto leasehold improv ements should be presented separately from the related ROU asset. Refer to section \n4.7.3, Amortization of leasehold improvements , for more information on amortization of these assets. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 144}), Document(page\_content=' \nFinancial reporting developments Lease accounting | 133 3 Lease classification \nExcerpt from Accounting Sta ndards Codification \nLeases — Overall \nRecognition \n842-10-25-2 \nA lessee shall classify a lease as a finance lease and a lessor shall classify a lease as a sales -type lease \nwhen the lease meets any of the following criteria at lease commencement: \na. The lease transfers ownership of the underlying asset to the lessee by the end of the lease term. \nb. The lease grants the lessee an option to purchase the underlying asset that the lessee is \nreasonably certain to exercise. \nc. The lease term is for the major part of the remaining economic life of the underlying asset. \nHowever, if the commencement date falls at or near the end of the economic life of the \nunderlying asset, this criterion shall not be used for purposes of classifyi ng the lease. \nd. The present value of the sum of the lease payments and any residual value guaranteed by the \nlessee that is not already reflected in the lease payments in accordance with paragraph 842 -10-\n30-5(f) equals or exceeds substantially all of the fair value of the underlying asset. \ne. The underlying asset is of such a specialized nature that it is expected to have no alternative use \nto the lessor at the end of the lease term. \n842-10-25-3 \nWhen none of the criteria in paragraph 842 -10-25-2 are met: \na. A lessee shall classify the lease as an operating lease . \nb. A lessor shall classify the lease as either a direct financing lease or an operating lease. A lessor \nshall classify the lease as an operating lease unless both of the following criteria are met, in which \ncase the lessor shall classify the lease as a direct financing lease: \n1. The present value of the sum of the lease payments and any residual value guaranteed by \nthe lessee that is not already reflected in the lease payments in accordance with paragraph \n842-10-30-5(f) and/or any other third party unrelated to the lessor equals or exceeds \nsubstantially all of the fair value of the underlying asset. \n2. It is probable that the lessor will collect the lease payments plus any amount necessary to \nsatisfy a residual value guarantee . \n842-10-25-3A \nNotwithstanding the requirements in paragraphs 842 -10-25-2 through 25 -3, a lessor shall classify a \nlease with variable lease payments that do not depend on an index or a rate as an operating lease at \nlease commencement if classifying the lease as a sales -type lease or a direct financing lease would \nresult in the recognition of a selling loss . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 145}), Document(page\_content='3 Lease classification \nFinancial reporting developments Lease accounting | 134 842-10-25-4 \nA lessor shall assess the criter ia in paragraphs 842 -10-25-2(d) and 842 -10-25-3(b)(1) using the rate \nimplicit in the lease . For purposes of assessing the criterion in paragraph 842 -10-25-2(d), a lessor \nshall assume that no initial direct costs will be deferred if, at the commencement dat e, the fair value \nof the underlying asset is different from its carrying amount. \nLessees and lessors classify leases at the lease commencement date (except when the lessee elects the \nshort -term lease election discussed in section 4.1.1, Short -term leases ). Lessees classify leases as either \nfinance leases or operating leases. Lessors classify leases as sales -type leases, direct financing leases or \noperating leases. Lease classification determines how and when a lessee and a lessor recognize lease \nexpense an d income, respectively, and what assets and liabilities they record. The criteria used for lease \nclassification are discussed in detail below. The lease classification criteria are applied to all leases other \nthan short -term leases, including those with re lated parties (refer to section 9.1, Related -party leasing \ntransactions, for further discussion of considerations associated with related -party leases). \n3.1 Criteria for lease classification — lessees \nAt lease commencement, a lessee classifies a lease as a finance lease if the lease meets any one of the \nfollowing criteria: \n• The lease transfers ownership of the underlying asset to the lessee by the end of the lease term \n(refer to section 3.4.1, Transfer of ownership ). \n• The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably \ncertain t o exercise (refer to section 2.3.5, Evaluating lease term and purchase options ). \n• The lease term (refer to section 2.3.1, Lease term ) is for a major part of the remaining economic life \n(refer to section 2.7, Economic life ) of the underlying asset. This crit erion is not applicable for leases \nthat commence at or near the end of the underlying asset’s economic life (refer to section 3.4.3, \nEvaluating ‘major part,’ ‘substantially all’ and ‘at or near the end’ ). \n• The present value of the sum of the lease payments (refer to section 2.4, Lease payments ) and any \nresidual value guaranteed by the lessee7 (refer to section 3.4.5, Residual value guarantees included \nin the lease classification test ) that is not already included in the lease payments equals or exceeds \nsubs tantially all of the fair value (refer to section 2.8, Fair value ) of the underlying asset (refer to \nsection 3.4.3, Evaluating ‘major part,’ ‘substantially all’ and ‘at or near the end’ ). \n• The underlying asset is of such a specialized nature that it is expe cted to have no alternative use to \nthe lessor at the end of the lease term (refer to section 3.4.7, Alternative use criterion ). \nNeither of the following forms of consideration affect lease classification: (1) indemnifications for environmental \ncontaminatio n (refer to section 3.4.8, Lessee indemnifications for environmental contamination ) nor (2) a \nlessee’s guarantee of a lessor’s debt (refer to section 2.4.10, Amounts not included in lease payments ). \nA lessee classifies a lease as an operating lease when it does not meet any one of these criteria. \n \n7 As discussed in section 2.10.3, Residual value guarantee of a group of assets — lessees , for classification purposes, a lessee should carefully \nevaluate a residual value guarantee on a portfolio of underlying assets when determining the guarant ee to include as a lease payment. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 146}), Document(page\_content='3 Lease classification \nFinancial reporting developments Lease accounting | 135 The decision tree below summarizes the evaluation of lease classification for lessees under ASC 842: \n \n3.2 Criteria for lease classification — lessors \nAt lease commencement, a lessor classifies a lease as a sales -type lease if the lease meets any one of the \ncriteria in section 3.1, Criteria for lease classification — lessees , and, after the adoption of ASU 2021 -05, \ndoes not have a selling loss and has variable lease payments that are not based on an index or rate . \nIf none of the criteria in section 3.1, Criteria for lease classification — lessees , are met, a lessor classifies a \nlease as a direct financing lease when the lease meets both of the following criteria (and after the \nadoption of ASU 2021 -05, does not have a selling loss and has variable lease payments that are not based \non an index or rate ): \n• The present value of the sum of lease payments and any residual value guaranteed by the lessee and any \nother third party unrelated to the lessor equals or exceeds substantially all the fair value of the underlying \nasset. As discussed in section 2.8, Fair v alue, in certain circumstances, for lessors that are not manufacturers \nor dealers, the fair value of the underlying asset is their cost, less any volume or trade discounts. \n• It is probable that the lessor will collect the lease payments plus any amount nece ssary to satisfy a \nresidual value guarantee. \nNeither of the following forms of consideration affect lease classification: (1) indemnifications for environmental \ncontamination (refer to section 3.4.8, Lessee indemnifications for environmental contamination ) nor (2) a \nlessee’s guarantee of a lessor’s debt (refer to section 2.4.10, Amounts not included in lease payments ). \nFor lessors, all leases not classified as sales -type leases or direct financing leases are classified as \noperating leases. Additionally, after the adoption of ASU 2021 -05, leases with variable lease payments that \nare not based on an index or rate ( e.g., long-term leases of machinery where the consideration in the contracts is \ndetermined based on hours used by the lessee) are classified as oper ating leases if they would have otherwise \nbeen classified as sales -type or direct financing leases and the lessor would have recognized a selling loss at lease \ncommencement. A lessor in this situation should keep in mind that it must also determine whether the \nunderlying asset is impaired prior to lease commencement ( e.g., by applying the impairment guidance in \nASC 360-10). For example, if the selling loss that would be avoided by applying ASC 842-10-25-3A results from \nreasons other than just the variable lease payments ( e.g., total expected lease payments, including the expected \nvariable lease payments, are less than the carrying amount of the underlying asset), that would be an indicator \nunder ASC 360-10 that the underlying asset is impaired before the lease commences. A key difference \nbetween the sales -type lease and direct financing lease classification tests is the treatment of residual \nvalue guarantees provided by unrelated third parties other than the lessee. Those third -party guarantees are \nexcluded from the evaluation of the “substantially all” criterion in the sales -type lease test. However, they \nare included in the evaluation in the direct financing lease test. In addition, the evaluation of th e collectibility \nof lease payments and residual value guarantees affects direct financing lease classification, whereas it \ndoes not affect sales -type lease classification. However, the evaluation of collectibility does affect sales -\ntype lease recognition a nd measurement. \nYes \n Yes \n Yes \n Yes \nNo \nYes \nNo \n No \n No \n No \nOperating lease \nFinance lease \nTransfer of \nownership? \nPurchase option \nreasonably \ncertain to be \nexercised? \nLease term = \nmajor part of \neconomic life? \nPresent value \n(lease payments \n+ any residual \nvalue guaranteed \nby lessee) ≥ \nsubstantially all \nof fair value ? \nSpecialized \nasset? ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 147}), Document(page\_content='3 Lease classification \nFinancial reporting developments Lease accounting | 136 The lease classification test is designed so that a direct financing lease involves a residual value guarantee \nfrom an unrelated third party other than the lessee that is sufficient to satisfy the “substantially all” \ncriterion. Although suc h a residual value guarantee from an unrelated third party other than the lessee \ncan exist in a sales -type or an operating lease, a lease without a residual value guarantee from an \nunrelated third party other than the lessee must be classified as either a sales -type or an operating lease. \nThe decision tree below summarizes the evaluation of lease classification for lessors under ASC 842. \n \n\* Lessors do not assess the collectibility of lease payments and any residual value guarantee provided by the lessee in the sales -\ntype lease classification test. However, lessors are required to assess the collectibility of lease payments and any residual value \nguarantee provided by the lessee to determine the recognition and initial measurement of sales -type leases. Refer to section 5.2, \nSales -type leases , on the accounting for sa les-type leases. \n\*\* As discussed in section 2.8, Fair value, in certain circumstances, for lessors that are not manufacturers or dealers , the fair value \nof the underlying asset is their cost, less any volume or trade discounts. \n^ After the adoption of ASU 2021 -05, l essors are required to classify leases as operating leases if they have variable lease \npayments that do not depend on an index or rate and would result in selling losses if th ey were classified as sales -type or direct \nfinancing leases. \n3.2.1 Evaluating collectibility \nCollectibility refers to the lessee’s ability and intent to pay the lease payments and any guaranteed residual \nvalue. A lessor should assess a lessee’s ability to pay based on the lessee’s financial capacity and its \nintention to pay, considering all relevant facts and circumstances, including past experiences with that lessee \nor similar lessees. Collectibility determinations must be made on a lease -by-lease basis or using a portfolio \napproach when “the entity reasonably expects that the application of the leases model to the portfolio \nwould not differ materially from the application of the leases model to the individual leases in that portfolio.” \nThese collectibilit y determinations can affect the classification of a lease between a direct financing or \noperating lease (refer to section 3.2, Criteria for lease classification — lessors) and the recognition and \nmeasurement of income on a sales -type and operating lease. R efer to section 5.2.1.2, Initial recognition \nand measurement when collectibility is not probable at lease commencement — sales -type leases, for a \ndiscussion of the accounting for sales -type leases when collectibility is not probable and section 5.4, Operating \nleases, for considerations related to operating leases when collectibility is not probable. Additionally, refer \nto section 5.7.4.1 , Portfolio approach , for considerations relating to the use of a portfolio approach. \nNo \nOperating lease \nYes \nSales -type lease\* ^ \nYes \nDirect financing lease ^ \nNo \nDoes the lease meet both of the following criteria in section 3.2, Criteria for lease \nclassification — lessors (ASC 842-10-25-3)? \n• The present value of the sum of the lease payments and any residual value \nguaranteed by the lessee and any other third party unrelated to the lessor equals \nor exceeds substantially all the fair value\*\* of the underlying asset. \n• It is probable that the lessor will collect the lease payments plus any amounts \nnecessary to satisfy a residual value guarantee. \nDoes the lease meet any one of the criteria in s ection 3.1, Criteria for lease \nclassification — lessees (ASC 842-10-25-2)? ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 148}), Document(page\_content='3 Lease classification \nFinancial reporting developments Lease accounting | 137 3.2.2 Lease classification fo r certain sales that include a residual value guarantee in \nthe form of a repurchase option (lessors only) \nExcerpt from Accounting Standards Codification \nLeases — Lessor \nImplementation Guidance and Illustrations \n842-30-55-5 \nThe lease payments used as part of the determination of whether the transaction should be classified \nas an operating lease , a direct financing lease , or a sales -type lease generally will be the difference \nbetween the proceeds upon the equipment’s initial transfer and the am ount of the residual value \nguarantee to the purchaser as of the first exercise date of the guarantee. \nAn entity that sells equipment may guarantee that the customer will receive a minimum resale amount \nwhen the customer resells the equipment ( i.e., a residual value guarantee). If the residual value \nguarantee is in the form of a repurchase provision ( e.g., the customer has a contractual put option to \nrequire the entity to repurchase equipment two years after its initial purchase at 85% of the pr ice the \ncustomer paid), the seller would first evaluate the guidance in ASC 606 on repurchase arrangements and \ndetermine whether the existence of the repurchase provision precludes the customer from obtaining \ncontrol of the acquired item. Refer to section 7.3.2 , Put option held by the customer , of our FRD, \nRevenue from contracts with customers ( ASC 606) , which discusses the guidance requiring an \narrangement to be accounted for as a lease if the seller is obligated to repurchase the item under a put \noption held by the customer for an amount less than the original selling price and the holder of the put \noption has a significant economic incentive to exercise the put . \nIf the arrangemen t is accounted for as a lease, the lease payments used to determine whether the transaction \nshould be classified as an operating lease, a direct financing lease or a sales -type lease generally will be the \ndifference between the proceeds upon the equipment’ s initial transfer and the amount of the residual value \nguarantee the entity provides to the purchaser as of the first exercise date of the guarantee. \nWe believe that entities should view a guaranteed resale amount (residual value ) on a net present value \nbasis when they determine the classification of the transaction. \nFor example, Company X sells a computer for $100 ( i.e., fair value) and agrees to reacquire the computer \nin five years for $10 through a put option held by the customer . In accordance with ASC 606-10-55-72, \nthe arrangement is accounted for as a lease because Company X is obligated to repurchase the computer \nfor an amount that is less than the original selling price and the entity determines that the holder of the \nput option has a significant ec onomic incentive to exercise the put . The present value of the $10 \nrepurchase obligation is $6. As a result, the transaction is classified as a sales -type lease because the \nproceeds of the sale ($100) less the present value of the repurchase obligation ($6 ) equals or exceeds \nsubstantially all of the equipment’s fair value. That is because the FASB said in ASC 842-10-55-2 that \n“one reasonable approach” would be to conclude that “[n]inety percent or more of the fair value of the \nunderlying asset amounts to su bstantially all the fair value of the underlying asset.” Refer to section 3.2, \nCriteria for lease classification — lessors . \nRefer to section 5.7.7, Sales of equipment with guaranteed minimum resale amount , for further \ndiscussion on these types of transactions. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 149}), Document(page\_content='3 Lease classification \nFinancial reporting developments Lease ac counting | 138 3.3 Discount rates used to determine lease classification \nDiscount rates are used to determine the present value of the lease payments an entity will use to \nevaluate the “substantially all” criterion in the finance lease classification test for lessees and the sales -\ntype and direct financing lease classification tests for lessors. \n3.3.1 Discount rates used to determine lease classification — lessees \nFor lessees, the discount rate used to evaluate the “substantially all” criterion is the “rate implicit in the \nlease” or the lessee’s incremental borrowing rate (or for a lessee that is not a PBE, the risk -free rate if \nthe lessee has made the risk -free rate election for that class of underlying asset) , if the rate implicit in the \nlease cannot be re adily determined. Refer to section 2.5, Discount rates . \n3.3.2 Discount rates used to determine lease classification — lessors \nSales -type lease classification test \nThe discount rate used to evaluate the “substantially all” criterion in the sales -type lease classification \ntest (as described in ASC 842-10-25-2(d)) is the rate implicit in the lease (refer to section 2.5, Discount \nrates ). However, a lessor assumes that n one of its initial direct costs (refer to section 2.6, Initial direct \ncosts ) will be deferred ( i.e., initial direct costs are excluded from the calculation of the rate implicit in the \nlease) if, at the commencement date, the fair value (refer to section 2. 8, Fair value ) of the underlying \nasset is different from its carrying amount. If the fair value of the underlying asset is the same as its \ncarrying amount at lease commencement, a lessor includes initial direct costs in the calculation of the \nrate implicit in the lease. \nDirect financing lease classification test \nThe discount rate used to evaluate the “substantially all” criterion in the direct financing lease \nclassification test (as described in ASC 842-10-25-3(b)(1)) is the rate implicit in the lease (refe r to \nsection 2.5, Discount rates ). \nThe following table summarizes the discount rates used to determine lease classification by lessors. \n At lease commencement, the fair value \nof the underlying asset does not equal its \ncarrying value At lease commencement, the fair value \nof the underlying asset is equal to its \ncarrying value \nSales -type lease \nclassification test \n(as described in \nASC 842-10-25-2(d)) Rate implicit in the lease, assuming that \nno initial direct costs of the lessor will be \ndeferred ( i.e., exclude initial direct costs \nfrom the calculation of the rate implicit in \nthe lease) Rate implicit in the lease (including initial \ndirect costs of the lessor in the calculation \nof the rate) \nDirect financing lease \nclassification test \n(as described in \nASC 842-10-25-3(b)(1)) Rate implicit in the lease (including initial \ndirect costs of the lessor in the calculation \nof the rate) Rate implicit in the lease (including initial \ndirect costs of the l essor in the calculation \nof the rate) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 150}), Document(page\_content='3 Lease classification \nFinancial reporting developments Lease accounting | 139 3.4 Lease classification considerations \n3.4.1 Transfer of ownership \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \n842-10-55-4 \nThe criterion in paragraph 842 -10-25-2(a) is met in leases that provide, upon the lessee’s \nperformance in accordance with the terms of the lease, that the lessor should execute and deliver to \nthe lessee such documents (including, if applicable, a bill of sale) as may be re quired to release the \nunderlying asset from the lease and to transfer ownership to the lessee. \n842-10-55-5 \nThe criterion in paragraph 842 -10-25-2(a) also is met in situations in which the lease requires the \npayment by the lessee of a nominal amount (for example, the minimum fee required by the statutory \nregulation to transfer ownership) in connection with the transfer of ownership. \n842-10-55-6 \nA provision in a lease that ownership of the underlying asset is not transferred to the lessee if the \nlessee elects not to pay the specified fee (whether nominal or otherwise) to complete the transfer is an \noption to purchase the underlying asset. Such a provision does not satisfy the transfer -of-ownership \ncriterion in paragraph 842 -10-25-2(a). \nA lease is class ified as a finance lease by a lessee and a sales -type lease by a lessor if the lease transfers \nownership of the underlying asset to the lessee by the end of the lease term ( e.g., through the transfer of \ntitle). This includes the transfer of ownership of th e underlying asset to the lessee at or shortly after the \nend of the lease term in exchange for no additional consideration or the payment of a nominal amount \n(e.g., the minimum fee required by statutory regulation to transfer ownership). A provision in a l ease \nagreement that ownership of the underlying asset does not transfer if the lessee elects not to pay a \nspecified fee (nominal or otherwise) to complete the transfer is a purchase option and not an automatic \ntransfer of ownership (refer to section 2.3.2, Purchase options ). \n3.4.2 Evaluating purchase options \nA lease is classified as a finance lease by a lessee and a sales -type lease by a lessor if the lease grants the \nlessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise. The \nterm “reasonably certain” is generally considered to be a high threshold, similar to the phrase “reasonably \nassured” in ASC 840 (refer to section 2.3.1, Lease term ). Purchase options should be assessed in the \nsame way as options to extend the lease term or terminate the lease. Factors that coul d create an \neconomic incentive for the lessee to exercise the purchase option might include a bargain purchase \noption ( e.g., a fixed -price purchase option priced significantly below the expected fair value of the \nunderlying asset ) or contractual or economi c penalties. Refer to section 2.3.5, Evaluating lease term and \npurchase options. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 151}), Document(page\_content='3 Lease classification \nFinancial reporting developments Lease accounting | 140 3.4.3 Evaluating ‘major part,’ ‘substantially all’ and ‘at or near the end’ \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illus trations \n842-10-55-2 \nWhen determining lease classification, one reasonable approach to assessing the criteria in \nparagraphs 842 -10-25-2(c) through (d) and 842 -10-25-3(b)(1) would be to conclude: \na. Seventy -five percent or more of the remaining economic lif e of the underlying asset is a major \npart of the remaining economic life of that underlying asset. \nb. A commencement date that falls at or near the end of the economic life of the underlying asset \nrefers to a commencement date that falls within the last 25 percent of the total economic life of \nthe underlying asset. \nc. Ninety percent or more of the fair value of the underlying asset amounts to substantially all the \nfair value of the underlying asset . \nThe terms “major part,” “substantially all” and “at or near the end” are not defined in ASC 842. \nHowever, ASC 842 includes implementation guidance that states that one reasonable approach to lease \nclassification is to conclude that 75% or greater is a “maj or part” of the remaining economic life (refer to \nsection 2.7, Economic life ) of an underlying asset (refer to section 2.2, Commencement date of the lease ), \n90% or greater is “substantially all” the fair value (as defined in ASC 820, or in ASC 842 for cert ain \nlessors that are not manufacturers or dealers, as applicable, refer to section 2.8, Fair value ) of the \nunderlying asset and a commencement date that falls within the last 25% of the total economic life of the \nunderlying asset is “at or near the end” of the total economic life of the underlying asset (refer to section \n2.7, Economic life ). We believe an entity should establish accounting policies for the thresholds it uses to \ndetermine lease classification, have a reasonable basis for those policies if th ey differ from the \n“reasonable approach” articulated in the standard and apply those policies consistently. Policies that \ndiffer from the “reasonable approach” discussed in ASC 842 may be challenged. \n3.4.4 Lease component that contains the right to use mo re than one underlying asset \nExcerpt from Accounting Standards Codification \nLeases — Overall \nRecognition \n842-10-25-5 \nIf a single lease component contains the right to use more than one underlying asset (see paragraphs \n842-10-15-28 through 15 -29), an entity shall consider the remaining economic life of the predominant \nasset in the lease component for purposes of applying the criterion in paragraph 842 -10-25-2(c). \nIf a single lease component contains the right to use more than one underlying asset, the remaining \neconomic life of the predominant asset is used to determine lease classification. Refer to section 1.4.1, \nIdenti fying and separating lease components of a contract , for further discussion of assessing whether a \nlease contains multiple lease components. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 152}), Document(page\_content='3 Lease classification \nFinancial reporting developments Lease accounting | 141 3.4.5 Residual value guarantees included in the lease classification test \nA lessee is required to include the full amount of a residual value guarantee ( or an allocated portion of a \nportfolio -based residual value guarantee in certain circumstances — refer to section 2.10.3, Residual \nvalue guarantees of a group of assets — lessees ) it provides to a lessor ( i.e., its ma ximum obligation) in \nits evaluation of the “substantially all” criterion of the lease classification test ( i.e., in its evaluation of \nASC 842-10-25-2(d)). A lessor is also required to include the full amount of such a residual value guarantee \nprovided by a lessee in its evaluation of whether a lease is a sales -type lease (excluding certain portfolio -\nbased residual value guarantees — refer to section 2.10.4, Residual value guarantees of a group of assets — \nlessors ). However, if a lease does not qualify as a sales -type lease, a lessor includes the full amounts \nof such residual value guarantees provided by both lessees and any other third party unrelated to the \nlessor in its evaluation of the “substantially all” criterion of the lease classification test to det ermine \nwhether a lease is a direct financing lease ( i.e., in its evaluation of ASC 842-10-25-3(b)(1)). \nResidual value guarantees are treated differently when determining lease payments ( i.e., for purposes of \nrecognizing the lease rather than classifying it ). A lessee includes the amount that it is probable it will owe \nto the lessor under a residual value guarantee as a lease payment when recognizing a lease. A lessee is \nrequired to remeasure and reallocate the remaining consideration in the contract and rem easure finance \nand operating lease liabilities when it changes its assessment of the amount it is probable that it will owe \nunder such a residual value guarantee. Refer to section 4.5, Remeasurement of lease liabilities and right -\nof-use assets — operating and finance leases . Lessors exclude residual guarantees from lease payments. \nRefer to section 2.4, Lease payments . Lessors would account for receipt of payment under a residual \nvalue guarantee in income when it is earned. \nNote that ASC 842-10-55-9 through 55-10 excludes, for lease classification purposes only, portfolio -\nbased residual value guarantees from lease payments for lessors (refer to section 2.10.4, Residual value \nguarantee of a group of assets — lessors ). \n3.4.6 Fair value of the underlying asset \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \n842-10-55-3 \nIn some cases, it may not be practicable for an entity to determine the fair value of an underlying \nasset. In the context of this Topic, practicable means that a reasonable estimate of fair value can be \nmade without undue cost or effort. It is a dynamic co ncept; what is practicable for one entity may not \nbe practicable for another, what is practicable in one period may not be practicable in another, and \nwhat is practicable for one underlying asset (or class of underlying asset) may not be practicable for \nanother. In those cases in which it is not practicable for an entity to determine the fair value of an \nunderlying asset, lease classification should be determined without consideration of the criteria in \nparagraphs 842 -10-25-2(d) and 842 -10-25-3(b)(1). \nIn some cases, it may not be practicable for an entity to determine the fair value (refer to section 2.8, \nFair value ) of an underlying asset without undue cost or effort . For example, t his may be the case when \nthe underlying asset is part of a larger asset . If a reasonable estimate of fair value cannot be made \nwithout undue cost or effort, lessees and lessors will not evaluate the “substantially all” classification \ncriterion described in sections 3.1, Criteria for lease classification — lessees , and 3.2, Criteria for lease \nclassification — lessors . Instead, lease classification will be based on the remaining classification criteria \ndescribed in section 3.1, Criteria for lease classification — lessees . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 153}), Document(page\_content='3 Lease classification \nFinancial reporting developments Lease accounting | 142 If a lessor classifies the lease as a sales -type lease fo r other reasons such as the length of the lease term \ncompared with the remaining economic life of the asset ( e.g., if a lessee leases a floor in a multi -floor \nbuilding for a term of 35 years and the building has a remaining useful life of 40 years), the le ssor will \nstill be required to estimate fair value for purposes of initial recognition and measurement of the sales -\ntype lease ( e.g., to determine the residual value as well as the amount of the underlying asset to derecognize). \nFees paid by a lessee to th e owners of a special -purp ose entity for structuring a transaction are included \nas lease payments (refer to section 2.4, Lease payments ). However, such fees are excluded from the fair \nvalue of the underlying asset for purposes of the lease classification t est. \n3.4.6.1 Effect of investment tax credits on lease classification \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \n842-10-55-8 \nWhen evaluating the lease classification criteria in paragraphs 842 -10-25-2(d) and 842 -10-25-3(b)(1), \nthe fair value of the underlying asset should be reduced by any related investment tax credit retained \nby the lessor and expected to be realized by the lessor. \nWhen an entity cal culates the fair value of an underlying asset to evaluate the “substantially all” classification \ncriterion in the lease classification tests discussed in sections 3.1, Criteria for lease classification — lessees , \nand 3.2, Criteria for lease classification — lessors , the fair value of the underlying asset is reduced by any \nrelated investment tax credits retained by the lessor and expected to be realized by the lessor. \n3.4.7 Alternative use criterion \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \n842-10-55-7 \nIn assessing whether an underlying asset has an alternative use to the lessor at the end of the lease \nterm in accordance with paragraph 842 -10-25-2(e), an entity should consider the effects of \ncontractual restrictions and practical limitations on the lessor’s ability to readily direct that asset for \nanother use (for example, selling it or leasing it to an enti ty other than the lessee ). A contractual \nrestriction on a lessor’s ability to direct an underlying asset for another use must be substantive for \nthe asset not to have an alternative use to the lessor. A contractual restriction is substantive if it is \nenfor ceable. A practical limitation on a lessor’s ability to direct an underlying asset for another use \nexists if the lessor would incur significant economic losses to direct the underlying asset for another \nuse. A significant economic loss could arise because the lessor either would incur significant costs to \nrework the asset or would only be able to sell or re -lease the asset at a significant loss. For example, a \nlessor may be practically limited from redirecting assets that either have design specifications t hat are \nunique to the lessee or that are located in remote areas. The possibility of the contract with the \ncustomer being terminated is not a relevant consideration in assessing whether the lessor would be \nable to readily direct the underlying asset for an other use. \nA lease is classified as a finance lease by a lessee and a sales -type lease by a lessor if the underlying asset \nis of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the \nlease term. The FASB indicated in the Basis for Conclusions (BC 71(e)) of ASU 2016 -02 that lessors \ngenerally would lease special ized assets that have no alternative use to them at the end of the lease term ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 154}), Document(page\_content='3 Lease classification \nFinancial reporting developments Lease accounting | 143 under terms that would transfer substantially all the benefits (and risks) of the asset to the lessee. That \nis, when this criterion is met, it is likely that one of the other cri teria described in section 3.1, Criteria for \nlease classification — lessees , will also be met. An exception could be when a significant amount of anticipated \nlease payments is in the form of variable lease payments that do not depend on an index or rate. \nWhen assessing whether an underlying asset has an alternative use to the lessor at the end of the lease \nterm, lessees and lessors should consider the effects of substantive contractual restrictions and practical \nlimitations on the lessor’s ability to readil y direct that asset for another use ( e.g., sell it, re -lease it). A \npractical limitation exists if the lessor would incur significant economic losses to repurpose the \nunderlying asset for another use ( e.g., if the lessor either would incur significant cost s to rework the \nasset or would only be able to sell or re -lease the asset at a significant loss). \n3.4.8 Lessee indemnifications for environmental contamination \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \n842-10-55-15 \nA provision that requires lessee indemnification for environmental contamination, whether for \nenvironmental contamination caused by the lessee during its use of the underlying asset over the lease \nterm or for preexis ting environmental contamination, should not affect the classification of the lease . \nA provision that requires lessee indemnifications for preexisting environmental contamination or \nenvironmental contamination caused by the lessee during its use of the un derlying asset over the term of \nthe lease does not affect classification of the lease. Indemnities for preexisting environmental \ncontamination are accounted for under ASC 460, whereas indemnities for contamination caused by the \nlessee during the lease term are excluded from the requirements of ASC 460 as they represent a \nguarantee of the lessee’s own performance. Contamination caused by the lessee during the lease term \nand related obligations are accounted for under ASC 410-30, Environmental obligations . \n3.4.9 Leases of government -owned facilities \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \n842-10-55-13 \nBecause of special provisions normally present in leases involving terminal space and other airport \nfacilities owned by a governmental unit or authority, the economic life of such facilities for purposes of \nclassifying a lease is essentially indeterminate. Likewise, it may not be practicable to determine the \nfair value of the underlying asset . If it is impracticable to determine the fair value of the underlying \nasset and such leases also do not provide for a transfer of ownership or a purchase option that t he \nlessee is reasonably certain to exercise, they should be classified as operating leases . This guidance \nalso applies to leases of other facilities owned by a governmental unit or authority in which the rights \nof the parties are essentially the same as in a lease of airport facilities. Examples of such leases may be \nthose involving facilities at ports and bus terminals. The guidance in this paragraph is intended to apply \nto leases only if all of the following conditions are met: \na. The underlying asset is owned by a governmental unit or authority. \nb. The underlying asset is part of a larger facility, such as an airport, operated by or on behalf of \nthe lessor . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 155}), Document(page\_content='3 Lease classification \nFinancial reporting developments Lease accounting | 144 c. The underlying asset is a permanent structure or a part of a permanent structure, such as a \nbuilding, that normally could not be moved to a new location. \nd. The lessor, or in some circumstances a higher governmental authority, has the explicit right \nunder the lease agreement or existing statutes or regulations applicable to the underlying asset \nto terminate the lease at any time during the lease term , such as by closing the facility containing \nthe underlying asset or by taking possession of the facility. \ne. The lease neither transfers ownership of the underlying asset to the lessee nor allows th e lessee \nto purchase or otherwise acquire ownership of the underlying asset. \nf. The underlying asset or equivalent asset in the same service area cannot be purchased or leased \nfrom a nongovernmental unit or authority. An equivalent asset in the same servi ce area is an asset \nthat would allow continuation of essentially the same service or activity as afforded by the \nunderlying asset without any appreciable difference in economic results to the lessee. \n842-10-55-14 \nLeases of underlying assets not meeting all of the conditions in paragraph 842 -10-55-13 are subject \nto the same criteria for classifying leases under this Subtopic that are applicable to leases not involving \ngovernment -owned property. \nArrangements for the use of property owned by a governmental un it may meet the definition of a service \nconcession arrangement that is within the scope of ASC 853, Service Concession Arrangements (refer to \nsection 1.8, Service concession arrangements ). If the arrangement is not within the scope of ASC 853 and \nis a leas e (or contains a lease), the lease is classified as an operating lease when it meets all of the criteria \nin ASC 842-10-55-13. \n3.4.10 Classification of subleases \nExcerpt from Accounting Standards Codification \nLeases — Overall \nRecognition \n842-10-25-6 \nWhen classifying a sublease , an entity shall classify the sublease with reference to the underlying \nasset (for example, the item of property, plant, or equipment that is the subject of the lease) rather \nthan with reference to the right -of-use a sset. \nLessees often enter into arrangements to sublease a n underlying asset to a third party while the original \nlease contract is in effect. In these arrangements, one party acts as both the lessee and lessor of the \nsame underlying asset. The original lease is often referred to as a head lease, the original lessee is often \nreferr ed to as a sublessor and the ultimate lessee is often referred to as the sublessee. \nUnder ASC 842, a sublessor assesses sublease classification independently of the classification \nassessment that it makes as the lessee of the same asset. A sublessor consid ers the lease classification \ncriteria for lessors, discussed in section 3.2, Criteria for lease classification — lessors , with reference to \nthe underlying asset ( i.e., the item of property, plant or equipment that is the subject of the lease) when \nclassify ing a sublease. A sublessee assesses classification of the sublease in the same manner as any \nother lease using the criteria discussed in section 3.1, Criteria for lease classification — lessees . Refer to \nsection 6, Subleases, for further discussion of the accounting for subleases by sublessors and sublessees. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 156}), Document(page\_content='3 Lease classificati on \nFinancial reporting developments Lease accounting | 145 3.5 Reassessment of lease classification \nExcerpt from Accounting Standards Codification \nLeases — Overall \nRecognition \n842-10-25-1 \nAn entity shall classify each separate lease component at the commencement date . An entity shall not \nreassess the lease classification after the commencement date unless the contract is modified and the \nmodification is not accounted for as a separate contr act in accordance with paragraph 842 -10-25-8. In \naddition, a lessee also shall reassess the lease classification after the commencement date if there is a \nchange in the lease term or the assessment of whether the lessee is reasonably certain to exercise an \noption to purchase the underlying asset . When an entity (that is, a lessee or lessor) is required to \nreassess lease classification, the entity shall reassess classification of the lease on the basis of the facts \nand circumstances (and the modified terms a nd conditions, if applicable) as of the date the reassessment \nis required (for example, on the basis of the fair value and the remaining economic life of the underlying \nasset as of the date there is a change in the lease term or in the assessment of a lessee option to \npurchase the underlying asset or as of the effective date of a modification not accounted for as a \nseparate contract in accordance with p aragraph 842 -10-25-8). \nSubsequent measurement \n842-10-35-3 \nA lessor shall not reassess the lease term or a lessee option to purchase the underlying asset unless \nthe lease is modified and that modification is not accounted for as a separate contract in accor dance \nwith paragraph 842 -10-25-8. When a lessee exercises an option to extend the lease or purchase the \nunderlying asset that the lessor previously determined the lessee was not reasonably certain to \nexercise or exercises an option to terminate the lease t hat the lessor previously determined the lessee \nwas reasonably certain not to exercise, the lessor shall account for the exercise of that option in the \nsame manner as a lease modification . \nLessees and lessors are required to reassess lease classification as noted in the following table: \n Reassess lease classification? \nEvent Lessee Lessor \nLease modification ( i.e., a change to the \nterms and conditions of the contract that \nresults in a change in the scope of or the \nconsideration for the lease) that is not \naccounted for as a separate contract Yes1 Yes1 \nChange in assessment of lease term Yes N/A2 \nChange in assessment of whether lessee is \nreasonably certain to exercise an option to \npurchase the underlying asset (refer to \nsection 2.3.6, Reassessment of the lease \nterm and purchase options ) Yes N/A2 \n1 Refer to section 4.6, Lease modifications , and section 5.6, Lease modifications , for a discussion of which modifications are \naccounted for as separate contracts for lessees and lessors, respectively. \n2 When a lessee exercises an option to extend or terminate the lease or purchase the underlying asset and the exercise of the \noption is inconsistent with the existing lease term determination, the lessor accounts for the exercise in the same manner as a \nlease modification (refer to section 5.6, Lease modifications , and section 5.6.1, Summ ary of the accounting for lease \nmodifications — lessors , for further discussion). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 157}), Document(page\_content='3 Lease classification \nFinancial reporting developments Lease accounting | 146 Lessees and lessors reassess lease classification as of the effective date of a modification to a contract \n(i.e., an agreement between two or more parties that creates enforc eable rights and obligations) that is \nnot accounted for as a separate contract, using the modified terms and conditions and the facts and \ncircumstances as of that date, including: \n• The remaining economic life of the underlying asset on that date \n• The fair va lue of the underlying asset on that date \n• The discount rate for the lease on that date \n• The remeasurement and reallocation of the remaining consideration in the contract on that date \nWhen there is a change in the lease term or the assessment of whether a lessee is reasonably certain to \nexercise an option to purchase the underlying asset, the lessee would reassess lease classification based \non the facts and circumstances as of the date that the reassessment is required. \nIf a modification to a cont ract is accounted for as a separate contract that contains a lease, that separate \nlease is classified in the same manner as any new lease. Refer to sections 3.1, Criteria for lease \nclassification — lessees , and 3.2, Criteria for lease classification — lessors. \n3.5.1 Summary of lease reassessment and remeasurement requirements \nThis table summarizes lessee and lessor reassessment and remeasurement requirements under \nASC 842. Refer to section 11.3, Lessee transition, and section 11.4 , Lessor transition, for the \nrequirements for leases that commenced prior to the effective date of ASC 842. \n Lessees Lessors \nAssessment of \nwhether an \narrangement \ncontains a lease Reassess whether a contract is or contains \na lease only if the terms and conditions of \nthe contract are changed. \n(ASC 842-10-15-6 and section 1.3, \nReassessment of the contract ) Reassess whether a contract is or contains \na lease only if the terms and condit ions of \nthe contract are changed. \n(ASC 842-10-15-6 and section 1.3, \nReassessment of the contract) \nAllocation of \nconsideration in the \ncontract between \nlease and non -lease \ncomponents Remeasure and reallocate1 the consideration \nin the contract upon either of the following: \n• A remeasurement of the lease liability \n(section 4.5, Remeasurement of lease \nliabil ities and right -of-use assets — \noperating and finance leases ) \n• The effective date of a contract \nmodification that is not accounted for as \na separate contract (section 4.6.2, \nDetermining whether a lease \nmodification is accounted for as a \nseparate contract ) \n(ASC 842-10-15-36 and section 1.4.3.3, \nReassessment: determinin g and allocating \nthe consideration in the contract — lessees ) Remeasure and reallocate2 the remaining \nconsideration in the contract upon a \ncontract modification that is not \naccounted for as a separate contract \n(section 5.6.2, Determining whether a \nlease mo dification is accounted for as a \nseparate contract). \nIf the consideration in the contract \nchanges, allocate those changes in \naccordance with the requirements in \nASC 606-10-32-42 through 32 -45. \n(ASC 842-10-15-41 through 15 -42 and \nsection 1.4.4.5, Reassessme nt: \ndetermining and allocating the \nconsideration in the contract — lessors ) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 158}), Document(page\_content='3 Lease classification \nFinancial reporting developments Lease accounting | 147 Lessees Lessors \nAssessment of lease \nterm and purchase \noptions Reassess upon any of the following: \n• There is a significant event or change in \ncircumstances within the lessee’s control \nthat directly affects whether the lessee is \nreasonably certain to (1) extend the \nlease term, (2) not terminate the lease or \n(3) purchase the underlying asset. A \nchange in market -based factors should \nnot, in isolation, trigger a reassessment. \n• There is an event t hat is written into the \ncontract that obliges the lessee to \nexercise or not to exercise an option to \nextend or terminate the lease. \n• The lessee elects to exercise an option in \nthe lease ( i.e., extension, termination or \npurchase) even though it had previousl y \ndetermined that it was not reasonably \ncertain to do so. \n• The lessee elects not to exercise an option \nin the lease ( i.e., extension, termination or \npurchase) even though it had previously \ndetermined that it was reasonably certain \nto do so. \n(ASC 842-10-35-1 and section 2.3.6.1, \nReassessment of the lease term and \npurchase options — lessees ) Reassess when the lease is modified, and \nthe modified lease is not accounted for as \na separate contract (section 5.6.2, \nDetermining whether a lease modification \nis account ed for as a separate contract ). \nWhen a lessee exercises an option to \nextend or terminate the lease or purchase \nthe underlying asset and the exercise of \nthe option is inconsistent with the existing \nlease term determination, the lessor \naccounts for the exerc ise of that option in \nthe same manner as a lease modification \n(refer to section 5.6, Lease modifications , \nand section 5.6.1, Summary of the \naccounting for lease modifications — lessors ). \n(ASC 842-10-35-3 and section 2.3.6.2, \nReassessment of the lease term and \npurchase options — lessors ) \nMeasurement of \nlease payments \n(including variable \nlease payments that \ndepend on an index \nor rate, the exercise \nprice of a purchase \noption and, for \nlessees only, \namounts it is \nprobable they will \nowe under residual \nvalue guarantees) \nAlso, refer to \nsections 2.10.3, \nResidual value \nguarantee of a group \nof assets — lessees , \nand 2.10.4, Residual \nvalue guarantee of a \ngroup of assets — \nlessors Remeasure upon any of the following: \n• A lease modification that is not \naccounted for as a separate contract \n(section 4.6.2, Determining whether a \nlease modification is accounted for as a \nseparate contract ) \n• A resolution of a contingency that results \nin some or all of the lease payments that \nwere previously determined to be variable \nmeeting the definition of lease payments \n• A change in the lease term (section \n2.3.6.1, Reassessment of the lease term \nand purchase options — lessees) \n• A change in the assessment of whether a \nlessee is reasonably certain to exercise an \noption in the lease to purchase the \nunderlying asset (section 2.3.6.1, \nReassessment of the lease term and \npurchase options — lessees) \n• A change in amounts it is probable that \na lessee will owe under residual value \nguarantees \n(ASC 842-10-35-4 through 35 -5 and section \n2.4.11.1, Subsequent remeasurement of \nlease payments — lessees ) Remeasure upon a modification that is not \naccounted for as a separate contract \n(section 5.6.2, Determining whether a lease \nmodification is accounted for as a separate \ncontract ). \n(ASC 842-10-35-6 and section 2.4.11.2, \nSubsequent remeasurement of lease \npayments — lessors ) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 159}), Document(page\_content='3 Lease classification \nFinancial reporting developments Lease accounting | 148 Lessees Lessors \nAssessment of lease \nclassification3 Reassess upon any of the following: \n• A modification that is not accounted for \nas a separate contract (section 4.6.2, \nDetermining whether a lease modification is \naccounted for as a separate contract ) \n• A change to the lease term or assessment \nof whether a lessee is reasonably certain \nto exercise an option in the lease to \npurchase the u nderlying asset (section \n2.3.6.1, Reassessment of the lease term \nand purchase options — lessees ) \n(ASC 842-10-25-1 and section 3.5, \nReassessment of lease classification ) Reassess upon a modification that is not \naccounted for as a separate contract \n(section 5.6.2, Determining whether a lease \nmodification is accounted for as a separate \ncontract ). \n(ASC 842-10-25-1 and section 3.5, \nReassessment of lease classification ) \nAssessment of the \ndiscount rate Reassess upon any of the following: \n• A change in the lease term or the \nassessment of whether a lessee is \nreasonably certain to exercise an option \nto purchase the underlying asset if the \ndiscount rate for the lease liability does \nnot already reflect the lessee’s option in \nthe lease to extend or terminate the \nlease or to purchase the underlying asset \n• A modification that is not accounted for \nas a separate contract (section 4.6.2, \nDetermining whether a lease \nmodification is accounted for as a \nseparate contract ) \n(ASC 842-20-35-5, section 2.5.3.2, \nReassessment of the d iscount rate — \nlessees, and section 4.5, Remeasurement \nof lease liabilities and right -of-use assets ) Reassess, for purposes of lease \nclassification, upon a modification that is \nnot accounted for as a separ ate contract. \n(ASC 842-10-25-9 and section 3.5, \nReassessment of lease classification ) \nThe discount rate used to account for the \nmodified lease depends on the \nclassification of the lease before and after \nthe lease modification. \n(ASC 842-10-25-15 through 25 -17, \nsection 2.5.3.1, Reassessment of the \ndiscount rate — lessors , and section 5.6.3, \nLessor accounting for a modification that \nis not accounted for as a separate \ncontract ) \nAssessment of \ncollectibility Not applicable If collectibility is probable at the \ncommencement date for a sales -type or a \ndirect financing lease, a lessor does not \nreassess collectibility for purposes of lease \nclassification. Changes in collectibility are \naccounted for in accordance with the \nimpairment guidance appli cable to the net \ninvestment in the lease. \n(ASC 842-30-25-6, section 5.2.1.1, Initial \nrecognition and measurement when \ncollectibility is probable at lease \ncommencement — sales -type leases , for \nsales -type leases, and section 5.3.1, Initial \nrecognition and me asurement — direct \nfinancing leases , for direct financing leases) \nIf collectibility is not probable at the \ncommencement date for a sales -type \nlease, a lessor continually reassesses \ncollectibility until it becomes probable. \n(ASC 842-30-25-3 and section 5.2. 1.2, \nInitial recognition and measurement when \ncollectibility is not probable at lease \ncommencement — sales -type leases ) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 160}), Document(page\_content='3 Lease classification \nFinancial reporting developments Lease accounting | 149 Lessees Lessors \nIf collectibility is not probable at the \ncommencement date, a lease that would \notherwise be classified as a direct \nfinancing lease is instead classified and \naccounted for as an operating lease. The \nclassification of such a lease is not changed \nbased upon a subsequent evalu ation of \ncollectibility. \nFor an operating lease, a lessor continually \nreassesses collectibility. \n(ASC 842-30-25-13 and section 5.4, \nOperating leases ) \nNote: Refer to section 4.6, Lease modifications , and section 5.6, Lease modifications , for further detail s on accounting for lease \nmodifications by lessees and lessors, respectively. \n1 ASC 842 provides a practical expedient that permits lessees to make an accounting policy election (by class of underlying asset) \nto account for each separate lease component of a contract and its associated non -lease components as a single lease \ncomponent. Les sees that elect this practical expedient do not reallocate the remaining consideration in the contract to non -lease \ncomponents upon the events discussed above. Refer to section 1.4.2.3, Practical expedient to not separate lease and non -lease \ncomponents — lessees . \n2 ASC 842 provides a practical expedient that permits lessors to make an accounting policy election (by class of underlying asset) to \naccount for each separate lease component of a contract and its associated non -lease components as a single componen t if certain \ncriteria are met. Refer to section 1.4.2.4, Practical expedient to not separate lease and non -lease components — lessors . \n3 For leases that were classified as leveraged leases in accordance with ASC 840, and for which the commencement date is before \nthe effective date of ASU 2016 -02, a lessor applies the requirements in ASC 842-50 (i.e., the leveraged lease accounting \nguidance). If a leveraged lease is modified on or after the effective date, it is accounted for as a new lease as of the effe ctive date \nof the modification in accordance with ASC 842-10 and 842 -30 (i.e., it will no longer be accounted for as a leveraged lease) \n(ASC 842-10-65-1(z) and section 11.4.5, Leases previously classified as leveraged leases under ASC 840). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 161}), Document(page\_content=' \nFinancial reporting developments Lease accounting | 150 4 Lessee accounting \nUnder ASC 842, lessees are required to recognize a n ROU asset and lease liability on the balance sheet \nfor most leases. The initial measurement of the lease liability and ROU asset on the commencement date \nis the same for both operating and finance leases. The difference in accounting for an operating lease \nand finance lease is in the subsequent measurement. The income statement presentation and expense \nrecognition pattern for finance leases is similar to that of capital leases under ASC 840 ( i.e., separate \ninterest and amortization expense with higher periodic expense in the earlier periods of a lease). For \noperating leases, the income statement presentation and expense recogn ition pattern are similar to that \nof operating leases under ASC 840 (i.e., a single lease cost generally recognized on a straight -line basis). \nThe following chart provides an overview of the accounting for operating and finance leases by lessees , \nwhich is discussed in further detail in this section : \n Operating leases Finance leases \nInitial recognition and \nmeasurement Initially measure the ROU asset1 and lease liability at the present value of the lease \npayments to be made over the lease term \nSubsequent \nmeasurement — \nlease liability3 Measure the lease liability at the \npresent value of remaining lease \npayments using the discount rate \ndetermined at lease commencement2 Accrete the lease liability based on the interest \nmethod using the discount rat e determined at \nlease commencement2 and reduce the lease \nliability by the payments made \nSubsequent \nmeasurement — \nROU asset Measure the ROU asset at the amount \nof the remeasured lease liability, \nadjusted for the remaining balance of \nany lease incentives re ceived, any \ncumulative prepaid or accrued rents \n(i.e., uneven rent payments), any \nunamortized IDCs and any impairment \nof the ROU asset Amortize the ROU asset, generally on a \nstraight -line basis, over the shorter of the \nlease term or the useful life of the ROU asset, \nand record any impairment of the ROU asset \nIncome statement effect Generally , straight -line expense Generally , “front -loaded” expense \n1 Initial measurement of the ROU asset also includes the lessee’s IDCs and prepayments made to the lessor at or before the \ncommencement date, less lease incentives received from the lessor. \n2 As long as the discount rate has not been updated as a result of a reassessment event. \n3 Although the subsequent measurement of operating lease liabilities and fin ance lease liabilities is described differently, the \ncalculation results in the same amount each period. \n4.1 Initial recognition \nExcerpt from Accounting Standards Codification \nLeases — Lessee \nRecognition \n842-20-25-1 \nAt the commencement date , a lessee shall recognize a right -of-use asset and a lease liability . \nMaster Glossary \nShort -Term Lease \nA lease that, at the commencement date , has a lease term of 12 months or less and does not include \nan option to purchase the underlying asset that the lesse e is reasonably certain to exercise. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 162}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 151 Right -of-Use Asset \nAn asset that represents a lessee’s right to use an underlying asset for the lease term. \nLease Liability \nA lessee’s obligation to make the lease payments arising from a lease , measured on a discounted basis. \nLeases — Lessee \nRecognition \n842-20-25-2 \nAs an accounting policy, a lessee may elect not to apply the recognition requirements in this Subtopic \nto short -term leases . Instead, a lessee may recognize the lease payments in profit or loss on a \nstraight -line basis over the lease term and variable lease payments in the period in which the \nobligation for those payments is incurred (consistent with paragraphs 842 -20-55-1 through 55 -2). \nThe accounting policy election for short -term leases shall be m ade by class of underlying asset to \nwhich the right of use relates. \n842-20-25-3 \nIf the lease term or the assessment of a lessee option to purchase the underlying asset changes such \nthat, after the change, the remaining lease term extends more than 12 month s from the end of the \npreviously determined lease term or the lessee is reasonably certain to exercise its option to purchase \nthe underlying asset, the lease no longer meets the definition of a short -term lease and the lessee shall \napply the remainder of t he guidance in this Topic as if the date of the change in circumstances is the \ncommencement date . \nAt the commencement date of a lease, a lessee recognizes a liability to make lease payments ( i.e., the \nlease liability) and an asset representing the right to use the underlying asset during the lease term \n(i.e., the right -of-use asset). \nThe initial recognition of the right -of-use asset and the lease liability is the same for operating leases and \nfinance leases, as is the subsequent measurement of the l ease liability. However, the subsequent \nmeasurement of the right -of-use asset for operating leases and finance leases differs under ASC 842 \n(refer to section 4.2.2.2, Subsequent measurement of right -of-use assets — operating leases, and 4.3.2.2, \nSubsequent measurement of right -of-use assets — finance leases ). \n4.1.1 Short -term leases \nLessees can make an accounting policy election (by class of underlying asset to which the right of use \nrelates) to apply accounting similar to ASC 840’s operating lease accounting to leases that meet ASC 842’s \ndefinition of a short -term lease ( i.e., the short -term lease election ). This accounting policy election does not \napply to lessors. A short -term lease is defined as a lease that, at the commencement date, has a lease term \nof 12 months or less and does not include an option to purchase the underlying asset that the lessee is \nreasonably certain to exercise. The short -term lease election can only be made at the commencement date \n(refer to section 2.2, Commencement date of the lease , for discussion of the commencement date). \nASC 842 does not address how an entity should identify a class of underlying asset. Entities may want to \nconsider the following: \n• ASC 360-10-50 also requires disclosures of ”balances o f major classes of depreciable assets, by \nnature or function.” \n• The ASC Master Glossary defines an intangible asset class as “a group of intangible assets that are \nsimilar, either by their nature or by their use in the operations of an entity.” ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 163}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 152 A lessee tha t makes this accounting policy election does not recognize a lease liability or right -of-use \nasset on its balance sheet. Instead, the lessee recognizes lease payments on a straight -line basis over the \nlease term and variable lease payments that do not depe nd on an index or rate in the period in which the \nachievement of the specified target that triggers the variable lease payments becomes probable. Any \npreviously recognized variable lease cost is reversed if it becomes probable that the specified target wil l \nno longer be met. Refer to section s 2.4.10 , Amounts not included in lease payments , and 2.9.1 , Lessee \naccounting for variable lease payments , for further discussion of variable lease payments that do not \ndepend on an index or rate and the accounting for their reversal . \nWhen determining whether a lease qualifies as a short -term lease, a lessee evaluates the lease term and \nthe purchase option in the same manner as all other leases. Refer to section 2.3, Lease term and purchase \noption s. That is, the lease term includes the noncancelable term of the lease and all of the following: \n• Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option \n• Periods covered by an option to terminate the lea se if the lessee is reasonably certain not to exercise \nthat option \n• Periods covered by an option to extend (or not terminate) the lease in which the exercise of the \noption is controlled by the lessor \nA lease that qualifies as a short -term lease at the commencement date no longer meets the definition of \na short -term lease when there is a change in a lessee’s assessment of either: \n• The lease term so that, after the change, the remaining lease term extends more than 12 months \nfrom the end of the previously determined lease term \n• Whether it is reasonably certain to exercise an option to purchase the underlying asset \nWhen the lease no longer meets the definition of a short -term lease, a lessee that is applying the short -\nterm lease election must apply the recogn ition and measurement guidance for all other leases as if the \ndate of the change in circumstances is the commencement date. Additionally, if a t lease commencement \na lessee determine s that the lease term is longer than 12 months, it cannot elect the short -term lease \nelection if the lease is subsequently reassessed (refer to section 2.3.6, Reassessment of the lease term \nand purchase options ) and has a lease term less than 12 months. Likewise, a lessee cannot elect the \nshort -term lease election if, as a result of a lease modification that is not accounted for as a separate \ncontract (refer to section 4.6.2, Determining whether a lease modification is accounted for as a separate \ncontract ), the lease term is modified to be less than 12 months . \nThe short -term lease election is intended to reduce the cost and complexity of applying ASC 842. However, \na lessee that makes the election must make certain quantitative and qualitative disclosures about short -\nterm leases. Refer to section 4.10, Disclosure . \nOnce a lessee establishes a policy for a class of underlying assets, all future short -term leases fo r that \nclass are required to be accounted for in accordance with the lessee’s policy. A lessee evaluates any \npotential change in its accounting policy in accordance with the guidance in ASC 250, Accounting \nChanges and Error Corrections . \nIllustration 4 -1: Short -term lease \nScenario A \nA lessee enters into a lease with a nine -month noncancelable term with an option to extend the lease \nfor four months. The leas e does not include a purchase option. At the lease commencement date, the \nlessee concludes that it is reasonably certain to exercise the extension option because the monthly \nlease payments during the extension period are significantly below market rates. T he lessee has an \nestablished accounting policy to use the short -term lease election for the class of underlying asset \nsubject to this lease. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 164}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 153 Analysis : The lease term is greater than 12 months ( i.e., 13 months). Therefore, the lessee may not \naccount for the lease as a short -term lease. \nScenario B \nAssume the same facts as in Scenario A except, at the lease commencement date, the lessee \nconcludes that it is not reasonably certain to exercise the extension option because the monthly lease \npayments during the optional extension period are what the lessee expects to be market rates, and \nthere are no other factors that would make exercise of the renewal option reasonably certain. \nAnalysis : The lease term is 12 months or less ( i.e., nine months). Therefore, the l essee accounts for the lease \nunder the short -term lease election (i.e., it recognizes lease payments on a straight -line basis over the \nlease term and does not recognize a lease liability or right -of-use asset on its balance sheet). \n \nIllustration 4 -2: Noncancelable lease term of nine months with a four -month renewal option \n(assume no purchase option) \nScenario A: Exercise of option is reasonably certain = not short -term lease \nNine months Four months \nScenario B: Exercise of option is not reasonably certain = short -term lease \nNine months Four months \n \n Noncancelable lease term Optional renewal period \n \n \n4.2 Operating leases \n4.2.1 Initial measurement — operating leases \nExcerpt from Accounting Standards Codification \nLeases — Lessee \nInitial Measurement \n842-20-30-1 \nAt the commencement date , a lessee shall measure both of the following: \na. The lease liability at the present value of the lease payments not yet paid, discounted using the \ndiscount rate for the lease at lease commencement (as described in paragraphs 842 -20-30-2 \nthrough 30 -4) \nb. The right -of-use asset as described in paragraph 842 -20-30-5. \n842-20-30-5 \nAt the commencement date , the cost of the right -of-use asset shall consist of all of the following: \na. The amount of the initial measurement of the lease liability \nb. Any lease payments made to the lessor at or before the commencement date, minus any lease \nincentives received \nc. Any initial direct costs incurred by the lessee (as described in paragraphs 842 -10-30-9 through 30 -10). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 165}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 154 4.2.1.1 Initial measurement of lease liabilities — operating l eases \nAt the commencement date (refer to section 2.2, Commencement date of the lease ), a lessee initially \nmeasures the lease liability at the present value of the lease payments to be made over the lease term. \nLessees apply the concepts previously described in section 1, Scope and scope exceptions , and section 2, \nKey concepts , to identify the lease components and to determine the lease term, lease payments and \ndiscount rate as of the commencement date of the lease. \nThe diagram below illustrates the inputs need ed to initially calculate the lease liability: \n \n1 Lease incentives that are pay able to the lessee on the commencement date are deducted from lease payments (i.e., they reduce \nthe lease liability) . Refer to section 2.4.1.2, Lease incentives . \n4.2.1.2 Initial measurement of right -of-use assets — operating l eases \nA lessee initially measures the right -of-use asset at cost, which consists of all of the following: \n• The amount of the initial measurement of the lease liability \n• Any lease payments made to the lessor at or before the commencement date, less any lease \nincent ives received (refer to section 2.4.1.2, Lease incentives ) \n• Any initial direct costs incurred by the lessee (refer to section 2.6, Initial direct costs ) \nThe diagram below illustrates the inputs need ed to initially calculate the ROU asset: \n \nWhile ASC 842 does not specifically prohibit lessees from recognizing a right -of-use asset that exceeds the \nfair value of the underlying asset, we believe that lessees should challenge the inputs and assumptions \nused to measure the right -of-use asset if the carrying amount of the right -of-use asset would exceed the \nfair value of the underlying asset. Inputs and assumptions that could be challenged include the identification \nof lease and non -lease components, the allocation of consideration in the contract to those co mponents \nand the discount rate used. Lease \nliabilityLease \nprepaymentsInitial direct \ncostsLease \nincentives \nreceivedROU assetPresent value using \nthe discount rate \ndetermined on the \ncommencement \ndateLease \npayments to \nbe made over \nthe lease \nterm1Lease liability', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 166}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 155 4.2.2 Subsequent measurement — operating leases \nExcerpt from Accounting Standards Codification \nLeases — Lessee \nSubsequent Measurement \n842-20-35-3 \nAfter the commencement date, for an operating lease , a lessee shall measure both of the following: \na. The lease liability at the present value of the lease payments not yet paid discounted using the \ndiscount rate for the lease established at the commencem ent date (unless the rate has been \nupdated after the commencement date in accordance with paragraph 842 -20-35-5, in which case \nthat updated rate shall be used) \nb. The right -of-use asset at the amount of the lease liability, adjusted for the following, unl ess the \nright -of-use asset has been previously impaired, in which case the right -of-use asset is measured in \naccordance with paragraph 842 -20-35-10 after the impairment: \n1. Prepaid or accrued lease payments \n2. The remaining balance of any lease incentive s received, which is the amount of the gross \nlease incentives received net of amounts recognized previously as part of the single lease \ncost described in paragraph 842 -20-25-6(a) \n3. Unamortized initial direct costs \n4. Impairment of the right -of-use asset . \n842-20-35-4 \nAfter the commencement date , a lessee shall remeasure the lease liability to reflect changes to the \nlease payments as described in paragraphs 842 -10-35-4 through 35 -5. A lessee shall recognize the \namount of the remeasurement of the lease liab ility as an adjustment to the right -of-use asset . \nHowever, if the carrying amount of the right -of-use asset is reduced to zero, a lessee shall recognize \nany remaining amount of the remeasurement in profit or loss. \nRecognition \n842-20-25-6 \nAfter the commencement date , a lessee shall recognize all of the following in profit or loss, unless the \ncosts are included in the carrying amount of another asset in accordance with other Topics: \na. A single lease cost, calculated so that the remaining cost of the lease (as described in paragraph \n842-20-25-8) is allocated over the remaining lease term on a straight -line basis unless another \nsystematic and rational basis is more representative of the pattern in which benefit is expected to \nbe derived from the right to use the underlying asset (see paragraph 842 -20-55-3), unless the \nright -of-use asset has been impaired in accordance with paragraph 842 -20-35-9, in which case \nthe single lease cost is calculated in accordance with paragraph 842 -20-25-7 \nb. Variable lease payments not included in the lease liability in the period in which the obligation \nfor those payments is incurred (see paragraphs 842 -20-55-1 through 55 -2) \nc. Any impairment of the right -of-use asset determined in accordance with paragraph 842 -20-35-9. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 167}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 156 842-20-25-8 \nThroughout the lease term, the remaining cost of an operating lease for which the right -of-use asset \nhas not been impaired consists of the following: \na. The total lease payments (including those paid and those not yet paid), reflecting any adjustment \nto that total amount resulting from either a remeasurement in accordance with paragraphs 842 -\n10-35-4 through 35 -5 or a lease modification ; plus \nb. The total initial direct costs attributable to the lease; minus \nc. The periodic lease cost recognized in prior periods. \n4.2.2.1 Subsequent measurement of lease liabilities — operating leases \nAfter lease commencement, a lessee measures the lease liability for an operating lease at the present \nvalue of the remaining lease payments using the discount rate determined at lease commencement, as \nlong as the discount rate has not been updated as a result of a reassessment event (refer to section \n2.5.3, Reassessment of the discount rate ). \n4.2.2.2 Subsequent measurement of right -of-use assets — operating leases \nA lessee su bsequently measures the right -of-use asset for an operating lease at the amount of the remeasured \nlease liability ( i.e., the present value of the remaining lease payments), adjusted for the remaining balance \nof any lease incentives received, any cumulative prepaid or accrued rent if the lease payments are uneven \nthroughout the lease term and any unamortized initial direct costs. If the right -of-use asset becomes \nimpaired, refer to section 4.2.3, Expense recognition — operating leases . \nThe FASB indicated in the Basis for Conclusions (BC 253) of ASU 2016 -02 that the carrying amount of \nthe right -of-use asset for an operating lease is intended to approximate the present value of the \nremaining benefits to the lessee at each measurement date. Therefore, the subsequent measurement of \nthe right -of-use asset reflects the subsequent measurement of the lease liability ( i.e., the present value of \nthe remaining lease payments), adjusted for the effect of uneven lease payments. \nASC 842 requires the right -of-use asset for an operating lease to be subsequently measured using the \nlease liability balance, adjusted for the effect of uneven lease payments, assuming there is no impairment. \nTherefore, the right -of-use asset is effectively a “plug” necessary to achieve straigh t-line expense \nrecognition for operating leases. \nASC 842 does not address the accounting for lease incentives that are contingently receivable by the \nlessee at the lease commencement date ( i.e., lease incentives that are not received or receivable until th e \noccurrence of an event subsequent to lease commencement) . Examples include reimbursements for \nmoving costs or leasehold improvements that become receivable by the lessee when the lessee incurs \nthese costs. Refer to section 2.4.1.2, Lease incentives, for a discussion of lease incentives, including the \ntiming of recognition of contingently receivable incentives. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 168}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 157 4.2.3 Expense recognition — operating leases \nWhen subsequently accounting for an operating lease, l essees recognize the following: \n \nTo clarify, a lessee’s lease cost includes both amounts recognized in profit or loss during the period and \nany amou nts capitalized as part of the cost of another asset in accordance with other applicable \nguidance , such as ASC 330. \nSingle lease cost \nAfter lease commencement, a lessee recognizes a single lease cost for an operating lease on a straight -\nline basis. This is consistent with the concept of the lessee paying to use the asset during the lease term \nrather than paying to finance the acquisition of the underlying asset in a finance lease. The single lease cost \nfor an operating lease differs from the cost for a fina nce lease ( i.e., a lessee separately recognizes interest on \nthe finance lease liability and amortization on the finance lease right -of-use asset). \nAbsent an impairment of the right -of-use asset, the single lease cost is calculated so that the remaining \ncost of the lease is allocated over the remaining lease term on straight -line basis unless another \nsystematic and rational basis is more representative of the pattern in which benefit is expected to be \nderived from the right to use the underlying asset. \nThe r emaining cost of the lease is calculated as: \n• Total lease payments (including those previously paid and not yet paid) \n• Plus total lessee initial direct costs (attributable to the lease) \n• Minus the periodic lease cost recognized in prior periods \nTotal lease payments are adjusted to reflect changes that arise from a lease modification ( i.e., a change \nto the terms and conditions of the contract that results in a change in the scope of or consideration for \nthe lease) or the remeasurement of the lease liabi lity not recognized in profit or loss at the date of \nremeasurement ( e.g., a change in lease term). Refer to section 4.5, Remeasurement of lease liabilities \nand right -of-use assets — operating and finance leases . \nA single lease cost \nVariable lease payments that are not included in the lease liability \n(i.e., variable lease payments that do not depend on \nan index or rate) \nChanges to variable lease payments that \ndepend on an index or rate \nImpairment of the right -of-use asset (refer to section 4.2.5, \nImpairment of the right -of-use assets in operating leases ) \nOperating leases ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 169}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 158 Pattern of benefit from use of the underlying asset \nExcerpt from Accounting Standards Codification \nLeases — Lessee \nImplementation Guidance and Illustrations \n842-20-55-3 \nThis Subtopic considers the right to control the use of the underlying asset as the equivalent of physical \nuse. If the lessee controls the use of the underlying asset, recognition of lease cost in accordance with \nparagraph 842 -20-25-6(a) or amortization of the right -of-use asset in accordance with paragraph \n842-20-35-7 should not be affected by the extent to which the lessee uses the underlying asset. \nOperating lease agreements may specify scheduled rent increases over the lease term (refer to \nsection 2.3, Lease term and purchase options ) or periods during the lease term for which rent payments \nare not required ( i.e., rent holidays). Uneven rental payments (increases, decreases or holidays) are often \ndesigned to provide an inducement for the lessee, to reflect the anticipated effects of inflation, to ease the \nlessee’s near -term cash flow requirements or to acknowledge t he time value of money. For operating \nleases that include uneven rental payments, rental expense should be recognized by a lessee on a \nstraight -line basis over the lease term unless another systematic and rational allocation basis is more \nrepresentative of the time pattern in which a benefit is expected to be derived from the right to use the \nunderlying asset, unless the right -of-use asset becomes impaired (refer to section 4.2.5, Impairment of \nright -of-use assets in operating leases ). Using factors such as the time value of money or anticipated \ninflation is inappropriate because these factors do not relate to the physical usage of the underlying asset. \nLease agreements may include scheduled rent increases designed to accommodate the lessee’s \nprojected physi cal use of the underlying asset. For example, rents may escalate in contemplation of the \nlessee’s physical use of the underlying asset even though the lessee takes possession of or controls the \nphysical use of the underlying asset at commencement. \nIt is im portant to note the standard emphasizes the benefit from the “right to use” as opposed to how the \nlessee is expected to use the underlying asset. If rents escalate in contemplation of the lessee’s physical \nuse of the underlying asset but the lessee takes p ossession of or controls the physical use of the \nunderlying asset at the beginning of the lease term, all rental payments, including the escalated rents, \nshould be recognized as rental expense on a straight -line basis starting with the beginning of the lea se \nterm ( i.e., rent expense is not affected by the extent to which the lessee uses the asset). \nThe application of the guidance above to an operating lease with uneven rental payments that are not \nrepresentative of the pattern in which benefit is expected t o be derived from the right to use the \nunderlying asset results in prepaid or accrued rentals. If the lessee purchases the underlying asset prior \nto the expiration of the lease term, any prepaid or accrued rentals should be included in the \ndetermination of the purchase price of the asset (refer to section 4.8.2, Purchase of a n underlying asset \nduring the lease term, for further discussion). If the lease agreement is extended, lessees should apply \nthe guidance in section 4.6, Lease modifications. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 170}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 159 Variable le ase payments \nExcerpt from Accounting Standards Codification \nLeases — Lessee \nImplementation Guidance and Illustrations \n842-20-55-1 \nA lessee should recognize costs from variable lease payments (in annual periods as well as in interim \nperiods) before the achievement of the specified target that triggers the variable lease payments, \nprovided the achievement of that target is considered probable . \n842-20-55-2 \nVariable lease costs recognized in acco rdance with paragraph 842 -20-55-1 should be reversed at such \ntime that it is probable that the specified target will not be met. \nAfter the commencement date, lessees also recognize as part of lease -related cost any variable lease \npayments not included in the operating lease liability in the period in which the achievement of the \nspecified target that triggers the variable lease payments becomes probable. Any previously recognized \nvariable lease costs are reversed if it becomes probable that the specified target will no longer be met. \nRefer to section 2. 4.10 , Amounts not included in lease payments , for a discussion of variable leases \npayments that do not depend on an index or rate. \nImpairment of the right -of-use as set \nIf a lessee determines that a right -of-use asset is impaired, it recognizes an impairment loss and measures \nthe right -of-use asset at its carrying amount immediately after the impairment. Following an impairment, \nthe single lease cost is calculated in the manner described in section 4.2.5, Impairment of right -of-use \nassets in operating leases . \n4.2.4 Example — lessee accounting for an operating lease \nIllustration 4 -3: Lessee accounting for an operating lease \nEntity L (lessee) makes a payment of $5,000 to an existing tenant to obtain a lease and enters into a \nthree -year lease of the same office space that it concludes is an operating lease. The lease commences \nat the beginning of Year 1 . Entity L agrees to make the following annual payments at the end of each \nyear: $10,000 in Year 1, $12,000 in Year 2 and $14,000 in Year 3. Entity L concludes that the \n$5,000 payment to the former tenant qualifies as an initial direct cost (IDC). For simplicity, there are \nno purc hase options, payments to the lessor before the lease commencement date, variable payments \nbased on an index or rate, or lease incentives from the lessor. The initial measurement of the right -of-\nuse asset and lease liability is $33,000 using a discount rat e of 4.235%. Entity L uses its incremental \nborrowing rate because the rate implicit in the lease cannot be readily determined. Entity L calculates \nthat the annual straight -line lease expense is $12,000 per year [($10,000 + $12,000 + $14,000) ÷ 3]. \nAnalysis : At lease commencement, Entity L would recognize the right -of-use asset and lease liability: \nRight -of-use asset $ 38,000 \n Lease liability $ 33,000 \n Cash 5,000 \nTo initially recognize the right -of-use asset, lease liability and the payment that qualifies as an IDC. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 171}), Document(page\_content='4 Lessee ac counting \nFinancial reporting developments Lease accounting | 160 The following journal entries would be recorded in Year 1: \nLease expe nse $ 12,000 \n Right -of-use asset (accrued rent) $ 2,000 \n Cash 10,000 \nTo record lease expense and adjust the right -of-use asset for the difference between cash p aid and \nstraight -line lease expense ( i.e., accrued rent). \nLease expense (amortization of IDC) $ 1,667 \n Right -of-use asset (amortization of IDC) $ 1,667 \nTo record amortization of the IDC ($5,000 ÷ 3 years = $1,667). \nLease liability $ 8,602 \n Right -of-use asset $ 8,602 \nTo adjust the lease liability to the present value of the remaining lease payments with an offset to the \nright -of-use asset. The adjustment of $8,602 is calculated as the initially recognized lease liability \n($33,000) less th e present value of remaining lease payments ($24,398) at the end of Year 1. \nA summary of the lease contract’s accounting (assuming no changes due to reassessment, lease \nmodification or impairment) is as follows: \n Initial Year 1 Year 2 Year 3 \nCash lease payments: $ 10,000 $ 12,000 $ 14,000 \nIncome statement: \nPeriodic lease expense (straight -line) (12,000 ) (12,000 ) (12,000 ) \nAmortization of IDC (1,667 ) (1,667 ) (1,666 ) \nTotal lease expense $ (13,667 ) $ (13,667 ) $ (13,666 ) \n(Accrued) /prepaid rent for period $ (2,000) $ — $ 2,000 \nBalance sheet: \nLease liability $ (33,000) $ (24,398) $ (13,431) $ — \nRight -of-use asset \nLease liability $ 33,000 $ 24,398 $ 13,431 $ — \nUnamortized IDC 5,000 3,333 1,666 — \n(Accrued) /prepaid rent \n(cumulative) — (2,000) (2,000) — \n $ 38,000 $ 25,731 $ 13,097 $ — \nImmaterial differences may arise in the recomputation of amounts in the example above due to rounding. \nRefer to section 4.3. 5, Example — lessee accounting for a finance lease , for a table that illustrates the \nsimilarities and differences in the accounting for an operating lease and a finance lease. \n4.2.5 Impairment of right -of-use assets in operating leases (updated August 2023) \nExcerpt from Accounting Standards Codification \nLeases — Lessee \nSubsequent Measurement \n842-20-35-9 \nA lessee shall determine whether a right -of-use asset is impaired and shall recognize any impairment \nloss in accordance with Section 360 -10-35 on impairment or disposal of long -lived assets. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 172}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 161 A lessee ’s right -of-use asset in an operating or finance lease is subject to the impairment guidance in \nASC 360-10 (for guidance on impairment of right -of-use assets in finance leases refer to section 4.3 .4, \nImpairment of right -of-use assets in f inance leases ). Lessees must also apply the guidance in ASC 360-10 \nwhen there are significant changes to the current or expecte d use of a right -of-use asset because it could \naffect the asset groupings used to evaluate the right -of-use asset for impairment and the estimated useful \nlife of both a right -of-use asset and any leasehold improvements associated with the underlying asset . \nFurther, lessees that separately account for non -lease components ( i.e., entities that have not made the \npolicy election under ASC 842 to combine lease and associated non -lease components) must consider \nthe guidance in ASC 420 to determine whether any ex it or disposal costs associated with non -lease \ncomponents should be accrued (e.g., when a lessee has concluded that it has permane ntly ceased using \nan asset , whether for its own use or through subleasing, and costs allocated to the non -lease component \nthat will continue to be incurred for its remaining term will not provide economic benefit to the entity ). \nThe following flowchart illustrates the interaction of the guidance in ASC 842, ASC 360-10 and ASC 420: \n \n\* Generally, applies only to lessees that do not make the policy election to combine the lease and associated non -lease components \nof a contract. \nThe FASB indicated in the Basis for Conclusions (BC 255) of ASU 2016 -02 that the impairment model in \nASC 360-10 is appropriate to apply to a lessee’s right -of-use assets because these asset s are long-lived \nnonfinancial asset s and should be accounted for th e same way as an entity’s other long -lived nonfinancial \nassets. This treatment is intended to give users of the financial statements comparable information \nabout all of an entity’s long -lived nonfinancial assets. \nThe guidance in ASC 360-10 requires three s teps to identify, recognize and measure the impairment of a \nlong-lived asset (asset group ) to be held and used: \n• Indicators of impairment (Step 1) — Consider whether impairment indicators are present \n(i.e., whether there are any events or changes in circums tances that indicate that the carrying \namount of the long -lived asset ( asset group) might not be recoverable) . \nASC 360-10 \nStep 1 \nConsider whether impairment \nindicators are present \n(e.g., a decision to abandon \nan ROU asset). \nStep 2 \nCompare the sum of the estimated \nundiscounted future cash flows to \nthe carrying amount of the long -\nlived asset (asset group). \nStep 3 \nMeasure and record any \nimpairment loss if the carrying \namount of the long -lived asset \ngroup exceeds its fair value. \nASC 420 \nDetermine whether any \nexit or disposal costs \nshould be accrued. \nContract within the scope of ASC 842 \nLease component \n(i.e., ROU asset) \nNon-lease component\* ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 173}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 162 • Test for recoverability (Step 2) — If indicators of impairment are present, perform a recoverability \ntest by comparing the sum of the estimated undiscounted future cash flows attributable to the long-\nlived asset ( asset group) in q uestion to its carrying amount (as a reminder , entities cannot record an \nimpairment for a held and used asset unless the asset first fails this recoverability test) . \n• Measure an impairment (Step 3) — If the undiscounted cash flows used in the test for recoverability \nare less than the carrying amount of the long -lived asset (asset group) , determine the fair value of \nthe long -lived asset ( asset group ) and recognize an impairment loss if the carrying amount of the \nlong-lived asset ( asset group) exceeds it s fair value. \nGrouping long-lived assets \nASC 360-10 defines an asset group as “the unit of accounting for a long -lived asset or assets to be held \nand used, which represents the lowest level for which identifiable cash flows are largely independent of \nthe cash flows of other groups of assets and liabilities. ” Assets generally should be grouped when they \nare used together ( i.e., when they are part of the same group of assets and are used together to \ngenerate joint cash flows). \nGrouping long-lived assets requires judgment and will require consideration of the facts and \ncircumstances as well as an understanding of the entity’s business. We believe the im pairment \nassessment for ROU assets often will be performed at an asset -group level with any impairment allocated \namong the long -lived assets of the group in accordance with ASC 360-10. \nEach time a lessee performs a recoverability test, it should reassess whether its grouping of long -lived \nassets continues to be appropriate. Significant c hanges to the current or expected use of the individual \nassets of the group might indicate that the related asset grouping may have changed. This might be the case \neven when the ROU asset is not the primary asset in the asset group. \nWhen evaluating whether the inclusion of an ROU asset in an asset group continues to be appropria te, a \nlessee needs to determine whether there has been a fundamental change in the use of the leased asset. \nFor example, a functionally independent asset that is abandoned (e.g., a building) may no longer be part \nof an existing asset group. Refer to sectio n 4.2.5.3, Abandonment of ROU assets , for discussion on when \nan ROU asset is abandoned. However, it may be challenging to determine whether an ROU asset that is \nnot (or will not be) abandoned has changed asset groups or is a separate asset group. Examples of \nsituations that could indicate the asset group has changed for an ROU asset that is not (or will not be) \nabandoned include: \n• The lessee has ceased using the leased asset and does not plan to reoccupy or use the leased asset in \nthe future. \n• The lessee has incurred significant costs (e.g., readying the space for sublease by removing signage) \nto cease using the leased asset in the near future. \n• The lessee has executed a sublease for the leased asset for substantially all of the remaining lease term. \n• The les see is actively marketing the leased asset for sublease (e.g., hired a broker). \n• The lessee has changed how the leased asset is used in its operations, including moving the leased \nasset to a different line of business in a different asset group. \nThese situations are not all inclusive, and no one situation is determinative. A lessee will need to evaluate \nits facts and circumstances to determine whether there is a change in how it uses the leased asset and \nwhether the asset group has changed. A plan to change how the leased asset will be used by the business \nor to sublease the leased asset, by itself, generally does not indicate that the ROU asset’s group has \nchanged, since the lowest level of identifiable cash flows has not yet changed. For example, a lessee may ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 174}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 163 decide that in one year it will sublease a leased asset that is part of an enterprise -wide asset group but it \nwill continue to use the leased asset until then . The ROU asset would still be part of the enterprise -wide \nasset group because the l essee continues to use the leased asset. \nRefer to section 6.3, Sublessor accounting , for discussion on evaluating the grouping of long -lived assets \nwhen a lessee has executed a sublease for a leased asset in the asset group. \n4.2.5.1 Test for recoverability (Step 2) \nASC 360-10 provides principles for evaluating long -lived assets for impairment, but it does not \nspecifically address how lease liabilities should be considered in the recoverability test. Under ASC 360-\n10, financial liabilities ( e.g., long-term d ebt) generally are excluded from an asset group and operating \nliabilities ( e.g., accounts payable) generally are included. Financial liabilities generally are excluded \nbecause when the FASB was deliberating Statement 144 (later codified in ASC 360-10), it indicated that \nhow an entity capitalizes or finances its operations should not influence the recognition of an impairment \nloss (see B34 of Statement 144). ASC 360-10 requires an entity to exclude asset retirement obligation \n(ARO) liabilities from an asset group and to exclude estimated future cash outflows associated with ARO \nliabilities from both the recoverability test (Step 2) and measurement of an impairment (Step 3). \nASC 842 characterizes operating lease liabilities as operating liabilities. In the Basis for Conclusions (BC \n264) of ASU 2016 -02, the FASB noted that while both operating and finance lease liabilities are financial \nliabilities, finance lease liabilities are the equivalent of debt, and operating lease liabilities are operating in \nnatur e and not “debt like.” \nBecause operating lease liabilities may be viewed as having attributes of finance liabilities as well as operating \nliabilities, we believe it is acceptable for a lessee to either include or exclude operating lease liabilities from \nan asset group when testing whether the carrying amount of an asset group is recoverable. A lessee should \napply its approach ( i.e., include or exclude operating lease liabilities) consistently for all operating leases and \nwhen performing Steps 2 and 3 of the impairment model in ASC 360-10 (refer to section 4.2.5.2, Measure \nan impairment (Step 3) , for guidance on measur ing an impairment loss). \nIn some cases, including operating lease liabilities in an asset group may result in the long -lived asset (asset \ngroup) having a zero or negative carrying amount. For example, this may occur if a lessee receives lease \nincentives or has back -loaded lease payments, both of which would result in reductions to the lessee’s right -\nof-use assets. In these cases, a lessee is still required to test whether the carrying amount of the asset \ngroup is recoverable and, if not recoverable, measure the asset group for impairment. \nDetermining which future cash outflows for operating lease payments should be included in the Step 2 \nrecoverability test \nA lessee that excludes operating lease liabilities from its asset group should exclude future cash lease \npayments ( i.e., fixed, in -substance fixed and variable payments based on an index or rate) in the \nundiscounted future cash flows. \nASC 360-10 does not specifically address how future cash outflows for operating lease payments should \nbe considered in the recoverability test. The FASB staff said in response to a technical inquiry that if a \nlessee include s an operating lease liability as par t of the carrying amount of the asset group, only the \nprincipal component of future lease payments would be included as an outflow in the undiscounted future \ncash flows used to test recoverability of the asset group. That is, the lessee would include the f uture cash \nlease payments for the lease, excluding the component that effectively represents the accretion of the \nlease liability (even though interest expense is not recognized separately for an operating lease). As a \nresult, we believe a lessee’s decisio n to include or exclude operating lease liabilities from an asset group \ngenerally should not affect the outcome of its recoverability test (refer to Illustration 4-4). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 175}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 164 In summary, if a lessee includes operating lease liabilities in its asset group, it shou ld include only the principal \ncomponent of future cash lease payments in the undiscounted future cash flows. If it excludes operating \nlease liabilities from its asset group, it should exclude future cash lease payments (i.e., fixed, in -substance \nfixed and variable payments based on an index or rate) for the lease. \nASC 842 requires lessees to exclude certain variable lease payments from lease payments and, therefore, \nfrom the measurement of a lessee’s lease liabilities. Because these payments do not reduce a lessee’s lease \nliability, we believe the variable payments a lessee expects to make should be included in a lessee’s estimate \nof undiscounted cash flows in the recoverability test (Step 2) , regardless of whether the lessee in cludes or \nexcludes operating lease liabilities from the asset group. How these payments are included in the lessee’s \nestimate of future cash flows will depend on the cash flow estimation approach ( e.g., probability -weighted, \nbest estimate) it uses. We also believe these variable payments should be included when determining the \nfair value in Step 3 if the lessee uses a discounted cash flow approach. \nAs a reminder, a lessee uses its own assumptions to develop estimates of future cash flows in Step 2. This \ndiffers from the approach in Step 3 , where the lessee measures fair value of the asset group based on \nmarket participant assumptions. \nRefer to our FRD, Impairment or disposal of long -lived assets , for further discussion of evaluating assets for \nimpairment in accordance with ASC 360-10. \nIllustration 4 -4: Recoverability test for an asset group that is held and used \nOn 1 January 20X1, a retailer (Lessee) leases space from the owner of a shopping center (Lessor) for \n10 years. Under the terms of the agreement, Lessee agrees to pay fixed payments payable on \n31 December of each year starting at $10 ,000 and increasing 2 % each y ear. \nAssume t he lease is cl assified as an operating lease , and Lessee ’s incremental borrowing rate is 4%. \nLessee determines that the appropriate level at which to group assets to test for and measure \nimpairment of long -lived assets is at the store level. \nOn 1 January 20X4, Lessee identifies a change in circumstances that indicates the carrying amount of \nthe asset group may not be recoverable and performs a recoverability test. On this date, assume that \nthe carrying amount of the asset group, excluding the o perating lease liability, is $500,000 and the \ncarrying amount of the operating lease liability is $67,436 (calculation not shown). Also, assume that \nthe cash flow estimation period is seven years and that the undiscounted future expected cash flows \nper yea r, excluding lease payments, are $75,000 per year. \nScenario 1 \nLessee excludes the operating lease liability from the asset group when determining the carrying \namount of the asset group and, therefore, excludes the cash outflows for lease payments in \ndeterm ining the undiscounted future expected cash flows of the asset group. \nYear Undiscounted future \nexpected cash flows \n(before lease payments) Total \n1 $ 75,000 $ 75,000 \n2 $ 75,000 $ 75,000 \n3 $ 75,000 $ 75,000 \n4 $ 75,000 $ 75,000 \n5 $ 75,000 $ 75,000 \n6 $ 75,000 $ 75,000 \n7 $ 75,000 $ 75,000 \n $ 525,000 $ 525,000 \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 176}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 165 Carrying amount of asset group \n(excluding operating lease liability) $ 500,000 \nTotal undiscounted future expected cash flows $ 525,000 \nExcess $ 25,000 \nRecoverable? (Yes or No) Yes \n \nScenario 2 \nLessee includes the operating lease liability in the asset group when determining the carrying amount \nof the asset group and, therefore, includes the cash outflows for the principal portion of the lease \npayments in determining the undiscounted future expected cash flows of the asset group. \nYear Undiscounted future \nexpected cash flows \n(before lease payments) Lease payments Add back portion \nrelated to accreted \ninterest Total undiscounted \nfuture expected \ncash flows \n1 $ 75,000 (10,612) 2,697 $ 67,085 \n2 $ 75,000 (10,824) 2,381 $ 66,557 \n3 $ 75,000 (11,041) 2,043 $ 66,002 \n4 $ 75,000 (11,262) 1,683 $ 65,421 \n5 $ 75,000 (11,487) 1,300 $ 64,813 \n6 $ 75,000 (11,717) 893 $ 64,176 \n7 $ 75,000 (11,95 0) 460 $ 63,510 \n $ 525,000 (78,893) 11,457 $ 457,564 \n \nCarrying amount of asset group \n(excluding operating lease liability) $ 500,000 \nCarrying amount of operating lease liability (67,436) \nCarrying amount of asset group (including \noperating lease liability) $ 432,564 \n \nTotal undiscounted future expected cash flows $ 457,564 \nExcess $ 25,000 \nRecoverable? (Yes or No) Yes \nAs shown in Scenario 2, including the operating lease liability in the asset group results in the same \noutcome as the recoverability test in Scenario 1. This is because by excluding accreted interest from the \nundiscounted future cash flows both the carrying amount of the asset group and the undiscounted future \ncash flows are reduced by the existing discounted lease obligation ( i.e., $67,436). \n4.2.5.2 Measure an impairment (Step 3) \nIf the undiscounted cash flows used in the recoverability test are less than the carrying amount of the long -\nlived asset (as set group), an entity is required to determine the fair value of the long -lived asset (asset \ngroup) and recognize an impairment loss when the carrying amount of the long -lived asset (asset group) \nexceeds its fair value. \nWe believe that if a lessee excludes operating lease liabilities from the asset group when performing the \nrecoverability test, it also should exclude operating lease liabilities from the asset group when measuring \nthe group’s fair value. Alternatively, if a lessee includes operating lease li abilities in the asset group when \nperforming the recoverability test, it also should include operating lease liabilities in the asset group when \ndetermining the group’s fair value. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 177}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 166 Regardless of which approach a lessee chooses, we generally do not expect s ignificant differences in the \nmeasurement of an impairment loss because we would expect a lessee’s estimate of the fair value of the \nasset group to appropriately reflect whether the asset group includes or excludes operating lease liabilities. \nFor example, consistent with the guidance in ASC 360-10 for AROs, if a lessee excludes operating lease \nliabilities from the carrying amount of an asset group but the fair value of the asset group is based on a \nquoted market price that considers the lessee’s obligation to make lease payments, the quoted market price \nshould be increased by the fair value of the operating lease liabilities. Alternatively, if a lessee includes \noperating lease liabilities in the carrying amount of an asset group but the fair value of the as set group is \nbased on a quoted market price that does not consider the lessee’s obligation to make lease payments, the \nquoted market price should be decreased by the fair value of the operating lease liabilities. \nIf the fair value of the asset group is det ermined based on discounted cash flows, the market participant cash \nflows should be adjusted to align with an entity’s decision to include or exclude operating lease liabilities in \nthe carrying amount of the asset group. If the carrying amount of the asset group includes operating lease \nliabilities, the market participant discounted cash flows used to estimate fair value should include both principal \nand interest payments, unlike the cash flows used in the recoverability test , which, as discussed above , exclude \nthe component of the operating lease payments that effectively represents the accretion of the lease liability . \nWhile we may not expect including or excluding the lease liability to cause significant differences in the \nmeasurement of impairments, measurement differences could exist in some circumstances ( e.g., due to \ndecreases in the fair value of the lease liabilit y relative to its carrying amount) . \nAs a reminder, in accordance with ASC 360-10, an impairment loss for an asset group reduce s only the carrying \namounts of long -lived assets of the group (including lease -related right -of-use assets). The loss must be \nallocated to the long -lived assets of the group on a pro rata basis using the relative carrying amounts of those \nassets, except that the loss allocated to an individual long -lived asset of the group must not reduce the carrying \namount of that asset below its f air value whenever the fair value is determinable without undue cost and effort. \nASC 360-10 prohibits the subsequent reversal of an impairment loss for an asset held and used. \nIllustration 4 -5: Measurement of impairment for an asset group that is held and used \nOn 1 January 20X2, Lessee enters into a five -year lease of an asset. Lease payments are fixed at $10,000 \nper year due on 31 December of each year. The lease is classified as an operating lease, and Lessee’s \nincremental borrowing rate is 5%. Assum e that Lessee has no other assets or liabilities that should be \ngrouped with the operating lease right -of-use asset and liability for purpose of testing for impairment. \nOn 1 January 20X4, Lessee identifies a change in circumstances that indicates the carry ing amount of the \nright -of-use asset ($27,232) may not be recoverable and performs a recoverability test. Lessee determines \nthat the right -of-use asset is not recoverable ( i.e., the carrying amount of the right -of-use asset is greater \nthan the related enti ty-specific undiscounted cash flows) and, therefore, needs to determine whether the \ncarrying amount of the asset exceeds its fair value and, if so, measure and recognize an impairment loss. \nLessee determines that the fair value of the right -of-use asset is $20,000, based on its estimate of the \namount a market participant would be willing to pay up front in one payment for the right to use the asset \nfor three years in its highest and best use assuming no additional lease payments would be due. \nScenario 1 \nLessee’s approach for determining and measuring impairment in long -lived asset groups is to exclude \noperating lease liabilities from the asset group. \n Carrying amount Fair value Measurement impairment loss \nROU asset $ 27,232 $ 20,000 \nLease liability $ 0 $ 0 \n $ 27,232 $ 20,000 $ (7,232) \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 178}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 167 In Scenario 1, Lessee would recognize an impairment loss of $7,232, reducing the carrying amount of \nthe right -of-use asset by that amount. \nScenario 2 \nAssume the same facts as in Scenario 1 except that Lessee’s approach for determining and measuring \nimpairment in long -lived asset groups is to include operating lease liabilities in the asset group, which \nresults in the asset group having a carrying amount of zero. Lessee determines that the right -of-use asset \nis not recoverable because the entity -specific undiscounted cash flows are negative. Also, assume there \nhas not been a significant change in the lessee’s credit quality or interest rates since 1 Janua ry 20X2 such \nthat the fair value of the lease liability is determined to be the same as its carrying amount ( i.e., $27,232). \n Carrying amount Fair value Measured impairment loss \nROU asset $ 27,232 $ 20,000 \nLease liability $ (27,232) $ (27,232 ) \n $ 0 $ (7,232) $ (7,232) \nIn Scenario 2, Lessee would recognize an impairment loss of $7,232, reducing the carrying amount of \nthe right -of-use asset by that amount. \nScenario 3 \nAssume the same facts as Scenario 1 except that Lessee’s approach for determining and measuring \nimpairment in long -lived asset groups is to include operating lease liabilities in the asset group, which \nresults in the asset group having a carrying amount of zero. Lessee determines that the right -of-use \nasset is not recoverable because the entity -specific undiscounted cash flows are negative. However, \nfurther assume that Lessee determines that the fair value of the lease liability is $30,000 due to a \nsignific ant improvement in its credit quality since 1 January 20X2. \n Carrying amount Fair value Measured impairment loss \nROU asset $ 27,232 $ 20,000 \nLease liability $ (27,232) $ (30,000) \n $ 0 $ (10,000) $ (10,000) \nIn Scenario 3, Lessee would recognize an impairment loss of $7,232, reducing the carrying amount of \nthe right -of-use asset by that amount. Although the measured impairment loss for the asset group is \n$10,000, Lessee can reduce only the carrying amount of t he long -lived assets in the group ( i.e., the \nright -of-use asset) and cannot reduce the carrying amount of that asset below its fair value whenever the \nfair value is determinable without undue cost and effort. \nScenario 4 \nAssume the same facts as Scenario 1 except that Lessee’s approach for determining and measuring \nimpairment in long -lived asset groups is to include operating lease liabilities in the asset group, which \nresults in the asset group having a carrying amount of zero. Lessee determines that the ri ght-of-use \nasset is not recoverable because the entity -specific undiscounted cash flows are negative. However, \nfurther assume Lessee determines that the fair value of the lease liability is $15,000 due to a \nsignificant deterioration in its credit quality since 1 January 20X2. \n Carrying amount Fair value Measured impairment loss \nROU asset $ 27,232 $ 20,000 \nLease liability $ (27,232) $ (15,000) \n $ 0 $ 5,000 $ 0 \nIn Scenario 4, Lessee would not recognize an impairment loss even though the carrying amount of the \nright -of-use asset exceeds its fair value by $7,232. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 179}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 168 Fair value considerations \nASC 820 provides a principles -based framework for measuring fair value when US GAAP requires or \npermits a fair value measurement and requires disclosures about the use of fair value measurements. \nASC 820 defines f air value as “the price that would be received to sell an asset or paid to transfer a \nliability in an orderly transaction between market participants at the measurement date.” \nUnder ASC 820, a fair value measurement of a nonfinancial asset takes into account a market \nparticipant’s ability to generate economic benefits by using the asset in its highest and best u se or by \nselling it to another market participant that would use the asset in its highest and best use. Therefore, \nfair value is a market -based measurement and not an entity -specific measurement. It is determined \nbased on assumptions that market participants would use in pricing the asset or liability. The exit price \nobjec tive of a fair value measurement applies regardless of the reporting entity’s intent and/or ability to \nsell the asset or transfer the liability at the measurement date. \nWhen determining the fair value of a right -of-use asset, a lessee should consider what market participants \nwould pay to lease the asset (i.e., what a market participant would pay for the right -of-use asset) for its \nhighest and best use , even if that use differs from the current or intended use by the reporting entity. \nFor example, a lessee t hat currently leases space for use as a grocery store may conclude that the highest \nand best use of the space by market participants would be to use it as a fitness center. \nWhile the concept of highest and best use of an asset may consider its use in a dif ferent condition, the \nobjective of a fair value measurement is to determine the price of the asset in its current form. Therefore, \nif no market exists for an asset in its current form, but there is a market for the transformed asset, the \nreporting entity s hould back out the costs to transform the asset (as well as any associated profit margin) \nto determine the fair value of the asset in its current condition. That is, a fair value measurement should \nconsider the costs market participants would incur to reco ndition the asset (after acquiring the asset in \nits current condition) and the compensation they would expect for this effort. \nA contract restriction, which does not allow the lessee to sublease the asset, does not result in a fair value \nof zero. Instead, a lessee must consider how a market participant would value the right to use the asset with \na sublease restriction in a hypothetical sale. Refer to section 5.2.1 , Restrictions on assets (before the \nadoption of ASU 2022 -03) or section 5.2.1 A, Restrictions on assets (after the adoption of ASU 2022 -03), \nof our FRD, Fair value measurement , for further discussion on the effect on fair value of a restriction on \nthe use of an asset . \nRefer to our FRD, Impairment or disposal of long -lived assets , for further discussion of evaluating assets for \nimpairment in accordance with ASC 360-10 and our FRD, Fair value measurement , for further discussion on \nmeasuring fair value. \nRefer to section 6.3, Sublessor accounting , for discussion of evaluating right -of-use assets for impairment \nwhen a lessee enters into a sublease. \n4.2.5.3 Abandonment of ROU asset s \nA lessee that decides to cease using a n underlying asset , either immediately or at a future date ( e.g., in 12 \nmonths), needs to assess wh ether the corresponding ROU asset is or will be abandoned. A plan to \nabandon an ROU asset is considered an indicator of impairment under ASC 360-10 that results in the \nlessee evaluating the ROU asset (asset group) for recoverability and may also result in the lessee \nreassessing the lease term and classification under ASC 842. Evaluating a lessee’s intent and ability to \nsublease a n underlying asset is an important factor in determining whether the underlying asset has been \nor will be abandoned. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 180}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 169 If the lessee does not have a contractual right to sublease the underlying asset and the lessee’s cease \nuse of the asset is not temporary , the ROU asset is abandoned at the date the lessee ceases using the \nunderlying asset. \nA lessee that has a contractual right to sublease the asset will need to consider the facts and circumstances \nof the lease and its planned remaining use of the underlying asset. If the lessee may or will sublease the \nunderlying asset, it is not abandoning the ROU asset. As noted in ASC 842-10-15-17, economic benefits \nfrom using an asset include subleasing the asset. An entity that may or will sublease an asset (it will not \notherwise use) can obtain those economic benefits and, therefore , has not abandoned (or will not abandon) \nthe ROU asset. However, a decision to sublease the underlying asset still may be an indicator of impairment \nor indicate a change in the asset grouping. \nA lessee that has ceased use of the underlying asset and will no t sublease it or use i t for other purposes \n(e.g., storage) generally has abandoned the asset. However, if the lessee does not currently plan to \nsublease or otherwise use the asset but may subleas e it in the future ( e.g., a lessee may wait to make \nfinal dec isions until existing economic conditions change or use its right to not sublease as a negotiating \ntactic when attempting to terminate a lease early ), the ROU asset is not or will not be abandoned \nbecause the lessee has not yet decided that it will not sublease or otherwise use the underlying asset . \nThe following flowchart summarizes considerations for determin ing whether a n ROU asset is (or will be) \nabandoned: \n \nAccounting for an abandonment \nIf a lessee determines that it has abandon ed an ROU asset or will abandon it at a future date (e.g., in 12 \nmonths) , it reassess es its lease term if any of the following conditions in ASC 842-10-35-1 exist s: \n• There is a significant event or a significant change in circumstances that is within the control of the \nlessee that directly affects whether the lessee is reasonably certain to exercise or not to exercise an \noption to extend or terminate the lease or to pu rchase the underlying asset. \n• There is an event that is written into the contract that obliges the lessee to exercise (or not to \nexercise) an option to extend or terminate the lease. \n• The lessee elects to exercise an option even though the entity had previ ously determined that the \nlessee was not reasonably certain to do so. \n• The lessee elects not to exercise an option even though the entity had previously determined that \nthe lessee was reasonably certain to do so. \nIf the lease term changes, the lessee also reassesses the lease classification. The existence of an \nimpairment indicator alone does not result in reassessment of the lease term and classification. Refer to \nsection 2.3.6, Reassessment of the lease term and purchase options , for further guidance. \nHas the lessee ceased \nusing the asset \npermanently (or will it) ? \nYes \nThe ROU asset is not (or will not be) abandoned. \nNo \nDoes the lessee have a contractual right to \nsublease the asset ? \nThe ROU asset is (or will \nbe) abandoned . \nNo \nYes \nHas the lessee determined it will not \nsublease the asset ? \nYes \nNo ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 181}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 170 Under ASC 360-10, a long -lived asset to be disposed of in a manner other than a sale ( e.g., abandonment) \nis considered held and used until the long -lived asset ceases to be used. Because a decision to abandon a \nlong-lived asset before the end of the lease te rm is akin to a decision to dispose of a long -lived asset before \nthe initially intended date, a decision to abandon the asset is viewed as an indicator of impairment for a held \nand used long -lived asset. Therefore, if a lessee decides to abandon a n ROU asset, the lessee should test \nwhether the carrying amount of the ROU asset (asset group) is recoverable before abandoning it and, if it is \nnot recoverable, measure it for impairment consistent with the discussion in sections 4.2.5.1, Test for \nrecoverabili ty (Step 2) , and 4.2.5.2, Measure an impairment (Step 3) . \nPrior to assessing impairment, a lessee that abandons or decides to abandon at a future date (e.g., in \n12 months) an ROU asset that is part of a larger asset group should first reassess whether its grouping of \nlong-lived assets continues to be appropriate. For example, a functionally independent asset that is \nabandoned ( e.g., a building) may no longer be part of an existing asset group. Refer to section 2.3.1, \nGrouping long -lived assets to be held and used , and section 3.1, Long -lived assets to be abandoned , of \nour FRD, Impairment or disposal of long -lived assets , for further discussion of grouping of long -lived \nassets and abandonment of assets , respectively . \nRegardless of whether a n ROU asset is impaired, a lessee that commits to a plan to abandon an ROU asset \nin the future ( e.g., in 12 months) but before the end of the lease term should update its estimate of the \nuseful life of the ROU asset. This is consistent with the views expressed by the Securities and Exchange \nCommission ( SEC) staff at the 2020 AICPA Conference on Current SEC and PCAOB Developments.8 The SEC \nstaff discussed a consultation involving a registrant that identified leases for abandonment but expected there \nto be an extended period of time between the identification of the leases and the abandonment date. After \nidentifying the specific leases that would be abandoned, the registrant did not change the asset group for \nwhich it assessed impairment, and it did not recognize an impairment. In this case, the SEC staff did not object \nto the registrant’s conclusion to re -evaluate the economic life of the ROU assets subject to abandonment and \namortize those assets ratably over the period between its identification of leases for abandonment and the \nactual abandonment date. \nThe evaluation of whether a lessee has committed to a plan to abandon a n ROU asset in the future is based on \nthe facts and circumstances. If the lessee is ceasing to use an asset temporarily ( e.g., a lessee plans to vacate \na leased office building for one year as part of a restructuring but intends to reoccupy that facility), the \ntemporary abandonment would not result in a reassessment of the useful life of the related ROU asset. \nIf no impairment is recorded but the useful life is shortened, we believe a lessee would follow the guidance \nin section 4.2.5.4, Accounting for an operating lease after an impairment of a right -of-use asset (single \nlease cost ), to subsequently account for the ROU asset and lease liability and to determine its single lease \ncost after est imating the useful life of the right -of-use asset. If an impairment is recorded, the lessee measures \nthe ROU asset at its carrying amount immediately after the impairment and follows the guidance in section \n4.2.5.4, Accounting for an operating lease after an impairment of a right -of-use asset (single lease cost ), \nto subsequently account for the ROU asset and lease liability and to determine its single lease cost. \nAn ROU asset that has been abandoned should be reduced to its salvage value ( or zero, if there is no salvage \nvalue ) as of its cease -use date. The salvage value of an ROU asset will often be de minimis. \n \n8 Speech by Geoff Griffin, 7 December 2020. Refer to the SEC website at https://www.sec.gov/news/speech/griffin -remarks -\naicpa -2020 . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 182}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 171 The following flowchart summarizes the accounting considerations for a lessee that abandons a n ROU \nasset or decides to abandon it at a future date ( e.g., in 12 months) . The flowchart assumes that the lessee \nhas appropriately considered ASC 360-10 up to the date the decision is made to abandon the asset. \n \nYes \nNo \nNo \nYes \nNo \nYes \nNo \nYes \nFollow ASC 842-20-35-10 and ASC 842-20-25-7 \nto subsequently account for the ROU asset and \nlease liability and to determine its single lease \ncost using the updated useful life of the ROU \nasset . \nReduce the ROU asset to its salvage value (or \nzero, if there is no salvage value) . \nDo any of the conditions in ASC 842-10-35-1 exist ( e.g., is the lessee \nno longer reasonably certain to exercise a renewal option on the \nasset it has decided to abandon)? \nDoes the grouping of long -lived assets for purposes of assessing \nimpairment continue to be appropriate ( i.e., if the abandoned (or to be \nabandoned) ROU asset is part of a larger asset group)? \nReassess the lease term. \nIf the lease term changes, also reassess lease classification . \nIs the carrying amount of the ROU asset (asset group) recoverable? \nMeasure and reco gnize any impairment loss if the carrying amount of \nthe long -lived asset group exceeds its fair value . \nWill the lessee cease us ing the ROU asset immediately \n(i.e., not on a date in the future) ? \nDetermine new asset groups . \nUpdate estimate of the useful life of the ROU asset . \nThe ROU asset is abandoned , or a decision has been reached to abandon the ROU asset in the future. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 183}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 172 Accounting when there is no abandonment \nIf a lessee determines that it has not abandoned an ROU asset or will not abandon it at a future date, it \nshould reassess its lease term only if any of the conditions in ASC 842-10-35-1 exist s. \nLessee s that determi ne that an ROU asset is not abandoned ( e.g., because it may be subleased) should \nconsider whether the temporary cease use (or future plan to temporarily cease use) of the asset is an \nindicator of impairment in accordance with ASC 360-10. Lessee s that deter mine that an indicator of \nimpairment is present should perform the recoverability test for the asset (or asset group) and measure and \nrecord any impairment. In doing so, the lessee should first reassess whether its grouping of long -lived assets \ncontinues t o be appropriate. If an impairment is recorded, the lessee measures the ROU asset at its carrying \namount immediately after the impairment and follows the guidance in ASC 842-20-25-7 and ASC 842-20-\n35-10 to subsequently account for the ROU asset and lease l iability and to determine its single lease cost. \n4.2.5.4 Accounting for an operating lease after an impairment of a right -of-use asset \n(single lease cost) \nExcerpt from Accounting Standards Codification \nLeases — Lessee \nSubsequent Measurement \n842-20-35-10 \nIf a right -of-use asset is impaired in accordance with paragraph 842 -20-35-9, after the impairment, it shall \nbe measured at its carrying amount immediately after the impairment less any accumulated amortization. \nA lessee shall amortize, in acc ordance with paragraph 842 -20-25-7 (for an operating lease ) or paragraph \n842-20-35-7 (for a finance lease ), the right -of-use asset from the date of the impairment to the earlier \nof the end of the useful life of the right -of-use asset or the end of the lease term . \nRecognition \n842-20-25-7 \nAfter a right -of-use asset has been impaired in accordance with paragraph 842 -20-35-9, the single \nlease cost described in paragraph 842 -20-25-6(a) shall be calculated as the sum of the following: \na. Amortization of the rema ining balance of the right -of-use asset after the impairment on a straight -\nline basis, unless another systematic basis is more representative of the pattern in which the lessee \nexpects to c onsume the remaining economic benefits from its right to use the un derlying asset \nb. Accretion of the lease liability, determined for each remaining period during the lease term as the \namount that produces a constant periodic discount rate on the remaining balance of the liability. \nIf a lessee determines that an operating lease right -of-use asset is impaired, it recognizes an impairment \nloss and measures the ROU asset at its carrying amount immediately after the impairment. A lessee \nsubsequently amortizes the held -for-use ROU asset, generally on a straight -line basis, from the date of the \nimpairment to the earlier of the end of the useful life of the ROU asset or the end of t he lease term. Events or \nchanges in circumstances that indicate the carrying amount of an ROU asset may not be recoverable in \naccordance with ASC 360-10 that do not occur or arise as a result of an action that is within the control of \nthe lessee do not, in isolation, trigger a reassessment of the lease term or a lessee option to purchase the \nunderlying asset. Refer to section 2.3.6.1, Reassessment of the lease term and purchase options — lessees . \nIf the lease is remeasured after the impairment ( e.g., as a result of a modificatio n or a subsequent \nreassessment event ), we believe that a lessee would continue to amortize a held -for-use ROU asset, generally \non a straight -line basis , from the date of remeasurement to the earlier of the end of the useful life of the ROU \nasset or the end of the lease term. \nASC 842 includes the following example of the subsequent accounting for an operating lease following \nan impairment of the right -of-use asset. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 184}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 173 Excerpt from Accounti ng Standards Codification \nLeases — Lessee \nImplementation Guidance and Illustrations \nExample 5 — Impairment of a Right -of-Use Asset in an Operating Lease \n842-20-55-48 \nLessee enters into a 10 -year lease of a nonspecialized asset. Lease payments are $10,000 per year, \npayable in arrears. The lease does not transfer ownership of the underlying asset or grant Lessee an \noption to purchase the underlying asset. At lease commencement, the remain ing economic life of the \nunderlying asset is 50 years, and the fair value of the underlying asset is $600,000. Lessee does not \nincur any initial direct costs as a result of the lease. Lessee’s incremental borrowing rate is 7 percent, \nwhich reflects the fix ed rate at which Lessee could borrow the amount of the lease payments in the \nsame currency, for the same term, and with similar collateral as in the lease at commencement. The \nlease is classified as an operating lease. \n842-20-55-49 \nAt the commencement date , Lessee recognizes the lease liability of $70,236 (the present value of the \n10 lease payments of $10,000, discounted at the rate of 7 percent). Lessee also recognizes a right -of-\nuse asset of $70,236 (the initial measurement of the lease liability). Lessee determines the cost of the \nlease to be $100,000 (the total lease payments for the lease term). The annual lease expense to be \nrecognized is therefore $10,000 ($100,000 ÷ 10 years). \n842-20-55-50 \nAt the end of Year 3, when the carrying amount of the lease l iability and the right -of-use asset are both \n$53,893, Lessee determines that the right -of-use asset is impaired in accordance with Section 360 -10-\n35 and recognizes an impairment loss of $35,000. The right -of-use asset is part of an asset group that \nLessee tested for recoverability because of a significant adverse change in the business climate that \naffects Lessee’s ability to derive benefit from the assets within the asset group. The portion of the total \nimpairment loss for the asset group allocated to the right -of-use asset in accordance with paragraph \n360-10-35-28 is $35,000. After the impairment charge, the carrying amount of the right -of-use asset at \nthe end of Year 3 is $18,893 ($53,893 — $35,000). Because of the impairment, the total expense \nrecognized in Year 3 is $45,000 ($10,000 in lease expense + the $35,000 impairment charge). \nBeginning in Year 4, and for the remainder of the lease term, the single lease cost recognized by Lessee \nin accordance with paragraphs 842 -20-25-6(a) and 842 -20-25-7 will equ al the sum of the following: \na. Amortization of the right -of-use asset remaining after the impairment ($18,893 ÷ 7 years = \n$2,699 per year) \nb. Accretion of the lease liability. For example, in Year 4, the accretion is $3,773 ($53,893 × 7%) \nand, in Year 5, the accretion is $3,337 ($47,665 × 7%). \n842-20-55-51 \nConsequently, at the end of Year 4, the carrying amount of the lease liability is $47,665 (that is, \ncalculated as either the present value of the remaining lease payments, discounted at 7 percent, or the \nprevious balance of $53,893 — $10,000 Year 4 lease payment + the $3,773 accretion of the lease \nliability). The carrying amount of the right -of-use asset is $16,194 (the previous balance of $18,893 — \n$2,699 amortization). Lessee measures the lease liabi lity and the right -of-use asset in this manner \nthroughout the remainder of the lease term. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 185}), Document(page\_content='4 Lessee ac counting \nFinancial reporting developments Lease accounting | 174 4.3 Finance leases \n4.3.1 Initial measurement — finance leases \nThe initial measurement of the lease liabilities and right -of-use assets for finance leases is the same as \nfor operating leases. \n4.3.1.1 Initial measurement of lease liabilities — finance l eases \nAt the commencement date (refer to section 2.2, Commencement da te of the lease ), a lessee initially \nmeasures the lease liability at the present value of the lease payments to be made over the lease term. \nLessees apply the concepts previously described in section 1, Scope and scope exceptions , and section 2, \nKey concep ts, to identify the lease components and to determine the lease term, lease payments and \ndiscount rate as of the commencement date of the lease. \nThe diagram below illustrates the inputs need ed to initially calculate the lease liability: \n \n1 Lease incentive s that are payable to the lessee on the commencement date are deducted from lease payments (i.e., they reduce \nthe lease liability) . Refer to section 2.4.1.2, Lease incentives . \n4.3.1.2 Initial measurement of right -of-use assets — finance l eases \nA lessee initially measures the right -of-use asset at cost, which consists of all of the following: \n• The amount of the initial measurement of the lease liability \n• Any lease payments made to the lessor at or before the commencement date, less any lease \nincentives received (refer to section 2.4.1.2, Lease incentives ) \n• Any initial direct costs incurred by the lessee (refer to section 2.6, Initial direct costs ) \nThe diagr am below illustrates the inputs need ed to initially calculate the ROU asset: \n \nWhile ASC 842 does not specifically prohibit lessees from recognizing a n ROU asset that exceeds the fair \nvalue of the underlying asset, we believe that lessees should challenge the inputs and assumptions used \nto measure the ROU asset if the carrying amount of the ROU asset would exceed the fair value of the \nunderlying asset. Inputs and assumptions th at could be challenged include the identification of lease and \nnon-lease components, the allocation of consideration in the contract to those components and the \ndiscount rate used. Lease \nliabilityLease \nprepaymentsInitial direct \ncostsLease \nincentives \nreceivedROU assetPresent value using \nthe discount rate \ndetermined on the \ncommencement \ndateLease \npayments to \nbe made over \nthe lease \nterm1Lease liability', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 186}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 175 4.3.2 Subsequent measurement — finance leases \nExcerpt from Accounting Stan dards Codification \nLeases — Lessee \nSubsequent Measurement \n842-20-35-1 \nAfter the commencement date , for a finance lease , a lessee shall measure both of the following: \na. The lease liability by increasing the carrying amount to reflect interest on the lease liability and \nreducing the carrying amount to reflect the lease payments made during the period. The lessee \nshall determine the interest on the lease liability in each period during the lease term as the amount \nthat produces a constant periodic discount rate on the remaining balance of the liability, taking into \nconsideration the reassessment requirements in paragraphs 842 -10-35-1 through 35 -5. \nb. The right -of-use asset at cost less any ac cumulated amortization and any accumulated impairment \nlosses, taking into consideration the reassessment requirements in paragraphs 842 -10-35-1 \nthrough 35 -5. \n842-20-35-2 \nA lessee shall recognize amortization of the right -of-use asset and interest on the le ase liability for a \nfinance lease in accordance with paragraph 842 -20-25-5. \n842-20-35-7 \nA lessee shall amortize the right -of-use asset on a straight -line basis, unless another systematic basis \nis more representative of the pattern in which the lessee expects to consume the right -of-use asset’s \nfuture economic benefits. When the lease liability is remeasured and the right -of-use asset is adjusted in \naccordance with paragraph 842 -20-35-4, amortization of the right -of-use asset shall be adjusted \nprospectively from the date of remeasurement. \n842-20-35-8 \nA lessee shall amortize the right -of-use asset from the commencement date to the earlier of the end \nof the useful life of the right -of-use asset or the end of the lease term . However, if the lease transfers \nownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise an \noption to purchase the underlying asset, the lessee shall amortize the right -of-use asset to the end of \nthe useful life of the underlying asset. \nRecognition \n842-20-25-5 \nAfter the commencement date , a lessee shall recognize in profit or loss, unless the costs are included \nin the carrying amount of another asset in accordance with other Topics: \na. Amortization of the right -of-use asset and interest on the lease liability \nb. Variable lease payments not includ ed in the lease liability in the period in which the obligation for \nthose payments is incurred (see paragraphs 842 -20-55-1 through 55 -2) \nc. Any impairment of the right -of-use asset determined in accordance with paragraph 842 -20-35-9. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 187}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 176 Implementation Guidan ce and Illustrations \n842-20-55-1 \nA lessee should recognize costs from variable lease payments (in annual periods as well as in interim \nperiods) before the achievement of the specified target that triggers the variable lease payments, \nprovided the achieveme nt of that target is considered probable . \n842-20-55-2 \nVariable lease costs recognized in accordance with paragraph 842 -20-55-1 should be reversed at such \ntime that it is probable that the specified target will not be met. \n4.3.2.1 Subsequent measurement of lease liabilities — finance l eases \nThe FASB indicated in the Basis for Conclusions (BC 223) of ASU 2016 -02 that a lease liability for \nfinance leases should be accounted for in a manner similar to other financial liabilities ( i.e., on an \namor tized cost basis). Consequently, the lease liability for finance leases is accreted using an amount that \nproduces a constant periodic discount rate on the remaining balance of the liability ( i.e., the discount rate \ndetermined at commencement, as long as a reassessment requiring a change in the discount rate has not \nbeen triggered) (refer to section 2.5.3, Reassessment of the discount rate ). Lease payments reduce the \nlease liability as they are paid. \nPeriodic lease payments on finance leases are allocated between a reduction of the lease liability and \ninterest expense to produce a constant periodic interest rate on the remaining balance of the lease \nliability. This will result in a remaining balance of the lease liability at the end of the lease term equal to \nthe amount of any of the following that were included in lease payments used to measure the lease \nliability (refer to section 2.4, Lease payments ): \n• The exercise price of a purchase option (refer to section 2.4.3, The exercise price of a purchase option ) \n• Amounts that it is probable a lessee will owe under a residual value guarantee (refer to section 2.4.6, \nAmount it is probable that a lessee will owe under residual value guarantees — lessees only ) \n• A termination penalty (refer to section 2.4.4, Payments for penalties for terminating a lease ) \nWhile ASC 842 describes the subsequent measurement of a finance lease liability differently from that of \nan operating lease liability, from a practical perspective , we expect the lease liability balance to be the \nsame. The difference in the expense recognition pattern of an operating lease ( i.e., generally straight -line \nexpense) and a finance lease ( i.e., generally front -loaded expense) is driven by the subsequent \naccounting for the right -of-use asset. \n4.3.2.2 Subsequent measurement of right -of-use assets — finance l eases \nAmortization of the right -of-use asset is recognized in a manner consistent with existing guidance for \nnonfinancial assets that are measured at co st. Lessees amortize the right -of-use asset on a straight -line \nbasis, unless another systematic basis better represents the pattern in which the lessee expects to \nconsume the right -of-use asset’s future economic benefits. The right -of-use asset is amortize d from the \nlease commencement date to the earlier of the end of the useful life of the right -of-use asset or the end \nof the lease term. However, the amortization period is the remaining useful life of the underlying asset if \nthe lessee is reasonably certai n to exercise an option to purchase the underlying asset or if the lease \ntransfers ownership of the underlying asset to the lessee by the end of the lease term. \nRefer to section 4.3.5, Example — lessee accounting for a finance lease , for a comprehensive ex ample. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 188}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 177 4.3.3 Expense recognition — finance l eases \nWhen subsequently accounting for a finance lease, l essees recognize the following: \n \nTo clarify, a lessee’s lease cost includes both amounts recognized in profit or loss during the period and \nany amounts capitalized as part of the cost of another asset in accordance with other applicable \nguidance , such as ASC 330. \nAmortization of the right -of-use asset and interest on the lease liability \nAfter the commencement date, a lessee recognizes amortization of the right -of-use asset and separately \nrecognizes interest on the lease liability for a finance lease. The recognition of interest and amortization \nfor finance leases is consistent with a view that such leases are effectively installment purchases. That is, \nthe lessee is paying to finance the acquisition of the underlying asset that will be consumed during the \nlease term. \nThe total periodic cost (i.e., the sum of interest and amortization) of a finance lease is typically higher in \nthe early periods and l ower in the later periods. Because a constant interest rate is applied to the lease \nliability, interest decreases as cash payments are made during the lease term and the lease liability \ndecreases. Therefore, more interest is incurred in the early periods a nd less in the later periods. This \ntrend in interest, combined with the straight -line amortization of the right -of-use asset, results in a front -\nloaded cost recognition pattern. This cost pattern is consistent with the subsequent measurement of \ncapital lea ses under ASC 840. \nVariable lease payments \nAfter the commencement date, lessees also recognize as part of lease -related cost any variable lease \npayments not included in the finance lease liability in the period in which the achievement of the specified \ntarget that triggers the variable lease payments becomes probable. Any previously recognized variable \nlease costs are reversed if it becomes probable that the specified target will no longer be met. We believe \nvariable lease costs are most appropriately prese nted as interest expense (when not otherwise \ncapitalized in the cost of another asset, such as inventory under ASC 330). Refer to section 2. 4.10 , \nAmounts not included in lease payments , for a discussion of variable lease payments that do not depend \non an index or rate. \nImpairment of the right -of-use asset \nIf a lessee determines that a finance lease right -of-use asset is impaired, it recognizes an impairment loss \nand measures the right -of-use asset at its carrying amount immediately after the impairment. A lessee \nsubsequently amortizes, generally on a straight -line basis, the right -of-use asset from the date of the \n', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 189}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 178 impairment to the earlier of the end of the useful life of the right -of-use asset or the end of the lease \nterm. However, the amortization period is the remaining useful life of the underlying asset if the lessee is \nreasonably certain to exercise an option to purchase the underlying asset or if the lease transfers ownership \nof the underlying asset to the lessee by the end of the lease term. Refer to section 4. 3.4, Impairment of \nright -of-use assets in finance leases , for additional discussion of impairment of right -of-use assets . \n4.3.4 Impairment of right -of-use assets in finance leases (updated August 2023) \nA lessee ’s right -of-use asset in an operati ng or finance lease is subject to the impairment guidance in \nASC 360-10 (for guidance on impairment of right -of-use assets in operating leases refer to section 4.2.5 , \nImpairment of right -of-use assets in operating leases ). Lessees must also apply the guidance in ASC 360-10 \nwhen there are significant changes to the current or expected use of a right -of-use asset because it could \naffect the asset groupings used to evaluate the right -of-use asset for impairment and the estim ated useful \nlife of both a n right -of-use asset and any leasehold improvements associated with the underlying asset . \nFurther, lessees that separately account for non -lease components ( i.e., entities that have not made the \npolicy election under ASC 842 to c ombine lease and associated non -lease components) must consider \nthe guidance in ASC 420 to determine whether any exit or disposal costs associated with non -lease \ncomponents should be accrued (e.g., when a lessee has concluded that it has permanently ceased using \nan asset, whether for its own use or through subleasing, and costs allocated to the non -lease component \nthat will continue to be incurred for its remaining term will not provide economic benefit to the entity) . \nThe following flowchart illustrates t he interaction of the guidance in ASC 842, ASC 360-10 and ASC 420: \n \n\* Generally, applies only to lessees that do not make the policy election to combine the lease and associated non -lease components \nof a contract. \nThe FASB indicated in the Basis for Conclusions (BC 255) of ASU 2016 -02 that the impairment model in \nASC 360-10 is appropriate to apply to a lessee’s right -of-use assets because the se assets are long-lived \nnonfinancial asset s and should be accoun ted for the same way as an entity’s other long -lived nonfinancial \nassets. This treatment is intended to give users of the financial statements comparable information \nabout all of an entity’s long -lived nonfinancial assets. \nASC 360-10 \nStep 1 \nConsider whether impairment \nindicators are present \n(e.g., a decision to abandon \nan ROU asset). \nStep 2 \nCompare the sum of the estimated \nundiscounted future cash flows to \nthe carrying amount of the long -\nlived asset (asset group). \nStep 3 \nMeasure and record any \nimpairment loss if the carrying \namount of the long -lived asset \ngroup exceeds its fair value. \nASC 420 \nDetermine whether any \nexit or disposal costs \nshould be accrued. \nContract within the scope of ASC 842 \nLease component \n(i.e., ROU asset) \nNon-lease component\* ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 190}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 179 The guidance in ASC 360-10 requir es three steps to identify, recognize and measure the impairment of a \nlong-lived asset ( asset group) to be held and used: \n• Indicators of impairment (Step 1) — Consider whether impairment indicators are present \n(i.e., whether there are any events or changes in circumstances that indicate that the carrying \namount of the long -lived asset (asset group) might not be recoverable) . \n• Test for recoverability (Step 2) — If indicators of impairment are present, perform a recoverability \ntest by comparing the sum of the e stimated undiscounted future cash flows attributable to the long-\nlived asset ( asset group) in q uestion to its carrying amount ( as a reminder , entities cannot record an \nimpairment for a held and used asset unless the asset first fails this recoverability test) . \n• Measure an impairment (Step 3) — If the undiscounted cash flows used in the test for recoverability \nare less than the carrying amount of the long -lived asset (asset group) , determine the fair value of \nthe long -lived asset ( asset grou p) and recognize an impairment loss if the carrying amount of the \nlong-lived asset ( asset group) exceeds it s fair value. \nGrouping long -lived assets \nASC 360-10 defines an asset group as “the unit of accounting for a long -lived asset or assets to be held \nand used, which represents the lowest level for which identifiable cash flows are largely independent of \nthe cash flows of other groups of assets and liabilities. ” Assets generally should be grouped when they \nare used together ( i.e., when they are part of th e same group of assets and are used together to \ngenerate joint cash flows). \nGrouping long-lived assets requires judgment and will require consideration of the facts and \ncircumstances as well as an understanding of the entity’s business. We believe the impairment \nassessment for ROU assets often will be performed at an asset -group level with any impairment allocated \namong the long -lived assets of the group in accordance with ASC 360-10. \nEach time a lessee performs a recoverability test, i t should reassess whether its grouping of long -lived \nassets continues to be appropriate. Significant c hanges to the current or expected use of the individual \nassets of the group might indicate that the related asset grouping may have changed. This might be the \ncase even when the ROU asset is not the primary asset in the asset group . \nWhen evaluating whether the inclusion of an ROU asset in an asset group continues to be appropriate, a \nlessee needs to determine whether there has been a fundamental change in the use of the leased asset. \nFor example, a functionally independent asset that is abandoned (e.g., a building) may no longer be part \nof an existing asset group. Refer to section 4.2.5.3, Abandonment of ROU assets , for discussion on when \nan ROU asset is ab andoned. However, it may be challenging to determine whether an ROU asset that is \nnot (or will not be) abandoned has changed asset groups or is a separate asset group. Examples of \nsituations that could indicate the asset group has changed for an ROU asset that is not (or will not be) \nabandoned include: \n• The lessee has ceased using the leased asset and does not plan to reoccupy or use the leased asset in \nthe future. \n• The lessee has incurred significant costs (e.g., readying the space for sublease by removing signage) \nto cease using the leased asset in the near future. \n• The lessee has executed a sublease for the leased asset for substantially all of the remaining lease term. \n• The lessee is actively marketing the leased asset for sublease (e.g., hired a broker). \n• The lessee has changed how the leased asset is used in its operations, including moving the leased \nasset to a different line of business in a different asset group. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 191}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 180 These situations are not all inclusive, and no one situation is determinative. A lessee wi ll need to evaluate \nits facts and circumstances to determine whether there is a change in how it uses the leased asset and \nwhether the asset group has changed. A plan to change how the leased asset will be used by the business \nor to sublease the leased ass et, by itself, generally does not indicate that the ROU asset’s group has \nchanged, since the lowest level of identifiable cash flows has not yet changed. For example, a lessee may \ndecide that in one year it will sublease a leased asset that is part of an e nterprise -wide asset group but it \nwill continue to use the leased asset until then . The ROU asset would still be part of the enterprise -wide \nasset group because the lessee continues to use the leased asset. \nRefer to section 6.3, Sublessor accounting , for discussion on evaluating the grouping of long -lived assets \nwhen a lessee has executed a sublease for a leased asset in the asset group. \n4.3.4.1 Test for recoverability (Step 2) \nASC 360-10 provides principles for evaluating long -lived assets for impairment, but it does not specifically \naddress how lease liabilities should be considered in the recoverability test. Under ASC 360-10, financial \nliabilities ( e.g., long-term debt) generally are e xcluded from an asset group and operating liabilities \n(e.g., accounts payable) generally are included. Financial liabilities generally are excluded because when the \nFASB was deliberating Statement 144 (later codified in ASC 360-10), it indicated that how a n entity \ncapitalizes or finances its operations should not influence the recognition of an impairment loss (see B34 of \nStatement 144). ASC 360-10 requires an entity to exclude asset retirement obligation (ARO) liabilities \nfrom an asset group and to exclude estimated future cash outflows associated with ARO liabilities from \nboth the recoverability test (Step 2) and measurement of an impairment (Step 3). \nIn the Basis for Conclusions (BC 264) of ASU 2016 -02, the FASB noted that while both operating and \nfinance lease liabilities are financial liabilities, finance lease liabilities are the equivalent of debt, and \noperating lease liabilities are operating in nature and no t “debt like.” Therefore, we generally believe it \nwould be most appropriate to exclude finance lease liabilities from an asset group when testing whether the \nasset group is recoverable and determining the fair value of the asset group. \nA lessee should apply its approach ( i.e., include or exclude finance lease liabilities) consistently for al l finance \nleases and when performing Steps 2 and 3 of the impairment model in ASC 360-10 (refer to section \n4.3.4.2 , Measur e an impairment (Step 3) , for guidance on measur ing an impairment loss). \nIn some cases, including finance lease liabilities in an asset group may result in the long -lived asset (asset \ngroup) having a zero or negative carrying amount. For example, this may occur with the passage of time or \nif a lessee receives lease incentives or has back -loaded lease payments , all of which would result in \nreductions to the lessee’s right -of-use assets. In these cases, a lessee is still required to test whether the \ncarrying amount of the asset group is recoverable and, if not recoverable, measure the asset group for \nimpairment. \nDetermining which future cash outflows for lease payments should be included in the Step 2 \nrecoverability test \nA lessee that excludes finance lease liabilities from its asset group should exclude future cash lease \npayments (i.e., fixed, in -substance fixed and variable payments based on an index or rate) in the \nundiscounted future cash flows. If a lessee includes finance lease liabilities in its asset group, only the \nprincipal component of future lease payments would be included as an outflow in the undisco unted future \ncash flows used to test recoverability of the asset group. That is, the lessee would include the future cash lease \npayments for the lease, excluding the component that represents the accretion of the lease liability. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 192}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 181 ASC 842 requires lessees t o exclude certain variable lease payments from lease payments and, therefore, \nfrom the measurement of a lessee’s lease liabilities. Because these payments do not reduce a lessee’s lease \nliability, we believe the variable payments a lessee expects to make s hould be included in a lessee’s \nestimate of undiscounted cash flows in the recoverability test (Step 2) , regardless of whether the lessee \nincludes or excludes finance lease liabilities from the asset group. How these payments are included in the \nlessee’s e stimate of future cash flows will depend on the cash flow estimation approach ( e.g., probability -\nweighted, best estimate) it uses. We also believe these variable payments should be included when \ndetermining the fair value in Step 3 if the lessee uses a dis counted cash flow approach . \nAs a reminder, a lessee uses its own assumptions to develop estimates of future cash flows in Step 2. This \ndiffers from the approach in Step 3, where the lessee measures fair value of the asset group based on \nmarket participant assumptions. \nRefer to our FR D, Impairment or disposal of long -lived assets , for further discussion of evaluating assets for \nimpairment in accordance with ASC 360-10. \n4.3.4.2 Measur e an impairment (Step 3) \nIf the undiscounted cash fl ows used in the recoverability t est are less than the carrying amount of the \nlong-lived asset (asset group), an entity is required to determine the fair value of the long -lived asset \n(asset group) and recognize an impairment loss when the carrying amount of the long -lived asset (asset \ngroup) exceeds it s fair value . \nWe believe that if a lessee excludes finance lease liabilities from the asset group when performing the \nrecoverabili ty test, it also should exclude finance lease liabilities from the asset group when measuring \nthe group’s fair value. Alternatively, if a lessee includes finance lease liabilities in the asset group when \nperforming the recoverability test, it also should i nclude finance lease liabilities in the asset group when \ndetermining the group’s fair value. \nRegardless of which approach a lessee chooses, we generally do not expect significant differences in the \nmeasurement of an impairment loss because we would expect a lessee’s estimate of the fair value of the \nasset group to appropriately reflect whether the asset group includes or excludes finance lease liabilities. \nFor example, consistent with the guidance in ASC 360-10 for AROs, if a lessee excludes finance lease \nliabilities from the carrying amount of an asset group but the fair value of the asset group i s based on a \nquoted market price that considers the lessee’s obligation to make lease payments, the quoted market \nprice should be increased by the fair value of the finance lease liabilities. Alternatively, if a lessee \nincludes finance lease liabilities in the carrying amount of an asset group but the fair value of the asset \ngroup is based on a quoted market price that does not consider the lessee’s obligation to make lease \npayments, the quoted market price should be decreased by the fair value of the finan ce lease liabilities. \nIf the fair value of the asset group is determined based on discounted cash flows, the market participant \ncash flows should be adjusted to align with an entity’s decision to include or exclude finance lease \nliabilities in the carrying amount of the asset group. If the carrying amount of the asset group includes \nfinance lease liabilities, the market participant discounted cash flows used to estimate fair value should \ninclude both principal and interest payments, unlike the cash flows us ed in the recoverability test, which, \nas discussed above, exclude the component of the finance lease payments that represent s the accretion \nof the lease liability. \nWhile we may not expect including or excluding the lease liability to cause significant diff erences in the \nmeasurement of impairments, measurement differences could exist in some circumstances ( e.g., due to \ndecreases in the fair value of the lease liability relative to its carrying amount). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 193}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 182 As a reminder, in accordance with ASC 360-10, an impairm ent loss for an asset group reduce s only the \ncarrying amounts of long -lived assets of the group (including lease -related right -of-use assets). The loss \nmust be allocated to the long -lived assets of the group on a pro rata basis using the relative carrying \namounts of those assets, except that the loss allocated to an individual long -lived asset of the group must \nnot reduce the carrying amount of that asset below its fair value whenever the fair value is determinable \nwithout undue cost and effort. ASC 360-10 prohibits the subsequent reversal of an impairment loss for \nan asset held and used. \nRefer to section 4.2.5.2, Measur e an impairment (Step 3) , for fair value considerations that apply to \nright -of-use assets in both operating and finance leases. \n4.3.4.3 Abandonment of ROU asset s \nA lessee that decides to cease using a n underlying asset , either immediately or at a future date ( e.g., in 12 \nmonths) , needs to assess whether the corresponding ROU asset is or will be abandoned. A plan to \nabandon an ROU asset is considered an indicator of impairment under ASC 360-10 that results in the \nlessee evaluating the ROU asset (asset group) for recoverability and may also result in the lessee \nreassessing the lease term and classification under ASC 842. Evaluating a lessee’s intent and ability to \nsublease a n underlying asset is an important factor in determining whether the underlying asset has been \nor will be abandoned. \nIf the lessee does not have a contractual right to sublease the underlying asset and the lessee’s cease use \nof the asset is not temporary , the ROU asset is a bandoned at the date the lessee ceases using the \nunderlying asset. \nA lessee that has a contractual right to sublease the asset will need to consider the facts and \ncircumstances of the lease and its planned remaining use of the underlying asset. If the less ee may or will \nsublease the underlying asset, it is not abandoning the ROU asset. As noted in ASC 842-10-15-17, \neconomic benefits from using an asset include subleasing the asset. An entity that may or will sublease an \nasset (it will not otherwise use) can obtain those economic benefits and, therefore , has not abandoned \n(or will not abandon) the ROU asset. However, a decision to sublease the underlying asset still may be an \nindicator of impairment or indicate a change in the asset grouping. \nA lessee that has ceased use of the underlying asset and will not sublease it or use it for other purposes \n(e.g., storage) generally has abandoned the asset . However, if the lessee does not currently plan to \nsublease or otherwise use the asset but may subleas e it in the future ( e.g., a lessee may wait to make \nfinal decisions until existing economic conditions change or use its right to not sublease as a negotia ting \ntactic when attempting to terminate a lease early ), the ROU asset is not or will not be abandoned \nbecause the lessee has not yet decided that it will not sublease or otherwise use the underlying asset . \nThe following flowchart summarizes considerations for determining whether a n ROU asset is (or wil l be) \nabandoned: \n \nHas the lessee ceased \nusing the asset \npermanently (or will it) ? \nYes \nThe ROU asset is not (or will not be) abandoned . \nNo \nDoes the lessee have a contractual right \nto sublease the asset ? \nThe ROU asset is (or will \nbe) abandoned . \nNo \nYes \nHas the lessee determined it will not \nsublease the asset ? \nYes \nNo ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 194}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 183 Accounting for an abandonment \nIf a lessee determines that it has abandon ed an ROU asset or will abandon it at a future date, it \nreassesses its lease term if any of the following conditions in ASC 842-10-35-1 exist s: \n• There is a significant event or a significant change in circumstances that is within the control of the \nlessee that directly affects whether the lessee is reasonably certain to exercise or not to exercise an \noption to extend or terminate the lease or to pu rchase the underlying asset. \n• There is an event that is written into the contract that obliges the lessee to exercise (or not to \nexercise) an option to extend or terminate the lease. \n• The lessee elects to exercise an option even though the entity had previ ously determined that the \nlessee was not reasonably certain to do so. \n• The lessee elects not to exercise an option even though the entity had previously determined that \nthe lessee was reasonably certain to do so. \nIf the lease term changes, the lessee also reassesses the lease classification. The existence of an \nimpairment indicator alone does not result in reassessment of the lease term and classification. Refer to \nsection 2.3.6, Reassessment of the lease term and purchase options , for further guidance. \nUnder ASC 360-10, a long -lived asset to be disposed of in a manner other than a sale ( e.g., abandonment) \nis considered held and used until the long -lived asset ceases to be used. Because a decision to abandon a \nlong-lived asset before the end of the lease term is akin to a decision to dispose of a long -lived asset before the \ninitially intended date, a decision to abandon the asset is viewed as an indicator of impairment for a held and \nused long -lived asset. Therefore, if a lessee decides to abandon a n ROU asset, the lessee should test \nwhether the carrying amount of the ROU asset (asset group) is recoverable before abandoning it and, if it is \nnot recoverable, measure it for impairment consistent with the discussion in sections 4.3.4.1, Test for \nrecoverability (Step 2) , and 4.3.4.2, Measure an impairment (Step 3) . \nPrior to assessing impairment, a lessee that abandons or decides to abandon at a future date (e.g., in \n12 months) an ROU asset that is part of a larger asset group should first reassess whether its grouping of \nlong-lived assets continues to be appropriate. For example, a functionally independent asset that is \nabandoned ( e.g., a building) may no longer be part of an existing asset group. Refer to section 2.3.1, \nGrouping long -lived assets t o be held and used , and section 3.1, Long -lived assets to be abandoned , of \nour FRD, Impairment or disposal of long -lived asse ts, for further discussion of grouping of long-lived \nassets and abandonment of assets , respectively . \nRegardless of whether an ROU asset is impa ired, a lessee that commits to a plan to abandon a n ROU \nasset in the future ( e.g., in 12 months) but before the end of the lease term should update its estimate of \nthe useful life of the ROU asset. This is consistent with the views expressed by the SEC staff at the 2020 \nAICPA Conference on Current SEC and PCAOB Developments. Refer to section 4.2.5.3, Abandonmen t of \nROU assets , for a summary of the SEC staff’s views. \nThe evaluation of whether a lessee has c ommitted to a plan to abandon a n ROU asset in the future is based \non the facts and circumstances . If the lessee is ceasing to use an asset temporar ily (e.g., a lessee plans to \nvacate a leased office building for one year as part of a restructuring but intends to reoccupy that facility) , \nthe temporary abandonment would not result in a reassessment of the useful life of the related ROU asset . \nIf no impairme nt is recorded but the useful life is shortened, we believe a lessee would follow the guidance \nin section 4.3.4.4, Accounting for a finance lease after an impairment of an ROU asset , to subsequently \naccount for the ROU asset after updating its estimate of the useful life of the ROU asset. If an impairment is \nrecorded, the lessee measures the ROU asset at its carrying amount immediately after the impairment and \nfollows the guidance in section 4.3.4.4, Accounting for a fi nance lease after an impairment of an ROU asset , \nto subsequently account for the ROU asset. Absent a modification, there is no change in how the lessee \naccounts for the lease liability throughout the remaining lease term. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 195}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 184 An ROU asset that has been abandon ed should be reduced to its salvage value ( or zero, if there is no salvage \nvalue ) as of its cease -use date. The salvage value of an ROU asset will often be de minimis. \nThe following flowchart summarizes the accounting considerations for a lessee that aband ons a n ROU \nasset or decides to abandon it at a future date ( e.g., in 12 months) . The flowchart assumes that the lessee \nhas appropriately considered ASC 360-10 up to the date the decision is made to abandon the asset . \n \nThe ROU asset is abandoned , or a decision has been reached to abandon the ROU asset in the future. \nYes \nYes \nNo \nNo \nDo any of the conditions in ASC 842-10-35-1 exist ( e.g., is the lessee no \nlonger reasonably certain to exercise a renewal option on the asset it has \ndecided to abandon)? \nDoes the grouping of long -lived assets for purposes of assessing impairment \ncontinue to be appropriate ( i.e., if the abandoned (or to be abandoned) ROU \nasset is part of a larger asset group)? \nDetermine new asset groups . \nIs the carrying amount of the ROU asset (asset group) recoverable? \nNo \nMeasure and reco gnize any impairment loss if the carrying amount of \nthe long -lived asset group exceeds its fair value . \nReassess the lease term. \nIf the lease term changes, also reassess lease classification . \nYes \nReduce the ROU asset to its salvage value (or \nzero, if there is no salvage value) . \nNo \nWill the lessee cease us ing the ROU asset immediately \n(i.e., not on a date in the future) ? \nYes \nUpdate estimate of the useful life of the ROU asset . \nFollow ASC 842-20-35-10 and ASC 842-20-35-7 \nto subsequently account for the ROU asset and \nlease liability . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 196}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 185 Accounting when there is no abandonment \nIf a lessee determines that it has not abandoned an ROU asset or will not abandon it at a future date, it \nshould reassess its lease term only if any of the conditions in ASC 842-10-35-1 exist. \nLessees that determine that an ROU asset is not abandoned ( e.g., because it may be subleased) should \nconsider whether the temporary cease use (or future plan to temporarily cease use) of the asset is an \nindicator of impairment in accordance with ASC 360-10. Lessees that determine that an indicator of \nimpairment is pr esent should perform the recoverability test for the asset (or asset group) and measure \nand record any impairment. In doing so, the lessee should first reassess whether its grouping of long -\nlived assets continues to be appropriate. If an impairment is reco rded, the lessee measures the ROU \nasset at its carrying amount immediately after the impairment and follows the guidance in ASC 842-20-\n35-7 and ASC 842-20-35-10 to subsequently account for the ROU asset and lease liability . \n4.3.4.4 Accounting for a finance lease after an impairment of an ROU asset \nExcerpt from Accounting Standards Codification \nLeases — Lessee \nSubsequent Measurement \n842-20-35-10 \nIf a right -of-use asset is impaired in accordance with paragraph 842 -20-35-9, after the impairment, it shall \nbe measured at its carrying amount immediately after the impairment less any accumulated amortization. \nA lessee shall amortize, in accordance with paragraph 842 -20-25-7 (for an operating lease ) or paragraph \n842-20-35-7 (for a finance lease ), the right -of-use asset from the date of the impairment to the earlier \nof the end of the useful life of the right -of-use asset or the end of the lease term . \nIf a lessee determines that a finance lease right -of-use asset is impaired, it recognizes an impairment loss \nand measures the right -of-use asset at its carrying amount immediately after the impairment. A lessee \nsubsequently amortizes, generally on a straight -line basis, the right -of-use asset from the date of the \nimpairment to the earlier of the end of the useful life of the right -of-use asset or the end of the lease term. \nHowever, the amortization period is the remaining useful life of the underlying asset if the lessee is \nreasonably certain to exercise an option to purchase the underlying asset or if the lease transfers ownership \nof the underlying asset to the lessee by the end of the lease term. Refer to section 4.2.5, Impairment of \nright -of-use assets in ope rating leases , for additional discussion of impairment of right -of-use assets. Events \nor changes in circumstances that indicate the carrying amount of an ROU asset may not be recoverable in \naccordance with ASC 360-10 that do not occur or arise as a result of an action that is within the control of \nthe lessee do not, in isolation, trigger a reassessment of the lease term or a lessee option to purchase the \nunderlying asset. Refer to section 2.3.6.1, Reassessment of the lease term and purchase options — lessees . \n4.3.5 Example — lessee accounting for a finance lease \nIllustration 4 -6: Lessee accounting for a finance lease \nEntity H (lessee) makes a payment of $5,000 to an existing tenant to obtain a lease and enters into a three -\nyear lease of the same equipment that it concludes is a finance lease because the lease term is for a major \npart of the remaining economic life of t he underlying asset (also three years). The lease commences at the \nbeginning of Year 1 . Entity H agrees to make the following annual payments at the end of each year: \n$10,000 in Year 1, $12,000 in Year 2 and $14,000 in Year 3. Entity H concludes that the $ 5,000 payment \nto the former tenant qualifies as an IDC. For simplicity, there are no purchase options, payments to the \nlessor before the lease commencement date, variable payments based on an index or rate, or lease \nincentives from the lessor. The initial measurement of the right -of-use asset and lease liability is $33,000 \n(present value of lease payments using a discount rate of 4.235%). Entity H uses its incremental borrowing \nrate because the rate implicit in the lease cannot be readily determined . Entity H amortizes the right -of-\nuse asset on a straight -line basis over the lease term. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 197}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 186 Analysis : At lease commencement, Entity H would recognize the right -of-use asset and lease liability: \nRight -of-use asset $ 38,000 \n Lease liability $ 33,000 \n Cash 5,000 \nTo initially recognize the right -of-use asset, lease liability and payment that qualif ies as an IDC. \nThe following journal entries would be recorded in Year 1: \nInterest expense $ 1,398 \n Lease liability $ 1,398 \nTo record interest expense and accrete the lease liability using the interest method ($33,000 x 4.235%) \nAmortization expense $ 11,000 \n Right -of-use asset $ 11,000 \nTo record amortization expense on the right -of-use asset ($33,000 ÷ 3 years) \nAmortization expense for IDC $ 1,667 \n Right -of-use asset $ 1,667 \nTo record the amortization of the IDC ($5,000 ÷ 3 years) \nLease liability $ 10,000 \n Cash $ 10,000 \nTo record lease payment \nA summary of the lease contract’s accounting (assuming no changes due to reassessment, lease \nmodification or impairment) is as follows: \n Initial Year 1 Year 2 Year 3 \nCash lease payments $ 10,000 $ 12,000 $ 14,000 \nLease expense recognized \nInterest expense $ (1,398 ) $ (1,033 ) $ (569) \nAmortization expense (12,667 ) (12,667 ) (12,666 ) \nTotal periodic expense $ (14,065 ) $ (13,700 ) $ (13,235 ) \nBalance sheet \n \nLease liability $ (33,000) $ (24,398) $ (13,431) $ — \nRight -of-use asset $ 38,000 $ 25,333 $ 12,666 $ — \nImmaterial differences may arise in the recomputation of amounts in the example above due to rounding. \n \nIllustration 4 -7: Comparing a lessee’s accounting for finance leases and operating leases \nThis table illustrates the similarities and differences in accounting for finance (see Illustration 4-6) and \noperating (see Illustration 4-3) leases: \nFinance lease: \nTime Lease liability Right -of-use \nasset Interest \nexpense Amortization \nexpense Total expense \nInitial $ 33,000 $ 38,000 \nYear 1 $ 24,398 $ 25,333 $ 1,398 $ 12,667 $ 14,065 \nYear 2 $ 13,431 $ 12,666 1,033 12,667 13,700 \nYear 3 $ — $ — 569 12,666 13,235 \n $ 3,000 $ 38,000 $ 41,000 \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 198}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 187 Operating lease: \nTime Lease liability Right -of use \nasset Lease expense \nInitial $ 33,000 $ 38,000 \nYear 1 $ 24,398 $ 25,731 $ 13,667 \nYear 2 $ 13,431 $ 13,097 13,667 \nYear 3 $ — $ — 13,666 \n $ 41,000 \nThe initial measurement of the right -of-use asset and the lease liability is the same for finance and operating \nleases. Also, the same total lease expense is recognized over the life of the arrangement, but it is classified \ndifferently in the income statem ent and recognized at different times. A lessee generally recognizes higher \nperiodic lease expense in the earlier periods of a finance lease than it does for an operating lease. \n4.4 Master lease agreements \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \n842-10-55-17 \nUnder a master lease agreement, the lessee may gain control over the use of additional underlying \nassets during the term of the agreement. If the agreement specifies a mi nimum number of units or \ndollar value of equipment, the lessee obtaining control over the use of those additional underlying \nassets is not a lease modification . Rather, the entity (whether a lessee or a lessor ) applies the \nguidance in paragraphs 842 -10-15-28 through 15 -42 when identifying the separate lease components \nand allocating the consideration in the contract to those components. Paragraph 842 -10-55-22 \nexplains that a master lease agreement may, therefore, result in multiple commencement dates . \n842-10-55-18 \nIf the master lease agreement permits the lessee to gain control over the use of additional underlying \nassets during the term of the agreement but does not commit the lessee to doing so, the lessee’s \ntaking control over the use of an additional und erlying asset should be accounted for as a lease \nmodification in accordance with paragraphs 842 -10-25-8 through 25 -18. \nUnder a master lease agreement, a lessee may gain control over the use of additional underlying assets during \nthe term of the agreement. In certain cases, a master lease agreement may specify a minimum number or value \nof underlying assets the lessee is required to obtain. For example, a lessee enters into an agreement to obtain \nthe right to lease three floors of a building with an option to lease an additional floor ( i.e., the fourth floor). \nTo the extent that a lessee is required to take a specified minimum quantity or value of the underlying \nassets, the lessee obtaining control over the use of those additional u nderlying assets is not a lease \nmodification ( i.e., a change to the terms and conditions of a contract that results in a change in the scope \nof or the consideration for a lease). To identify the separate lease components and allocate the amount \nof consider ation in the master lease agreement attributed to the additional underlying assets, the lessor \napplies the guidance in ASC 842-10-15-28 through 15 -42 (refer to section 1.4, Identifying and \nseparating lease and non -lease components of a contract and allocat ing contract consideration ). \nTo the extent that additional underlying assets beyond the specified minimum are leased under the master \nlease agreement, the lessee obtaining control over the use of those additional underlying assets is considered \na lease mod ification. Refer to section 4.6, Lease modifications , for the accounting of a lease modification. \nIf a master lease agreement does not include a specified minimum quantity or dollar value, the lessee \nobtaining control over the use any additional underlying asset is also considered a lease modification. \nRefer to section 4.6, Lease modifications , for the accounting of a lease modification. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 199}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounti ng | 188 4.5 Remeasurement of lease liabilities and right -of-use assets — operating and \nfinance leases \nExcerpt from Accounting Standards Codification \nLeases — Lessee \nSubsequent Measurement \n842-20-35-4 \nAfter the commencement date , a lessee shall remeasure the lease liability to reflect changes to the \nlease payments as described in paragraphs 842 -10-35-4 through 35 -5. A lessee shall recognize the \namount of the remeasurement of the lease liability as an adjustment t o the right -of-use asset . \nHowever, if the carrying amount of the right -of-use asset is reduced to zero, a lessee shall recognize \nany remaining amount of the remeasurement in profit or loss. \n842-20-35-5 \nIf there is a remeasurement of the lease liability in accordance with paragraph 842 -20-35-4, the lessee \nshall update the discount rate for the lease at the date of remeasurement on the basis of the \nremaining lease term and the remaining lease payments unless the remeasurement of the lease \nliability is the res ult of one of the following: \na. A change in the lease term or the assessment of whether the lessee will exercise an option to \npurchase the underlying asset and the discount rate for the lease already reflects that the lessee \nhas an option to extend or term inate the lease or to purchase the underlying asset. \nb. A change in amounts probable of being owed by the lessee under a residual value guarantee (see \nparagraph 842 -10-35-4(c)(3)). \nc. A change in the lease payments resulting from the resolution of a contin gency upon which some \nor all of the variable lease payments that will be paid over the remainder of the lease term are \nbased (see paragraph 842 -10-35-4(b)). \nLeases — Overall \nSubsequent Measurement \n842-10-35-4 \nA lessee shall remeasure the lease payments if any of the following occur: \na. The lease is modified, and that modification is not accounted for as a separate contract in \naccordance with paragraph 842 -10-25-8. \nb. A contingency upon which some or all of the variable lease payments that will be paid over the \nremainder of the lease term are based is resolved such that those payments now meet the \ndefinition of lease payments. For example, an event occurs that results i n variable lease payments \nthat were linked to the performance or use of the underlying asset becoming fixed payments for \nthe remainder of the lease term. However, a change in a reference index or a rate upon which \nsome or all of the variable lease payments in the contract are based does not constitute the \nresolution of a contingency subject to (b) (see paragraph 842 -10-35-5 for guidance on the \nremeasurement of variable lease payments that depend on an index or a rate). \nc. There is a change in any of the f ollowing: \n1. The lease term, as described in paragraph 842 -10-35-1. A lessee shall determine the revised \nlease payments on the basis of the revised lease term. \n2. The assessment of whether the lessee is reasonably certain to exercise or not to exercise an option \nto purchase the underlying asset, as described in paragraph 842 -10-35-1. A lessee shall determine \nthe revised lease payments to reflect the change in the as sessment of the purchase option. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 200}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 189 3. Amounts probable of being owed by the lessee under residual value guarantees . A lessee \nshall determine the revised lease payments to reflect the change in amounts probable of \nbeing owed by the lessee under residual valu e guarantees. \n842-10-35-5 \nWhen one or more of the events described in paragraph 842 -10-35-4(a) or (c) occur or when a \ncontingency unrelated to a change in a reference index or rate under paragraph 842 -10-35-4(b) is \nresolved, variable lease payments that de pend on an index or a rate shall be remeasured using the \nindex or rate as of the date the remeasurement is required. \nLessees are required to remeasure finance and operating lease liabilities when there is a lease \nmodification ( i.e., a change to the terms and conditions of the contract that results in a change in the \nscope of or the consideration for the lease) that is not accounted for as a separate contract. Refer to \nsection 4.6, Lease modifications . \nLessees are also required to remeasure finance and oper ating lease liabilities when any of the following occurs: \n• A resolution of a contingency that is unrelated to a change in a reference index or rate and results in \nsome or all of the payments allocated to the lease component that were previously determined t o be \nvariable meeting the definition of a lease payment ( e.g., an event occurs that results in variable \npayments that were linked to the performance or use of the underlying asset becoming fixed payments \nfor the remainder of the lease term) \n• A change in any of the following: \n• The lease term (refer to section 2.3.1, Lease term ) \n• The assessment of whether a lessee is reasonably certain to exercise an option to purchase the \nunderlying asset (refer to section 2.3.2, Purchase options ) \n• The amount it is probable the lessee will owe under a residual value guarantee (refer to section 2.4. 6, \nAmounts it is probable that a lessee will owe under residual value guarantees — lessees only ) \nIn these cases, a lessee remeasures the lease liability at the reassessment date and adjusts the right -of-use \nasset by the change in the lease liability. However, if the right -of-use asset is reduced to zero, a lessee \nrecognizes any remaining amount in pro fit or loss. The FASB indicated in the Basis for Conclusions (BC 225) \nof ASU 2016 -02 that a right -of-use asset that was previously reduced to zero could be remeasured to an \namount greater than zero if a reassessment of the lease term or a lessee’s purchase option increases the \nlease liability. However, the FASB observed that a right -of-use asset would generally be measured at zero \nbefore the end of the lease term if it has been fully impaired (refer to section 4.2.5, Impairment of right -of-\nuse assets in ope rating leases ), and it would be unlikely that a lessee would reassess the lease term upward \nor conclude that it is reasonably certain to exercise an option to purchase the underlying asset when it \nhas previously concluded the fair value of the right -of-use asset was fully impaired. \nThe discount rate is also revised at the remeasurement date based on the remaining lease term and lease \npayments unless the remeasurement of the lease liability is the result of one of the following: \n• A change in the lease term or the assessment of whether the lessee will exercise an option to \npurchase the underlying asset and the discount rate for the lease already reflects that the lessee has \nan option to extend or terminate the lease or to purchase the underlying asset \n• A change in the amount it is probable the lessee will owe under a residual value guarantee \n• A resolution of a contingency that results in some or all of the lease payments that were previously \ndetermined to be variable meeting the definition of lease payments ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 201}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 190 The fo llowing chart provides an overview of the reassessment and remeasurement requirements applicable \nto lessees. \n In remeasuring the ROU asset/lease \nliability, reassess the following: \nRemeasurement of the lease liability and the \nROU asset occurs when: Measurement/ \nallocation of \nconsideration, \nlease payments1 Discount \nrate Lease \nterm and \nclassification \nA modification occurs that is not accounted for as a separate \ncontract, and the modified contract is or contains a lease ✓ ✓ ✓ \nA change in lease term result s from a triggering event ( e.g., a significant \nevent or a significant change in circumstances within the lessee’s \ncontrol, contractual event, option exercised, option not exercised) ✓ ✓2 ✓ \nThe lessee changes its a ssessment of whether it is reasonably certain \nto exercise an option to purchase the underlying asset resulting from \na triggering event ✓ ✓2 ✓ \nA contingency is resolved that results in v ariable lease payments \nmeet ing the definition of lease payments ✓ \nThe lessee changes its a ssessment of amount owed under a residual \nvalue guarantee ✓ \n1 Includes updating variable lease payments that depend on an index or rate as of the remeasurement date using the remeasurement \ndate index or rate. \n2 If the discount rate for the lease liability does not already reflect the lessee’s option in the lease to extend or terminate the lease \nor to purchase the underlying asset. \nRefer to section 3.5.1, Summary of lease reassessment and remeasurement requirements , and section 4.6, \nLease modif ications , for additional details . \n4.6 Lease modifications (updated August 2023) \nExcerpt from Accounting Standards Codification \nMaster Glossary \nLease Modification \nA change to the terms and conditions of a contract that results in a change in the scope of or the \nconsideration for a lease (for example, a change to the terms and conditions of the con tract that adds or \nterminates the right to use one or more underlying assets or extends or shortens the contractual lease term). \nIf a lease is modified ( i.e., a change to the terms and conditions of a contract that results in a change in \nthe scope of or consideration for the lease), the modified contract is evaluated to determine whether it is \nor contains a lease (refer to section 1.3, Reassessment of the contra ct). If a lease continues to exist, a \nlease modification can result in: \n• A separate contract (refer to section 4.6.2, Determining whether a lease modification is accounted \nfor as a separate contract) \n• A change in the accounting for the existing lease and not a separate contract (refer to section 4.6.3, \nLessee accounting for a modification that is not accounted for as a separate contract ) \nRefer to section 4.6.1, S ummary of the accounting for lease modifications — lessees . \nExamples of lease modification include a change to the terms and conditions of the contract that adds or \nterminates the right to use one or more underlying assets or extends or shortens the contractual lease \nterm . Additionally, a change to lease payments (regardless of whether they are fixed or variable ) or a \nchange in the timing of lease payments is a lease modification . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 202}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 191 The exercise of an existing purchase or renewal option or a change in the assessment of whether such \noptions are reasona bly certain to be exercised is not a lease modification but can result in the remeasurement \nof lease liabilities and right -of-use assets. Refer to section 4.5 , Remeasurement of lease liabilities and \nright -of-use assets — operating and finance leases . \n4.6.1 Summary of the accounting for lease modifications — lessees \n \nIs the modified contract a lease, or does it contain a lease? \n(ASC 842-10-15-6; section 1.2, Determining whether an \narrangement contains a lease ; and section 1.3, \nReassessment of the contract ) \nLease termination ( ASC 842-20-40-1 and \nsection 4.8.1, Lease termination ) \nDoes the modification result in a separate contract? \n(ASC 842-10-25-8 and section 4.6.2, \nDetermining whether a lease modification is \naccounted for as a separate contract ) \nAccount for two separate contracts: \n• The unmodified original contract \n• A separate contract, which is accounted for in the \nsame manner as any other new lease \n(ASC 842-10-25-8 and section 4.6.2, Determining whether a \nlease modification is accounted for as a separate contract ) \nDoes the modification fully or partially terminate \nan existing lease? (ASC 842-10-25-11(c) and \nsection 4.6.3, Lessee accounting for a modification that \nis not accounted for as a separate contract ) \nRemeasure the lease liability and adjust the carrying \namount of the right -of-use asset by the amount \nof the remeasurement of the lease liability \n(ASC 842-10-25-12 and section 4.6.3, Lessee accounting for a \nmodification that is not accounted for as a separate contract ) \nAccount for any difference between (1) the carrying \namount of the right -of-use asset after recording \nthe adjustment required by \nASC 842-10-25-12 or ASC 842-10-25-13 and (2) the \ncarrying amount of the right -of-use asset that would result if \nthe initial operating right -of-use asset measurement guidance \nin ASC 842-20-30-5 had been applied in the same manner as a \nrent prepayment or a lease incentive (ASC 842-10-25-14 \nand section 4.6.3, Lessee accounting fo r a modification \nthat is not accounted for as a separate contract ) \nApply the subsequent measurement guidance \nfor the applicable classification \nYes \nYes \nNo \nNo \nYes \nYes \n No \nWas a finance lease modified and the modified lease classified as an operating lease? (ASC 842-10-25-14 and \nsection 4.6.3, Lessee accounting for a modification that is not accounted for as a separate contract ) \n• Remeasure and reallocate the remaining consideration in the contract \n• Reassess the classification of the lease at the effective date of the modification \n• Account for any initial direct costs, lease incentives and other payments made to or by the lessee \n(ASC 842-10-25-9 through 25 -12 and section 4.6.3, Lessee accounting for a modification that is not accounted for as a separate contract) \nRemeasure the lease liability and decrease the carrying amount \nof the right -of-use asset in proportion to the full or partial \ntermination of the existing lease \nand \nRecognize in profit or loss any difference between the reduction \nin the lease liability and the reduction in the right -of-use asset \n(ASC 842-10-25-13 and section 4.6.3, Lessee accounting for a \nmodification that is not accounted for as a separate contract ) No ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 203}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 192 4.6.2 Determining whether a lease modification is accounted for as a separate contract \n(updated August 2023) \nExcerpt from Accounting Standards Codification \nLeases — Overall \nRecognition \n842-10-25-8 \nAn entity shall account for a modification to a contract as a separate contract (that is, separate from \nthe original contract) when both of the following conditions are present: \na. The modification grants the lessee an additional right of use not included in the original lease (for \nexample, the right to use an additional asset). \nb. The lease payments increase commensurate with the standalone price for the additional right of \nuse, adjusted for the circumstances of the particular contract. For example, the s tandalone price for \nthe lease of one floor of an office building in which the lessee already leases other floors in that \nbuilding may be different from the standalone price of a similar floor in a different office building, \nbecause it was not necessary for a lessor to incur costs that it would have incurred for a new lessee. \nA lessee accounts for a lease modification ( i.e., a change to the terms and conditions of a contract that \nresults in a change in the scope of or consideration for the lease) as a separate contract ( i.e., separate \nfrom the original contract) when both of the following conditions are met: \n• The modification grants the lessee an additional right of use that is not included in the original lease \n(e.g., a right to use an additional underl ying asset). \n• The lease payments increase commensurate with the standalone price for the additional right of use, \nadjusted for the circumstances of the particular contract. \nIf both of these conditions are met, the lease modification results in two separate contracts, the unmodified \noriginal contract and a separate new contract . Lessees account for the separate contract that contains a \nlease in the same manner as other new leases. Refer to Example 15 in ASC 842 that illustrates this concept \nin section 4.6.5, Examples — lessees’ accounting for lease modifications . \nIf both of the conditions are not met, the modified lease is not accounted for as a separate contract. Refer \nto section 4.6.3, Lessee accounting for a modification that is not accounted for as a separate contract . \nThe FASB indicated in the Basis for Conclusions (BC 176(a)) of ASU 2016 -02 that the right to use an \nadditional underlying asset ( e.g., an additional floor of a building) will generally be a separate lease \ncomponent, even if the modification granting that additional right of use does not create a separate \ncontract ( i.e., separate from the original contract). To illustrate, if an existing lease for a floor of a \nbuilding is modified to include a second floor, the right to use the second floor will often be a separate \nlease component from the right to use the first floor, even if the second floor is not accounted for under a \nseparate contract ( e.g., because the increase in lease payments is not commensurate with the standalone \nprice for the additional floor). Refer to section 1.4.1, Identifying and separating lease components o f a \ncontract , and Example 17 in ASC 842 that illustrates this concept in section 4.6.5, Examples — lessees’ \naccounting for lease modifications . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 204}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 193 If the lease modification grants the lessee the right to use the existing underlying asset for an additional \nperiod of time ( i.e., a period of time not included in the original lease agreement), the modified lease is not \naccounted for as a separate contract. In such cases, as indicated in the Basis for Conclusions (BC 176(b)) of \nASU 2016 -02, the modification only changes an attribute of the lessee’s existing right to use the underlying \nasset that it already controls. This is the case e ven if the extended term is priced at market. Refer to \nExample 16 in ASC 842 that illustrates this concept in section 4.6.5.2, Modification increases the lease term . \n \nQuestion 4-1 When a modification both grants an additional right of use and includes othe r changes to existing \nrights and obligations , should the additional right of use be accounted for as a separate contract ? \n(added August 2023) \nA modification is accounted for as a separate contract if the only change to the contract is granting \nan additional right of use with increased lease payments that are commensurate with the standalone \nprice for the additional right of use . If there are other changes to existing rights and obligations , the \nmodification does not meet the criteria to be accounte d for as a separate contract in accordance with \nASC 842-10-25-8. \n \n4.6.3 Lessee accounting for a modification that is not accounted for as a separate \ncontract (updated August 2022) \nExcerpt from Accounting Standards Codification \nMaster Glossary \nEffective Date of the Modification \nThe date that a lease modification is approved by both the lessee and the lessor . \nLeases — Overall \nScope and Scope Exceptions \n842-10-15-6 \nAn entity shall reassess whether a contract is or contains a lease only if the terms and conditions of \nthe contract are changed. \nRecognition \n842-10-25-1 \nAn entity shall classify each separate lease component at the commencement date . An entity shall not \nreassess the lease classification after the commencement date unless the contract is modified and the \nmodification is not accounted for as a separate contract in accordance with paragraph 842 -10-25-8. In \naddition, a lessee also shall reassess the lease classification after the commencement date if there is a \nchange in the lease term or the assessment of whether the lessee is reasonably certain to exercise an \noption to purchase the underlying asset . When an entity (that is, a lessee or lessor) is required to \nreassess lease classification, the entity shall reassess classification of the lease on the basis of the facts \nand circumstances (and the modified terms and conditions, if applicable) as of the date the reassessment \nis required (for example, on the basis of the fair value and the remaining economic life of the underlying \nasset as of the date there is a change in the lease term or in the assessment of a lessee option to \npurchase the underlying asset or as of the effective date of a mod ification not accounted for as a \nseparate contract in accordance with paragraph 842 -10-25-8). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 205}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 194 842-10-25-9 \nIf a lease is modified and that modification is not accounted for as a separate contract in accordance with \nparagraph 842 -10-25-8, the entity shall re assess the classification of the lease in accordance with \nparagraph 842 -10-25-1 as of the effective date of the modification . \n842-10-25-10 \nAn entity shall account for initial direct costs , lease incentives, and any other payments made to or by \nthe entity i n connection with a modification to a lease in the same manner as those items would be \naccounted for in connection with a new lease. \n842-10-25-11 \nA lessee shall reallocate the remaining consideration in the contract and remeasure the lease liability \nusing a discount rate for the lease determined at the effective date of the modification if a contract \nmodification does any of the following: \na. Grants the lessee an additional right of use not included in the original contract (and that \nmodification is not acc ounted for as a separate contract in accordance with paragraph 842 -10-25-8) \nb. Extends or reduces the term of an existing lease (for example, changes the lease term from five \nto eight years or vice versa), other than through the exercise of a contractual option to extend or \nterminate the lease (as described in paragraph 842 -20-35-5) \nc. Fully or partially terminates an existing lease (for example, reduces the assets subject to the lease) \nd. Changes the consideration in the contract only. \n842-10-25-12 \nIn the case of (a), (b), or (d) in paragraph 842 -10-25-11, the lessee shall recognize the amount of the \nremeasurement of the lease liability for the modified lease as an adjustment to the corresponding right -of-\nuse asset . \n842-10-25-13 \nIn the case of (c) in paragraph 842 -10-25-11, the lessee shall decrease the carrying amount of the \nright -of-use asset on a basis proportionate to the full or partial termination of the existing lease. Any \ndifference between the reduction in the lease liability and the pr oportionate reduction in the right -of-\nuse asset shall be recognized as a gain or a loss at the effective date of the modification. \n842-10-25-14 \nIf a finance lease is modified and the modified lease is classified as an operating lease , any difference \nbetween the carrying amount of the right -of-use asset after recording the adjustment required by paragraph \n842-10-25-12 or 842 -10-25-13 and the carrying amount of the r ight-of-use asset that would result from \napplying the initial operating right -of-use asset measurement guidance in paragraph 842 -20-30-5 to the \nmodified lease shall be accounted for in the same manner as a rent prepayment or a lease incentive. \nASC 842 req uires lessees to reassess whether a contract is or contains a lease when the terms and \ncondition of a contract are changed. If the contract continues to be or contain a lease, the lessee will \nreassess lease classification at the effective date of a lease m odification ( i.e., the date that the lease \nmodification is approved by both the lessee and the lessor) that is not accounted for as a separate \ncontract. Lease classification is reassessed using the modified terms and conditions and the facts and \ncircumstan ces as of that date, including: \n• The remaining economic life of the underlying asset on that date \n• The fair value of the underlying asset on that date ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 206}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 195 • The discount rate for the lease on that date \n• The remeasure d and reallocat ed remaining consideration in the contract on that date , which includes \nthe remaining balance of any unamortized lease prepayments \nThe following provides an overview of the reassessment and remeasurement requirements applicable to \nlessees when a modified le ase is not accounted for as a separate contract: \n \n1 Includes updating variable lease payments that depend on an index or rate as of the remeasurement date using the \nremeasurement date index or rate. \nLessees remeasure and reallocate the remaining considera tion in the contract and remeasure the lease \nliability (using the discount rate determined at the effective date of the modification) for the following \ntypes of modifications : \nType of modification Remeasurement and \nreallocation requirement Implementation guidance \nGrants the lessee an additional \nright of use that was not \nincluded in the original contract \nand the modification is not \naccounted for as a separate \ncontract (refer to section 4.6.2, \nDetermining whether a \nmodification is accounted for as \na separate contract ) ASC 842-10-25-12 requires the \nlessee to recognize the amount \nof the remeasurement of the \nlease liability as an adjustment \nto the corresponding right -of-\nuse asset without affecting \nprofit or loss. Refer to Example 17 in section \n4.6.5.3, Modification grants an \nadditional right of use — not a \nseparate contract . \nExtends or reduces the term of \nan existing lease ( e.g., changes \nthe lease term from five to eight \nyears), other than through the \nexercise of a contractual option \nto extend or terminate the lease \nalready included in the lease term ASC 842-10-25-12 requires the \nlessee to recognize the amount \nof the remeasurement of the \nlease liability as an adjustment \nto the corresponding right -of-\nuse asset without affecting \nprofit or loss. However, if the \nright -of-use asset is reduced to \nzero, a lessee would recognize \nany remaining amount in profit \nor loss. Refer to section 4.5, \nRemeasurement of lease liabilities \nand right -of-use assets — \noperati ng and finance leases . Refer to Example 16 in section \n4.6.5.2, Modification increases \nthe lease term . \nLess ees reassess the following upon a lease modification that is not accounted for as a separate contract: \nLease term and purchase options \nMeasurement/allocation of consideration \nin the contract1 \nDiscount rate \n Lease classification ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 207}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 196 Type of modification Remeasurement and \nreallocation requirement Implementation guidance \nFully or partially terminates an \nexisting lease ( e.g., reduces the \nassets subject to the lease) For a modification that fully or \npartially terminates the existing \nlease ( e.g., reduces the square \nfootage of leased space), \nASC 842-10-25-13 requires \na lessee to decrease the \ncarrying amount of the right -of-\nuse asset in proportion to the \nfull or partial termination of the \nlease. Any difference between \nthose adj ustments is recognized \nin profit or loss at the effective \ndate of the modification. Refer \nto Example 18 in section 4.6.5, \nExamples — lessees’ accounting \nfor lease modifications , and \nIllustration 4-8 below for an \nexample of the accounting for a \npartial termination of a lease. Refer to Example 18 in section \n4.6.5.4, Modification partially \nterminates a lease . \nChanges the consideration in \nthe contract only ASC 842-10-25-12 requires the \nlessee to recognize the amount \nof the remeasurement of the \nlease liability as an adjustment \nto the corresponding right -of-\nuse asset without affecting \nprofit or loss. However, if the \nright -of-use asset is reduced to \nzero, a lessee would recognize \nany remaining amount in profit \nor loss. Refer to section 4.5, \nRemeasurement of lease liabilities \nand right -of-use assets — \noperating and finance leases . Refer to Example 19 in section \n4.6.5.5, Modification only \nchanges lease payments . \nModi fied lease — lease classification changes \nIf a finance lease is modified and the modified lease is classified as an operating lease, any difference \nbetween the carrying amount of the right -of-use asset after recording the adjustment required by \nASC 842-10-25-12 or ASC 842-10-25-13 (discussed above) and the carrying amount of the right -of-use \nasset that would result from applying the initial operating right -of-use asset measurement guidance in \nASC 842-20-30-5 (i.e., the amount of the lease liability, any lea se prepayments less any lease incentives \nreceived and any initial direct costs incurred by the lessee) to the modified lease is accounted for in the \nsame manner as a rent prepayment or a lease incentive. \nRefer to Example 16, Case B in section 4.6.5.2, Modification increases the lease term , for an example of \nan operating lease that is modified and becomes a finance lease. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 208}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 197 Modified lease – termination at a future date \nIn some cases, a lease may be modified to fully or partially terminate the lease at a fu ture date ( i.e., the \ntermination does not take effect contemporaneously with the effective date of the modification). Questions \nhave arisen about whether the guidance on full or partial terminations in ASC 842-10-25-11(c) and \nASC 842-10-25-13 applies to th ese modifications. We believe lease terminations that do not take effect \ncontemporaneously with the effective date of the lease modification are effectively reductions in the \nlease term and a lessee should apply the guidance in ASC 842-10-25-11(b) and ASC 842-10-25-12. As \ndiscussed above, when a lease is modified to extend or reduce the term of an existing lease , a lessee \nrecognizes the amount of the remeasurement of the lease liability for the modified lease as an adjustment \nto the corresponding ROU asset. \nInitial direct costs \nLessees account for initial direct costs, lease incentives and any other payments made to or by the lessee \nin connection with the lease modification in the same manner as those items are accounted for in \nconnection with a new lease. R efer to section 2, Key concepts. \nIllustration 4-8: Lessee partially terminates an existing lease \nOn 1 January 20 X0 Lessee entered into a 10 -year lease with Landlord for retail space in an enclosed \nshopping mall. The retail store is 5,000 square feet. \nOn 1 April 20 X2, Lessee and Landlord modified the contract to reduce the square footage of the \nleased space to 4,000 square feet from 5,000 square feet and to reduce the lease payments . No other \nterms of the lease were modified. Lessee appropriately accounted for the lease modification as a \nmodification that is not accounted for as a separate contract. \nOn 1 April 20 X2, immediately before the parties signed the modified lease agreement, Lessee had a \nremaining ROU asset of $100,000 for the lease and a lease liability of $120,000. Based on the terms \nof the modified lease agreement, the lease liability is $90,000, which reflects the early termination of \nthe right to use 1,000 square feet of space, the remaining consideration in the co ntract (based on the \ndecreased lease payments) and a discount rate for the lease determined at the effective date of the \nmodification. The classification of the lease did not change as a result of the modification. \nLessee may decide to remeasure the ROU as set based on the change in lease liability or remaining \nright of use. \nScenario A — remeasuring the ROU asset based on change in lease liability \nThe pre -modification ROU asset was $100,000. Lessee decreased the carrying amount of the ROU \nasset to reflect th e partial termination of the lease based on the adjustment to the carrying amount of \nthe lease liability, with any difference recognized in profit or loss. \nThe difference between the pre -modification liability and the modified lease liability was $30,000 \n($120,000 — $90,000). That difference is 25% ($30,000 ÷ $120,000) of the pre -modification lease \nliability. \nTherefore, at the effective date of the modification, Lessee reduced the carrying amount of the ROU \nasset by $25,000 (25% × $100,000). Lessee recogniz ed the difference between the adjustment to the \nlease liability and the adjustment to the ROU asset ($30,000 — $25,000 = $5,000) as a gain. \nLease liability $ 30,000 (a) \n ROU asset $ 25,000 ( b) \n Gain from modification $ 5,000 ( c) \n(a) Difference between the pre -modification liability ($120,000) and the modified lease liability ($90,000). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 209}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 198 (b) Reduction of ROU asset based on the percentage change in lease liability (remaining ROU asset of $100,000 x 25% change in \nlease liability). \n(c) Difference between the reduction in the lease liability ($30,000) and the proportionate reduction in the ROU asset ($25,000). \nThe following table illustrates the adjusted carrying values for the ROU asset and lease liability: \n ROU a sset Lease liability Gain \nRemaining carrying value prior to lease modification $ 100,000 $ 120,000 \nReduction in carrying value based on change in lease liability (25,000) (30,000) $ 5,000 \nAdjusted carrying value $ 75,000 $ 90,000 \nScenario B — remeasuring the ROU asset based on the remaining right of use \nRetailer decreased the carrying amount of the ROU asset by the same proportion as the decrease in \nsquare footage. \nThe difference in square feet leased between the pre -modification lease and the modified lease was \n1,000 square feet (5,000 square feet — 4,000 square feet). That difference is 20% (1,000 square feet \n÷ 5,000 square feet) of the pre -modification lease. \nTherefore, at the effective date of the modification, Lessee reduced the carrying am ount of the ROU \nasset by $20,000 (20% × $100,000) and reduced the carrying amount of the lease liability by \n$24,000 (20% × $120,000). Lessee recognized the difference between the reduction in the lease \nliability and the reduction in the ROU asset ($24,000 — $20,000 = $4,000) as a gain. \nLease liability $ 24,000 (a) \n ROU asset $ 20,000 ( b) \n Gain from modification $ 4,000 ( c) \n(a) Reduction of lease liability in proportion to the reduction of leased space (remaining lease liability of $120,000 x 20% \nreducti on in space). \n(b) Reduction of ROU asset in proportion to the reduction of leased space (remaining ROU asset of $100,000 x 20% reduction in \nspace). \n(c) Difference between the reduction in the lease liability ($24,000) and the reduction in the ROU asset ($2 0,000). \nLessee then recognized the $6,000 difference between the remaining lease liability of $96,000 \n($120,000 lease liability immediately before the modification less the reduction of $24,000) and the \nmodified lease liability of $90,000 as an adjustment to the ROU asset reflecting the change in the \nconsideration paid for the lease and the revised discount rate. Retailer records the following entry: \nLease liability $ 6,000 \n ROU asset $ 6,000 \nThe following table illustrates the adjusted carrying values fo r the ROU asset and lease liability: \n ROU a sset Lease liability Gain \nRemaining carrying value prior to lease modification $ 100,000 $ 120,000 \nReduction in carrying value in proportion to reduction in space (20,000) (24,000) $ 4,000 \nAdjusted carrying value (prior to remeasurement of lease liability) $ 80,000 $ 96,000 \nChange in consideration paid for the lease (and revised discount rate) (6,000) (6,000) \nAdjusted carrying value $ 74,000 $ 90,000 \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 210}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 199 4.6.3.1 Lessee accounting for a modification due to reference rate reform (updated August 2023) \nNote \nIn January 2021, t he FASB issued ASU 2021 -01, Reference Rate Reform (Topic 848): Scope , to \nclarify that all derivative instruments affected by changes to the interest rates used for discounting, \nmargining or contract price alignment due to reference rate reform are in the scop e of ASC 848. The \nASU does not amend the guidance in ASC 842 or affect the optional expedient provided to lessees by \nASC 848 to not apply certain modification accounting requirements to contracts affected by reference \nrate reform . Amendments to the followi ng excerpts from ASC 848 as a result of the ASU are reflected as \npending content below . \n \nExcerpt from Accounting Standards Codification \nReference Rate Reform — Contract Modifications \nScope and Scope Exceptions \n848-20-15-2 \nThe guidance in this Subtopic, if elected, shall apply to contract modifications if the terms that are \nmodified directly replace, or have the potential to replace, a reference rate within the scope of \nparagraph 848 -10-15-3 with another interest rate index. If other terms are contemporaneously \nmodified in a manner that changes, or has the potential to change, the amount or timing of contractual \ncash flows, the guidance in this Subtopic shall apply only if those modifications are related to the \nreplacement of a reference rate. For example, the addition of contractual fallback terms or the amendment \nof existing contractual fallback terms related to the replacement of a reference rate that are contingent \non one or more events occurring has the potential to chang e the amount or timing of contractual cash \nflows and the entity potentially would be eligible to apply the guidance in this Subtopic. \nPending Content: \nTransition Date: (P) January 1, 2025; (N) January 1, 2025 | Transition Guidance: 848-10-65-2 \nThe guidance in this Subtopic, if elected, shall apply to contracts that meet the scope of paragraph \n848-10-15-3 if either or both of the following occur: \na. The terms that are modified directly replace, or have the potential to replace, a reference rate \nwithin t he scope of paragraph 848 -10-15-3 with another interest rate index. If other terms are \ncontemporaneously modified in a manner that changes, or has the potential to change, the \namount or timing of contractual cash flows, the guidance in this Subtopic shall apply only if \nthose modifications are related to the replacement of a reference rate. For example, the \naddition of contractual fallback terms or the amendment of existing contractual fallback terms \nrelated to the replacement of a reference rate that are co ntingent on one or more events \noccurring has the potential to change the amount or timing of contractual cash flows and the \nentity potentially would be eligible to apply the guidance in this Subtopic. \nb. The interest rate used for margining, discounting, or contract price alignment is modified as a \nresult of reference rate reform. \n848-20-15-3 \nThe guidance in this Subtopic shall not apply if a contract modification is made to a term that changes, \nor has th e potential to change, the amount or timing of contractual cash flows and is unrelated to the \nreplacement of a reference rate. That is, this Subtopic shall not apply if contract modifications are \nmade contemporaneously to terms that are unrelated to the re placement of a reference rate. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 211}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 200 Pending Content: \nTransition Date: (P) January 1, 2025; (N) January 1, 2025 | Transition Guidance: 848-10-65-2 \nOther than a modification of the interest rate used for margining, discounting, or contract price alignment \nin accordance with paragraph 848 -20-15-2(b), for contracts that meet the scope of paragraph 848 -\n10-15-3, the guidance in this Subtopic shall not apply if a contract modification is made to a term that \nchanges, or has the potential to change, the amount or timing of contractual cash flows and is unrelated \nto the replacement of a reference rate. That is, this Subtopic shall not apply if contract modifications \nare made contemporaneously to terms that are unrelated to the replacement of a reference ra te. \n848-20-15-4 \nContemporaneous modifications of contract terms that do not change, or do not have the potential to \nchange, the amount or timing of contractual cash flows shall not preclude application of the guidance \nin this Subtopic, regardless of whether those contemporaneous contract modifications are related or \nunrelated to the replacement of a reference rate. \nPending Content: \nTransition Date: (P) January 1, 2025; (N) January 1, 2025 | Transition Guidance: 848-10-65-2 \nContemporaneo us modifications of contract terms that do not change, or do not have the potential \nto change, the amount or timing of contractual cash flows shall not preclude application of the \nguidance in this Subtopic, regardless of whether those contemporaneous contr act modifications are \nrelated or unrelated to the replacement of a reference rate or the modification of the interest rate \nused for margining, discounting, or contract price alignment as a result of reference rate reform. \n848-20-15-5 \nChanges to terms that are related to the replacement of the reference rate are those that are made to \neffect the transition for reference rate reform and are not the result of a business decision that is \nseparate from or in addition to changes to the terms of a contract to effect that transition. Examples \nof changes to terms that are related to the replacement of a reference rate in accordance with the \nguidance in paragraph 848 -20-15-2 include the following: \na. Changes to the referenced interest rate index (for example, a change from London Interbank \nOffered Rate [LIBOR] to another interest rate index) \nb. Addition of or changes to a spread adjustment (for example, adding or adjusting a spread to the \ninterest rate index, amending the fixed rate for an interest rate swap, or paying or receiving a \ncash settlement for any difference intended to compensate for t he difference in reference rates) \nc. Changes to the reset period, reset dates, day -count conventions, business -day conventions, \npayment dates, payment frequency, and repricing calculation (for example, a change from a \nforward -looking term rate to an overn ight rate or a compounded overnight rate in arrears) \nd. Changes to the strike price of an existing interest rate option (including an embedded interest \nrate option) \ne. Addition of an interest rate floor or cap that is out of the money on the basis of the spot rate at \nthe time of the amendment of the contract \nf. Addition of a prepayment option for which exercise is contingent upon the replacement reference \ninterest rate index not being determinable in accordance with the terms of the agreement \ng. Additio n of or changes to contractual fallback terms that are consistent with fallback terms \ndeveloped by a regulator or by a private -sector working group convened by a regulator \nh. Changes to terms (including those in the examples in paragraph 848 -20-15-6) that are necessary \nto comply with laws or regulations or to align with market conventions for the replacement rate . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 212}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 201 Pending Content: \nTransition Date: (P) January 1, 2025; (N) January 1, 2025 | Transition Guidance: 848-10-65-2 \nChanges to terms that are related to the replacement of the reference rate are those that are made \nto effect the transition for reference rate reform and are not the result of a business decision that is \nseparate from or in addition to changes to the terms of a contract to effect that transition. Examples \nof changes to terms that are related to the replacement of a reference rate in accordance with the \nguidance in paragraph 848 -20-15-2(a) include the following: \na. Changes to the referenced interest rate index (for example, a change from London Interbank \nOffered Rate [LIBOR] to another interest rate index) \nb. Addition of or changes to a spread adjustment (for example, adding or adjusting a spread to the \ninterest rate index, amending the fixed rate for an interest r ate swap, or paying or receiving a \ncash settlement for any difference intended to compensate for the difference in reference rates) \nc. Changes to the reset period, reset dates, day -count conventions, business -day conventions, \npayment dates, payment frequency, and repricing calculation (for example, a change from a \nforward -looking term rate to an overnight rate or a compounded overnight rate in arrears) \nd. Changes to the strike price of an existing interest rate option (including an embedded interest \nrate option) \ne. Addition of an interest rate floor or cap that is out of the money on the basis of the spot rate at \nthe time of the amendment of the contract \nf. Addition of a prepayment option for which exercise is contingent upon the replacement \nreference interest rate inde x not being determinable in accordance with the terms of the \nagreement \ng. Addition of or changes to contractual fallback terms that are consistent with fallback terms \ndeveloped by a regulator or by a private -sector working group convened by a regulator \nh. Change s to terms (including those in the examples in paragraph 848 -20-15-6) that are \nnecessary to comply with laws or regulations or to align with market conventions for the \nreplacement rate . \n848-20-15-6 \nExamples of changes to terms that are generally unrelated to the replacement of a reference rate in \naccordance with paragraph 848 -20-15-3 include the following: \na. Changes to the notional amount \nb. Changes to the maturity date \nc. Changes from a referenced interest rate index to a stated fixed rate \nd. Changes to the loan structure (for example, changing a term loan to a revolver loan) \ne. The addition of an underlying or variable unrelated to the referenced rate index (for example, \naddition of payments that are indexed to the price of gold) \nf. The add ition of an interest rate floor or cap that is in the money on the basis of the spot rate at \nthe time of the amendment of the contract \ng. A concession granted to a debtor experiencing financial difficulty ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 213}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 202 h. The addition or removal of a prepayment or con version option except for the addition of a \nprepayment option for which exercise is contingent upon the replacement reference interest rate \nindex not being determinable in accordance with the terms of the agreement \ni. The addition or removal of a feature that is intended to provide leverage \nj. Changes to the counterparty except in accordance with paragraphs 815 -20-55-56A, 815 -25-40-1A, \nand 815 -30-40-1A \nk. Changes to the priority or seniority of an obligation in the ev ent of a default or a liquidation event \nl. The addition or termination of a right to use one or more underlying assets in a lease contract \nm. Changes to renewal, termination, or purchase option provisions in a lease contract. \nSubsequent Measurement \n848-20-35-11 \nIf an entity elects the optional expedient in this paragraph for a modification of a contract within the \nscope of Topic 840 or 842 that meets the scope of paragraphs 848 -20-15-2 through 15 -3, the entity \nshall not do any of the foll owing: \na. Reassess lease classification and the discount rate (for example, the incremental borrowing rate \nfor a lessee) \nb. Remeasure lease payments \nc. Perform other reassessments or remeasurements that would otherwise be required under Topic \n840 or 842 when a modification of a lease contract is not accounted for as a separate contract. \n848-20-35-12 \nIf the optional expedient in paragraph 848 -20-35-11 is elected, it shall be applied to all contracts \nunder Topic 840 or 842 as described in paragraph 848 -20-35-1. \n848-20-35-13 \nIf the optional expedient in paragraph 848 -20-35-11 is elected, the modification of the reference rate \nand other terms related to the replacement of the reference rate on which variable lease payments in \nthe original contract depended sha ll not require an entity to remeasure the lease liability. The change \nin the reference rate shall be treated in the same manner as the variable lease payments that were \ndependent on the reference rate in the original lease. That change shall not be include d in the \ncalculation of the lease liability; that is, the change shall be recognized in profit or loss in the period in \nwhich the obligation for those payments is incurred. \nASC 848, Reference Rate Reform , provide s temporary optional expedients and exceptions to the US GAAP \nguidance on contract modifications to ease the financial reporting burden related to the expected market \ntransition from LIBOR and other interbank offered rates to alternative reference rates, su ch as SOFR. \nUnder ASC 842, a lease modification is a change to the terms and conditions of a contract that results in \na change in the scope of or consideration for the lease. Therefore, a change in the index or rate on which \nlease payments are dependent w ould be accounted for as a lease modification because it will result in a \nchange in the consideration for the lease. A lease modification generally requires the remeasurement \nand reallocation of consideration in the contract; reassessment of lease term, di scount rate and lease \nclassification; and, for lessees, remeasurement of the ROU asset and lease liability. Refer to section 4.6, \nLease modifications , for further discussion of the accounting for lease modifications by lessees. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 214}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 203 However, the guidance in ASC 848 provides entities with an optional expedient to not apply certain modification \naccounting requirements to contracts affected by reference rate reform, if certain criteria are met. If a \nmodified lease contract meets the following required criteria and the entity elects to apply the optional \nexpedient in ASC 848, the entity would not account for the change in the lease contract as a lease modification: \n• The lease contract references LIBOR or another rate that is expected to be discontinued due to \nreferen ce rate reform. \n• The modified terms of the lease contract directly replace or have the potential to replace the \nreference rate that is expected to be discontinued due to reference rate reform. \nIf contemporaneous changes are made to other terms in the contra ct that change or have the potential \nto change the amount or timing of contractual cash flows, the optional expedient may only be applied if \nthose changes are related to the replacement of the reference rate. For example, a change to the lease \nterm concurr ent with the change in the rate in which lease payments are dependent would disqualify an \nentity from applying the relief from modification accounting to that lease; the change in lease term \nchanges the amount and timing of cash flows in the lease and is u nrelated to the change in the rate in the \nlease due to reference rate reform. \nIf an entity elects the optional expedient, it must apply it consistently for all eligible modified leases \naccounted for under ASC 842. \nThe guidance was effective upon issuance in March 2020 . The guidance on contract modifications is \napplied prospectively from any date beginning 12 March 2020. It may also be applied to modifications of \nexisting contracts made earlier in the interim period that includes the effective date ( i.e., modifications \nmade as early as 1 January 2020 for a calendar -year company). The relief is temporary and generally \ncannot be applied to contract modifications that occur after 31 December 202 4. Entities that elect the \nrelief are required to disclose the nat ure of the optional expedients and exceptions they are applying and \ntheir reasons for doing so. \n4.6.4 Lease modifications in connection with the refunding of tax -exempt debt \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \nLease Modifications in Connection with the Refunding of Tax -Exempt Debt \n842-10-55-16 \nIn some situations, tax -exempt debt is issued to finance construction of a facility, such as a plant or \nhospital, that is transfe rred to a user of the facility by lease . A lease may serve as collateral for the \nguarantee of payments equivalent to those required to service the tax -exempt debt. Payments \nrequired by the terms of the lease are essentially the same, as to both amount and timing, as those \nrequired by the tax -exempt debt. A lease modification resulting from a refunding by the lessor of tax -\nexempt debt (including an advance refunding ) should be accounted for in the same manner (that is, in \naccordance with paragraphs 842 -10-25-8 through 25 -18) as any other lease modification. For \nexample, if the perceived economic advantages of the refunding are passed through to the lessee in \nthe form of reduced lease payments , the lessee should account for the modification in accordance \nwith paragraph 842 -10-25-12, while the lessor should account for the modification in accordance with \nthe applicable guidance in paragraphs 842 -10-25-15 through 25 -17. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 215}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 204 Tax-exempt debt is often issued by a governmental or quasi -governmental authority to finance the \nconstruction of a facility such as a plant or a hospital. The user of the facility either buys the facility or \nleases it from the authority. The mortgage note or the lease serves as collateral for the tax -exempt debt, \nand the amount and timing of payme nts on the note or lease are the same as the debt service \nrequirements of the tax -exempt debt. Often, in the case of a lease, title passes at the end of the lease \nterm, thereby meeting one of the criteria for classification as a finance lease. \nMany tax -exempt organizations have entered into a refunding by replacing the old debt with new debt to \nobtain an economic advantage ( e.g., lower interest costs) for the lessee or mortgagor. As a result of the \nrefunding, the terms of the related mortgage note or lease are changed to conform with the terms of the \nnew debt issued. \nRefundings of tax -exempt debt transactions when the property is leased to the user are accounted for by \nthe user in the same manner as any other lease modification. Refer to section 4.6.2, Deter mining whether \na lease modification is accounted for as a separate contract, and section 4.6.3, Lessee accounting for a \nmodification that is not accounted for as a separate contract, for further discussion of the accounting for \nlease modifications by lesse es. \n4.6.5 Examples — lessees’ accounting for lease modifications \n4.6.5.1 Modification is accounted for as a separate contract \nASC 842 includes the following example of a lessee’s accounting for a modified lease that is accounted \nfor as a separate contract. \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \nExample 15 — Modification Accounted for as a Separate Contract \n842-10-55-160 \nLessee enters into a 10 -year lease for 10,000 square feet of o ffice space. At the beginning of Year 6, \nLessee and Lessor agree to modify the lease for the remaining 5 years to include an additional 10,000 \nsquare feet of office space in the same building. The increase in the lease payments is commensurate \nwith the mar ket rate at the date the modification is agreed for the additional 10,000 square feet of \noffice space. \n842-10-55-161 \nLessee accounts for the modification as a new contract, separate from the original contract. This is \nbecause the modification grants Lessee an additional right of use as compared with the original \ncontract, and the increase in the lease payments is commensurate with the standalone price of the \nadditional right of use. Accordingly, from the effective date of the modification, Lessee woul d have 2 \nseparate contracts, each of which contain a single lease component — the original, unmodified contract \nfor 10,000 square feet of office space and the new contract for 10,000 additional square feet of office \nspace, respectively. Lessee would not ma ke any adjustments to the accounting for the original lease as \na result of this modification. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 216}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 205 4.6.5.2 Modification increases or decreases the lease term (updated August 2023) \nASC 842 includes the following example of a lessee’s accounting for a modified lease that increases the \nterm of the lease. \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \nExample 16 — Modification That Increases the Lease Term \nCase A — No Change in Lease Classification \n842-10-55-162 \nLessee and Lessor enter into a 10 -year lease for 10,000 square feet of office space in a building with \na remaining economic life of 50 years. Annual payments are $100,000, paid in arrears. Lessee’s \nincremental borrowing rate at the commencement date is 6 percent. The lease is classified as an operating \nlease. At the beginning of Year 6, Lessee and Lessor agree to modify the lease such that the total \nlease term increases from 10 years to 15 years. The annual lease payments increa se to $110,000 per \nyear for the remaining 10 years after the modification. Lessee’s incremental borrowing rate is 7 percent \nat the date the modification is agreed to by the parties. \n842-10-55-163 \nAt the beginning of Year 6, Lessee’s lease liability and its right -of-use asset both equal $421,236 (that \nis, because the lease payments are made annually in arrears and because the lease payments are even \nthroughout the lease term, the lease liability and right -of-use asset will be equal). \n842-10-55-164 \nThe modification does not grant an additional right of use to the lessee; rather, it changes (modifies) \nan attribute of the right to use the 10,000 square feet of office space Lessee already controls. That is, \nafter the modification, Lessee still c ontrols only a single right of use transferred to Lessee at the \noriginal lease commencement date. \n842-10-55-165 \nBecause the modification does not grant Lessee an additional right of use, the modification cannot be a \nseparate contract. Therefore, at the eff ective date of the modification, Lessee reassesses classification \nof the lease (which does not change in this Example — see Case B [paragraphs 842 -10-55-166 through \n55-167] for a change in lease classification) and remeasures the lease liability on the bas is of the \n10-year remaining lease term, 10 remaining payments of $110,000, and its incremental borrowing \nrate at the effective date of the modification of 7 percent. Consequently, the modified lease liability \nequals $772,594. The increase to the lease liab ility of $351,358 is recorded as an adjustment to the \nright -of-use asset (that is, there is no income or loss effect from the modification). \nThe example below assumes the same facts as Case A above except that the underlying asset is a piece \nof equipment with a 12 -year remaining economic life at the effective date of the modification. Therefore, \nwhen the lessee reassesses classification as of the effective date of the modification, the modified lease is \nclassified as a finance lease ( i.e., lease classification changes). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 217}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 206 Excerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \nExample 16 — Modification That Increases the Lease Term \nCase B — Change in Lease Classification \n842-10-55-166 \nAssume the same facts as in Case A (paragraphs 842 -10-55-162 through 55 -165), except that the \nunderlying asset is a piece of equipment with a 12 -year remaining economic life at the effective date \nof the modification. Consequently, when the lessee reassesses classific ation of the lease in accordance \nwith paragraph 842 -10-25-1 as of the effective date of the modification based on the modified rights \nand obligations of the parties, the lessee classifies the modified lease as a finance lease (that is, \nbecause the remainin g lease term of 10 years is for a major part of the 12 -year remaining economic \nlife of the equipment). \n842-10-55-167 \nConsistent with Case A, at the effective date of the modification, the lessee remeasures its lease liability \nbased on the 10 -year remaining lease term, 10 remaining payments of $110,000, and its incremental \nborrowing rate of 7 percent. Consequently, the modified lease liability equals $772,594. The increase to \nthe lease liability of $351,358 is recorded as an adjustment to the right -of-use as set (that is, there is no \nincome or loss effect from the modification). However, different from Case A, beginning on the effective \ndate of the modification, Lessee accounts for the 10 -year modified lease as a finance lease. \nThe following example illustrat es a lessee’s accounting for a modified lease that decreases the term of \nthe lease. \nIllustration 4 -9: Modification that decreases lease term and change in lease classification \nLessee and Lessor enter into a 1 5-year lease for a piece of equipment with a remaining economic life \nof 17 years. Annual payments are $100,000, paid in arrears. Lessee’s incremental borrowing rate at \nthe commencement date is 6 percent. The lease is classified as a finance lease. At the beginning of Year \n6, Lessee and Lessor agree to modify the lease such that the total lease term decreases from 15 years \nto 8 years. The annual lease payments increase to $110,000 per year for the remaining 3 years after \nthe modification. Lessee’s incremental borrowing rate is 7 percent at the date the modification is \nagreed to by the parties . \nOn the modification date, t he Lessee classifies the lease as an operating lease as the remaining lease \nterm of 3 years is not a major part of the 12-year remaining economic life of the equipment and no \nother lease classification criteria are met . The Lessee remeasures its lease liability based on the three -\nyear remaining lease term , three remaining payments of $110,000, and its incremental borrowing \nrate of 7 percent. The modified lease liability equals $ 288,675 . The decrease to the lease liability of \n$447,334 is recorded as an adjustment to the right -of-use asset ( i.e., there is no income or loss effect \nfrom the modification because, in this example, the right -of-use asset is not reduced below zero ). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 218}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 207 4.6.5.3 Modification grants an additional right of use — not a separate contract \nASC 842 includes the following example of a lessee’s accounting for a modified lease that grants an \nadditional right of use but is not accounted for as a separate contract. \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \nExample 17 — Modific ation That Grants an Additional Right of Use \n842-10-55-168 \nLessee enters into a 10 -year lease for 10,000 square feet of office space. The lease payments are \n$100,000 per year, paid in arrears. Lessee’s incremental borrowing rate at lease commencement is \n6 percent. At the beginning of Year 6, Lessee and Lessor agree to modify the contract to include an \nadditional 10,000 square feet of office space on a different floor of the building for the final 4 years of \nthe original 10 -year lease term for a total annual fixed payment of $150,000 for the 20,000 square feet. \n842-10-55-169 \nThe increase in the lease payments (of $50,000 per year) is at a substantial discount to the market rate \nat the date the modification is agreed to for leases substantially similar to that for the new 10,000 square \nfeet of office space that cannot be attributed solely to the circumstances of the contract. Consequently, \nLessee does not account for the modification as a separate contract. \n842-10-55-170 \nInstead, Lessee accounts for the modified contract, which contains 2 separate lease components — \nfirst, the original 10,000 square feet of office space and, second, the right to use the additional \n10,000 square feet of office space for 4 years that commences 1 year after the effective dat e of the \nmodification. There are no nonlease components of the modified contract. The total lease payments, \nafter the modification, are $700,000 (1 payment of $100,000 + 4 payments of $150,000). \n842-10-55-171 \nLessee allocates the lease payments in the modi fied contract to the 2 separate lease components on a \nrelative standalone price basis, which, in this Example, results in the allocation of $388,889 to the \noriginal space lease and $311,111 to the additional space lease. The allocation is based on the rema ining \nlease terms of each separate lease component (that is, 5 years for the original 10,000 -square -foot \nlease and 4 years for the additional 10,000 -square -foot lease). The remaining lease cost for each \nseparate lease component is equal to the total payments, a s allocated, which will be recognized on a \nstraight -line basis over their respective lease terms. Lessee remeasures the lease liability for the \noriginal space lease as of the effective date of the modification — the lease classification of which does \nnot c hange as a result of the modification — on the basis of all of the following: \na. A remaining lease term of 5 years \nb. Annual allocated lease payments of $77,778 in Years 6 through 10 (see paragraph 842 -10-55-173) \nc. Lessee’s incremental borrowing rate a t the effective date of the modification of 7 percent. \n842-10-55-172 \nThe remeasured lease liability for the original space lease equals $318,904. Lessee recognizes the \ndifference between the carrying amount of the modified lease liability and the carrying amount of the \nlease liability immediately before the modification of $102,332 ($421,236 — $318,904) as an adjustment \nto the right -of-use asset. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 219}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 208 842-10-55-173 \nDuring Year 6, Lessee recognizes lease cost of $77,778. At the end of Year 6, Lessee makes its lease \npayment of $100,000, of which $77,778 is allocated to the lease of the original office space and $22,222 \nis allocated to the lease of the additional office space as a prepayment of rent. Lessee allocates the lease \npayment in this manner to reflect ev en payments for the even use of the separate lease components over \ntheir respective lease terms. \n842-10-55-174 \nAt the commencement date of the separate lease component for the additional office space, which is \n1 year after the effective date of the modific ation, Lessee measures and recognizes the lease liability \nat $241,896 on the basis of all of the following: \na. A lease term of 4 years \nb. Four allocated annual payments of $72,222 ([allocated lease payments of $311,111 − $22,222 \nrent prepayment] ÷ 4 year s) \nc. Lessee’s incremental borrowing rate at the commencement date of the separate lease \ncomponent for the additional office space of 7.5 percent. \n842-10-55-175 \nAt the commencement date, the right -of-use asset for the additional office space lease compon ent is \nrecognized and measured at $264,118 (the sum of the lease liability of $241,896 and the prepaid \nrent asset of $22,222). \n842-10-55-176 \nDuring Years 7 –10, Lessee recognizes lease cost of $77,778 each year for each separate lease \ncomponent and allocate s each $150,000 annual lease payment of $77,778 to the original office space \nlease and $72,222 to the additional office space lease. \n4.6.5.4 Modification partially terminates a lease \nASC 842 includes the following example of a lessee’s accounting for a modified lease that partially \nterminates a lease. \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \nExample 18 — Modification That Decreases the Scope of a Lease \n842-10-55-177 \nLessee enters into a 10 -year lease for 10,000 square feet of office space. The annual lease payment is \ninitially $100,000, paid in arrears, and increases 5 percent each year during the lease term. Lessee’s \nincremental borrowing rate at lease commencement is 6 percent. Lessee does not provide a residual \nvalue guarantee. The lease does not transfer ownership of the office space to Lessee or grant Lessee \nan option to purchase the space. The lease is an operating lease for all of the following rea sons: \na. The lease term is 10 years, while the office building has a remaining economic life of 40 years. \nb. The fair value of the office space is estimated to be significantly in excess of the present value of \nthe lease payments. \nc. The office space is expected to have an alternative use to Lessor at the end of the lease term. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 220}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 209 842-10-55-178 \nAt the beginning of Year 6, Lessee and Lessor agree to modify the original lease for the remaining 5 years \nto reduce the lease to only 5,000 square feet of the origi nal space and to reduce the annual lease payment \nto $68,000. That amount will increase 5 percent each year thereafter of the remaining lease term. \n842-10-55-179 \nThe classification of the lease does not change as a result of the modification. It is clear ba sed on the \nterms of the modified lease that it is not a finance lease because the modification reduces both the \nlease term and the lease payments. Lessee remeasures the lease liability for the modified lease at the \neffective date of the modification on the basis of all of the following: \na. A remaining lease term of 5 years \nb. Lease payments of $68,000 in the year of modification (Year 6), increasing by 5 percent each \nyear thereafter \nc. Lessee’s incremental borrowing rate at the effective date of the modification of 7 percent. \n842-10-55-180 \nThe remeasured lease liability equals $306,098. \nCase A — Remeasuring the Right -of-Use Asset Based on Change in Lease Liability \n842-10-55-181 \nThe difference between the premodification liability and the modified leas e liability is $284,669 \n($590,767 — $306,098). That difference is 48.2 percent ($284,669 ÷ $590,767) of the \npremodification lease liability. The decrease in the lease liability reflects the early termination of the \nright to use 5,000 square feet of space (50 percent of the original leased space), the change in the \nlease payments, and the change in the di scount rate. \n842-10-55-182 \nLessee decreases the carrying amount of the right -of-use asset to reflect the partial termination of \nthe lease based on the adjustment to the carrying amount of the lease liability, with any difference \nrecognized in profit or los s. The premodification right -of-use asset is $514,436. Therefore, at the \neffective date of the modification, Lessee reduces the carrying amount of the right -of-use asset by \n$247,888 (48.2% × $514,436). Lessee recognizes the difference between the adjustmen t to the lease \nliability and the adjustment to the right -of-use asset ($284,669 — $247,888 = $36,781) as a gain. \nCase B — Remeasuring the Right -of-Use Asset Based on the Remaining Right of Use \n842-10-55-183 \nLessee determines the proportionate decrease in t he carrying amount of the right -of-use asset based \non the remaining right -of-use asset (that is, 5,000 square feet corresponding to 50 percent of the \noriginal right -of-use asset). \n842-10-55-184 \nFifty percent of the premodification right -of-use asset is $257,218 (50% x $514,436). Fifty percent of the \npremodification lease liability is $295,384 (50% x $590,767). Consequently, Lessee decreases the carrying \namount of the right -of-use asset by $257,218 and the carrying amount of the lease liability by $295,38 4. \nAt the effective date of the modification, Lessee recognizes the difference between the decrease in the \nlease liability and the decrease in the right -of-use asset of $38,166 ($295,384 — $257,218) as a gain. \n842-10-55-185 \nLessee recognizes the difference between the remaining lease liability of $295,384 and the modified \nlease liability of $306,098 (which equals $10,714) as an adjustment to the right -of-use asset \nreflecting the change in the consideration paid for the lease and the revised discount rate. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 221}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 210 4.6.5.5 Modification only changes lease payments \nASC 842 includes the following example of a lessee’s accounting for a modified lease that only changes \nthe lease payments. \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \nExample 19 — Modification That Changes the Lease Payments Only \n842-10-55-186 \nLessee enters into a 10 -year lease for 10,000 square feet of office space. The lease payments are \n$95,000 in Year 1, paid in arrears, and increase by $1,000 every year thereafter. The original \ndiscount rate for the lease is 6 percent. The lease is an operating lease. At the beginning of Year 6, \nLessee and Lessor agree to modify the original lease for the remaining 5 years to reduce the leas e \npayments by $7,000 each year (that is, the lease payments will be $93,000 in Year 6 and will continue \nto increase by $1,000 every year thereafter). The modification only changes the lease payments and, \ntherefore, cannot be accounted for as a separate con tract. The classification of the lease does not \nchange as a result of the modification. \n842-10-55-187 \nLessee remeasures the lease liability for the modified lease on the basis of all of the following: \na. Remaining lease term of 5 years \nb. Payments of $93,000 in Year 6, increasing by $1,000 each year for the remainder of the lease term \nc. Lessee’s incremental borrowing rate at the effective date of the modification of 7 percent. \n842-10-55-188 \nThe remeasured lease liability equals $388,965. Lessee recogn izes the difference between the \ncarrying amount of the modified lease liability and the lease liability immediately before the effective \ndate of the modification of $40,206 ($429,171 premodification lease liability — $388,965 modified \nlease liability) as a corresponding reduction to the right -of-use asset. Therefore, the adjusted right -of-\nuse asset equals $376,465 as of the effective date of the modification. Lessee calculates its remaining \nlease cost as $462,500 (the sum of the total lease payments, as adj usted for the effects of the lease \nmodification, of $960,000 reduced by the total lease cost recognized in prior periods of $497,500), \nwhich it will recognize on a straight -line basis over the remaining lease term. \n842-10-55-189 \nDuring Year 6, Lessee recog nizes lease cost of $92,500 ($462,500 remaining lease cost ÷ 5 years). As \nof the end of Year 6, Lessee’s lease liability equals $323,193 (present value of the remaining lease \npayments, discounted at 7 percent), and its right -of-use asset equals $311,193 (t he balance of the lease \nliability — the remaining accrued rent balance of $12,000). Lessee recognizes additional lease cost of \n$92,500 each year of the remaining lease term and measures its lease liability and right -of-use asset in \nthe same manner as at th e end of Year 6 each remaining year of the lease term. The following are the \nbalances of the lease liability and the right -of-use asset at the end of Years 7 through 10 of the lease. \n Lease \nLiability Right -of-Use \nAsset \nYear 7 $ 251,816 $ 241,316 \nYear 8 $ 174,443 $ 166,443 \nYear 9 $ 90,654 $ 86,154 \nYear 10 $ — $ — \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 222}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 211 4.6.6 Relocating from one leased space to another leased space with the same landlord \nA lessee that immediately terminates an existing contract and enters into a new lease arrangement for a \ndifferent underlying asset with a different unrelated landlord generally should account for the change as \na termination of the existing lease in accordance with ASC 842-20-40-1 (i.e., by removing the ROU asset \nand the lease liability from the balance sheet and recognizing the difference between the ROU asset and the \nlease liability in profit or loss) and the execution of a new lease. Refer to section 4.8.1, Lease termination , \nfor further discussion of lease terminations and section 4.6.3, Lessee accounting for a modification that \nis not accounted for as a separate contract , for further discussion of lease modification s that reduce the \nterm of an existing lease instead of immediatel y terminating the lease . \nA lessee that immediately terminates an existing lease and contemporaneously enters into a new lease \narrangement (i.e., the new lease w ould not be executed and the existing lease would not be terminated \nwithout the other ) for a substantively different underlying asset with the same landlord (or a related \nparty of the landlord) generally should account for the change as a termination of the existing lease by \nremoving the ROU asset and the lease liability from the balance sheet . Any difference between the ROU \nasset and the lease liability is included as part of the ROU asset of the new lease upon initial recognition , \nsimilar to a lease incentive or initial direct cost of the new lease . That is because ASC 842-10-25-19 states \nthat an entity should combine two or more contracts, at least one of which is or contains a lease, entered \ninto at or near the same time with the same count erparty (or related parties) and consider the contracts as \na single transaction if the contracts are negotiated as a package with the same commercial objective(s). \nA retailer that relocates from one leased space to another leased space should also consider the \naccounting effects of that change on any long -lived assets ( e.g., leasehold improvements) at the old \nspace. That is, a retailer that intends to abandon long -lived assets when it relocates to another space \nshould determine whether its depreciation esti mates must be revised (in accordance with the change in \nestimate guidance in ASC 250) and whether the corresponding asset group is impaired (in accordance \nwith ASC 360-10). A decision to abandon long -lived assets is generally an indicator of impairment. \nThe following example illustrates the lessee’s accounting for relocating from one leased space to a \nsmaller leased space with the same landlord , and the new lease would not be executed and the existing \nlease would not be terminated without the other ( i.e., the two contracts with the same counterparty are \ncombined in accordance with ASC 842). The accounting treatment would be similar if the lessee \nrelocated from one leased space to a larger leased space with the same landlord, and the new lease \nwould not be ex ecuted and the existing lease would not be terminated without the other. \nIllustration 4 -10: Relocating from one leased space to another leased space with the same landlord \nOn 1 January 20X0, Retailer (lessee) entered into a 10-year operating lease with Landlord for retail store A \nin an enclosed shopping mall. Retail store A is 10,000 square feet. The lease requires Retailer to make fixed \nmonthly payments at the beginning of each month , but the amount increases each year . There are no initial \ndirect costs or incentives associated with the lease , and there are no non-lease components in the contract. \nOn 1 January 20X2, Retailer and Landlord negotiate a new contract to immediately terminate the \nlease for retail store A and contemporaneously enter into a new lease for retail store B (i.e., the \ntermination of the retail store A lease is dependent on the execut ion of the new retail store B lease) . \nRetail store B is 5,000 square feet and is located in a more desirable location in the same shopping \nmall that Retailer believes will help increase foot traffic . The term of the new lease is eight years, \nconsistent wit h the remaining term of the retail store A lease . There are no lease termination \npayments for retail store A, and no lease prepayments, initial direct costs or lease incentives \nassociated with the retail store B lease . Also, there are no non -lease componen ts in the contract . \nOn 1 January 20X2, immediately before the parties signed the new lease agreement, Retailer ha s a \nremaining ROU asset of $1 15,000 and a lease liability of $120,000. For simplicity, also assume the \nasset group that includ es the ROU asset and leasehold improvements for retail store A are not impaired. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 223}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 212 Based on the terms of the retail store B lease agreement, the initial measurement of the lease liability \nis $70,000, which represents the lease payments in the new lease, discounted using Retailer’s \nincremental borrowing rate at the commencement date of the new lease . \nAnalysis \nRetailer first needs to consider whether any leasehold improvements at retail store A will be \nabandoned and, if so, revise their useful lives and depreciation estimates . \nRetailer then accounts for the change as a termination of the existing lease of retail s tore A by \nremoving the ROU asset and the lease liability from the balance sheet and including any difference \nbetween the ROU asset and the lease liability as part of the ROU asset it recognizes related to the new \nlease of retail store B (which in this case is similar to a lease incentive received to enter into the retail \nstore B lease) . Retailer records the following entry: \nLease liability (existing lease) $ 120,000 (a) \n ROU asset (existing lease) $ 115,000 (a) \nROU asset (new lease) 65,000 (b) \n Lease liability ( new lease) 70,000 (c) \n(a) Removal of remaining lease liability ($120,000) and ROU asset ($1 15,000) associated with existing lease of retail s tore A. \n(b) Recognition of ROU asset associated with the new lease of retail s tore B ($70,000) less the difference between the lease \nliability and ROU asset from retail store A lease ($ 5,000) (which in this case is similar to a lease incentive received to enter \ninto the retail store B lease) . \n(c) Recognition of lease liability associated with the new lease for retail s tore B. \n4.7 Lease incentives and improvements \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \n842-10-55-30 \nLease incentives include both of the following: \na. Payments made to or on behalf of the lessee \nb. Losses incurred by the lessor as a result of assuming a lessee’s preexisting lease with a third \nparty . In that circumstance, the lessor and the lessee should independently estimate any loss \nattributable to that assumption. For example, the lessee’s estimate of the lease incentive could be \nbased on a comparison of the new lease with the market rental rate available for similar \nunderlying assets or the market rental rate from the same lessor without the lease assumption. \nThe lessor should estimate any loss on the basis of the total remaining costs reduced by the \nexpected benefits from the sublease for use of the assumed underlying asset. \nA lease agreement might include incentives for the lessee to sign the lease, such as an up -front cash \npayment to the lessee, payment of costs for the lessee (such as moving expenses) or the assumption by \nthe lessor of the lessee’s preexisting lease with a third party. \nPayments made to or on behalf of the lessee represent incentives that the lessee should consider reductions \nof the right -of-use asset and rental expense over the term of the lease ( refer to section 4.2.3, Expense \nrecognition — operating leases, and section 4.3.3, Expense recognition — finance leases, for further discussion). \nSimilarly, losses incurred by the lessor as a result of assuming a lessee’s preexisting lease with a third \nparty should be considered an incentive by the lessee. Incentives should be recognized on a straight -line \nbasis over the term of the lease. The lessee should independently estimate any loss attributable to the \nassumption of a preexisting lease with a third pa rty. For example, the lessee’s estimate of the incentive ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 224}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 213 could be based on a comparison of the lease with the market rental rate available for similar lease \nproperty or the market rental rate from the same lessor without the lease assumption. Refer to sect ion \n2.4.1.2 , Lease incentives , for further discussion of lease incentives . \n4.7.1 Whether improvements are lessee or lessor assets \nEntities should evaluate whether improvements made to the underlying asset are lessee or lessor assets \nbecause the determinat ion affects whether a lessor payment to the lessee for the improvements is a \nlease incentive or a reimbursement of the costs incurred by the lessee (refer to section 2.11, \nImprovements to the underlying asset , for factors to consider). For example, if a re tailer leases general \npurpose retail space and has its own contractor build specific improvements to make the store look like \nthe others it operates around the Country (i.e., the improvements are lessee assets ), any amounts the \nlessor provides to pay a portion of the cost will generally be viewed as an incentive. \n4.7.2 Lessee involvement in asset construction (‘build -to-suit’ lease transactions) \nBuild -to-suit lease transactions involve various forms of lessee involvement in the construction of an asset \nfor the lessee’s own use. The guidance in ASC 842 focuses on whether the lessee controls the asset being \nconstructed rather than whether the lessee takes on risks during the construction period. Under ASC 842, \nif the lessee controls the asset during construction, the asset is capitalized as construction -in-progress and is \nsubject to the sale and leaseback guidance at the end of construction. \nRefer to section 7.7.2, Determining whether the lessee controls the under lying asset being constructed , \nand section 7.2, Determining whether the transfer of an asset is a sale , on the accounting for sale and \nleaseback transactions. \n4.7.3 Amortization of leasehold improvements \nExcerpt from Accounting Standards Codification \nLeases — Lessee \nSubsequent Measurement \n842-20-35-12 \nLeasehold improvements shall be amortized over the shorter of the useful life of those leasehold \nimprovements and the remaining lease term , unless the lease transfers ownership of the underlying \nasset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying \nasset, in which case the lessee shall amortize the leasehold improvements to the end of their useful life. \nPending Content: \nTransition Date: (P) December 16, 20 23; (N) December 16, 20 23 | Transition Guidance: 842-10-65-8 \nLeasehold improvements, other than those accounted for in accordance with paragraph 842 -20-35-\n12A, shall be amortized over the shorter of the useful life of those leasehold improve ments and the \nremaining lease term , unless the lease transfers ownership of the underlying asset to the lessee or \nthe lessee is reasonably certain to exercise an option to purchase the underlying asset, in which case \nthe lessee shall amortize the leasehold improvements to the end of their useful life. \n \nASC 842 requires lessees to amortize leasehold improvements over the shorter of the following: \n• The useful life of those leasehold improvements \n• The remaining lease term \nHowever, if the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably \ncertain to exercise an option to purchase the underlying asset, leasehold improvements are amortized \nover their useful life. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 225}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 214 The accounting for the amortization of leaseh old improvements should be consistent with the lease term. \n4.7.3.1 Leasehold improvements placed in service subsequent to lease commencement \nAs discussed in ASC 842-10-35-1 (refer to section 2.3.6, Reassessment of the lease term and purchase \noptions ), a lessee is required to monitor events that could trigger a change in the lease term. One example \nwould be a lessee’s construction of significant leasehold improvements ( e.g., in the eighth year of a 10 -year \nlease) that are expected to have significant eco nomic value for the lessee when a renewal option becomes \nexercisable. Regardless of when they are constructed, leasehold improvements should be amortized over \nthe lesser of the remaining useful life of the asset(s) or the remaining lease term after reasses sment in \naccordance with ASC 842-10-35-1. However, if the lease transfers ownership of the underlying asset to \nthe lessee, or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the \nlessee should amortize the leasehold improvements to the end of their useful life. This treatment is \nconsistent with the guidance for leasehold improvements acquired in a business combination (refer to \nsection 4.7.3.2, Leasehold improvements acquired in business combinations ). \nFor example, Re tailer A enters into a 10 -year lease with a five -year renewal option. At the commencement \ndate of the lease, Retailer A determined that the lease term was 10 years ( i.e., it determined that it was \nnot reasonably certain to exercise the five -year renewal op tion). Leasehold improvements placed in \nservice at or near the commencement date of the lease are amortized over the shorter of their useful life \nor 10 years. In year eight, the retailer remodels the store and adds extensive leasehold improvements. \nRetaile r A reassesses the lease term and determines that it is now reasonably certain that it will exercise \nthe five -year renewal option, and the remaining lease term is now seven years. Retailer A would amortize \nthe leasehold improvements added in year eight ove r the shorter of their useful life or seven years \n(i.e., the revised remaining lease term consists of two remaining years of the original lease term plus five \nadditional years related to the renewal option ). The lessee would also reassess the amortization period for \nthose leasehold improvements placed into service at or near commencement of the lease, which in the \nexample above was the original 10 -year term. \nJudgment is required to analyze the facts, including the nature of the expenditures, to determine wh ether \nreassessment of the lease term is required and what the appropriate amortization period is. Refer to \nsection 4.5, Remeasurement of lease liabilities and right -of-use assets — operating and finance leases , for \nfurther discussion of a lessee’s accounti ng for a lease when it reassesses the lease term. \n4.7.3.2 Leasehold improvements acquired in business combinations \nExcerpt from Accounting Standards Codification \nLeases — Lessee \nSubsequent Measurement \n842-20-35-13 \nLeasehold improvements acquired in a business combination or an acquisition by a not -for-profit \nentity shall be amortized over the shorter of the useful life of the assets and the remaining lease term \nat the date of acquisition. \nPending Content: \nTransition Date : (P) January 1, 202 5; (N) January 1, 202 5 | Transition Guidance: 805-60-65-1 \nLeasehold improvements acquired in a business combination , acquired in an acquisition by a not -\nfor-profit entity , or recognized by a joint venture upon formation shall be amortized over the \nshorter of the useful life of the assets and the remaining lease term at the date of acquisition. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 226}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 215 Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest \nSubsequent Measurement \n805-20-35-6 \nLeasehold improvements acquired in a business combination shall be amortized over the shorter of the \nuseful life of the assets and the remaining lease term at the date of acquisition. However, if the lease \ntransfers ownership of the underlying asset to the lessee, or the lessee is reasonably certain to exercise \nan option to purchase the underlying asset, the lessee shall amortize the leasehold improvements to \nthe end of their useful life. \nA leasehold improvement acquired in a busine ss combination is similar to a leasehold improvement placed in \nservice after the commencement date of a lease (as described in section 4.7.3.1, Leasehold improvements \nplaced in service subsequent to lease commencement ) and, as such, the asset should be amo rtized over the \nshorter of the useful life or the lease term (determined at the date the business combination is recorded) that \nincludes renewals that are reasonably certain to be exercised. However, if the lease transfers ownership of \nthe underlying asset to the lessee, or the lessee is reasonably certain to exercise an option to purchase the \nunderlying asset, the lessee will amortize the leasehold improvements to the end of their useful life. Refer to \nsection 4.4.4.4.4, Acquired leasehold improvement , of our FRD, Business combinations . \n4.7.3.2.1 Leasehold improvements acquired in asset acquisitions \nIn a circumstance w here an entity acquires a land lease (as a lessee) and related existing leasehold \nimprovements (e.g., a commercial building on leased land, which is commonly called a leasehold interest \nby real estate entities) in an asset acquisition rather than a busines s combination, we believe it is \nappropriate to treat the asset acquired as a leasehold improvement placed in service at or near lease \ncommencement (the accounting described in section 4.7.3. 1, Leasehold improvements placed into service \nsubsequent to lease commencement ). Also, refer to Appendix A , Accounting for asset acquisitions , of our \nFRD, Business combinations , for additional discussion on the accounting for asset acquisitions. \n4.7.3.2.2 Fresh start accounting for lease hold improvements \nIn general, the accounting for leasehold improvements that have been revalued in fresh start accounting \nshould follow the guidance for business combinations noted in section 4.7.3.2, Leasehold improvements \nacquired in business combination s. This is because when an entity emerges from a Chapter 11 \nbankruptcy and applies fresh -start accounting, ASC 852, Reorganizations , requires the emerging entity \nto apply the business combination guidance in ASC 805, Business Combinations , and generally me asure \nassets and liabilities at fair value. Refer to section 4.2 , Method for applying fresh -start accounting , of our \nFRD, Bankruptcies, liquidations and quasi -reorganizations , for more guidance on fresh -start accounting. \n4.7.3.3 Salvage values \nThe amortization of leasehold improvements should take into account any net salvage value that would \naccrue to the lessee. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 227}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 216 4.7.3.4 Lessee amortization of leasehold improvements associated with a lease between entities \nunder common control (added August 2023) \nExcerpt from Accounting Standards Codification \nPending Content: \nTransition Date: (P) December 16, 2023; (N) December 16, 2023 | Transition Guidance: 842 -10-\n65-8 \nLeases — Lessee \nSubsequent Measurement \n842-20-35-12A \nLeasehold improvements associated with a lease between entities under common control shall be: \na. Amortized over the useful l ife of those improvements to the common control group as long as \nthe lessee controls the use of the underlying asset through a lease. If the lessor obtained the \nright to control the use of the underlying asset through a lease with another entity not within \nthe same common control group, the amortization period shall not exceed the amortization \nperiod of the common control group determined in accordance with paragraph 842 -20-35-\n12. \nb. Accounted for as a transfer between entities under common control through an adjustment to \nequity (net assets for a not-for-profit entity ) when the lessee no longer controls the use of \nthe underlying asset. \n842-20-35-12B \nAn entity with leasehold improvements accounted for in accordance with paragraph 842 -20-35-12A \nshall apply the impairment requirements in paragraph 360 -10-40-4, considering the useful life to the \ncommon control group. \n 842-20-35-12C \nIf after the commencement date the lessee and lessor become within the same common control \ngroup or are no longer within the same common control group, any change in the required \namortization period for leasehold improvements shall be accounted for prospectively as a change in \naccounti ng estimate in accordance with paragraph 250 -10-45-17. \n \nAll lessees , including public business entities, in a lease with a lessor under common control are required to: \n• Amortize leasehold improvements over their useful life to the common control group, as long as the \nlessee controls the use of the underlying asset through a lease \n• Account for the leasehold improvements as a transfer of assets between entities under common \ncontrol through an adjustment to equity (or net assets for not -for-profit entities) when the lessee no \nlonger controls the use of the underlying asset \nIf after the commencement date the lessee and lessor become part of the same common control group \nor stop being part of the same common control group, the lessee would account for any change in the \nrequired amortization period for leasehold improvements prospectively as a change in accounting \nestimate under ASC 250, Accounting Changes and Error Corrections . \nLessees are also required to apply the impairment guidance in ASC 360-10-40-4 to leasehold \nimprovements associated with common control leases so that leasehold improvements are not \nimmediately impaired after they are transfer red to the entity under common control at the end of the \nlease term . Refer to section 4.10, Disclosure , for the related disclosure requirements. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 228}), Document(page\_content='4 Lessee ac counting \nFinancial reporting developments Lease accounting | 217 4.8 Other lessee matters \n4.8.1 Lease termination (updated August 2022) \nExcerpt from Accounting Standards Codification \nLeases — Less ee \nDerecognition \n842-20-40-1 \nA termination of a lease before the expiration of the lease term shall be accounted for by the lessee by \nremoving the right -of-use asset and the lease liability , with profit or loss recognized for the difference. \nAn immediate termination of a lease (operating or finance) before the expiration of the lease term is \naccounted for by derecognizing the lease -related asset and liability. Any consideration paid or received \nupon termination that was not already included in th e lease payments ( e.g., a termination penalty that \nwas not included in lease payments based on the lease term) is included in the gain or loss on termination \nof the lease. \nWhen the parties agree that a lease will be terminated before the expiration of the lease term but the \ntermination will be effective at a future date ( i.e., a lessee does not immediately cease using the \nunderlying asset), the change to the lease is generally a ccounted for as a lease modification that \nshortens the lease term rather than a lease termination. This type of modification can occur if a \ntermination is agreed to but the lessee is given a month to move out, for example. S ee section 4.6.3, \nLessee accounting for a modification that is not ac counted for as a separate contract , for guidance on \nmodifications that shorten the lease term. \nIf there is an ongoing arrangement between the lessee and the lessor that will arise in conjunction with \nthe termination of a lease ( e.g., a lease is reevaluated based on a change in the contractual terms and is \ndetermined to be a service contract), we believe the lessee would consider the net asset or liability \nassociated with the lease in the measurement of the remaining arrangement. \nASC 405-20-40-1 provides gui dance for determining when a liability (including a lease liability) has been \nextinguished and therefore can be removed from the obligor’s (lessee’s) balance sheet. A lease liability is \nconsidered extinguished (and a gain or loss is recognized) if either o f the following two conditions is met: \n• The lessee pays the lessor and is relieved of its obligation for the liability. Paying the lessor includes \ndelivery of cash or other consideration. \n• The lessee is legally released from being the primary obligor under t he liability, either by a judicial \nbody or by the lessor. \nSome sale and assumption agreements may have other components that need to be accounted for. For \nexample, a lessor might release a lessee as primary obligor on the condition that a third party assum es \nthe obligation and that the original lessee becomes secondarily liable. While the release extinguishes the \noriginal lessee’s liability as the primary obligor, the lessee becomes a guarantor, regardless of whether \nconsideration was paid for the guarantee . As a guarantor, the original lessee will recognize a guarantee \nobligation at fair value (under ASC 460) in the same manner as a guarantor that had never been primarily \nliable to that lessor. Refer to section 6, Subleases , for further discussion of accoun ting for subleases. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 229}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 218 Under ASC 460, recognition of the guarantee would take into consideration the likelihood that the new \nprimary obligor will fulfill its obligation. For example, if the new primary obligor had little substance and, \ntherefore, would be una ble to honor its obligation, the guarantor of that obligation would have to \nrecognize a fair value liability that would likely not differ significantly from the obligation that would be \nrecorded if it were still the primary obligor because of the inability of the new primary obligor to fulfill its \nobligation. Additionally, the guarantee obligation, initially measured at fair value, reduces the gain or \nincreases the loss recognized from the extinguishment. \nUnder ASC 405-20-55-3 through 55 -4, an “in -substance defeasance” transaction ( e.g., when the \nunderlying asset s and the related obligations are transferred to a trust) does not meet the derecognition \ncriteria for either the asset or the liability because of the following: \n• The lessee is not released from the obligation by putting assets in a trust. For example, if the assets \nin a trust prove insufficient because a default by the lessee accelerates its obligation, the lessee is \nobligated to make the lessor whole. \n• The lessor is not limited to the cash flows from the assets in trust. \n• The lessor does not have the ability to dispose of the assets at will or to terminate the trust. \n• If the assets in the trust exceed what is necessary to meet scheduled lease payments, the lessee can \nremove the excess. \n• The lessee do es not surrender control of the benefits of the assets because those assets are still \nbeing used for the lessee’s benefit to extinguish its liability. Because no asset can be an asset of more \nthan one entity, those benefits must still be the lessee’s asset s. \n4.8.2 Purchase of a n underlying asset during the lease term \nExcerpt from Accounting Standards Codification \nLeases — Lessee \nDerecognition \n842-20-40-2 \nThe termination of a lease that results from the purchase of an underlying asset by the lessee is not \nthe type of termination of a lease contemplated by paragraph 842 -20-40-1 but, rather, is an integral \npart of the purchase of the underlying asset. If the lessee purchases the underlying asset, any \ndifference between the purchase price and the carry ing amount of the lease liability immediately \nbefore the purchase shall be recorded by the lessee as an adjustment of the carrying amount of the \nasset. However, this paragraph does not apply to underlying assets acquired in a business \ncombination , which ar e initially measured at fair value in accordance with paragraph 805 -20-30-1. \nA lease termination does not include the lessee purchasing the underlying asset . Instead, the difference \nbetween the purchase price and the carrying amount of the lease liability is recorded as an adjustment to \nthe carrying amount of the purchased asset. This guidance does not apply to underlying assets acquired in a \nbusiness combination, which are initially measured at fair value. Refer to section 8, Business combinations . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 230}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 219 Illust ration 4 -11: Accounting for the purchase of a n underlying asset during the term of a lease \nEntity X (lessee) has just completed the third year of a five -year finance lease agreement. The right -of-\nuse asset has a net book value of $3,000, and the lease liability is $2,000. If the lease were terminated \nat the end of year three because the lessee purchased the underlying asset for $1,500, Entity X would \nrecord the following entry: \nLeas e liability $ 2,000 \nFixed assets 2,500 \n Right -of-use asset $ 3,000 \n Cash 1,500 \nThe right -of-use asset is reclassified as an owned asset, and the carrying amount of the owned asset \n($3,000) is adjusted by the difference between the carrying value of the lease liability ($2,000) and the \nconsideration paid ($1,500). \n4.8.3 Leases denominated in a foreign currency \nExcerpt from Accounting Standards Codification \nLeases — Lessee \nImplementation Guidance and Illustrations \n842-20-55-10 \nThe right -of-use asset is a nonmonetary asset while the lease liability is a monetary liability . \nTherefore, in accordance with Subtopic 830 -10 on foreign currency matters, when accounting for a \nlease that is denominated in a foreign currency, if remeasurement into the lessee’s functional currency \nis required, the lease liability is remeasured using the current exchange rate, while the right -of-use \nasset is remeasured using the exchange rate as of the commencement date . \nLessees apply ASC 830, Foreign Currency Matters , to leases denominated in a foreign currency. As they do \nfor other monetary liabilities, lessees remeasure a foreign currency -denominated lease liability using the \nexchange rate at each reporting date. Any changes to the lease liability due to exch ange rate changes are \nrecognized in profit or loss. Because the right -of-use asset is a nonmonetary asset measured at historical cost, \nit is not affected by subsequent changes in the exchange rate. Therefore, the subsequent measurement of the \nright -of-use asset will not equal the lease liability for operating leases denominated in a foreign currency. \nThe FASB acknowledged in the Basis for Conclusions (BC 247) of ASU 2016 -02 that this approach could \nresult in volatility in profit or loss from the recognition of foreign currency exchange gains or losses but \nbelieved it would be clear to users of financial statements that the gains or losses result solely from \nchanges in exchange rates. \nQuestions have arisen regarding what foreign exchange rate a lessee should use to remeasure a right -of-use \nasset into the lessee’s functional currency upon a reassessment event or a modification that is not accounted \nfor as a separate contract. As described in section 4.5, Remeasurement of lease liabilities and right -of-use \nasset s — operating and finance leases , a lessee is required to remeasure a right -of-use asset (and lease \nliability) when there is a lease modification that is not accounted for as a separate contract. Lessees are \nalso required to remeasure a right -of-use asset (and lease liability) when any of the following occur: \n1. There is a change in lease term \n2. There is a change in the assessment of whether a lessee is reasonably certain to exercise an option \nto purchase the underlying asset ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 231}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 220 3. There is a change in the amount it i s probable the lessee will owe under a residual value guarantee \n4. A resolution of a contingency that is unrelated to a change in a reference index or rate and results in \nsome or all of the payments allocated to the lease component that were previously determ ined to be \nvariable meeting the definition of a lease payment \nIn response to a technical inquiry, the SEC staff said it would not object to a lessee making an accounting \npolicy election to either: \n• Remeasure the entire right -of-use asset using the exchange rate on the date of modification (that is \nnot accounted for as a separate new lease) or, if the lease is remeasured for a reassessment event listed \nin (1) or (2) above , using the exchange rate on the date of reassessm ent. If the lease is remeasured \nfor a reassessment event listed in (3) or (4) above, a lessee should remeasure the entire right -of-use \nasset using the historical exchange rate ( i.e., it does not update the exchange rate for any portion of \nthe right -of-use asset). \n• Remeasure only the portion of the right -of-use asset that was added as a result of the modification \n(that is not accounted for as a separate lease) or reassessment event using the exchange rate on the \ndate of modification or reassessment. \nThe SEC s taff said a lessee should apply its accounting policy election consistently to all leases and \nshould disclose its accounting policy, if material. This view should not be applied by analogy to other \nnonmonetary assets or nonmonetary liabilities. \n4.8.4 Portfolio approach \nASC 842 applies to individual leases. However, entities that have a large number of leases of similar \nassets ( e.g., leases of a fleet of similar railcars) may face practical challenges in applying the leases \nmodel on a lease -by-lease basis. The FASB acknowledged these concerns and said in the Basis for \nConclusions (BC 120) of ASU 2016 -02 that an entity can use a portfolio approach when “the entity \nreasonably expects that the application of the leases model to the portfolio would not differ ma terially \nfrom the application of the leases model to the individual leases in that portfolio.” For example, applying \na portfolio approach to four -year leases of new automobiles of the same make and model, entered into in \nthe same month with the same terms and conditions, may not differ materially from applying ASC 842 to \nthe individual leases in the portfolio. \nASC 842 does not define “reasonably expects” and “materially.” The FASB also said in the Basis for \nConclusions (BC 120) of ASU 2016 -02 that “an entity would need to apply judgment in selecting the size \nand composition of the portfolio” and “it did not intend f or an entity to quantitatively evaluate each \noutcome but, instead, that the entity should be able to take a reasonable approach to determine the \nportfolios that would be appropriate for its types of leases.” \nThe FASB also said in the Basis for Conclusions (BC 121) of ASU 2016 -02 that “the cost relief offered by \napplying the leases guidance at a portfolio level need not be limited to simply grouping contracts \ntogether.” The portfolio approach could also be applied to other aspects of the leases guidance for which \nlessees need to make judgments and estimates, such as determining the discount rate and determining \nand reassessing the lease term. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 232}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 221 ASC 842 provides the following implementation guidance for applying the portfolio approach to establish \nthe discount r ate for the lease. \nExcerpt from Accounting Standards Codification \nLeases — Lessee \nImplementation Guidance and Illustrations \nExample 2 — Portfolio Approach to Establishing the Discount Rate for the Lease \n842-20-55-18 \nLessee, a public entity, is the parent of several consolidated subsidiaries. During the current period, \n2 subsidiaries entered into a total of 400 individual leases of large computer servers, each with terms \nranging between 4 and 5 years and annual payment s ranging between $60,000 and $100,000, \ndepending on the hardware capacity of the servers. In aggregate, total lease payments for these \nleases amount to $30 million. \n842-20-55-19 \nThe individual lease contracts do not provide information about the rate impl icit in the lease. Lessee is BBB \ncredit rated and actively raises debt in the corporate bond market. Both subsidiaries are unrated and do not \nactively engage in treasury operations in their respective markets. On the basis of its credit rating and the \ncollateral represented by the leased servers, Lessee’s incremental borrowing rate on $60,000 through \n$100,000 (the range of lease payments on each of the 400 leases) would be approximately 4 percent. Lessee \nnotes that 5 -year zero -coupon U.S. Treasury instrumen ts are currently yielding 1.7 percent (a risk -free rate). \nBecause Lessee conducts its treasury operations centrally (that is, at the consolidated group level), it is \nreasonably assumed that consideration of the group credit standing factored into how each lease was priced. \n842-20-55-20 \nLessee may determine the discount rate for the lease for the 400 individual leases entered into on \ndifferent dates throughout the current period by using a portfolio approach. That is, Lessee can apply \na single discount rate to the portfolio of new leases. This is because during the period, the new leases \nare all of similar terms (four to five years), and Lessee’s credit rating and the interest rate environment \nare stable. Because the pricing of the lease is influenced by the credit standing and profile of Lessee \nrather than the subsidiaries (that is, because Lessee conducts treasury operations for the consolidated \ngroup), Lessee concludes that its incremental borrowing rate of 4 percent is an appropriate discount \nrate for each of the 400 leases entered into by Lessee’s 2 subsidiaries during the period. Because \nLessee is a public entity, it is not permitted to use a risk -free discount rate. \n4.8.5 Effects of lease -related assets and liabilities on income tax accounting \nASC 842 also affects lessees’ accounting for income taxes. For lessees, ASC 842 requires recognition of \nadditional lease -related assets and liabilities that will likely result in additional book -tax basis differences \nsuch as the following: \n• Recognition and measurem ent of deferred tax assets and liabilities associated with book -tax basis \ndifferences \n• Assessment of the realizability of deferred tax assets ( i.e., the need for a valuation allowance) \nRefer to our FRD, Income taxes . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 233}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 222 4.8.6 Rent capitalization \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrat ions \n842-10-55-19 \nIn some lease arrangements, the lessor may make the underlying asset available for use by the lessee \n(for example, the lessee may take possession of or be given control over the use of the underlying \nasset) before it begins operations or makes lease payments under the terms of the lease. During this \nperiod, the lessee has the right to use the underlying asset and does so for the purpose of constructing \na lessee asset (for example, leasehold improvements). \n842-10-55-20 \nThe contract may require the lessee to ma ke lease payments only after construction is completed and \nthe lessee begins operations. Alternatively, some contracts require the lessee to make lease payments \nwhen it takes possession of or is given control over the use of the underlying asset. The timin g of when \nlease payments begin under the contract does not affect the commencement date of the lease. \n842-10-55-21 \nLease costs (or income) associated with building and ground leases incurred (earned) during and after a \nconstruction period are for the right to use the underlying asset during and after construction of a lessee \nasset. There is no distinction between the right to use an underlying asset during a construction period \nand the right to use that asset after the construction period. Therefore, lease costs (or income) associated \nwith ground or building leases that are incurred (earned) during a construction period should be \nrecognized by the lessee (or lessor) in accordance with the guidance in Subtopics 842 -20 and 842 -30, \nrespectively. That guidance d oes not address whether a lessee that accounts for the sale or rental of real \nestate projects under Topic 970 should capitalize rental costs associated with ground and building leases. \nA lessee is prohibited from capitalizing rent under an operating lease as part of the cost of a constructed \nasset. Rental costs incurred during and after a construction period are for the right to direct the use of an \nunderlying asset during and after construction of a lessee asset. There is no distinction between the right to \nuse a n underlying asset during the construction period and the right to use that asset after the construction \nperiod. Therefore, lease costs associated with ground or building operating leases that are incurred during \na construction period are recognize d in accordance with ASC 842’s guidance for lessee accounting for \noperating leases (refer to section 4.2, Operating leases ). Interest related to a finance lease should be \nincluded in the interest cost used to determine capitalized interest in accordance wi th ASC 835-20. \nThe guidance in ASC 842-10-55-21 does not address whether a lessee of real estate under development \nwithin the scope of ASC 970-360 should capitalize rental costs associated with ground and building \noperating leases during development. Refer to section 2.2.2, Rental costs incurred during a construction \nperiod , of our FRD, Real estate project costs , for further discussio n on accounting for such costs. \nIt should be noted that it is not appropriate to defer occupancy costs as a component of startup activities \n(ASC 720-15). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 234}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 223 4.8.7 Lessee accounting for maintenance deposits \nExcerpt from Accounting Standards Codification \nLeases — Lessee \nImplementation Guidance and Illustrations \n842-20-55-4 \nUnder certain leases (for example, certain equipment leases), a lessee is legally or contractually \nresponsible for repair and maintenance of the underlying asset throughout the lease term . \nAdditionally, certain lease agreements include provisions requiring the lessee to make deposits to the \nlessor to financially protect the lessor in the event the lessee does not properly maintain the underlying \nasset. Lease agreements often refer to these deposits as maintenance reserves or supplemental rent. \nHowever, the lessor is required to reimburse the deposits to the lessee on the comp letion of maintenance \nactivities that the lessee is contractually required to perform under the lease agreement. \n842-20-55-5 \nUnder a typical arrangement, maintenance deposits are calculated on the basis of a performance \nmeasure, such as hours of use of the underlying asset, and are contractually required under the terms \nof the lease agreement to be used to reimburse the lessee for required maintenance of the underlying \nasset on the completion of that maintenance. The lessor is contractually required to reim burse the \nlessee for the maintenance costs paid by the lessee, to the extent of the amounts on deposit. \n842-20-55-6 \nIn some cases, the total cost of cumulative maintenance events over the term of the lease is less than \nthe cumulative deposits, which result s in excess amounts on deposit at the expiration of the lease. In \nthose cases, some lease agreements provide that the lessor is entitled to retain such excess amounts, \nwhereas other agreements specifically provide that, at the expiration of the lease agree ment, such \nexcess amounts are returned to the lessee (refundable maintenance deposit). \n842-20-55-7 \nThe guidance in paragraphs 842 -20-55-8 through 55 -9 does not apply to payments to a lessor that \nare not substantively and contractually related to maintenance of the leased asset. If at the \ncommencement date a lessee determines that it is less than probabl e that the total amount of \npayments will be returned to the lessee as a reimbursement for maintenance activities, the lessee \nshould consider that when determining the portion of each payment that is not addressed by the \nguidance in paragraphs 842 -20-55-8 through 55 -9. \n842-20-55-8 \nMaintenance deposits paid by a lessee under an arrangement accounted for as a lease that are \nrefunded only if the lessee performs specified maintenance activities should be accounted for as a \ndeposit asset. \n842-20-55-9 \nA lessee sho uld evaluate whether it is probable that an amount on deposit recognized under paragraph \n842-20-55-8 will be returned to reimburse the costs of the maintenance activities incurred by the lessee. \nWhen an amount on deposit is less than probable of being retu rned, it should be recognized in the same \nmanner as variable lease expense. When the underlying maintenance is performed, the maintenance \ncosts should be expensed or capitalized in accordance with the lessee’s maintenance accounting policy. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 235}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 224 Under certain lease arrangements, a lessee may be contractually or legally responsible for repair and \nmaintenance of the leased asset during the term of the lease arrangement. In addition, the lease \narrangement may require the lessee to make deposits (also commonly refe rred to as maintenance reserves \nor supplemental rent) with the lessor to protect the lessor if the lessee does not properly maintain the \nleased asset ( i.e., the lessor would use the funds to restore the leased asset to proper working order). \nUnder a typica l lease arrangement, the lessor is contractually required to reimburse the lessee a portion of \nthe deposit as qualifying maintenance activities are performed and paid for by the lessee. If the deposits \npaid to the lessor exceed costs incurred for maintenan ce activities, the lease arrangement may allow the \nlessor to retain the excess amounts when the lease expires or may require the lessor to refund such excess \namounts to the lessee. While refundable maintenance deposits are accounted for by lessees as a dep osit, \nsome had questioned the accounting for lessee maintenance deposits that are not automatically refundable \nin all instances, including those that are not refunded if the lessee does not perform the maintenance \nactivities specified by the lease arrangem ent. \nMaintenance deposits paid by the lessee under an arrangement accounted for as a lease that are refunded \nonly if the lessee performs specified maintenance activities should be considered deposit assets by the lessee \nif it is probable that the deposits will be refunded. The cost of maintenance activities should be expensed or \ncapitalized by the lessee, as appropriate, when the underlying maintenance is performed. If a lessee \ndetermines that it isn’t probable that its maintenance deposit will be refunded, the deposit is recognized as \nvariable rent expense. If it is probable at inception of the lease that a portion of the deposits will not be \nrefunded, the lessee should recognize as an expense a pro rata portion of the deposits as they are paid as \nvariable lease payments (refer to section 2.9.1, Lessee accounting for variable lease payments ). \nSome lease agreements call for maintenance deposits and refunds to be made throughout the term of \nthe lease. For instance, an airplane lease may require the lessee to m ake a deposit with the lessor based \non usage of the airplane ( e.g., pay a defined amount for every hour or cycle flown) and the lessor to \nrefund those deposits upon the performance of required maintenance activities. In such leases, deposits \ncan be made an d refunded multiple times over the lease. The following illustration depicts the accounting \ntreatment for multiple cycle maintenance deposits. \nIllustration 4 -12: Deposits in leases with multiple maintenance cycles \nAirline A leases an airplane from Lessor B for 10 years and agrees to provide Lessor B with maintenance \ndeposits of $50 for every flight hour flown. Airline A is responsible for maintaining the airplane, and Lessor \nB must reimburse Airline A for engine overhaul maintenance costs incurred u p to the amounts on deposit \nwhen the engine overhaul maintenance occurs. Any excess amounts on deposit are retained by Lessor B. \nAssume that the airplane being leased requires engine overhaul maintenance after every 20,000 flight \nhours, and the expected cost of the engine overall maintenance exceeds the amounts to be placed on \ndeposit ( i.e., expected cost of engine overhaul is greater than $1,000,000 = $50/hour x 20,000 \nhours). Airline A expects to fly the leased airplane between 4,000 and 5,000 hours each year. \nIn the early periods of the lease, deposits made by Airline A are probable of being returned because \nAirline A expects to incur reimbursable maintenance costs by performing engine overhaul maintenance. \nAs such, maintenance deposits made sh ould be accounted for as deposit assets. \nToward the end of the lease, Airline A may be required to make maintenance deposits that are not probable \nof being returned if Airline A does not expect to perform another engine overall. For instance, assume that \nAirline A flies the airplane for a total of 40,000 hours over the first nine years of the lease, performs the \nsecond engine overhaul at the end of the ninth year and receives reimbursement from Lessor B for the funds \non deposit. Airline A would still be req uired to make payments of $50 for every flight hour flown in the 10th \nyear of the lease. However, because Airline A will not perform another engine overhaul, those payments will \nnot be returned ( i.e., not probable of being returned). As such, the maintenan ce deposit payments made by \nAirline A after the second engine overhaul would not be considered deposit assets (as they are less than \nprobable of being returned to Airline A) and should be accounted for as variable lease payments. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 236}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 225 To determine whether it is probable that the deposit will be refunded, entities should use the second definition \nof probable in the ASC Master Glossary, which states that “the future events are likely to occur.” This is the \nsame threshold of probability th at is used in ASC 450 with respect to loss contingencies . \n4.8.8 Lessee accounting for costs to prepare an asset for its intended use or to \ndeliver the asset to the location of its intended use \nA lessee may incur certain costs to prepare an asset for its intended use or to deliver the asset to the \nlocation of its intended use. Questions have arisen about how a lessee accounts for such costs when paid \nto a third party (other than the lessor) or when the lessee performs the work itself. \nIn response to a tech nical inquiry, the FASB staff said that such costs are not initial direct costs because \nthey do not represent costs incurred prior to lease inception that are directly attributable to negotiating \nand arranging a lease (refer to section 2.6, Initial direct costs ). However, the FASB staff believes if no \nother GAAP applies to such costs, it would be permissible for a lessee to make an accounting policy \nelection to analogize to the guidance in ASC 360-10 on accounting for costs to bring an asset to the \nconditio n and location necessary for its intended use or to expense the costs as incurred. A lessee should \napply its accounting policy election consistently to all leases and should disclose its accounting policy, if \nmaterial. A lessee that analogizes to the guida nce in ASC 360-10 capitalizes such costs if the activities \nare consistent with the ASC 360-10 glossary definition of activities necessary to bring an asset to the \ncondition and location necessary for its intended use. In a speech,9 a member of the SEC sta ff reiterated \nthe views expressed by the FASB staff. \nNote that the FASB technical inquiry did not address costs paid to the lessor. Those costs are accounted \nfor as consideration in the contract (refer to section 1.4.3.1, Determining the consideration in t he \ncontract — lessees ) or as part of a variable payment not based on an index or rate (refer to section 2.9.1, \nLessee accounting for variable lease payments ). \n4.8.9 Capitalization thresholds \nConsistent with the discussion in the Basis for Conclusions (BC 122) of ASU 2016 -02, we expect that \nentities may adopt a reasonable capitalization threshold below which ROU assets and lease liabilities will not \nbe recognized on the balance sheet. We believ e it also may be acceptable for an entity to adopt a policy to \nrecognize lease liabilities, but not recognize the related ROU asset on the balance sheet ( i.e., a lessee would \nexpense the amount that otherwise would be recognized as the ROU asset at lease c ommencement). \nAlthough the Board acknowledged in BC 122 that an entity’s practice of adopting a capitalization \nthreshold for leases may be consistent with its accounting policies in other areas of GAAP such as \npurchases of property, plant and equipment (PP &E), we believe it would be inappropriate for entities to \ndefault to using an existing threshold for PP&E because the established threshold does not consider the \neffect of not recognizing liabilities. Because previously established capitalization threshold s did not \ncontemplate the non -recognition of the additional asset class introduced by ASC 842 ( i.e., the ROU \nasset), entities may need to consider whether their previously established capitalization thresholds in \nother areas of GAAP remain appropriate. Ent ities also should consider implications on internal control \nover financial reporting when establishing or re -evaluating a capitalization threshold. \n \n9 Speech by And rew W. Pidgeon, 10 December 2018. Refer to the SEC website at https://www.sec.gov/news/speech/speech -\npidgeon -121018 . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 237}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 226 4.8.10 Exit or disposal cost obligations under ASC 420 ( ‘cease -use’ liabilities) \nExcerpt from Accounting S tandards Codification \nExit or Disposal Cost Obligations — Overall \nScope and Scope Exceptions \nTransactions \n420-10-15-3 \nThe guidance in the Exit or Disposal Cost Obligations Topic applies to the following transactions \nand activities: \na. Termination benefits provided to current employees that are involuntarily terminated under the \nterms of a benefit arrangement that, in substance, is not an ongoing benefit arrangement or an \nindividual deferred compensation contract (referred to as one-time employee termination benefits ) \nb. Costs to terminate a contract that is not a lease (see paragraphs 420 -10-25-11 through 25 -13 \nfor further description of contract termination costs and paragraph 84 2-20-40-1 for terminations \nof a lease) \nc. Costs to consolidate facilities or relocate employees \nd. Costs associated with a disposal activity c overed by Subtopic 205 -20 \ne. Costs associated with an exit activity, including exit activities associated with an entity newly \nacquired in a business combination or an acquisition by a not -for-profit entity . \n \nThe leases standard amended ASC 420 to exclude costs to terminate a contra ct that is a lease from the \nscope of that guidance. However, the amended guidance in ASC 420 does not specify whether the non -\nlease component in a contract that contains both a lease and non -lease component continues to be subject \nto ASC 420. \nA lessee that makes the policy election to account for a lease component of a contract and its associated \nnon-lease components as a single lease component allocates all of the contract consideration to the lease \ncomponent (refer to section 1.4.2.3, Practical expedient to not separate lease and non -lease components — \nlessees ), and the lease and associated non -lease components are accounted for as a single lease component \nunder ASC 842. In this case, a lessee does not apply ASC 420 to that contract because leases are excluded \nfrom the scope of ASC 420. Refer to section 11.2.8, Practical expedient to not separate lease and non -lease \ncomponents , for further discussion of how an entity may elect to apply the practical expedient to c ombine \nlease and non -lease components for its existing leases when it transitions to the new leases standard. \nA lessee that does not make the policy election to combine the lease and associated non -lease components \nfollows the guidance in ASC 842 to account for the lease component and other applicable guidance to \naccount for the non -lease component. As such, we believe lessees should consider the guidance in ASC 420 \nfor exit or disposal costs associated with the non -lease component. \n4.8.11 R&D activities \nA lessee may use a n underlying asset in performing research and development (R&D) activities. Under \nASC 730, Research and Development , materials, equipment and facilities that are acquired or \nconstructed and intangi ble assets purchased from others for R&D activities are capitalized and \ndepreciated/amortized if they have alternative future use. If an entity cannot identify alternative future \nuse, the costs of those items have no separate economic value and are conside red R&D costs that are ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 238}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 227 expensed when incurred. Questions have arisen about whether the guidance in ASC 730 should be \napplied to ROU assets recognized under ASC 842. \nWe believe there are two acceptable approaches to the accounting for an operating lease ROU asset \nrelated to PP&E used in R&D activities: \n• Approach A: A lessee applies the guidance in ASC 730 to the operating lease ROU asset. As a result, \nan operating lease ROU asset with no alternative future use would be expensed immediately. \n• Approach B: A less ee does not apply the guidance in ASC 730 to an operating lease ROU asset. Instead, \nthe lessee applies the subsequent measurement and expense recognition guidance in ASC 842. In \naccordance with ASC 842, a lessee also determines whether its ROU asset is imp aired under ASC 360-10. \nRefer to section 4.2.5, Impairment of right -of-use assets in operating leases , for further discussion. \nA lessee should apply its accounting policy election consistently to all operating lease ROU assets and \nshould disclose its accounting policy, if material. \nWe believe finance lease ROU assets related to PP&E used in R&D activities should be accounted for in a \nmanner similar to purchased PP&E. That is, we believe a lessee should apply the guidance in ASC 730 to \nfinance lease ROU assets. \n4.8.12 Lessee accounting for entities in bankruptcy \nLessees that file for Chapter 11 bankruptcy protection continue to app ly ASC 842 when accounting for \nleases during and upon emergence from bankruptcy. Additional consideration should be given to the \nguidance in ASC 852 and ASC 805 upon emergence, due to the special requirements of ASC 852 related \nto emerging from bankruptcy and applying fresh -start accounting. \nRefer to sections 2.16, Leases ; 3.9.9, Leases ; and 4.4.1, Leases , of our FRD, Bankruptc ies, liquidations \nand quasi -reorganizations , for further discussion on accounting considerations for lessees before, during \nand upon emergence from bankruptcy, respectively. \n4.8.13 Lessee accounting for contract manufacturing arrangeme nts \n(added August 2022) \nAs discussed in section 1.4.2.3, Practical expedient to not separate lease and non -lease components — \nlessees , when a contract manufacturing arrangement contains a lease , the lessee generally is not \npurchas ing inventory . Instead, the lessee is produc ing inventory with the leased asset ( e.g., a \nmanufacturing facility, identified equipment ) and the associated manufacturing service provided by the \nlessor/ contract manufacturer . As such, certain costs associated with the lease and non -lease \ncomponents in a contract manufacturing arrangement may be capitalizable as inventory under ASC 330. \n4.9 Presentation (updated August 2022 ) \nExcerpt from Accounting Standards Codification \nLeases — Lessee \nOther Presentation Matters \nStatement of Financial Position \n842-20-45-1 \nA lessee shall either present in the statement of financial position or disclose in the notes all of the \nfollowing: \na. Finance lease right -of-use assets and operating lease right -of-use assets separately from each \nother and from other assets \nb. Finance lease liabilities and operating lease liabilities separately from each other and from ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 239}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 228 other liabilities. \nRight -of-use assets and lease liabilities shall be subject to the same considerations as other \nnonfinancial assets and financial liabilities in classifying them as current and noncurrent in classified \nstatements of financial position. \n842-20-45-2 \nIf a lessee does not present finance lease and operating lease right -of-use assets and lease liabilities \nseparately in the statement of fi nancial position, the lessee shall disclose which line items in the \nstatement of financial position include those right -of-use assets and lease liabilities. \n842-20-45-3 \nIn the statement of financial position, a lessee is prohibited from presenting both of the following: \na. Finance lease right -of-use assets in the same line item as operating lease right -of-use assets \nb. Finance lease liabilities in the same line item as operating lease liabilities. \nStatement of Comprehensive Income \n842-20-45-4 \nIn the stateme nt of comprehensive income, a lessee shall present both of the following: \na. For finance leases , the interest expense on the lease liability and amortization of the right -of-use \nasset are not required to be presented as separate line items and shall be pre sented in a manner \nconsistent with how the entity presents other interest expense and depreciation or amortization \nof similar assets, respectively \nb. For operating leases , lease expense shall be included in the lessee’s income from continuing \noperations. \nStatement of Cash Flows \n842-20-45-5 \nIn the statement of cash flows, a lessee shall classify all of the following: \na. Repayments of the principal portion of the lease liability arising from finance leases within \nfinancing activities \nb. Interest on the lease liability arising from finance leases in accordance with the requirements \nrelating to interest paid in Topic 230 on cash flows \nc. Payments arising from operating leases within operating activities, except to the extent that those \npayments represent costs t o bring another asset to the condition and location necessary for its \nintended use, which should be classified within investing activities \nd. Variable lease payments and short -term lease payments not included in the lease liability within \noperating activit ies. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 240}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 229 The following table summarizes how lease -related amounts and activities are presented in lessees’ \nfinancial statements. \nFinancial statement Lessee presentation \nBalance sheet • Finance leases: \n• ROU assets presented either: \n• Separately from other assets ( e.g., owned assets) and separately from \noperating lease ROU assets \n• Together with other assets and separate from operating lease ROU \nassets, with disclosures of the balance sheet line items that include \nfinance lease ROU assets \n• Lease liabilities pr esented either: \n• Separately from other liabilities and separately from operating lease \nliabilities \n• Together with other liabilities and separate from operating lease \nliabilities, with disclosure of the balance sheet line items that include \nfinance lease liab ilities and their amounts \n• Operating leases: \n• ROU assets presented either: \n• Separately from other assets ( e.g., owned assets) and separately from \nfinance lease ROU assets \n• Together with other assets and separate from finance lease ROU \nassets, with disclosures of the balance sheet line items that include \noperating lease ROU assets \n• Lease liabilities presented either: \n• Separately from other liabilities and separately from finan ce lease \nliabilities \n• Together with other liabilities and separate from finance lease \nliabilities, with disclosure of the balance sheet line items that include \noperating lease liabilities and their amounts \nIncome statement • Finance leases: \n• Lease -related amortization and lease -related interest expense are not required \nto be presented as separate line items and should be presented in a manner \nconsistent with how the entity presents depreciation and amortization of \nsimilar assets and other inte rest expense. However, lease -related amortization \nand lease -related interest expense cannot be combined in the same line item. \n• Operating leases: \n• Lease expense is included in income from continuing operations. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 241}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 230 Financial statement Lessee presentation \nStatement of cash flows • Finance leases: \n• Cash payments for the principal portion of the lease liability are presented \nwithin financing activities . \n• Cash payments for the interest portion are presented in accordance with \nASC 230, Statement of Cash Flows . \n• Operating leases: \n• Cash payments for lease pa yments are presented within operating \nactivities, except for payments that represent costs to bring another asset \nto the condition and location necessary for its intended use, which are \npresented within investing activities. \n• We believe c hanges in the lease liability and changes in the ROU asset \nshould be separately presented as adjustments to net income within \noperating activities. For example, a decrease in the ROU asset would be a \nnoncash increase to net income. A lessee should present s uch amounts \ngross in the statement of cash flows or provide proper disclosure, if presented \nnet. A lessee should appropriately label such adjustments in the statement \nof cash flows ( e.g., changes in the ROU asset could be described as \nnoncash lease expense, but should not b e labeled as amortization expense) . \n• Both types of leases: \n• Lease payments for short -term leases not recognized on the balance sheet \nand variable lease payments (not included in the lease liability) are \npresented within operating activities. \n• Noncash activity (e.g., the initial recognition of the lease at \ncommencement) is disclosed as a supplemental noncash item (refer to \nsection 4.10.1, Supplemental noncash information ). \nThe following example illustrates the cash flow presentation for a lessee. \nIllustration 4 -13: Cash flow presentation for a lessee \nEntity L (lessee) enters into a three -year lease of office space that it concludes is an operating lease. The lease \ncommences at the beginning of Year 1. Entity L agrees to make the following annual payments at the end of each \nyear: $10,000 in Year 1, $12,000 in Year 2 and $14,000 in Year 3. For simplicity, there are no purchase options, \ninitial direct costs, payments to the lessor before the lease commencement date, variable payments based on an \nindex or rate, or lease incentives from the lessor. The initial measurement of the right -of-use asset and lease \nliability is $33,000 using a discount rate of 4.235%. Entity L uses its incremental borrowing rate because the rate \nimplicit in the lease cannot be readily determined. Entity L calculates that the annual straight -line lease expense is \n$12,000 per year [($10,000 + $12,000 + $14,000) ÷ 3]. \nA summary of Entity L’s accounting for the operating lease (assuming no changes due to reassessment, lease \nmodification or impairment) is as follows: \n Initial Year 1 Year 2 Year 3 \nCash lease payments: $ 10,000 (9) $ 12,000 $ 14,000 \nIncome statement: \nPeriodic lease expense (straight -line) (12,000) (1) (12,000) (12,000) \n(Accrued) prepaid rent for period $ (2,000) $ — $ 2,000 \nBalance sheet: \nLease liability $ (33,000) (6) $ (24,398) (7) $ (13,431) $ — \nRight -of-use asset \nLease liability $ 33,000 (13) $ 24,398 $ 13,431 $ — \n(Accrued) prepaid rent \n(cumulative) — (2,000) (2,000) — \n $ 33,000 (3) $ 22,398 (4) $ 11,43 1 $ — ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 242}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounti ng | 231 Immaterial differences may arise in the recomputation of amounts in the example above due to rounding. \nAt the same time it enters into the operating lease , Entity L (lessee) enters into a three -year lease of equipment that \nit concludes is a finance lease because the lease term is for a major part of the remaining economic life of the \nunderlying asset (also three years). Otherwise, the terms of th is lease ar e the same as those of the operating lease . \nThat is, t he finance lease commences at the beginning of Year 1. Entity L agrees to make the following annual \npayments at the end of each year: $10,000 in Year 1, $12,000 in Year 2 and $14,000 in Year 3. For sim plicity, \nthere are no purchase options, initial direct costs, payments to the lessor before the lease commencement date, \nvariable payments based on an index or rate, or lease incentives from the lessor. The initial measurement of the \nright -of-use asset and lease liability is $33,000 (present value of lease payments using a discount rate of 4.235%). \nEntity L uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. \nEntity L amortizes the right -of-use asset on a straight -line basis over the lease term. \nA summary of Entity L’s accounting for the finance lease (assuming no changes due to reassessment, lease \nmodification or impairment) is as follows: \n Initial Year 1 Year 2 Year 3 \nCash lease payments \nCash payments of principal \nCash payments of interest $ 10,000 \n 8,602 \n 1,398 (10) \n(8) \n(11) $ 12,000 \n 10,967 \n 1,033 $ 14,000 \n 13,431 \n 569 \nIncome statement \nInterest expense $ (1,398) $ (1,033) $ (569) \nAmortization expense (11,000) (5) (11,000) (11,000) \nTotal periodic expense $ (12,398) (2) $ (12,033) $ (11,569) \nBalance sheet \nLease liability $ (33,000) $ (24,398) $ (13,431) $ — \nRight -of-use asset $ 33,000 (12) $ 22,000 $ 11,000 $ — \n \nImmaterial differences may arise in the recomputation of amounts in the example above due to rounding. \nEntity L prepares the following rollfo rward of the ROU assets and lease liabilities for Year 1 in order to make sure cash \nand non -cash activities are pro perly identified and presented in the statement of cash flows: \n Operating lease Finance lease \n ROU asset Lease liability ROU asset Lease liability \nBeginning balance Year 1 \nNew lease $ — \n 33,000 $ — \n (33,000) $ — \n 33,000 $ — \n (33,000) \nChange in operating lease liability\* (8,602) 8,602 \nAccrued rent (2,000) \nROU asset amortization (11,000) \nInterest accretion (1,398) \nCash lease payments 10,000 \nEnding balance Year 1 $ 22,398 $ (24,398) $ 22,000 $ (24,398) \n\* This amount is to adjust the lease liability to the present value of the remaining lease payments with an offset to the right -of-\nuse asset ($10,000 – ($33,000 x 4.235%)) . \nFor simplicity, assume that Entity L does not have any other activity other than the opera ting and finance lease. Cash \nflow presentation for Year 1 is as follows: \nYear 1 \nOperating activities \nNet income $ (24,398) (1) + (2) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 243}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 232 Adjustments to reconcile net income to net cash used in operating \nactivities: \nNoncash operating lease expense 10,602 (3) - (4) \nROU asset amortization for finance lease 11,000 (5) \nChanges in operating assets and liabilities \nChange in operating lease liabilit y (8,602) (6) - (7) \nNet cash used in operating activities (11,398) \nInvesting activities \nInvesting activities — \nNet cash provided by (used in) investing activities — \n \nFinancing activities \nPayments on principal portion of finance lease obligation (8,602) (8) \nNet cash used in financing activities (8,602) \n \nNet decrease in cash, cash equivalents and restricted cash (20,000) (9) + (10) \nCash, cash equivalents and restricted cash at beginning of year - \nCash, cash equivalents and restricted cash at end of year $ (20,000) \n \nSupplemental disclosures: \nCash paid for interest (230-10-50-2) (1,398) (11) \nNoncash recognition of new leases ( ASC 842-20-50-4(g)(2) ) 66,000 (12) + (13) \n \n \n4.9.1 Presentation of ROU assets and lease liabilities in classified balance sheets \nConsistent with the classification of property , plant and equipment , and other assets that are depreciated \nor amortized, we believe right -of-use assets generally shou ld be classified as a single noncurrent asset . \nWe believe a les see should classify current and noncurrent portions of its lease liabilities consistent with \nthe guidance in ASC 210, Balance Sheet . Under that guidance, current liabilities include liabilities whose \nliquidation is expected to occur within 12 months (or op erating cycle, if longer). For example, we believe \none acceptable approach is for a lessee to determine the current and noncurrent portions of its lease \nliabilities as follows : \n• Calculate the current liability as the present value of lease payments to be ma de within 12 months \n(or operating cycle, if longer) from the balance sheet date . \n• Calculate t he noncurrent liability as the portion of the lease liability to be paid following 12 months (or \noperating cycle, if longer) from the balance sheet date ( i.e., the difference between the total lease \nliability and the current portion). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 244}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 233 Illustration 4-14: Calculation of current and noncurrent lease liabilities in classified balance sheets \nManufacturer enters into a lease of equipment for its production line from Lessor . The lease \ncommences on 1 January 20X1 , has a lease term of 4 years and annual payments of $100 due in \narrears . Manufacturer determines the current portion of its lease liability based on payments to be \nmade within the next 12 months. \nAfter the initial payment on 31 December 20X1, Manufacturer calculates its remaining lease liability at \n31 D ecember 20X1, 20X2 and 20X3 , using its IB R at lease commencement of 6%: \n 20X1 20X2 20X3 \nTotal l ease liability $ 267 $ 183 $ 94 \nAnalysis: Manufacturer determines the current and noncurrent portions of its lease liabilit y for the \nyear ended 31 December 20X1 as follows : \n• The current liability is calculated as the present value of lease payments to be made within \n12 months (present value of $100 due at the end of year 2, discounted at the IBR of 6% = $94 ). \n• The noncurrent liability is the difference between the total lease liability and the current portion \n($267 less $94 current portion = $17 3). \n4.9.2 Other presentation matters \nIn certain situations , the carrying amount of an ROU asset may be reduced below zero (i.e., the ROU asset \nhas a negative carrying amount) . For example, this may occur if the only lease payments are variable \nlease payments that do not depend on an index or rate and the lessee receives a lease incentive ( e.g., an \nup-front cash payment from the lessor) upon executing a lease. That’s because the incentive is deducted \nfrom the carrying amount of the ROU asset, which would otherwise be zero when there are only variable \nlease payments that do not depend on an index or rate. ASC 842 does not address the presentation of an \nROU asset that is reduced below zero. We believe these ROU asset s should be reclassified and presented \nas liabilit ies, separate from any related lease liabilit y. However, t his presentation guidance does not appl y \nwhen a lease liability is remeasured upon certain lease modification s or other lease liability remeasurement \nevent s and the corresponding ROU asset is reduced to zero. In those cases, any remaining amount of the \nremeasurement is recognized in profit or l oss (refer to section 4.5 , Remeasurement of lease liabilities \nand right -of-use assets – operating and finance leases ). \n4.10 Disclosure (updated August 2023) \nThe objective of lessee disclosures is to enable financial statement users to assess the amount, timing \nand uncertainty of cash flows arising from leases. ASC 842 requires a lessee to disclose quantitative and \nqualitative information about its leases, the significant judgments and assumptions made in applying \nASC 842 and the amounts recognized in the financial statements related to those leases. ASC 842 does not \nrequire a specific format for lessees’ quantitative disclosures but includes an example in a tabular format. \nLessees may need to exercise judgment to determine the appropriate level at which to aggregate or \ndisaggregate disclosures so that meaningful info rmation is not obscured by insignificant details or by \ngroupings of items with different characteristics. The disclosure requirements apply to all entities. \nAfter the year of adoption ( e.g., 2020 for a calendar -year entity that adopts on 1 January 2019), t here \nare no required interim period lessee disclosures. However, a lessee should evaluate whether it needs to \nmake additional interim disclosures under ASC 270, Interim Reporting , and Article 10 of Regulation S -X \nfor SEC registrants (also refer to ASC 270-10-S99-1). For example, a lessee may include interim lease \ndisclosures that are consistent with its annual financial statements if its leasing activities are significant \nor if there are significant events or changes in its leasing activities during the int erim period. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 245}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 234 When the useful life of leasehold improvements to the common control group exceeds the lease term, a \nlessee is required to disclose the unamortized balance of the leasehold improvements at the balance sheet \ndate, their remaining useful life to the common control group and the remaining lease term. We believe \nthat the disclosures on remaining useful life and lease term can be provided on a weighted -average basis \n(as applicable) by class of underlying asset. Refer to section 4.7.3.4, Lessee amort ization of leasehold \nimprovements associated with a lease between entities under common control for further details. \nASC 842 includes the following disclosure requirements for lessees. \nExcerpt from Accounting Standards Codification \nStatement of Cash Flows — Overall \nDisclosure \nNoncash Investing and Financing Activities \n230-10-50-3 \nInformation about all investing and financing activities of an entity during a period that affect \nrecognized assets or liabilities but that do not result in cash receipts or cash payments in the period \nshall be disclosed. Those disclosures may be either narrative or summarized in a schedule, and they \nshall clea rly relate the cash and noncash aspects of transactions involving similar items. \nLeases — Lessee \nDisclosure and Implementation Guidance and Illustrations \n842-20-50-1 \nThe objective of the disclosure requirements is to enable users of financial statements to assess the \namount, timing, and uncertainty of cash flows arising from leases . To achieve that objective, a lessee \nshall disclose qualitative and quantitative informa tion about all of the following: \na. Its leases (as described in paragraphs 842 -20-50-3(a) through (b) and 842 -20-50-7 through 50 -10) \nb. The significant judgments made in applying the requirements in this Topic to those leases (as \ndescribed in paragraph 8 42-20-50-3(c)) \nc. The amounts recognized in the financial statements relating to those leases (as described in \nparagraphs 842 -20-50-4 and 842 -20-50-6). \n842-20-50-2 \nA lessee shall consider the level of detail necessary to satisfy the disclosure objective and how much \nemphasis to place on each of the various requirements. A lessee shall aggregate or disaggregate \ndisclosures so that useful information is not obscured by including a large amount of insignificant \ndetail or by aggregating items that h ave different characteristics. \n842-20-50-3 \nA lessee shall disclose all of the following: \na. Information about the nature of its leases, including: \n1. A general description of those leases. \n2. The basis and terms and conditions on which variable lease payme nts are determined. \n3. The existence and terms and conditions of options to extend or terminate the lease. A lessee \nshould provide narrative disclosure about the options that are recognized as part of its right -\nof-use assets and lease liabilities and those that are not. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 246}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 235 4. The e xistence and terms and conditions of residual value guarantees provided by the lessee. \n5. The restrictions or covenants imposed by leases, for example, those relating to dividends or \nincurring additional financial obligations. \nA lessee should identify the information relating to subleases included in the disclosures provided in \n(1) through (5), as applicable. \nb. Information about leases that have not yet commenced but that create significant rights and \nobligations for the lessee, including the nature of any involvement with the construction or design \nof the underlying asset . \nc. Information about significant assumptions and judgments made in applying the requirements of \nthis Topic, which may include the following: \n1. The determination of whether a contract contains a lease (as described in paragraphs 842 -\n10-15-2 through 15 -27) \n2. The allocation of the consideration in a contract between lease and nonlease components (as \ndescribed in paragraphs 842 -10-15-28 through 15 -32) \n3. The determination of the discount rate for the lease (as described in paragraphs 842 -20-30-2 \nthrough 30 -4). \n842-20-50-4 \nFor each period presented in the financial statements, a lessee shall disclose the following amounts \nrelating to a lessee’s total lease cost, which includes both amounts recognized in profit or loss during \nthe period and any amounts capitalized as part of the cost of another asset in accordance with other \nTopics, and the cash flows arising from lease transactions: \na. Finance lease cost, segregated between the amortization of the right -of-use assets and interest \non the lease liabilities. \nb. Operating lease cost determined in accordance with paragraphs 842 -20-25-6(a) and 842 -20-25-7. \nc. Short -term lease cost, excluding expenses relating to leases with a lease term of one month or \nless, determined in accordance with paragraph 842 -20-25-2. \nd. Variable lease cost determined in accordance with paragraphs 842 -20-25-5(b) and 842 -20-25-6(b). \ne. Sublease income, disclosed on a gross basis, separ ate from the finance or operating lease expense. \nf. Net gain or loss recognized from sale and leaseback transactions in accordance with paragraph \n842-40-25-4. \ng. Amounts segregated between those for finance and operating leases for the following items: \n1. Cash paid for amounts included in the measurement of lease liabilities, segregated between \noperating and financing cash flows \n2. Supplemental noncash information on lease liabilities arising from obtaining right -of-use assets \n3. Weighted -average remaining lease term \n4. Weighted -average discount rate. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 247}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 236 Pending Content: \nTransition Date: (P) December 16, 2023; (N) December 16, 2023 | Transition Guidance: 842 -10-65-8 \nLeases — Lessee \nSubsequent Measurement \n842-20-50-7A \nWhen the useful life of leasehold improvements to the common control group determined in \naccordance with paragraph 842 -20-35-12A exceeds the related lease term, a lessee shall disclose the \nfollowing information: \na. The unamortized balance of the leasehold improvements at the balance sheet date \nb. The remaining useful life of the leasehold improvements to the common control group \nc. The remaining lease term. \n842-20-55-11 \nThe lessee should calculate the weighted -average remaining lease term on the basis of the remaining \nlease term and the lease liability balance for each lease as of the reporting date. \n842-20-55-12 \nThe lessee should calculate the weighted -average discount rate on the basis of both of the following: \na. The discount rate for the lease that was used to calculate the lease liability balance for each \nlease as of the reporting date \nb. The remaining balance of the lease payments for each lease as of the reporting date. \n842-20-55-53 \nThe following Example illustrates how a lessee may meet the quantitative disclosure requirements in \nparagraph 842 -20-50-4. \n Year Ending December 31, \n 20X2 20X1 \nLease cost \nFinance lease cost: $ XXX $ XXX \nAmortization of right -of-use assets XXX XXX \nInterest on lease liabilities XXX XXX \nOperating lease cost XXX XXX \nShort -term lease cost XXX XXX \nVariable lease cost XXX XXX \nSublease income (XXX ) (XXX ) \nTotal lease cost $ XXX $ XXX \n \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 248}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 237 Other information \n(Gains) and losses on sale and leaseback transactions, net $ (XXX) $ XXX \nCash paid for amounts included in the measurement of \nlease liabilities XXX XXX \nOperating cash flows from finance leases XXX XXX \nOperating cash flows from operating leases XXX XXX \nFinancing cash flows from finance leases XXX XXX \nRight -of-use assets obtained in exchange for new finance \nlease liabilities XXX XXX \nRight -of-use assets obtained in exchange for new operating \nlease liabilities XXX XXX \nWeighted -average remaining lease term — finance leases XX years XX years \nWeighted -average remaining lease term — operating leases XX years XX years \nWeighted -average discount rate — finance leases X.X% X.X% \nWeighted -average discount rate — operating leases X.X% X.X% \n842-20-50-6 \nA lessee shall disclose a maturity analysis of its finance lease liabilities and its operating lease liabilities \nseparately, showing the undiscounted cash flows on an annual basis for a minimum of each of the first \nfive years and a total of the amounts for the remaining years. A lessee shall disclose a reconciliation of \nthe undiscounted cash flows to the finance lease liabilities and operating lease liabilities recognized in \nthe statement of financial position. \n842-20-50-7 \nA lessee shall disclose lease transactions between related parties in accordance with paragraphs 850 -\n10-50-1 through 50 -6. \n842-20-50-8 \nA lessee that accounts for short -term leases in accordance with paragraph 842 -20-25-2 shall disclose that \nfact. If the short -term lease expense for the period does not reasonably reflect the lessee’s short -term \nlease commitments, a lessee shall disclose th at fact and the amount of its short -term lease commitments. \n842-20-50-9 \nA lessee that elects the practical expedient on not separating lease components from nonlease \ncomponents in paragraph 842 -10-15-37 shall disclose its accounting policy election and which class or \nclasses of underlying assets it has elected to apply the practical expedient. \n842-20-50-10 \nA lessee that makes the accounting policy election in paragrap h 842 -20-30-3 to use a risk -free rate as \nthe discount rate shall disclose its election and the class or classes of underlying assets to which the \nelection has been applied. \n4.10.1 Supplemental noncash information \nASC 842-20-50-4(g) requires a lesse e to disclose supplemental nonc ash information for lease liabilities \narising from new right -of-use assets . Consistent with the ASC 230’s guidance that requires disclosure of \nall noncash investing and financing activities, in addition to the noncash disclosures for the initial \nrecognition of a new lease, a lessee should also make disclosures for other noncash changes to lease \nbalances , including modifications (refer to section 4.6, Lease modifications ) and r emeasurement of the \nlease liabilities and right -of-use assets , including those resulting from a reassessment of the lease term \nand purchase options (refer to section s 4.5, Remeasurement of lease liabilities and right -of-use assets — \noperating and finance leases , and 2 .3.6, Reassessment of the lease term and purchase options ). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 249}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 238 For example, a lessee would disclose noncash changes related to an increase in the right -of-use asset resulting \nfrom a reassessment event where there is an increase in the lease term (refer to sec tion 2.3.6 .1, Reassessment \nof the lease term and purchase options — lessees , for more discussion on lessee reassessment events ). \n4.11 Lessee illustrations \nExcerpt from Accounting Standards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \nExample 23 —Lessee Purchase Option \n842-10-55-211 \nLessee enters into a 5-year lease of equipment with annual lease payments of $59,000, payable at the \nend of each year. There are no initial direct costs incurred by Lessee or lease incentives. At the end of \nYear 5, Lessee has an option to purchase the equipment for $5,000. The expected residual value of \nthe equipment at the end of the lease is $75,000. Because the exercise price of the purchase option is \nsignificantly discounted from the expected fair value of the equipment at the time the purchase option \nbecomes exercisable , Lessee concludes that it is reasonably certain to exercise the purchase option. \nThe fair value of the equipment at the commencement date is $250,000, and its economic life is 7 \nyears. The discount rate for the lease, which is Lessee’s incremental borrowi ng rate because the rate \nimplicit in the lease is not available, is 6.5 percent. \n842-10-55-212 \nBecause the lease grants Lessee an option to purchase the underlying asset that it is reasonably \ncertain to exercise, Lessee classifies the lease as a finance le ase. \n842-10-55-213 \nLessee recognizes the lease liability at the commencement date at $248,834 (the present value of 5 \npayments of $59,000 + the present value of the $5,000 payment for the purchase option, discounted \nat 6.5%). Because there are no initial direct costs, lease incentives, or other payments made to Lessor \nat or before the commencement date, Lessee recognizes the right -of-use asset at the same amount as \nthe lease liability. \n842-10-55-214 \nLessee amortizes the right -of-use asset over the seven -year expected useful life of the equipment, \nrather than over the lease term of five years, because Lessee is reasonably certain to exercise the \noption to purchase the equipment. Lessee depreciates its owned assets on a straight -line basis. \nTherefore, the right -of-use asset is amortized on a straight -line basis. \n842-10-55-215 \nDuring the first year of the lease, Lessee recognizes interest expense on the lease liability of $16,174 \n(6.5% × $248,834) and amortization of the right -of-use asset of $35,548 ($ 248,834 ÷ 7). \n842-10-55-216 \nAt the end of Year 1, the right -of-use asset is $213,286 ($248,834 — $35,548), and the lease liability \nis $206,008 ($248,834 + $16,174 — $59,000). \n842-10-55-217 \nAt the end of Year 5, the carrying amount of the right -of-use asset is $71,094 ($248,834 — [$35,548 \n× 5]), and the remaining lease liability is $5,000, which is the exercise price of the purchase option. \nLessee exercises the purchase option and settles the remaining lease liability. If the right -of-use a sset \nwas not previously presented together with property, plant, and equipment, Lessee reclassifies the \nright -of-use asset to property, plant, and equipment and applies Topic 360 to the asset beginning on \nthe date the purchase option is exercised. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 250}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 239 Leases — Lessee \nImplementation Guidance and Illustrations \nExample 3 —Initial and Subsequent Measurement by a Lessee and Accounting for a Change in the \nLease Term \nCase A —Initial and Subsequent Measurement of the Right -of-Use Asset and the Lease Liability \n842-20-55-22 \nLessee enters into a 10 -year lease of an asset, with an option to extend for an additional 5 years. \nLease payments are $50,000 per year during the initial term and $55,000 per year during the \noptional period, all payable at the beginning of each year. Lessee incurs initial direct costs of $15,000. \n842-20-55-23 \nAt the commencement date, Lessee concludes that it is not reasonably c ertain to exercise the option \nto extend the lease and, therefore, determines the lease term to be 10 years. \n842-20-55-24 \nThe rate implicit in the lease is not readily determinable. Lessee’s incremental borrowing rate is 5.87 \npercent, which reflects the fix ed rate at which Lessee could borrow a similar amount in the same \ncurrency, for the same term, and with similar collateral as in the lease at the commencement date. \n842-20-55-25 \nAt the commencement date, Lessee makes the lease payment for the first year, i ncurs initial direct costs, \nand measures the lease liability at the present value of the remaining 9 payments of $50,000, discounted at \nthe rate of 5.87 percent, which is $342,017. Lessee also measures a right -of-use asset of $407,017 (the \ninitial measurem ent of the lease liability plus the initial direct costs and the lease payment for the first year). \n842-20-55-26 \nDuring the first year of the lease, Lessee recognizes lease expense depending on how the lease is \nclassified. Paragraphs 842-20-55-27 through 55 -30 illustrate the lease expense depending on \nwhether the lease is classified as a finance lease or as an operating lease. \nIf the Lease Is Classified as a Finance Lease \n842-20-55-27 \nLessee depreciates its owned assets on a straight -line basis. Therefore, the right -of-use asset would be \namortized on a straight -line basis over the 10 -year lease term. The lease liability is increased to reflect \nthe Year 1 interest on the lease liability in accordance with the interest method. As such, in Year 1 of \nthe lease, Lessee recognizes the amortization expense of $40,702 ($407,017 ÷ 10) and the interest \nexpense of $20,076 (5.87% × $342,017). \n842-20-55-28 \nAt the end of the first year of the lease, the carrying amount of Lessee’s lease liability is $ 362,093 \n($342,017 + $20,076), and the carrying amount of the right -of-use asset is $366,315 ($407,017 — \n$40,702). \nIf the Lease Is Classified as an Operating Lease \n842-20-55-29 \nLessee determines the cost of the lease to be $515,000 (sum of the lease payment s for the lease term \nand initial direct costs incurred by Lessee). The annual lease expense to be recognized is therefore \n$51,500 ($515,000 ÷ 10 years). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 251}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 240 842-20-55-30 \nAt the end of the first year of the lease, the carrying amount of Lessee’s lease liability is $362,093 \n($342,017 + $20,076), and the carrying amount of the right -of-use asset is $375,593 (the carrying \namount of the lease liability plus the remaining initial direct costs, which equal $13,500). \nCase B —Accounting for a Change in the Lease Term \n842-20-55-31 \nAt the end of Year 6 of the lease, Lessee makes significant leasehold improvements. Those \nimprovements are expected to have significant economic value for Lessee at the end of the original \nlease term of 10 years. The improvements result in the un derlying asset having greater utility to \nLessee than alternative assets that could be leased for a similar amount and that are expected to have \nsignificant economic life beyond the original lease term. Consequently, construction of the leasehold \nimprovemen ts is deemed a significant event or significant change in circumstances that directly \naffects whether Lessee is reasonably certain to exercise the option to extend the lease and triggers a \nreassessment of the lease term. Upon reassessing the lease term, at the end of Year 6, Lessee \nconcludes that it is reasonably certain to exercise the option to extend the lease for five years. Taking \ninto consideration the extended remaining lease term, Lessee’s incremental borrowing rate at the end \nof Year 6 is 7.83 perc ent. As a result of Lessee’s remeasuring the remaining lease term to nine years, \nLessee also would remeasure any variable lease payments that depend on an index or a rate; however, \nin this Example, there are no variable lease payments that depend on an ind ex or a rate. In accordance \nwith paragraph 842 -10-25-1, Lessee reassesses the lease classification as a result of the change in \nthe lease term. Assume for purposes of this Example that the reassessment does not change the \nclassification of the lease from t hat determined at the commencement date. \n842-20-55-32 \nAt the end of Year 6, before accounting for the change in the lease term, the lease liability is \n$183,973 (present value of 4 remaining payments of $50,000, discounted at the rate of 5.87 \npercent). Less ee’s right -of-use asset is $162,807 if the lease is classified as a finance lease or \n$189,973 if the lease is classified as an operating lease (the balance of the remeasured lease liability \nat the end of Year 6 plus the remaining initial direct costs of $6 ,000). \n842-20-55-33 \nLessee remeasures the lease liability, which is now equal to the present value of 4 payments of \n$50,000 followed by 5 payments of $55,000, all discounted at the rate of 7.83 percent, which is \n$355,189. Lessee increases the lease liability by $171,216, representing the difference between the \nremeasured liability and its current carrying amount ($355,189 — $183,973). The corresponding \nadjustment is made to the right -of-use asset to reflect the cost of the additional rights. \n842-20-55-34 \nFollowing the adjustment, the carrying amount of Lessee’s right -of-use asset is $334,023 if the lease \nis a finance lease (that is, $162,807 + $171,216) or $361,189 if the lease is an operating lease (that \nis, $189,973 + $171,216). \n 842-20-55-35 \nLesse e then makes the $50,000 lease payment for Year 7, reducing the lease liability to $305,189 \n($355,189 — $50,000), regardless of how the lease is classified. \n842-20-55-36 \nLessee recognizes lease expense in Year 7 as follows, depending on how the lease had b een classified \nat the commencement date. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 252}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 241 If the Lease Is Classified as a Finance Lease at the Commencement Date \n842-20-55-37 \nLessee depreciates its owned assets on a straight -line basis. Therefore, the right -of-use asset will be \namortized on a straight -line basis over the lease term. The lease liability will be reduced in accordance \nwith the interest method. As such, in Year 7 (the first year following the remeasurement), Lessee \nrecognizes amortization expense of $37,114 ($334,023 ÷ 9) and inter est expense of $23,896 (7.83% \n× $305,189). \nIf the Lease Is Classified as an Operating Lease at the Commencement Date \n842-20-55-38 \nLessee determines the remaining cost of the lease as the sum of the following: \na. The total lease payments, as adjusted for the r emeasurement, which is the sum of $500,000 (10 \npayments of $50,000 during the initial lease term) and $275,000 (5 payments of $55,000 during \nthe term of the lease extension); plus \nb. The total initial direct costs attributable to the lease of $15,000; minus \nc. The periodic lease cost recognized in prior periods of $309,000. \n842-20-55-39 \nThe amount of the remaining cost of the lease is therefore $481,000 ($775,000 + $15,000 — \n$309,000). Consequently, Lessee determines that the annual expense to be recognized throughout \nthe remainder of the lease term is $53,444 ($481,000 ÷ the remaining lease term of 9 years). \nExample 4 —Recognition and Initial and Subsequent Measurement by a Lessee in an Operating Lease \n842-20-55-41 \nLessee enters into a 10 -year lease for 5,000 square feet of office space. The annual lease payment is \n$10,000, paid in arrears, and increases 5 percent each year during the lease term. Lessee’s incremental \nborrowing rate at lease commencement is 6 percent. Lessee classifies the lease as an operating lease \nin accordance with paragraphs 842 -10-25-2 through 25 -3. Lessee incurs initial direct costs of $5,000. \n842-20-55-42 \nAt the commencement date, Lessee receives a $10,000 cash payment from Lessor that Lessee accounts \nfor as a l ease incentive. Lessee measures the lease liability at the present value of the 10 remaining lease \npayments ($10,000 in Year 1, increasing by 5 percent each year thereaf ter), discounted at the rate of 6 \npercent, which is $90,434. Lessee also measures a rig ht-of-use asset of $85,434 (the initial \nmeasurement of the lease liability + the initial direct costs of $5,000 — the lease incentive of $10,000). \n842-20-55-43 \nDuring the first year of the lease, Lessee determines the remaining cost of the lease as the sum of \nthe following: \na. The total lease payments of $115,779 (the sum of the 10 escalating payments to Lessor during the \nlease term of $125,779 − the lease incentive paid to Lessee at the commencement date of $10,000) \nb. The total initial direct costs attri butable to the lease of $5,000. \nThe amount of the remaining lease cost is therefore $120,779 ($115,779 + $5,000). Consequently, \nLessee determines that the single lease cost to be recognized every year throughout the lease term is \n$12,078 ($120,779 ÷ 10 yea rs). This assumes that there are no remeasurements of the lease liability \nor modifications to the lease throughout the lease term. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 253}), Document(page\_content='4 Lessee accounting \nFinancial reporting developments Lease accounting | 242 842-20-55-44 \nAt the end of Year 1, the carrying amount of the lease liability is $85,860 (9 remaining lease \npayments, discoun ted at the rate of 6 percent), and the carrying amount of the right -of-use asset is \nthe amount of the liability, adjusted for the following: \na. Accrued lease payments of $2,578 (the amount of payments to Lessor to be recognized as part \nof the single lease cost each year during the lease of $12,578 [total payments to Lessor of \n$125,779 ÷ 10 years] − the first year’s lease payment of $10,000) \nb. Unamortized initial direct costs of $4,500 (gross initial direct costs of $5,000 — amounts recognized \npreviously as part of the single lease cost of $500 [total initial direct costs of $5,000 ÷ 10 years]) \nc. The remaining balance of the lease incentive of $9,000 (gross lease incentive of $10,000 — \namounts recognized previously as part of the single lease cost of $1,000 [total lease incentives of \n$10,000 ÷ 10 years]). \nTherefore, at the end of Year 1, Lessee measures the right -of-use asset at the amount of $78,782 \n($85,860 — $2,578 + $4,500 — $9,000). \n842-20-55-45 \nAt the beginning of Year 2, Lessee determines the re maining cost of the lease to be $108,701 (the \ntotal lease payments of $115,779 + the total initial direct costs of $5,000 — the single lease cost \nrecognized in Year 1 of $12,078). The single lease cost to be recognized in Year 2 is still $12,078 \n($108,701 ÷ 9 years). For the purposes of the Example, only the first two years’ determination of the \nsingle lease cost are shown. However, the single lease cost will be determined in the same way as in \nYears 1 and 2 for the remainder of the lease and, in this Examp le, will continue to equal $12,078 \nevery period for the remainder of the lease term assuming that there are no remeasurements of the \nlease liability or modifications to the lease. \n842-20-55-46 \nAt the end of Year 2, the carrying amount of the lease liability is $80,511, and the carrying amount of \nthe right -of-use asset is $71,855 (the carrying amount of the lease liability of $80,511 — the accrued \nlease payments of $4,656 + the unamortized initial direct costs of $4,000 — the remaining balance of \nthe lease incentive received of $8,000). For the purposes of the Example, the subsequent \nmeasurement of the lease liability and the subsequent measurement of the right -of-use asset are \nshown only for the first two years. However, Lessee will continue to measu re the lease liability and the \nright -of-use asset for this lease in the same manner throughout the remainder of the lease term . \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 254}), Document(page\_content=' \nFinancial reporting developments Lease accounting | 243 5 Lessor accounting \nThe following chart provides an overview of the initial recognition and measurement o f sales -type, direct \nfinancing and operating leases , which are discussed in further detail in this section: \nSales -type leases\* Direct financing leases\* Operating leases \n• Collectibility is probable \n• Derecognize the \nunderlying asset \n• Recognize the net \ninvestment in the lease \n• Recognize any selling \nprofit or loss \n• Collectibility is not probable \n• Do not derecognize the \nunderlying asset \n• Account for lease \npayments received as a \ndeposit liability • Derecognize t he underlying \nasset \n• Recognize the net \ninvestment in the lease \n• Recognize any selling loss \n• Defer any selling profit and \ninclude it in the initial \nmeasurement of the net \ninvestment in the lease \n• Classify as an operating \nlease if collectibility is not \nprobable • Continue to recognize the \nunderlying asset \n• Collectibility assessment \naffects subsequent \nmeasurement \n\* If a lease arrangement includes significant variable lease payments that do not depend on an index or rate, the net investmen t in \nthe lease recognized may be lower than the carrying amount of the underlying asset at lease commencement. In these cases, the \ndifference between the initially recognized net investment in the lease and the carrying amount of the underlying asset \nderecognized is recognized as a selling loss . After the adoption of ASU 2021 -05, the existence of a selling loss in such situations , \nat lease commencement, would result in the lease being classified as an operating lease. Refer to section 3.2, Criteria for lease \nclassification – lessors . \nSales -type leases \nUnder ASC 842, there is no requirement for a sales -type lease to have selling profit or loss. Additionally, \na lessor does not assess the collectibility of lease payments and any residual value guarantee provided by \nthe lessee for purposes of evaluating whether a lea se is classified as a sales -type lease under ASC 842. \nHowever, a lessor has to assess the collectibility of these amounts when accounting for a sales -type \nlease. Specifically, if at lease commencement, the collectibility of lease payments and any residual value \nguarantee provided by the lessee is not probable, the lessor does not derecognize the underlying asset \nand instead recognizes lease payments received, including variable lease payments that do not depend \non an index or rate, as a deposit liability. R efer to section 5.2, Sales -type leases , for further discussion of \nthe accounting for sales -type leases under ASC 842. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 255}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 244 Direct financing leases \nSelling profit on a direct financing lease is deferred at lease commencement, while selling loss is always \nrecogni zed at lease commencement. The lease classification test is designed so that a lease can be \nclassified as a direct financing lease only when the lessor obtains a residual value guarantee from an \nunrelated third party other than the lessee and that guarante e is sufficient to satisfy the “substantially \nall” criterion discussed in section 3.2, Criteria for lease classification — lessors . Although a residual value \nguarantee from an unrelated third party other than the lessee can exist in a sales -type lease or a n \noperating lease, a lease without a residual value guarantee from an unrelated third party other than the \nlessee must be classified as either a sales -type lease or an operating lease. Refer to section 5.3, Direct \nfinancing leases , for further discussion o f the accounting for direct financing leases under ASC 842. \nLeveraged leases \nASC 842 eliminate d leveraged lease accounting for new leases and existing leases modified on or after \nthe standard’s effective date. Refer to section 5.7.5, Leveraged leases . \n5.1 Lessor accounting concepts \nAt lease commencement, lessors apply the key concepts described in section 2, Key concepts , such as \ndetermining the initial direct costs, lease term, lease payments, fair value of the underlying asset and the \nrate implicit in the lease. Lessors also apply the lessor accounting concepts in this section to recognize \nand measure their leases. \n5.1.1 Net investment in the lease \nExcerpt from Accounting Standards Codification \nMaster Glossary \nNet Investment in the Lease \nFor a sales -type lease , the sum of the lease receivable and the unguaranteed residual asset . \nFor a direct financing lease , the sum of the lease receivable and the unguaranteed residual asset, net \nof any deferred selling profit. \nLease Receivable \nA lessor’s right to receive lease payments arising from a sales -type lease or a direct financing lease \nplus any amount that a lessor expects to derive from the underlying asset following the end of the \nlease term to the extent that it is guaranteed by the lessee or any other third party unrelated to the \nlessor, measured on a discounted basis. \nUnguaranteed Residual Asset \nThe amount that a lessor expects to derive from the underlying asset following the end of the lease \nterm that is not guaranteed by the lessee or any other third party unrelated to the lessor, measured \non a discounted basis. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 256}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 245 A lessor’s net investment in a sales -type or a direct financing lease consists of the following: \n +\n =\n — =\n \n• Lease receivable — The lease receivable is (1) the lessor’s right to receive lease payments (refer to \nsection 2.4, Lease payments ) and (2) any amount a lessor expects to derive from the underlying \nasset at the end of the lease term that is guaranteed by the lessee or any oth er third party unrelated \nto the lessor ( i.e., the guaranteed residual asset), both discounted using the rate implicit in the lease. \n• Unguaranteed residual asset — The unguaranteed residual asset is any amount the lessor expects to \nderive from the underlying asset at the end of the lease term that is not guaranteed by the lessee or \nany other third party unrelated to the lessor, discounted using the rate implicit in the lease. \n• Deferred selling profit (direct financing leases only) — Any selling profit (refer t o section 5.1.3, Selling \nprofit or selling loss ) for a direct financing lease is deferred and reduces the lessor’s net investment \nin the lease. \n5.1.2 Leases with significant variable lease payments (updated August 2023 ) \nVariable lease payments that do not depend on an index or rate, such as those based on performance \n(e.g., a percentage of sales) or usage of the underlying asset ( e.g., the number of hours flown, the number of \nunits produced), are not included as lease pay ments as discussed in section 2.4.10, Amounts not \nincluded in lease payments . If a lease arrangement includes significant variable lease payments that do not \ndepend on an index or rate, the net investment in the lease recognized for a sales -type or a direc t financing \nlease may be lower than the carrying amount of the underlying asset at lease commencement. In such \ncircumstances, the difference between the initially recognized net investment in the lease and the carrying \namount of the underlying asset dereco gnized is recognized as a selling loss at lease commencement. \nAfter the adoption of ASU 2021 -05, the existence of a selling loss in such situations would result in the \nlease being classified as an operating lease. A lessor in this situation should keep in mind that it must also \ndetermine whether the underlying asset is impaired prior to lease commencement ( e.g., by applying the \nimpairment guidance in ASC 360-10). For example, if the selling loss that would be avoided by applying \nASC 842-10-25-3A results fr om reasons other than just the variable lease payments ( e.g., total expected \nlease payments, including the expected variable lease payments, are less than the carrying amount of the \nunderlying asset), that would be an indicator under ASC 360-10 that the un derlying asset is impaired \nbefore the lease commences. Refer to section 2.5.1, Discount rate — lessors , for discussion of determining \nthe rate implicit in the lease for leases with significant variable lease payments and section 3.2, Criteria \nfor lease classification — lessors , for the accounting after the adoption of ASU 2021 -05. \nAdditionally, after the adoption of ASU 2021 -05, upon a lease modification , a lessor need s to assess \nwhether the modified lease should be classified as an operating lease in accordance with ASC 842-10-25-\n3A. For example, a sales type lease that is modified to introduce new variable lease payments may result \nin the new modified lease being classified as an operating lease if the variable lease payments would result \nin a selling loss . Lease \nreceivable Unguaranteed \nresidual asset Net \ninvestment \nin a sales -type \nlease Deferred \nselling profit Net \ninvestment \nin a direct \nfinancing lease ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 257}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 246 Illustration 5-1: Recognizing a loss at lease commencement for a sales -type lease with \nsignificant variable lease payments (before the adoption of ASU 2021 -05) \nAssume Lessor enters into a 10-year lease of machinery with Lessee. Lessor sells and leases the \nmachinery , which is not speci alized in nature and is expected to have alternative use to Lessor at the \nend of the 10-year lease term. The underlying asset is not impaired before lease commencem ent. \nUnder the lease: \n• Lessor receives variable lease payments of 4% of the Lessee’s monthly sales of units produced \nusing the machinery . The lease arrangement does not include fixed lease payments. \n• Lessor expects the residual value of the machinery to be $ 15,000 at the end of the 10-year lease term. \n• At lease commencement, t he machinery has an estimated remaining economic life of 12 years, a \ncarrying amount of $ 110,000 and a fair value of $ 130,000 . \n• The lease does not transfer ownership of the underlying asset to Lessee at the end of the lease \nterm or contain an option for Lessee to purchase the machinery . \n• At lease commencement, Lessor concludes that it is probable it wi ll collect any amount probable of \nbeing owed under the residual value guarantee provided by Lessee. \n• There are no initial direct costs. \n• There are no non -lease components in the arrangement. \nLessor classi fies the lease as a sales -type lease because the lease term of 10 years represents a major \npart (83%) of the remaining economic life of the machinery . None of the other criteria for classification \nas a sales -type lease are met. \nThe rate implicit in the lease is negative because the sum of (1) the lease paym ents ($0, because the \nlease payments are entirely variable) and (2) the estimated residual value of the machinery at the end \nof the lease term ($ 15,000) is less than the machinery’s fair value at the lease commencement date \n($130,000). However, it is not appropriate for the Lessor to use a negative discount rate as the rate \nimplicit in the lease . Therefore, the L essor must use a rate of 0% and record a selling loss at the \ncommencement date of the lease. Refer to section 2.5.1, Discount r ate — lessors , for further discussion. \nAt lease commencement, Lessor accounts for the sale s-type lease as follows: \nNet investment in the lease $ 15,000(a) \nLoss 95,000(b) \n Property, plant and equipment (machinery) $ 110,000 \nTo record the net investment in the lease, derecognize the underlying asset and record the loss at the \ncommencement date of the lease. \n(a) The n et investment in the lease consists of (1) the present value of the annual lease payments of $0 plus the present value of the \nguaranteed residual value of $ 5,000, both discounted at the rate implicit in the lease (0%), which equals $ 5,000 (i.e., the lease \nreceivable) and (2) the present value of the unguaranteed residual value of $10,000 discounted at 0% . \n(b) The loss is calculated as the carrying amount of the machinery of $1 10,000 less the net investment in the lease of $15,000 . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 258}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 247 5.1.3 Selling profit or selling loss \nExcerpt from Accounting Standards Codification \nMaster Glossary \nSelling Profit or Selling Loss \nAt the commencement date , selling profit or selling loss equals: \na. The fair value of the underlying asset or the sum of (1) the lease receivable and (2) any lease \npayments prepaid by the lessee, if lower; minus \nb. The carrying amount of the underlying asset net of any unguaranteed residual asset ; minus \nc. Any deferred initial direct costs of the lessor. \nLeases that give rise to selling profit or selling loss normally result when the lessor uses leasing as a \nmeans of marketing its products or disposing of an asset. \nUnder ASC 842, selling profit or selling loss is calculated as follows: \n \nThe calculation of selling profit is based on the lower of (1) the fair value of the underlying asset and (2) the \nsum of the lease receivable and any prepaid lease payments from the lessee (net of any lease incentives \npaid to the lessee) because lease reve nue in a sales -type lease is limited to the sum of the receivable and \nany prepayments received (net of incentives paid to the lessee). Refer to section 5.8, Presentation . \nSelling profit — sales -type leases \nASC 842 requires a lessor to recognize any selling profit on a sales -type lease at lease commencement, \nassuming that collectibility of both lease payments and any residual value guarantee provided by the \nlessee is probable (refer to section 5.2.1.1, Initial recognition and measurement when collectibility is \nprobable at lease commencement — sales -type leases ). When collectibility of lease payments and any \nresidual value guarantee provided by the lessee is not probable, the underlying asset is not derecognized, \nand no selling profit is recognized (refer to s ection 5.2.1.2, Initial recognition and measurement when \ncollectibility is not probable at lease commencement — sales -type leases ). \n“A” \nFV of the \nunderlying asset \n(refer to section 2.8, \nFair value) \n“B” \n(1) Lease receivable \n+ \n(2) Any prepayments \nfrom the lessee \n(net of any lease \nincentives paid to \nthe lessee) \n \nThe lower of \n“A” OR “B” \n— \nCarrying amount \nof the underlying \nasset, net of any \nunguaranteed \nresidual asset \n— \nAny deferred \ninitial direct costs \nof the lessor \n= \nSelling profit \nOR \n(Selling loss) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 259}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 248 The FASB included the collectibility threshold for the recognition of a sales -type lease to better align the \nleases guidance with the principles in ASC 606. The FASB indicated in the Basis for Conclusions (BC 93) \nof ASU 2016 -02 that even though a sales -type lease is not necessarily identical to a sale, the transactions \nare economically similar ( e.g., because sales -type lessors often use leasing as an alternative means to \nsell their assets and have no intention of reusing or re -leasing assets leased out under a sales -type lease). \nSelling profit — direct financing leases \nAs noted above, the lease classification test is designed so that a lease can be a direct financing lease \nonly when the lessor obtains a residual value guarantee from an unrelated third party other than the \nlessee and that guarantee is sufficient to satisfy (when added to lease payments) the “substantially all” \ncriterion discussed in section 3.2, Criteria for lease classification — lessors . Although a residual value \nguarantee from an unrelated third party other than the lessee can exist in a sales -type lease or an \noperating lease, a lease without a residual value gu arantee from an unrelated third party other than the \nlessee must be classified as either a sales -type lease or an operating lease. \nASC 842 requires a lessor to defer any selling profit on a direct financing lease at lease commencement \nand amortize it over the lease term in a manner that, when combined with the interest income on the \nlease receivable and the unguaranteed residual asset, produces a constant periodic discount rate on the \nremaining balance of the net investment in the lease. Refer to section 5. 3.2, Subsequent measurement — \ndirect financing leases, for further discussion. \nSelling loss \nAny selling loss on a sales -type lease or direct financing lease is recognized immediately at lease \ncommencement, but a loss may indicate that the underlying asset was impaired prior to lease \ncommencement. Refer to section 5.2.1, Initial recognition and measurement — sales -type leases , and \nsection 5.3.1, Initial recognition and measurement — direct financing leases , for further discussion. \nA lessor that concludes, in accordance with ASC 842-10-55-3 (refer to section 3.4.6, Fair value of the \nunderlying asset ), that it is not practicable for it to determine the fair value of an underlying asset \n(particularly an identified portion of an underly ing asset, such as a floor in a building) and does not \nevaluate the “substantially all” lease classification criterion may face practical challenges if the lease is \nclassified as a sales -type lease based on the other applicable criteria discussed in sectio n 3.2, Criteria for \nlease classification — lessors , (e.g., lease term). In that case, the lessor is still required to determine the \nfair value of the underlying asset for purpose of measurement under ASC 842 ( e.g., to calculate selling \nprofit or loss, dete rmine the rate implicit in the lease). \nAfter the adoption of ASU 2021 -05, lessors are require d to classify leases with variable lease payments \nthat are not based on an index or rate ( e.g., long-term leases of machinery where the consideration in \nthe contra cts is determined based on hours used by the lessee) as operating leases if they would have \notherwise been classified as sales -type or direct financing leases and the lessor would have recognized a \nselling loss at lease commencement. Refer to section 3.2, Criteria for lease classification — lessors . \n5.1.4 Collectibility \nCollectibility is not assessed for purposes of the sales -type lease classification test. Rather, lessors in \nsales -type leases assess the collectibility of lease payments and any residual val ue guarantee provided by \nthe lessee for purposes of determining initial recognition and measurement. For example, if collection of \nlease payments and any residual value guarantee provided by the lessee is not probable ( i.e., not likely to \noccur), the under lying asset is not derecognized, and all income is deferred. Under ASC 840, this type of \nlease would be classified as an operating lease. Refer to section 5.2, Sales -type leases . \nASC 842 requires lessors to evaluate the collectibility of lease payments and any residual value guarantee \n(i.e., a guarantee provided by a lessee or any other third party unrelated to the lessor) to determine lease \nclassification for leases that would otherwise be classified as direct financing leases. That is, if collection of ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 260}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 249 lease payments and any residual value guarantee is not probable ( i.e., it is not likely to occur), a lease that \nwould otherwise qualify as a direct financing lease is classified as an operating lease. Refer to section 3.2, \nCriteria for lease classification — lessors . \nCollectibility of lease payments must also be evaluated for operating leases to determine the income \nrecognition pattern for those leases. Refer to section 5.4, Operating leases . \nThe following table summarizes how the collectibility assessment affects lease classification, \nrecognition and measurement for lessors. \n Sales -type lease Direct financing lease Operating lease \nClassification \nat lease \ncommencement Collectibility has no ef fect on \nlease classification . Collectibility is probable \n(assuming the other \nclassification criterion is met) . Operating leases are leases \nthat do not meet the criteria to \nbe classified as sales -type or \ndirect financing leases ( e.g., if \ncollectibility is n ot probable for \na lease that would otherwise \nbe classified as a direct \nfinancing lease) . \nInitial recognition \nand measurement \nat lease \ncommencement If collectibility is probable , \nrecognize any selling profit \nor loss. \nIf collectibility is not probable , do \nnot derecognize the underlying \nasset and account for lease \npayments received as a deposit \nliability. Refer to section 5.2.1.2, \nInitial recognition and \nmeasurement when collectibility \nis not probable at lease \ncommencement — sales -type \nleases , for details. Not applicable . Not applicable . \nSubsequent \nmeasurement If collectibility is probable at \nlease commencement , net \ninvestment is evaluated for \nimpairment under ASC 310, \nReceivables (before the \nadoption of ASU 2016 -13, \nMeasurement of Credit Losses \non Financial Instruments ) or \nASC 326 ( after the adoption of \nASU 2016 -13). Refer to \nsection 2.11.3, Leases , of our \nFRD, Credit impairment under \nASC 326, for additional details. \nIf collectibility is not probable \nat lease commencement , refer \nto section 5.2.1.2, Initial \nrecognition and measurement \nwhen collectibility is not probable \nat lease commencement — \nsales -type leases . Net investment is evaluated \nfor impairment under \nASC 310 ( before the adoption \nof ASU 2016 -13) or ASC 326 \n(after the adoption of \nASU 2016 -13). Refer to \nsection 2.11.3, Leases , of our \nFRD, Credit impairment \nunder ASC 326, for additional \ndetails. If collectibility is probable , \nrecognize income generally \non a straight -line basis . \nIf collectibility is not probable , \nincome recognition is \nconstrained to the lesser of \ncash collected, or lease income \nreflected on a straight -line or \nanother systema tic basis, plus \nvariable rent when it becomes \naccruable . Refer to section 5.4, \nOperating leases. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 261}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 250 5.1.5 Master lease agreements \nExcerpt from Accounting Standards Codification \nLeases — Lessor \nImplementation Guidance and Illustrations \n842-10-55-17 \nUnder a master lease agreement, the lessee may gain control over the use of additional underlying \nassets during the term of the agreement. If the agreement specifies a minimum number of units or \ndollar value of equipment, the lessee obtaining control over the use of those additional underlying \nassets is not a lease modification . Rather, the entity (whether a lessee or a lessor ) applies the \nguidance in paragraphs 842 -10-15-28 through 15 -42 when identifying the separate lease components \nand alloc ating the consideration in the contract to those components. Paragraph 842 -10-55-22 \nexplains that a master lease agreement may, therefore, result in multiple commencement dates . \n842-10-55-18 \nIf the master lease agreement permits the lessee to gain control over the use of additional underlying \nassets during the term of the agreement but does not commit the lessee to doing so, the lessee’s \ntaking control over the use of an additional underlying asset should be accounted for as a lease \nmodification in accordan ce with paragraphs 842 -10-25-8 through 25 -18. \nUnder a master lease agreement, a lessee may gain control over the use of additional underlying assets \nduring the term of the agreement. In certain cases, a master lease agreement may specify a minimum \nnumber or value of underlying assets the lessee is required to obtain. For example, a lessee enters into \nan agreement to obtain the right to lease three floors of a building with an option to lease an additional \nfloor ( i.e., the fourth floor). \nTo the exten t that a lessee is required to take a specified minimum quantity or value of the underlying \nassets, the lessee obtaining control over the use of those additional underlying assets is not a lease \nmodification ( i.e., a change to the terms and conditions of a contract that results in a change in the scope \nof or the consideration for a lease). To identify the separate lease components and allocate the amount \nof consideration in the master lease agreement attributed to the additional underlying assets, the lesso r \napplies the guidance in ASC 842-10-15-28 through 15 -42 (refer to section 1.4, Identifying and \nseparating lease and non -lease components of a contract and allocating contract consideration ). Further, \nrefer to section 5.4.1, Time pattern of use of property in an operating lease , for the accounting of \nescalating lease payments of an operating lease under a master lease agreement. \nTo the extent that additional underlying assets beyond the specified minimum are leased under the master \nlease agreement, the less ee obtaining control over the use of those additional underlying assets is considered \na lease modification. Refer to section 5.6, Lease modifications , for the accounting of a lease modification. \nIf a master lease agreement does not include a specified mini mum quantity or dollar value, the lessee \nobtaining control over the use of any additional underlying asset is also considered a lease modification. \nRefer to section 5.6, Lease modifications , for the accounting of a lease modification. \nTo determine lease co mmencement date for master lease agreements, refer to section 2.2.1, Lease \ncommencement date for master lease agreements . \n5.1.6 Fulfillment costs incurred by a lessor \nA lessor may incur certain costs to prepare an asset for its intended use after lease in ception but prior to \nlease commencement ( e.g., costs to mobilize the asset). Questions have arisen about how a lessor \naccounts for such costs when paid to a third party or when the lessor performs the work itself. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 262}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 251 In response to a technical inquiry, the FA SB staff said that such costs are not initial direct costs because they \ndo not represent costs incurred prior to lease inception that are directly attributable to negotiating and \narranging a lease (refer to section 2.6, Initial direct costs ). However, the FASB staff believes if no other GAAP \napplies to such costs it would be permissible for a lessor to make an accounting policy election to analogize to \nthe guidance on contract fulfillment costs in ASC 340-40 or to expense such costs as incur red. A lessor should \napply its accounting policy election consistently to all leases and should disclose its accounting policy, if \nmaterial. Any change s to the lessor elected accounting policy need to be evaluated under ASC 250, \nAccounting Changes and Erro r Corrections . A lessor that analogizes to the guidance on contract fulfillment \ncosts in ASC 340-40 recognizes an asset from costs incurred to fulfill a contract only if those costs meet the \ncriteria in ASC 340-40-25-5 (refer to section 9.3, Costs to fulfi ll a contract , of our FRD, Revenue from \ncontracts with customers ( ASC 606) ). In a speech,10 a member of the SEC staff reiterated the views \nexpressed by the FASB staff. \n5.2 Sales -type leases \n5.2.1 Initial recognition and measurement — sales -type leases \nExcerpt from Accounting Standards Codification \nLeases — Lessor \nRecognition \n842-30-25-1 \nAt the commencement date , a lessor shall recognize each of the following and derecognize the \nunderlying asset in accordance with paragraph 842 -30-40-1: \na. A net investment in the lease , measured in accordance with paragraph 842 -30-30-1 \nb. Selling profit or selling loss arising from the lease \nc. Initial direct costs as an expense if, at the commencement date, the fair value of the underlying \nasset is differ ent from its carrying amount. If the fair value of the underlying asset equals its carrying \namount, initial direct costs (see paragraphs 842 -10-30-9 through 30 -10) are deferred at the \ncommencement date and included in the measurement of the net investment in the lease. The rate \nimplicit in the lease is defined in such a way that those initial di rect costs eligible for deferral are \nincluded automatically in the net investment in the lease; there is no need to add them separately. \n842-30-25-3 \nThe guidance in paragraphs 842 -30-25-1 through 25 -2 notwithstanding, if collectibility of the lease \npayment s, plus any amount necessary to satisfy a residual value guarantee provided by the lessee , is \nnot probable at the commencement date, the lessor shall not derecognize the underlying asset but \nshall recognize lease payments received — including variable leas e payments — as a deposit liability \nuntil the earlier of either of the following: \na. Collectibility of the lease payments, plus any amount necessary to satisfy a residual value guarantee \nprovided by the lessee, becomes probable. If collectibility is not pr obable at the commencement \ndate, a lessor shall continue to assess collectibility to determine whether the lease payments and \nany amount necessary to satisfy a residual value guarantee are probable of collection. \n \n10 Speech by Andrew W. Pidgeon, 10 December 2018. Refer to the SEC website at https://www.sec.gov/news/speech/speech -\npidgeon -121018 . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 263}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 252 b. Either of the following events occurs: \n1. The contract has been terminated, and the lease payments received from the lessee are \nnonrefundable. \n2. The lessor has repossessed the underlying asset, it has no further obligation under the \ncontract to the lessee, and the lease payments receiv ed from the lessee are nonrefundable. \n842-30-25-4 \nWhen collectibility is not probable at the commencement date, at the date the criterion in paragraph \n842-30-25-3(a) is met (that is, the date at which collectibility of the lease payments plus any amount \nnecessary to satisfy a residual value guarantee provided by the lessee is assessed as probable), the \nlessor shall do all of the following: \na. Derecognize the carrying amount of the underlying asset \nb. Derecognize the carrying amount of any deposit liability recognized in accordance with paragraph \n842-30-25-3 \nc. Recognize a net investment in the lease on the basis of the remaining lease payments and \nremaining lease term , using the rate implicit in the lease determined at the commencement date \nd. Recognize sell ing profit or selling loss calculated as: \n1. The lease receivable ; plus \n2. The carrying amount of the deposit liability; minus \n3. The carrying amount of the underlying asset, net of the unguaranteed residual asset . \n842-30-25-5 \nWhen collectibility is not probable at the commencement date, at the date the criterion in paragraph \n842-30-25-3(b) is met, the lessor shall derecognize the carrying amount of any deposit liability \nrecognized in accordance with paragraph 842 -30-25-3, with the c orresponding amount recognized as \nlease income. \n842-30-25-6 \nIf collectibility is probable at the commencement date for a sales -type lease or for a direct financing \nlease , a lessor shall not reassess whether collectibility is probable. Subsequent changes in the credit \nrisk of the lessee shall be accounted for in accordance with the impairment guidance applicable to the \nnet investment in the lease in paragraph 842 -30-35-3. \nPending Content: \nTransition Date: (P) December 16, 2019; (N) December 16, 2022 | Transit ion Guidance: 326-10-65-1 \nIf collectibility is probable at the commencement date for a sales -type lease or for a direct \nfinancing leas e, a lessor shall not reassess whether collectibility is probable. Subsequent changes in \nthe credit risk of the lessee shall be accounted for in accordance with the credit loss guidance \napplicable to the net investment in the lease in paragraph 842 -30-35-3. \nDerecognition \n842-30-40-1 \nAt the commencement date , a lessor shall derecognize the carrying amount of the underlying asset \n(if previously recognized) unless the lease is a sales -type lease and collectibility of the lease \npayments is not probable (see paragraph 842 -30-25-3). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 264}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 253 Initial Measurement \n842-30-30-1 \nAt the commencement date , for a sales -type lease , a lessor shall measure the net investment in the \nlease to include both of the following: \na. The lease receivable , which is measured at the present value, discounted using the rate implicit \nin the lease , of: \n1. The lease payments (as described in paragraph 842 -10-30-5) not yet received by the lessor \n2. The amount the lessor expects to derive from the underlying asset following the end of the \nlease term that is guaranteed by the lessee or any other third party unrelated to the lessor \nb. The unguaranteed residual asset at the present value of the amount the lessor expects to derive \nfrom the underlying asset following th e end of the lease term that is not guaranteed by the lessee \nor any other third party unrelated to the lessor, discounted using the rate implicit in the lease. \n5.2.1.1 Initial recognition and measurement when collectibility is probable at lease \ncommencement — sales -type leases \nAt lease commencement, a lessor accounts for a sales -type lease for which the collectibility of lease \npayments and any residual value guarantee provided by the lessee is probable as follows: \n• Derecogniz es the carrying amount of the underlying asset \n• Recognizes the net investment in the lease (refer to section 5.1.1, Net investment in the lease ) \n• Recognizes, in net income, any selling profit or selling loss (refer to section 5.1.3, Selling profit or \nselling loss) \n• Expenses any initial direct costs if the fair value of the underlying asset is different from its carrying \namount (refer to section 2.6, Initial direct costs , and section 2.8, Fair value ) \n• Defers any initial direct costs and includes them in the net investment in the lease if the fair value of \nthe underlying asset equals its carrying amount \nIf initial direct costs are deferred, they are included in the computation of the rate implicit in the lease and \ntherefore automatically included in the measuremen t of the net investment in the lease. Refer to section 2.5, \nDiscount rates , for further discussion of the rate implicit in the lease. \nA lessor does not change lease classification after lease commencement due to changes in the assessment \nof collectibility. Subsequent changes in the collectibility of the lease payments that were determined to be \nprobable of collection at lease commencement are identified and accounted for in the impairment assessment \nof the net investment in the sales -type lease. Refer to se ction 5.2.3, Impairment of the net investment in the \nlease — sales -type leases. Also refer to section 5.5, Examples — lessor accounting , Example 1, Case A. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 265}), Document(page\_content='5 Lessor accoun ting \nFinancial reporting developments Lease accounting | 254 5.2.1.2 Initial recognition and measurement when collectibility is not probable at lease \ncommencement — sales -type leases \nIf the collection of the lease payments and any residual value guarantee provided by the lessee is not \nprobable at lease commencement for a sales -type lease, a lessor does not derecognize the under lying \nasset and does not recognize its net investment in the lease. Instead, a lessor continues to account for \nthe underlying asset using other US GAAP ( e.g., depreciates, evaluates the asset for impairment in \naccordance with ASC 360-10) and recognizes lea se payments received, including variable lease payments \nthat do not depend on an index or rate, as a deposit liability until the earlier of either of the following: \n• Collection of the lease payments, plus any amount necessary to satisfy a residual value gua rantee \nprovided by the lessee, becomes probable. \n• Either of the following events occurs: \n• The contract is terminated, and the lease payments received from the lessee are nonrefundable. \n• The lesso r repossesses the underlying asset and has no further obligation to the lessee under the \ncontract, and the lease payments received from the lessee are nonrefundable. \nCollectibility of lease payments and any residual value guarantee provided by the lessee is continually \nreassessed when collection is not probable at the commencement date. \nAlso refer to section 5.5, Examples — lessor accounting , Example 1 Case B. \nCollectibility is not probable at lease commencement but subsequently becomes probable \nWhen collectibility of lease payments and any residual value guarantee prov ided by the lessee is not \nprobable at lease commencement but subsequently becomes probable, a lessor accounts for the sales -\ntype lease as follows: \n• Derecognizes the carrying amount of the underlying asset \n• Derecognizes the carrying amount of any deposit liab ility recognized \n• Recognizes a net investment in the lease, measured based on the remaining lease payments and \nremaining lease term, using the rate implicit in the lease determined at the commencement date \n• Recognizes selling profit or selling loss calculate d as: \n• The lease receivable \n• Plus the carrying amount of the deposit liability \n• Minus the carr ying amount of the underlying asset, net of the unguaranteed residual asset \nCollectibility is not probable at lease commencement and the contract is subsequently terminated or \nthe underlying asset is repossessed by the lessor \nWhen collectibility of lease payments and any residual value guarantee provided by the lessee is not probable at \nlease c ommencement, a lessor derecognizes the carrying amount of any deposit liability previously recognized \nand recognizes lease income when the lease payments received from the lessee are nonrefundable and either: \n• The contract terminates. \n• The lessor repossesses the underlying asset and has no further obligation to the lessee under the contract. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 266}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 255 5.2.2 Subsequent measurement — sales -type leases \nASC 842’s subsequent measurement guidance for sales -type leases is similar to the subsequent measurement \nguidance for dir ect financing leases, discussed in section 5.3.2, Subsequent measurement — direct \nfinancing leases . Deferring selling profit as part of the net investment in the lease for direct financing \nleases is the key difference. \nExcerpt from Accounting Standards Cod ification \nLeases — Lessor \nSubsequent Measurement \n842-30-35-1 \nAfter the commencement date , a lessor shall measure the net investment in the lease by doing both \nof the following: \na. Increasing the carrying amount to reflect the interest income on the net investment in the lease. \nA lessor shall determine the interest income on the net investment in the lease in each period \nduring the lease term as the amount that produces a constant pe riodic discount rate on the \nremaining balance of the net investment in the lease. \nb. Reducing the carrying amount to reflect the lease payments collected during the period. \nRecognition \n842-30-25-2 \nAfter the commencement date, a lessor shall recognize all of t he following: \na. Interest income on the net investment in the lease, measured in accordance with paragraph \n842-30-35-1(a) \nb. Variable lease payments that are not included in the net investment in the lease as income in \nprofit or loss in the period when the changes in facts and circumstances on which the variable \nlease payments are based occur \nc. Impairment of the net investment in the lease (as described in paragraph 842 -30-35-3). \nPending Content: \nTransition Date: (P) December 16, 2019; (N) December 16, 2022 | Transition Guidance: 326-10-65-1 \nAfter the commencement date, a lessor shall recognize all of the following: \na. Interest income on the net investment in the lease, measured in accordance with paragraph \n842-30-35-1(a) \nb. Variable lease payments that are not included in the net investment in the lease as income in \nprofit or loss in the period when the changes in facts and circumstances on which the variable \nlease payments are based occur \nc. Credit losses on the net investment in the lease (as described in paragraph 842 -30-35-3). \n \nAfter lease commencement, a lessor accounts for a sales -type lease as follows: \n• Recognizes interest income (in profit or loss) over the lease term in an amount that produces a \nconstant periodic discount rate on the remaining balance of the net investment in the lease \n(i.e., using the rate implicit in the lease), including: \n• Interest on the lease receivable \n• Interest from accretion of the unguaranteed residual asset to its expected value at the end of the lease ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 267}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 256 • Reduces the net investment in the lease for lease payments received (net of interest income \ncalculated above) \n• Separately recognizes income from variable lease payments that are not included in the net \ninvestment in the lease (e.g., performance - or usage -based variable payments) in the period when \nthe changes in facts and circumstances on which the variable lease payments are based occur \n• Recognizes changes to variable lease payments that depend on an index or rate in profit or loss in \nthe period of the change \n• Recognizes any impairment (or credit losses after adoption of ASU 2016 -13) of the net investment in \nthe lease (refer to section 5.2.3, Impairment of the net investment in the lease — sales -type leases ) \nWe believe variable lease payments that are not included in the net investment in a lease are most \nappropriately presented as adjustments in interest income. Refer to section 2.9, Variable lease \npayments , for a discussion of variable leases payments that d o not depend on an index or rate. \n5.2.3 Impairment of the net investment in the lease — sales -type leases \n(updated August 2022) \nExcerpt from Accounting Standards Codification \nLeases — Lessor \nSubsequent Measurement \nImpairment of the Net Investment in the Lease \n842-30-35-3 \nA lessor shall determine impairment related to the net investment in the lease and shall recognize any \nimpairment in accordance with Topic 310 on receivables (as described in paragraphs 310 -10-35-16 \nthrough 35 -30). When determining the loss allowance for a net investment in the lease, a lessor shall \ntake into consideration the collateral relating to the net investment in the lease. The collateral relating \nto the net investment in the lease represents the cash flows that t he lessor would expect to receive (or \nderive) from the lease receivable and the unguaranteed residual asset during and following the end of \nthe remaining lease term . \nPending Content: \nTransition Date: (P) December 16, 2019; (N) December 16, 2022 | Transition Guidance: 326-10-65-1 \nLoss Allowance on the Net Investment in the Lease \nA lessor shall determine the loss allowance related to the net investment in the lease and shall \nrecord any loss allowance in accordance with Subtopic 326 -20 on financial instruments measured at \namortized cost. When determining the loss allowance for a net investment in the lease, a lessor shall \ntake into consideration the collateral relating to the net investment in the lease. T he collateral \nrelating to the net investment in the lease represents the cash flows that the lessor would expect to \nreceive (or derive) from the lease receivable and the unguaranteed residual asset during and \nfollowing the end of the remaining lease term . \n \nASC 842 requires lessors to evaluate their net investment in a sales -type lease and a direct financing \nlease (refer to section 5.3, Direct financing leases ) for impairment using the guidance for receivables in \nASC 310 (before the adoption of ASU 2016 -13) or for credit losses using guidance in ASC 326 ( after the \nadoption of ASU 2016 -13). Refer to section 2.11.3, Leases , of our FRD, Credit impairment under \nASC 326, for additional details. The FASB indicated in the Basis for Conclusions (BC 310) of ASU 2016 -02 \nthat even though the unguaranteed residual asset component of the net investment in the lease does not ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 268}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 257 meet the de finition of a financial asset in US GAAP, it would be overly complex and provide little benefit \nto require entities to separately assess the unguaranteed residual asset for impairment in accordance \nwith ASC 360-10 while the receivable ( i.e., the financial asset) is evaluated for impairment in accordance \nwith ASC 310 (before the adoption of ASU 2016 -13) or ASC 326 ( after the adoption of ASU 2016 -13). \nWhen determining the loss allowance for a net investment in the lease, a lessor takes into consideration \nthe collateral relating to the net investment in the lease , including cash flows that the lessor expects to \nreceive (or derive) from the lease receivable and the unguaranteed residual asset during both the \nremaining lease term and after it en ds. The amount that the lessor expects to derive from the \nunguaranteed residual asset would be based on the expected value of the residual asset at the end of the \nlease term, less any amounts guaranteed by the lessee or any other third party unrelated to t he lessor. The \nFASB staff has clarified that expected cash flows from the disposal of leased asset s (including any gains and \nlosses) should be included in the estimate of expected credit losses on net investments in leases in the scope \nof ASC 326-20.11 \n5.2.4 Remeasurement of the net investment in the lease — sales -type leases \nASC 842’s remeasurement provisions for a net investment in a sales -type lease are the same as for a \ndirect financing lease, discussed in section 5.3.4, Remeasurement of the net investment in the lease — \ndirect financing leases . \nExcerpt from Accounting Standard s Codification \nLeases — Overall \nSubsequent Measurement \n842-10-35-3 \nA lessor shall not reassess the lease term or a lessee option to purchase the underlying asset unless \nthe lease is modified and that modification is not accounted for as a separate contrac t in accordance \nwith paragraph 842 -10-25-8. When a lessee exercises an option to extend the lease or purchase the \nunderlying asset that the lessor previously determined the lessee was not reasonably certain to \nexercise or exercises an option to terminate t he lease that the lessor previously determined the lessee \nwas reasonably certain not to exercise, the lessor shall account for the exercise of that option in the \nsame manner as a lease modification . \nLeases — Lessor \nSubsequent Measurement \n842-30-35-2 \nAfter the commencement date, a lessor shall not remeasure the net investment in the lease unless the \nlease is modified and that modification is not accounted for as a separate contract in accordance with \nparagraph 842 -10-25-8. \nAfter lease commencement, the net investment in a sales -type lease is not remeasured unless the lease \nis modified ( i.e., there is a change to the terms and conditions of a contract that results in a change in the \nscope of or the consideration for the lease) and the modified lease is not accounted for as a separate \ncontract. Refer to section 5.6, Lease modifications . \n \n11 11 June 2018 Credit Losses TRG Meeting; see me eting minutes . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 269}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 258 Additionally, ASC 842-10-35-3 requires lessors to account for a lessee’s exercise of an option to e xtend \nor terminate the lease or purchase the underlying asset in the same manner as a lease modification when \nthe exercise is inconsistent with the lessor’s assumption about whether the lessee would exercise the \noption. For example, if a lessor excluded an optional period to extend the lease from the lease term \nbecause it concluded that the lessee was not reasonably certain to exercise that option, the exercise of \nthe option by the lessee should be accounted for as a lease modification. Refer to section 5.6 .3, Lessor \naccounting for a modification that is not accounted for as a separate contract . \n5.2.5 Example — lessor accounting for a sales -type lease (updated August 2023) \nIllustration 5-2 shows how a lessor accounts for a sales -type lease that gives rise to selling profit when \nthe collectibility of lease payments and the residual value guarantee provided by the lessee is probable at \nlease commencement. In contrast, Illustration 5 -3 shows how a lessor accounts for a sales -type lease \nthat gives rise to selling profit when the collectibility of lease payments and the residual value guarantee \nprovided by the lessee is not probable at lease commencement. Refer to section 5.5, Examples — lessor \naccounting , for additional examples of lessor accounting included in ASC 842. \nIllustration 5 -2: Lessor accounting for a sales -type lease (collect ibility is probable) \nAssume Lessor enters into a 10 -year lease of equipment with Lessee . Lessor sells and leases the \nequipment, which is not specialized in nature and is expected to have alternative use to Lessor at the \nend of the 10 -year lease term. Under the lease: \n• Lessor receives annual lease payments of $15,000, payable at the end of each year. \n• Lessor expects the residual value of the equipment to be $50,000 at the end of the 10 -year lease term. \n• Lessee provides a residual value guarantee that protects Lessor on the first $30,000 of loss below \nthe estimated residual value at the end of the lease term of $50,000. \n• At lease commencement, t he equipment has an estimated remaining economic life of 15 years, a \ncarrying amount of $100,000 and a fair value of $111,000. \n• Lessor incurred and paid costs of $2,000 for a broker’s commission as a result of obtaining \nthe lease. These costs qualify as initial direct costs and are capitalized when the lease is obtained. \nThe broker’s commission is incurred and paid at lease inception . \n• The lease does not transfer ownership of the underlying asset to Lessee at the end of the lease \nterm or contain an option for Lessee to purchase the equipment. \n• The rate implicit in the lease is 10.078%. \n• At lease commencement, Lessor concludes that it is probable it will collect the lease payments and \nany amount probable of being owed under the residual value guarantee provided by Lessee. \nLessor classifies the lease as a sales -type lease because the present value of the sum of lease \npayments and the residual value guaranteed by Lessee exceeds substantially all of the fair value of the \nunderlying asset. None of the other criteria for classification as a sales -type lease are met. If the \nresidual value guarantee was from an unrelated party other than the lessee, the Lessor would have \nexcluded it when determining whether the lease met the requirements to be classified as a sales -type \nlease (refer to section 3.2, Criteria for lease classification — lessors ). \nAt lease inception , Lessor accounts for the broker’s commission as follows: \nCapitalized initial direct costs $ 2,000 \n Cash $ 2,000 \nTo capitalize the initial direct costs at lease inception . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 270}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 259 At lease commencement, Lessor accounts for the sales -type lease as follows: \nNet investment in the lease $ 111,000(a) \nCost of goods sold 92,344(b) \nBroker’s commission expense 2,000(c) \n Revenue $ 103,344(d) \n Property held for lease 100,000(e) \n Capitalized initial direct costs 2,000(c) \nTo record the net investment in the sales -type lease and de recognize the underlying asset. \n(a) The net investment in the lease consists of (1) the p resent value of the 10 annual lease payments of $15,000 plus the present value \nof the guaranteed residual value of $30,000, both discounted at the rate implicit in the lease, which equals $103,344 ( i.e., the lease \nreceivable) and (2) the present value of unguaranteed residual asset of $20,000, which equals $7,656. Note that the net investment \nin the lease is subject to the same considerations as other assets when classifying its components as current or noncurrent a ssets in a \nclassified balance sheet. \n(b) Cost of goods sold is the carrying amount of the equipment of $100,000 less the present value of the unguaranteed residual \nasset of $7,656. \n(c) Costs incurred and paid for a broker’s commission are capitalized as initial direct costs at lease inception but are expensed at \nlease commencement. \n(d) Revenue equals the lease receivable, which consists of (1) the present value of the 10 annual lease payments of $15,000 plus (2) the \npresent value of the guaranteed residual value of $30,000, both discounted at the rate implicit in the lease, which equals $103,344. \n(e) $100,000 is the carrying amount of the underlying asset. \nAt lease commencement, Lessor recognizes selling profit of $11,000, which is calculated as the lease \nreceivable of $103,344 le ss the carrying amount of the asset of $100,000, net of any unguaranteed \nresidual asset of $7,656, which equals $92,344. \nCash $ 15,000(f) \n Net investment in the lease $ 3,813(g) \n Interest income 11,187(h) \nYear 1 journal en tries for the sales -type lea se. \n(f) Receipt of annual lease payment at the end of the year. \n(g) Reduction of the net investment in the lease for lease payment received of $15,000, net of interest income of $11,187. \n(h) Interest income is the amount that produces a constant periodic d iscount rate on the remaining balance of the net investment \nin the lease (see computation below). \nThe following table summarizes the interest income from this lease and the related amortization of the \nnet investment over the lease term. \nYear Annual rental \npayment Annual interest \nincome(a) Net investment \nat end of year \nInitial net investment $ — $ — $ 111,000 \n1 15,000 11,187 107,187 \n2 15,000 10,803 102,990 \n3 15,000 10,380 98,370 \n4 15,000 9,914 93,284 \n5 15,000 9,401 87,685 \n6 15,000 8,837 81,522 \n7 15,000 8,216 74,738 \n8 15,000 7,532 67,270 \n9 15,000 6,780 59,050 \n10 15,000 5,950 50,000(b) \n(a) Interest income equals 10.078% of the net investment in the lease at the beginning of each year. For example, Year 1 annual \ninterest income is calculated as $111,000 initial net investment x 10.078%. \n(b) The estimated residual value of the equipment at the end of the lease term. \nImmaterial differences may arise in the recomputa tion of amounts in the example above due to rounding. \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 271}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 260 Illustration 5 -3: Lessor accounting for a sales -type lease (collect ibility is not probable) \nThis illustration assumes the same facts as Illustration 5 -2 except that the collection of lease payments \nis not probable. \nAt lease inception, Lessor accounts for the broker’s commission as follows (assumes Lessor does not \nreceive payments in Year 1) : \nCapitalized initial direct costs $ 2,000 \n Cash $ 2,000 \nTo capitalize the initial direct costs at lease inception. \nAt lease commencement, Lessor does not derecognize the underlying asset , but similar to illustration \n5-2, lessor expenses the initial direct costs. \nBroker’s commission expense $ 2,000 \n Capitalized initial direct cost s $ 2,000 \nTo expense initial direct costs at lease commencement. \nIn Year 2, when Lessor receives the lease payment for Year 1 , Lessor accounts for the lease payment \nas follows : \nCash $ 15,000 \n Deposit liability $ 15,000 \nTo recognize deposit liability. \nSeparately, the lessor continues to depreciate the equipment. At the end of Year 2, collectability \nbecomes probable. Lessor accounts for the sales -type lease as follows: \nCash $ 15,000 \nDeposit liability 15,000 \nNet investment in the lease 102,990(a) \nCost of goods sold 80,723(b) \n Revenue $ 123,713(c) \n Property held for lease 90,000(d) \nTo record the net investment in the sales -type lease and de recognize the underlying asset and \npreviously recognized deposit liability . \n(a) The net investment in the lease consists of (1) the present value of eight remaining years of annual payments of $15,000 and the \npresent value of the guaranteed residual value of $30,000, both discounted at the rate implicit in the lease, which equals $ 93,713 \n(i.e., the lease receivable) and (2) the present value of the unguaranteed residual value of $20,000, which equals $ 9,27 7. \n(b) The cost of goods sold is the carrying amount of the equipment of $ 90,000 less the present value of the unguaranteed \nresidual asset of $ 9,277 . \n(c) Revenue equals the lease receivable calculated above, plus cash and deposit liability . \n(d) Property he ld for lease equals the $100,000 original carrying amount of the equipment less accumulated depreciation of $10,000, \nwhich represents two years of depreciation (($100,000 carrying amount - $50,000 residual value) / 10 years) ). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 272}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 261 5.3 Direct financing leases \n5.3.1 Initial recognition and measurement — direct financing leases \nExcerpt from Accounting Standards Codification \nLeases — Lessor \nRecognition \n842-30-25-7 \nAt the commencement date , a lessor shall recognize both of the following and derecognize the \nunderlying asset in accordance with paragraph 842 -30-40-1: \na. A net investment in the lease , measured in accordance with paragraph 842 -30-30-2 \nb. Selling loss arising from the lease , if applicable. \n842-30-25-8 \nSelling profit and initial direct costs (see paragraphs 842 -10-30-9 through 30 -10) are deferred at the \ncommencement date and included in the measurement of the net investment in the lease. The rate implicit \nin the lease is defined in such a way that initial direct costs deferred in accordance w ith this paragraph are \nincluded automatically in the net investment in the lease; there is no need to add them separately. \n842-30-25-6 \nIf collectibility is probable at the commencement date for a sales -type lease or for a direct financing \nlease , a lessor s hall not reassess whether collectibility is probable. Subsequent changes in the credit \nrisk of the lessee shall be accounted for in accordance with the impairment guidance applicable to the \nnet investment in the lease in paragraph 842 -30-35-3. \nPending Cont ent: \nTransition Date: (P) December 16, 2019; (N) December 16, 2022 | Transition Guidance: 326-10-65-1 \nIf collectibility is probable at the commencement date for a sales -type lease or for a direct \nfinancing lease , a lessor shall not reassess whether collec tibility is probable. Subsequent changes in \nthe credit risk of the lessee shall be accounted for in accordance with the credit loss guidance \napplicable to the net investment in the lease in paragraph 842 -30-35-3. \n \nInitial Measurement \n842-30-30-1 \nAt the commencement date , for a sales -type lease , a lessor shall measure the net investment in the \nlease to include both of the following: \na. The lease receivable , which is measured at the present value, discounted using the rate implicit \nin the lease , of: \n1. The lease payments (as described in paragraph 842 -10-30-5) not yet received by the lessor \n2. The amount the lessor expects to derive from the underlying asset following the end of the \nlease term that is guaranteed by the lessee or any other third party unrelated to the lessor \nb. The unguaranteed residual asset at the present value of the amount the lessor expects to derive \nfrom the underlying asset following th e end of the lease term that is not guaranteed by the lessee \nor any other third party unrelated to the lessor, discounted using the rate implicit in the lease. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 273}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 262 842-30-30-2 \nAt the commencement date, for a direct financing lease , a lessor shall measure the n et investment in \nthe lease to include the items in paragraph 842 -30-30-1(a) through (b), reduced by the amount of any \nselling profit. \nDerecognition \n842-30-40-1 \nAt the commencement date , a lessor shall derecognize the carrying amount of the underlying asset \n(if previously recognized) unless the lease is a sales -type lease and collectibility of the lease \npayments is not probable (see paragraph 842 -30-25-3). \nThe lease classification test is designed so that a lease can be a direct financing lease only when the lessor \nobtains a residual value guarantee from an unrelated third party other than the lessee and that guarantee is \nsufficient to satisfy the “substanti ally all” criterion discussed in section 3.2, Criteria for lease classification — \nlessors . Although a residual value guarantee from an unrelated third party other than the lessee can exist in \na sales -type lease or an operating lease, a lease without a resi dual value guarantee from an unrelated third \nparty other than the lessee must be classified as either a sales -type lease or an operating lease. \nAt lease commencement, a lessor accounts for a direct financing lease as follows: \n• Derecognizes the carrying amou nt of the underlying asset \n• Recognizes the net investment in the lease (refer to section 5.1.1, Net investment in the lease ) \n• Recognizes, in net income, any selling loss (refer to section 5.1.3, Selling profit or selling loss) \n• Defers any selling profit and i nitial direct costs (refer to section 2.6, Initial direct costs ) and includes \nthose amounts in the initial measurement of the net investment in the lease \nThe initial measurement of the net investment in a direct financing lease is similar to that of a sale s-type \nlease ( i.e., the present value of the lease payments not yet received and the unguaranteed residual \nasset). However, for a direct financing lease, any selling profit is deferred at lease commencement and \nincluded in the initial measurement of the ne t investment in the lease ( i.e., selling profit reduces the net \ninvestment in the lease). Any selling loss is recognized at lease commencement. \nFor a direct financing lease, because initial direct costs are deferred, they are included in the \ncomputation of the rate implicit in the lease and therefore automatically included in the measurement of \nthe net investment in the lease ( i.e., initial direct costs increase the net investment in the lease). Refer to \nsection 2.5, Discount rates , for furthe r discussion of the rate implicit in the lease. \nThe lease classification test is designed so that in order for a lessor to classify a lease as a direct financing \nlease, the collection of lease payments and any residual value guarantee ( i.e., those guarante es provided by \nthe lessee and any other third party unrelated to the lessor) must be probable at the commencement date. \nA lessor does not change lease classification after lease commencement due to changes in the assessment \nof collectibility. If a lease is classified as a direct financing lease at lease commencement, subsequent \nchanges in collectibility are identified and accounted for in the impairment assessment of the net investment \nin the direct financing lease. Refer to section 5.3.3, Impairment of the net investment in the lease — direct \nfinancing leases . If the lease that would otherwise be classified as a direct financing lease at lease \ncommencement is instead classified as an operating lease because collection of lease payments and any \nresidual valu e guarantee is not probable at lease commencement, the subsequent change in collectibility \nmay affect the income recognition pattern of the operating lease but would not affect its lease classification. \nAlso refer to section 5.5, Examples — lessor accounti ng, Example 1 Case D. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 274}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 263 5.3.2 Subsequent measurement — direct financing leases \nThe subsequent measurement guidance for direct financing leases is similar to the subsequent measurement \nguidance for sales -type leases, discussed in section 5.2.2, Subsequent mea surement — sales -type leases . \nDeferring selling profit as part of the net investment in the lease for direct financing leases is the key difference. \nExcerpt from Accounting Standards Codification \nLeases — Lessor \nSubsequent Measurement \n842-30-35-1 \nAfter the commencement date , a lessor shall measure the net investment in the lease by doing both \nof the following: \na. Increasing the carrying amount to reflect the interest income on the net investment in the lease. \nA lessor shall determine the interest income on the net investment in the lease in each period \nduring the lease term as the amount that produces a constant pe riodic discount rate on the \nremaining balance of the net investment in the lease. \nb. Reducing the carrying amount to reflect the lease payments collected during the period. \nRecognition \n842-30-25-9 \nAfter the commencement date, a lessor shall recognize all of the following: \na. Interest income on the net investment in the lease, measured in accordance with paragraph \n842-30-35-1(a) \nb. Variable lease payments that are not included in the net investment i n the lease as income in \nprofit or loss in the period when the changes in facts and circumstances on which the variable \nlease payments are based occur \nc. Impairment of the net investment in the lease (as described in paragraph 842 -30-35-3). \nPending Conten t: \nTransition Date: (P) December 16, 2019; (N) December 16, 2022 | Transit ion Guidance: 326-10-65-1 \nAfter the commencement date, a lessor shall recognize all of the following: \na. Interest income on the net investment in the lease, measured in accordance with paragraph \n842-30-35-1(a) \nb. Variable lease payments that are not included in the net investment i n the lease as income in \nprofit or loss in the period when the changes in facts and circumstances on which the variable \nlease payments are based occur \nc. Credit losses on the net investment in the lease (as described in paragraph 842 -30-35-3). \n \nAfter lease commencement, a lessor accounts for a direct financing lease as follows: \n• Recognizes interest income (in profit or loss) over the lease term in an amount that produces a \nconstant periodic discount rate on the remaining balance of the net investm ent in the lease, including: \n• Interest on the lease receivable \n• Interest from accretion of the unguaranteed residual asset to its expected value at the end of the lease \n• Amortization of any deferred selling profit \n• Reduces the net investment in the lease for l ease payments received (net of interest income \ncalculated above) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 275}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 264 • Separately recognizes income from variable lease payments that are not included in the net \ninvestment in the lease ( e.g., performance - or usage -based variable payments) in the period when \nthe changes in facts and circumstances on which the variable lease payments are based occur \n• Recognizes changes to variable lease payments that depend on an index or rate in profit or loss in \nthe period of the change \n• Recognizes any impairment (or credit losses after adoption of ASU 2016 -13) of the net investment in \nthe lease (refer to section 5.2.3, Impairment of the net investment in the lease — sales -type leases ) \nWe believe variable lease payments that are not included in the net investment in a lease are most \nappropriately presented as adjustments in interest income. Refer to section 2.9, Variable lease \npayments , for a discussion of variable leases payments that d o not depend on an index or rate. \nNote that as illustrated in section 5.3.5, Example — lessor accounting for a direct financing lease , the rate \nused to recognize interest income on a direct financing lease differs from the rate implicit in the lease at \nlease commencement when there is deferred selling profit. Also refer to section 5.5, Examples — lessor \naccounting , Example 1 Case C. \n5.3.3 Impairme nt of the net investment in the lease — direct financing leases \nASC 842’s provisions for evaluating impairment of the net investment in a direct financing lease are the \nsame as for a sales -type lease. Refer to section 5.2.3 , Impairment of the net investmen t in the lease — \nsales -type leases , for further discussion. \n5.3.4 Remeasurement of the net investment in the lease — direct financing leases \nASC 842’s remeasurement provisions for the net investment in a direct financing lease are the same as \nfor a sales -type lease, discussed in section 5.2.4, Remeasurement of the net investment in the lease — \nsales -type leases . \nExcerpt from Accounting Standards Codification \nLeases — Lessor \nSubsequent Measurement \n842-30-35-2 \nAfter the commencement date, a lessor shall not remeasure the net investment in the lease unless the \nlease is modified and that modification is not accounted for as a separate contract in accordance with \nparagraph 842 -10-25-8. \nLeases — Overall \nSubsequent M easurement \n842-10-35-3 \nA lessor shall not reassess the lease term or a lessee option to purchase the underlying asset unless the \nlease is modified and that modification is not accounted for as a separate contract in accordance with \nparagraph 842 -10-25-8. When a lessee exercises an option to extend the lease or purchase the underlying \nasset that the lessor previously determined the lessee was not rea sonably certain to exercise or exercises an \noption to terminate the lease that the lessor previously determined the lessee was reasonably certain not to \nexercise, the lessor shall account for the exercise of that option in the same manner as a lease modifi cation . \nAfter lease commencement, the net investment in a direct financing lease is not remeasured unless the \nlease is modified ( i.e., there is a change to terms and conditions of a contract that results in a change in \nthe scope of or the consideration fo r the lease) and the modified lease is not accounted for as a separate \ncontract. Refer to section 5.6, Lease modifications . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 276}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 265 Additionally, ASC 842-10-35-3 requires lessors to account for a lessee’s exercise of an option to extend \nor terminate the lease or p urchase the underlying asset in the same manner as a lease modification when \nthe exercise is inconsistent with the lessor’s assumption about whether the lessee would exercise the \noption. For example, if a lessor excluded an optional period to extend the le ase from the lease term \nbecause it concluded that the lessee was not reasonably certain to exercise that option, the exercise of \nthe option by the lessee should be accounted for as a lease modification. Refer to section 5.6.3, Lessor \naccounting for a modif ication that is not accounted for as a separate contract . \n5.3.5 Example — lessor accounting for a direct financing lease \nThe following illustration shows how a lessor accounts for a direct financing lease that gives rise to selling \nprofit. Refer to section 5.5, Examples — lessor accounting , for additional examples of lessor accounting \nincluded in ASC 842. \nIllustration 5 -4: Lessor accounting for a direct financing lease \nAssume Lessor enters into a 10 -year lease of equipment with Lessee. Lessor sells and leases the \nequipment, which is not specialized in nature and is expected to have alternative use to Lessor at the \nend of th e 10 -year lease term. Under the lease: \n• Lessor receives annual lease payments of $15,000, payable at the end of each year. \n• Lessor expects the residual value of the equipment to be $50,000 at the end of the 10 -year lease term. \n• Lessor obtains a residual value guarantee from an unrelated third party other than Lessee that \nprotects Lessor on the first $30,000 of loss below the estimated residual value of $50,000. \n• At lease commencement, t he equipment has an estimated remaining economic life of 15 years, a \ncarryin g amount of $100,000 and a fair value of $111,000. \n• The lease does not transfer ownership of the underlying asset to Lessee at the end of the lease \nterm or contain an option for Lessee to purchase the underlying asset. \n• The rate implicit in the lease is 10.0 78%. \n• At lease commencement, Lessor concludes that it is probable it will collect the lease payments and \nany amount owed under the residual value guarantee provided by the third party. \nNone of the criteria for a classification as a sales -type lease are met ( e.g., the present value of the \nlease payments is 83% of the fair value of the equipment, which is less than the 90% threshold that \nLessor uses in the lease classification test). Lessor classifies the lease as a direct financing lease \nbecause (1) the p resent value of the sum of the lease payments and the residual value guaranteed by \nthe unrelated third party exceeds substantially all of the fair value of the underlying asset and (2) it is \nprobable that Lessor will collect the lease payments and any amou nt owed under the residual value \nguarantee. If the residual value guarantee was provided by Lessee, the lease would be classified as a \nsales -type lease (refer to section 3.2, Criteria for lease classification — lessors ). \nAt lease commencement, Lessor accounts for the direct financing lease as follows: \nNet investment in the lease $ 100,000(a) \n Property held for lease $ 100,000(b) \nTo record the net investment in the direct financing lease and derecognize the underlying asset . \n(a) The net investment in the lease consists of (1) the present value of the 10 annual lease payments of $15,000 plus the present value \nof the guaranteed residual value of $30,000, both discounted at the rate implicit in the lease, which equals $103,344 ( i.e., the lease \nreceivable) , plus (2) the present value of unguaranteed residual asset of $20,000, which equals $7,656, less (3) deferred selling profit \nof $11,000. Deferred selling profit is calculated as the lease receivable of $103,344, less the carrying amount of the underl ying asset \nof $100,000, net of any unguaranteed residual asset of $7,656. Note that the net investment in the lease is subject to the same \nconsiderations as other assets when classifying its components as current or noncurrent assets in a classified balance she et. \n(b) $100,000 is the carrying amount of the underlying asset. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 277}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 266 Cash $ 15,000(c) \n Net investment in the lease $ 2,825(d) \n Interest income 12,175(e) \nYear 1 journal entries for the direct financing lease. \n(c) Receipt of annual lease payment at the end of the year. \n(d) Reduction of the net investment in the lease for lease payment received of $15,000, net of interest income of $12,175. \n(e) Interest income is the amount that produces a constant periodic discount rate on the remaining balance of the ne t investment \nin the lease (see computation below). \nThe following table summarizes the interest income for this lease and the related amortization of the \nnet investment over the lease term. \nYear Annual rental \npayment Annual interest \nincome(a) Net investment at \nend of year \nInitial net investment $ — $ — $ 100,000 \n1 15,000 12,175 97,175 \n2 15,000 11,831 94,006 \n3 15,000 11,445 90,451 \n4 15,000 11,012 86,463 \n5 15,000 10,527 81,990 \n6 15,000 9,982 76,972 \n7 15,000 9,371 71,343 \n8 15,000 8,686 65,029 \n9 15,000 7,917 57,946 \n10 15,000 7,054 50,000(b) \n(a) Interest income includes interest on the lease receivable, accretion of the unguaranteed residual asset and amortization of \ndeferred selling profit. The rate for recognizing interest income to produce a constant periodic rate of return on the remain ing \nnet investment is 12.175%. \n(b) The estimated residual value of the equipment at the end of the lease term. \nThe following table summarizes the components of interest income recognized over the lease term. \nYear Interest on \nlease \nreceivable(a) Accretion of \nunguaranteed \nresidual asset(b) Amortization of \ndeferred selling \nprofit(c) Annual \ninterest \nincome \n1 $ 10,415 $ 772 $ 988 $ 12,175 \n2 9,954 849 1,028 11,831 \n3 9,445 935 1,065 11,445 \n4 8,885 1,029 1,098 11,012 \n5 8,269 1,133 1,125 10,527 \n6 7,590 1,247 1,145 9,982 \n7 6,843 1,373 1,155 9,371 \n8 6,021 1,511 1,154 8,686 \n9 5,117 1,663 1,137 7,917 \n10 4,119 1,831 1,104 7,054 \n(a) Interest on the lease receivable is based on the rate implicit in the lease of 10.078%. For example, Year 1 interest on the l ease \nreceivable is calculated as the lease receivable of $103,344 multiplied by the rate implicit in the lease of 10.078%. \n(b) Accretion of the unguaranteed residual asset is based on the rate implicit in the lease of 10.078%. For example, Year 1 \naccretion of the residual as set is calculated as the present value of the unguaranteed residual asset at lease commencement \nof $7,656 multiplied by the rate implicit in the lease of 10.078%. \n(c) Deferred selling profit is amortized into interest income over the lease term in a manner that, when combined with the intere st \nincome on the lease receivable and unguaranteed residual asset, produces a constant periodic rate of return on the lease of 1 2.175%. \nImmaterial differences may arise in the recomputation of amounts in the example above due to rounding. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 278}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 267 5.4 Operating leases \nExcerpt from Accounting Standards Codification \nLeases — Lessor \nRecognition \n842-30-25-10 \nAt the commencement date , a lessor shall defer initial direct costs . \n842-30-25-11 \nAfter the commencement date, a lessor shall recognize all of the following: \na. The lease payments as income in profit or loss over the lease term on a straight -line basis unless \nanother systematic and r ational basis is more representative of the pattern in which benefit is \nexpected to be derived from the use of the underlying asset , subject to paragraph 842 -30-25-12 \nb. Variable lease payments as income in profit or loss in the period in which the changes in facts \nand circumstances on which the variable lease payments are based occur \nc. Initial direct costs as an expense over the lease term on the same basis as lease income (as \ndescribed in (a)). \n842-30-25-12 \nIf collectibility of the lease payments plus an y amount necessary to satisfy a residual value guarantee \n(provided by the lessee or any other unrelated third party) is not probable at the commencement \ndate, lease income shall be limited to the lesser of the income that would be recognized in accordance \nwith paragraph 842 -30-25-11(a) through (b) or the lease payments, including variable lease \npayments, that have been collected from the lessee. \n842-30-25-13 \nIf the assessment of collectibility changes after the commencement date, any difference between the \nlease income that would have been recognized in accordance with paragraph 842 -30-25-11(a) \nthrough (b) and the lease payments, including variable lease payments, that have been collected from \nthe lessee shall be recognized as a current -period adjustment to lease income. \nInitial Measurement \n842-30-30-4 \nA lessor shall continue to measure the underlying asset subject to an operating lease in accordance \nwith other Topics. \nSubsequent Measurement \n842-30-35-6 \nA lessor shall continue to measure, including testing for impairment in accordance with Section 360 -\n10-35 on impairment or disposal of long -lived assets, the underlying asset subject to an operating \nlease in accordance with other Topics. \nImplementation Guidance and Illustrations \n842-30-55-17 \nThis Subtopic considers the right to control the use of the underlying asset as the equivalent of \nphysical use. If the lessee controls the use of the underlying asset, recognition of lease income in \naccordance with paragraph 842-30-25-11(a) should not be affected by the extent to which the lessee \nuses the underlying asset. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 279}), Document(page\_content='5 Lessor ac counting \nFinancial reporting developments Lease accounting | 268 Under ASC 842, lessors account for operating leases in a manner similar to how they account for \noperating leases under ASC 840. That is, they continue to recognize the underlying asset and do not \nrecognize a net investment in the lease on the balance sheet or initial profit (if any) in the income \nstatement. The underlying asset continues to be accounted for in accordance with ASC 360. \nCollectibility of lease payments is probable \nIf the collectibility of the lease payments and any residual value guarantee , provided by the lessee or any \nother unrelated third party , for an operating lease is probable at lease commencement, a lessor \nsubsequently recognizes lease income over the lease term on a straight -line basis unless another \nsystematic and rational basis better represents the pattern in which benefit is expected to be derived from \nthe use of the underlying asset. After lease commencement, lessors recognize variable lease payments that \ndo not depend on an index or rate ( e.g., performance - or usage -based payments) when the changes in facts \nand circumstances on which the variable lease payments are based occur. Similarly, lessors recognize changes \nto variable lease payments that depend on an index or rate in profit or loss in the period of the change. \nCollectibility of lease payments is not probable \nIf the collectibility of the lease payments and any residual value guarantee , provided by the lessee or any \nother unrelated third party , is not probable at the commencement date for an operating lease (including a \nlease that would otherwise have qualified as a direct financing lease if it had met the collectibility \nrequirements — refer to section 3.2, Criteria for lease classification — lessors ), a lessor’s lease income is \nconstrained to the lesser of (1) the income that would have been recognized if collection were probable, \nincluding income from variable lease payments, and (2) the lease payments, including variable lease \npayments, that have been collected from the lessee. \nSubsequent changes to collectibility assessment \nIf the collectibility assessment changes to probable afte r the commencement date, any difference between \nthe lease income that would have been recognized if collectibility had always been assessed as probable \nand the lease income recognized to date is recognized as a current -period adjustment to lease income. If \nthe collectibility assessment changes to not probable after the commencement date, lease income is \nreversed to the extent that the lease payments, including variable lease payments, that have been \ncollected from the lessee are less than the lease income r ecognized to date. \nReserves for uncollectible amounts \nBefore the adoption of ASC 842, many lessors applied ASC 450-20, Contingencies — Loss Contingencies, \nto recognize reserves for the portion of an operating lease portfolio that, based on historical data, they \ndid not expect to collect. ASC 842 does not address whether a lessor can continue to record such a \nreserve after applying the new standard’s collectibility guidance , as described above . Further, the FASB \nissued final guidance in ASU 2018-19, Codification Improvements to Topic 326, Financial Instruments — \nCredit Losses , clarifying that operating lease receivables are not in the scope of ASC 326. \nAt a FASB meeting, the FASB staff described two acceptable approaches to account for uncoll ectible \noperating lease receivables. The staff said the approach a company elects should be applied consistently \nand disclosed in the financial statements if the amounts are material. \n• Approach A: The guidance in ASC 842 is a complete impairment model, and a lessor cannot use \nother US GAAP ( e.g., ASC 450-20) as a basis to recognize a reserve for uncollectible operating lease \nreceivables. Under ASC 842, if collection of the operating lease payments, plus any amount \nnecessary to satisfy a residual value guaran tee for any individual lease , is not probable (either at \nlease commencement or after the commencement date), lease income is constrained to the lesser of \ncash collected or lease income reflected on a straight -line or another systematic basis, plus variable \nlease payments when accruable. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 280}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 269 Illustration 5 -5: Journal entries when applying Approach A \nLessor A has multiple operating leases that commence on 1 January 20X9. Lessor A evaluates each \nindividual operating lease and concludes that collectibility of the lease payments plus any amounts necessary \nto sati sfy a residual value guarantee, provided by the lessee or any other unrelated third party, is probable . \n31 March 20X9 \nOn 31 March 20X9, Lessor A re-evaluates it s leases and concludes that collectibility of the lease \npayments is probable . Lessor A recognizes total lease revenue for its operating leases as follows \n(inclusive of accrued rent): \nOperating lease receivable $ 1,000 \n Lease revenue $ 1,000 \nTo recognize lease revenue and related receivables \n30 June 20X9 \nOn 30 June 20X9 , Lessor A concludes that collectibility of the remaining lease payments for Lease Y \nis no longer probable. Lessor A had previously recognized a $100 operating lease receivable and \n$100 of lease revenue related to Lease Y . The operating lease receivable remains outstanding as of \n30 June 20X9. Lessor A recognizes the impairment of the receivable related to Lease Y as follows: \nLease revenue $ 100 \n Operating lease receivable $ 100 \nTo recognize the impairment of the operating lease receivable related to Lease Y \nBecause the collectibility of lease payments related to Lease Y is not probable, lease income is \nreversed to the extent that the lease payments, including variable lease p ayments that have been \ncollected from the lessee , are less than the lease income recognized to date . If the collectibility of the \nlease payments subsequently becomes probable, Lessor A would recognize a cumulative catch -up \nadjustment for any difference between the lease income that would have been recognized if \ncollectibility had always been assessed as probable and the lease income recognized to date . \n• Approach B: After applying the guidance in ASC 842, a lessor can record a reserve under ASC 450-\n20 for uncollectible amounts . Under ASC 842, if collection of the operating lease payments, plus any \namount necessary to satisfy a residual value guarantee for any individual lease , is not probable \n(either at lease commencement or after the c ommencement date), lease income is constrained to \nthe lesser of cash collected or lease income reflected on a straight -line or another systematic basis, \nplus variable lease payments when accruable. After completing the ASC 842 assessment, a lessor \nwould ap ply an ASC 450-20 reserve to the remaining operating lease receivables ( i.e., receivables \nfor all leases that are not impaired under ASC 842). It is possible under this approach for an entity to \nrecognize an amount of lease revenue that exceeds what otherw ise would be permitted under \nASC 842 had an individual lease (or portfolio) been determined not to meet the ASC 842 collectibility \nrequirements (i.e., total lease revenue recognized may exceed cash collected). \nThe FASB staff said the accounting for the ASC 450-20 reserve would be consistent with the \naccounting currently applied for trade receivables ( before the adoption of ASC 326). A lessor that \nchooses this approach will have to apply the guidance in both ASC 842 and ASC 450-20. This may be \noperationally challenging because the thresholds for impairment differ. That is, ASC 842 requires a \ncharge to income when it is not probable that the lease payments in a contract will be collected , but \nASC 450-20 requires entities to recognize a charge to income when a loss on a recognized \nreceivable is probable and the amount of the loss can be reasonably estimated. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 281}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 270 In addition, an entity also applying an ASC 450-20 reserve may end up with a gross -up in its income \nstatement ( i.e., additional lease revenue and offsetting bad debt expense) vs. an entity solely \napplying ASC 842. \nThe following graphic illustrates the difference in the thresholds used for assessing collectibility in \nASC 842 and ASC 450-20. \n \nIllustration 5 -6: Journal entries when applying Approach B \nLessor A has multiple operating leases that commence on 1 January 20X9. Lessor A evaluates each \nindividual operating lease and concludes that collectibility of the lease payments plus any amount s \nnecessary to satisfy a residual value g uarantee, provided by the lessee or any other unrelated third \nparty, is probable. \n31 March 20X9 \nOn 31 March 20X9, Lessor A first re-evaluates its leases in accordance with the collectibility guidance \nin ASC 842 and concludes that collectibility of the lease payments is probabl e. However, based on \nhistorical data, Lessor A concludes that while not attribut able to a particular lease, it is probable that \n5% of its operating lease portfolio will not be collected. As a result, Lessor A has elected to recognize \nan ASC 450-20 reserve for this portion of its lease portfolio. Lessor A recognizes total lease revenue \nfor its operating leases (inclusive of accrued rent ) and an ASC 450-20 reserve as follows: \nOperating lease receivable $ 1,000 \n Lease revenue $ 1,000 \nTo recognize lease reven ue and related receivables \nBad debt expense\* $ 50 \n Allowance for doubtful accounts $ 50 \nTo recognize an ASC 450-20 reserve based on historical data \n\* Recognizing the ASC 450-20 reserve through a reduction of lease income is also an acceptable approach . \nASC 842 \n ASC 450-20 \n•Collectibility of lease payments \nplus any amount necessary to \nsatisfy a residual value \nguarantee (provided by the \nlessee or any other unrelated \nthird party) is probable at lease \ncommencement \n(ASC 842-30-25-12). \n•Any operating leases that do not \nmeet this t hreshold have their \nrevenue recognition constrained \nto the lesser of cash collected \nor lease income reflected on \na straight -line or another \nsystematic basis, plus variable \nlease payments when accruable. \n•A loss is recognized when it is \nprobable and the am ount can \nbe reasonably estimated \n(ASC 450-20-25-2). \n•A loss can only be recognized \nif lease revenue has been \nrecorded under ASC 842. \nHigh \n Unlikely \n Collectibility ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 282}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 271 30 June 20X9 \nOn 30 June 20X9, Lessor A concludes that collectibility of the remaining lease payments for Lease Y is no \nlonger probable. Lessor A had previously recognized a $100 operating lease receivable and $100 of \nlease revenue related to Lease Y. The operating lease receivable remains outstanding as of 30 June \n20X9. Lessor A recognizes the impairment of the receivable related to Lease Y as follows :\* \nLease revenue $ 95 \nAllowance for doubtful accounts 5(a) \nOperating lease receivable $ 100 \nTo recognize the impairment of the operating lease receivable related to Lease Y \n(a) Represents the portion of the receivable that was contemplated in the ASC 450-20 reserve ($100 x 5%). \n\* There may be other acceptable approaches for writing off an uncollectible receivable when an entity recognizes an ASC 450-\n20 reserve. However, in all cases , an entity must continue to evaluate the remaining reserve for appropriateness. \nBecause the collectibility of lease payments related to Lease Y is not probable, lease income and \namounts related to the lease that were previously recognized as part of the ASC 450-20 reserve are \nadjusted . If the collectibility of the lease payments subsequently becomes probable, Lessor A would \nrecognize a cumulative catch -up adjustment for any difference between the lease income that would \nhave been recognized if collectibilit y had always been assessed as probable and the lease income \nrecognized to date . \nReserves for uncollectible amounts — contracts that contain both lease and non -lease components \nMany contracts contain a lease coupled with an agreement to purchase or sell ot her goods or services \n(non -lease components). As mentioned previously, ASU 2018 -19 clarif ies that operating lease receivables \nare not in the scope of ASC 326. As a result, a lessor that does not apply the practical expedient to not \nseparate lease and non -lease components follows the guidance in ASC 842 to evaluate the collectibility \nof operating lease payments (including recognized operating lease receivables) and the guidance in \nASC 326 to evaluate the collectibility of receivables related to non -lease components if the receivables \nare financial assets measured at amortized cost . This may be operationally challenging because any \nrecognized lease and non -lease receivables from a single counterparty will be subject to two different \nimpairment models . \nA lessor that applies the practical expedient to not separate lease and non -lease components (refer to \nsection 1.4.2.4, Practical expedient to not separate lease and n on-lease components — lessors ) \ndetermines the predominant component in the arrangement and follows either ASC 842 or ASC 606 \nbased on the predominant component to account for and present the combined components. If the lease \ncomponent is the predominant co mponent, a lessor account s for the combined component as an \noperating lease in accordance with ASC 842 and applies Approach A or Approach B, as described above. \nIf the non -lease component is the predominant component, a lessor account s for the combined \ncomponent in accordance with ASC 606 and appl ies ASC 326 to the receivables arising from the \ncontract. Refer to our FRD, Credit impairment under ASC 326, for additional details. \nPortfolio approach to ASC 842 \nWhile we would expect lessors to evaluat e whether collection is probable under ASC 842 on a lease -by-\nlease basis, we note that ASC 842 permits an entity to use a portfolio approach when “the entity reasonably \nexpects that the application of the leases model to the portfolio would not differ mate rially from the \napplication of the leases model to the individual leases in that portfolio.” Refer to section 5.7.4.1 , \nPortfolio approach , for considerations relating to the use of a portfolio approach. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 283}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 272 We believe that if a lessor that accounts for its lea ses on a portfolio basis has data that indicates that collection of \nthe lease payments and any residual value guarantee ( i.e., provided by the lessee or any other unrelated third \nparty) is not probable under ASC 842 for a portion of its operating lease population, it may be appropriate to \napply a portfolio approach to reflect the portion of the population for which collection is not probable ( i.e., as an \nadjustment to lease income). This approach may be applied by a lessor that has many homogeneous operating \nlease contracts that can be appropriately grouped for the purpose of evaluating whether collection is probable. \nThe following chart s provide an overview of the steps to apply the guidance in both ASC 842 and ASC 450-20: \n \n1 While we would expect lessors to evaluate whether collection is probable under ASC 842 on a lease -by-lease basis, ASC 842 permits an entity \nto use a portfolio approach , which may be appropriate to use to reflect the portion of the population for which collection is not probable. \n \nNo \nYes \nYes \n No \nStep 2: Application of ASC 450-20 \n Step 1: Application of ASC 842 \nConstrain lease income \nto the lesser of cash \ncollected or lease \npayments reflected on a \nstraight -line or another \nsystematic basis, plus \nvariable rent when it \nbecomes accruable. \nRecogni ze lease payments as lease \nincome on a straight -line or another \nsystematic basis, plus variable rent \nwhen it becomes accruable. \nThe guidance in \nASC 450-20 is applied to \nthe remaining oper ating \nlease receivables \n(i.e., leases that were \nnot impaired under \nASC 842) \nNo \nadditional \nsteps. \nDoes the entity elect to also apply a loss contingency \nreserve on a portfolio basis? \nAt lease commencement, \nis collectibility of lease payments \nplus any amount necessary to \nsatisfy a residual value guaran tee \nfor each lease probable? 1 \nYes \nLease income is \nreversed to the \nextent that the \nlease payments, \nincluding variable \nlease payments \nthat have been \ncollected from the \nlessee, are less \nthan the lease \nincome recognized \nto date. \nRecognize a \ncumulative catch -\nup adjustment for \nany difference \nbetween the lease \nincome that would \nhave been \nrecognized if \ncollectibility had \nalways been \nassessed as \nprobable and the \nlease income \nrecognized to \ndate. \nRefer to Step 2: \nApplication of \nASC 450-20. \nNo \nYes \nStep 2: Application of ASC 450-20 \n Step 1: Application of ASC 842 \nDetermine whether the loss contingency reserve \ncontemplated the impairment. Adjust lease income \nunder ASC 842 and the loss con tingency reserve \nunder ASC 450-20 as necessary. \nNo \nadditional \nsteps. \nNo \nYes \nYes \nAfter lease commencement, does the assessment of \ncollectibility of lease payments for a specific lease change? \nDoes the entity elect to also \napply a n ASC 450-20 loss \ncontingency reserve? \nDid the \nassessment \nchange from \nprobable to \nnot probable? \n \nDid the \nassessment \nchange from not \nprobable to \nprobable? ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 284}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 273 Lease classification \nA lessor does not reassess lease classification if the collection of lease payments becomes probable after \nlease commencement. For example, a lease that would have otherwise been classified as a direct financing \nlease except that collectibility of lease payments and any residual value guarantee was not probable at \nlease com mencement is classified as an operating lease. If the lease payments and any residual value \nguarantee are subsequently determined to be probable of collection, the lease continues to be classified \nas an operating lease. However, a change in collectibility could affect the timing of recognition of income \nfor the operating lease. \nInitial direct costs \nASC 842 requires lessors of operating leases to defer initial direct costs at lease commencement and \namortize them over the lease term on the same basis as lease income. \n5.4.1 Time pattern of use of property in an operating lease \nOperating lease agreements may specify scheduled lease payment increases over the lease term, or \nperiods during the lease term for which lease payments are not required (“rent holidays”). Uneven lease \npayments (increases, decreases or holidays) are often d esigned to provide an inducement for the lessee, \nto reflect the anticipated effects of inflation, to ease the lessee’s near -term cash flow requirements or to \nacknowledge the time value of money. For operating leases that include uneven lease payments or re nt \nholidays, lease income should be recognized by a lessor on a straight -line basis over the lease term \nunless another systematic and rational allocation basis is more representative of the time pattern in \nwhich benefit is expected to be derived from the u se of the underlying asset, subject to the limitation \nwhen collectibility of lease payments is not probable as discussed in section 5.4, Operating leases , above. \nUsing factors such as the time value of money or anticipated inflation is inappropriate because these \nfactors do not relate to the benefit that is expected to be derived from the use of the underlying asset. \nLease agreements may also include scheduled lease payment increases designed to accommodate the \nlessee’s projected use of the underlying asset. For example, lease payments may escalate in contemplation \nof the lessee’s use of commercial real estate ( i.e., the underlying asset) even though the lessee takes \npossession of or is given control over the use of the underlying asset(s ) at the lease commencement. \nThe FASB staff, through a technical inquiry, indicated that it did not expect a change in practice in how \nsuch lease payments are recognized from the accounting under ASC 840 ( i.e., a straight -line basis). \nTherefore, the lessor should recognize the lease payments as follows: \n• If rents escalate in contemplation of the lessee’s use of the underlying asset but the lessee takes \npossession of or is given control over the use of the underlying asset(s) at the lease commencement, \nall le ase payments, including the escalated lease payments, should be recognized as lease income on \ngenerally a straight -line basis starting at the lease commencement. \n• If lease payments escalate under a master lease agreement because the lessee gains control ove r the \nuse of additional underlying assets and the right to use such additional assets is not accounted for as \na lease modification (refer to section 5.1.5, Master lease agreements , for the accounting of master \nlease agreements), the escalated lease payment s should be considered lease income attributable to \nthe additional underlying assets in the periods that the lessee has control over the use of the \nadditional underlying assets. To identify the separate lease components and allocate the amount of \nlease inc ome attributed to the additional underlying assets, the lessor applies the guidance in \nASC 842-10-15-28 through 15 -42 (refer to section 1.4, Identifying and separating lease and non -\nlease components of a contract and allocating contract consideration ). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 285}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 274 The application of the above accounting to an operating lease with uneven lease payments results in prepaid \nor accrued lease payments to the lessor. If the lessee purchases the underlying asset prior to the expiration \nof the lease term, any prepaid or accrued rentals should be included in the determination of the gain or \nloss on the cancellation of the lease and the sale of the asset (refer to section 5.7.3, Lease termination ). \n5.4.1.1 Revenue recognition — operating leases \nAssuming collection of lease payment s is probable, a lessor begins recording revenue under an operating \nlease when the lessor makes the underlying asset available for use by the lessee ( e.g., the lessee takes \npossession of or is given control over the use of the underlying asset). It should be noted that this may be \nbefore or after lease payments begin. If the lessor turns the underlying asset over to the lessee so that the \nlessee can begin making leasehold improvements to the underlying asset (e.g., lessee begins constructing \nlessee assets — leasehold improvements), then the lessor would begin recognizing lease income when the \nunderlying asset is turned over to the lessee for that purpose. If, instead, the lessor has determined that \nthe lessee is acting on the lessor’s behalf in constructing the improvements ( e.g., lessee is constructing \nlessor assets), lease income would not begin until the underlying asset is substantially complete. \n5.4.1.2 Impact of lessee vs. lessor asset on revenue recognition — operating leases \nDetermining whether an improvement, which is paid for by the lessor, is a lessee or lessor asset (refer to \nsection 2.11 , Improvements to the underlying asset ) generally impacts the determination of when the \nlessee takes possession of or is given control over the use of the under lying asset (and, consequently, \nimpacts when the lessor can begin recognizing operating lease income). The lessee generally has not \ntaken possession of or been given control over the use of the underlying asset until it is substantially \ncomplete. The follo wing illustration demonstrates this point: \nIllustration 5 -7: Impact of lessee vs. lessor asset on revenue recognition \nAssume Lessee A contracts to lease a building from Lessor B. Lessor B agrees to reimburse Lessee A \nfor $10 million of improvements ( e.g., carpeting, interior walls and similar improvements that will be \ninstalled before the lessee occupies and begins to use the building for its intended purpose) as specified \nin the lease agreement. If Lessor B determines that the improveme nts are lessor assets ( i.e., leasing the \nimproved space to the lessee), it would record lease income on a straight -line basis once the lessee has \npossession of or is given control over the use of the space (generally when the building and improvements \nare substantially complete). However, if Lessor B determines that the improvements are lessee assets, it \nwould record lease income on a straight -line basis once the lessee takes possession or is given control \nover the use of the unimproved space. In the case o f lessee’s improvements, the lessee would have \npossession of the space when it has access to begin constructing its improvements. The fact that the \nlessee may delay the date when they occupy the space ( i.e., enter to make or have their agent make \nimproveme nts) is not relevant — instead, control and possession are based on the lessee’s rights to \npossess or use. Additionally, if Lessor B determines the improvements are lessee assets, Lessor B would \nbe required to recognize the $10 million as a lease incentive (refer to section 5.4.2.1, Lease incentives \nand tenant improvements — operating leases ) and would record a liability for the incentive once incurred. \n5.4.2 Lease incentives in an operating lease \nA lessor may include incentives for the lessee to enter into the lease, such as an up -front cash payment \nto the lessee, payment of certain costs for the lessee ( e.g., lessor may reimburse the lessee for its \nmoving expenses or the construction of lessee assets) or the assumption by the lessor of the lessee’s \npreexisting lease with a third party. A payment made to or on behalf of the lessee represents an incentive \nthat should be capitalized at lease commencement and recognized on a straight -line basis over th e lease \nterm as a reduction to the lease income by the lessor (refer to section 2.4.1.2, Lease incentives ). \nSimilarly, losses incurred by the lessor as a result of assuming a lessee’s preexisting lease with a third ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 286}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 275 party should be considered a lease incent ive by the lessor. The lessor will often estimate the value of \nsuch lease incentive based on the total remaining costs reduced by the expected benefits from the \nsublease or use of the assumed underlying asset. \nThe following example illustrates the accounti ng by a lessor for lease incentives: \nIllustration 5 -8: Lessor accounting for lease incentive \nLessor A enters into an operating lease of property with Lessee B for a five -year term at a monthly \nrental of $110. In order to induce Lessee B to enter into the lease, Lessor A provides $600 to Lessee B \nat lease commencement for lessee improvements ( i.e., lessee assets). \nAt lease commencement, Lessor A accounts for the incentive as follows: \nDeferred asset (lease incentive) $ 600 \n Cash $ 600 \nTo record the lease incentive . \nRecurring monthly journal entries in Years 1 –5: \nCash $ 110 \n Lease income $ 100 \n Amortization of deferred asset (lease incentive) 10 \nTo record cash received on the lease and amortization of leas e incentive over the lease term ($600 ÷ \n60 months = $10 ). \n5.4.2.1 Lease incentives and tenant improvements — operating leases \nWhen a less or makes an up -front payment to the lessee to fund (or partially fund) lessee asset \nimprovements, the incentive is recorded as a receivable by the lessor ( i.e., a credit to cash and an \noffsetting debit to lease incentive receivable) for an operating lease. As payments are received by the \nlessor under the lease, a portion (incentive ÷ lease term) of those payments are, in substance, \nrepayments of the incentive (that is, a credit to the lease incentive receivable and an offsetting debit to \ncash). The fact tha t the incentive paid by the lessor is earmarked specifically to reimburse the lessee for \nthe cost of the new leasehold improvements (lessee assets) does not impact the accounting for the \nincentive. That is, even if the funding is designated to partially or fully fund the lessee’s leasehold \nimprovements, the lessor would still record an incentive receivable. This accounting would also apply if, \ninstead of receiving and paying cash, the lessee simply submits invoices to the lessor for a prescribed \namount of i mprovements that are determined to be lessee assets and that the lessor has agreed to fund. \n5.4.3 Asset impairment — operating leases \nAssets leased out under an operating lease should be assessed for impairment, as necessary, under the \nprovisions of ASC 360-10. Refer to our FRD, Impairment or disposal of long -lived assets , for further \ndiscussion on assessing an asset for impairment. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 287}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 276 5.5 Examples — lessor accounting \nASC 842 includes the following example of the accounting for a sales -type lease for which the collection of \nlease payments and the residual value guarantee provided by the lessee is pr obable at lease commencement. \nExcerpt from Accounting Standards Codification \nLeases — Lessors \nImplementation Guidance and Illustration s \nExample 1 — Lessor Accounting Example \nCase A — Lessor Accounting — Sales -Type Lease \n842-30-55-19 \nLessor enters into a 6-year lease of equipment with Lessee, receiving annual lease payments of \n$9,500, payable at the end of each year. Lessee provides a residual value guarantee of $13,000. \nLessor concludes that it is probable it will collect the lease payments and any amo unt necessary to \nsatisfy the residual value guarantee provided by Lessee. The equipment has a 9 -year estimated \nremaining economic life, a carrying amount of $54,000, and a fair value of $62,000 at the \ncommencement date. Lessor expects the residual value of the equipment to be $20,000 at the end of \nthe 6 -year lease term. The lease does not transfer ownership of the underlying asset to Lessee or \ncontain an option for Lessee to purchase the underlying asset. Lessor incurs $2,000 in initial direct \ncosts in conn ection with obtaining the lease, and no amounts are prepaid by Lessee to Lessor. The \nrate implicit in the lease is 5.4839 percent. \n842-30-55-20 \nLessor classifies the lease as a sales -type lease because the sum of the present value of the lease payments \nand the present value of the residual value guaranteed by the lessee amounts to substantially all of the \nfair value of the equipment. None of the other criteria to be classified as a sales -type lease are met. In \naccordance with paragraph 842 -10-25-4, the discount rate used to determine the present value of the \nlease payments and the present value of the residual value guaranteed by Lessee (5.4839 percent) for \npurposes of assessing whether the lease is a sales -type lease under the criterion in parag raph 842 -10-\n25-2(d) assumes that no initial direct costs will be capitalized because the fair value of the equipment is \ndifferent from its carrying amount. \n842-30-55-21 \nLessor measures the net investment in the lease at $62,000 at lease commencement, which is equal to \nthe fair value of the equipment. The net investment in the lease consists of the lease receivable (which \nincludes the 6 annual payments of $9,500 and the residual value guarantee of $13,000, both discounted \nat the rate implicit in the lease, w hich equals $56,920) and the present value of the unguaranteed \nresidual value (the present value of the difference between the expected residual value of $20,000 and \nthe residual value guarantee of $13,000, which equals $5,080). Lessor calculates the selli ng profit on \nthe lease as $8,000, which is the difference between the lease receivable ($56,920) and the carrying \namount of the equipment net of the unguaranteed residual asset ($54,000 — $5,080 = $48,920). The \ninitial direct costs do not factor into the c alculation of the selling profit in this Example because they are \nnot eligible for deferral on the basis of the guidance in paragraph 842 -30-25-1(c) (that is, because the \nfair value of the underlying asset is different from its carrying amount at the comme ncement date). \n842-30-55-22 \nAt the commencement date, Lessor derecognizes the equipment (carrying amount of $54,000) and \nrecognizes the net investment in the lease of $62,000 and the selling profit of $8,000. Lessor also pays \nand recognizes the initial dir ect costs of $2,000 as an expense. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 288}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 277 842-30-55-23 \nAt the end of Year 1, Lessor recognizes the receipt of a lease payment of $9,500 and interest on the \nnet investment in the lease (the beginning balance of the net investment in the lease of $62,000 × the \nrate implicit in the lease of 5.4839% = $3,400), resulting in a balance in the net investment of the \nlease of $55,900. For disclosure purposes, Lessor also calculates the separate components of the net \ninvestment in the lease: the lease receivable and the ungu aranteed residual asset. The lease receivable \nequals $50,541 (the beginning balance of the lease receivable of $56,920 — the annual lease payment \nreceived of $9,500 + the amount of interest income on the lease receivable during Year 1 of $3,121, \nwhich is $ 56,920 × 5.4839%). The unguaranteed residual asset equals $5,360 (the beginning balance \nof the unguaranteed residual asset of $5,081 + the interest income on the unguaranteed residual \nasset during Year 1 of $279, which is $5,081 × 5.4839%). \n842-30-55-24 \nAt the end of Year 6, Lessor reclassifies the net investment in the lease, then equal to the estimated \nresidual value of the underlying asset of $20,000, as equipment. \nThe following example assumes the same facts as in Case A above except that the collection of lease \npayments and the residual value guarantee provided by the lessee is not probable at lease commencement. \nExcerpt from Accounting Standards Codification \nImplementation Guidance and Illustration s \nExample 1 — Lessor Accounting Example \nCase B — Lessor Accounting — Sales -Type Lease — Collectibility of the Lease Payments Is \nNot Probable \n842-30-55-25 \nAssume the same facts and circumstances as in Case A (paragraphs 842 -30-55-19 through 55 -24), \nexcept that it is not probable Lessor will collect the lease payments and any amount necessary to \nsatisfy the residual value guarantee provided by Lessee. In reaching this conclusion, the entity \nobserves that Lessee ’s ability and intention to pay may be in doubt because of the following factors: \na. Lessee intends to make the lease payments primarily from income derived from its business in \nwhich the equipment will be used (which is a business facing significant risk s because of high \ncompetition in the industry and Lessee’s limited experience) \nb. Lessee has limited credit history and no significant other income or assets with which to make the \npayments if the business is not successful. \n842-30-55-26 \nIn accordance wit h paragraph 842 -30-25-3, Lessor does not derecognize the equipment and does not \nrecognize a net investment in the lease or any selling profit or selling loss. However, consistent with Case A, \nLessor pays and recognizes the initial direct costs of $2,000 as an expense at the commencement date. \n842-30-55-27 \nAt the end of Year 1, Lessor reassesses whether it is probable it will collect the lease payments and \nany amount necessary to satisfy the residual value guarantee provided by Lessee and concludes that it \nis not probable. In addition, neither of the events in paragraph 842 -30-25-3(b) has occurred. The \ncontract has not been terminated and Lessor has not repossessed the equipment because Lessee is \nfulfilling the terms of the contract. Consequently, Lessor acco unts for the $9,500 Year 1 lease \npayment as a deposit liability in accordance with paragraph 842 -30-25-3. Lessor recognizes \ndepreciation expense on the equipment of $7,714 ($54,000 carrying value ÷ 7 -year useful life). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 289}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 278 842-30-55-28 \nLessor’s accounting in Years 2 and 3 is the same as in Year 1. At the end of Year 4, Lessee makes the \nfourth $9,500 annual lease payment such that the deposit liability equals $38,000. Lessor concludes \nthat collectibility of the lease payments and any amou nt necessary to satisfy the residual value \nguarantee provided by Lessee is now probable on the basis of Lessee’s payment history under the \ncontract and the fact that Lessee has been successfully operating its business for four years. Lessor \ndoes not reasse ss the classification of the lease as a sales -type lease. \n842-30-55-29 \nConsequently, at the end of Year 4, Lessor derecognizes the equipment, which has a carrying amount \nof $23,143, and recognizes a net investment in the lease of $35,519. The net investmen t in the lease \nconsists of the lease receivable (the sum of the 2 remaining annual payments of $9,500 and the \nresidual value guarantee of $13,000, discounted at the rate implicit in the lease of 5.4839 percent \ndetermined at the commencement date, which equ als $29,228) and the unguaranteed residual asset \n(the present value of the difference between the expected residual value of $20,000 and the residual \nvalue guarantee of $13,000, which equals $6,291). Lessor recognizes selling profit of $50,376, the \ndiffere nce between (a) the sum of the lease receivable and the carrying amount of the deposit liability \n($29,228 lease receivable + $38,000 in lease payments already made = $67,228) and (b) the carrying \namount of the equipment, net of the unguaranteed residual as set ($23,143 — $6,291 = $16,852). \n842-30-55-30 \nAfter the end of Year 4, Lessor accounts for the remaining two years of the lease in the same manner \nas any other sales -type lease. Consistent with Case A, at the end of Year 6, Lessor reclassifies the net \ninvestment in the lease, then equal to the estimated residual value of the underlying asset of $20,000, \nas equipment. \nThe following example assumes the same facts as in Case A above except that the lease is classified as a direct \nfinancing lease because the residual value guarantee is provided by a third party unrelated to the lessee. \nExcerpt from Accounting Standards Codification \nImplementation Guidance and Illustration s \nExample 1 — Lessor Accounting Example \nCase C — Lessor Accounting — Direct Financing Lease \n842-30-55-31 \nAssume the same facts and circumstances as in Case A (paragraphs 842 -30-55-19 through 55 -24), except \nthat the $13,000 residual value guarantee is provided by a third party, not by Lessee. Collectibility of the \nlease payments an d any amount necessary to satisfy the third party residual value guarantee is probable. \n842-30-55-32 \nNone of the criteria in paragraph 842 -10-25-2 to be classified as a sales -type lease are met. In \naccordance with paragraph 842 -10-25-4, the discount rate u sed to determine the present value of the \nlease payments (5.4839 percent) for purposes of assessing whether the lease is a sales -type lease \nunder the criterion in paragraph 842 -10-25-2(d) assumes that no initial direct costs will be capitalized \nbecause the fair value of the equipment is different from its carrying amount. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 290}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 279 842-30-55-32A \nRather, Lessor classifies the lease as a direct financing lease because the sum of the present value of \nthe lease payments and the present value of the residual value guarant eed by the third party amounts \nto substantially all of the fair value of the equipment, and it is probable that Lessor will collect the \nlease payments plus any amount necessary to satisfy the third -party residual value guarantee. The \ndiscount rate used to determine the present value of the lease payments and the present value of the \nthird -party residual value guarantee for purposes of assessing whether the lease meets the criterion in \nparagraph 842 -10-25-3(b)(1) to be classified as a direct financing lease is the rate implicit in the lease \nof 4.646 percent, which includes the initial direct costs of $2,000 that Lessor incurred. \n842-30-55-33 \nAt the commencement date, Lessor derecognizes the equipment and recognizes a net investment in \nthe lease of $56,000, which is equal to the carrying amount of the underlying asset of $54,000 plus \nthe initial direct costs of $2,000 that are included in the measurement of the net investment in the \nlease in accordance with paragraph 842 -30-25-8 (that is, because the lease is classified as a direct \nfinancing lease). The net investment in the lease includes a lease receivable of $58,669 (the present \nvalue of the 6 annual lease payments of $9,500 and the third -party residual value guarantee of \n$13,000, discounted at the rate implicit in the lease of 4.646 percent), an unguaranteed residual \nasset of $5,331 (the present value of the difference between the estimated residual value of $20,000 \nand the third -party residual value guarantee of $13,000, discounted at 4.646 percen t), and deferred \nselling profit of $8,000. \n842-30-55-34 \nLessor calculates the deferred selling profit of $8,000 in this Example as follows: \na. The l ease receivable ($58,669); minus \nb. The carrying amount of the equipment ($54,000), net of the unguaranteed residual asset \n($5,331), which equals $48,669; minus \nc. The initial direct costs included in the measurement of the net in vestment in the lease ($2,000). \n842-30-55-35 \nAt the end of Year 1, Lessor recognizes the receipt of the lease payment of $9,500 and interest on the \nnet investment in the lease of $4,624 (the beginning balance of the net investment in the lease of \n$56,000 × the discount rate that, at the commencement date, would have resulted in the sum of the \nlease receivable and the unguaranteed r esidual asset equaling $56,000, which is 8.258 percent), \nresulting in a balance in the net investment of the lease of $51,124. \n842-30-55-36 \nAlso at the end of Year 1, Lessor calculates, for disclosure purposes, the separate components of the net \ninvestment in the lease: the lease receivable, the unguaranteed residual asset, and the deferred selling \nprofit. The lease receivable equals $51,895 (the beginning balance of the lease receivable of $58,669 — \nthe annual lease payment received of $9,500 + the amount of interest income on the lease receivable \nduring Year 1 of $2,726, which is $58,669 × 4.646%). The unguaranteed residual asset equals $5,578 \n(the beginning balance of the unguaranteed residual asset of $5,331 + the interest income on the \nunguaranteed resi dual asset during Year 1 of $247, which is $5,331 × 4.646%). The deferred selling \nprofit equals $6,349 (the initial deferred selling profit of $8,000 — $1,651 recognized during Year 1 \n[the $1,651 is the difference between the interest income recognized on the net investment in the \nlease during Year 1 of $4,624 calculated in paragraph 842 -30-55-35 and the sum of the interest \nincome earned on the lease receivable and the unguaranteed residual asset during Year 1]). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 291}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 280 842-30-55-37 \nAt the end of Year 2, Lessor re cognizes the receipt of the lease payment of $9,500 and interest on the \nnet investment in the lease (the beginning of Year 2 balance of the net investment in the lease of \n$51,124 × 8.258%, which is $4,222), resulting in a carrying amount of the net investm ent in the lease \nof $45,846. \n842-30-55-38 \nAlso at the end of Year 2, Lessor calculates the separate components of the net investment in the lease. \nThe lease receivable equals $44,806 (the beginning of Year 2 balance of $51,895 — the annual lease \npayment re ceived of $9,500 + the interest income earned on the lease receivable during Year 2 of \n$2,411, which is $51,895 × 4.646%). The unguaranteed residual asset equals $5,837 (the beginning of \nYear 2 balance of the unguaranteed residual asset of $5,578 + the int erest income earned on the \nunguaranteed residual asset during Year 2 of $259, which is $5,578 × 4.646%). The deferred selling \nprofit equals $4,797 (the beginning of Year 2 balance of deferred selling profit of $6,349 — $1,552 \nrecognized during Year 2 [the $1,552 is the difference between the interest income recognized on the \nnet investment in the lease during Year 2 of $4,222 and the sum of the interest income earned on the \nlease receivable and the unguaranteed residual asset during Year 2]). \n842-30-55-39 \nAt the end of Year 6, Lessor reclassifies the net investment in the lease, then equal to the estimated \nresidual value of the underlying asset of $20,000, as equipment. \nThe following example assumes the same facts as in Case C above except that the collecti bility of lease \npayments and the residual value guarantee provided by the third party unrelated to the lessee is not \nprobable at lease commencement and the lease is classified as an operating lease. \nExcerpt from Accounting Standards Codification \nImplementation Guidance and Illustration s \nExample 1 — Lessor Accounting Example \nCase D — Lessor Accounting — Collectibility Is Not Probable \n842-30-55-40 \nAssume the same facts and circumstances as Case C (paragraphs 842 -30-55-31 through 55 -39), except \nthat collectibility of the lease payments and any amount necessary to satisfy the residual value guarantee \nprovided by the third party is not probable and the lease payments escalate every year over the lease term. \nSpecifically, the lease payment due at the end of Year 1 is $7,000, and subsequent payments increase by \n$1,000 every year for the remainder of the lease term. Because it is not probable that Lessor w ill collect \nthe lease payments and any amount necessary to satisfy the residual value guarantee provided by the third \nparty in accordance with paragraph 842 -10-25-3, Lessor classifies the lease as an operating lease. \n842-30-55-41 \nLessor continues to measur e the equipment in accordance with Topic 360 on property, plant, and \nequipment. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 292}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 281 842-30-55-42 \nBecause collectibility of the lease payments is not probable, Lessor recognizes lease income only when \nLessee makes the lease payments, and in the amount of those lease payments. Therefore, Lessor only \nrecognizes lease income of $7,000 at the point in time Lessee makes the end of Year 1 payment for \nthat amount. \n842-30-55-43 \nAt the end of Year 2, Lessor concludes that collectibility of the remaining lease payments and any \namount necessary to satisfy the residual value guarantee provided by the third party is probable; \ntherefore, Lessor recognizes lease income of $12,000. The amount of $12,000 is the difference \nbetween lease income that would have been recognized through the end of Year 2 ($57,000 in total \nlease payments ÷ 6 years = $9,500 per year × 2 years = $19,000) and the $7,0 00 in lease income \npreviously recognized. Collectibility of the remaining lease payments remains probable throughout the \nremainder of the lease term; therefore, Lessor continues to recognize lease income of $9,500 each year. \nAs illustrated in the example above, a lessor does not reassess lease classification solely due to \ncollectibility of lease payments becoming probable after lease commencement ( i.e., the lease remains an \noperating lease). \n5.6 Lease modifications (updated August 2023) \nExcerpt from Accoun ting Standards Codification \nMaster Glossary \nLease Modification \nA change to the terms and conditions of a contract that results in a change in the scope of or the \nconsideration for a lease (for example, a change to the terms and conditions of the contract that adds \nor terminates the right to use one or more underlying assets or extends or shortens the contractual \nlease term). \nIf a lease is modified ( i.e., there is a change to the terms and conditions of a contract that results in a \nchange in the scope of or the consideration for the lease), the modified contract is evaluated to determine \nwhether it is or contains a lease (refer to section 1.3, Reassessment of the contract ). If a lease conti nues \nto exist, lease modification can result in: \n• A separate contract (refer to section 5.6.2, Determining whether a lease modification is accounted \nfor as a separate contract ) \n• A change in the accounting for the existing lease ( i.e., not a separate contract — refer to section \n5.6.3, Lessor accounting for a lease modification that is not accounted for as a separate contract ) \nRefer to section 5.6.1, Summary of the accounting for lease modifications — lessors . \nExamples of lease modification include a change to the terms and conditions of the contract that adds or \nterminates the right to use one or more underlying assets or extends or shortens the contractual lease \nterm . Additionally, a change to lease payments (regardless of whether they are fixed or variable) or a \nchange in the timing of lease payments is a lease modification. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 293}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounti ng | 282 5.6.1 Summary of the accounting for lease modifications — lessors \n \nLease termination if the original contract contained a sales -\ntype or direct financing lease ( ASC 842-30-40-2 and \nsection 5.7.3, Lease termination ) or if previously an operating \nlease not specifically addressed in ASC 842 — apply other guidance \nAccount for two separate contracts : \n• The unmodified original contract \n• A separate contract, which is accounted for in the same \nmanner as any other new lease \n(ASC 842-10-25-9 and section 5.6.2, Determining whether a \nlease modification is accounted for as a separate contract) \n• Remeasure and r eallocate the remaining consideration in the contract \n• Reassess the classification of the lease at the effective date of the modification \n• Account for any initial direct costs, lease incentives and other payments made to or by the lessor \n(ASC 842-10-25-9 through 25 -10 and section 5.6.3, Lessor accounting for a modification that is not accounted for as a separate contract) \nNo change in \nclassification of an \noperating lease \nA \nAn operating lease \nchanges to a sales -\ntype lease1 \nB \nAn operati ng lease \nchanges to a direct \nfinancing lease \nC \nNo change in \nclassification of a direct \nfinancing lease or a \nsales -type lease1 or \na sales -type lease1 \nchanges to a direct \nfinancing lease \nD \nA direct financing \nlease changes to an \noperating lease or a \nsales -type lease1 \nchanges to an \noperating lease \n \nE \nA direct financing \nlease changes to \na sales -type lease \nF \nApply the subsequent measurement guidance for the applicable classification \nNo \nYes \nYes \nNo \nNote: Refer to the lease modifications guidance in the table on the next page \nIs the modified contract a lease, or does it contain a lease? \n(ASC 842-10-15-6; section 1.2, Determining whether \nan arrangement contains a lease ; and section 1.3, \nReassessment of the contract ) \nDoes the modification result in a separate contract? \n(ASC 842-10-25-8 and section 5.6.2, Determining whether \na lease modification is accounted for as a separate contract ) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 294}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 283 Result of reassessing lease \nclassification Accounting on the effecti ve date of the modification Section \nreference \n No change in classification of \nan operating lease \n(ASC 842-10-25-15(a)) Recognize the lease payments to be made under the \nmodified lease, adjusted for any prepaid or accrued rent \nfrom the original lease, generally on a straight -line basis \nover the remaining lease term. 5.6.3.1, \nModification \nto an \noperating \nlease that \nis not \naccounted \nfor as a \nseparate \ncontract An operating lease changes to \na sales -type lease1 \n(ASC 842-10-25-15(b)) Apply the initial recognition and measurement guidance for \nsales -type leases and adjust the selling profit or selling loss \nby any prepaid or accrued rent from the original lease \n(i.e., derecognize any prepaid or accrued rent). \n An operating lease changes to \na direct financing lease \n(ASC 842-10-25-15(b)) Apply the initial recognition and measurement guidance for \ndirect financing leases and adjust the selling profit or selling \nloss by any prepaid or accrued rent from the original lease \n(i.e., derecognize any prepaid or accrued rent). \n No change in classification of \na direct financing lease \n(ASC 842-10-25-16(a)) \nor a sales -type lease1 \n(ASC 842-10-25-17(a)) \nor a sales -type lease1 changes to \na direct financing lease \n(ASC 842-10-25-17(a)) Adjust the discount rate in the measurement of the modified \nlease so that the initial net investment in the modif ied lease \nequals the carrying amount of the net investment in the \noriginal lease immediately before the effective date of the \nmodification. 5.6.3.2, \nModification \nto a direct \nfinancing \nlease that \nis not \naccounted \nfor as a \nseparate \ncontract , \nand \n5.6.3.3, \nModification \nto a sales -\ntype lease \nthat is not \naccounted \nfor as a \nseparate \ncontract A direct financing lease \nchanges to an operating lease \n(ASC 842-10-25-16(c)) or a \nsales -type lease1 changes to an \noperating lease ( ASC 842-\n10-25-17(b)) Recognize the carrying amount of the underlying asset at an \namount equal to the net investment in the original lease \nimmediately before the effective date of the modification. \n A direct financing lease \nchanges to a sales -type lease \n(ASC 842-10-25-16(b)) Apply the initial recognition and measurement guidance for \nsales -type leases and use the fair value of the underlying \nasset and the carrying value of the net investment in the \ndirect finan cing lease as of the effective date of the \nmodification to calculate any selling profit or loss. 5.6.3.2, \nModification \nto a direct \nfinancing \nlease that \nis not \naccounted \nfor as a \nseparate \ncontract \n1 This accounting is for sales -type leases for which the co llectibility of lease payments and any residual value guarantee provided \nby the lessee is probable. Refer to section 5.2.1.2, Initial recognition and measurement when collectibility is not probable at \nlease commencement — sales -type leases , for guidance when the collectibility of these items is not probable. A \nB \nC \nD \nE \nF ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 295}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 284 5.6.2 Determining whether a lease modification is accounted for as a separate contract \nExcerpt from Accounting Standards Codification \nLeases — Overall \nRecognition \n842-10-25-8 \nAn entity shall account for a modification to a contract as a separate contract (that is, separate from \nthe original contract) when both of the following conditions are present: \na. The modification grants the lessee an additional right of use n ot included in the original lease (for \nexample, the right to use an additional asset). \nb. The lease payments increase commensurate with the standalone price for the additional right of \nuse, adjusted for the circumstances of the particular contract. For exa mple, the standalone price \nfor the lease of one floor of an office building in which the lessee already leases other floors in \nthat building may be different from the standalone price of a similar floor in a different office \nbuilding, because it was not ne cessary for a lessor to incur costs that it would have incurred for a \nnew lessee. \nA lessor accounts for a modification to a contract ( i.e., a change to the terms and conditions of a \ncontract that results in a change in the scope of or consideration for the lease) as a separate contract \n(i.e., separate from the original contract) when both of the following conditions are met: \n• The modification g rants the lessee an additional right of use that is not included in the original lease \n(e.g., a right to use an additional underlying asset). \n• The lease payments increase commensurate with the standalone price for the additional right of use, \nadjusted for t he circumstances of the particular contract. \nIf both of these conditions are met, the lease modification results in two separate contracts, the \nunmodified original contract and a separate contract. Lessors account for the separate contract that \ncontains a lease in the same manner as other new leases. \nIf both of the conditions are not met, the modified lease is not accounted for as a separate contract. Refer \nto section 5.6.3, Lessor accounting for a modification that is not accounted for as a separate contra ct. \nThe FASB indicated in the Basis for Conclusions (BC 176(a)) of ASU 2016 -02 that the right to use an \nadditional underlying asset ( e.g., an additional floor of a building) will generally be a separate lease \ncomponent, even if the modification granting that additional right of use does not create a separate \ncontract. To illustrate, if an existing lease for a floor of a building is modified t o include a second floor, \nthe right to use the second floor will often be a separate lease component from the right to use the first \nfloor, even if the second floor is not accounted for under a separate contract. Refer to section 1.4.1, \nIdentifying and sep arating lease components of a contract . \nIf the lease modification grants the lessee the right to use the existing underlying asset for an additional \nperiod of time ( i.e., a period of time not included in the original lease agreement), the modified lease is not \naccounted for as a separate contract (refer to section 5.6.3, Lessor accounting for a modification that is not \naccounted for as a separate contract ). In such cases, as indicated in the Basis for Conclusions (BC 176(b)) of \nASU 2016 -02, the modification only changes an attribute of the lessee’s existing right to use the underlying \nasset that it already controls. This is the case even if the extended term is priced at market. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 296}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 285 5.6.3 Lessor accounting for a modification that is not accounted for as a separa te \ncontract \nExcerpt from Accounting Standards Codification \nMaster Glossary \nEffective Date of the Modification \nThe date that a lease modification is approved by both the lessee and the lessor . \nLeases — Overall \nRecognition \n842-10-25-1 \nAn entity shall classify each separate lease component at the commencement date . An entity shall not \nreassess the lease classification after the commencement date unless the contract is modified and the \nmodification is not accounted for as a separate contract in accordanc e with paragraph 842 -10-25-8. In \naddition, a lessee also shall reassess the lease classification after the commencement date if there is a \nchange in the lease term or the assessment of whether the lessee is reasonably certain to exercise an \noption to purch ase the underlying asset . When an entity (that is, a lessee or lessor) is required to \nreassess lease classification, the entity shall reassess classification of the lease on the basis of the facts \nand circumstances (and the modified terms and conditions, i f applicable) as of the date the reassessment \nis required (for example, on the basis of the fair value and the remaining economic life of the underlying \nasset as of the date there is a change in the lease term or in the assessment of a lessee option to \npurchase the underlying asset or as of the effective date of a modification not accounted for as a \nseparate contract in accordance with paragraph 842 -10-25-8). \n842-10-25-9 \nIf a lease is modified and that modification is not accounted for as a separate contract in accordance with \nparagraph 842 -10-25-8, the entity shall reassess the classification of the lease in accordance with \nparagraph 842 -10-25-1 as of the effective date o f the modification . \n842-10-25-10 \nAn entity shall account for initial direct costs , lease incentives, and any other payments made to or by \nthe entity in connection with a modification to a lease in the same manner as those items would be \naccounted for in co nnection with a new lease. \nThe following provides an overview of the reassessment and remeasurement require ments applicable to \nlessors when a modified lease is not accounted for as a separate contract: \n \n1 When a lessee exercises an option to extend or terminate the lease or purchase the underlying asset and the exercise of the \noption is inconsistent with the existing lease determination, the lessor accounts for the exercise of that option in the same \nmanner as a lease modification. \n2 Reassess for purposes of lease classification. The discount rate used to account for the modified lease depends on the classi fication \nof the lease before and after the lease modification. For more information, refer to section 2.5.3.1, Reassessment of the discount \nrate — lessors . \nLessors reassess the following upon a lease modif ication that is not accounted for as a separate contract: \nLease term and purchase options1 \nMeasurement/allocation of consideration \nin the contract \nDiscount rate2 \n Lease classification ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 297}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 286 ASC 842 requires lessors to reassess lease classification at the effective date of a lease modification \n(i.e., the date that the lease modification is approved by both the lessee and the lessor) that i s not \naccounted for as a separate contract. Lease classification is reassessed using the modified terms and \nconditions and the facts and circumstances as of that date, including: \n• The remaining economic life of the underlying asset on that date \n• The fair val ue of the underlying asset on that date \n• The rate implicit in the lease on that date (refer to section 2.5.1, Discount rate — lessors ) \n• The remeasure d and reallocat ed remaining consideration in the contract on that date , which includes \nthe remaining balance of any unamortized lease prepayments \nLessors account for initial direct costs, lease incentives and any other payments made to or by the lessor \nin connection with the lease modification in the same manner as those items are accounted for in \nconnection with a new lease. Refer to section 2, Key concepts . \nThe following chart provides an overview of the reassessment and remeasurement requirements applicable \nto less ors. \n Measurement/ \nallocation of \nconsideration, \nlease payments1 Discount \nrate2 Lease \nterm and \nclassification \nA modification occurs that is not accounted for as a separate \ncontract, and the modified contract is or contains a lease ✓ ✓ ✓ \nA lessee exercises an option to extend the lease or purchase the \nunderlying asset that the lessor previously determined the lessee was \nnot reasonably certain to exercise or exercises an option to terminate \nthe lease that the lessor previously determined the lessee was \nreasonably certain not to exercise N/A3 N/A3 N/A3 \nA contingency is resolved that results in v ariable lease payments \nmeet ing the definition of lease payments N/A N/A N/A \n1 Includes updating variable lease payments that depend on an index or rate as of the remeasurement date using the \nremeasurement date index or rate. \n2 The discount rate that is used to account for the modified lease depends on the classification of the lease before and after the \nlease modification. Refer to section 2.5.3.1, Reassessment of the discount rate — lessors , for further details. \n3 The lessor s hall account for these events in the same manner as a lease modification . Refer to section 5.6, Lease modifications , \nfor further details. \n5.6.3.1 Modification to an operating lease that is not accounted for as a separate contract \n Excerpt from Accounting Standards Codification \nLeases — Overall \nRecognition \n842-10-25-15 \nIf an operating lease is modified and the modification is not accounted for as a separate contract in \naccordance with paragraph 842 -10-25-8, the lessor shall account for the modification as if it were a \ntermination of the existing lease and the creation of a new lease that commences on the effective \ndate of the modification as follows: \na. If the modif ied lease is classified as an operating lease, the lessor shall consider any prepaid or accrued \nlease rentals relating to the original lease as a part of the lease payments for the modified lease. \nb. If the modified lease is classified as a direct financi ng lease or a sales -type lease , the lessor shall \nderecognize any deferred rent liability or accrued rent asset and adjust the selling profit or \nselling loss accordingly. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 298}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 287 Operating lease to operating lease \nIf the original lease and the modified lease are b oth classified as operating leases ( i.e., no change to lease \nclassification), the lessor recognizes lease payments to be made under the modified lease, adjusted for \nany prepaid or accrued rent from the original lease, generally on a straight -line basis ove r the new lease \nterm ( i.e., the remaining lease term from the original lease at the date of modification, adjusted for the \nadditional or terminated periods). Any initial direct costs incurred in connection with the modification are \nrecognized as an expense over the new lease term. We believe that any unamortized initial direct costs \nrecognized prior to the modification also should continue to be recognized as an expense over the new \nlease term. \nASC 842 includes the following example of a lessor’s accounting for a modification of an operating lease \nthat does not change lease classification. \nExcerpt from Accounting Standards Codification \nImplementation Guidance and Illustrations \nExample 20 — Modification of an Operating Lease That Does Not Change Lease Classification \n842-10-55-190 \nLessor enters into a 10 -year lease with Lessee for 10,000 square feet of office space. The annual \nlease payments are $100,000 in the first year, increasing by 5 percent each year thereafter, payable \nin arrears. The lease term i s not for a major part of the remaining economic life of the office space \n(40 years), and the present value of the lease payments is not substantially all of the fair value of the \noffice space. Furthermore, the title does not transfer to Lessee as a conseq uence of the lease, the \nlease does not contain an option for Lessee to purchase the office space, and the asset is not specialized \nsuch that it clearly has an alternative use to Lessor at the end of the lease term. Consequently, the \nlease is classified as an operating lease. \n842-10-55-191 \nAt the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining \n5 years to include an additional 10,000 square feet of office space in the same building for a total \nannual fixed payment of $150,000. The increase in total consideration is at a discount both to the \ncurrent market rate for the new 10,000 square feet of office space and in the context of that particular \ncontract. The modified lease continues to be classified as an operating lea se. \n842-10-55-192 \nAt the effective date of the modification (at the beginning of Year 6), Lessor has an accrued lease \nrental asset of $76,331 (rental income recognized on a straight -line basis for the first 5 years of the \nlease of $628,895 [$1,257,789 ÷ 10 years = $125,779 per year] less lease payments for the first \n5 years of $552,564 [that is, $100,000 in Year 1, $105,000 in Year 2, $110,250 in Year 3, \n$115,763 in Year 4, and $121,551 in Year 5]). \n842-10-55-193 \nBecause the change in pricing of the lease i s not commensurate with the standalone price for the \nadditional right -of-use asset, Lessor does not account for the modification as a new lease, separate \nfrom the original 10 -year lease. Instead, Lessor accounts for the modified lease prospectively from th e \neffective date of the modification, recognizing the lease payments to be made under the modified \nlease of $750,000 ($150,000 × 5 years), net of Lessor’s accrued rent asset of $76,331, on a \nstraight -line basis over the remaining 5 -year lease term ($673,66 9 ÷ 5 years = $134,734 per year). \nAt the end of the lease, Lessor will have recognized as lease income the $1,302,564 in lease \npayments it receives from Lessee during the 10 -year lease term. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 299}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 288 Operating lease to sales -type lease \nIf the original lease was an operating lease and the modified lease is classified as a sales -type lease \n(i.e., lease classification changes), a lessor derecognizes the underlying asset and applies the initial \nrecognition and measurement guidance for sales -type leases (refer to sect ion 5.2.1, Initial recognition \nand measurement — sales -type leases ) and adjusts the selling profit or loss by any prepaid or accrued rent \nfrom the original lease that is derecognized. \nFor modifications resulting in a sales -type lease with selling profit or loss, the profit or loss is recognized, \nand any initial direct costs incurred in connection with the modification are expensed. \nASC 842 includes the following example of a lessor’s ac counting for a modification to an operating lease \nthat is not accounted for as a separate contract but changes lease classification (i.e., operating lease to \nsales -type lease). \nExcerpt from Accounting Standards Codification \nImplementation Guidance and Illustrations \nExample 21 — Modification of an Operating Lease That Changes Lease Classification \nCase A — Operating Lease to Sales -Type Lease \n842-10-55-194 \nLessor enters into a four -year lease of a piece of nonspecialized equipment. The annual lease payment s \nare $81,000 in the first year, increasing by 5 percent each year thereafter, payable in arrears. The \nestimated residual value of the equipment is $90,000, of which none is guaranteed. The remaining \neconomic life of the equipment at lease commencement is seven years. The carrying amount of the \nequipment and its fair value are both $425,000 at the commencement date. The lease is not for a \nmajor part of the remaining economic life of the equipment, and the present value of the lease payments \nis not substanti ally all of the fair value of the equipment. Furthermore, title does not transfer to Lessee \nas a result of the lease, the lease does not contain an option for Lessee to purchase the underlying \nasset, and because the asset is nonspecialized, it is expected to have an alternative use to Lessor at \nthe end of the lease term. Consequently, the lease is classified as an operating lease. \n842-10-55-195 \nAt the beginning of Year 3, Lessee and Lessor agree to extend the lease term by two years. That is, the \nmodified l ease is now a six -year lease, as compared with the original four -year lease. The additional two \nyears were not an option when the original lease was negotiated. The modification alters the Lessee’s \nright to use the equipment; it does not grant Lessee an ad ditional right of use. Therefore, Lessor does \nnot account for the modification as a separate contract from the original four -year lease contract. \n842-10-55-196 \nOn the effective date of the modification, the fair value of the equipment is $346,250, and the remaining \neconomic life of the equipment is 5 years. The estimated residual value of the equipment is $35,000, \nof which none is guaranteed. The modified lease is for a major part of the remaining economic life of \nthe equipment at the effective date of the modification (four years out of the five -year - remaining \neconomic life of the equipment). Consequently, the modified lease is classified as a sales -type lease. \n842-10-55-197 \nIn accounting for the modification, Lessor determines the discount rate for the modified lease (that is, \nthe rate implicit in the modified lease) to be 7.6 percent. Lessor recognizes the net investment in the \nmodified lease of $346,250 and derecognizes bot h the accrued rent and the equipment at the effective \ndate of the modification. Lessor also recognizes, in accordance with paragraph 842 -10-25-15(b), \nselling profit of $34,169 ($320,139 lease receivable — $8,510 accrued rent balance — the $277,460 \ncarrying amount of the equipment derecognized, net of the unguaranteed residual asset [$277,460 = \n$303,571 — $26,111]). After the effective date of the modification, Lessor accounts for the modified \nlease in the same manner as any other sales -type lease in accorda nce with Subtopic 842 -30. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 300}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 289 Operating lease to direct financing lease \nIf the original lease was an operating lease and the modified lease is classified as a direct financing lease \n(i.e., lease classification changes), the lessor derecognizes the underlying asset and applies the initial \nrecognition and measurement guidance for direct financing leases (refer to section 5.3.1, Initial recognition \nand measurement — direct financing leases ) and adjusts the selling profit or loss by any prepaid or accrued \nrent from the original lease that is derecognized. A lessor recognizes any selling loss at lease commencement \n(i.e., the effective date of the lease modification) . A lessor would need to consider if any indicators of \nimpairment are present when a selling loss is present. Any selling profit and initial direct costs incurred in \nconnection with the modification are deferred and included in the measurement of the initial net investment \nin the modified lease. We believe that any unamortized initial direct costs associated with the original lease \nmay continue to be included in the measurement of the initial net investment in the modified lease. \nASC 842 includes the following example of a lessor’ s accounting for a modification to an operating lease \nthat is not accounted for as a separate contract but changes lease classification ( i.e., operating lease to \ndirect financing lease). \nExcerpt from Accounting Standards Codification \nImplementation Guidan ce and Illustrations \nExample 21 — Modification of an Operating Lease That Changes Lease Classification \nCase B — Operating Lease to Direct Financing Lease \n842-10-55-198 \nAt the beginning of Year 3, Lessee and Lessor enter into a modification to extend the le ase term by \n1 year, and Lessee agrees to make lease payments of $108,000 per year for each of the remaining \n3 years of the modified lease. No other terms of the contract are modified. Concurrent with the \nexecution of the modification, Lessor obtains a resi dual value guarantee from an unrelated third party \nfor $40,000. Consistent with Case A (paragraphs 842 -10-55-194 through 55 -197), at the effective \ndate of the modification the fair value of the equipment is $346,250, the carrying amount of the \nequipment is $303,571, and Lessor’s accrued rent balance is $8,510. The estimated residual value at \nthe end of the modified lease term is $80,000. The discount rate for the modified lease is 7.356 percent. \n842-10-55-199 \nLessor reassesses the lease classification as of the effective date of the modification and concludes \nthat the modified lease is a direct financing lease because none of the criteria in paragraph 842 -10-25-2 \nand both criteria in paragraph 842 -10-25-3(b) are met. \n842-10-55-200 \nTherefore, at the effective date of the modification, Lessor recognizes a net investment in the \nmodified lease of $312,081, which is the fair value of the equipment ($346,250) less the selling profit \non the lease ($34,169 =$313,922 lease receivable — $8,510 accrued rent bal ance — the $271,243 \ncarrying amount of the equipment derecognized, net of the unguaranteed residual asset [$271,243 = \n$303,571 — $32,328]), which is deferred as part of the net investment in the lease. After the effective \ndate of the modification, Lessor a ccounts for the modified lease in the same manner as any other \ndirect financing lease in accordance with Subtopic 842 -30. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 301}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 290 5.6.3.2 Modification to a direct financing lease that is not accounted for as a separate contract \nExcerpt from Accounting Standards C odification \nLeases — Overall \nRecognition \n842-10-25-16 \nIf a direct financing lease is modified and the modification is not accounted for as a separate contract \nin accordance with paragraph 842 -10-25-8, the lessor shall account for the modified lease as follows: \na. If the modified lease is classified as a direct financing lease, the lessor shall adjust the discount rate for \nthe modified lease so that the initial net investment in the modified lease equals the carrying amount \nof the net investment in the o riginal lease immediately before the effective date of the modification. \nb. If the modified lease is classified as a sales -type lease, the lessor shall account for the modified lease \nin accordance with the guidance applicable to sales -type leases in Subtop ic 842 -30, with the \ncommencement date of the modified lease being the effective date of the modification. In \ncalculating the selling profit or selling loss on the lease, the fair value of the underlying asset is its \nfair value at the effective date of the modification and its carrying amount is the carrying amount of \nthe net investment in the original lease immediately before the effective date of the modification. \nc. If the modified lease is classified as an operating lease, the carrying amount of the underlying \nasset equals the net investment in the original lease immediately before the effective date of \nthe modification. \nDirect financing lease to direct financing lease \nIf the original lease and the modified lease are both classified as direct financing leases ( i.e., there is no \nchange to lease classification), a lessor adjusts the discount rate used to measure the initial net investment \nin the modified lease so that it equals the carrying amount of t he net investment in the original lease \nimmediately before the effective date of the modification, plus any capitalized initial direct costs incurred in \nconnection with the modification. No gain or loss is recognized unless there is an impairment of the ne t \ninvestment in the lease, in which case, a loss is recognized. Refer to section 5.2.3, Impairment of the net \ninvestment in the lease — sales -type leases . \nASC 842 includes the following example of a lessor’s accounting for a modification to a direct financ ing \nlease that is not accounted for as a separate contract, and there is no change to lease classification. \nExcerpt from Accounting Standards Codification \nImplementation Guidance and Illustrations \nExample 22 — Modification of a Direct Financing Lease \n842-10-55-201 \nLessor enters into a six -year lease of a piece of new, nonspecialized equipment with a nine -year economic \nlife. The annual lease payments are $11,000, payable in arrears. The estimated residual value of the \nequipment is $21,000, of which $15,000 is guaranteed by a third -party unrelated to Lessee or Lessor. \nThe lease does not contain an option for Lessee to purchase the equipment, and the title does not transfer \nto Lessee as a consequence of the lease. The fair value of the equipment at lease comme ncement is \n$65,240, which is equal to its cost (and carrying amount). Lessor incurs no initial direct costs in \nconnection with the lease. The rate implicit in the lease is 7.5 percent such that the present value of the \nlease payments is $51,632 and does no t amount to substantially all of the fair value of the equipment. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 302}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 291 842-10-55-202 \nThe Lessor concludes that the lease is not a sales -type lease because none of the criteria in paragraph \n842-10-25-2 are met. However, the sum of the present value of the lease payments and the present \nvalue of the residual value of the underlying asset gua ranteed by the third -party guarantor is $61,352, \nwhich is substantially all of the fair value of the equipment, and collectibility of the lease payments is \nprobable. Consequently, the lease is classified as a direct financing lease. Lessor recognizes the n et \ninvestment in the lease of $65,240 (which includes the lease receivable of $61,352 and the present \nvalue of the unguaranteed residual value of $3,888 [the present value of the difference between the \nexpected residual value of $21,000 and the guaranteed residual value of $15,000]) and derecognizes \nthe equipment with a carrying amount of $65,240. \n842-10-55-203 \nAt the end of Year 1, Lessor receives a lease payment of $11,000 from Lessee and recognizes \ninterest income of $4,893 ($65,240 × 7.5%). Therefore, t he carrying amount of the net investment in \nthe lease is $59,133 ($65,240 + $4,893 — $11,000). \nCase A — Direct Financing Lease to Direct Financing Lease \n842-10-55-204 \nAt the end of Year 1, the lease term is reduced by 1 year and the annual lease payment is reduced to \n$10,000 for the remaining 4 years of the modified lease term. The estimated residual value of the \nequipment at the end of the modified lease term is $33,000, of which $30,000 is guaranteed by the \nunrelated third party, while the fair value of t he equipment is $56,000. The remaining economic life of the \nequipment is 8 years, and the present value of the remaining lease payments, discounted using the rate \nimplicit in the modified lease of 8.857 percent, is $32,499. Lessor concludes that the modifi ed lease is not \na sales -type lease because none of the criteria in paragraph 842 -10-25-2 are met. However, the sum of \nthe present value of the lease payments and the present value of the residual value of the underlying asset \nguaranteed by the third -party guarantor, discounted using the rate implicit in the modified lease of 8.857 \npercent, is $53,864, which is substantially all of the fair value of the equipment, and collectibility of the \nlease payments is probable. As such, the modified lease is classified as a direct financing lease. \n842-10-55-205 \nIn accounting for the modification in accordance with paragraph 842 -10-25-16(a), Lessor carries \nforward the balance of the net investment in the lease of $59,133 immediately before the effective \ndate of the modif ication as the opening balance of the net investment in the modified lease. To retain \nthe same net investment in the lease even while the lease payments, the lease term, and the estimated \nresidual value have all changed, Lessor adjusts the discount rate fo r the lease from the rate implicit in \nthe modified lease of 8.857 percent to 6.95 percent. This discount rate is used to calculate interest \nincome on the net investment in the lease throughout the remaining term of the modified lease and \nwill result, at th e end of the modified lease term, in a net investment balance that equals the estimated \nresidual value of the underlying asset of $33,000. \nDirect financing lease to sales -type lease \nIf the modified lease is classified as a sales -type lease ( i.e., lease classification changes), a lessor applies the \ninitial recognition and measurement guidance for sales -type leases (refer to section 5.2.1, Initial recognition \nand measurement — sales -type leases ) and uses the fair value of the underlying asset and the carrying value \nof the net investment in the direct financing lease as of the effective date of the modification to calculate any \ngain or loss to be recognized in profit or loss. If the modification results in a sales -type lease with selling profit \nor loss , a lessor recognizes initial direct costs incurred in connection with the modification as an expense. If there \nis no selling profit or loss, the initial direct costs are deferred and recognized over the remaining lease term. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 303}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 292 ASC 842 includes the following example of a lessor’s accounting for a modification to a direct financing \nlease that is not accounted for as a separate contract but changes lease classification. This example assumes \nthe same facts as in Case A above, except that the modified lease is cl assified as a sales -type lease. \nExcerpt from Accounting Standards Codification \nCase B — Direct Financing Lease to Sales -Type Lease \n842-10-55-206 \nAt the end of Year 1, the lease term is extended for two years. The lease payments remain $11,000 \nannually, paid in arrears, for the remainder of the lease term. The estimated residual value is $6,500, \nof which none is guaranteed. The rate implicit in the modified lease is 7.58 percent. At the effective \ndate of the modification, the remaining economic life of the equipment is 8 years , and the fair value of \nthe equipment is $62,000. Because the modified lease term is now for the major part of the remaining \neconomic life of the equipment, the modified lease is classified as a sales -type lease. \n842-10-55-207 \nOn the effective date of the modification, Lessor recognizes a net investment in the sales -type lease of \n$62,000, which is equal to the fair value of the equipment at the effective date of the modification, \nand derecognizes the carrying amount of the ne t investment in the original direct financing lease of \n$59,133. The difference of $2,867 is the selling profit on the modified lease. After the effective date \nof the modification, Lessor accounts for the sales -type lease in the same manner as any other sal es-\ntype lease in accordance with Subtopic 842 -30. \nDirect financing lease to operating lease \nIf the modified lease is classified as an operating lease ( i.e., lease classification changes), a lessor \nrecognizes the carrying amount of the underlying asset at an amount equal to the net investment in the \noriginal lease immediately before the effective date of the modification. A lessor recognizes initial direct \ncosts incurred in connection with the modification as an expense over the lease term. \nASC 842 includes the following example of a lessor’s accounting for a modification to a direct financing \nlease that is not accounted for as a separate contract but changes lease classification. This example assumes \nthe same facts as in Case A above, except that the modified lease is classified as an operating lease. \nExcerpt from Accounting Standards Codification \nCase C — Direct Financing Lease to Operating Lease \n842-10-55-208 \nAt the end of Year 1, the lease term is reduced by 2 years, and the lease payments are reduced to \n$9,000 per year for the remaining 3 -year lease term. The estimated residual value is revised to \n$33,000, of which only $13,000 is guaranteed by an unrelated third party. The fair value of the \nequip ment at the effective date of the modification is $56,000. The modified lease does not transfer \nthe title of the equipment to Lessee or grant Lessee an option to purchase the equipment. The \nmodified lease is classified as an operating lease because it does not meet any of the criteria to be \nclassified as a sales -type lease or as a direct financing lease. \n842-10-55-209 \nTherefore, at the effective date of the modification, Lessor derecognizes the net investment in the lease, \nwhich has a carrying amount of $59 ,133, and recognizes the equipment at that amount. Collectibility of \nthe lease payments is probable; therefore, Lessor will recognize the $27,000 ($9,000 × 3 years) in \nlease payments on a straight -line basis over the 3 -year modified lease term, as well as depreciation on \nthe rerecognized equipment. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 304}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 293 5.6.3.3 Modification to a sales -type lease that is not accounted for as a separate contract \nExcerpt from Accounting Standards Codification \nLeases — Overall \nRecognition \n842-10-25-17 \nIf a sales -type lease is modified and the modification is not accounted for as a separate contract in \naccordance with paragraph 842 -10-25-8, the lessor shall account for the modified lease as follows: \na. If the modified lease is classified as a sales -type or a direct financing le ase, in the same manner as \ndescribed in paragraph 842 -10-25-16(a) \nb. If the modified lease is classified as an operating lease, in the same manner as described in \nparagraph 842 -10-25-16(c). \nSales -type lease to sales -type lease or to direct financing leas e \nIf a modified sales -type lease is classified as a sales -type lease ( i.e., there is no change to lease classification) \nor a direct financing lease ( i.e., there is a change to lease classification), a lessor adjusts the discount rate used \nto measure the in itial net investment in the modified lease so that it equals the carrying amount of its net \ninvestment in the original lease immediately before the effective date of the modification plus any capitalized \ninitial direct costs incurred in connection with the modification. No gain or loss is recognized unless there is an \nimpairment of the net investment in the lease, in which case, a loss is recognized. Refer to section 5.2.3, \nImpairment of the net investment in the lease — sales -type leases. Lessors are prohi bited from recognizing a \nsecond gain on a sales -type lease that is modified and remains a sales -type lease. \nSales -type lease to operating lease \nIf a modified sales -type lease is classified as an operating lease ( i.e., lease classification changes), a \nlesso r recognizes the carrying amount of the underlying asset at an amount equal to the net investment \nin the original lease immediately before the effective date of the modification. A lessor recognizes initial \ndirect costs incurred in connection with the modi fication as an expense over the lease term. \n5.6.3.4 Lessor accounting for a modification due to reference rate reform (updated August 2023 ) \nNote \nIn January 2021, t he FASB issued ASU 2021 -01, Reference Rate Reform (Topic 848): Scope , to \nclarify that all derivative instruments affected by changes to the interest rates used for discounting, \nmargining or contract price alignment due to reference rate reform are in the scope of ASC 848. The \nASU does not amend the guidance in ASC 842 or affect the optional expedient provided to lessors by \nASC 848 to not apply certain modification accounting requirements to contracts affected by reference \nrate reform . Amendments to the following excerpts from ASC 848 as a result of the ASU are reflected as \npending content below. \n \nExcerpt from Accounting Standards Codification \nReference Rate Reform — Contract Modifications \nScope and Scope Exceptions \n848-20-15-2 \nThe guidance in this Subtopic, if elected, shall apply to contract modifications if the terms that are \nmodified directly replace, or have the potential to replace, a reference rate within the scope of \nparagraph 848 -10-15-3 with another interest rate index. If other terms are contemporaneously ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 305}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 294 modified in a manner that changes, or has the potential to change, the amount or timing of contractual \ncash flows, the guidance in this Subtopic shall apply only if those modifications are related to the \nreplacement of a reference rate. For example, the addition of contractual fallback terms or the amendment \nof existing contractual fallback terms related to the replacement of a reference rate that are contingent \non one or more events occurring has the potential to chang e the amount or timing of contractual cash \nflows and the entity potentially would be eligible to apply the guidance in this Subtopic. \nPending Content: \nTransition Date: (P) January 1, 2025; (N) January 1, 2025 | Transition Guidance: 848-10-65-2 \nThe guidance in this Subtopic, if elected, shall apply to contracts that meet the scope of paragraph \n848-10-15-3 if either or both of the following occur: \na. The terms that are modified directly replace, or have the potential to replace, a reference rate \nwithin t he scope of paragraph 848 -10-15-3 with another interest rate index. If other terms are \ncontemporaneously modified in a manner that changes, or has the potential to change, the \namount or timing of contractual cash flows, the guidance in this Subtopic shall apply only if \nthose modifications are related to the replacement of a reference rate. For example, the \naddition of contractual fallback terms or the amendment of existing contractual fallback terms \nrelated to the replacement of a reference rate that are co ntingent on one or more events \noccurring has the potential to change the amount or timing of contractual cash flows and the \nentity potentially would be eligible to apply the guidance in this Subtopic. \nb. The interest rate used for margining, discounting, or c ontract price alignment is modified as a \nresult of reference rate reform. \n848-20-15-3 \nThe guidance in this Subtopic shall not apply if a contract modification is made to a term that changes, \nor has the potential to change, the amount or timing of contractual cash flows and is unrelated to the \nreplacement of a reference rate. That is, this Subtopic shall not apply if contract modifications are \nmade contemporaneously to terms that are unrelated to the replacement of a reference rate. \nPending Content: \nTransition Date: (P) January 1, 2025; (N) January 1, 2025 | Transition Guidance: 848-10-65-2 \nOther than a modification of the interest rate used for margining, discounting, or contract price \nalignment in accordance with paragraph 848 -20-15-2(b), for contracts that meet the scope of \nparagraph 848 -10-15-3, the guidance in this Subtopic shall not app ly if a contract modification is \nmade to a term that changes, or has the potential to change, the amount or timing of contractual \ncash flows and is unrelated to the replacement of a reference rate. That is, this Subtopic shall not \napply if contract modific ations are made contemporaneously to terms that are unrelated to the \nreplacement of a reference rate. \n848-20-15-4 \nContemporaneous modifications of contract terms that do not change, or do not have the potential to \nchange, the amount or timing of contractual cash flows shall not preclude application of the guidance \nin this Subtopic, regardless of whether those contemporaneous contract modifications are related or \nunrelated to the replacement of a reference rate. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 306}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 295 \nPending Content: \nTransition Date: (P) January 1, 2025; (N) January 1, 2025 | Transition Guidance: 848-10-65-2 \nContemporaneous modifications of contract terms that do not change, or do not have the potential \nto change, the amount or timing of contractual cash flows shall not preclude application of the \nguidance in this Subtopic, regardless of whether those contemporaneous contract modifications are \nrelated or unrelated to the replacement of a reference rate or the modification of the interest rate \nused for margining, discounting, or contract price alignment as a result of reference rate reform. \n848-20-15-5 \nChanges to terms that are related to the replacement of the reference rate are those that are made to \neffect the transition for reference rate reform and are not the result of a business decision that is \nseparate from or in addition to changes to the terms of a contract to effect that transition. Examples \nof changes to terms that are related to the replacement of a reference rate in accordance with the \nguidance in paragraph 848 -20-15-2 include the following: \na. Changes to the referenced interest rate index (for example, a change from London Interbank \nOffered Rate [LIBOR] to another interest rate index) \nb. Addition of or changes to a spread adjustment (for example, adding or adjusting a spread to the \ninterest rate index, amending the fixed rate for an intere st rate swap, or paying or receiving a \ncash settlement for any difference intended to compensate for the difference in reference rates) \nc. Changes to the reset period, reset dates, day -count conventions, business -day conventions, \npayment dates, payment fr equency, and repricing calculation (for example, a change from a \nforward -looking term rate to an overnight rate or a compounded overnight rate in arrears) \nd. Changes to the strike price of an existing interest rate option (including an embedded interest \nrate option) \ne. Addition of an interest rate floor or cap that is out of the money on the basis of the spot rate at \nthe time of the amendment of the contract \nf. Addition of a prepayment option for which exercise is contingent upon the replacement referenc e \ninterest rate index not being determinable in accordance with the terms of the agreement \ng. Addition of or changes to contractual fallback terms that are consistent with fallback terms \ndeveloped by a regulator or by a private -sector working group convened by a regulator \nh. Changes to terms (including those in the examples in paragraph 848 -20-15-6) that are necessary \nto comply with laws or regulations or to align with market conventions for the replacement rate . \nPending Content: \nTransition Date: (P) January 1, 2025; (N) January 1, 2025 | Transition Guidance: 848-10-65-2 \nChanges to terms that are related to the replacement of the reference rate are those that are made \nto effect the transition for reference rate reform and are not the result of a business decision that is \nseparate from or in addition to changes to the terms of a contract to effect that transition. Examples \nof changes to terms that are related to the replacement of a reference rate in accordance with the \nguidance in paragraph 848 -20-15-2(a) include the following: \na. Changes to the referenced interest rate index (for example, a change from London Interbank \nOffered Rate [LIBOR] to another interest rate index) \nb. Addition of or changes to a spread adjustment (for example, adding or adjusting a spread to the \ninterest rate index, amending the fixed rate for an interest r ate swap, or paying or receiving a \ncash settlement for any difference intended to compensate for the difference in reference rates) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 307}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 296 c. Changes to the reset period, reset dates, day -count conventions, business -day conventions, \npayment dates, payment frequency, and repricing calculation (for example, a change from a \nforward -looking term rate to an overnight rate or a compounded overnight rate in arrears) \nd. Changes to the strike price of an existing interest rate option (including an embedded interest \nrate option) \ne. Addition of an interest rate floor or cap that is out of the money on the basis of the spot rate at \nthe time of the amendment of the contract \nf. Addition of a prepayment option for which exercise is contingent upon the replacement reference \ninterest rate inde x not being determinable in accordance with the terms of the agreement \ng. Addition of or changes to contractual fallback terms that are consistent with fallback terms \ndeveloped by a regulator or by a private -sector working group convened by a regulator \nh. Change s to terms (including those in the examples in paragraph 848 -20-15-6) that are \nnecessary to comply with laws or regulations or to align with market conventions for the \nreplacement rate. \n848-20-15-6 \nExamples of changes to terms that are generally unrelated to the replacement of a reference rate in \naccordance with paragraph 848 -20-15-3 include the following: \na. Changes to the notional amount \nb. Changes to the maturity date \nc. Changes from a referenced interest rate index to a stated fixed rate \nd. Changes to the loan structure (for example, changing a term loan to a revolver loan) \ne. The addition of an underlying or variable unrelated to the referenced rate index (for example, \naddition of payments that are indexed to the price of gold) \nf. The add ition of an interest rate floor or cap that is in the money on the basis of the spot rate at \nthe time of the amendment of the contract \ng. A concession granted to a debtor experiencing financial difficulty \nh. The addition or removal of a prepayment or con version option except for the addition of a \nprepayment option for which exercise is contingent upon the replacement reference interest rate \nindex not being determinable in accordance with the terms of the agreement \ni. The addition or removal of a feature that is intended to provide leverage \nj. Changes to the counterparty except in accordance with paragraphs 815 -20-55-56A, 815 -25-40-\n1A, and 815 -30-40-1A \nk. Changes to the priority or seniority of an obligation in the event of a default or a liquidation eve nt \nl. The addition or termination of a right to use one or more underlying assets in a lease contract \nm. Changes to renewal, termination, or purchase option provisions in a lease contract. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 308}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 297 Subsequent Measurement \n848-20-35-11 \nIf an entity elects the optional expedient in this paragraph for a modification of a contract within the \nscope of Topic 840 or 842 that meets the scope of paragraphs 848 -20-15-2 through 15 -3, the entity \nshall not do any of the following: \na. Reassess lease classification and the discount rate (for example, the incremental borrowing rate \nfor a lessee) \nb. Remeasure lease payments \nc. Perform other reassessments or remeasurements that would otherwise be required under Topic 840 \nor 842 when a mod ification of a lease contract is not accounted for as a separate contract. \n848-20-35-12 \nIf the optional expedient in paragraph 848 -20-35-11 is elected, it shall be applied to all contracts \nunder Topic 840 or 842 as described in paragraph 848 -20-35-1. \n848-20-35-13 \nIf the optional expedient in paragraph 848 -20-35-11 is elected, the modification of the reference rate \nand other terms related to the replacement of the reference rate on which variable lease payments in \nthe original contract depended shall not req uire an entity to remeasure the lease liability. The change \nin the reference rate shall be treated in the same manner as the variable lease payments that were \ndependent on the reference rate in the original lease. That change shall not be included in the \ncalculation of the lease liability; that is, the change shall be recognized in profit or loss in the period in \nwhich the obligation for those payments is incurred. \nASC 848 provide s temporary optional expedients and exceptions to the US GAAP guidance on con tract \nmodifications to ease the financial reporting burden related to the expected market transition from \nLIBOR and other interbank offered rates to alternative reference rates, such as SOFR. \nUnder ASC 842, a lease modification is a change to the terms an d conditions of a contract that results in \na change in the scope of or consideration for the lease. Therefore, a change in the index or rate on which \nlease payments are dependent would be accounted for as a lease modification because it will result in a \nchange in the consideration for the lease. A lease modification generally requires the remeasurement \nand reallocation of consideration in the contract; reassessment of lease term, discount rate and lease \nclassification; and, for lessees, remeasurement of the ROU asset and lease liability. Refer to section 5.6, \nLease modifications , for further discussion of the accounting for lease modifications by lessors. \nHowever, the guidance in ASC 848 provides entities with an optional expedient to not apply certain \nmodification accounting requirements to contracts affected by reference rate reform, if certain criteria are \nmet. If a modified lease contract meets the following required criteria and t he entity elects to apply the optional \nexpedient in ASC 848, the entity would not account for the change in the lease contract as a lease modification: \n• The lease contract references LIBOR or another rate that is expected to be discontinued due to \nreferenc e rate reform. \n• The modified terms of the lease contract directly replace or have the potential to replace the \nreference rate that is expected to be discontinued due to reference rate reform. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 309}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 298 If contemporaneous changes are made to other terms in the contract that change or have the potential \nto change the amount or timing of contractual cash flows, the optional expedient may only be applied if \nthose changes are related to the replacement of the reference rate. For example, a change to the lease \nterm concurrent with the change in the rate in which lease payments are dependent would disqualify an \nentity from applying the relief from modification accounting to that lease; the change in lease term \nchanges the amount and timing of cash flows in the lease and is unrelated to the change in the rate in the \nlease due to reference rate reform. \nIf an entity elects the optional expedient, it must apply it consistently for all eligible modified leases \naccoun ted for under ASC 842. \nThe guidance was effective upon issuance in March 2020 . The guidance on contract modifications is \napplied prospectively from any date beginning 12 March 2020. It may also be applied to modifications of \nexisting contracts made earlie r in the interim period that includes the effective date ( i.e., modifications \nmade as early as 1 January 2020 for a calendar -year company). The relief is temporary and generally \ncannot be applied to contract modifications that occur after 31 December 202 4. Entities that elect the \nrelief are required to disclose the nature of the optional expedients and exceptions they are applying and \ntheir reasons for doing so. \n5.7 Other lessor matters \n5.7.1 Sale of lease receivables \nExcerpt from Accounting Standards Codif ication \nLeases — Lessor \nSubsequent Measurement \n842-30-35-4 \nIf a lessor sells substantially all of the lease receivable associated with a sales -type lease or a direct \nfinancing lease and retains an interest in the unguaranteed residual asset , the lessor shall not continue to \naccrete the unguaranteed residual asset to its estimated value over the remaining lease term . The lessor \nshall report any remaining unguaranteed residual asset thereafter at its carrying amount at the date of \nthe sale of the lease receivable and apply Topic 360 on property, plant, and equipment to determine \nwhether the unguaranteed residual asset is impaired. \nIn certain cases, a lessor sells substantially all of a lease receivable ( i.e., the future lease payments and \nany guaranteed residual value) associated with a sales -type or a direct financing lease but retains an \ninterest in the unguaranteed residual asset. In a common transaction, a lessor securitizes lease \nreceivables, retains the interest in the underlying assets ( i.e., the unguaranteed residual assets) and \nmanages the residual value risk. Under ASC 842, if a lessor retains an interest in an unguaranteed \nresidual asset (after selling the lease receivable), it no longer accretes the value of the unguaranteed \nresidual asset to its estimated value over the remaining lease term. Instead, the lessor reports any \nremaining unguaranteed residual as set at its carrying amount at the date of the sale of the lease \nreceivable and applies ASC 360 to determine whether the unguaranteed residual asset is impaired. \nLessors should evaluate the sale of lease receivables associated with sales -type or direct fina ncing leases \n(i.e., future lease payments and any guaranteed residual values) under the financial asset derecognition \nguidance in ASC 860, Transfers and Servicing . Refer to section 5.7.1.1, Sales or securitizations of lease \nreceivables associated with sale s-type and direct financing leases . \nRefer to section 5.7.1.4, Sale or assignment of operating lease payments by a lessor , for the accounting \nof sale lease payments associated with an operating lease. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 310}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 299 5.7.1.1 Sales or securitizations of lease receivables as sociated with sales -type and direct \nfinancing leases \nExcerpt from Accounting Standards Codification \nTransfers and Servicing — Overall \nImplementation Guidance and Illustrations \n860-10-55-6 \nLease receivables from sales -type and direct financing leases are made up of two components: the right \nto receive lease payments and guaranteed residual values. Lease payments for sales -type and direct \nfinancing leases involve requirements for lessees to p ay cash to lessors and meet the definition of a \nfinancial asset. Residual values represent the lessor’s estimate of the salvage value of the underlying \nasset at the end of the lease term and may be either guaranteed or unguaranteed. Residual values meet \nthe definition of financial assets to the extent that they are guaranteed at the commencement of the \nlease. Thus, transfers of lease receivables from sales -type and direct financing leases are subject to the \nrequirements of this Subtopic. Unguaranteed residu al assets do not meet the definition of financial \nassets, nor do residual values guaranteed after commencement, and transfers of them are not subject to \nthe requirements of this Subtopic. \nTransfers and Servicing — Sales of Financial Assets \nImplementation Guidance and Illustrations \n860-20-55-26 \nA transferor of lease receivables shall allocate the gross investment in receivables between lease \npayments , residual values guaranteed at commencement, and residual values not guaranteed at \ncommenceme nt using the individual carrying amounts of those components at the date of transfer. Those \ntransferors also shall record a servicing asset or liability in accordance with Subtopic 860 -50, if appropriate. \nThe original accounting for a sales -type or direct financing lease is not changed if the lease or the \nunderlying asset is subsequently sold or assigned to a third party. The accounting for sale or assignment \nof the lease receivable and any residual values guaranteed at lease commencement relating to a sales -\ntype or direct financing lease is addressed by the provisions of ASC 860, Transfers and Servicing . Refer \nto section 5.7.1.4, Sale or assignment of operating lease payment by a lessor , for operating lease s. \nPursuant to the relevant provision of ASC 860, sales -type and direct financing receivables (gross \ninvestment in lease receivables) are made up of two components: lease receivables and guaranteed \nresidual values. Lease receivables represent requirements for lessees to pay cash to lessors and meet \nthe definition of a financial asset. Thus, transfers of lease receivables from sales -type and direct \nfinancing leases are subject to the requirements of ASC 860. The residual value component meets the \ndefinition of a financial asset only if it is guaranteed (by the lessee or by a third party) at the \ncommencement of the lease. Transfers of guaranteed residual values that are guaranteed at the \ncommencement of the lease are subject to the derecognition requirements o f ASC 860, while transfers \nof unguaranteed residual assets and residual values guaranteed after the commencement of the lease \nare not (refer to section 5.7.1.3 , Sale of unguaranteed residual value in sales -type or direct financing \nleases ). As a result, if an unguaranteed residual asset or a residual value that is guaranteed subsequent to \nlease commencement exists as part of the gross investment, entities selling or securitizing all or part of \nlease receivables (without transferring title to the underlying a sset or their right to the remaining \nunguaranteed residual asset) should allocate the gross investment in receivables between lease \npayments (including guaranteed residual value) and unguaranteed residual asset (or residual value \nguaranteed after commencem ent) using the individual carrying amounts of those components at the \ndate of transfer. The allocated amount of financial assets being transferred (lease payments and residual ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 311}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 300 value guaranteed at commencement of the lease) will represent the carrying amoun t to be used in the \ndetermination of gain or loss if the transfer meets the derecognition requirements of ASC 860. The \ntransfers of unguaranteed residual asset (or residual value guaranteed after commencement) are subject \nto evaluation under the applicable revenue recognition/asset sale guidance. Entities also should recognize \na servicing asset or liability in accordance with ASC 860, if applicable. The following example illustrates \nthis allocation. \nExcerpt from Accounting Standards Codification \nTransfers and Servicing — Sales of Financial Assets \nImplementation Guidance and Illustrations \nExample 5: Transfer of Lease Receivables with Residual Values \n860-20-55-58 \nThis Example illustrates the guidance in paragraph 860 -20-25-1. At the beginning of the second year in a \n10-year sales -type lease, Entity E transfers for $505 a nine -tenths participating interest in the lease \nreceivable to an independent third party, and t he transfer is accounted for as a sale. Entity E retains a one -\ntenth participating interest in the lease receivable and a 100 percent interest in the unguaranteed residual \nasset, which is not subject to the requirements of this Subtopic as discussed in par agraph 860 -10-55-6 \nbecause it is not a financial asset and, therefore, is excluded from the analysis of whether the transfer of \nthe nine -tenths participating interest in the lease receivable meets the definition of a participating \ninterest. The servicing a sset has a fair value of zero because Entity E estimates that the benefits of \nservicing are just adequate to compensate it for its servicing responsibilities. The carrying amounts and \nrelated gain computation are as follows. \nCarrying Amounts \nLease receivable $ 540 \nUnearned income related to lease receivable 370 \nGross investment in lease receivable 910 \nUnguaranteed residual asset $ 30 \nUnearned income related to unguaranteed residual asset 60 \nGross investment in unguaranteed residual asset 90 \nTotal gross investment in lease receivable $ 1,000 \nGain on Sale \nCash received $ 505 \nNine-tenths of carrying amount of gross investment in lease \nreceivable $ 819 \nNine -tenths of carrying amount of unearned income \nrelated to lease receivable 333 \nNet carrying amount of lease receivable sold 486 \nGain on sale $ 19 \n860-20-55-59 \nThe following journal entry is made by Entity E. \nJournal entry \nCash $ 505 \nUnearned income 333 \n Lease receivable $ 819 \n Gain on sale 19 \nTo record sale of nine -tenths of the lease receivable at the beginning of Year 2 ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 312}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 301 As discussed above, only transfers of residual values guaranteed at the commencement of the lease are \nsubject to the derecognition requirements of ASC 860. If the lessee guarantees the residual value, the \nlease payments (including the residual value guaran teed by the lessee) should be viewed as a single unit \nof account pursuant to ASC 860. If a third party guarantees the residual value, we believe the guaranteed \nresidual value can be considered a separate unit of account) pursuant to ASC 860. Whether a thir d-party \nresidual value guarantee should be considered a separate unit of account or combined with the payments \ndue from the lessee into a single unit of account pursuant to ASC 860 is an accounting policy election. \nRefer to our FRD, Transfers and servicing of financial assets , for further information. \n5.7.1.2 Accounting for a guaranteed residual value \nExcerp t from Accounting Standards Codification \nTransfers and Servicing — Overall \nImplementation Guidance and Illustrations \n860-10-55-6 \nLease receivables from sales -type and direct financing leases are made up of two components: the \nright to receive lease payments and guaranteed residual values. Lease payments for sales -type and \ndirect financing leases involve requirements for lessees to p ay cash to lessors and meet the definition \nof a financial asset. Residual values represent the lessor’s estimate of the salvage value of the underlying \nasset at the end of the lease term and may be either guaranteed or unguaranteed. Residual values \nmeet th e definition of financial assets to the extent that they are guaranteed at the commencement of \nthe lease. Thus, transfers of lease receivables from sales -type and direct financing leases are subject \nto the requirements of this Subtopic. Unguaranteed residu al assets do not meet the definition of \nfinancial assets, nor do residual values guaranteed after commencement, and transfers of them are \nnot subject to the requirements of this Subtopic. \nA residual value of a n underlying asset is a financial asset to the extent that the residual value is \nguaranteed at commencement of the lease by the lessee or a third party unrelated to the lessor. \nTherefore, sales of lease receivables from sales -type and direct financing leases, including the residual \nvalue guaranteed at lease commencement, are in the scope of the guidance in ASC 860 on transfers and \nservicing of financial assets. Refer to section 5.7.1.1, Sales or securitizations of lease receivables \nassociated with sales -type and direct finan cing leases . \n5.7.1.3 Sale of unguaranteed residual value in sales -type or direct financing leases \nIf, in conjunction with a sale of lease receivables (in accordance with ASC 860, refer to section 5.7.1.1, Sales \nor securitizations of lease receivables associated with sales -type and direct financing leases ), a lessor also sells \nto a third party its interest in an unguaranteed residual value or in a residual interest that was guaranteed \nsubsequent to lease commencement, the gain or loss on the sale of the residual value should be recognized in \nearnings if it qualifies as a sale in accordance with ASC 606 or ASC 610-20. If the lessor sells the unguaranteed \nresidual value or a guaranteed residual value that was guaranteed subsequent to lease comm encement to a \nthird party, without selling the lease receivable, the gain or loss represents a revision in the estimate of the \nresidual value based on a completed transaction and should be recognized at the time of the sale. It would \nnot be appropriate to defer a gain or loss on the sale of an unguaranteed residual value or a guaranteed \nresidual value that was guaranteed after lease commencement over the remaining lease term. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 313}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 302 5.7.1.4 Sale or assignment of operating lease payments by a lessor \nSale of future lease payments \nThe sale or assignment by the lessor of future lease payments due under an operating lease is accounted for as \na borrowing regardless of whether substantial risks have been retained. This is consistent with the accounting \nfor a sale of futur e revenues under ASC 470, Debt , when an entity has significant continuing involvement in \nthe generation of the cash flows due to the investor . \nA sale of future revenue typically involves an entity receiving an up -front payment from an investor in \nexchange for granting the investor the right to receive a specified percentage or amount of the future \nrevenue (or other measure of income such as gross margin, operating income or pretax income) of a \nparticular product or service of the entity for a defined period . Refer to section 2.2.6.8, Sales of future \nrevenues , in our FRDs , Issuer’s accounting for debt and equity financings (after the adoption of ASU \n2020 -06, Accounting for Convertible Instruments and Contracts in an Entity’s Own Equity) or Issuer’s \naccounting for debt and equity financings (before the adoption of ASU 2 020-06, Accounting for \nConvertible Instruments and Contracts in an Entity’s Own Equity ), for further detail regarding the \naccounting of a sale of future revenue. \nSale of billed and earned lease payments \nASC 860 applies only to transfers of recognized finan cial assets. Lease payments that are billed and \nearned but not yet received under an operating lease are similar to other trade receivables as they \nrepresent requirements for lessees to pay cash to lessors and meet the definition of a financial asset. \nTher efore, the sale or assignment by the lessor of such payments is subject to the derecognition \nrequirements of ASC 860. Careful consideration should be given in determining whether an asset meets \nthe definition of a recognized financial asset. Refer to secti on 1.2, Scope and scope exceptions , of our \nFRD, Transfers and servicing of financial assets , for further detail regarding the designation of \ntransactions that fall within the scope of ASC 860. \n5.7.2 Accounting for the underlying asset at the end of a lease \nExcerpt from Accounting Standards Codification \nLeases — Lessor \nSubsequent Measurement \n842-30-35-5 \nAt the end of the lease term , a lessor shall reclassify the net investment in the lease to the \nappropriate category of asset (for example, property, plant, and equipment) in accordance with other \nTopics, measured at the carrying amount of the net investment in the lease. The lessor shall accou nt \nfor the underlying asset that was the subject of a lease in accordance with other Topics. \nAt the end of the lease term, lessors may receive the underlying asset back from the lessee. Under \nASC 842, lessors reclassify the carrying amount of the net inve stment in the lease to the applicable \ncategory of assets ( e.g., inventory or property, plant and equipment). Thereafter, lessors account for the \nunderlying asset using ASC 330 or ASC 360, whichever is appropriate. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 314}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 303 5.7.3 Lease termination (updated August 20 22) \nExcerpt from Accounting Standards Codification \nLeases — Lessor \nDerecognition \n842-30-40-2 \nIf a sales -type lease or a direct financing lease is terminated before the end of the lease term , a \nlessor shall do all of the following: \na. Test the net investment in the lease for impairment in accordance with Topic 310 on receivables \nand recognize any impairment loss identified \nb. Reclassify the net investment in the lease to the appropriate category of asset in accordance with \nother Topics, measured at the sum of the carrying amounts of the lease receivable (less any \namounts still expected to be received by the lessor) and the residual asset \nc. Account for the underlying asset that was the subject of the lease in accordance with other Topics. \nPending Content: \nTransition Date: (P) December 16, 2019; (N) December 16, 2022 | Transition Guidance: 326-10-65-1 \nIf a sales -type lease or a direct financing lease is terminated before the end of the lease term , a \nlessor shall do all of the following: \na. Measure the net investment in the lease for credit losses in accordance with Subtopic 326 -20 \non financial instruments measured at amortized cost and record any credit loss identified \nb. Reclassify the net investment in the lease to the appropriate category of asset in accordance \nwith other Topics, measured at the sum of the carrying amounts of the lease receivable (less \nany amounts still expected to be received by the lessor) and the residual asset \nc. Account for the underlying asse t that was the subject of the lease in accordance with other Topics. \n \nFor a termination of a sales -type or direct financing lease before the expiration of the lease term, a lessor \ndoes the following: \n• Tests the net investment in the lease for impairment in accordance with ASC 310 (before the adoption of \nASU 2016 -13) or measure credit losses on the net investment in the lease in accordance with \nASC 326 ( after the adoption of ASU 2016 -13) and recognizes any impairment or credit loss identified \n(refer to section 5.2.3, Impairment of the net investment in the lease — sales -type leases ) \n• Reclassifies the net investment in the lease to the appropriate category of asset in accordance with \nASC 330 or ASC 360, if applicable, measured at the sum of the carrying amount of the lease \nreceivable (less any amounts still expected to be received by the lessor) and the residual asset \n• Accounts for the underlying asset that was the subject of the leas e under ASC 330 or ASC 360, if applicable \nASC 842 does not address how lessors would account for terminations of operating leases. Upon a \ntermination of an operating lease (with no other ongoing arrangement between the customer and supplier), \nwe believe that the net lease -related asset or liability associated with the operating lease ( e.g., remaining \nunamortized initial direct costs, prepaid lease payments) should be written off with a ny gain or loss \nrecognized in income. To the extent there is an ongoing arrangement between the customer and the \nsupplier ( e.g., a lease is modified such that it is no longer a lease for accounting purposes but instead a \nservice contract), the net lease -related asset or liability associated with the operating lease would be \nconsidered when necessary in the accounting for the ongoing service arrangement. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 315}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accoun ting | 304 When the parties agree that a lease will be terminated befor e the expiration of the lease term but the \ntermination will be effective at a future date ( i.e., a lessee does not immediately cease using the \nunderlying asset), the change to the lease is generally accounted for as a lease modification that \nshortens the l ease term rather than a lease termination. This type of modification can occur if a \ntermination is agreed to but the lessee is given a month to move out, for example. See section 5.6.3, \nLessor accounting for a modification that is not accounted for as a se parate contrac t, for guidance on \nmodification s that shorten the lease term. \n5.7.4 Lessor accounting for a group of assets \nLease accounting principles (including sale and leaseback transactions ) are applied on a lease component -by-\nlease component basis. Accordingly, for transactions involving numerous pieces of equipment or properties, it \nis often necessary to segregate the related assets on a lease component -by-lease component basis. If one or \nboth of the criteria in ASC 842-10-15-28 (refer to section 1.4.1, Identifying and separating lease components \nof a contract ) are not met , the right to use multiple assets is considered a single lease component . \n5.7.4.1 Portfolio approach \nASC 842 applies t o individual lease components. However, entities that have a large number of leases of \nsimilar underlying asset s (e.g., leases of a fleet of similar railcars) may face practical challenges in \napplying the leases model on a lease component -by-lease componen t basis. The FASB acknowledged \nthese concerns and said in its Basis for Conclusions (BC 120) of ASU 2016 -02 that an entity can use a \nportfolio approach when “the entity reasonably expects that the application of the leases model to the \nportfolio would not differ materially from the application of the leases model to the individual leases in \nthat portfolio.” For example, applying a portfolio approach to four -year leases of fungible, new railcars \nentered into in the same month with lessees of a similar credit quality may not differ materially from \napplying ASC 842 to the individual lease components in the portfolio. \nASC 842 does not define “reasonably expects” and “materially.” The FASB also said in the Basis for \nConclusions (BC 120) of ASU 2016 -02 that “an en tity would need to apply judgment in selecting the size \nand composition of the portfolio” and “it did not intend for an entity to quantitatively evaluate each \noutcome but, instead, that the entity should be able to take a reasonable approach to determine t he \nportfolios that would be appropriate for its types of leases.” \nThe FASB also said in the Basis for Conclusions (BC 121) of ASU 2016 -02 that “the cost relief offered by \napplying the leases guidance at a portfolio level need not be limited to simply group ing contracts together.” \nThe portfolio approach could also be applied to other aspects of the leases guidance for which lessors \nneed to make judgments and estimates, such as determining the discount rate and determining and \nreassessing the lease term. Howe ver, the portfolio approach cannot be applied to combine lease and non -\nlease components (refer to section 1.4, Identifying and separating lease and non -lease components of a \ncontract and allocating contract consideration ). \n5.7.5 Leveraged leases \nExcerpt from Accounting Standards Codification \nMaster Glossary \nLeveraged Lease \nFrom the perspective of a lessor , a lease that was classified as a leveraged lease in accordance with \nthe leases guidance in effect before the effective date and for which the commencement date is \nbefore the effective date. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 316}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 305 Leases — Overall \nTransition and Open Effective Date Information \n842-10-65-1 \nLeases previously classified as leveraged leases under Topic 840 \nz. For leases that were classified as leveraged leases in accordance with Topic 840, and for which \nthe commencement date is before the effective date, a lessor shall apply the requirements in \nSubtopic 842 -50. If a leveraged lease is modified on or after the e ffective date, it shall be \naccounted for as a new lease as of the effective date of the modification in accordance with the \nguidance in Subtopics 842 -10 and 842 -30. \n1. A lessor shall apply the pending content that links to this paragraph to a leveraged lea se that \nmeets the criteria in (z) that is acquired in a business combination or an acquisition by a not -\nfor-profit entity on or after the effective date. \nLeases — Leveraged Lease Arrangements \nScope and Scope Exceptions \n842-50-15-1 \nThis Subtopic addresses accounting for leases that meet the criteria in transition paragraph 842 -10-\n65-1(z). If a lessee exercises an option to extend a lease that meets the criteria in transition paragraph \n842-10-65-1(z) that it was not previously reasona bly assured of exercising, the exercise of that option \nshall be considered a lease modification as described in paragraph 842 -10-65-1(z). \nPending Content: \nTransition Date: (P) January 1, 2025; (N) January 1, 2025 | Transit ion Guidance: 805-60-65-1 \nThis Subtopic addresses accounting for leases that meet the criteria in transition paragraph 842 -\n10-65-1(z). If a lessee exercises an option to extend a lease that meets the criteria in transition \nparagraph 842 -10-65-1(z) that it was not previo usly reasonably assured of exercising, the exercise \nof that option shall be considered a lease modification as described in paragraph 842 -10-65-1(z). A \njoint venture formation accounted for in accordance with Subtopic 805 -60 shall apply the guidance \nin thi s Subtopic applicable to the acquiring entity in a business combination . The joint venture shall \nbe viewed as analogous to the acquiring entity in a business combination, and any recognized \nbusinesses and/or assets shall be viewed as analogous to an acquir ee. \n \nASC 842 eliminates leveraged lease accounting for new leases on its effective date. That is, subsequent \nto the effective date, lessors account for all new leases, including those that would have qualified as \nleveraged leases under ASC 840, using the classification criteria discussed in section 3.2, Criteria for \nlease classification — lessors (i.e., sales -type, direct financing or operating). For such leases, entities \napply other relevant US GAAP ( e.g., ASC 740, Income Taxes , ASC 470, Debt ) to account for the non -\nlease components of such tran sactions . \nLeveraged lease arrangements that exist before the effective date are grandfathered and therefore \ncontinue to follow the existing recognition, measurement , presentation and disclosure guidance for \nleveraged leases that was carried forward to ASC 842-50. Leases of to -be-constructed assets that \nqualified to be leveraged leases at lease inception prior to the effective date under ASC 840 but are not \ncompleted (i.e. the lease has not commenced) prior to the effective date would not be grandfathered. \nIf an existing leveraged lease is modified on or after the eff ective date of the ASC 842, the existing \nleveraged lease is required to be reclassified as a sales -type, direct financing or operating lease, as \napplicable, using the lease classification guidance in ASC 842. Refer to section 3.2, Criteria for lease ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 317}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 306 classi fication — lessors , and section 11.2, Transition . In that case, there would be no basis to net the \nremaining non -recourse debt balance with the lease receivable (if any), and any deferred tax balances \nwould need to be adjusted as required under ASC 740 to comply with that guidance. \nIn addition, if a lessee exercises an option to extend a leveraged lease on or after the effective date of \nASC 842 that it was not previously reasonably assured of exercising ( i.e., under ASC 840, the renewal \noption was not inclu ded in the original accounting lease term for purposes of classifying the lease at \ninception), the exercise of that option is accounted for as a lease modification, and the lease no longer \nqualifies for leveraged lease accounting. Refer to section 5.6, Lease modifications. \nRefer to section 10, Leveraged leases , for an in -depth discussion of the accounting for leveraged leases. \n5.7.6 Income tax accounting \nASC 842 could affect certain aspects of lessors’ accounting for income taxes. For example, it could affect \nthe timing of recognition of lease income for some leases, recognition and measurement of deferred tax \nassets and liabilities, and assessment of the realizability of deferred tax assets ( i.e., the need for valuation \nallowances). In addition, the special accounting for leveraged leases is eliminated, except for leveraged \nleases that exist at the transition date, which are grandfathered (refer to section 5.7.5, Leveraged leases ). \nRefer to our FRD, Income taxes . \n5.7.7 Sales of equipment with guaranteed minimum resale amount \nExcerpt from Accounting Standards Codification \nLeases — Lessor \nImplementation Guidance and Illustrations \n842-30-55-1 \nThis implementation guidance addresses the application of the provisions of this Subtopic in the \nfollowing circumstances. A manufacturer sells equipment with an expected useful life of several years \nto end users (purchasers) utilizing various sales incenti ve programs. Under one such sales incentive \nprogram, the manufacturer contractually guarantees that the purchaser will receive a minimum resale \namount at the time the equipment is disposed of, contingent on certain requirements. \n842-30-55-2 \nThe manufacture r provides the guarantee by agreeing to do either of the following: \na. Reacquire the equipment at a guaranteed price at specified time periods as a means to facilitate \nits resale \nb. Pay the purchaser for the deficiency, if any, between the sales proceeds receive d for the \nequipment and the guaranteed minimum resale value. \nThere may be dealer involvement in these types of transactions, but the minimum resale guarantee is \nthe responsibility of the manufacturer. \n842-30-55-3 \nA sales incentive program in which an entit y (for example, a manufacturer) contractually guarantees \nthat it has either a right or an obligation to reacquire the equipment at a guaranteed price (or prices) \nat a specified time (or specified time periods) as a means to facilitate its resale should be evaluated in \naccordance with the guidance on satisfaction of performance obligations in paragraph 606 -10-25-30 \nand the guidance on repurchase agreements in paragraphs 606 -10-55-66 through 55 -78. If that \nevaluation results in a lease , the manufacturer shoul d account for the transaction as a lease using the \nprinciples of lease accounting in Subtopic 842 -10 and in this Subtopic. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 318}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 307 842-30-55-4 \nA sales incentive program in which an entity (for example, a manufacturer) contractually guarantees \nthat it will pay a pu rchaser for the deficiency, if any, between the sales proceeds received for the \nequipment and the guaranteed minimum resale value should be accounted for in accordance with \nTopic 460 on guarantees and Topic 606 on revenue from contracts with customers. \n842-30-55-5 \nThe lease payments used as part of the determination of whether the transaction should be classified \nas an operating lease , a direct financing lease , or a sales -type lease generally will be the difference \nbetween the proceeds upon the equipment’s initial transfer and the amount of the residual value \nguarantee to the purchaser as of the first exercise date of the guarantee. \n842-30-55-6 \nIf the transaction qualifies as an oper ating lease, the net proceeds upon the equipment’s initial transfer \nshould be recorded as a liability in the manufacturer’s balance sheet. \n842-30-55-7 \nThe liability is then subsequently reduced on a pro rata basis over the period to the first exercise date \nof the guarantee to the amount of the guaranteed residual value at that date with corresponding \ncredits to revenue in the manufacturer’s income statement. Any further reduction in the guaranteed \nresidual value resulting from the purchaser’s d ecision to continue to use the equipment should be \nrecognized in a similar manner. \n842-30-55-8 \nThe equipment should be included in the manufacturer’s balance sheet and depreciated following the \nmanufacturer’s normal depreciation policy. \n842-30-55-9 \nThe Imp airment or Disposal of Long -Lived Assets Subsections of Subtopic 360 -10 on property, plant, \nand equipment provide guidance on the accounting for any potential impairment of the equipment. \n842-30-55-10 \nAt the time the purchaser elects to exercise the residu al value guarantee by selling the equipment to \nanother party, the liability should be reduced by the amount, if any, paid to the purchaser. The remaining \nundepreciated carrying amount of the equipment and any remaining liability should be removed from the \nbalance sheet and included in the determination of income of the period of the equipment’s sale. \n842-30-55-11 \nAlternatively, if the purchaser exercises the residual value guarantee by selling the equipment to the \nmanufacturer at the guaranteed price, the liability should be reduced by the amount paid to the \npurchaser. Any remaining liability should be included in the determination of income of the period of \nthe exercise of the guarantee. \n842-30-55-12 \nThe accounting for a guaranteed minimum resale value is not in the scope of Topic 815 on derivatives \nand hedging. In the transaction described, the embedded guarantee feature is not an embedded \nderivative instrument that must be accounted for separately from the lease because it does not \nmeet the criterion in paragraph 815-15-25-1(c). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 319}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 308 842-30-55-13 \nSpecifically, if freestanding, the guarantee feature would be excluded from the scope of paragraph \n815-10-15-59(b) because of both of the following conditions: \na. It is not exchange traded. \nb. The underlying on which settlement is based is the price of a nonfinancial asset of one of the \nparties, and that asset is not readily convertible to cash. It is assumed that the equipment is not \nreadily convertible to cash, as that phrase is used in Topic 815. \n842-30-55-14 \nParagraph 815 -10-15-59(b)(2) states that the related exception applies only if the nonfin ancial asset \nrelated to the underlying is owned by the party that would not benefit under the contract from an \nincrease in the price or value of the nonfinancial asset. (In some circumstances, the exclusion in \nparagraph 815 - 10-15-63 also would apply.) \n842-30-55-15 \nLastly, Topic 460 on guarantees does not affect the guarantor’s accounting for the guarantee \nbecause that Topic does not apply to a guarantee for which the underlying is related to an asset of \nthe guarantor. Because the manufacturer continues to recognize the residual value of the equipment \nguaranteed by the manufacturer as an asset (included in the seller -lessor’s net investment in the \nlease ) if recording a sales -type lease, that guarantee does not meet the characteristics in paragraph \n460-10-15-4 and is, therefore, not subject to the guidance in Topic 460. Additionally, if the lease is \nclassified as an operating lease, the manufacturer does not remove the asset from its books, and \nits guarantee would be a market value guarantee of its own asset. A market value guarantee of \nthe guarantor’s own asset is not within the scope of Topic 460, and the guidance in paragraphs \n842-10-55-32 through 55-33 for an operating lease is not affected. As a result, the guarantor’s \naccounting for the guarantee is unaffected by Topic 460 . \nAlthough not a lease transaction, in some transactions, an entity ( e.g., a manufacturer) sells equipment \nutilizing a sales incentive program. Under the sales incentive program, the manufacturer contractually \nguarantees that the purchaser will receive a minimum resale amount at the time the equipment is disposed \nof, contingent on certain requirements. This guarantee is provided by agreeing to (1) reacquire the \nequipment at a guarantee d price (or prices) at specified time period (or specified time periods) as a means to \nfacilitate its resale or (2) pay the purchaser for the deficiency, if any, between the sales proceeds received \nfor equipment and the guaranteed minimum resale value. Alt hough a third -party dealer may be involved in \nthis type of transaction, the minimum resale guarantee remains the responsibility of the manufacturer. \nPay the purchaser for the deficiency \nIf the manufacturer provides the guarantee by paying a purchaser for t he deficiency, if any, between the \nsales proceeds received for the equipment and the guaranteed minimum resale value, the manufacturer \nshould account for such guarantee and sale in accordance with ASC 460 and ASC 606. \nReacquire the equipment at a guarantee d price \nA manufacturer should evaluate the sales incentive program, which includes the guarantees in \naccordance with the guidance on satisfaction of performance obligations in ASC 606-10-25-30 and the \nguidance on repurchase agreements in ASC 606-10-55-66 through 55 -78. If such evaluation results in a \nlease ( e.g., the guaranteed price is less than the original selling price of the asset, and the transaction is \nnot part of a sale and leaseback transaction), the manufacturer accounts for the transaction as lea se in \naccordance with ASC 842. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 320}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 309 The lease payments used as a part of the determination of whether the transaction should be classified \nas an operating lease, a direct financing lease or a sales -type lease generally will be the difference \nbetween the proceed s on the equipment’s initial transfer and the amount of the residual value guarantee \nto the purchaser as of the first exercise date of the guarantee. Refer to sections 3, Lease classification , \nand 3.2.2 , Lease classification for certain sales that include a residual value guarantee in the form of a \nrepurchase option (lessors only) , for further discussion on lease classification. \nIt is our view that the guaranteed resale (residual) should be viewed on a net present value basis in \ndetermining the classificati on of the transaction. \nIllustration 5 -9: Accounting for a sale with guaranteed minimum resale amount \nCompany X sells a computer with a cost of $80 for $100 ( i.e., fair value) and agrees to reacquire the \ncomputer in five years for $10. In accordance with ASC 606-10-55-68, the arrangement is accounted \nfor as a lease because Company X is obligated to repurchase the computer for an amount that is less \nthan the original selling price. \nThe present value of the $10 repurchase obligation is $6. As a result, the transaction is classified as a \nsales -type lease because the proceeds of the sale ($100) less the present value of the repurchase \nobligation ($6) exceed substantially all of the equipment’s fair value ($100). That’s because the FASB \nsaid in ASC 842-10-55-2 that “one reasonable approach” would be to conclude that “[n]inety percent \nor more of the fair value of the underlying asset amounts to substantially all the fair val ue of the \nunderlying asset.” Refer to section 3.2, Criteria for lease classification — lessors . \nCompany X accounts for the sales -type lease as follows: \nCash (received at time of sale) $ 100 \n Sales $ 100 \nCost of sale $ 80 \n Inventory $ 80 \nResidual value of asset sold $ 6 \n Guaranteed repurchase obligation $ 6 \nBoth the residual value and the guarantee should be accreted to $10 at the end of the five -year \nperiod. If, at any time, the residual value of the computer is deemed to be less than $10, a loss for the \nshortfall should be recorded. \nIf the transaction should be accounted for by the manufacturer as an operating lease, the net proceeds \non the equipment’s initial transfer should be recorded as a liability in the manufacturer’s balance sheet. \nThe liability subsequently would be reduced on a pro rata basis over the period to the first exercise date \nof the guarantee, to the amount of the guaranteed residual value at that date, with corresponding credits \nto revenue in the manufacturer’s income statement. Any further reduction in the guarantee d residual \nvalue resulting from the purchaser’s decision to continue to use the equipment should be recognized in a \nsimilar manner. The equipment should be included in the manufacturer’s balance sheet and depreciated \nfollowing the manufacturer’s normal dep reciation policy. ASC 360-10 provides guidance on the accounting \nfor any potential impairment of the equipment. At the time the purchaser elects to exercise the residual \nvalue guarantee by selling the equipment to another party, the liability should be red uced by the amount, \nif any, paid to the purchaser. The remaining undepreciated carrying amount of the equipment and any \nremaining liability should be removed from the balance sheet and included in the determination of \nincome in the period of the equipment’ s sale. Alternatively, if the purchaser exercises the residual value \nguarantee by selling the equipment to the manufacturer at the guaranteed price, the liability should be \nreduced by the amount paid to the purchaser. Any remaining liability should be incl uded in the \ndetermination of income in the period of the exercise of the guarantee. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 321}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 310 ASC 460 does not apply to a guarantee for which the underlying is related to an asset of the guarantor. \nBecause the manufacturer continues to recognize the residual value o f the equipment guaranteed by the \nmanufacturer as an asset (included in the seller -lessor’s net investment in the lease) when recording a \nsales -type lease, that guarantee does not meet the characteristics in ASC 460-10-15-4 and is, therefore, \nnot subject t o the provisions of ASC 460. Additionally, if the lease is classified as an operating lease, the \nmanufacturer does not remove the asset from its books, and its guarantee would be a market value guarantee \nof its own asset. A market value guarantee of the gu arantor’s own asset is not within the scope of ASC 460 \nand, as a result, the accounting prescribed in ASC 842-10-55-32 through 55 -33 is unaffected by ASC 460. \nASC 842 does not address a transaction where the seller can be required by the buyer, at a specif ied time \nsubsequent to the sale, to repurchase the asset at fair value as determined at the time of the buyback. \nASC 842 also does not address the accounting for an arrangement that gives a customer the right to \ntrade in an asset at a guaranteed value or s pecified price that can only be exercised when the customer \npurchases a new asset or require arrangements that include such rights to be accounted for as a lease. \n5.8 Presentation \nExcerpt from Accounting Standards Codification \nLeases — Lessor \nOther Presen tation Matters \nSales -Type and Direct Financing Leases \nStatement of Financial Position \n842-30-45-1 \nA lessor shall present lease assets (that is, the aggregate of the lessor’s net investment in sales -type \nleases and direct financing leases ) separately from other assets in the statement of financial position. \n842-30-45-2 \nLease assets shall be subject to the same considerations as other assets in classification as current or \nnoncurrent assets in a classified balance sheet. \nStatement of Comprehensive Income \n842-30-45-3 \nA lessor shall either present in the statement of comprehensive income or disclose in the notes in come \narising from leases . If a lessor does not separately present lease income in the statement of \ncomprehensive income, the lessor shall disclose which line items include lease income in the statement \nof comprehensive income. \n842-30-45-4 \nA lessor shall pr esent any profit or loss on the lease recognized at the commencement date in a manner \nthat best reflects the lessor’s business model(s). Examples of presentation include the following: \na. If a lessor uses leases as an alternative means of realizing value from the goods that it would \notherwise sell, the lessor shall present revenue and cost of goods sold relating to its leasing \nactivities in separate line items so that income and expenses from sold and leased items are \npresented consistently . Revenue recognized is the lesser of: \n1. The fair value of the underlying asset at the commencement date \n2. The sum of the lease receivable and any lease payments prepaid by the lessee . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 322}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 311 Cost of goods sold is the carrying amount of the underlying asset at the commencement date \nminus the unguaranteed residual asset . \nb. If a lessor uses leases for the purposes of providing finance, the lessor shall present the profit or \nloss in a single line item. \nStatement of Cash Flows \n842-30-45-5 \nIn the statement of cash flows, a lessor shall classify cash receipts from leases within operating activities. \nHowever, if the lessor is within the scope of Topic 942 on financial services —depository and lending, it \nshall follow the guidance in paragraph 9 42-230-45-4 for the presentation of principal payments received \nfrom leases. \nOperating Leases \nStatement of Financial Position \n842-30-45-6 \nA lessor shall present the underlying asset subject to an operating lease in accordance with other Topics. \nStatement o f Cash Flows \n842-30-45-7 \nIn the statement of cash flows, a lessor shall classify cash receipts from leases within operating activities. \nThe table below summarizes how lease -related amounts and activities are presented in lessors’ financial \nstatements: \nFinancial statement Lessor presentation \nBalance sheet • Sales -type and direct financing leases: \n• The net investment in the lease is presented separately from other assets. \n• The net investment in the lease is subject to the same considerations as \nother assets in classification as current or noncurrent assets in a classified \nbalance sheet. \n• Operating leases: \n• Underlying assets are presented in accordance with applicable guidance. \nIncome statement • All leases: \n• Income arising from lea ses is presented separately from other activity or \ndisclosed in the notes (along with the corresponding line item(s) in the \nincome statement). \n• Sales -type leases and direct financing leases: \n• Profit (for sales -type leases) or loss (for sales -type and direct financing \nleases) recognized at the commencement date is presented on either a \ngross or net basis, based on the lessor’s business model. \n• For example, lessors that use leasing as an alternative means to \nrealize value from goods they would otherwise sell present lease \nrevenue and cost of goods sold on a gross basis ( i.e., revenue and cost of \ngoods sold in separate line items). \n• For example, le ssors that use leases for the purpose of providing \nfinancing present the profit or loss on a net basis ( i.e., in a single line item). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 323}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 312 Financial statement Lessor presentation \nStatement of cash flows • All leases: \n• Cash lease payments received by lessors are presented in operating activities. \n• Except ion: Lessors in the scope of ASC 942, Financial Services — \nDepository and Lending , must classify principal payments received under \nsales -type and direct financing leases in investing activities . \n5.8.1 Income statement presentation of lessee reimbursements \nLessors may receive reimbursement from lessees for certain periodic costs relating to the lessor’s \nownership of the underlying asset. For example, in many multi -tenant commercial properties, a lessor’ s \nperiodic costs to own and maintain the building ( e.g., insurance, taxes , maintenance) are often passed \nalong to the lessees in the form of variable payments that do not depend on an index or rate . Under \nASC 842, a lessor that does not apply the practical expedient to not separate lease and non -lease \ncomponents (e.g., common area maintenance) allocates such payments to the lease and non -lease \ncomponents on a relative standalone selling price basis (refer to section 1.4.2, Identifying and separating \nlease f rom non -lease components of a contract ). The lessor then follows the guidance in ASC 842 to \naccount for and present lease components and follows other GAAP ( e.g., ASC 606) to account for and \npresent non -lease components. A lessor that applies that practical expedient to not separate lease and \nnon-lease components (refer to section 1.4.2.4, Practical expedient to not separate lease and non -lease \ncomponents — lessors ) determines the predominant component in the arrangement and follows either \nASC 842 or ASC 606 to account for and present the combined components. Regardless of whether a \nlessor applies the practical expedient to separate lease and non -lease components, presentation of \nreimbursements received from lessees as a s eparate line item on the income statement is not permitted. \nRefer to section 5.9, Disclosure , for discussion on disclosure of lessee reimbursements. \n5.8.2 Statement of cash flows presentation of certain principal payments for \nlessors in the scope of ASC 942 \nWith the issuance of ASU 2019 -01, Leases (Topic 842): Codification Improvements , the FASB clarified \nthat lessors in the scope of ASC 942 must classify principal payments received under sales -type and \ndirect financing leases in inv esting activities in the statement of cash flows. All other lessors classify cash \nreceipts from leases in operating activities, as required by ASC 842. \nThe amendments were in response to concerns raised by lessors in the scope of ASC 942, who sought \nthe cl arification because, when the FASB issued the leases standard, it did not amend an example in \nASC 942 that the lessors rel ied on to include these payments in investing activities. \n5.9 Disclosure \nThe objective of lessor disclosures is to enable financial s tatement users to assess the amount, timing and \nuncertainty of lease -related cash flows. ASC 842 requires a lessor to disclose quantitative and qualitative \ninformation about its leases, the significant judgments made in applying ASC 842 and the amounts \nrecognized in the financial statements related to those leases. \nLessors may need to exercise judgment to determine the appropriate level at which to aggregate or \ndisaggregate disclosures so that meaningful information is not obscured by insignificant details or by grouping \nitems with different characteristics. The disclosure requirements apply to both public and nonpublic entities. \nFor interim disclosures, a lessor is required to disclose a table of all lease -related income items in its \ninterim financial state ments in accordance with ASC 842-30-50-5 and ASC 270-10-50-6A. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 324}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 313 ASC 842 includes the following disclosure requirements for lessors. \nExcerpt from Accounting Standards Codification \nLeases — Lessor \nDisclosure \n842-30-50-1 \nThe objective of the disclosure requirements is to enable users of financial statements to assess the \namount, timing, and uncertainty of cash flows arising from leases . To achieve that objective, a lessor \nshall disclose qualitative and quantitative information about all of the following: \na. Its leases (as described in paragraphs 842 -30-50-3(a), 842 -30-50-4, and 842 -30-50-7) \nb. The significant judgments made in applying the requirements in this Topic to tho se leases (as \ndescribed in paragraph 842 -30-50-3(b)) \nc. The amounts recognized in the financial statements relating to those leases (as described in \nparagraphs 842 -30-50-5 through 50 -6 and 842 -30-50-8 through 50 -13). \n842-30-50-2 \nA lessor shall consider the level of detail necessary to satisfy the disclosure objective and how much \nemphasis to place on each of the various requirements. A lessor shall aggregate or disaggregate \ndisclosures so that useful information is not obscured by including a la rge amount of insignificant \ndetail or by aggregating items that have different characteristics. \n842-30-50-3 \nA lessor shall disclose both of the following: \na. Information about the nature of its leases, including: \n1. A general description of those leases \n2. The basis and terms and conditions on which variable lease payments are determined \n3. The existence and terms and conditions of options to extend or terminate the lease \n4. The existence and terms and conditions of options for a lessee to purchase the unde rlying asset . \nb. Information about significant assumptions and judgments made in applying the requirements of \nthis Topic, which may include the following: \n1. The determination of whether a contract contains a lease (as described in paragraphs \n842-10-15-2 through 15 -27) \n2. The allocation of the consideration in a contract between lease and nonlease components (as \ndescribed in paragraphs 842 -10-15-28 through 15 -32), unless a lessor elects the practical \nexpedient in paragraph 842 -10-15-42A and all nonlease com ponents in the contract qualify \nfor that practical expedient \n3. The determination of the amount the lessor expects to derive from the underlying asset \nfollowing the end of the lease term . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 325}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 314 842-30-50-3A \nAn entity that elects the practical expedient in paragraph 842 -10-15-42A on not separating nonlease \ncomponents from associated lease components (including an entity that accounts for the combined \ncomponent entirely in Topic 606 on revenue from contracts wi th customers) shall disclose the \nfollowing, by class of underlying asset: \na. Its accounting policy election and the class or classes of underlying assets for which it has elected \nto apply the practical expedient \nb. The nature of: \n1. The lease components an d nonlease components combined as a result of applying the \npractical expedient \n2. The nonlease components, if any, that are accounted for separately from the combined \ncomponent because they do not qualify for the practical expedient \nc. The Topic the entity applies to the combined component (this Topic or Topic 606). \n842-30-50-4 \nA lessor shall disclose any lease transactions between related parties (see Topic 850 on related party \ndisclosures). \n842-30-50-5 \nA lessor shall disclose lease income recognized in ea ch annual and interim reporting period, in a \ntabular format, to include the following: \na. For sales -type leases and direct financing leases : \n1. Profit or loss recognized at the commencement date (disclosed on a gross basis or a net \nbasis consistent with pa ragraph 842 -30-45-4) \n2. Interest income either in aggregate or separated by components of the net investment in \nthe lease . \nb. For operating leases , lease income relating to lease payments . \nc. Lease income relating to variable lease payments not included in the measurement of the \nlease receivable . \n842-30-50-6 \nA lessor shall disclose in the notes the components of its aggregate net investment in sales -type and \ndirect financing leases (that is, th e carrying amount of its lease receivables, its unguaranteed residual \nassets , and any deferred selling profit on direct financing leases). \n842-30-50-7 \nA lessor shall disclose information about how it manages its risk associated with the residual value of \nits leased assets. In particular, a lessor should disclose all of the following: \na. Its risk management strategy for residual assets \nb. The carrying amount of residual assets covered by residual value guarantees (excluding guarantees \nconsidered to be lease payments for the lessor, as described in paragraph 842 -30-30-1(a)(2)) \nc. Any other means by which the lessor reduces its residual asset risk (for example, buyback \nagreements or variable lease payments for use in excess of specified limits). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 326}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 315 Sales -Type and Direct Financing Leases \n842-30-50-8 \nIn addition to the disclosures required by paragraphs 842 -30-50-3 through 50 -7, a lessor also shall \nprovide the disclosures in paragraphs 842 -30-50-9 through 50 -10 for sales -type leases and direct \nfinancing leases . \n842-30-50-9 \nA lessor shall explain significant changes in the balance of its unguaranteed residual assets and \ndeferred selling profit on direct financing leases. \n842-30-50-10 \nA lessor shall disclose a maturity analysis of its lease receivables , showing the undiscounted cash \nflows to be received on an annual basis for a minimum of each of the first five years and a total of the \namounts for the remaining years. A lessor shall dis close a reconciliation of the undiscounted cash \nflows to the lease receivables recognized in the statement of financial position (or disclosed separately \nin the notes). \nOperating Leases \n842-30-50-11 \nIn addition to the disclosures required by paragraphs 842 -30-50-3 through 50 -7, a lessor also shall \nprovide the disclosures in paragraphs 842 -30-50-12 through 50 -13 for operating leases. \n842-30-50-12 \nA lessor shall disclose a maturity analysis of lease payments , showing the undiscounted cash flows to \nbe received on an annual basis for a minimum of each of the first five years and a total of the amounts \nfor the remaining years. A lessor shall present that maturity analysis separately from the maturity \nanalysis required by paragraph 842 -30-50-10 for sales -type leas es and direct financing leases . \n842-30-50-13 \nA lessor shall provide disclosures required by Topic 360 on property, plant, and equipment separately \nfor underlying assets under operating leases from owned assets. \n842-30-50-14 \nA lessor that makes the accounting policy election in paragraph 842 -10-15-39A shall disclose its accounting \npolicy election and comply with the disclosure requirements in paragraphs 235 -10-50-1 through 50 -6. \nInterim Reporting — Overall \nDisclosure \n270-10-50-6A \nA lessor shall disclose a table of all lease -related income items in its interim financial statements \n(see paragraph 842 -30-50-5 for lease -related income items). \nTable of lease income disclosure \nLessors are required to disclose lease income recognized in each ann ual and interim reporting period, in \na tabular format, disaggregate d by sales -type and direct financing lease income (i.e., profit or loss \nrecognized at lease commencement, interest income) , operating lease income , and lease income relat ing \nto variable lea se payments not included in the measurement of the lease receivable. A lessor’s disclosure \nof lease income relat ing to variable lease payments should include all lease income that is not otherwise \nincluded in the income disclosures for sales -type and direc t financing lease s or operating lease s. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 327}), Document(page\_content='5 Lessor accounting \nFinancial reporting developments Lease accounting | 316 Disclosure of lessee reimbursements \nAs discussed in section 5.8.1, Income statement presentation of lessee reimbursements, presentation of \nreimbursements received from lessees as a separate line item on the income s tatement is not permitted. \nHowever, a lessor may want to disclose information about lessee reimbursements ( e.g., lessee \nreimbursements received in a reporting period) because analysts may use that data for certain industry \nperformance measures. Disclosure of such information may be permissible. However, lessors should consider \nthe SEC staff’s guidance on non -GAAP measures when disclosing information about lessee reimbursements. \nRefer to our non -GAAP discussion in the SEC Reporting Update: Highlights of tr ends in 2022 SEC comment \nletters and our Technical Line , Navigating the requirements for non -GAAP financial measure s. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 328}), Document(page\_content=' \nFinancial reporting developments Lease accounting | 317 6 Subleases \n6.1 Definition of a sublease \nExcerpt from Accounting Standards Codification \nMaster Glossary \nSublease \nA transaction in which an underlying asset is re-leased by the lessee (or intermediate lessor ) to a third \nparty (the sublessee) and the original (or head) lease between the lessor and the lessee remains in effect. \nLessees often enter into arrangements to sublease an underlying asset to a third party. In these \narrangements, one party acts as both the lessee and lessor of the same underlying asset. The original \nlease is often referred to as a head lease, the original lessee is often referred to as an intermediate lessor \nor sublessor, and the ultimate lessee is ofte n referred to as the sublessee. \n \nIn some cases, the sublease is a separate lease agreement. In other cases, a third party assumes the \noriginal lease, but the original lessee remains the primary obligor under the original lease. \n6.1.1 The original lessee is relieved of the primary obligation — not a sublease \nExcerpt from Accounting Standards Codification \nLeases — Lessees \nDerecognition \n842-20-40-3 \nIf the nature of a sublease is such that the original lessee is relieved of the primary obligation under \nthe original lease , the transaction shall be considered a termination of the original lease. Paragraph \n842-20-35-14 addresses subleases in which the original lessee is not relieved of the primary obligation \nunder the original lease. Any consideration paid or received upon termination that was not already \nincluded in the lease payments (for example, a termination payment that was not included in the lease \npayments based on the lease term ) shall be included in the determination of profit or loss to be \nrecognized in accordance with paragraph 842 -20-40-1. If a sublease is a termination of the original \nlease and the original lessee is secondarily liable, the guarantee obligation shall be recognized by the \nlessee in accordance with paragraph 405 -20-40-2. \nLessor \nHead lease \nOriginal lessee/sublessor \nSublease \nLessee/sublessee \n•The accounting for the original lease doesn’t change. \n•Sublease term may affect head lease classification . \n•Consider the underlying asset for classification purposes (rather than the ROU \nasset arising from the head lease) . \n•Use the discount rate of the head lease if the rate implicit in the lease cannot \nbe readily determined . \n•Additional sublease disclosures are required . \n•Lease classification is assessed in the same manner as any new lease . \n•Consider the underlying asset for classification purposes (rather than the \nROU asset arising from the head lease) . \n• ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 329}), Document(page\_content='6 Subleases \nFinancial reporting developments Lease accounting | 318 If the original lessee is relieved of the primary obligation under the original lease, the transaction is not a \nsublease. Such transactions are considered a termination (refer to section 4.8.1, Lease termination ) of \nthe original lease, and the lease -related assets and obligations are derecognized. Any consideration paid \nor received upon termination that wa s not already included in the lease payments ( e.g., a termination \npenalty that was not included in lease payments based on the lease term) is included in the gain or loss on \ntermination of the original lease. If the original lessee remains secondarily liab le for the original lease, the \nguarantee obligation is recognized by the lessee in accordance with ASC 405-20-40-2 (i.e., measured at fair \nvalue and included in the determination of gain or loss on lease termination). \n6.2 Original lessor accounting for a s ublease \nExcerpt from Accounting Standards Codification \nLeases — Lessor \nSubsequent Measurement \n842-30-35-7 \nIf the original lessee enters into a sublease or the original lease agreement is sold or transferred \nby the original lessee to a third party, the original lessor shall continue to account for the lease as it \ndid before. \nDerecognition \n842-30-40-3 \nIf the original lease agreement is replaced by a new agreement with a new lessee, the lessor shall \naccount for the termination of the original lease as provided in paragraph 842 -30-40-2 and shall classify \nand account for the new lease as a separate transaction. \nIf the original lessee enters into a sublease or sells or transfers th e original lease to a third party, the \noriginal lessor does not change its accounting for the original lease. However, if the original lease \nagreement is replaced by a new agreement with a new lessee, the original lessor accounts for both the \ntermination o f the original lease and the new lease as separate transactions. Refer to section 5.7.3, \nLease termination . \n6.3 Sublessor accounting \nExcerpt from Accounting Standards Codification \nLeases — Overall \nRecognition \n842-10-25-6 \nWhen classifying a sublease , an entity shall classify the sublease with reference to the underlying \nasset (for example, the item of property, plant, or equipment that is the subject of the lease) rather \nthan with reference to the right -of-use asset . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 330}), Document(page\_content='6 Subleases \nFinancial reporting developments Lease accou nting | 319 Leases — Lessee \nSubsequent Measurement \n842-20-35-14 \nIf the nature of a sublease is such that the original lessee is not relieved of the primary obligation \nunder the original lease , the original lessee (as sublessor) shall continue to account for the origin al \nlease in one of the following ways: \na. If the sublease is classified as an operating lease , the original lessee shall continue to account \nfor the original lease as it did before commencement of the sublease. If the lease cost for the \nterm of the subleas e exceeds the anticipated sublease income for that same period, the original \nlessee shall treat that circumstance as an indicator that the carrying amount of the right -of-\nuse asset associated with the original lease may not be recoverable in accordance wit h \nparagraph 360-10-35-21. \nb. If the original lease is classified as a finance lease and the sublease is classified as a sales -type \nlease or a direct financing lease , the original lessee shall derecognize the original right -of-use \nasset in accordance with p aragraph 842 -30-40-1 and continue to account for the original lease \nliability as it did before commencement of the sublease. The original lessee shall evaluate its \ninvestment in the sublease for impairment in accordance with paragraph 842 -30-35-3. \nc. If the original lease is classified as an operating lease and the sublease is classified as a sales -type \nlease or a direct financing lease, the original lessee shall derecognize the original right -of-use \nasset in accordance with paragraph 842 -30-40-1 and, from the sublease commencement date , \naccount for the original lease liability in accordance with paragraphs 842 -20-35-1 through 35 -2. \nThe original lessee shall evaluate its investment in the sublease for impairment in accordance with \nparagraph 842 -30-35-3. \n842-20-35-15 \nThe original lessee (as sublessor) in a sublease shall use the rate implicit in the lease to determine the \nclassification of the sublease and to measure the net investment in the sublease if the sublease is \nclassified as a sales -type or a direct f inancing lease unless that rate cannot be readily determined. If \nthe rate implicit in the lease cannot be readily determined, the original lessee may use the discount \nrate for the lease established for the original (or head) lease. \nIf an underlying asset is re-leased by a lessee to a third party and the original lessee retains the primary \nobligation under the original lease, the transaction is a sublease. A sublessor assesses sublease \nclassification independently of the classification assessment that it made as the lessee of the same asset. \nA sublessor considers the lease classifica tion criteria in section 3.2, Criteria for lease classification — \nlessors , with reference to the underlying asset when classifying a sublease ( e.g., the underlying asset \nsubject to the sublease) rather than the right -of-use asset recognized as part of the head lease. A \nsublessor uses the rate implicit in the lease ( i.e., the rate implicit in the sublease) to determine the \nclassification of the sublease and to measure the net investment in a sublease that is classified as a sales -\ntype or a direct financing l ease. If the rate implicit in the lease cannot be readily determined, the \nsublessor uses the discount rate for the lease established for the head lease. Refer to section 3.4.10, \nClassification of subleases, and section 2.5, Discount rates . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 331}), Document(page\_content='6 Subleases \nFinancial reporting developments Lease accounting | 320 The following ta ble summarizes how the original lessee/sublessor accounts for the head lease and \nsublease at the commencement of the sublease. \n Sublease — sales -type or direct financing lease Sublease — operating lease \nHead lease — finance \nlease The original lessee derecognizes the original right -of-\nuse asset and continues to account for the original \nlease liability as it did before the commencement of \nthe sublease ( i.e., in accordance with the finance \nlease provisions of the lessee accounting guidance). \nThe o riginal lessee, as the sublessor, recognizes a \nnet investment in the sublease and evaluates it \nfor impairment under ASC 310 (before the adoption of \nASU 2016 -13) or ASC 326 ( after the adoption of \nASU 2016 -13). Refer to section 2.11.3, Leases , of \nour FRD, Credit impairment under ASC 326, for \nadditional details. Additionally, refer to section 5.2.3, \nImpairment of th e net investment in the lease — sales -\ntype leases. The original lessee continues to \naccount for the head lease as it did \nbefore the commencement date of \nthe sublease ( i.e., in accordance with \nthe lessee accounting guidance). \nIf the lease cost for the term of the \nsublease exceeds the sublessor’s \nanticipated sublease income for \nthe same period, this indicates that \nthe right -of-use asset associated \nwith the head lease should be \nassessed for impairment under \nthe long-lived asset impairment \nprovisions of ASC 360-10 (i.e., an \nimpairment indicator). Head lease — \noperating lease The original lessee derecognizes the original right -of-\nuse asset at the sublease commencement date and \naccounts for the original lease liability in accordance \nwith the finance lease provisions of the lessee \naccounting guidance. The original lessee, as the \nsublessor, recognizes a net investment in the \nsublease and evaluates it for impairment under \nASC 310 (before the adoption of ASU 2016 -13) or \nASC 326 ( after the adoption of ASU 2016 -13). Refer to \nsection 2.11.3, Leases , of our FRD, Credit \nimpairment under ASC 326, for additional details. \nAdditionally, r efer to section 5.2.3, Impairment of the \nnet investment in the lease — sales -type leases . \nSublease may affect head lease classification \nWhen a sublessor enters into sublease arrangements and determines that the term of the sublease (including \nthe noncancelable term and any lease renewal options that are reasonably certain to be exercised by the \nsublessee or controlled by the sublessor) is longer than the lease term of the head lease, the sublessor is \nrequired to reassess the lease term of the head lease in accordance with ASC 842-10-35-1(a) as discussed in \nsection 2.3.6.1, Reassessment of the lease term and purchase options — lessees . Howev er, the existence of \nthe renewal option on its own does not result in the head lease being extended. \nFor example, assume a head lease has a noncancelable term of five years and provides a lessee with an option \nto renew for two additional years that it det ermines it is not reasonably certain to exercise. If the lessee \nsubleases the underlying asset and provides the sublessee with the same noncancelable term and renewal \noption and determines that the sublessee is reasonably certain to exercise that renewal o ption, the lessee \nwould reassess the term of the head lease as the renewal options are now reasonably certain to be exercised. \nThis is because the lease term under the sublease effectively establishes an obligation to renew the head \nlease. If the lease ter m of the head lease changes, the sublessor is also required to reassess the lease \nclassification of the head lease. Refer to section 3.5, Reassessment of lease classification . Alternatively, if \nthe lessee determines that the sublessee is not reasonably cer tain to exercise the renewal option, the \nlessee would not remeasure the lease term on the head lease solely as a result of entering into the sublease \n(refer to section 3.5.1, Summary of lease reassessment and remeasurement requirements , for a discussion \nof events that could result in reassessment). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 332}), Document(page\_content='6 Subleases \nFinancial reporting developments Lease accounting | 321 Likewise, a head lease may provide a lessee with an option to purchase the underlying asset that it \ndetermines it is not reasonably certain to exercise. If the lessee then subleases the underlying asset and \nprovi des the sublessee with a purchase option and determines that the sublessee is reasonably certain to \nexercise that option, the sublessor will change its assessment of whether it is reasonably certain to \nexercise its purchase option on the head lease to fulf ill the terms of the sublease in accordance with \nASC 842-10-35-1(c) as discussed in section 2.3.6.1, Reassessment of the lease term and purchase \noptions — lessees . The sublessor is also required to reassess the lease classification of the head lease as \ndiscussed in section 3.5, Reassessment of lease classification . \nRecognition of profit or loss \nASC 842 does not address when the sublessor should recognize the selling profit (sales -type lease) or \nloss (sales -type or direct financing lease) resulting from a sublease. We believe that any selling profit \nshould be recognized at the sublease commencement date ( i.e., the date on which a sublessor makes the \nunderlying asset available for use by a sublessee) when a sub lease is classified as a sales -type lease or \ndeferred when a sublease is classified as a direct financing lease. When a sublease is classified as a sales -\ntype or direct financing lease, we believe that any selling loss should be recognized no later than th e \nsublease commencement date ( i.e., selling loss is not deferred), consistent with the accounting for a \nsales -type or direct financing lease, and in some cases earlier as an impairment of the right -of-use asset \nunder the head lease. \nWe also believe that wh en a sales -type sublease is for a portion of the underlying asset, the sublessor \nmust determine the portion of the right -of-use asset to derecognize on a rational and systematic basis \n(e.g., by relative fair value). Likewise, a sublessor must determine the portion of the lease liability that \nmay be converted from an operating lease to a finance lease for purposes of subsequent measurement \non a rational and systematic basis ( e.g., in proportion to the right -of-use asset). \nPresentation of sublease income \nASC 842 does not address how a sublessor should present the income from a sublease in the statement \nof comprehensive income . However, the FASB indicated in the Basis for Conclusions (BC 115) of \nASU 2016 -02 that the head lease and the sublease should be account ed for as two separate contracts \nunless those contracts meet all of the criteria in ASC 842’s contract combinations guidance. Therefore, \nwe believe that the sublessor should present the income from a sublease separately from the lease expense \non the head l ease ( i.e., gross presentation) unless both the head lease and the sublease meet all of the \ncriteria in the contract combinations guidance in ASC 842-10-25-19. Refer to section 1.5, Contract \ncombinations, for further information about contract combinations . However, we are aware that diversity \nexists in this area and that other forms of presentation may be acceptable in certain situations. \nRegardless of the presentation in the statement of comprehensive income , ASC 842 requires an original \nlessee/sublessor to disclose sublease income, on a gross basis, separate from finance or operating lease \nexpense. Refer to section 6.5, Disclosure , for other disclosure requirements. \nIn some instances, a sublessee may be required to make variable lease payments directly t o the head \nlessor, rather than to the sublessor. ASC 842 require s a lessor to exclude lessor costs paid directly by a \nlessee to third parties on the lessor’s behalf (e.g., taxes) from variable payments. However, a sublessor \nshould not exclude a sublessee’s variable lease payments that are not lessor costs (e.g., variabl e \npayments based on sales) from variable payments. Rather, a sublessor should present the sublessee’s \nvariable lease payments made directly to the head lessor as variable sublease income separately from \nlease expense on the head lease ( i.e., gross presenta tion). If the sublessor does not know the amount of \nthese payments, it should develop reasonable estimate s of the amount. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 333}), Document(page\_content='6 Subleases \nFinancial reporting developments Lease accounting | 322 Right -of-use asset groups for purposes of impairment assessments \nLessees’ right -of-use assets, for both operating and finance leases, are subject to existing impairment \nguidance in ASC 360-10 (refer to section 4.2.5, Impairment of right -of-use assets in operating leases , \nand section 4.3.4 , Impairment of right -of-use assets in finance leases ). Questions have arisen regarding \nwhether the original asset group that included the ROU asset should be reassessed for purposes of the \nASC 360-10 impairment assessment if all or part of the original ROU asset is subleased to a third party. \nWe believe in certain circumstances it is reasonable for the original lessee to conclude that a subleased \nportion of a right -of-use asset meets the criteria to be identified as a single lease component. For \nexample, an original lessee may conclude there is no accounting difference between accounting for its \nlease o f a 10 -floor building as one lease component (the building) or as 10 lease components (the 10 \nfunctionally independent floors). That is, even though each floor meets the criteria to be considered a \nseparate lease component (refer to section 1.4.1, Identify ing and separating lease components of a \ncontract ), the original lessee may have historically accounted for the entire 10 -floor building as one lease \ncomponent because there is no accounting difference between recognizing 10 separate right -of-use \nassets an d lease liabilities and recognizing one right -of-use asset and lease liability for the entire building. \nTherefore, in this example, if the original lessee subleases a single functionally independent floor, we \nbelieve it is also reasonable to disaggregate t he right -of-use asset for the subleased floor from the \nexisting asset group as long as that floor meets the criteria to be identified as a separate lease \ncomponent (refer to section 1.4.1, Identifying and separating lease components of a contract ). \nAs ment ioned above, in accordance with ASC 842-20-35-14, if the sublease is classified as a sales -type \nlease or a direct financing lease, the original lessee shall derecognize the original right -of-use asset. \nTherefore, in the example above, the original lessee w ould disaggregate the asset group in order to \nderecognize the portion of the asset being subleased. \n6.4 Sublessee accounting \nA sublessee accounts for a sublease in the same manner as any other lease ( i.e., as a new lease subject \nto ASC 842’s recognition an d measurement provisions). Refer to section 4, Lessee accounting . A \nsublessee classifies the sublease by referring to the underlying asset rather than by referring to the right -\nof-use asset arising from the head lease. \n6.5 Disclosure \nIn addition to making other lessor disclosures (refer to section 5.9, Disclosure ), ASC 842 requires an \noriginal lessee/sublessor to disclose (1) the existence, and terms and conditions, of residual value \nguarantees provided by the sublessee and (2) sublease income, on a gross b asis, separate from finance \nor operating lease expense. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 334}), Document(page\_content=' \nFinancial reporting developments Lease accounting | 323 7 Sale and leaseback transactions \n7.1 Overview — sale and leaseback transactions (updated August 2022) \nExcerpt from Accounting Standards Codification \nLeases — Sale and Leaseback Transactions \nScope and Scope Exceptions \n842-40-15-2 \nIf an entity (the seller -lessee) transfers an asset to another entity (the buyer -lessor) and leases that \nasset back from the buyer -lessor, both the seller -lessee and the buyer -lessor shall accou nt for the \ntransfer contract and the lease in accordance with Sections 842 -40-25, 842 -40-30, and 842 -40-50. \nImplementation Guidance and Illustrations \n842-40-55-1 \nA lessee may obtain legal title to the underlying asset before that legal title is transferred to the \nlessor and the asset is leased to the lessee. If the lessee controls the underlying asset (that is, it can \ndirect its use and obtain substantially all of its remaining benefits) before the asset is transferred to \nthe lessor, the transaction is a sale and leaseback transaction that is accounted for in accordance with \nthis Subtopic. \n842-40-55-2 \nIf the lessee obtains legal title, but does not obtain control of the underlying asset before the asset is \ntransferred t o the lessor, the transaction is not a sale and leaseback transaction. For example, this \nmay be the case if a manufacturer, a lessor, and a lessee negotiate a transaction for the purchase of \nan asset from the manufacturer by the lessor, which in turn is le ased to the lessee. For tax or other \nreasons, the lessee might obtain legal title to the underlying asset momentarily before legal title \ntransfers to the lessor. In this case, if the lessee obtains legal title to the asset but does not control the \nasset be fore it is transferred to the lessor, the transaction is accounted for as a purchase of the asset \nby the lessor and a lease between the lessor and the lessee. \nSale and leaseback accounting applies to both the seller -lessee and the buyer -lessor. A sale and \nleaseback transaction involves the transfer of an asset by an entity (the seller -lessee) to another entity \n(the buyer -lessor) and the leaseback of the same asset by the seller -lessee. Because ASC 842 requires \nlessees to recognize most leases on their bala nce sheets ( i.e., all leases except for short -term leases if \nthe lessee makes that accounting policy election), sale and leaseback transactions do not provide lessees \nwith a source of off -balance sheet financing. Both the seller -lessee and the buyer -lessor are required to \napply ASC 842 and certain provisions in ASC 606 to determine whether to account for a sale and \nleaseback transaction as a sale and purchase of an asset, respectively. Finally, ASC 842-40’s guidance on \nsale and leaseback transactions applie s to all assets that are within the scope of ASC 842. We believe this \nincludes the sale of a legal entity when the assets leased back constitute substantially all of the assets of \nthe legal entity that is sold. Sale and leaseback transactions among entitie s under common control are \nsubject to ASC 842-40’s sale and leaseback guidance. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 335}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 324 In some cases, a lessee may obtain legal title to the underlying asset before that legal title is transferred \nto the lessor and the asset is leased to the lessee. For example, a manufacturer, a lessor and a lessee \ntogether negotiate a transaction for the purchase of a piece of equipment from the manufacturer by the \nlessor, which in turn is leased to the lessee. For tax or other reasons, the lessee obtains legal title to the \nunde rlying asset shortly before legal title transfers to the lessor. If the lessee obtains legal title, but does \nnot obtain control of the underlying asset before the asset is transferred to the lessor, the transaction is \nnot a sale and leaseback transaction. If the lessee controls the underlying asset ( i.e., it can direct its use \nand obtain substantially all of its remaining benefits) before the asset or legal title is transferred to the \nlessor, the transaction is a sale and leaseback transaction and accounted for in accordance ASC 842-40. \nThe following table summarizes the accounting for sale and leaseback transactions for the seller -lessee and \nthe buyer -lessor. \nSeller -lessee Buyer -lessor \nSuccessful s ale and leaseback transaction accounting \nAccounting for the sale \n• Recognize the transaction price for the sale \nin accordance with the guidance on \ndetermining the transaction price in ASC 606 \nat the point in time that the buyer -lessor \nobtains control of the asset \n• Derecognize the carrying amount of the \nunderlying asset \n• Recognize any gain or loss, adjusted for off -\nmarket terms, immediately \nAccounting for the leaseback \n• Account for the leaseback in the same \nmanner as any other lease, adjusted for off -\nmarket terms \n• Additional disclosures are required Accounting for the purchase \n• Account for the asset in accordance with \nASC 360 \nAccounting for the leaseback \n• Account for the leaseback in the same \nmanner as any other lease, adjusted for \noff-market terms \nFinancing transaction ( i.e., failed sale ) accounting \n• Do not derecognize the asset \n• Account for amounts received as a financial \nliability • Do not recognize the transferred asset \n• Account for amounts paid as a receivable ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 336}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 325 7.1.1 Seller leases back less than 100% of asset sold \nThe sale and leaseback provisions of ASC 842-40 apply regardless of whether the seller -lessee leases \nback 100% or 1% of the asset sold. For example, if the asset sold is a 20 -floor office building and 10 \nfloors are leased back, sale and leaseback accounting under the provisions of ASC 842-40 is applicable. \n7.1.2 Partial sale and leaseback \nASC 842 does not specifically address the application of the sale and leaseback provisions of ASC 842-40 \nfor partial sale and leaseback transactions. For example, assume Entity A owns 100% of a limited liability \ncompany (LLC) (whose sole asset is a building En tity A uses for its manufacturing operations) and sells a \n51% interest in the LLC, deconsolidates the LLC and leases the building back from the deconsolidated LLC. \nTo determine whether to account for the partial sale and leaseback transaction as a sale and purchase of \nan asset, the seller -lessee and the buyer -lessor are required to apply ASC 842 and certain provisions in \nASC 606 as discussed in section 7.2, Determining whether the transfer of an asset is a sale . In this example, \nwe believe the transaction w ould be subject to sale and leaseback accounting. \n7.1.3 Asset sold is different from the asset leased back \nIn certain sale and leaseback transactions, the asset sold is not the same as the asset leased back. In \nconsidering such transactions, we believe tha t despite the fact that the assets sold and leased back are \ndifferent, the transaction should be recorded as a sale and leaseback if the sale and lease were entered \ninto as part of a single transaction and the assets involved are essentially identical, or the future cash \nflows are not expected to significantly change as a result of the exchange). \n7.1.4 Lease -leaseback transactions \nIn a lease transaction where the owner of an asset leases an asset to a third party and then leases it back, the \nquestion often arises as to whether the transaction should be accounted for as a sale and leaseback. \nTransactions of this type are often tax driven (refer to section 10, Leveraged leases ). Lease -leaseback \ntransactions, also referred to as lease -in, lease -out (LILO ) transactions, should be assessed in consideration of \nthe guidance in ASC 842-10-25-19 (refer to section 1.5, Contract combinations ), which requires that two or \nmore contracts entered into at or near the same time with the same counterparty (or related par ty) be \nconsidered a single contract if at least one of the contracts is or contains a lease and certain criteria are met. \nThat is, both the original lease out of the asset from the owner to the third party and the leaseback from the \nthird party to the owne r should be evaluated concurrently when the criteria under ASC 842-10-25-19 are \nmet. Often, this evaluation results in the determination that a lease does not exist ( i.e., in substance a \nfinancing recorded on the balance sheet and/or a lease for only a por tion of the term) as the right to control \nthe use of the asset is not conveyed from the owner to the third party when both the original lease out and \nthe leaseback are considered a single arrangement. For example, an entity leases its medical equipment wit h \na 10-year useful life to a third party and then leases the equipment back for the first seven years. In this \ncase, the right to control the use of the equipment is not transferred to the third party until the completion of \nthe leaseback period ( i.e., the first seven years). Therefore, the entity would record the transaction as a \nfinancing during the leaseback period and then account for the lease to the third party at the end of the \nleaseback period (and allocate the consideration in the contract accordin gly). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 337}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 326 7.1.5 Sale subject to a preexisting lease \nExcerpt from Accounting Standards Codification \nLeases — Sale and Leaseback Transactions \nImplementation Guidance and Illustrations \n842-40-55-8 \nAn entity owns an interest in an underlying asset and also is a lessee under an operating lease \nfor all or a portion of the underlying asset. Acquisition of an ownership interest in the underlying \nasset and consummation of the lease occurred at or near the same time. This owner -lessee relationship \ncan occur, for example, when the entity has an investment in a partnership that owns the underlying \nasset (or a larger asset of which the underlying asset is a distinct portion). The entity subsequently sells \nits interest or the partnership sells the underlying asset to an independent third party, and the \nentity continues to lease the underlying asset under the preexisting operating lease. \n842-40-55-9 \nA transaction should be subject to the guidance in this Subtopic if the scope or price of the preexisting \nlease i s modified in connection with the sale. If the scope or the price of the preexisting lease is not \nmodified in conjunction with the sale, the sale should be accounted for in accordance with other Topics. \n842-40-55-10 \nA lease between parties under common control should not be considered a preexisting lease. \nAccordingly, the guidance in this Subtopic should be applied to transactions that include nonfinancial \nassets within its scope, except if Topic 980 on regulated operations applies. That is, if one of the \nparties under common control is a regulated entity with a lease that has been approved by the \nappropriate regulatory agency, that lease should be considered a preexisting lease. \nAn entity has an ownership interest in an underlying asset ( e.g., 30% noncontrolling ownership interest in \na partnership that owns the underlying asset) and also leases all or a portion of the underlying asset \nunder an operating lease. Subsequently, the entity sells its interest in the underlying asset to an \nindependent third party and continues to lease all or a portion of the underlying asset under the \npreexisting operating lease. If the scope or the consideration of the preexisting operating lease is not \nmodified in connection with the sale, the sale of the entity’s in terest is accounted for in accordance with \nother US GAAP and the entity’s accounting of the preexisting lease is not changed. Alternatively, if the \npreexisting operating lease is modified in connection with the sale and such modification meets the \ndefiniti on of lease modification as discussed in section 5.6, Lease modifications , (i.e., a change to the \nterms and conditions of the contract that results in a change in the scope of or the consideration for the \nlease), the transaction is accounted for as a sale and leaseback transaction. If the entity consolidates the \nlessor, this guidance would not apply, and instead, the sale of a controlling interest of the lessor would be \nsubject to leaseback accounting. \nHowever, a sale subject to a preexisting lease between parties under common control is not a preexisting \nlease. As an exception, when one of the parties under common control is a regulated entity in the scope \nof ASC 980, Regulated Operations, and the lease has been approved by the appropriate regulatory \nagency , an unmodified lease with a related party should be considered a preexisting lease. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 338}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 327 Illustration 7 -1: Sale subject to a preexisting lease — common control and no regulated operations \nAssume a parent company (Entity A) has two consolidated subsidiaries both with standalone financial \nreporting requirements: Subsidiary B and Subsidiary C. Also, assume the following: \n• Entity A, Subsidiary B and Subsidiary C do not have regulated operations subject to the guidance \nin ASC 980. \n• Subsidiary B owns an asset ( e.g., a pipeline) and leases it to Entity A. \n• Subsidiary B transfers the underlying asset to Subsidiary C. \n• Entity A continues to lease the underlying asset, except now it leases it from Subsidiary C. \n• The lease is otherwise unmodified, other than to change the name of the lessor. \n• Subsidiary B is relieved of its primary obligation under its lease with Entity A. \nAnalysis : In this example, the sale subject to a preexisting lease is not a preexisting lease; therefore, \nASC 842-40’s sale and leaseback guidance would be applicable. Each entity (Subsidiary B and \nSubsidiary C in their standalone financial reporting) would account for this transaction as follows: \n• The transaction would eliminate in consolidation for Entity A (the seller -lessee). \n• Since Subsidiary B is no longer the lessor, it follows other GAAP for the sale of the underlying \nasset to an entity under common control in its standalone financial reporting. \n• Subsidiary C (the buyer -lessor) considers ASC 842-40’s sale and leaseback guidance in its \nstandalone financial reporting due to its acquisition of the underlying asset from Subsidiary B and \nits lease with Entity A. \n• If the transaction is accounted for as a sale and leaseback, Subsidiary C (in its standalone \nfinancial reporting) would follow the accounting model for lessors (refer to section 5, Lessor \naccounting ) including performing a lease classification test. For ot her aspects of the transaction, \nthe entity would follow the guidance for common control transactions ( refer to our FRD, \nBusiness comb inations ). \n• If the transaction does not qualify as a sale, Subsidiary C (in its standalone financial reporting) \nwould account for the transaction as a financing. Refer to section 7.4, Transactions in which \nthe transfer of an asset is not a sale . \n \nIllustrat ion 7 -2: Sale subject to a preexisting lease — common control with regulated operations \nAssume the same facts as Illustration 7-1, except as follows: \n• Entity A, Subsidiary B and Subsidiary C operate in a regulated industry subject to the guidance in \nASC 980. \n• The lease between Entity A and Subsidiary B has been approved by an appropriate regulatory agency. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 339}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 328 Analysis : In this example, the sale subject to a preexisting lease is a preexisting lease; therefore, \nASC 842-40’s sale and leaseback guidance would not be applicable. Each entity would account for this \ntransaction as follows: \n• The transaction would eliminate in cons olidation for Entity A. \n• Since Subsidiary B is no longer the owner -lessor, it follows other GAAP (in its standalone financial \nreporting) for the sale of the underlying asset to an entity under common control. \n• Subsidiary C follows other GAAP (in its standalo ne financial reporting) for the purchase of the \nunderlying asset from an entity under common control and recognizes a lease following the lessor \nmodel (refer to section 5, Lessor accounting ). \n7.1.6 Sale-leaseback -sublease transactions \nExcerpt from Account ing Standards Codification \nLeases — Sale and Leaseback Transactions \nImplementation Guidance and Illustrations \n842-40-55-18 \nAn entity enters into a sale and leaseback of an asset that meets either of the following criteria: \na. The asset is subject to an operating lease . \nb. The asset is subleased or intended to be subleased by the seller -lessee to another party under an \noperating lease. \n842-40-55-19 \nA sale -leaseback -sublease transaction is within the scope of this Subtopic. The existence of the \nsublease (that is, the operating lease in paragraph 842 -40-55-18(a) or (b)) does not, in isolation, \nprevent the buyer -lessor from obtaining control of the asset in accordance with paragraphs 842-\n40-25-1 through 25-3, nor does it prevent the seller -lessee from controlling the asset before its \ntransfer to the buyer -lessor (that is, the seller -lessee is subject to the same requirements for \ndetermining whether the transfer of the asset is a sale as it would be without the sublease). All \nfacts and circumstances should be considered in determining whether the buyer -lessor obtains \ncontrol of the underlying asset from the seller -lessee in a sale-leaseback -sublease transaction. \nUnder a sale -leaseback -sublease arrangement, the owner of an asset sells an asset to a third party and \nleases it back, then, concurrently or subsequently, subleases the asset to another party. Under ASC 842-40, \nthe existence of the sublease in a sale and leaseback transaction, on its own, does not preclude the application \nof sale and leaseback accounting if both the leaseback and the sublea se are classified as operating leases. \nAn entity will need to consider all facts and circumstances in determining whether the buyer -lessor obtains \ncontrol of the underlying asset from the seller -lessee in a sale -leaseback -sublease transaction. \n7.1.7 Sale of construction -in-progress that is leased back after constructio n of the \nasset is completed \nIn some instances, an entity (seller) may begin construction of an asset and then transfer the asset to an \nunrelated entity (buyer). The buyer will then complete construction of the asset and lease back the \ncompleted asset to the seller. ASC 842 does not a ddress how an entity should account for the sale of a \npartially constructed building that is then leased back in completed form. As a result, questions have \narisen about whether the sale of a partially constructed building is required to be assessed under the sale \nand leaseback guidance in ASC 842-40 on the date of sale . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 340}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 329 In response to this question, t he FASB and SEC staffs have said there are likely multiple acceptable \ninterpretations about whether the sale of a partially constructed building should be su bject to the sale \nand leaseback guidance in ASC 842-40 because the question is not addressed by ASC 842. For example, \none acceptable interpretation is that an entity account s for the transaction as a sale and leaseback if \nexpenses directly related to const ruction of a n asset have been incurred (regardless of how significant \nthey are). In contrast, another acceptable interpretation is that the entity account s for the transaction as \na sale and leaseback only if the construction -in-progress is “substantially s imilar ” to the completed asset \nthat will be leased back. Since there are multiple acceptable views , an entity will need to apply judgment \nin consistently applying the sale and leaseback guidance in ASC 842-40. \n7.2 Determining whether the transfer of an asset is a sale \n(updated August 2022) \nExcerpt from Accounting Standards Codification \nMaster Glossary \nIntegral Equipment \nIntegral equipment is any physical structure or equipment attached to the real estate that cannot be \nremoved and used separately without incurring significant cost. \nLeases — Sale and Leaseback Transactions \nRecognition \n842-40-25-1 \nAn entity shall apply the following requirements in Topic 606 on revenue from contracts with customers \nwhen determining whether the transfer of an asset shall be accounted for as a sale of the asset: \na. Paragraphs 606 -10-25-1 through 25 -8 on the existence of a contract \nb. Paragraph 606 -10-25-30 on when an entity satisfies a performance obligation by transferring \ncontrol of an asset. \n842-40-25-2 \nThe existence of a leaseback (that is, a seller -lessee’s right to use the underlying asset for a period of \ntime) does not, in isolation, prevent the buyer -lessor from obtaining control of the asset. However, the \nbuyer -lessor is not considered to have obtaine d control of the asset in accordance with the guidance \non when an entity satisfies a performance obligation by transferring control of an asset in Topic 606 if \nthe leaseback would be classified as a finance lease or a sales -type lease . \n842-40-25-3 \nAn option for the seller -lessee to repurchase the asset would preclude accounting for the transfer of \nthe asset as a sale of the asset unless both of the following criteria are met: \na. The exercise price of the option is the fair value of the a sset at the time the option is exercised. \nb. There are alternative assets, substantially the same as the transferred asset, readily available in \nthe marketplace. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 341}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 330 The following flowchart depicts the decision -making process for determining whether the trans fer of an \nasset is a sale. \n \nWhen determining w hether the transfer of an asset should be accounted for as a sale and purchase, both \nthe seller -lessee and the buyer -lessor apply the guidance in (1) ASC 606-10-25-1 through 25 -8 on the \nexistence of a contract, (2) ASC 606-10-25-30 on when an entity satisfies a performance obligation by \ntransferring control of an asset and (3) ASC 842-40-25-2 through 25 -3. \nRefer to section 3, Identifying the contract with t he customer, of our FRD, Revenue from contracts with \ncustomers ( ASC 606) , for an in -depth discussion of identifying the contr act with the customer and \nsection 7.2, Control transferred at a point in time , of that publication for a discussion of transferring \ncontrol at a point in time. \nASC 842-40-25-2 through 25-3 also includes guidance for evaluating whether the transfer of an asset with a \nleaseback to the seller is a sale and purchase. Under this guidance, the existence of the leaseback, in and of \nitself, does not preclude a sale and purchase. However, a sale an d purchase does not occur if the leaseback \nwould be classified as a finance lease (seller -lessee) or a sales -type lease (buyer -lessor). In these types of \nleases, the FASB believes that the seller -lessee effectively retains control of the underlying asset. Therefore, \nthe FASB indicated in the Basis for Conclusions (BC 352(b)) of ASU 2016 -02 that it is inappropriate for a \nseller -lessee to account for the sale of an underlying asset that it concurrently repurchases. Instead, these \ntransactions are accounted fo r as financings by both the buyer -lessor (lender) and the seller -lessee \nYes \nNo \nNo \nAccount for as a financing transaction \n(i.e., a failed sale) (refer to section 7.4, \nTransactions in which the transfer of an \nasset is not a sale ) \nIs the transaction a sale under ASC 606\* ( i.e., does it transfer \ncontrol of the asset to the buyer -lessor)? [ ASC 842-40-25-1] \n\* Excluding the evaluation of the repurchase option under ASC 606 as the \nrepurchase option is subject to the evaluation under ASC 842 (see below). \nIs the leaseback classified as a sales -type lease by the buyer -lessor \nor a finance lease by the seller -lessee? [ ASC 842-40-25-2] \nDoes the transaction include an option for the seller -lessee \n to repurchase the asset? [ ASC 842-40-25-3] \nDoes the repurchase option meet both of the following conditions? \n• The exercise price of the option is the fair value of the underlying asset at the \ntime the option is exercised. \n• Alternative assets that are substantially the same as the transferred asset are \nreadily available in the marketplace. \n[ASC 842-40-25-3] \nAccount for as a sale and leaseback \ntransaction (refer to section 7.3, \nTransactions in which the transfer of an \nasset is a sale ) \nNo \nYes \nYes \nNo \n Yes ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 342}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 331 (borrower). After the adoption of ASU 2021 -05, leases with variable lease payments that are not based on an \nindex or rate ( e.g., long-term leases of machinery where the consideration i n the contracts is determined based \non hours used by the lessee) are classified as operating leases if they would have otherwise been classified as \nsales -type or direct financing leases and the lessor would have recognized a selling loss at lease commencem ent. \nAs a result, more sale and leaseback transactions may be accounted for as successful purchases of the asset \nby buyer -lessors (not seller -lessees) because the leases will be classified as operating leases in these situations. \nIf the leaseback is classi fied as an operating lease (seller -lessee) or a direct financing lease or an \noperating lease (buyer -lessor), such leaseback, in and of itself, does not preclude sale and purchase \naccounting, respectively. \nWhile an option for a seller -lessee to repurchase the transferred asset would generally preclude sale \naccounting under ASC 606, ASC 842-40 specifies that an option for the seller -lessee to repurchase the \nasset does not preclude sale and purchase accounting when both of the following conditions are met: \n1. The exercise price of the option is the fair value of the underlying asset at the time the option is exercised. \n2. There are alternative assets, substantially the same as the transferred asset, readily ava ilable in the \nmarketplace. \nIn the Basis for Conclusions (BC 352(c)) of ASU 2016 -02, the Board noted that real estate assets would not \nmeet criterion (2) (i.e., there are alternative assets, substantially the same as the transferred asset, readily \navailable in the marketplace ). This is because real estate is, by nature, ”unique ” (that is, no two pieces of \nland occupy the same space on this planet) such that no other similar real estate asset is ”substantially the \nsame. ” Therefore, we believe a sale and lease back of real estate, including a sale and leaseback of integral \nequipment as defined in ASC 978 ( i.e., any physical structure or equipment attached to the real estate that \ncannot be removed and used separately without incurring significant cost), when the seller -lessee retains \nany form of a repurchase option will result in a financing for both the seller -lessee and buyer -lessor. \n \nQuestion 7 -1 If a seller -lessee transfers an asset compris ing distinct portions (e.g., floors of a building) to another \nparty and leases back only a distinct portion (e.g., a single floor ) in what would be classified as a \nfinance lease, does that preclude the application of sale and leaseback accounting for the entire \ntransaction assuming no other facts would preclude sale recognition ? (added August 2022) \nIt depends. We believe the unit of account for determining whether there is a successful sale is each \nportion of the asset that is divided into distinct and separately recognized legal inter ests \n(e.g., condomi niums within a legally recognized condominiumized building) . Therefore, i f a seller -lessee \nleases back a single floor that is condominiumized and the lease is classified as a finance lease, the seller -\nlessee would account for that portio n of the transaction as a failed sale and the remaining portion of the \nbuilding as a successful sale. If a seller -lessee leases back a single floor of a building that is not divided \ninto distinct and separately recognized legal interests and the lease is classified as a finance lease, the \nfinance leaseback would preclude the seller -lessee from accounting for the entire transaction as a \nsuccessful sale. However, i f the portion leased back is a minor part of the asset , some entities may \nrecognize a sale for the entire asset , regardless of whether the minor component is a distinct and \nseparately recognized legal interest ( e.g., a condomini umized portion of the building) . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 343}), Document(page\_content='7 Sale and leaseba ck transactions \nFinancial reporting developments Lease accounting | 332 Question 7 -2 How should a seller -lessee account for the transfer of land and a building with an associated leaseback \nwhen the leaseback of the building would be classified as a finance leaseback and the leaseback of the \nland would be classified as an operating leasebac k? \nWe believe that land and a building may be considered separate units of account, even if they are not \ndivided into distinct and separately recognized legal interests (e.g., they are not separately titled), for \npurposes of determining whether there is a successful sale under the sale and leaseback guidance. That \nis because land and a building are accounted for separately under ASC 360-10, and ASC 842-10-15-29 \nstates that the right to use land should be accounted for as a separate lease component , even if the \nseparating lease components criteria are not met , unless the accounting effect of doing so would be \ninsignificant. Therefore, we believe that land may be evaluated similarly for purposes of the sale and \nleaseback guidance . \n \n7.2.1 Lease renewals — effect on sale accounting \nCertain leaseback transactions provide the seller -lessee with the right to continue to extend the lease, at \na fixed -price rental or at fair value at the date of exercise, for substantially all ( e.g., 90% or more) of the \nunderlyin g asset’s remaining economic life. ASC 842-40 does not address whether a lessee’s renewal \noptions ( e.g., fixed price, fair value at the date of exercise) permitting the seller -lessee to extend the \nlease for substantially all of the remaining economic life of the underlying asset preclude sale accounting. \nWhile ASC 842 and ASC 606 do not specifically address rights to extend the lease and the effect on sale \naccounting, the Board noted in the Basis for Conclusions (BC 218) of ASU 2016 -02 that “a lessee that \nhas an option to extend a lease for all of the remaining economic life of the underlying asset is, \neconomically, in a similar position to a lessee that has an option to purchase the underlying asset.” \nGiven the lack of specific guidance, w e believe one acce ptable view is that w hen the renewal price is not \nfair value , determined at the time the renewal option is exercised, the renewal option would prohibit sale \naccounting in the same way a seller’s re purchase agreement (i.e., a forward or call option ) would \npreclude sale accounting under ASC 606. However, there may be other reasonable approaches to \nevaluate whether control is transferred to the buyer under ASC 606 when a renewal option(s) that \nextends a lease for substantially all of the remaining economic lif e of the underlying asset is present. \n7.2.2 Right of first refusal and first offer — effect on sale accounting \nA right of first refusal based on a bona fide offer by a third party ordinarily is not an obligation or an \noption to repurchase. An agreement tha t allows the seller -lessee to repurchase the asset in the event no \nthird -party offer is made is an option to repurchase. As a result, care must be taken so that the right of \nfirst refusal is predicated on a “real” offer from an unrelated third party with t he ability and intention to \npurchase the asset. \nIn a related issue, certain sale and leaseback transactions provide that the seller -lessee has the right to make a \nfirst offer to buy the property at the end of the lease term. As long as the buyer -lessor is not compelled to \naccept this offer and the offer amount is not fixed, a right of first offer generally would not preclude sale \naccounting. If the buyer -lessor is compelled to accept the offer, the right of first offer is effectively a seller -\nlessee repurch ase option, resulting in a failed sale if the two additional criteria for determining whether the \ntransfer of an asset is accounted for as a sale under ASC 842-40-25-3 are not met ( i.e., (i) the exercise price \nof the option is the fair value of the asset a t the time the option is exercised, and (ii) there are alternative \nassets, that are substantially the same as the transferred asset, readily available in the marketplace). If the \nseller -lessee is compelled to make the offer (under a right of first offer), the right of first offer is effectively \na buyer -lessor put. Refer to section 7.3.2, Put option held by the customer , of our FRD, Revenue from \ncontracts with customers ( ASC 606) , for an in -depth discussion of customer -held put options. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 344}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 333 7.2.3 Seller -lessee guarantee of the residual value — effect on sale accounting \nExcerpt from Accounting Standards Codification \nLeases — Sale and Leaseback Transactions \nImplementation Guidance and Illustrations \n842-40-55-20 \nThe seller -lessee may guarantee to the lessor that the residual value will be a stipulated amount at \nthe end of the lease term . If the transfer of the asset is a sale in accordance with paragraphs 842-\n40-25-1 through 25-3, the seller -lessee residual value guarantee should be accounted for in the \nsame manner as any other residual value guarantee provided by a lessee . \n842-40-55-21 \nThe residual value guarantee does not, on its own, preclude accounting for the transaction as a \nsale and leaseback, but should be considered in evaluating whether control of the asset has \ntransferred to the buyer -lessor in accordance with paragraph 606-10-25-30. For example, a \nsignificant residual value guarantee by the seller -lessee may affect an entity’s consideration of \nthe transfer of control indicator in paragraph 606-10-25-30(d) . \nUnder ASC 842-40, the existence of the seller -lessee guarantee of the residual value in a sale and leaseback \ntransaction does not automatically preclude the application of sale and leaseback accounting. Such \nguarantee would impact the evaluation of whether the trans fer of an asset is a sale and purchase under \nASC 606-10-25-30. If a significant residual value guarantee is provided in a sale and leaseback transaction \nby the seller -lessee, it would impact the evaluation of whether the buyer -lessor obtains control of the leased \nasset ( e.g., it may indicate that the significant risks and rewards of ownership of the leased asset have not \nyet transferred to the buyer -lessor). Further, with the significant residual value guarantee, the leaseback \nmay likely be classified as a finance lease (seller -lessee) or a sales -type lease (buyer -lessor) as any residual \nvalue guaranteed by the seller -lessee is included in the fair value criteria testing ( i.e., the present value of the \nsum of lease payments and any residual value guaranteed by the lessee equals or exceeds substantially all \nthe fair value of the underlying asset) for lease classification. The classification of the lease as a finance lease \n(seller -lessee) or a sales -type lease (buyer -lessor) would preclude sales accounting unde r ASC 842-40-25-2. \nRefer to section 3.2, Criteria for lease classification — lessors , for further detail. \n7.2.4 Contingent repurchase options — effect on sale accounting \nEntities should carefully consider whether a contingent repurchase option precludes the transfer of control \nof the asset to the buyer. We believe that an entity should evaluate contingent repurchase options consistent \nwith how we believe conditional call o ptions should be evaluated under ASC 606. That is, in evaluating \nwhether an option precludes the transfer of control of the asset, an entity should consider who controls \n(i.e., the seller -lessee, the buyer -lessor or neither) the outcome of the condition th at causes the option to \nbecome active . Refer to section 7.3.1, Forward or call option held by the entity , of our FRD, Revenue from \ncontracts with customers ( ASC 606) , for an in -depth discussion of conditional call options. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 345}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 334 7.3 Transactions in which the transfer of an asset is a sale \nExcerpt from Accounting Standards Codification \nLeases — Sale and Leaseback Transactions \nRecognition \n842-40-25-4 \nIf the transfer of the asset is a sale in accordance with paragraphs 842 -40-25-1 through 25 -3, both of \nthe following apply: \na. The seller -lessee shall: \n1. Recognize the transaction price for the sale at the point in time the buyer -lessor obtains \ncontrol of the asset in accordance with paragraph 606 -10-25-30 in accordance with the \nguidance on determining the transaction price in paragraphs 606 -10-32-2 through 32 -27 \n2. Derecognize the carrying amount of the underlying asset \n3. Account for the lease in accordance with Subtopic 842 -20. \nb. The buyer -lessor shall account for the purchase in accordance with other Topics and for the lease \nin accordance with Subtopic 842 -30. \nInitial Measurement \n842-40-30-1 \nAn entity shall determine whether a sale and leaseback transaction is at fair value on the basis of the \ndifference between either of the following, whichever is more readily determinable: \na. The sale price of the asset and the fair value of the asset \nb. The pres ent value of the lease payments and the present value of market rental payments. \n842-40-30-2 \nIf the sale and leaseback transaction is not at fair value, the entity shall adjust the sale price of the \nasset on the same basis the entity used to determine that the transaction was not at fair value in \naccordance with paragraph 842 -40-30-1. The entity shall account for both of the following: \na. Any increase to the sale price of the asset as a prepayment of rent \nb. Any reduction of the sale price of the asset as a dditional financing provided by the buyer -lessor to \nthe seller -lessee. The seller -lessee and the buyer -lessor shall account for the additional financing \nin accordance with other Topics. \n842-40-30-3 \nA sale and leaseback transaction is not off market solely because the sale price or the lease payments \ninclude a variable component. In determining whether the sale and leaseback transaction is at fair \nvalue, the entity should consider those variable payments it reasonably expects to be entitled to (or to \nmake) o n the basis of all of the information (historical, current, and forecast) that is reasonably \navailable to the entity. For a seller -lessee, this would include estimating any variable consideration to \nwhich it expects to be entitled in accordance with paragr aphs 606 -10-32-5 through 32 -9. \n842-40-30-4 \nIf the transaction is a related party lease , an entity shall not make the adjustments required in \nparagraph 842 -40-30-2, but shall provide the required disclosures as discussed in paragraphs 842 -20-\n50-7 and 842 -30-50-4. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 346}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 335 If the transfer of the asset is a sale, the seller -lessee does each of the following: \n• Recognizes the transaction price for the sale in accordance with the guidance on determining the \ntransaction price in ASC 606-10-32-2 through 32 -27 at the point in time that the buyer -lessor obtains \ncontrol of the asset (refer to section 5, Determine the transaction price , of our FRD, Revenue from \ncontracts with customers ( ASC 606) , for an in -depth discussion of determining the transaction price) \n• Derecognizes the carrying amount of the underlying asset \n• Recognizes any gain or loss, adjusted for off -market terms, immediately (refer to section 7.3.2, \nAdjustment for off -market terms — sale and leaseback transactions ) \nA buyer -lessor accounts for the purchase of the asset in accordance with ASC 360. \n7.3.1 Accounting for the leaseback \nWhen a sale occurs, b oth the seller -lessee and the buyer -lessor account for the leaseback in the same \nmanner as any other lease ( i.e., in accordance with the lessee and lessor guidance, respectively), with \nadjustments for any off -market terms. \n7.3.2 Adjustment for off -market t erms — sale and leaseback transactions \nA sale transaction and the ensuing lease are generally interdependent and negotiated as a package. \nConsequently, some transactions could be structured with a negotiated sale price that is above or below the \nasset’s fair value and with lease payments for the ensuing lease that are above or below the then -current \nmarket rates. These off -market terms could distort the gain or loss on the sale and the recognition of lease \nexpense and lease income for the lease. To make s ure that the gain or loss on the sale and the lease -related \nassets and liabilities associated with such transactions are not understated or overstated, ASC 842-40 requires \nadjustments for any off -market terms of sale and leaseback transactions, except for sale and leaseback \ntransactions among related parties (refer to section 7.3.2.2, Related -party sale and leaseback transactions ). \nThe off -market adjustments are based on the difference between (1) the sale price of the asset and its \nfair value or (2) the pr esent value of the lease payments and the present value of market rental \npayments, whichever is more readily determinable. The FASB indicated in the Basis for Conclusions \n(BC 364) of ASU 2016 -02 that entities are expected to maximize the use of observable prices and \ninformation when determining which measure is the most appropriate to use. \nWhen the sale price is less than the underlying asset’s fair value or the present value of the lease payments \nis less than the present value of market rental payments, a seller -lessee recognizes the difference as an \nincrease to the sales price and the initial measurement of the right -of-use asset as a lease prepayment. When \nthe sale price is greater than the underlying asset’s fair value or the present value of the lease p ayments is \ngreater than the present value of market rental payments, a seller -lessee recognizes the difference as a \nreduction to the sales price and an additional financing received from the buyer -lessor separately from the \nlease liability. The seller -lessee accounts for the additional financing in accordance with other US GAAP. \nBuyer -lessors are also required to adjust the purchase price of the underlying asset for any off -market \nterms. Such adjustments are recognized as lease prepayments made by the selle r-lessee or as additional \nfinancing provided to the seller -lessee. The buyer -lessor accounts for any additional financing in \naccordance with other US GAAP. \n7.3.2.1 Variable lease payments — assessment of off -market terms in sale and leaseback transactions \nThe terms of a sale and leaseback transaction are not off market solely because the sale price or the lease \npayments include a variable component. In determining whether the sale and leaseback transaction is at fair \nvalue, an entity should consider variabl e payments it reasonably expects to be entitled to (or to make) on the \nbasis of all of the information ( i.e., historical, current and forecasted) that is reasonably available. For a seller -', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 347}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 336 lessee, this includes estimating any variable consideration it expe cts to be entitled to in accordance with \nASC 606-10-32-5 through 32 -9. Refer to section 5.2, Variable consideration , of our FRD, Revenue from \ncontracts with customers ( ASC 606) , for an in -depth discussion of estimating variable consideration. \n7.3.2.2 Related -party sale and leaseback transactions \nAdjustments are not made to reflect either the fair value of the purchase and sale or the current market \nrates for a lease in sale and leaseback transactions among related parties. Refer to section 9.1, Related -\nparty leasing transactions . \n7.3.3 Example s — sale and leaseback transaction \nThe following example illustrates the accounting for a sale and leaseback transaction and is based on the \nexample in ASC 842-40-55-23 through 55 -30. \nIllustration 7-3: Sale and leaseback transaction — seller -lessee sells under lying asset for a \nprice greater than fair value \nStar Corp. (seller -lessee) sells a piece of land to Milky Way Inc. (buyer -lessor) for $2 million. At the \nsame time, Star Corp. enters into a contract with Milky Way Inc. for the right to use the land for 10 years \n(the leaseback), with annual payments of $120,000 payable in arrears. On the date of the transaction, \nthe observable fair value of the land is $1.4 million, and the carry ing amount of the land is $1 million. \nIn this example, the difference between the fair value of the land and the sale price of the land is more \nreadily determinable than the difference between the present value of the lease payments and the \npresent value of the market rental payments. \nStar Co rp.’s incremental borrowing rate is 6%. Milky Way Inc. also uses 6 % as the applicable discount \nrate, which it determined in accordance with ASC 835-30-25-12 through 25 -13.1 For simplicity, this \nexample assumes the same discount rate of 6% for both Star Cor p. and Milky Way Inc. In practice, the \ndiscount rates used for buyer -lessors and seller -lessees would likely differ. \nBoth Star Corp. and Milky Way Inc. conclude that a sale occurs at the commencement of the leaseback \nbecause Milky Way Inc. obtains control of the underlying asset in accordance with ASC 606, the \nleaseback is classified as an operating lease by both Star Corp. and Milky Way Inc., and the transaction \ndoes not contain any repurchase options. \nAnalysis : Star Corp. sold the land for $2 million, whi ch is greater than its observable fair value of \n$1.4 million. Because the sales price of the land is not at fair value, both Star Corp. and Milky Way Inc. \nadjust for the off -market terms in accounting for the sale and leaseback transaction. \nStar Corp. (seller -lessee) records the following at lease commencement : \nCash $ 2,000,000(a) \nROU asset 283,210(b) \n Land $ 1,000,000(c) \n Lease liability 283,210(d) \n Financial liability 600,000(e) \nGain on sale 400,000(f) \nTo record the sale and leaseback tran saction with off -market terms. \n1 Interest — Imputation of Interest — Recognition — Determining an Appropriate Interest Rate . \n (a) Receipt of $2,000,000 for the transaction with Milky Way Inc. \n(b) The ROU asset is equal to the lease liability. \n(c) $1,000,000 is the carrying amount of the land. \n(d) The lease liability is calculated as the present value of the 10 contractual leaseback payments of $120,000, discounted at the \nincremental borrowing rate of 6%, less the additional financing from Milky Way Inc. of $600,000. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 348}), Document(page\_content='7 Sale and leaseback transact ions \nFinancial reporting developments Lease accounting | 337 (e) The difference between the sale price of $2 million and the observable fair value of $1.4 million is recorded as additional \nfinancing from Milky Way Inc. of $600,000. \n(f) The gain on the sale of land is calculated as the difference between the observable fair value of $1,400,000 and the carrying \namount of $1,000,000. \nMilky Way Inc. (buyer -lessor) records the following on the date of sale: \nLand $ 1,400,000(g) \nFinancial asset 600,000(h) \n Cash $ 2,000,000(i) \nTo record the sale and leaseback transaction with off -market terms. \n(g) $1,400,000 is the observable fair value of the land purchased from Star Corp. \n(h) The difference between the sale s price of $2 ,000,000 and the fair value of $ 1,400,000 is recorded as additional financing to \nStar Corp . of $600,000. \n(i) $2,000,000 is the amount paid for the transaction. \nIn this example, Milky Way Inc. ( the buyer -lessor ) does not have entries to initially recognize the \noperating lease. \nAt the end of year 1, Star Corp. (seller -lessee) records the follo wing entries: \nInterest expense $ 36,000 \nFinancial liability $ 36,000 \nTo record interest on the financial liability using the incremental borrowing rate ($600,000 x 6%) . \nStar Corp. (seller -lessee) will allocate the annual lease payment pro rata between l ease expense and \nthe financial liability: \n Relative % Allocated amount \nLease expense 32.0 %(j) $ 38,479(l) \nFinancial liability 68.0 %(k) 81,521(m) \n 100% $ 120,000 \n \nLease expense $ 38,479(l) \nFinancial liability 81,521(m) \nCash $ 120,000 \nTo decrease the financial liability and record lease expense by the allocated amounts of the annual \nlease payment ($120,000) . \nLease liability $ 21,487 \n ROU asset $ 21,487 \nTo adjust the lease liability to the present value of the remaining allocated lease payments ($38,479), \nwith an offset to the ROU asset. The adjustment of $21,287 is calculated as the initially recognized \nlease liability of $283,210 less the present value of remaining allocated lease payments ($261,723) at \nthe end of year 1. (j) $283,210 / ($283,210 + $600,000) = 32% . \n(k) $600,000 / ($283,210 + $600,000) = 68% . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 349}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 338 Star Corp. (seller -lessee) will record similar entries in years 2 through 10. At the end of the lease term , \nthe financing obligation and lease liability will equal $0. \nAt the end of year 1, Milky Way Inc. (buyer -lessor ) records the following entries: \nFinancial asset $ 36,000 \n Interest income $ 36,000 \nTo record interest on the financial asset using a discount rate of 6% ($600,000 x 6%). The discount rate \nis calculated by the buyer -lessor in accordance with ASC 835-30-25-12 through 25 -13. \nMilky Way Inc. (buyer -lessor) allocates the annual lease payment pro rata between lease income and \nthe financial asset: \n Relative % Allocated amount \nLease income 32.0 %(n) $ 38,479(p) \nFinancial asset 68.0 %(o) 81,521(q) \n 100% $ 120,000 \n \nCash $ 120,000 \n Lease income $ 38,479(p) \n Financial asset 81,521(q) \nTo record lease income and reduce the financial asset by the allocated amounts of the annual lease \npayment ($120,000). \nMilky Way Inc. (buyer -lessor ) will record similar entries in years 2 through 10. At the end of the lease \nterm the carrying amount of the financial asset will be $0 and Milky Way Inc. will continue to recognize \nthe land. \n \nIllustration 7-4: Adjustment for off -market terms — seller -lessee sells underlying asset for a \nprice less than fair value \nStar Corp. (seller -lessee) sells a piece of land to Milky Way Inc. (buyer -lessor) for $1.5 million. At the \nsame time, Star Corp. enters into a contract with Milky Way Inc. for the right to use the land for \n10 years (the leaseback), with annual payments of $120,000 payable in arrears. On the date of the \ntransaction, the observable fair value of the land is $1. 8 million, and the carry ing amount of the land is \n$1 million. In this example, the difference between the fair value of the land and sale price of the land \nis more readily determinable than the difference between present value of the lease payments and \npresent value of the market rental payments. \nStar Corp.’s incremental borrowing rate is 6%. Milky Way Inc. also uses 6 % as the applicable discount \nrate, w hich it determined in accordance with ASC 835-30-25-12 through 25 -13.1 For simplicity, this \nexample assumes the same discount rate of 6% for both Star Corp. and Milky Way Inc. In practice , the \ndiscount rates used for buyer -lessors and seller -lessees would likely differ. \nBoth Star Corp. and Milk y Way Inc. conclude that a sale occurs at the commencement of the leaseback \nbecause Milky Way Inc. obtains control of the underlying asset in accord ance with ASC 606, the \nleaseback is classified as an operating lease by both Star Corp. and Milky Way Inc., and the transaction \ndoes not contain any repurchase options. (n) $283,210 / ($283,210 + $600,000) = 32%. \n(o) $600,000 / ($283,210 + $600,000) = 68%. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 350}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 339 Analysis : Star Corp. sold the land for $1.5 million, which is less than its observable fair value of \n$1.8 million. Because the sales price of the land is not at fair value, both Star Corp. and Milky Way Inc. \nare required to adjust for the off -market terms in accounting for the sale and leaseback transaction. \nStar Corp. (seller -lessee) recor ds the following at lease commencement : \nCash $ 1,500,000(a) \nROU asset 1,183,210(b) \n Land $ 1,000,000(c) \n Lease liability 883,210(d) \n Gain on sale 800,000(e) \nTo record the sale and leaseback transaction with off -market terms. \n1 Interest — Imputation of Interest — Recognition — Determining an Appropriate Interest Rate . \n(a) Receipt of $1,500,000 for the transaction with Milky Way Inc. \n(b) The ROU asset is calculated as the lease liability of $883,210 plus the difference between the sales pr ice of the land and the \nobservable fair value of the land of $300,000 ($1,800,000 - $1,500,000) , which is recognized as a lease prepayment. \n(c) $1,000,000 is the carrying amount of the land. \n(d) Lease liability calculated as the present value of the 10 c ontractual leaseback payments of $120,000, discounted at the \nincremental borrowing rate of 6%. \n(e) The gain on the sale of land is calculated as the difference between the observable fair value of the land of $1,800,000 and \nthe carrying amount of $1,000,00 0. \nMilky Way Inc. (buyer -lessor) records the following on the date of sale: \nLand $ 1,800,000(f) \n Cash $ 1,500,000(g) \n Deferred rent 300,000(h) \nTo record the sale and leaseback transaction with off -market terms. \n(f) $1,800,000 is the fair value of the land purchased from Star Corp. \n(g) $1,500,000 is the amount paid by Milky Way Inc. for the transaction . \n(h) The buyer -lessor accounts for the difference between the observable fair value of the land and its sales price as deferred rent \n($1,800,000 - $1,500,000 = $300,000). This deferred rent will be recognized as lease income over the 10 -year lease term \non a pro rata basis. \nIn this example, Milky Way Inc. ( the buyer -lessor ) does not have entries to initially recognize the \noperating lease. \nAt the end of year 1, Star Corp. (seller -lessee) records the following entr ies: \nLease expense $ 120,000 \n Cash $ 120,000 \nTo record the lease payment made at the end of year 1. \nLease expense $ 30,000 \n ROU asset $ 30,000 \nTo record amortization of the lease prepayment ($300,000 ÷ 10 years = $30,000) . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 351}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 340 Lease liability $ 67,007 \nROU asset $ 67,007 \nTo adjust the lease liability to the present value of the remaining lease payments with an offset to the ROU \nasset. The adjustment of $67,007 is calculated as the initially recognized lease liability of $883,210 \nless the present value of remaining allocated lease payments ($816,203) at the end of year 1. \nStar Corp. (seller -lessee) will record similar entries in years 2 through 10. At the end of the lease term \nthe lease liability will equal $0. \nAt the end of year 1, Milky Way Inc. (buyer -lessor ) records the following entry: \nCash $ 120,000 \nDeferred rent 30,000 \n Lease income $ 150,000 \nTo record cash received on the lease and amortization of deferred rent over the lease term. \nMilky Way Inc. (buyer -lessor ) will record similar entries in years 2 through 10. At the end of the lease \nterm, Milky Way Inc. will c ontinue to recognize the land. \n7.4 Transactions in which the transfer of an asset is not a sale \nExcerpt from Accounting Standards Codification \nLeases — Sale and Leaseback Transactions \nRecognition \n842-40-25-5 \nIf the transfer of the asset is not a sale in accordance with paragraphs 842 -40-25-1 through 25 -3, \nboth of the following apply: \na. The seller -lessee shall not derecognize the transferred asset and shall account for any amounts \nreceived as a financial liability in accordance with other Topics. \nb. The buyer -lessor shall not recognize the transferred asset and shall account for the amounts paid \nas a receivable in accordance with other Topics. \nInitial Measurement \n842-40-30-6 \nThe guidance in paragraph 842 -40-25-5 notwithstanding, the seller -lessee shal l adjust the interest \nrate on its financial liability as necessary to ensure that both of the following apply: \na. Interest on the financial liability is not greater than the payments on the financial liability over the \nshorter of the lease term and the term o f the financing. The term of the financing may be shorter \nthan the lease term because the transfer of an asset that does not qualify as a sale initially may \nqualify as a sale at a point in time before the end of the lease term. \nb. The carrying amount of the a sset does not exceed the carrying amount of the financial liability at \nthe earlier of the end of the lease term or the date at which control of the asset will transfer to \nthe buyer -lessor (for example, the date at which a repurchase option expires if that date is earlier \nthan the end of the lease term). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 352}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 341 If the transfer of an asset is not a sale, the seller -lessee and the buyer -lessor account for the transaction \nas a financing. The seller -lessee keeps the asset subject to the sale and leaseback transaction on its \nbalance sheet and accounts for amounts received as a financial liability in accordance with other \nUS GAAP. The seller -lessee decreases the financial liability by lease payments made, less the portion \nconsidered interest expense. \nThe seller -lessee adjusts the interest rate on its financial liability as necessary to make sure that both: \n• Interest on the financ ial liability is not greater than the payments on the financial liability over the \nshorter of the lease term or the term of the financing . In other words , there should be no negative \namortization of the liability at the end of the shorter of the lease term or the term of the financing \n(which could occur when the interest on the financial liability exceeds the payments made in that term ). \n• The carrying amount of the asset does not exceed the carrying amount of the financial liability at the \nearlier of the en d of the lease term or the date at which control of the asset will transfer to the buyer -\nlessor ( i.e., there should be no built -in loss) \nIf the transfer of the asset is not a sale, the buyer -lessor does not recognize the transferred asset and \ninstead accou nts for the amounts paid as a loan receivable in accordance with other US GAAP. The \nbuyer -lessor recognizes interest income on its financial asset using the imputed interest rate determined \nby applying ASC 835-30, Interest — Imputation of Interest . The buyer -lessor assesses the financial asset \nfor impairment under ASC 310 (before the adoption of ASU 2016 -13) or ASC 326-20 (after the adoption \nof ASU 2016 -13). \nIf a sale and leaseback transaction that is accounted for as a financing subsequently qualif ies for sales \nrecognition under ASC 606 and ASC 842-40 (e.g., expiration of the repurchase option), the transaction \nwould, at that time, be accounted for using sale and leaseback accounting by both the seller -lessee and \nthe buyer -lessor. The seller -lessee would derecognize the carrying amounts of the financial liability and \nthe underlying asset and recognize the difference between the carrying amounts of the financial liability \nand the underlying asset as gain or loss. The buyer -lessor would recognize the p urchase of the underlying \nasset by derecognizing the carrying amount of its loan receivable and recognizing the transferred asset \nat that same amount. In addition, the leaseback would be classified and accounted for as any new leases \nas of the commencement date of the leaseback, which is the date of the transaction qualifies for sale \nrecognition under ASC 842, and the lease has commenced. The above discussion presumes there have \nbeen no additional changes in terms or conditions at the time of sale. Any such changes would affect the \naccounting at that time. \n7.4.1 Impairment of assets subject to a sale -leaseback \nAn entity enters into a sale and leaseback transaction as the seller -lessee that does not qualify as a sale \nunder ASC 842 is treated as a financing of the existing asset, which is not removed from the entity’s \nbalance sheet. A question arises as to whether any excess of carrying amount over fair market value at \nthe date of the sale should be recognized as a loss. \nAn asset that does not qualify for sale and leaseback accounting would continue to be subject to \nimpairment under ASC 360-10 as a held for use asset. An excess of carrying amount over fair market value \nat the date of sale would indicate that the recoverability of the carrying amount of an asset should \nbe assessed under the guidelines of ASC 360-10. Refer to our FRD, Impairment or disposal of long -lived \nassets , for further information on applying the provisions of ASC 360-10. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 353}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease a ccounting | 342 7.4.2 Example s — failed sale and leaseback transaction \nASC 842-40 provides the following example of the accounting for a failed sale and leaseback transaction. \nExcerpt from Accounting Standards Codification \nLeases — Sale and Leaseback Transactions \nImplementation Guidance and Illustrations \nExample 2 — Accounting for Failed Sale and Leaseback Transaction \n842-40-55-31 \nAn entity (Seller) sells an asset to an unrelated entity (Buyer) for cash of $2 million. Immediately \nbefore the transaction, the asset h as a carrying amount of $1.8 million and has a remaining useful life \nof 21 years. At the same time, Seller enters into a contract with Buyer for the right to use the asset for \n8 years with annual payments of $200,000 payable at the end of each year and no renewal options. \nSeller’s incremental borrowing rate at the date of the transaction is 4 percent. The contract includes \nan option to repurchase the asset at the end of Year 5 for $800,000. \n842-40-55-32 \nThe exercise price of the repurchase option is fixed a nd, therefore, is not the fair value of the asset on \nthe exercise date of the option. Consequently, the repurchase option precludes accounting for the \ntransfer of the asset as a sale. Absent the repurchase option, there are no other factors that would \nprec lude accounting for the transfer of the asset as a sale. \n842-40-55-33 \nTherefore, at the commencement date, Seller accounts for the proceeds of $2 million as a financial \nliability and continues to account for the asset. Buyer accounts for the payment of $2 million as a \nfinancial asset and does not recognize the transferred asset. Seller accounts for its financing obligation, \nand Buyer accounts for its financial asset in accordance with other Topics, except that, in accordance \nwith paragraph 842 -40-30-6, Sell er imputes an interest rate (4.23 percent) to ensure that interest on \nthe financial liability is not greater than the payments on the financial liability over the shorter of the \nlease term and the term of the financing and that the carrying amount of the a sset will not exceed the \nfinancial liability at the point in time the repurchase option expires (that is, at the point in time Buyer will \nobtain control of the asset in accordance with the guidance on satisfying performance obligations in \nTopic 606). Parag raph 842 -40-30-6 does not apply to the buyer -lessor; therefore, Buyer recognizes \ninterest income on its financial asset on the basis of the imputed interest rate determined in accordance \nwith paragraphs 835 -30-25-12 through 25 -13, which in this case Buyer determines to be 4 percent. \n842-40-55-34 \nDuring Year 1, Seller recognizes interest expense of $84,600 (4.23% × $2 million) and recognizes the \npayment of $200,000 as a reduction of the financial liability. Seller also recognizes depreciation expense \nof $85,714 ($1.8 million ÷ 21 years). Buyer recognizes interest income of $80,000 (4% × $2 million) \nand recognizes the payment of $200,000 as a reduction of its financial asset. \n842-40-55-35 \nAt the end of Year 1, the carrying amount of Seller’s financial liability is $1,884,600 ($2 million + \n$84,600 — $200,000), and the carrying amount of the underlying asset is $1,714,286 ($1.8 million — \n$85,714). The carrying amount of Buyer’s financial asset is $1,880,000 ($2 million + $80,000 — $200,000). \n842-40-55-36 \nAt the end of Year 5, the option to repurchase the asset expires, unexercised by Seller. The repurchase \noption was the only feature of the arrangement that precluded accounting for the transfer of the asset \nas a sale. Therefore, upon expiration of the repu rchase option, Seller recognizes the sale of the asset by \nderecognizing the carrying amount of the financial liability of $1,372,077, derecognizing the carrying ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 354}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 343 amount of the underlying asset of $1,371,429, and recognizing a gain of $648. Buyer recognizes the \npurchase of the asset by derecognizing the carrying amount of its financial asset of $1,350,041 and \nrecognizes the transferred asset at that same amount. The date of sale also is the commencement date \nof the leaseback for accounting purposes. The lease term is 3 years (8 year contractual leaseback \nterm — 5 years already passed at the commencement date). Therefore, Seller recognizes a lease liability \nat the present value of the 3 remaining contractual leaseback payments of $200,000, discounted at \nSeller’ s incremental borrowing rate at the contractually stated commencement date of 4 percent, which \nis $555,018, and a corresponding right -of-use asset of $555,018. Seller uses the incremental \nborrowing rate as of the contractual commencement date because that rate more closely reflects the \ninterest rate that would have been considered by Buyer in pricing the lease. \n842-40-55-37 \nThe lease is classified as an operating lease by both Seller and Buyer. Consequently, in Year 6 and \neach year thereafter, Seller recogn izes a single lease cost of $200,000, while Buyer recognizes lease \nincome of $200,000 and depreciation expense of $84,378 on the underlying asset ($1,350,041 ÷ 16 \nyears remaining useful life). \n842-40-55-38 \nAt the end of Year 6 and at each reporting date th ereafter, Seller calculates the lease liability at the \npresent value of the remaining lease payments of $200,000, discounted at Seller’s incremental \nborrowing rate of 4 percent. Because Seller does not incur any initial direct costs and there are no \nprepai d or accrued lease payments, Seller measures the right -of-use asset at an amount equal to the \nlease liability at each reporting date for the remainder of the lease term. \nThe following illustration shows the accounting for a failed sale and leaseback transaction where the \nrepurchase option is not reasonably certain to be exercised and the interest rate is required to be \nadjusted to avoid negative amortization of the liability at the end of the financing t erm, which in this \nexample is shorter than the lea se term . The financing term is the period from the date of legal sale \nthrough the date the transfer of the asset would initially qualif y as a sal e (e.g., when the purchase option, \nthat is not reasonably cer tain of exercise, would expire unexercised ). Refer to ASC 842-40-30-6 and \nsection 7.4 , Transactions in which the transfer of an asset is not a sale , for further information. \nIllustration 7-5: Accounting for failed sale and leaseback transaction — repurcha se option not \nreasonably certain to be exercised \nAssume the same facts as in Example 2 — Accounting for Failed Sale and Leaseback Transaction in \nASC 842-40-55-31 through 55 -33 except that the annual lease payments are $75,000 payable at the \nend of each year. At the end of year 5, the option to repurchase the asset expires, unexercised by \nSeller. \nUsing an interest rate of 4%, Seller initially calculate s the amortization table for the financial liability \nover the term of the financing as follows: \nTime Asset net \ncarrying amount Financial liability \nbalance Lease payment (Increase)/ \nreduction to \nprincipal payment Interest expense \nCommencement $ 1,800,000 $ 2,000 ,000 \nYear 1 $ 1,714,286(a) $ 2,00 5,000(b) $ 75,000 $ (5,000)(c) $ 80,000(d) \nYear 2 $ 1,628,572 $ 2,01 0,200 $ 75,000 (5,200) 80,200 \nYear 3 $ 1,542,858 $ 2,015,608 $ 75,000 (5,408) 80,408 \nYear 4 $ 1,457,144 $ 2,021,232 $ 75,000 (5,624) 80,624 \nYear 5 $ 1,371,430 $ 2,027,081 $ 75,000 (5,849) 80,849 \n $ 375,000 $ 402,081 ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 355}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 344 (a) Difference between the i nitial carrying amount of the asset ($1,800,000) and annual depreciation ($85,714 ). Annual \ndepreciation is calculated as initial carrying amount of the asset divided by the remaining useful life ( $1,800,000 ÷ 21). \n(b) Difference between the financial liability at lease commencement ( $2,000,000) and the principal portion of payment ( –$5,000). \n(c) Difference between the lease payment ( $75,000) and interest expense ($80,000 ). \n(d) Financial liability at commencement ( $2,000,000) multiplied by the interest rate (4%). \nAnalysis : Seller determines whether th e conditions specified under ASC 842-40-30-6 are satisfied \nwhereby ( 1) interest on the financial liability is not greater than the payments on the financial liability \nover the shorter of the lease term and the term of the financing and ( 2) the carrying amount of the \nasset does not exceed the carrying amount of the financial liability at the earlier of the end of the lease \nterm or the date at which control of the asset will transfer to the buyer -lessor (e.g., the date at which a \nrepurchase option expires if that date is earlier than the end of the lease term) . \nAs illustrated above, the condition specified in ASC 842-40-30-6(a) is not satisfied since the interest on \nthe financial liability ($4 02,081) is greater than the payments on the financial l iability ($375,000) over \nthe term of the financing ( i.e., five years when the repurchase option expires if unexercised by Seller). \nTherefore, t o comply with the guidance in ASC 842-40-30-6 and avoid negative amortization of the \nliability at the end of the financing term, Seller imputes an interest rate of 3.75% , which results in \ninterest expense over the term of the financing equal ing the contractual lease payments. The table \nbelow illustrates the calculated amounts using the imputed interest rate of 3.75% . \nTime Asset net \ncarrying \namount Financial liability \nbalance Lease payment (Increase)/ \nreduction to \nprincipal payment Interest expense \nCommencement $ 1,800,000 $ 2,000 ,000 \nYear 1 $ 1,714,286 $ 2,000 ,000 $ 75,000 $ - $ 75,000 \nYear 2 $ 1,628,572 $ 2,000 ,000 $ 75,000 - 75,000 \nYear 3 $ 1,542,858 $ 2,000 ,000 $ 75,000 - 75,000 \nYear 4 $ 1,457,144 $ 2,000 ,000 $ 75,000 - 75,000 \nYear 5 $ 1,371,430 $ 2,000 ,000 $ 75,000 - 75,000 \n $ 375,000 $ 375,000 \nImmaterial differences may arise in the recomputation of amounts in the example above due to rounding. \nWe believe the Seller -lessee should continue to monitor for reassessment events and modifications , \nwhich could result in the transaction qualifying as a sale or result in further adjustments to the interest \nrate to comply with ASC 842-40-30-6 (e.g., due to changes to the terms of the contract, lease term, \nfinanc ing term) . Refer to section s 2.3.6.1, Reassessment of the lease term and purchase options — \nlessees, and 4.6, Lease modifications , for additional details. \nThe following illustration shows the accounting for a failed sale and leaseback transaction where the \nrepurchase option is reasonably certain to be exercised. Therefore, in this example the term o f the \nfinancing and the lease term are the same. Refer to ASC 840-40-30-6 and section 7.4 , Transactions in \nwhich the transfer of an asset is not a sale , for further information. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 356}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 345 Illustration 7-6: Accounting for failed sale and leaseback transaction — repurchase option \nreasonably certain to be exercised \nAssume the same facts as in Example 2 — Accounting for Failed Sale and Leaseback Transaction in \nASC 842-40-55-31 through 55 -33 except that the cont ract includes an option to repurchase the asset \nat the end of year 5 for $1.5 million and Seller is reasonably certain to exercise the option. \nAnalysis : The interest rate of the financing is adjusted so that the financial liability at the end of year 5 \nwill equal the exercise price of the repurchase option . In this illustration, the lease term and financ ing \nterm are the same because control of the asset will not transfer to the buyer since Seller i s reasonably \ncertain that the repurchase option will be exe rcised . Therefore, in this illustration, Seller starts with its \nincremental borrowing rate and adjusts the rate to an impute d interest rate of 5.52% (rounded) , which \nwill result in no gain or loss recognized upon exercise of the option . The table below illustrates the \ncalculated amounts using the imputed interest rate of 5.52%. \nTime Asset net \ncarrying amount Financial liability \nbalance Lease payment Principal portion \nof payment Interest expense \nInitial $ 1,800,000 $ 2,000,000 \nYear 1 $ 1,714,286 $ 1,910,452 $ 200,000 $ 89,548 $ 110,452 (a) \nYear 2 $ 1,628,572 $ 1,815,959 $ 200,000 94,493 105,507 \nYear 3 $ 1,542,858 $ 1,716,247 $ 200,000 99,712 100,288 \nYear 4 $ 1,457,144 $ 1,611,029 $ 200,000 105,218 94,782 \nYear 5 $ 1,371,430 $ - $ 1,700,000 (b) 1,611,029 88,971 \n \n(a) Financial liability at commencement ( $2,000,000) multiplied by the imputed interest rate (5.52% ). \n(b) Annual lease payment ( $200,000) plus repurchase option price ($1,500,000) . \nImmaterial differences may arise in the recomputation of amounts in the example above due to rounding. \nWe believe the Seller -lessee should continue to monitor for reassessment events and modifications , \nwhich could result in the transaction qualifying as a sale or result in further adjustments to the interest \nrate to comply with ASC 842-40-30-6, (e.g., due to changes to the terms of the contract, lease term, \nfinanc ing term) . Refer to section s 2.3.6.1, Reas sessment of the lease term and purchase options — \nlessees , and 4.6, Lease modifications , for additional details. \n7.5 Other transactions subject to sale and leaseback accounting \nSale and leaseback accounting guidance also may be applicable to transactions that are structured other \nthan as a typical sale and leaseback. Entities may structure transactions differently from a typical sale \nand leaseback to achieve certain tax treatments, for financing or for other reasons. Examples of these \ntransactions are con tribution -leaseback, spin -off-leaseback and exchange -leaseback. Additionally, upon \nthe deconsolidation of a business or a subsidiary in the scope of ASC 810, Consolidation , the former \nparent and former subsidiary may need to evaluate any lease arrangements between the entities under \nthe sale and leaseback accounting guidance. Similarly, upon the acquisition of a business in the scope of \nASC 805, Business Combinations , the acquirer and the sel ling entity may need to evaluate any lease \narrangements between them under the sale and leaseback accounting guidance. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 357}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 346 Contribution -leaseback \nUnder a contribution -leaseback arrangement, an entity contributes ( i.e., transfers) an asset to another \nentity in exchange for a noncontrolling interest in that entity. Concurrent with the contribution of the \nasset, the contributor/transferor enters into an arrangement to lease back the contributed asset. We \nbelieve that a contribution -leaseback transaction represents a partial sale and leaseback that should be \naccounted for in accordance with the provisions for sale and leaseback transactions under ASC 842-40. \nAs discussed in section 7.1.2, Partial sale and leaseback , partial sale transactions do not automatically \npreclude the use of sale and leaseback accounting. The contribution -leaseback transactions should be \naccounted for in accordance with the provisions for sale and leaseback transactions under ASC 842-40. \nHowever, if the entity contributes ( i.e., transfers) an asset to another entity in exchange for a controlling \ninterest in that entity, the investee/transferee would be consolidated by the contributor/transferor. \nTherefore, the contribution -leaseback transaction would not subject to the lease accounting under ASC 842. \nSpin-off-leaseback \nUnder a spin -off-leaseback arrangement, an entity distributes the stock of a subsidiary that owns an \nunderlying asset (the underlying asset may or may not also be leased by other entities in the consolidated \ngroup) to the sharehol ders of the parent entity. Concurrent with the spin -off, the parent entity enters \ninto an arrangement to lease back all or a portion of the underlying asset that w as spun off. We also \nbelieve that a spin -off-leaseback transaction should be accounted for in accordance with the provisions \nfor sale and leaseback transactions under ASC 842-40. \nExchange -leaseback \nUnder an exchange -leaseback arrangement, an entity (seller -lessee) typically exchanges an underlying \nasset with another entity (buyer -lessor) in a nonmonetary exchange and leases the underlying asset back \nfrom the buyer -lessor. Similar to contribution and spin-off leaseback transactions, we believe that exchange -\nleaseback transactions should also be accounted for in accordance with the provisions for sale and leaseback \ntransactions under ASC 842-40. \n7.6 Sale and leasebacks by entities with regulated operati ons \nExcerpt from Accounting Standards Codification \nRegulated Operations — Leases \nOverview and Background \n980-842-05-1 \nThis Subtopic provides guidance on accounting for leases for entities with regulated operations. \nRecognition \n980-842-25-1 \nAccounting for sale and leaseback transactions in accordance with the guidance in Subtopic 842-40 \nmay result in a difference between the timing of income and expense recognition required by that \nSubtopic and the timing of income and expense recognition for rate-making purposes . \n980-842-25-2 \nThat difference shall be accounted for as follows: \na. If the difference in timing of income and expense recognition constitutes all or a part of a phase -\nin plan , it shall be accounted for in accordance with Subtopic 980 -340. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 358}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 347 b. Otherwise, the timing of income and expense recognition related to the sale and leaseback \ntransaction shall be modified as necessary to conform to the Regulated Operations Topic. That \nmodification required for a transaction that is accounted for as a financing is further described in \nthe following paragraph and paragraphs 980 -840-35-1 through 35 -2. \n980-842-25-3 \nThe difference between the amount of income or expense recognized for a transaction that is not part \nof a phase -in plan and that is accoun ted for as a financing under Subtopic 842 -40 and the amount of \nincome or expense included in allowable cost for rate -making purposes shall be capitalized or accrued \nas a separate regulatory -created asset or liability, as appropriate, if that difference mee ts the criteria \nof the Regulated Operations Topic. \nSubsequent Measurement \n980-842-35-1 \nIf the sale and leaseback transaction is accounted for as a financing and the sale is recognized for rate -\nmaking purposes, the total of interest imputed under the intere st method for the financing and the \ndepreciation of the underlying asset shall be modified to equal the total lease expense and the gain or \nloss allowable for rate -making purposes. \nThe provisions of ASC 842-40 apply to sale and leaseback transactions of an entity with regulated \noperations subject to ASC 980, Regulated Operations . Sale and leaseback accounting under ASC 842-40 \nmay result in a difference between the timing of income and expense recognition for accounting \npurposes and the timing of income and expense recognition for rate -making purposes. \n7.7 Lessee involvement in asset construction (‘build -to-suit’ transactions) \nExcerpt from Accounting Standards Codification \nLeases — Sale and Leaseback Trans actions \nImplementation Guidance and Illustrations \n842-40-55-3 \nAn entity may negotiate a lease before the underlying asset is available for use by the lessee . For \nsome leases, the underlying asset may need to be constructed or redesigned for use by the lessee. \nDepending on the terms and conditions of the contract , a lessee may be required to make payments \nrelating to the construction or design of the asset. \n842-40-55-4 \nIf a lessee incurs costs relating to the construction or design of an underlying asset before the \ncommencement date , the lessee should account for those costs in accordance with other Topics, for \nexample, Topic 330 on inventory or Topic 360 on pr operty, plant, and equipment. Costs relating to the \nconstruction or design of an underlying asset do not include payments made by the lessee for the right \nto use the underlying asset. Payments for the right to use the underlying asset are lease payments , \nregardless of the timing of those payments or the form of those payments (for example, a lessee might \ncontribute construction materials for the asset under construction). \n842-40-55-5 \nIf the lessee controls the underlying asset being constructed before the c ommencement date, the transaction \nis accounted for in accordance with this Subtopic. Any one (or more) of the following would demonstrate \nthat the lessee controls an underlying asset that is under construction before the commencement date: \na. The lessee ha s the right to obtain the partially constructed underlying asset at any point during \nthe construction period (for example, by making a payment to the lessor ). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 359}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 348 b. The lessor has an enforceable right to payment for its performance to date, and the asset doe s \nnot have an alternative use (see paragraph 842 -10-55-7) to the owner -lessor. In evaluating \nwhether the asset has an alternative use to the owner -lessor, an entity should consider the \ncharacteristics of the asset that will ultimately be leased. \nc. The le ssee legally owns either: \n1. Both the land and the property improvements (for example, a building) that are under construction \n2. The non -real-estate asset (for example, a ship or an airplane) that is under construction. \nd. The lessee controls the land that property improvements will be constructed upon (this includes \nwhere the lessee enters into a transaction to transfer the land to the lessor, but the transfer does \nnot qualify as a sale in accordance with paragraphs 842 -40-25-1 through 25 -3) and d oes not \nenter into a lease of the land before the beginning of construction that, together with renewal \noptions, permits the lessor or another unrelated third party to lease the land for substantially all \nof the economic life of the property improvements. \ne. The lessee is leasing the land that property improvements will be constructed upon, the term of \nwhich, together with lessee renewal options, is for substantially all of the economic life of the \nproperty improvements, and does not enter into a sublease of the land before the beginning of \nconstruction that, together with renewal options, permits the lessor or another unrelated third \nparty to sublease the land for substantially all of the economic life of the property improvements. \nThe list of circumstance s above in which a lessee controls an underlying asset that is under \nconstruction before the commencement date is not all inclusive. There may be other circumstances \nthat individually or in combination demonstrate that a lessee controls an underlying asset that is under \nconstruction before the commencement date. \nThe following flowchart summarizes how lessees evaluate and account for a build -to-suit transaction. \n \nASC 842’s guidance on lessee involvement in asset construction focuses on whether the lessee controls \nthe asset being constructed . In build -to-suit lease transactions, various forms of lessee involvement \nduring the construction period raise questions about whether the lessee has control of the underlying \nasset being constructed. In some asset construction arrangements, the prospective lessee participates in \nthe asset construction process. For e xample, a prospective lessee may act as a construction agent, \ngeneral contractor or as principal for the owner -lessor during the asset construction period. \nNo \nDoes the lessee control the underlying asset being constructed \nbefore the commencement date? \n[ASC 842-40-55-1 through 55 -2 and ASC 842-40-55-5] (refer to section 7.7.2, \nDetermining whether the lessee controls the underlying asset being constructed ) \n•ASC 842 does not provide specific recognition and \nmeasurement guidance \n•We believe an entity: \n•Recognizes the asset as costs are incurred \n•Recognizes a liability in an amount equal to the \ncapitalized costs not paid for by the lessee \n•When lease commences, evaluates the sale and \nleaseback guidance in ASC 842 \n(refer to section 7.7.4, Accounting when the lessee \ncontrols the underlying asset being constructed ) \n•An entity e valuates the nature of the payments \nmade or costs incurred prior to the \ncommencement date \n[ASC 842-40-55-4] (refer to section 7.7.3, \nAccounting when the lessee does no t control the \nunderlying asset being constructed ) \nYes ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 360}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 349 ASC 842-40-55-5 states that when a lessee controls the underlying asset being constructed before the \ncommencement date of the lease, it accounts for the transaction using the sale and leaseback guidance \nin ASC 842-40. Questions arise about whether a lessor would apply the build -to-suit guidance in \nASC 842. In response to a technical inquiry, the FASB sta ff said the lessor (in addition to the lessee) \nwould apply the build -to-suit guidance to determine whether the lessee has control of an underlying asset \nbeing constructed. When a lessee controls the underlying asset, the lessor will account for its costs t o \nconstruct the asset as a loan to the lessee to construct the lessee’s asset. At the end of the construction \nperiod, the lessor would apply the sale and leaseback guidance (refer to section 7.2, Determining \nwhether the transfer of an asset is a sale ) to d etermine whether it has purchased the asset. \nLessee involvement in projects where a long -lived asset is constructed may result in a sale and leaseback \ntransaction subject to the provisions of ASC 842-40. There is no requirement that the prospective lessee \nentity serve as a construction agent, general contractor or principal for the owner -lessor in the project \nfor sale and leaseback accounting to be applicable. In addition, the provisions that result in a lessee \ncontrolling the underlying asset being constru cted before commencement date of a lease, and thus \nsubject to the sale and leaseback provisions of ASC 842-40, are applicable to all assets that are within \nthe scope of ASC 842, for example, the construction of a vessel whereby the lessee has control of th e \nasset being constructed. \n7.7.1 Lessee indemnification of environmental contamination \nExcerpt from Accounting Standards Codification \nLeases — Sale and Leaseback Transactions \nImplementation Guidance and Illustrations \n842-40-55-7 \nA provision that requires lessee indemnifications for preexisting environmental contamination does \nnot, on its own, mean that the lessee controlled the underlying asset before the lease commenced \nregardless of the likelihood of loss resulting from the inde mnity. Consequently, the presence of such a \nprovision does not mean the transaction is in the scope of this Subtopic. \nA provision that requires lessee indemnifications for preexisting environmental contamination during its \nuse of the underlying asset over the term of the lease would not, on its own, result in the lessee obtaining \ncontrol over the underlying asset during t he construction period regardless of the likelihood of loss resulting \nfrom the indemnity. Refer to section 3.4.8, Lessee indemnifications for environmental contamination , for \na discussion of the accounting for indemnifications of preexisting environmental contamination in a lease. \n7.7.2 Determining whether the lessee controls the underlying asset being constructed \nThe FASB indicated in the Basis for Conclusions (BC 400(b)) of ASU 2016 -02 that the evaluation on \nwhether a lessee controls the underlying asset being constructed is similar to the evaluation undertaken \nin the revenue recognition guidance in accordance with ASC 606-10-25-27 to determine whether a \nperformance obligation is satisfi ed over time. In some cases, it is clear that the lessee controls the \nunderlying asset being constructed ( e.g., when the lessee legally owns the asset during the construction \nperiod and has the right to direct its use and obtain substantively all of its ec onomic benefit). In other cases, \nit is clear the lessee does not control the underlying asset being constructed ( e.g., when the lessee has little \nor no substantive involvement during construction). However, in many cases, judgment will be required \nto deter mine whether the lessee’s involvement, in substance, gives it control of the underlying asset. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 361}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 350 ASC 842-40 includes the following examples of circumstances that individually (or in the aggregate) \ndemonstrate that the lessee controls an underlying asset that is under construction before the \ncommencement date of a lease: \n• The lessee has the right to obtain the partially constructed underlying asset at any point during the \nconstruction period ( e.g., by making a payment to the lessor). This right may be in the fo rm of an \noption or obligation to purchase the asset from the lessor. ASC 842 does not provide additional \nguidance to demonstrate how to evaluate the term “any” in this example. Our view is that the \nreference to “any” in this example means the right to obta in the partially constructed underlying \nassets would need to exist at any single point in time and would not have to exist throughout the \nconstruction period. Also, if the right to obtain the partially constructed underlying assets is contingent \nupon an ev ent within the lessee’s control ( e.g., a default provision, a call option), then the lessee \nwould have such right at any point in time. \n• The lessor has an enforceable right to payment for its performance to date, and the asset does not \nhave an alternative u se to the owner -lessor. In evaluating whether the asset has an alternative use to \nthe owner -lessor, an entity should consider the characteristics of the asset that will ultimately be leased. \n• The lessee legally owns either: 1) both the land and the property improvements ( e.g., a building), or \n2) the non -real estate asset ( e.g., a ship or an airplane) that is under construction. \n• The lessee controls the land that property improvements will be constructed upon (this includes \nwhere the lessee enters into a trans action to transfer the land to the lessor, but the transfer does \nnot qualify as a sale in accordance with ASC 842-40-25-1 through 25 -3) and does not enter into a \nlease of the land before the beginning of construction that, together with renewal options, permits \nthe lessor or another unrelated third party to lease the land for substantially all of the economic life \nof the property improvements. The lessee may control the land via legal ownership or, if it has \ntransferred the land, in a transaction that does not qualify as a sale in accordance with ASC 842 \n(refer to section 7.4, Transactions in which the transfer of an asset is not a sale ). \n• The lessee is leasing the land that the property improvements will be constructed upon, the term of \nwhich, together with lessee renewal options, is for substantially all of the economic life of the \nproperty improvements, and does n ot enter into a sublease of the land before the beginning of \nconstruction that, together with renewal options, permits the lessor or another unrelated party to \nsublease the land for substantially all of the economic life of the property improvements. \nJudgm ent will be required to determine whether a lessee controls an asset under construction because \nthis list is not all inclusive. For example, we believe that a lessee also controls an asset that is under \nconstruction if it funds substantially all of the cos ts of the materials needed for the construction project. \nIn contrast, we do not believe a lessee control s the underlying asset that is under construction solely \nbecause of any one of the following: \n• The lessee acts as a construction agent or as a general c ontractor , or was involved in the design of \nthe construction project. \n• The lessee purchases the materials needed for the construction project. \n• The lessee incurs cost overruns that are not expected to represent substantially all of the cost s of \nthe materials needed for the construction project . \nInstead , each factor should be considered collectively with all facts and circumstances to determine \nwhether the lessee controls an asset under construction . \nASC 842-40 provides the following examples of how to determine whether a lessee controls an \nunderlying asset that is under construction. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 362}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 351 Excerpt from Accounting Standards Codification \nLeases — Sale and Leaseback Transactions \nImplementation Guidance and Illustrations \nExample 3 — Lessee Control over an Asset under Construction \n842-40-55-40 \nLessee and Lessor enter into a contract whereby Lessor will construct (whether itself or using \nsubco ntractors) a building to Lessee’s specifications and lease that building to Lessee for a period of \n20 years once construction is completed for an annual lease payment of $1,000,000, increasing by 5 \npercent per year, plus a percentage of any overruns above the budgeted cost to construct the \nbuilding. The building is expected to have an economic life of 50 years once it is constructed. Lessee \ndoes not legally own the building and does not have a right under the contract to obtain the building \nwhile it is unde r construction (for example, a right to purchase the construction in process from Lessor). \nIn addition, while the building is being developed to Lessee’s specifications, those specifications are \nnot so specialized that the asset does not have an alternativ e use to Lessor. \nCase A — Lessee Does Not Control the Asset under Construction \n842-40-55-41 \nAssume Lessee controls (that is, Lessee is the owner for accounting purposes) the land upon which the \nbuilding will be constructed and, as part of the contract, Lessee agrees to lease the underlying land to \nLessor for an initial period of 25 years. Lessor also is granted a series of six 5 -year renewal options for \nthe land lease. \n842-40-55-42 \nNone of the circumstances in paragraph 842 -40-55-5 exist. Even though Lessee owns the land \n(whether legally or for accounting purposes only) upon which the building will be constructed, Lessor \nlegally owns the property improvements and has rights to use the underlying land for at least \nsubstantially all of the economi c life of the building. Lessee does not own the building and does not \nhave a right under the contract to obtain the building (for example, a right to purchase the building \nfrom Lessor). In addition, the building has an alternative use to Lessor. Therefore, Lessee does not \ncontrol the building under construction. Consequently, the arrangement is not within the scope of this \nSubtopic. Lessee and Lessor will account for the lease of the building in accordance with Subtopics \n842-20 and 842 -30, respectively. If Lessee incurs costs related to the construction or design of the \nbuilding (for example, architectural services in developing the specifications of the building), it will \naccount for those costs as lease payments unless the costs are for goods or services p rovided to \nLessee, in which case Lessee will account for those costs in accordance with other Topics. \nCase B — Lessee Controls the Asset under Construction \n842-40-55-43 \nAssume Lessee leases, rather than owns, the land upon which the building will be constr ucted. Lessee \nhas a 20 -year lease of the underlying land and five 10 -year renewal options. Therefore, Lessee’s lease \nof the underlying land, together with the renewal options, is for at least substantially all of the \neconomic life of the building under con struction. Lessee enters into a sublease with Lessor for the \nright to use the underlying land for 20 years that commences upon completion of the building. The \nsublease has a single 10 -year rene wal option available to Lessor. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 363}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 352 842-40-55-44 \nLessee controls the building during the construction period and, therefore, the arrangement is within \nthe scope of this Subtopic. Lessee and Lessor will apply the guidance in this Subtopic to determine \nwhether this arrangement qualifies as a sale and a lea seback or whether this arrangement is, instead, \na financing arrangement. Lessee controls the building during the construction period because, in \naccordance with paragraph 842 -40-55-5(e), Lessee controls the use of the land upon which the \nbuilding will be c onstructed for a period that is at least substantially all of the economic life of the \nbuilding and the sublease entered into with Lessor does not both (a) grant Lessor the right to use the \nland before the beginning of construction and (b) permit Lessor to use the land for substantially all the \neconomic life of the building (that is, the sublease, including Lessor renewal options, only is for \n30 years as compared with the 50 -year economic life of the building). \n7.7.3 Accounting when the lessee does not con trol the underlying asset being \nconstructed \nIf the lessee does not control the underlying asset being constructed, any payments made (or other \nconsideration provided) for the right to use the underlying asset are lease payments, regardless of the \ntiming or form of those payments ( e.g., the lessee could provide some of the raw materials for use in \nconstruction). Lease payments made prior to lease commencement are recognized as prepayments and \nevaluated in the lease classification test. Costs incurre d by the lessee that relate specifically to construction \nor design of an asset that are not payments for the use of an asset to be leased are recognized in \naccordance with other US GAAP ( e.g., ASC 330, Inventory , ASC 360, Property, Plant , and Equipment ) \ndepending on the facts and circumstances. For example, those costs may be accounted for as nonmonetary \nprepaid lease, leasehold improvement or sales of a good ( e.g., inventory or property, plant and equipment). \n7.7.4 Accounting when the lessee controls the u nderlying asset being constructed \nASC 842 does not provide specific recognition and measurement guidance for a lessee that controls an \nasset being constructed. In that case, we believe that the asset is recognized during the construction period \nas costs a re incurred to construct the asset. A liability also should be recognized in an amount equal to the \ncapitalized costs that are not paid for by the lessee ( e.g., costs paid for by the lessor). If the lessee controls \nthe asset during the construction period, a sale and leaseback of the asset occurs at the commencement \ndate of the lease (generally at the completion of construction). The sale and leaseback guidance in \nASC 842 is evaluated to determine whether the underlying asset is derecognized. If the applica tion of the \nsale and leaseback guidance results in a failed sale, the asset remains on the lessee’s balance sheet, and the \nliability is subsequently accounted for as a financing obligation (refer to section 7.4.2, Example — failed \nsale and leaseback transa ction ). \nThe lessee would begin depreciat ing the asset when construction is complete ; depreciation generally \ncommences when the asset is substantially complete and ready for its intended use. We believe one acceptable \namortization approach would be to depreciate the asset to an amount that equal s the financing obligation \nat the end of the lease term, at which ti me the return of the asset would be considered a balloon payment \non the financing obligation . However, there may be diversity in practice for depreciating the underlying \nasset in a failed sale when the lessee had control of the underlying asset during the construction period. \nWhen a lessee controls the underlying asset, the lessor will account for its costs to construct the asset as \na loan to the lessee to construct the lessee’s asset. At the end of the construction period, the lessor \nwould apply the sale a nd leaseback guidance (refer to section 7.2, Determining whether the transfer of \nan asset is a sale ) to determine whether it has purchased the asset. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 364}), Document(page\_content='7 Sale and le aseback transactions \nFinancial reporting developments Lease accounting | 353 \nQuestion 7 -3 How should an entity account for land when a lessee control s a building being constructed but does \nnot have an existing contractual lease to use the land on which the building is being constructed ? \n(added August 202 3) \nIf a lessee controls a building being constructed (following the guidance in ASC 842-40-55-3 through \n55-5), it often does not have an existing contractual lease to the underlying land. Since the lessee \ncontrols the building (during construction ), it would generally also have the right to control the use of the \nland underlying such building . In this case, b oth th e lessee and lessor should account for the lease of the \nland under ASC 842. We believe the land lease commences when con struction of the building begins . \n \n7.8 Disclosure \nExcerpt from Accounting Standards Codification \nLeases — Sale and Leaseback Transactions \nDisclosure \n842-40-50-1 \nIf a seller -lessee or a buyer -lessor enters into a sale and leaseback transaction that is accounted for in \naccordance with paragraphs 842 -40-25-4 and 842 -40-30-1 through 30 -3, it shall provide the disclosures \nrequired in paragraphs 842 -20-50-1 through 50 -10 for a seller -lessee or paragraphs 842 -30-50-1 \nthrough 50 -13 for a buyer -lessor. \n842-40-50-2 \nIn addition to the disclosures required by paragraphs 842 -20-50-1 through 50 -10, a seller -lessee that \nenters into a sale and l easeback transaction shall disclose both of the following: \na. The main terms and conditions of that transaction \nb. Any gains or losses arising from the transaction separately from gains or losses on disposal of \nother assets. \nA seller -lessee that enters into a sale and leaseback transaction in which the transfer of the asset is a sale \nis required to provide disclosures applicable to lessees (refer to section 4.10, Disclosure ). Similarly, a \nbuyer -lessor that enters into a sale a nd leaseback transaction in which the transfer of the asset is a \npurchase is required to provide disclosures applicable to lessors (refer to section 5.9, Disclosure ). \nA seller -lessee in a sale and leaseback transaction is also required to disclose: \n• The mai n terms and conditions of the transaction \n• Any gains or losses arising from the transaction separately from gains or losses on the disposal of \nother assets \nASC 842 does not include specific disclosure requirements for transactions that are accounted for as financings. \nWe believe that entities would apply other US GAAP ( e.g., ASC 310, ASC 326, ASC 470) to make the \nappropriate disclosures. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 365}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 354 7.9 Transfer of tax benefits \nExcerpt from Accounting Standards Codification \nLeases — Sale and Leaseback Transactions \nImplementation Guidance and Illustrations \n842-40-55-11 \nA U.S. entity purchases an asset and enters into a contract with a foreign investor that provides that \nforeign investor with an ownership right in, but not necessarily title to, the asset. That ownership right \nenables the foreign investor to claim certain benefits of ownership of the asset for tax purposes in the \nforeign tax jurisdiction. \n842-40-55-12 \nThe U.S. entity also enters into a contract in the form of a leaseback for the ownership r ight with the \nforeign investor. The contract contains a purchase option for the U.S. entity to acquire the foreign \ninvestor’s ownership right in the asset at the end of the lease term . \n842-40-55-13 \nThe foreign investor pays the U.S. entity an amount of cash on the basis of an appraised value of the \nasset. The U.S. entity immediately transfers a portion of that cash to a third party, and that third party \nassumes the U.S. entity’s obligation to make th e future lease payments , including the purchase option \npayment. The cash retained by the U.S. entity is consideration for the tax benefits to be obtained by the \nforeign investor in the foreign tax jurisdiction. The U.S. entity may agree to indemnify the fo reign investor \nagainst certain future events that would reduce the availability of tax benefits to the foreign investor. \nThe U.S. entity also may agree to indemnify the third -party trustee against certain future events. \n842-40-55-14 \nThe result of the trans action is that both the U.S. entity and the foreign investor have a tax basis in the \nsame depreciable asset. \n842-40-55-15 \nAn entity should determine whether the transfer of the ownership right is a sale based on the guidance \nin paragraphs 842 -40-25-1 throu gh 25 -3. Consistent with paragraphs 842 -40-25-2 through 25 -3, if \nthe leaseback for the ownership right is a finance lease or if the U.S. entity has an option to repurchase \nthe ownership right at any exercise price other than the fair value of that right on the exercise date, \nthere is no sale. If the transfer of the ownership right is not a sale, consistent with the guidance in \nparagraph 842 -40-25-5, the entity should account for the cash received from the foreign investor as \na financial liability in accorda nce with other Topics . \n842-40-55-16 \nIf the transfer of the ownership right is a sale, income recognition for the cash received should be \ndetermined on the basis of individual facts and circumstances. Immediate income recognition is not \nappropriate if there is more than a remote possibility of loss of the cash consideration received \nbecause of indemnification or other contingencies. \n842-40-55-17 \nThe total consideration received by the U.S. entity is compensation for both the tax benefits and the \nindemnificat ion of the foreign investor or other third -party trustee. The recognition of a liability for the \nindemnification agreement at inception in accordance with the guidance in Topic 460 on guarantees \nwould reduce the amount of income related to the tax benefits that the seller -lessee would recognize \nimmediately when the possibility of loss is remote. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 366}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 355 Periodically, an entity enters into transactions that are, in substance, transfers of tax benefits through \ntax leases. These transactions are commonly referred to as “double -dip” transactions as their objective is \nto provide to more than one entity a deduction in separate tax jurisdictions ( e.g., Switzerland and the US). \nThe transaction generally involves the sale of a depreciable asset or transfers an ownership ri ght in an \nasset to an investor in a foreign jurisdiction in consideration for cash proceeds and an obligation by the \nseller to lease back the asset under a finance lease and an operating lease with a fixed -price purchase option. \nThe foreign investor is typically provided with an ownership right in, but not necessarily with title to, the \nasset. That ownership right enables the foreign investor to claim certain tax benefits associated with the \nownership of the asset such as accelera ted depreciation deductions or tax credits. The US entity generally \nmaintains a purchase option to acquire the foreign investor’s rights in the asset at the end of the lease term. \nTypically, most of the cash proceeds upon execution of the transaction are r equired to be deposited into \nan essen tially risk -free investment trust account, generally managed by a third party. The earnings and \nprincipal of the account are used solely for, and are sufficient to, satisfy the seller -lessee obligation, \nincluding paym ent of the purchase option. The free cash (the difference between the sales proceeds and \nthe deposit to the trust account) represents the consideration paid by the investor for the tax benefits. \nThe arrangement often contains indemni fication provisions by the seller -lessee, indemnifying the foreign \ninvestor against certain future events that would reduce the availability of tax benefits to the investor \nand/or the third -party trustee against certain future events. \nTo determine whether the transfer of the ow nership right of the underlying asset is a sale, both the \nseller -lessee and the buyer -lessor apply the guidance in accordance with ASC 842-40-25-1 through 25 -3. \nIn addition to meeting certain revenue recognition provisions in ASC 606 ( i.e., control transfe rs to the \nbuyer in accordance with ASC 606-10-25-30), the ownership right of the underlying asset is considered \na sale if all of the following conditions are met: \n• The leaseback is classified as an operating lease for the seller -lessee and either a direct f inancing \nlease or an operating lease for the buyer -lessor. \n• The exercise price of the purchase option on the leaseback is the fair value of the underlying asset at \nthe time the option is exercised. \n• There are alternative assets, substantially the same as the underlying asset , readily available in the \nmarketplace. Refer to section 7.2, Determining whether the transfer of an asset is a sale , for specific \nconsiderations for transactions involving real estate. \nIf the transfer of the ownership right of the underly ing asset as well as the transfer of tax benefits is not a \nsale, the seller -lessee and the buyer -lessor account for the transaction as a financing (refer to section 7.4, \nTransactions in which the transfer of an asset is not a sale ). The seller -lessee retains the underlying asset \non its balance sheet and accounts for amounts received from the foreign investor as a financial liability in \naccordance with other US GAAP. Refer to section 7.4, Transactions in which the transfer of an ass et is \nnot a sale , for further detail. \nIf the transfer of the ownership right of the underlying asset as well as the transfer of tax benefits is a \nsale (which often is not the case in double -dip tax structured transactions), the seller -lessee and the \nbuyer -lessor account for the transaction as a sale and leaseback transaction. Refer to section 7.3, \nTransactions in which the transfer of an asset is a sale , for the accounting of the transaction. Further, a \ndetermination should be made whether the consideration received by the US entity for the sale of the tax \nbenefits (net of related costs) should be recognized currently in income or deferred (this determination \napplies only to the portion of the gain associated with the sale of tax benefits). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 367}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 356 The timing of inc ome recognition of the compensation paid to the seller -lessee for the sale of income tax \nbenefits should be determined based on individual facts and circumstances. Immediate income \nrecognition (assuming the transaction meets sale and leaseback requirements ) is not appropriate if there \nis more than a remote possibility of loss of the cash consideration received by the seller ( e.g., due to \nindemnification or other contingencies that could require the seller of the tax benefits to make payment \nto the purchaser or to the third -party trustee). \nThe total consideration received by the seller -lessee ( i.e., US entity) is compensation for both the tax \nbenefits and the indemnification of the foreign investor or other third -party trustee. The recognition of a \nliability for the indemnification agreement at inception in accordance with the guidance in ASC 460 on \nguarantees would reduce the amount of income related to the tax benefits that the seller -lessee would \nrecognize immediately when the possibility of loss is remote. \nRegarding the lease liability or the financial liability recognized by the seller -lessee in a sale or a financing \ntransaction, the seller -lessee should consider the extinguishment requirements under ASC 405-20, \nLiabilities — Extinguishments of Liabilities , to determine the accounting for any payment made to the third -\nparty trustee to service future lease and purchase option payments due under the leaseback. To meet the \nextinguishment requirements of ASC 405-20, the seller -lessee must be legally released as the primary obligor \nunder the lease or financial obligation. As a result of failure to meet the debt extinguishment requirements of \nASC 405-20 (i.e., the seller -lessee continues to owe future lease and purchase option payments when they \nbecome due), the d eposit made with the third -party trustee (not consolidated with seller -lessee) is recorded on \nthe balance sheet of the seller -lessee as a prepaid asset and does not reduce the lease or financial liability. \nThe following is a graphic depiction of a typical structure: \nIllustration 7 -7: Transfer of tax benefits through tax leases — typical transaction structure \n \n7.9.1 Disclosure of a transfer of tax benefits through tax leases \nThe following is a summary of the disclosure requirements for a transfer of tax benefits through tax leases: \n• Significant accounting policies — The accounting policies or practices followed should include the \nmethod of accounting for the transfer of tax benefits transactions and the met hods of recognizing \nrevenue and allocating income tax benefits and asset costs to current and future periods. \nSeller/lessee \n Purchaser/lessor \nThird -party bank \n($100) \nTransfer of ownership right of PP&E \n(that is not real estate) \nNet present value \n($92) \nLease obligation prepayment ($92) \nAn operating l easeback with a \npurchase option not \nreasonably certain to be exercised ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 368}), Document(page\_content='7 Sale and leaseback transactions \nFinancial reporting developments Lease accounting | 357 • Income taxes — The reported amount of income tax expense attributable to continuing operations \nfor the year should be reconciled to the amount of income tax expense that would result from \napplying domestic federal statutory tax rates to pretax income from continuing operations, and the \nestimated amount and the nature of each significant reconciling item should b e disclosed ( ASC 740-\n10-50-11 through 50 -14). Transactions involving the transfer of tax benefits through tax leases may \ngive rise to a significant reconciling item that should be disclosed pursuant to these requirements. \n• Material transactions — If materia l and unusual or infrequent to the enterprise, the nature and \nfinancial effects of transactions involving the transfer of tax benefits through tax leases should be \npresented as a separate component of income from continuing operations or, alternatively, disclosed \nin notes to the financial statements in accordance with ASC 220-20, Income Statement — Reporting \nComprehensive Income — Unusual or Infrequently Occurring Items . \n• Contingencies — If significant contingencies exist with respect to the transfer of tax benefits, \ndisclosures in accordance with ASC 450 may be warranted. \n• Comparability — If comparative financial statements are presented, disclosure should be made of any \nchange in practice that significantly affects comparability.', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 369}), Document(page\_content=' \nFinancial reporting developments Lease accounting | 358 8 Business combinations \nLease assets and liabilities acquired in a business combination are accounted for using the guidance in \nASC 805, while lease assets and liabilities acquired in an asset acquisition are accounted for using the \nguidance in ASC 350-30 for acquired intangible assets and liabilities. Refer to our FRD, Business combinations , \nfor further discussion. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 370}), Document(page\_content=' \nFinancial reporting developments Lease accounting | 359 9 Other considerations \n9.1 Related party leasing transactions \nExcerpts from Accounting Standards Codification \nMaster Glossary \nRelated Parties \nRelated parties include: \na. Affiliates of the entity \nb. Entities for which investments in their equity securities would be required, absent the election of \nthe fair value option under the Fair Value Option Subsection of Section 825 -10-15, to be \naccounted for by the equity method by the investing entity \nc. Trust s for the benefit of employees, such as pension and profit -sharing trusts that are managed \nby or under the trusteeship of management \nd. Principal owners of the entity and members of their immediate families \ne. Management of the entity and members of their immediate families \nf. Other parties with which the entity may deal if one party controls or can significantly influence \nthe management or operating policies of the other to an extent that one of the transacting parties \nmight be prevented from fully pursuin g its own separate interests \ng. Other parties that can significantly influence the management or operating policies of the \ntransacting parties or that have an ownership interest in one of the transacting parties and can \nsignificantly influence the other to an extent that one or more of the transacting parties might be \nprevented from fully pursuing its own separate interests. \nLeases — Overall \nImplementation Guidance and Illustrations \n842-10-55-12 \nLeases between related parties should be classified in accorda nce with the lease classification criteria \napplicable to all other leases on the basis of the legally enforceable terms and conditions of the lease. \nIn the separate financial statements of the related parties, the classification and accounting for the \nleases should be the same as for leases between unrelated parties. \nPending Content: \nTransition Date: (P) December 16, 2023; (N) December 16, 2023 | Transition Guidance: 842 -10-65-7 \nExcept for leases between entities under common control accounted for in accordance with the \npractical expedient in paragraph 842 -10-15-3A, leases between related parties should be classified in \naccordance with the lease classification criteria applicable to all other leas es on the basis of the legally \nenforceable terms and conditions of the lease. Additionally, except for leases between entities under \ncommon control accounted for in accordance with paragraph 842 -10-15-3A the classification and \naccounting for the leases sho uld be the same as for leases between unrelated parties in the separate \nfinancial statements of the related parties. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 371}), Document(page\_content='9 Other considerations \nFinancial reporting developments Lease accounting | 360 Leases — Lessee \nDisclosure \n842-20-50-7 \nA lessee shall disclose lease transactions between related parties in accordance with paragraphs \n850-10-50-1 through 50 -6. \nLeases — Lessor \nDisclosure \n842-30-50-4 \nA lessor shall disclose any lease transactions between related parties (see Topic 850 on related \nparty disclosures). \nASC 842 requires lessees and lessors to classify and account for leases between related parties on the \nbasis of the legally enforceable terms and conditions of the lease ( i.e., in the same manner as leases \nbetween unrelated parties). An exception to this requirement arises when an entity in the scope of \nASC 842-10-15-3A has a lease with another entity that is under common control , and the entity in the \nscope of ASC 842-10-15-3A elects the practical expedient to use the written terms and conditions to \nclassify and account for the arrangement , rather than the legally enforceable terms and conditions (see \nsection 9. 1.1 below for additional discussion of this practical expedient ). \nUnder ASC 842, lessees and lessors are required to apply the disclosure requirements for related -party \ntransactions in accordance with ASC 850, Related Party Disclosures . These requirements include \ndisclosing the nature of the relationships and a description of the transactions, including information \ndeemed necessary to understand the effects of the t ransactions on the financial statements. \nAdditionally, these disclosures should not imply that a transaction is at arm’s length unless such an \nassertion can be substantiated. \nAs a reminder, lessees and lessors consider the sale and leaseback guidance in ASC 842-40 when the \nunderlying asset is sold or otherwise transferred and leased back to the seller/transferor. This includes \nsale and leaseback transactions among related parties. Refer to section 7.1, Overview — sale and \nleaseback transactions . \n9.1.1 Practical expedient to use the written terms and conditions of common \ncontrol arrangement s (added August 2023) \nExcerpts from Accounting Standards Codification \n \nPending Content: \nTransition Date: (P) December 16, 2023; (N) December 16, 2023 | Transition Guidance: 842 -10-\n65-7 \nLeases — Overall \nScope and Scope Exceptions \n842-10-15-3A \nAs a practical expedient, an entity that is not a public business entity ; a not-for-profit entity that has \nissued or is a conduit bond obligor for securities that are traded, listed, or quoted on an exchange or \nan over -the-counter market; or an employee benefit plan that files or furnishes financial statements \nwith or to the U.S. Securities and Exchan ge Commission may use the written terms and conditions of a ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 372}), Document(page\_content='9 Other considerations \nFinancial reporting developments Lease accounting | 361 related party arrangement between entities under common control to determine whether that \narrangement is or contains a lease. For purposes of determining whether a lease exists under this \npractica l expedient, an entity shall determine whether written terms and conditions convey the \npractical (as opposed to enforceable) right to control the use of an identified asset for a period of time \nin exchange for consideration. If an entity determines that a lease exists, the entity shall classify and \naccount for that lease on the basis of those written terms and conditions. An entity may elect the \npractical expedient on an arrangement -by-arrangement basis. \n842-10-15-3B \nIf no written terms or conditions exist, an entity shall not apply the practical expedient in paragraph \n842-10-15-3A. Rather, the entity shall determine whether the related party arrangement between \nentities under common control is or contains a lease in a ccordance with paragraph 842 -10-15-3 and, \nif so, classify and account for that lease on the basis of its legally enforceable terms and conditions in \naccordance with paragraph 842 -10-55-12. \n842-10-15-3C \nIf after an entity has applied the practical expedient in paragraph 842 -10-15-3A an arrangement is no \nlonger between entities under common control, the entity shall determine whether a lease exists in \naccordance with paragraph 842 -10-15-3. \na. If the arrangement was previously determined to be a lease and contin ues to be a lease, the entity \nshall classify and account for the lease on the basis of the enforceable terms and conditions. If the \nenforceable terms and conditions differ from the written terms and conditions previously used to \napply paragraph 842 -10-15-3A, the entity shall apply the modification requirements in paragraphs \n842-10-25-9 through 25 -17 using the enforceable terms and conditions. If the enforceable terms \nand conditions are the same as the written terms and conditions previously used to apply pa ragraph \n842-10-15-3A, the modification requirements in those paragraphs are not applicable. \nb. If the arrangement was previously not determined to be a lease and is determined to be a lease, the \nentity shall account for the arrangement as a new lease. \nc. If the arrangement was previously determined to be a lease and the lease ceases to exist: \n1. A lessee shall apply the derecognition requirements for fully terminated leases in paragraph \n842-20-40-1. \n2. A lessor with a lease previously classified as a sales -type leas e or a direct financing lease shall \napply the derecognition requirements for terminated leases in paragraph 842 -30-40-2. \n3. A lessor with a lease previously classified as an operating lease shall derecognize any amounts \nthat would not exist if the arrangement was not accounted for as a lease and account for the \narrangement in accordance with other generally accepted accounting principles (GAAP). \n \nAfter the adoption of ASU 2023 -01, ASC 842 allows, as a practical expedient, entities other than PBEs , \nnot for -profit conduit bond obligors or employee benefit plans that file or furnish financial statements \nwith the SEC the flexibility to use the written terms and conditions of a common control arrangement, \nrather than the legally enforceable terms, to determine whether a lease exists and to classify and \naccount for the lease. We believe that lessees and lessors that are eligible for and elect to apply the \npractical expedient would also use the written terms and conditions (if provided in the written terms and \nconditions) to allocate consideration to lease and non -lease components rather than using the relative \nstandalone price for lessee s or relative standalone selling price for lessors . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 373}), Document(page\_content='9 Other considerations \nFinancial reporting developments Lease accounting | 362 This practical expedient can be elected regardless of the nature of the other commonly control led entity to \nthe arrangement (i.e., a private entity could elect this practical expedient for an arrangement with a \ncommonly controlled PBE). \nIf no written terms and conditions exist (or the practical expedient is not elected), an entity is required to \ndetermine the legally enforceable terms and conditions of the common control arrangement and use \nthem to evaluat e whether a lease exists and to classify and account for the lease (i.e., in the same \nmanner as arrangements between unrelated parties). \nWhen this practical expedient is elected and the arrangement is no longer between entities under \ncommon control , the arrangement should be accounted for as follows: \n• An arrangement that was previously a lease and continues to be a lease should be accounted for using the \nlegally enforceable terms and conditions , instead of the written terms and conditions. If the leg ally \nenforceable terms and conditions differ from the written conditions, an entity sh ould apply the modification \nrequirements in ASC 842-10-25-9 through 25 -17 using the enforceable terms and conditions . \n• An arrangement that was previously not accounted for as a lease and is identified as a lease should \nbe account ed for as a new lease. \n• An arrangement that was previously determined to be a lease by a less ee and is no longer a lease \nshould be accounted for as a lease termination (see ASC 842-20-40-1 and section 4.8.1). \n• An arrangement that was previously determined to be a lease by a lessor and is no longer a lease \nshould be accounted for using the applicable derecognition guidance ba sed on the classification of \nthe lease, as follows: \n• If the arrangement was a sales type lease, apply the derecognition requirements in ASC 842-30-40-2 \n(see section 4.8.2). \n• If the arrangement was an operating lease, derecognize any amounts that would not ex ist if the \narrangement was not accounted for as a lease and then account for the arrangement using \nother GAAP. \nWe believe that any profit or loss upon derecognition of a lease -related asset and/or liability should be \naccounted for as consideration in the ongoing arrangement that is accounted for under other US GAAP \n(e.g., ASC 606) rather than immediately recognized as profit or lo ss in the income statement. \nASU 2023 -01 also changed how all lessees, including PBEs , amortize leasehold improvements associated \nwith common control leases. See section 4.7.3.4 , Lessee amortization of leasehold improvements \nassociated with a lease between entities under common control , for further discussion. \n9.2 Leases involving variable interest entities \nASC 810 includes provisions related to the consolidation of certain entities that have (1) an insufficient \namount of equity for the entity to finance its activities without additional subordinated financial support \nprovided by any parties, (2) a group of equit y owners that lack the characteristics of a controlling financial \ninterest or (3) non-substantive voting rights. Such entities are referred to as “variable interest entities.” \nExamples of arrangements that may involve variable interest entities and, accord ingly, may require the \napplication of the Variable Interest Model’s provisions in ASC 810 include: \n• Build -to-suit arrangements \n• Leases that include lessee guarantees of residual asset values ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 374}), Document(page\_content='9 Other considerations \nFinancial reporting developments Lease accounting | 363 • Leases that include fixed -price lessee purchase or renewal options \n• Sale and leaseback transactions \n• Enhanced Equipment Trust Certificates \n• Sales of property subject to operating leases \nTo determine whether a lease arrangement involves a variable interest entity, refer to our FRD, \nConsolidation , for further guidance. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 375}), Document(page\_content=' \nFinancial reporting developments Lease accounting | 364 10 Leveraged leases \n10.1 Introduction and grandfathering \nExcerpt from Accounting Standards C odification \nMaster Glossary \nLeveraged Lease \nFrom the perspective of a lessor , a lease that was classified as a leveraged lease in accordance with \nthe leases guidance in effect before the effective date and for which the commencement date is \nbefore the effective date. \nLeases — Overall \nTransition and Open Effective Date Information \n842-10-65-1 \nLeases previously classified as leveraged leases under Topic 840 \nz. For leases that were classified as leveraged leases in accordance with Topic 840, and for which \nthe commencement date is before the effective date, a lessor shall apply the requirements in \nSubtopic 842 -50. If a leveraged lease is modified on or after the e ffective date, it shall be \naccounted for as a new lease as of the effective date of the modification in accordance with the \nguidance in Subtopics 842 -10 and 842 -30. \n1. A lessor shall apply the pending content that links to this paragraph to a leveraged lea se that \nmeets the criteria in (z) that is acquired in a business combination or an acquisition by a not -\nfor-profit entity on or after the effective date. \nLeases — Leveraged Lease Arrangements \nScope and Scope Exceptions \n842-50-15-1 \nThis Subtopic addresses accounting for leases that meet the criteria in transition paragraph 842 -10-\n65-1(z). If a lessee exercises an option to extend a lease that meets the criteria in transition paragraph \n842-10-65-1(z) that it was not previously reasona bly assured of exercising, the exercise of that option \nshall be considered a lease modification as described in paragraph 842 -10-65-1(z). \nASC 842 eliminates leveraged lease accounting for new leases on its effective date. That is, subsequent \nto the effect ive date, lessors account for all new leases, including those that would have qualified as \nleveraged leases under ASC 840, using the classification criteria discussed in section 3.2, Criteria for \nlease classification — lessors , (i.e., sales -type, direct fi nancing or operating). For such leases, entities \napply other relevant US GAAP ( e.g., ASC 740, Income Taxes , ASC 470, Debt ) to account for the non -\nlease components of such tran sactions . \nLeveraged lease arrangements that exist before the effective date ( i.e., the lease has commenced before \nthe effective date) are grandfathered and therefore continue to follow the existing recognition, \nmeasurement , presentation and disclosure guidance for leveraged leases that was carried forward to \nASC 842-50. Leases of t o-be-constructed assets that qualified to be leveraged leases at lease inception \nprior to the effective date under ASC 840 but are not completed ( i.e., the lease has not commenced) \nprior to the effective date would not be grandfathered. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 376}), Document(page\_content='10 Leveraged leases \nFinancial reporting developments Lease accounting | 365 If an existing leve raged lease is modified on or after the effective date of ASC 842, the existing leveraged \nlease is required to be reclassified as a sales -type, direct financing or operating lease, as applicable, using \nthe lease classification guidance in ASC 842. Refer to section 3.2, Criteria for lease classification — \nlessors , and section 11.2, Transition . In that case, there would be no basis to net the remaining non -\nrecourse debt balance with the lease receivable (if any), and any deferred tax balances would need to be \nadjusted as required under ASC 740 to comply with that guidance. \nIn addition, if a lessee exercises an option to extend a leveraged lease on or after the effective date of \nASC 842 that it was not previously reasonably assured of exercising ( i.e., under ASC 840, the renewal \noption was not included in the original accounting lease term for purposes of classifying the lease at \ninception), the exercise of that option is accounted for as a lease modification, and the lease no longer \nqualifies for leveraged lease accounting and is instead accounted for under ASC 842. Refer to \nsection 5.6, Lease modifications. \n10.1.1 Leveraged lease acquired in a business combination or an acquisition by a not -\nfor-profit entity \nRefer to our FRD, Business combinations , for the discussion of a leveraged lease acquired in a business \ncombination or an acquisition by a not -for-profit entity that exists before the ef fective date of ASC 842. \n10.2 Definition of a leveraged lease \nExcerpt from Accounting Standards Codification \nLeases — Leveraged Lease Arrangements \nRecognition \n842-50-25-1 \nA lessor shall record its investment in a leveraged lease . The net of the balances of the following \naccounts as measured in accordance with this Subtopic shall represent the lessor’s initial and \ncontinuing investment in leveraged leases: \na. Rentals receivable \nb. Investment -tax-credit receivable \nc. Estimated residual value of the leased asset \nd. Unearned and deferred income. \nPrior to the effective date of ASC 842 ( e.g., 1 January 2019 for a calendar -year entity that did not early \nadopt ASU 2016 -02), a lease was a leveraged lease if it had all of the following characterist ics, at the \ninception of the lease: \n• It met the criteria for a direct financing lease in ASC 840-10-25-43(b). \n• It involved at least three parties: a lessee, a long -term creditor and a lessor (commonly referred to as \nthe equity participant). \n• The financing pro vided by the long -term creditor was non -recourse as to the general credit of the \nlessor. The amount of the financing was sufficient to provide the lessor with “substantial leverage” \nin the transaction. ASC 840 did not provide specific guidance on what is “ substantial leverage,” \nbut the illustration of leveraged lease accounting in ASC 842-50-55-11 (formerly ASC 840-30-55-14) \nassumes 60% non -recourse financing by the third -party lenders and 40% investment by the equity \nparticipant (lessor). \n• The lessor’s net investment declines during the early years once the investment has been completed \nand rises during the later years of the lease before its final elimination. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 377}), Document(page\_content='10 Leveraged leases \nFinancial reporting developments Lease accounting | 366 If all of these characteristics existed, the lease would be accounted for by the lessor as a lever aged lease. \nAll other leases were accounted for as sales -type, direct financing or operating leases by the lessor, as \nappropriate. Leveraged lease treatment is not relevant to the lessee and prohibited subsequent to the \neffective date of ASC 842 for the le ssor except for the grandfathered leveraged leases, which were \ndiscussed in section 10.1, Introduction and grandfathering . \nSpecial accounting rules were provided for leveraged leases using the “investment with separate phases \nmethod” (refer to section 10.3 .2, Recording income on a leveraged lease ) because of the unique \ncombination of characteristics of such leases that produces an overall economic effect that is distinct \nfrom that of other transactions. \nIn a typical leveraged lease, lessee rental payments m ay be equal to or exceed the non -recourse debt \nservice payments in all periods. Those typical leveraged lease transactions generate depreciation \ndeductions for income tax purposes that exceed the net of rental income and interest expense and result \nin tax savings to lessors that have other taxable income during the early periods of the lease term. Those \ntax savings allow the lessor to recover its equity investment quickly, leaving excess cash in the middle \nperiods but requiring reinvestment of cash in the l ater periods to pay deferred taxes as they become due. \n10.2.1 Leveraged lease involving an existing asset of a regulated entity \nExcerpt from Accounting Standards Codification \nLeases — Leveraged Lease Arrangements \nImplementation Guidance and Illustrations \n842-50-55-1 \nAlthough the carrying amount of an asset acquired previously may not differ significantly from its fair \nvalue , it is unlikely that the two will be the same. However, regulated utilities have argued that the carrying \namounts of cer tain of their assets always equal the fair value based on the utility’s ability to recover that \ncost in conjunction with a franchise to sell a related service in a specified area. That argument is not valid \nwhen considering the value of the asset to a thir d-party purchaser that does not own that franchise. \nAlthough the FASB retained this implementation guidance in ASC 842, it relates to the initial \nclassification of a leveraged lease at its inception under ASC 840 with a commencement date prior to the \neffective date and has no impact on new leases entered into by regulated or non -regulated entities \nsubsequent to the eff ective date. All leveraged leases previously classified under ASC 840 whether \nregulated or non -regulated entities required that the carrying value and fair value of the asset at \ninception be equal to qualify as direct financing leases and, therefore, a lev eraged lease. \n10.3 Accounting for leveraged leases \nExcerpt from Accounting Standards Codification \nLeases — Leveraged Lease Arrangements \nInitial Measurement \n842-50-30-1 \nA lessor shall initially measure its investment in a leveraged lease net of the nonrecourse debt (as \ndiscussed in paragraph 842 -50-25-1). The net of the balances of the following accounts shall \nrepresent the initial and continuing investment in leveraged leases: \na. Rentals receivable, net of that portion of the rental applicable to principal and interest on the \nnonrecourse debt. \nb. A receivable for the amount of the investment tax credit to be realized on the transaction. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 378}), Document(page\_content='10 Leveraged leases \nFinancial reporting developments Lease accounting | 367 c. The estimated residual value of the lease d asset. The estimated residual value shall not exceed \nthe amount estimated at lease inception except if the lease agreement includes a provision to \nescalate minimum lease payments either for increases in construction or acquisition cost of the \nleased property or for increases in some other measure of cost or value (such as general price \nlevels) during the construction or preacquisition period. In that case, the effect of any increa ses \nthat have occurred shall be considered in the determination of the estimated residual value of the \nunderlying asset at lease inception. \nd. Unearned and deferred income consisting of both of the following: \n1. The estimated pretax lease income (or loss), after deducting initial direct costs, remaining to \nbe allocated to income over the lease term . \n2. The investment tax credit remaining to be allocated to income over the lease term. \nSubsequent Measurement \n842-50-35-2 \nThe investment in leveraged leases minu s deferred taxes arising from differences between pretax \naccounting income and taxable income shall represent the lessor’s net investment in leveraged \nleases for purposes of computing periodic net income from the leveraged lease. Given the original \ninvestment and using the projected cash receipts and disbursements over the term of the lease , the \nrate of return on the net investment in the years in which it is positive shall be computed. The \nrate is that rate that, when applied to the net investment in the years in which the net investment \nis positive, will distribute the net income to those years and is distinct from the interest rate implicit in \nthe lease. In each year, whether positive or not, the difference between the net cash flow and the \namount of income recognized, if any, shall serve to increase or reduce the net investment balance. \nThe use of the term years is not intended to preclude application of the accounting prescribed in this \nparagraph to shorter accounting periods. \n842-50-35-3 \nThe net income (or loss) that a lessor recognizes on a leveraged lease shall be composed of the \nfollowing three elements: \na. Pretax lease income (or loss) \nb. Investment tax credit \nc. Tax effect of pretax lease income (or loss). \n842-50-35-4 \nThe pretax lease income (or loss) and investment tax credit elements shall be allocated in proportionate \namounts from the unearned and deferred income included in the lessor’s net investment (as described \nin paragraph 842 -50- 30-1(d)). The tax effect of the pretax lease income (or loss) recognized shall be \nreflected in tax expense for the year. The tax effect of the difference between pretax accounting income \n(or loss) and taxable income (or loss) for the year shall be charged or credited to def erred taxes. \n842-50-35-5 \nIf, at any time during the lease term the application of the method prescribed in this Subtopic \nwould result in a loss being allocated to future years, that loss shall be recognized immediately. \nThis situation might arise in circumstances in which one of the important assumptions affecting net \nincome is revised (see paragraphs 842-50-35-6 through 35 -15). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 379}), Document(page\_content='10 Leveraged leases \nFinancial reporting developments Lease accounting | 368 842-50-35-21 \nIf a lessor sells substantially all of the minimum rental payments associated with a leveraged lease and \nretains an interest in the residual value of the leased asset, the lessor shall not recognize increases in \nthe value of the lease residual to its estimated value over the remaining lease term . The lessor shall \nreport any remaining interest thereafter at it s carrying amount at the date of the sale of the lease \npayments . If it is determined subsequently that the fair value of the residual value of the leased asset \nhas declined below the carrying amount of the interest retained and that decline is other than \ntemporary, the asset shall be written down to fair value, and the amount of the write -down shall be \nrecognized as a loss. That fair value becomes the asset’s new carrying amount, and the asset shall not \nbe increased for any subsequent increase in its fair v alue before its sale or disposition. \n10.3.1 Determining the leveraged lease investment \nThe net investment reflected in the lessor’s balance sheet, which increases or decreases by the amount \nof the difference between each period’s net cash flow and the income recognized, consists of: \n• Rentals receivable, net of the portion applicable to principal and interest on the related non -recourse debt \n• A receivable for the investment tax credit until it is realized (the investment tax credit was repealed \nby the Tax Reform Act of 1986) \n• The estimated residual value of the leased asset \n• Unearned income (the remaining amount of estimated pretax lease income or loss and investment \ntax credit to be allocated to income over the lease term, after deducting initial direct cost s) (refer to \nsection 2.6, Initial direct costs , for entities that do not elect the package of practical expedients \ndescribed in section 11.2.2, Transition practical expedients ) \nThe accounting for deferred taxes in a leveraged lease is specifically excluded from the general \naccounting for income taxes in ASC 740 and computed in accordance with guidance provided in ASC 842 \n(specifically ASC 842-50-30-1, and ASC 842-50-35-2 through 35 -4). Although deferred taxes are \nincluded in the net investment in the levera ged lease for purposes of computing income (refer to \nsection 10.3.2, Recording income on a leveraged lease ), deferred taxes relating to leveraged leases are \nshown on the balance sheet with other deferred tax items ( i.e., deferred taxes computed in accordan ce \nwith ASC 740) and not netted against the lease investment on the face of the balance sheet. \n10.3.2 Recording income on a leveraged lease \nThe “investment with separate phases method,” which is required to be used to account for leveraged \nleases, recogniz es lease income at a level rate of return on the net investment in those periods in which \nthe net investment at the beginning of the period is a positive amount. This method and the FASB’s \nrationale for requiring its use are described in the basis for conc lusions for Statement 13 (paragraph 109(c) \nof Statement 13). Typically, the net investment in a leveraged lease follows this pattern: \nEarly periods Positive, based on initial investment in leased property \nMiddle periods Negative, due mainly to large incom e tax deductions from accelerated \ndepreciation and high interest payments on the non -recourse debt \nLater periods Positive, as accelerated depreciation reverses and interest \npayments diminish \nFinal period Zero, as residual value is realized on sale of the property ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 380}), Document(page\_content='10 Leveraged leases \nFinancial reporting developments Lease accounting | 369 When the FASB originally deliberated Statement 13, it rejected the theory of accruing so -called \n“secondary earnings” (earnings on temporary funds to be reinvested) over the lease term. Instead, in its \nbasis for conclusions, the FASB stated th ese earnings should be recorded in income only when they occur \nbecause this is the economic reality of the transaction and because anticipation of future interest on \nfunds expected to be held temporarily has no support in present generally accepted account ing principles \n(paragraph 109(d) of Statement 13). \nThe determination of the net investment and the amount of income recognized are interdependent. \nIncome is recognized using a rate calculated by a trial and error process, which is repeated until a rate is \nselected, which develops a total amount allocated to income that is equal to the net cash flow. As a practical \nmatter, a computer program normally would be used to calculate this rate. \nIncome from a leveraged lease is segregated into three components: pret ax lease income, tax effect of \nthe pretax lease income and investment tax credit. The amount of each component to be recognized \neach accounting period is based on the ratio of the after -tax net income for the period (as computed \nbased on a Multiple Investm ent Sinking Fund yield) to the total after -tax net income from the lease times \nthe total pretax lease income, total tax effect and total investment tax credit. A loss would be recognized \nimmediately for any projected excess of gross cash disbursements, exc luding the initial investment, over \nthe gross cash receipts from a leveraged lease. \nRefer to section 2.9.2, Lessor accounting for variable lease payments , for discussion of lessor accounting \nfor contingent rent. \n10.3.3 Accounting for income taxes related to leveraged leases \nExcerpt from Accounting Standards Codification \nLeases — Leveraged Lease Arrangements \nOther Presentation Matters \n842-50-45-1 \nFor purposes of presenting the investment in a leveraged lease in the lessor’s balance sheet, the \namoun t of related deferred taxes shall be presented separately (from the remainder of the net \ninvestment). In the income statement or the notes to that statement, separate presentation (from \neach other) shall be made of pretax income from the leveraged lease, t he tax effect of pretax income, \nand the amount of investment tax credit recognized as income during the period. \n842-50-45-2 \nIntegration of the results of income tax accounting for leveraged leases with the other results of \naccounting for income taxes under Topic 740 on income taxes is required if deferred tax credits \nrelated to leveraged leases are the only source (see paragraph 740 -10-30-18) for recognition of a tax \nbenefit for deductible temporary differences and carryforwards not related to leveraged lea ses. A \nvaluation allowance is not necessary if deductible temporary differences and carryforwards will offset \ntaxable amounts from future recovery of the net investment in the leveraged lease. However, to the \nextent that the amount of deferred tax credits for a leveraged lease as determined in accordance with \nthis Subtopic differs from the amount of the deferred tax liability related to the leveraged lease that \nwould otherwise result from applying the guidance in Topic 740, that difference is preserved and is not \na source of taxable income for recognition of the tax benefit of deductible temporary differences and \noperating loss or tax credit carryforwards. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 381}), Document(page\_content='10 Leveraged leases \nFinancial reporting developments Lease accounting | 370 842-50-45-3 \nThis Subtopic requires that the tax effect of any difference between the assigned value and the tax \nbasis of a leveraged lease at the date of a business combination or an acquisition by a not -for-profit \nentity shall not be accounted for as a deferred tax c redit. Any tax effects included in unearned and \ndeferred income as required by this Subtopic shall not be offset by the deferred tax consequences of \nother temporary differences or by the tax benefit of operating loss or tax credit carryforwards. \nHowever, d eferred tax credits that arise after the date of a combination shall be accounted for in the \nsame manner as for leveraged leases that were not acquired in a combination. \nPending Content: \nTransition Date : (P) January 1, 2025; (N) January 1, 2025 | Transition Guidance: 805-60-65-1 \nThis Subtopic requires that the tax effect of any difference between the assigned value and the tax \nbasis of a leveraged lease at the date of a business combination , an acquisition by a not -for-profit \nentity , or a joint ven ture formation shall not be accounted for as a deferred tax credit. Any tax \neffects included in unearned and deferred income as required by this Subtopic shall not be offset by \nthe deferred tax consequences of other temporary differences or by the tax bene fit of operating \nloss or tax credit carryforwards. However, deferred tax credits that arise after the date of a \ncombination shall be accounted for in the same manner as for leveraged leases that were not \nacquired in a combination. \nImplementation Guidance and Illustrations \n842-50-55-4 \nThe accounting for income taxes related to leveraged leases set forth in this Subtopic is not consistent \nwith the guidance in Topic 740 on income taxes. \n842-50-55-5 \nThe integration of the results of accounting for income taxes related to leveraged leases with the other \nresults of accounting for income taxes as required by Topic 740 is an issue if all of the following exist: \na. The accounting for a leveraged lease req uires recognition of deferred tax credits. \nb. The guidance in Topic 740 limits the recognition of a tax benefit for deductible temporary \ndifferences and carryforwards not related to the leveraged lease. \nc. Unrecognized tax benefits in this paragraph coul d offset taxable amounts that result from future \nrecovery of the net investment in the leveraged lease. \nDeferred income taxes in leveraged lease transactions are accounted for under specific guidance provided in \nASC 842-50 and not the general guidance related to accounting for income taxes provided in ASC 740. Income \ntax rates and the projected timing of inc ome tax cash flows are important assumptions in determining the rate \nof return on a leveraged lease. If tax rates change and that change has an impact on the total net income from \nthe lease or if the projected timing of income tax cash flows is revised, le ssors must recalculate the allocation of \nincome on the leveraged lease (refer to section 10.3.4, Change in leveraged lease assumptions ). In addition, \nASC 842-50-30-2 provides specific guidance for allocating consideration in a business combination to acqui red \nleveraged leases (refer to our FRD, Business combinations , for further discussion). Although the accounting for \nincome taxes rela ted to leveraged leases in ASC 842 is not consistent with the guidance related to accounting \nfor income taxes in ASC 740, as indicated in the Basis for Conclusions for Statement 109, when deliberating \nthe general guidance related to accounting for income t axes, the FASB decided not to re -open the subject of \nleveraged lease accounting (paragraph 126 of Statement 109). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 382}), Document(page\_content='10 Leveraged leases \nFinancial reporting developments Lease accounting | 371 Integration of leveraged lease income tax accounting and accounting for other temporary differences is \nrequired by ASC 740 when deferred tax c redits related to leveraged leases are the only source of taxable \nincome when assessing the need for a valuation allowance for deferred tax assets not related to leveraged \nleases. A valuation allowance is not required when the deductible temporary differen ces and carryforwards \nwill be offset by taxable amounts from future recover ies of the net investment in the leveraged lease. \nHowever, to the extent the leveraged -lease deferred tax credits , as determined by the leveraged lease \nguidance in ASC 842-50, differ from the amount of the deferred tax liability that would result from applying \nthe guidance for accounting for income taxes in ASC 740, that difference is preserved and is not considered \na source of taxable income for purposes of recognizing the tax benefit of deductible temporary differences \nand operating loss or tax credit carryforwards. In other words, the taxable temporary difference as computed \nunder the general guidance for deferred income taxes in ASC 740 is the maximum amount to be considered \nin evaluating the need for a valuation allowance. \nThe following illustration, although somewhat simplified, depicts the requirement to preserve the \ndifference between deferred tax balances computed under the leveraged lease guidance in ASC 842-50 \nand thos e computed under the accounting for income taxes guidance in ASC 740. \nIllustration 10 -1: Difference between deferred tax balances computed under the leveraged \nlease guidance in ASC 842-50 and income taxes guidance in ASC 740 \nAssume a company entered a leveraged lease prior to the effective date of ASC 842 and when tax \nrates were 45%, and tax rates are subsequently reduced to 35% at the end of year 2. \nAt the end of year 2, deferred tax effects related to the leveraged lease ar e computed as follows: \n ASC 842 ASC 740 \nNet rentals receivable $ 2,000 $ 2,000 \nTax basis (1,500 ) (1,500 ) \nTaxable temporary difference 500 500 \nTax rate 40%1 35% \nDeferred tax liability $ 200 $ 175 \nAlso assume at the end of year 2, the company has a deductible temporary difference of $1,500 \nscheduled to reverse in year 6 arising from a warranty accrual resulting in a gross deferred tax asset \nof $525 ($1,500 x 35%) . Absent consideration of the deferred tax credits related to the lever aged \nlease, the weight of available evidence indicates a valuation allowance is required for the entire $525 \ndeferred tax asset. In this case, a valuation allowance would be required for $350 ($525 — $175), and \na net deferred tax benefit of $175 is recogni zed. Although the recorded deferred tax credit related to \nthe leveraged lease temporary difference is $200, $25 of that credit relates to special tax recognition \nprovisions related to leveraged lease guidance in ASC 842-50 and is not available for offsetti ng \ndeferred tax assets . \n1 Derived. Deferred tax effects computed under ASC 842, adjusting for the change in total net income from the lease as a result \nof the decrease in tax rates from 45% to 35%. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 383}), Document(page\_content='10 Leveraged leases \nFinancial reporting developments Lease accounting | 372 10.3.4 Change in leveraged lease assumptions \nExcerpt from Accounting Standards Codification \nLeases — Leveraged Lease Arrangements \nSubsequent Measurement \n842-50-35-6 \nAny estimated residual value and all other important assumptions affecting estimated total net \nincome from the leveraged lease shall be reviewed at least annually. The rate of return and the \nallocation of income to positive investment years shall be recalculated from lease inception following \nthe method described in paragraphs 842 -50-35-2 through 35 -4 and using the revised assumption if, \nduring the lease term , any of the following conditions occur: \na. The estimate of the residual value is determined to be excessive , and the decline in the residual \nvalue is judged to be other than temporary. \nb. The revision of another important assumption changes the estimated total net income from the lease . \nc. The projected timing of the income tax cash flows is revised. \n842-50-35-7 \nThe lessor shall update all assumptions used to calculate total and periodic income if the lessor is \nperforming a recalculation of the leveraged lease. That recalculation shall include actual cash flows up \nto the date of the recalculation and projected cash flows following the date of recalculation. \n842-50-35-8 \nThe accounts constituting the net investment balance shall be adjusted to conform to the recalculated \nbalances, and the change in the net investment shall be recognized as a gain or loss in the ye ar in \nwhich the assumption is changed. The gain or loss shall be recognized as follows: \na. The pretax gain or loss shall be included in income from continuing operations before income \ntaxes in the same line item in which leveraged lease income is recogniz ed. \nb. The tax effect of the gain or loss shall be included in the income tax line item. \nc. An upward adjustment of the estimated residual value (including any guaranteed portion) shall \nnot be made. \n842-50-35-9 \nThe projected timing of income tax cash flo ws generated by the leveraged lease is an important \nassumption and shall be reviewed annually, or more frequently, if events or changes in circumstances \nindicate that a change in timing has occurred or is projected to occur. The income effect of a change i n \nthe income tax rate shall be recognized in the first accounting period ending on or after the date on \nwhich the legislation effecting a rate change becomes law. \n842-50-35-10 \nA revision of the projected timing of the income tax cash flows applies only to changes or projected \nchanges in the timing of income taxes that are directly related to the leveraged lease transaction. For \nexample, a change in timing or projected timing of the tax benefits generated by a leveraged lease as a \nresult of any of the follow ing circumstances would require a recalculation because that change in \ntiming is directly related to that lease: \na. An interpretation of the tax law ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 384}), Document(page\_content='10 Leveraged leases \nFinancial reporting developments Lease account ing | 373 b. A change in the lessor’s assessment of the likelihood of prevailing in a challenge by the taxing \nauthority \nc. A change in the lessor’s expectations about settlement with the taxing authority. \n842-50-35-11 \nIn contrast, as discussed in paragraph 842 -50-35-20, a change in timing of income taxes solely as a \nresult of an alternative minimum tax credit or insufficient taxable income of the lessor would not \nrequire a recalculation of a leveraged lease because that change in timing is not directly related to that \nlease. A recalculation would not be required unless there is an indication that the previous \nassu mptions about total after -tax net income from the leveraged lease were no longer valid. \n842-50-35-12 \nTax positions shall be reflected in the lessor’s initial calculation or subsequent recalculation on the \nrecognition, measurement, and derecognition criteri a in paragraphs 740 -10-25-6, 740 -10-30-7, and \n740-10-40-2. The determination of when a tax position no longer meets those criteria is a matter of \nindividual facts and circumstances evaluated in light of all available evidence. \n842-50-35-13 \nIf the lessor ex pects to enter into a settlement of a tax position relating to a leveraged lease with a \ntaxing authority, the cash flows following the date of recalculation shall include projected cash flows \nbetween the date of the recalculation and the date of any projec ted settlement and a projected \nsettlement amount at the date of the projected settlement. \n842-50-35-14 \nThe recalculation of income from the leveraged lease shall not include interest or penalties in the cash \nflows from the leveraged lease. \n842-50-35-15 \nAdvance payments and deposits made with a taxing authority shall not be considered an actual cash \nflow of the leveraged lease; rather, those payments and deposits shall be included in the projected \nsettlement amount. \nSEC Materials \nSEC Observer Comment: Effect of a Change in Tax Law or Rates on Leveraged Leases \n842-50-S99-1 \nThe following is the text of SEC Observer Comment: Effect of a Change in Tax Law or Rates on \nLeveraged Leases. \nSection 842 -50-35 requires that all components of a leveraged lease be recalcul ated from inception of \nthe lease based on the revised after -tax cash flows arising from the change in the tax law, including \nrevised tax rates. The difference between the amounts originally recorded and the recalculated \namounts must be included in income o f the year in which the tax law is enacted. \nThis accounting may have distortive effects on the ratio of earnings to fixed charges (“the ratio”) as \ncalculated. For example, a favorable after -tax effect might consist of an unfavorable adjustment to \npretax income that is more than offset by a favorable adjustment to income tax expense. In those \ncircumstances, despite the overall favorable effect, the ratio as calculated pursuant to the applicable \ninstructions to Item 503(d) of Regulation S -K would be affected negatively because the ”earnings” \ncomponent of the ratio is based on pretax income. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 385}), Document(page\_content='10 Leveraged leases \nFinancial reporting developments Lease accounting | 374 In filings with the Commission the SEC staff will expect the cumulative effect on pretax income and \nincome tax expense, if material, to be reported as separate line items in the income statement. SEC \nstaff will not o bject to exclusion of an unfavorable pretax adjustment from the “earnings” component \nof the ratio, in cases in which the after -tax effect is favorable, provided that (1) such exclusion is \nadequately identified and explained in connection with all disclosur es and discussions relating to the \nratio and (2) supplemental disclosure is made of the ratio as calculated in accordance with the \napplicable instructions. \nWhen important assumptions are changed that affect estimated total net income from the lease, inclu ding \nany other than temporary decline in the estimated residual value or the projected timing of income tax cash \nflows is revised, the allocation of income to periods in which the net investment is positive is recomputed \nfrom the inception of the lease. Th e net investment is then adjusted to equal the recalculated balance and a \ngain or loss is recognized. Upward adjustments in estimated residual value are prohibited. Sections 10.3.4.1 \nthrough 10.3.4.6 provide an overview of common changes in assumptions imp acting leveraged leases. \nAs a reminder, a change in leveraged lease assumptions ( i.e., assumptions affecting estimated total net \nincome from the leveraged lease) only is not a modification to a leveraged lease. Therefore, the lessor \nwould continue to apply leveraged lease accounting. Only a change to the terms and conditions of a \ncontract that results in a change in the scope of or the consideration for a lease ( e.g., a change to the \nterms and conditions of the contract that adds or terminates the right to use one or more underlying \nassets or extends or shortens the contractual lease term) is considered as a modification. If an existing \nleveraged lease is modified on or after the effective date of ASC 842, the lessor is required to reassess \nthe contract ( e.g., whether the arrangement contains a lease, lease classification) using the lease \nclassification guidance in ASC 842. Refer to section 5.6, Lease modifications . As a result of the \nmodification, leveraged lease accounting is no longer applicable, and the lessor would prospectively \napply sales -type, direct financing or operating lease accounting as applicable (assuming after the \nmodification, the arrangement still c ontains a lease). Upon modification, there would be no basis to net \nthe remaining non -recourse debt balance with a lease receivable, and any deferred tax balances would \nneed to be adjusted as required under ASC 740 to comply with that guidance. \nAs discusse d in section 10.1, Introduction and grandfathering , if a lessee exercises an option to extend a \nleveraged lease on or after the effective date of ASC 842 that it was not previously reasonably assured \nof exercising ( i.e., under ASC 840, the renewal option w as not included in the original accounting lease \nterm for purposes of classifying the lease at inception), the exercise of that option is accounted for as a \nlease modification, and the lease no longer qualifies for leveraged lease accounting and is instead \naccounted for under ASC 842. Refer to section 5.6, Lease modifications. \n10.3.4.1 Impact of change in effective tax rate \nThe lessor’s income tax rate is an important assumption in accounting for a leveraged lease. Accordingly, \nthe income effect of a change in the income tax rate should be recognized in the first accounting period \nending on or after the date on which the legislation effecting a rate change becomes law. If accounting \nfor the effect on leveraged leases of the change in tax rates results in a s ignificant variation from the \ncustomary relationship between income tax expense and pretax accounting income and the reason for \nthat variation is not otherwise apparent, the reason for that variation should be disclosed as required by \nASC 842-50-50-3 (refe r to section 10.4, Disclosures ). \nAll components of a leveraged lease must be recalculated from inception of the lease based on the \nrevised after -tax cash flows arising from the change in the tax law, including revised tax rates (including \nthe impact of alt ernative minimum tax (AMT), refer to section 10.3.4.2, Effect of AMT on leveraged lease \naccounting ) and repeal of the investment tax credit. The difference between the amounts originally \nrecorded and the recalculated amount would be included as a cumulativ e catch -up in income of the \nperiod in which the tax law is enacted. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 386}), Document(page\_content='10 Leveraged leases \nFinancial reporting developments Lease accounting | 375 10.3.4.2 Effect of AMT on leveraged lease accounting \nExcerpt from Accounting Standards Codification \nLeases — Leveraged Lease Arrangements \nSubsequent Measurement \n842-50-35-16 \nAn entity shall include assumptions about the effect of the alternative minimum tax, considering its \nconsolidated tax position, in leveraged lease computations. \n842-50-35-17 \nAny difference between alternative minimum tax depreciation and the tax depreciati on assumed in the \nleveraged lease or between income recognition for financial reporting purposes and alternative \nminimum tax income could, depending on the lessor’s overall tax situation, result in alternative \nminimum tax or the utilization of alternative minimum tax credits. \n842-50-35-18 \nIf alternative minimum tax is paid or an alternative minimum tax credit is utilized, the total cash flows \nfrom the leveraged lease could be changed and the lessor’s net investment in the leveraged lease and \nincome recognition would be affected. \n842-50-35-19 \nIf a change to the tax assumptions changes total estimated after -tax net income, the rate of return on \nthe leveraged lease shall be recalculated from inception, the accounts constituting the lessor’s net \ninvestme nt shall be adjusted, and a gain or loss shall be recognized in the year in which the assumption \nis changed. \n842-50-35-20 \nHowever, an entity whose tax position frequently varies between alternative minimum tax and regular \ntax shall not be required to recal culate the rate of return on the leveraged lease each year unless there \nis an indication that the original assumptions regarding total after -tax net income from the lease are \nno longer valid. In that circumstance, the entity shall be required to revise the leveraged lease \ncomputations in any period in which total net income from the leveraged lease changes because of the \neffect of the alternative minimum tax on cash flows for the lease. \nThe lessor’s income tax rate and the amount of taxes paid or tax benef its received are important \nassumptions in a leveraged lease calculation. Any difference between AMT depreciation and the tax \ndepreciation assumed in the leveraged lease or between income recognition for financial reporting \npurposes and AMT income could, de pending on the lessor’s overall tax situation, result in AMT or the \nutilization of AMT credits. In the circumstances in which AMT is paid or an AMT credit is utilized, the total \ncash flows from the leveraged lease could be changed, and the lessor’s net inv estment in the leveraged \nlease and income recognition would be affected. \nAn entity should include assumptions regarding the effect of the AMT, considering its consolidated tax \nposition, in leveraged lease computations. An entity whose tax position frequent ly varies between AMT \nand regular tax would not be required to recompute each year unless there was an indication that the \noriginal assumptions regarding total after -tax net income from the lease were no longer valid. In that \ncircumstance, the entity would be required to revise the leveraged lease computations in any period in \nwhich management believes that total net income from the leveraged lease will be affected due to the \neffect of the AMT on cash flows for the lease. In addition, if the lessor is requi red to recompute its \nleveraged lease income for a change in assumption other than solely AMT, that recalculation shall include \nactual cash flows up to the date of the recalculation and projected cash flows following the date of \nrecalculation, including con sideration of projected AMT impact. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 387}), Document(page\_content='10 Leveraged leases \nFinancial reporting developments Lease accounting | 376 10.3.4.3 Impact of change or projected change in the timing of cash flows relating to income taxes \ngenerated by a leveraged lease transaction \nThe timing of the cash flows relating to income taxes generated by a leveraged lease is an important \nassumption that affects the periodic income recognized by the lessor for that lease. Because tax benefits \nin a leveraged lease are often realized in the early periods of the lease, disproportionately more income \nfrom the lease is typ ically allocated to earlier periods. For certain leveraged lease transactions, the \nInternal Revenue Service (IRS) has challenged both the ability to accelerate the timing of tax deductions \nand the amounts of those deductions. The settlement in a challenge from the IRS may result in a \nsignificant change in the timing of the realization of tax benefits, which changes the timing of the \nestimated after -tax cash flows from the leveraged lease (and therefore the timing of income recognition \nfrom the lease) and re duces the overall expected rate of return, although it does not change the \nestimated total net income. The settlement may also result in interest and penalties that would change \nthe estimated total net income from the lease. \nLessors are required to review the projected timing of income tax cash flows generated by a leveraged \nlease annually, or more frequently if events or changes in circumstances indicate that a change in timing \nhas occurred or is projected to occur. If the projected timing of the income ta x cash flows is revised, the \nrate of return and the allocation of income to positive investment years should be recalculated from the \ninception of the lease based on the revised projected cash flows, including any projected settlements and \nan update of all assumptions used. The recalculation should include the actual or expected changes and \nan update of all assumptions in timing of all cash flows, including those due to AMT credits or net \noperating loss carryforwards, if significant. The recalculation shoul d not include interest or penalties in \nthe cash flows from the leveraged lease. Any advance payments or deposits made with a taxing authority \nshould not be considered an actual cash flow of the leveraged lease; rather, those payments and deposits \nshould be included in the projected settlement amount. The difference between the amounts originally \nrecorded and the recalculated amount should be recognized as a gain or loss in income from continuing \noperations in the year in which the assumption is changed in t he same line item in which leveraged lease \nincome is recognized. The tax effect of the recognized gain or loss should be included in the income tax \nline item ( ASC 842-50-35-9 through 35 -15). \nThe following example illustrates how a lessor would include adva nce payments in a recalculation of a \nleveraged lease: \nExcerpt from Accounting Standards Codification \nLeases — Leveraged Lease Arrangements \nImplementation Guidance and Illustrations \n842-50-55-24 \nThis Example illustrates how (in accordance with the guidance in paragraph 842 -50-35-13 and other \nparagraphs) a lessor would include advance payments and deposits in a recalculation of a leveraged \nlease resulting from a determination by the lessor that it would enter into a settlement of a tax position \narising from a leveraged lease. \n842-50-55-25 \nThis Example assumes that the lessor has concluded that the position originally taken on the tax return \nwould meet the more -likely -than -not threshold in Subtopic 7 40-10 on income taxes. It also assumes \nthat the lessor would conclude that the estimate of $50 for the projected lease -in, lease -out \nsettlement is consistent with the measurement guidance in that Subtopic. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 388}), Document(page\_content='10 Leveraged leases \nFinancial reporting developments Lease accounting | 377 842-50-55-26 \nA lessor makes an advance payment of $25 on July 1, 2007, $10 of which is estimated to be associated \nwith issues arising from a lease -in, lease -out transaction. On July 1, 2007, the lessor changes its \nassumption about the timing of the tax cash flows and projects a settlement with the Internal Revenue \nService on September 1, 2009. The projected settlement would result in a payment to the taxing \nauthority of $125 of which $50 is associated with the lease -in, lease -out transaction. On July 1, 2007, \nwhen the lessor recalculates the leveraged lease, the lessor would include a $50 cash flow on \nSeptember 1, 2009 , as a projected outflow in the leveraged lease recalculation. \nTax positions should be reflected in a lessor’s initial calculation and/or subsequent recalculation based on \nthe recognition, derecognition and measurement criteria in ASC 740-10 (refer to our FRD, Income taxes , \nfor further discussion). \n10.3.4.4 Impact of a change in estimated residual value \nAs noted in ASC 842-50-35-8(c), an upwar d adjustment of the estimated residual value is prohibited. \nTransactions in which a lessor has sold an interest in any appreciation in the residual value to a third -\nparty investor have raised the question as to whether reflecting such a sale is essentially recognizing \nappreciation in the residual value. The following example illustrates. \nLessor X is the equity participant in a leveraged lease. When the leveraged lease was originally recorded, \nthe residual value was determined to be $100. A group of speculat ors now pays $30 for an option for \nany excess of the residual value over $100. Either the speculators would pay the $100 to Lessor X at the \nend of the lease and sell the asset itself, or Lessor X would sell the asset and all proceeds in excess of \n$100 woul d be paid to the speculators. The question concerns how to account for the $30 when it is \nreceived. The following three alternatives have been identified: \n1. Treat the $30 cash inflow as a change in lease assumptions in accordance with ASC 842-50-35-6 \nthrough 35 -8 and recalculate the cash flows from the leveraged lease since inception by including \nthe $30 received in the current year with no change in the $100 residual reflected at the end of the \nlease. Any income tax expense related to the $30 option premi um should also be reflected in the \nrevised cash flow in the period in which it is subject to income tax. A cumulative catch -up adjustment \nwould be recorded in the current year resulting from the difference between cumulative income to \ndate under the revise d calculation and the old calculation. \n2. Revise the leveraged lease calculations as in alternative 1 above with the exception that the \ncalculation would reflect a $70 residual at the end of the lease term and $30 of proceeds received \nwhen paid by the spec ulators. \n3. Record the $30 as a deferred credit to be taken into income at the end of the lease as additional \nsales proceeds for the residual. \nAlthough merits exist for each of the three alternatives, assuming that the equity participant has no new \nobligat ions with respect to the disposition of the residual at the end of the lease ( i.e., merely providing \nspeculator with any upside benefit when it is realized), we believe that alternative 1 most closely follows \nthe leveraged lease model. The sale of the upwa rd appreciation of the residual does not represent an \nupward adjustment of the residual value. Instead, it represents the monetization of a previously unvalued \nand unrecorded asset. \nIf, in the above example, the lessor had sold the residual value, alternat ive 2 would best approximate the \naccounting for such a revision in the timing of cash flows associated with that transaction within the \nleveraged lease model. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 389}), Document(page\_content="10 Leveraged leases \nFinancial reporting developments Lease accounting | 378 10.3.4.5 Refinancing of non -recourse debt \nThe interest rate of the non -recourse debt in a leverag ed lease transaction is an important assump tion in \nthe leveraged lease model. If, as a result of refinancing non -recourse debt (in a lease that was classified \nas a leveraged lease under ASC 840), the lessor’s cash flow assumptions change, the revised cash flows \nunder the refinanced debt should be reflected and a cumulative catch -up adjustment recorded as noted \nin section 10.3.4, Change in leveraged lease assumptions . \nIf the lessor refinances the non -recourse debt subsequent to the inception of the lease and either \nborrowed an amount greater than the original non -recourse loan principal at the inception of the lease or \ngreater than the existing non -recourse loan princip al at the time of the refinancing, we believe it would be \ninappropriate to treat the borrowings in excess of the outstanding principal at the time of the refinancing \nas part of the leveraged lease. Instead, such additional borrowings should be recorded sep arately in the \nfinancial statements as opposed to being offset in the net investment in leveraged lease. \n10.3.4.6 Changes in terms and conditions of a leveraged lease \nAs discussed in section 10.1, Introduction and grandfathering , a lessor and a lessee may enter into an \namendment to modify the terms and conditions of an existing leveraged lease, or the lessee may exercise \nan option to extend a leveraged lease that it was not previously reasonably assured of exercising. As \nindicated in ASC 842-10-65-1(z), onc e an existing leveraged lease is modified on or after the effective \ndate of ASC 842, the existing leveraged lease is accounted for as a new lease as of the effective date of \nthe modification in accordance with the guidance in ASC 842-10 and ASC 842-30. As a result, the \nleveraged lease classification and accounting is no longer applicable to the modified lease. \n10.3.5 Impact of delayed equity investment on leveraged lease accounting \nExcerpt from Accounting Standards Codification \nMaster Glossary \nDelayed Equi ty Investment \nIn leveraged lease transactions that have been structured with terms such that the lessee's rent \npayments begin one to two years after lease inception , equity contributions the lessor agrees to make (in \nthe lease agreement or a separate binding contract ) that are used to service the nonrecourse debt during \nthis brief period. The total amount of the lessor's contributions is specifically limited by the agreements. \nLeases — Leveraged Lease Arrangements \nImplementation Guidance and Illustrations \n842-50-55-2 \nA delayed equity investment frequently obligates the lessor to make up the shortfall between rent \nand debt service in the first several years of the transaction. The type of recourse debt resulting from \nthe delayed equity investment does not contradict the notion of nonrecourse and, therefore, does not \npreclude leveraged lease accounting as long as other requirements of leveraged lease accounting are \nmet. The lessor’s related obligation should be recorded as a liability at present value at lease inception . \n842-50-55-3 \nRecognition of the liability would increase the lessor’s net investment on which the lessor bases its \npattern of income recognition. While the increase to the ne t investment results in an increase in \nincome, it may be offset by the accrual of interest on the liability. ", metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 390}), Document(page\_content='10 Leveraged leases \nFinancial reporting developments Lease accounting | 379 Leveraged lease transactions are sometimes structured with terms such that the lessee’s rent payments \nbegin one to two years after inception of th e lease. In these transactions, the lessor normally is required \nto make up the shortfall between rent and debt service in the first several years of the transaction by \nagreeing, in the lease agreement or a separate binding contract, to make equity contribu tions that are \nused to service the non -recourse debt during this brief period. This arrangement is commonly referred to \nas a delayed equity investment, which typically is limited to the amounts specified, and is measurable at \nthe inception of the lease. Th e debt is non -recourse to the lessor; however, the creditor frequently has \nrecourse to the lessor’s general credit for the debt service contributions. As discussed in section 10.1, \nIntroduction and grandfathering , one of the required characteristics of a l everaged lease is that the \nfinancing provided by the long -term creditor must be non -recourse as to the general credit of the lessor. \nThe type of recourse debt resulting from the delayed equity investment does not contradict the notion of \nnon-recourse for p urposes of qualifying for leveraged lease. As such, recourse debt resulting from the \ndelayed equity investment does not preclude leveraged lease accounting as long as other requirements of \nleveraged lease accounting are met. The lessor’s obligation for the delayed equity investment should be \nrecorded as a liability at present value at the inception of the lease. The lessor’s net investment on which \nthe lessor bases its pattern of income recognition would reflect the delayed equity investment ( i.e., the net \ninvestment would increase due to the recognition of the liability). While the increase to the net investment \nresults in an increase in income, it tends to be offset by the accrual of interest on the liability. \n10.3.6 Leveraged lease — comprehensive illustration \nASC 842-50-55-6 through 55 -15 provides an illustration of accounting and financial statement \npresentation for leveraged leases. The illustration begins with a set of assumptions and uses them to \nprepare an analysis of cash flows by years. This analysis provides the basis for the calculation of the net \ninvestment in the leased property. Below is a summarized version of the illustration. \nIllustration 10-2: Accounting for leveraged leases \nIn the illustration, a $1,000,000 asset is f inanced by a $600,000 non -recourse borrowing and \n$400,000 of equity investment by the lessor (it is assumed there are no initial direct costs). The \ncomponents of total income to be earned follows: \nTotal rentals, including residual value $ 1,550,000 $ 1,550,000 \nTax depreciation (1,000,000) \nLoan interest (516,530 ) (516,530) \nTaxable income 33,470 \nAssumed tax rate/tax effect X 50.4% (16,869) \nLoan principal (600,000) \nInvestment tax credit 100,000 \nInitial investment (400,000 ) \nTotal lease income $ 116,601 \nThe net investment at the beginning of the first year is $400,000, and the net investment and related \ndeferred taxes at the end of the first year are calculated as follows: \nNet investment: \nInitial investment $ 400,000 \nAnnual rental (90,000) \nLoan interest and principal payment 74,435 \nInvestment tax credit realized (100,000) \nIncome realized (see below): \nPretax lease income 9,929 \nInvestment tax credit 29,663 \n $ 324,027 ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 391}), Document(page\_content='10 Leveraged leases \nFinancial reporting developments Lease accounting | 380 Deferred taxes: \nFirst year tax loss: \nAnnual rental $ 90,000 \nTax depreciation (142,857) \nLoan interest (54,000 ) \n (106,857) \nAssumed tax rate X 50.4% \n $ (53,856) \nTax effect of pretax lease income recognized (see below) (5,004 ) \n $ (58,860 ) \nThe net investment at the beginning of the second year for purposes of computing income is \n$265,167 ($324,027 net investment less $58,860, the deferred taxes). \nThe rate that is applied to each year’s beginning net investment in calculating annual income is the \nsum of the net investment in positive years divided into the total income to be earned on the lease. In \nthe illustration, the total income ($116,601) is divided by the sum of the positive net investment \namount s ($1,348,477) to produce a rate of 8.647%. This rate is applied to the initial net investment of \n$400,000 and results in $34,588 as the amount of income to be recognized for the first year. The \nfirst year’s income is allocated to its components based on t he relationship of the components of total \nincome to be earned as follows: \nComponent Total income Percentage of \ntotal First year income \n Total Components \nPretax lease income $ 33,470 28.705% x $ 34,588 $ 9,929 \nTax effect of pretax lease \nincome (16,869) (14.467) x 34,588 (5,004) \nInvestment tax credit 100,000 85.762 x 34,588 29,663 \n $ 116,601 100.000% $ 34,588 \n \n \n10.4 Disclosures \nExcerpt from Accounting Standards Codification \nLeases — Leveraged Lease Arrangements \nDisclosure \n842-50-50-1 \nIf leveraged leasing is a significant part of the lessor’s business activities in terms of revenue, net \nincome, or assets, the components of the net investment balance in leveraged leases as set forth in \nparagraph 842 -50-25-1 shall be disclosed in the notes to financial statements. \n842-50-50-2 \nFor guidance on disclosures about financing receivables, which include receivables relating to a \nlessor’s rights to payments from leveraged leases, see the guidance beginning in par agraphs 310 -10-\n50-5A, 310 -10-50-27, and 310 -10-50-31. \nPending Content: \nTransition Date: (P) December 16, 2019; (N) December 16, 2022 | Transition Guidance: 326-10-65-1 \nFor guidance on disclosures about financing receivables, which include receivables relating to a \nlessor’s rights to payments from leveraged leases, see the guidance in Subtopic 326 -20 on financial \ninstruments measured at amortized cost and paragraph 310 -10-50-31. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 392}), Document(page\_content='10 Lever aged leases \nFinancial reporting developments Lease accounting | 381 \nPending Content: \nTransition Date: (P) December 16, 2 022; (N) December 16, 202 2 | Transition Guidance: 326-10-65-5 \nFor guidance on disclosures about financing receivables, which include receivables relating to a \nlessor’s rights to payments from leveraged leases, see the guidance in Subtopic 326 -20 on financial \ninstruments measured at amortized cost. \n842-50-50-3 \nIf accounting for the effect on leveraged leases of the change in tax rates results in a significant variation \nfrom the customary relationship between income tax expense and pretax accounting i ncome and the \nreason for that variation is not otherwise apparent, the lessor shall disclose the reason for that variation. \nSEC Materials \nSEC Observer Comment: Effect of a Change in Tax Law or Rates on Leveraged Leases \n842-50-S99-1 \nThe following is the tex t of SEC Observer Comment: Effect of a Change in Tax Law or Rates on \nLeveraged Leases. \nSection 842-50-35 requires that all components of a leveraged lease be recalculated from inception of \nthe lease based on the revised after -tax cash flows arising from th e change in the tax law, including \nrevised tax rates. The difference between the amounts originally recorded and the recalculated \namounts must be included in income of the year in which the tax law is enacted. \nThis accounting may have distortive effects on the ratio of earnings to fixed charges ("the ratio") as \ncalculated. For example, a favorable after -tax effect might consist of an unfavorable adjustment to \npretax income that is more than offset by a favorable adjustment to income tax expense. In those \ncircumstances, despite the overall favorable effect, the ratio as calculated pursuant to the applicable \ninstructions to Item 503(d) of Regulation S -K would be affected negatively because the "earnings" \ncomponent of the ratio is based on pretax income. \nIn filings with the Commission the SEC staff will expect the cumulative effect on pretax income and \nincome tax expense, if material, to be reported as separate line items in the income statement. SEC \nstaff will not object to exclusion of an unfavorable pretax adjustment from the "earnings" component \nof the ratio, in cases in which the after -tax effect is favorable, provided that (1) such exclusion is \nadequately identified and explained in connection with all disclosures and discussions relating to the \nratio an d (2) supplemental disclosure is made of the ratio as calculated in accordance with the \napplicable instructions. \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 393}), Document(page\_content=' \nFinancial reporting developments Lease accounting | 382 11 Effective date and transition \n11.1 Effective date \nExcerpts from Accounting Standards Codification \nMaster Glossary \nNot-for-Profit Entity \nAn entity that possesses the following characteristics, in varying degrees, that distinguish it from \na business entity: \na. Contributions of significant amounts of resources from resource providers who do not expect \ncommensurate or proportionate pecuniary return \nb. Operating purposes other than to provide goods or services at a profit \nc. Absence of ownership interests like those of business entities. \nEntities that clearly fall outside this definition include the follo wing: \na. All investor -owned entities \nb. Entities that provide dividends, lower costs, or other economic benefits directly and \nproportionately to their owners, members, or participants, such as mutual insurance entities, \ncredit unions, farm and rural electric cooperatives, and employee benefit plans. \nPublic Business Entity \nA public business entity is a business entity meeting any one of the criteria below. Neither a not-for-\nprofit entity nor an employee benefit plan is a business entity. \na. It is requi red by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial \nstatements, or does file or furnish financial statements (including voluntary filers), with the SEC \n(including other entities whose financial statements or financial info rmation are required to be or \nare included in a filing). \nb. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or \nregulations promulgated under the Act, to file or furnish financial statements with a regulatory \nagency other than the SEC. \nc. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in \npreparation for the sale of or for purposes of issuing securities that are not subject to contractual \nrestrictions on trans fer. \nd. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an \nexchange or an over -the-counter market. \ne. It has one or more securities that are not subject to contractual restrictions on transfer, and it is \nrequired by law, contract, or regulation to prepare U.S. GAAP financial statements (including \nnotes) and make them publicly available on a periodic basis (for example, interim or annual \nperiods). An entity must meet both of these conditions to meet this crit erion. \nAn entity may meet the definition of a public business entity solely because its financial statements or \nfinancial information is included in another entity’s filing with the SEC. In that case, the entity is only a \npublic business entity for purpose s of financial statements that are filed or furnished with the SEC. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 394}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 383 Leases — Overall \nTransition and Open Effective Date Information \n842-10-65-1 \nThe following represents the transition and effective date information related to Accounting Standards \nUpdates N o. 2016 -02, Leases (Topic 842) , No. 2018 -01, Leases (Topic 842): Land Easement Practical \nExpedient for Transition to Topic 842 , No. 2018 -10, Codification Improvements to Topic 842, Leases, \nNo. 2018 -11, Leases (Topic 842): Targeted Improvements, No. 2018 -20, Leases (Topic 842): Narrow -Scope \nImprovements for Lessors , No. 2019 -01, Leases (Topic 842): Codification Improvements , No. 2019 -10, \nFinancial Instruments —Credit Losses (Topic 326), Derivatives and H edging (Topic 815), and Leases (Topic \n842): Effective Dates , No. 2020 -05, Revenue from Contracts with Customers (Topic 606) and Leases \n(Topic 842): Effective Dates for Certain Entities , No. 2021 -05, Leases (Topic 842): Lessors —Certain Leases \nwith Variable Lease Payments, No. 2021 -09, Leases (Topic 842): Discount Rate for Lessees That Are Not \nPublic Business Entities , and No. 2023 -01, Leases (Topic 842): Common Control Arrangements : [Note: \nSee paragraph 842 -10-S65-1 for an SEC Staff Announcement on transition related to Update 2016 -02.] \na. A public business entity , a not-for-profit entity that has issued or is a conduit bond obligor for \nsecurities that are traded, listed, or quoted on an exchange or an over -the-counter market (with \nan exception for those entities that have not yet issued their financial statements or made \nfinan cial statements available for issuance as described in the following sentence), and an \nemployee benefit plan that files or furnishes financial statements with or to the U.S. Securities \nand Exchange Commission shall apply the pending content that links to t his paragraph for \nfinancial statements issued for fiscal years beginning after December 15, 2018, and interim \nperiods within those fiscal years. A not -for-profit entity that has issued or is a conduit bond \nobligor for securities that are traded, listed, or quoted on an exchange or an over -the-counter \nmarket that has not yet issued financial statements or made financial statements available for \nissuance as of June 3, 2020 shall apply the pending content that links to this paragraph for fiscal \nyears beginning after December 15, 2019, and interim periods within those fiscal years. Earlier \napplication is permitted. \nb. All other entities shall apply the pending content that links to this paragraph for financial \nstatements issued for fiscal years beginning after December 15, 2021, and interim periods within \nfiscal years beginning after December 15, 2022. Earlier application is permitted. \nASC 842 was effective for annual periods beginning after 15 December 2018 ( i.e., 1 January 2019 for a \ncalendar -year entity), and interim periods within those years, for PBEs and both of the following: \n• Not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, \nlisted or quoted on an exchange or an over -the-counter market and that had issued (or made \navailable for issuance) financial statements that reflect the new standard as of 3 June 2020 \n• Employee benefit plans that file or furnish financial statements with or to the SEC \nRefer to section 11.2.1, SEC reporting considerations , for further discussion of the effective date for \ncertain PBEs based on an SEC staff announcement. \nASC 842 was effective for annual periods beginning after 15 December 2019 and interim periods within \nthose annual periods for the following: \n• Not-for-profit entities that have issued or are conduit bond obligor s for securities traded, listed or \nquoted on an exchange or over -the-counter market and that had not issued (or made available for \nissuance) financial statements that reflect the new standard as of 3 June 2020 . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 395}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 384 ASC 842 was effective for all other entities for annual periods beginning after 15 December 2021 and \ninterim periods within annual periods beginning after 15 December 2022. \nThese effective dates are based on ASU 2020 -05, Revenue from Contracts with Customers (Topic 606) \nand Leases (Topic 842): Effective Dates for Certain Entities . \nInterim adoption \nEarly adoption is permitted for all entities. ASC 842 neither specifically addresses nor prohibits early \nadoption in an interim period other than the first interim period of an entity’s fiscal year. We believe an \nentity can early adopt the standard in an interim period other than the first interim period; however, the \nadoption would be reflect ed as of the beginning of the annual period in accordance with ASC 250. For \nexample, if a calendar -year entity early adopts in the second quarter of 2017, it should reflect the adoption of \nASC 842 as if it had adopted the standard on 1 January 2017. The ne xt time an entity presents its financial \nstatements for the first quarter of 2017 ( i.e., in the first quarter of 2018), it would adjust them to reflect \nthe adoption of ASC 842. \n11.1.1 Disclosure before adoption \nExcerpts from Accounting Standards Codificati on \nAccounting Changes and Error Corrections — Overall \nSEC Materials \nSEC Staff Guidance \n250-10-S99-6 \nThe following is the text of SEC Staff Announcement: Disclosure of the Impact That Recently Issued \nAccounting Standards Will Have on the Financial Statements of a Registrant When Such Standards Are \nAdopted in a Future Period (in accordance with Staff Accounting Bulletin [SAB] Topic 11.M) . \nThis announcement applies to Accounting Standards Update (ASU) No. 2014 -09, Revenue from \nContracts with Customers (Topic 606) ; ASU No. 2016 -02, Leases (Topic 842) ; and ASU No. 2016 -\n13, Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial \nInstruments . FN1 \nSAB Topic 11.M provides the SEC staff view that a registrant should evalua te ASUs that have not \nyet been adopted to determine the appropriate financial statement disclosures FN2 about the \npotential material effects of those ASUs on the financial statements when adopted. Consistent with \nTopic 11.M, if a registrant does not know or cannot reasonably estimate the impact that adoption of \nthe ASUs referenced in this announcement is ex pected to have on the financial statements, then in \naddition to making a statement to that effect, that registrant should consider additional qualitative \nfinancial statement disclosures to assist the reader in assessing the significance of the impact that \nthe standard will have on the financial statements of the registrant when adopted. In this regard, \nthe SEC staff expects the additional qualitative disclosures to include a description of the effect of \nthe accounting policies that the registrant expects to apply, if determined, and a comparison to the \nregistrant’s current accounting policies. Also, a registrant should describe the status of its process \nto implement the new standards and the significant implementation matters yet to be addressed. \nFN 1 This announcement also applies to any subsequent amendments to guidance in the ASUs \nthat are issued prior to a registrant’s adoption of the aforementioned ASUs. \nFN 2 Topic 11.M provides SEC staff views on disclosures that registrants should consider i n both \nManagement’s Discussion & Analysis (MD&A) and the notes to the financial statements. MD&A may \ncontain cross references to these disclosures that appear within the notes to the financial statements. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 396}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 385 Entities subject to SEC reporting requirements sho uld provide disclosures about the effects of ASC 842 in \nregistration statements and periodic reports filed with the SEC. As noted in SEC Staff Accounting Bulletin \n(SAB) Topic 11.M, the SEC staff expects disclosure of the potential effects of new standards if they are \nknown. These entities should make the following disclosures within MD&A and the financial statements: \n• A brief description of the new standard, the date that adoption is required and the date that the \nregistrant plans to adopt, if earlier \n• A disc ussion of the method of adoption allowed, including whether the optional practical expedients \nwill be applied (refer to section 11.2.2, Transition practical expedients) \n• A discussion of the effect the standard is expected to have on the financial statements or, if the \neffect is not known or reasonably estimable, a statement to that effect \n• Disclosure of other significant matters that the entity believes might result from adopting the \nstandard ( e.g., planned or intended changes in business practices, effect on debt covenants) \nConsistent with SAB Topic 11.M, at an October 2016 Emerging Issues Task Force (EITF) Meeting, the \nSEC Observer said that if a registrant does not know or cannot reasonably estimate the effect that the \nadoption of a new standard will have o n its financial statements, it should make a statement to that \neffect and consider providing qualitative disclosures to help the reader assess the significance of the \neffect on the registrant’s financial statements. These qualitative disclosures should inc lude a description \nof the new standard’s effect on the registrant’s accounting policies and provide a comparison to the \nregistrant’s previous accounting policies under ASC 840. The SEC Observer also said that registrants \nshould describe the status of their processes to implement the new standards and the significance of any \nimplementation matters yet to be addressed in those processes. The SEC staff expects an entity’s \ndisclosures to evolve in each reporting period as more information about the effects of a new standard \nbecomes available. Members of the SEC staff have said that disclosure of the probable outcomes of applying \nnew accounting standards, including ASC 842, will be a focus in reviews of registrants’ 10 -K filings. \n11.1.2 Adoption of ASC 842 and ASC 606 (updated August 2022) \nThe FASB aligned several concepts in ASC 842 with concepts in ASC 606 ( e.g., determining whether the \ntransfer of an asset is a sale in a sale and leaseback transaction) and in some cases required lessors to \napply specific guidance in ASC 606 to their leasing transactions ( e.g., for a lessor’s allocation of the \nconsideration in the contract). ASU 2014 -09, the update that created ASC 606, included consequential \namendments to ASC 840 that require both the purchaser (lessee) and supplier (lessor) to apply the \nallocation guidance in ASC 606 to multiple -element arrangements that contain a lease. The FASB \nclarified at a June 2017 Board meeting that it did not intend for an entity to revisit the allocation of \ncontract consideration to lease components for existing unmodified contracts upon the adoption of \nASC 842, except when lease classific ation changes upon the adoption of ASC 842. \nQuestions have arisen about the accounting for certain maintenance activities. Under ASC 840, certain \nmaintenance activities are considered executory costs ( i.e., a lease element). However, u nder ASC 842, \npayment s for maintenance activities, including common area maintenance ( e.g., cleaning a lobby of a building, \nremoving snow from a parking lot for employees and customers), will instead be considered non -lease \ncomponents and will be accounted for under ASC 606 by lessors (refer to section 1.4.2.1, Executory costs ). \nUpon adoption of ASC 842, a lessor’s accounting for such activities will depend on whether the lease \nclassification changes. If lease classification does not change upon adoption of ASC 842 ( e.g., an \noperating lease under ASC 840 remains an operating lease under ASC 842), a lessor generally runs out \nits existing ASC 840 accounting ( i.e., the lessor continues to account for maintenance costs as executory \ncosts under ASC 840). In contrast, if classification changes ( e.g., an operating lease under ASC 840 ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 397}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 386 becomes a direct financing lease under ASC 842), the lessor will apply concepts from ASC 842 in \ntransition, including the guidance on accounting for the non -lease maintenance components. Refer to \nsection 11.4, Lessor transition , for further discussion of accounting for existing leases in transition. \n11.2 Transition (updated August 2023) \nExcerpt from Accounting Standards Codification \nLeases — Overall \nTransition and Open Effective Date Information \n842-10-65-1 \nc. In the financial statements in which an entity first applies the pending content that links to this \nparagr aph, the entity shall recognize and measure leases within the scope of the pending content \nthat links to this paragraph that exist at the application date, as determined by the transition \nmethod that the entity elects. An entity shall apply the pending con tent that links to this paragraph \nusing one of the following two methods: \n1. Retrospectively to each prior reporting period presented in the financial statements with the \ncumulative effect of initially applying the pending content that links to this parag raph \nrecognized at the beginning of the earliest comparative period presented, subject to the \nguidance in (d) through (gg). Under this transition method, the application date shall be the \nlater of the beginning of the earliest period presented in the finan cial statements and the \ncommencement date of the lease. \n2. Retrospectively at the beginning of the period of adoption through a cumulative -effect \nadjustment, subject to the guidance in (d) through (gg). Under this transition method, the \napplication date shall be the beginning of the reporting period in which the entity first applies \nthe pending content that links to this paragraph. \nd. An entity shall adjust equity and, if the entity elects the transition method in (c)(1), the other \ncompar ative amounts disclosed for each prior period presented in the financial statements, as if \nthe pending content that links to this paragraph had always been applied, subject to the \nrequirements in (e) through (gg). \ne. If a lessee elects not to apply the rec ognition and measurement requirements in the pending \ncontent that links to this paragraph to short -term leases , the lessee shall not apply the approach \ndescribed in (k) through (t) to short -term leases. \nSee Examples 28 through 29 (paragraphs 842-10-55-243 through 55 -254) for illustrations of the \ntransition requirements for an entity that applies the pending content that links to this paragraph in \naccordance with (c)(1) . \nEntities are required to adopt ASC 842 using a modified retrospective tra nsition method, as illustrated \nbelow. Full retrospective transition is prohibited. Upon the adoption of ASC 842, an entity applies the \nstandard’s transition provisions at one of the following application dates: \n• The later of (1) the beginning of the earlies t comparative period presented in the financial statements \nand (2) the commencement date of the lease \n• The beginning of the period of adoption ( i.e., on the effective date) \nThis choice affects only the timing of when an entity applies the transition provis ions. All entities are \nrequired to apply the same modified retrospective transition method to existing leases. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 398}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 387 An entity that applies the transition provisions at the beginning of the earliest comparative period records \nits cumulative adjustment to retaine d earnings at the beginning of the earliest period presented . As \nillustrated below, a calendar year -end entity that adopts the standard on 1 January 2019 and presents \nthree years of financial statements applies the transition provisions on 1 January 2017 ( i.e., the \nbeginning of the earliest comparative period presented). \nAn entity that applies the transition provisions at the beginning of the period of adoption records its \ncumulative adjustment to the opening balance of retained earnings in the period of ad option rather than in \nthe earliest period presented ( i.e., 1 January 2019 for a calendar year -end entity that adopts the standard \non that date). In this case, an entity continues to apply the legacy guidance in ASC 840, including its \ndisclosure requirement s, in the comparative periods presented in the year it adopts the standard. \nThe amount of each entity’s cumulative effect adjustment to retained earnings will depend on when the \nentity elects to apply the transitions provisions. Regardless of when an entit y applies the transition \nprovisions, entities are required to apply different recognition and measurement requirements in the \npost-adoption period to leases they entered into before the effective date and those they enter into after \nthe effective date . \n \n1 An entity that applies the transition provisions at the beginning of the period of adoption does not retrospectively adjust t he prior \nperiods presented. That is, it continues to apply ASC 840 in those periods. \n2 Public entities include public business enti ties and certain not -for-profit entities and employee benefit plans . \n3 Assumes two years of comparative financial statements are presented. For not -for-profit entities that have issued or are conduit \nbond obligor s for securities traded, listed or quoted on an exchange or over -the-counter market and that ha d not issued (or made \navailable for issuance) financial statements that reflect the new standard as of 3 June 2020 , the standard was effective for \nannual periods beginning after 15 December 2019 and interi m periods within those annual periods . The standard was effective \nfor all other entities for annual periods beginning after 15 December 2021 and interim periods within annual periods beginning \nafter 15 December 2022. \nLessees that make an accounting policy election (by class of underlying asset to which the right of use \nrelates) to apply the short -term lease election do not apply the lessee transition provisions discussed in \nsection 11.3, Lessee transition , to qualifying leases. Refer to section 4.1.1, Short -term leases , for a \ndiscussion of identifying a short -term lease. \nThe modified retrospective transition method generally results in an entity applying concepts from both \nASC 840 and ASC 842 to certain le ases that existed before the effective date. For example, a lessee that \nclassified a lease as an operating lease under ASC 840 will use its remaining minimum rental payments as \ndefined under ASC 840 and a discount rate determined at the later of the date o f initial application or the lease \ncommencement date to initially measure its lease liability and right -of-use asset (refer to section 11.3, Lessee \ntransition ). The lessee would continue to apply the transition accounting until certain lease modifications or \nremeasurement events occur following the effective date. As a result, an entity could be required to continue \napplying guidance from ASC 840 to certain existing leases after the effective date of ASC 842. \nSEC Staff Accounting Bulletin (SAB) Topic 11.M disclosures \n2021 \n 2019 \n 2018 \nEffective \n2016 \n 2017 \nModified \nretrospective \napplication \n(calendar -year \npublic entities )2 \nLeases standard issued and \nearly adoption permitted \n2020 \nModified \nretrospective \napplication \n(all other \ncalendar -year \nentities )3 \nPrior periods presented1 \nPrior periods presented \n2022 ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 399}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 388 Targeted improvements ( ASU 2018 -11) \nExcerpt from Accounting Standards Codification \nLeases — Overall \nTransition and Open Effective Date Information \n842-10-65-2 \nThe following represents the transition and effective date information related to Accounting Standards \nUpdate No. 2018 -11, Leases (Topic 842): Targeted Improvements: \na. An entity that has not yet adopted the pending content that links to paragraph 842 -10-65-1 shall \napply the pending content that links to paragraph 842 -10-65-2, by class of underlying asset, to \nall new and existing leases when the entity first applies the pending content that links to \nparagraph 842 -10-65-1 and shall apply the same transition method elected for the pending \ncontent that links to paragraph 842 -10-65-1. \nb. An entity that has adopted the pending content that links to paragraph 842 -10-65-1 shall apply \nthe pending content that links to this paragraph, by class of underlying asset, to all new and \nexisting leases either: \n1. In the first reporting period following the issuance of the pending content that links to \nparagra ph 842 -10-65-2 \n2. At the original effective date of this Topic for that entity as determined in paragraph 842 -10-\n65-1(a) and (b). \nc. An entity that has adopted the pending content that links to paragraph 842 -10-65-1 shall apply \nthe pending content that lin ks to this paragraph, by class of underlying asset, to all new and \nexisting leases either: \n1. Retrospectively to all prior periods beginning with the fiscal years in which the pending \ncontent that links to paragraph 842 -10-65-1 was initially applied \n2. Prospectively. \nASU 2018 -11, Targeted Improvements , provides a practical expedient that allows lessors to elect, by class of \nunderlying asset, to not separate lease and associated non -lease components if certain criteria are met (refer \nto section 1.4.2.4, Practical expedient to not separate lease and non -lease components — lessors ). ASC 842-\n10-65-2 provides the transition provisions for the guidance related to this lessor practical expedient. The \namendments apply to new and existing leases and have the same ef fective date and transition requirements \nas the new leases standard for entities that have not yet adopted the standard. Entities that early adopted the \nnew leases standard may apply the amendments in the first reporting period following the issuance of \nASU 2018 -11 or on the date they would have been required to adopt ASC 842. For example, a calendar -year \nend public business entity that early adopted the new leases standard could adopt these amendments in its \nfourth interim period ( i.e., the first reporting period following the issuance of ASU 2018 -11 in July 2018) or in \nthird interim period of 2018 if it applies it as of the entity’s original effective date of 1 January 2018). Entities \nthat early adopted the new leases standard may apply the amendments either retrospectively or prospectively. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 400}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 389 Narrow -scope i mprovements for lessors ( ASU 2018 -20) \nExcerpt from Accounting Standards Codification \nLeases — Overall \nTransition and Open Effective Date Information \nTransition Related to Accounting Standards Update No. 2018 -20, Leases (Topic 842): Narrow -\nScope Improvements for Lessors \n842-10-65-3 \nThe following represents the transition and effective date information related to Accounting Standards \nUpdate No. 2 018-20, Leases (Topic 842): Na rrow -Scope Improvements for Lessors : \na. An entity that has not yet adopted the pending content that links to paragraph 842-10-65-1 shall \napply the pending content that links to this paragraph to all new and existing leases when the \nentity first applies the pending content that links to paragraph 842 -10-65-1 and shall apply the \nsame transition method elected for the pending content that links to paragraph 842-10-65-1. \nb. An entity that has adopted the pending content that lin ks to paragraph 842 -10-65-1 before the \nissuance of the pending content that links to this paragraph shall adopt the pending content that \nlinks to this paragraph to all new and existing leases at the original effective date of this Topic for \nthat entity as determined in paragraph 842 -10-65-1(a) through (b). Alternatively, an entity that \nhas adopted the pending content that links to paragraph 842 -10-65-1 may adopt the pending \ncontent that links to this paragraph to all new and existing leases either: \n1. In the first reporting period ending after the issuance of the pending content that links to this \nparagraph \n2. In the first reporting period beginning after the issuance of the pending content that links to \nthis paragraph . \nc. An entity that has adopted the pe nding content that links to paragraph 842 -10-65-1 before the \nissuance of the pending content that links to this paragraph shall apply the pending content that \nlinks to this paragraph to all new and existing leases either: \n1. Retrospectively to all prior pe riods beginning with the fiscal years in which the pending \ncontent that links to paragraph 842 -10-65-1 was initially applied \n2. Prospectively. \nThe FASB issued ASU 2018 -20, Narrow -Scope Improvements for Lessors , which amended ASC 842 to \nallow lessors to ma ke an accounting policy election not to evaluate whether sales taxes and similar taxes \nimposed by a governmental authority on a specific lease revenue -producing transaction and collected by \nthe lessor from the lessee are the primary obligation of the lesso r as owner of the underlying leased \nasset. A lessor that makes this election must exclude from the consideration in the contract and from \nvariable payments not included in the consideration in the contract all taxes within the scope of the \nelection and mak e additional disclosures. The amendments also require a lessor to exclude lessor costs \npaid directly by a lessee to third parties on the lessor’s behalf from variable payments, but lessor costs \nthat are paid by the lessor and reimbursed by the lessee are required to be included in variable payments. \nRefer to section 1.4.4, Determining, allocating and reassessing the consideration in the contract — lessors , \nfor further d iscussion. \nThe amendments also clarify that when lessors allocate variable payments to lease and non -lease \ncomponents they are required to follow the recognition guidance in ASC 842 for the lease component and \nother applicable guidance, such as ASC 606, fo r the non -lease component. Refer to section 1.4.4.3, \nAllocating variable payments — lessors , for further discussion . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 401}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 390 The amendments in ASU 2018 -20 have the same effective date and transition requirements as the new \nleases standard for entities that have no t yet adopted the standard. Entities that early adopted the new \nleases standard can apply the amendments at the original effective date or , alternatively, either in the \nfirst reporting period ending after the amendments were issued or in the first reportin g period following \nthe issuance of the amendment. For example, because the amendments were issued in December 2018 , \na calendar -year end public business entity that early adopted the new leases standard could adopt these \namendments in its fourth interim per iod of 2018 or the first interim period of 2019 . Entities that early \nadopted the new leases standard may apply these amendments either retrospectively or prospectively. \nCodification Improvements ( ASU 2019 -01), Financial Instruments — Credit Losses (Topic 326), \nDerivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates (ASU 2019 -10); and \nRevenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for \nCertain Entities (ASU 2020 -05) \nExcerpt from Accounting Standards Codification \nLeases — Overall \nTransition and Open Effective Date Information \nTransition Related to Accounting Standards Update s No. 2019 -01, Leases (Topic 842): Codification \nImprovements , No. 2019 -10, Financial Instruments —Credit Loss es (Topic 326), Derivatives and \nHedging (Topic 815), and Leases (Topic 842): Effective Dates , and No. 2020 -05, Revenue from \nContracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities \n842-10-65-4 \nThe following represents the transition and effective date information related to Accounting Standards \nUpdate s No. 2019 -01, Leases (Topic 842): Codification Improvements , No. 2019 -10, Financial \nInstruments —Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): \nEffective Dates , and No. 2020 -05, Revenue from Contracts with Customers (Topic 606) and Leases \n(Topic 842): Effective Dates for Certain Entities : \na. All entities within the scope of paragraph 842 -10-65-1(a) shall apply the pending c ontent that \nlinks to this paragraph for financial statements issued for fiscal years beginning after December \n15, 2019, and interim periods within those fiscal years (with an exception for those entities that \nhave not yet issued their financial statements or made financial statements available for issuance \nas described in the following sentence). A not-for-profit entity that has issued or is a conduit \nbond obligor for securities that are traded, listed, or quoted on an exchange or an over -the-\ncounter market that has not yet issued financial statements or made financial statements \navailable for issuance as of June 3, 2020 shall apply the pending content that links to this \nparagraph for fiscal years beginning after December 15, 2019, and interim periods within those \nfiscal years. All other entities shall apply the pending content that links to this paragraph for \nfinancial statements issued for fiscal years beginning after December 15, 2021, and interim \nperiods within fiscal years beginning after December 15, 20 22. Earlier application is permitted. \nb. An entity shall apply the pending content that links to this paragraph as of the date that it first \napplied the pending content that links to paragraph 842 -10-65-1 and shall apply the same \ntransition method elected for the pending content that links to paragraph 842 -10-65-1 in \naccordance with paragraph 842 -10-65-1(c). \nCodification Improvements ( ASU 2019 -01) \nThe FASB issued ASU 2019 -01, Codification Improvements , which added guidance to ASC 842 that is \nsimilar to the guidance in ASC 840-10-55-44 and states that, for lessors that are not manufacturers or \ndealers , the fair value of the underlying asset is their cost, less any volume or trade discounts. However, ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 402}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 391 if there is a significant amount of time betw een the acquisition of the underlying asset and lease \ncommencement , a lessor would have to measure the fair value using the guidance in ASC 820. Refer to \nsection 2.8, Fair value, for further discussion. \nThe amendment s also clarified that lessors in the sco pe of ASC 942 must classify principal payments \nreceived from sales -type and direct financing leases in investing activities in the statement of cash flows. \nRefer to section 5.8, Presentation , for further discussion. \nThe amendments on the fair value excepti on and on the presentation on the statement of cash flows are \neffective for public business entities, certain not -for-profit entities and certain employee benefit plans for \nfiscal years beginning after 15 December 2019, and interim periods within those fis cal years. For all \nother entities, the amendments are effective for fiscal years beginning after 15 December 20 20, and \ninterim periods beginning after 15 December 202 1. Early adoption is permitted. The amendments are \napplied at the date that an entity firs t applied or applies ASC 842 and have the same transition \nrequirements as the new leases standard. \nRevenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for \nCertain Entities (ASU 2020 -05) \nThe FASB issued ASU 2020 -05, Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): \nEffective Dates for Certain Entities , that deferred the effective date of the new leases standard for \nprivate companies; not -for-profit entities that have issued or are conduit bond obligor s for securities \ntraded, listed or quoted on an exchange or over -the-counter market and that ha d not issued (or made \navailable for issuance) financial statements that reflect the new standard as of 3 June 2020; and other \nnot-for-profit entities that had not issued (or made available for issuance) financial statements that \nreflect the new standard as of 3 June 2020. \nNot-for-profit entities that have issued or are conduit bond obligors for securities traded, listed or quoted \non an exchange or over -the-counter market and that ha d not issued (or made available for issuance) \nfinancial statements that reflect the new standard as of 3 June 2020 were required to adopt the standard \nfor annual reporting periods beginning after 15 December 2019 and interim repo rting periods within \nthose annual reporting periods. Private companies and other not -for-profit entities that ha d not issued (or \nmade available for issuance) financial statements that reflect the new standard as of 3 June 2020 were \nrequired to adopt the ne w leases standard for annual reporting periods beginning after 15 December 2021 \nand interim reporting periods in annual reporting periods beginning after 15 December 2022. \nLessors — Certain Leases with Variable Lease Payments (ASU 2021 -05) \nExcerpt from Acc ounting Standards Codification \nLeases — Overall \nTransition and Open Effective Date Information \nTransition Related to Accounting Standards Update No. 2021 -05, Leases (Topic 842): Lessors —\nCertain Leases with Variable Lease Payments \n842-10-65-5 \nThe following represents the transition and effective date information related to Accounting Standards \nUpdate No. 2021 -05, Leases (Topic 842): Lessors —Certain Leases with Variable Lease Payments : \na. An entity that has not yet adopted the pending content that l inks to paragraph 842 -10-65-1 as of \nJuly 19, 2021, shall apply the pending content that links to this paragraph when it first applies \nthe pending content that links to paragraph 842 -10-65-1 and shall apply the same transition \nmethod elected for the pending content that links to paragraph 842 -10-65-1. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 403}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 392 b. An entity within the scope of paragraph 842 -10-65-1(a) that has adopted the pending content \nthat links to paragraph 842 -10-65-1 as of July 19, 2021, shall apply the pending content that \nlinks to this paragr aph for fiscal years beginning after December 15, 2021, and interim periods \nwithin those fiscal years. Earlier application is permitted. \nc. An entity within the scope of paragraph 842 -10-65-1(b) that has adopted the pending content \nthat links to paragraph 842 -10-65-1 as of July 19, 2021, shall apply the pending content that \nlinks to this paragraph for fiscal years beginning after December 15, 2021, and interim periods \nwithin fiscal years beginning after December 15, 2022. Earlier application is pe rmitted. \nd. An entity within the scope of (b) or (c) shall apply the pending content that links to this paragraph \nby using one of the following two methods: \n1. Retrospectively to the date in which the pending content that links to paragraph 842 -10-65-\n1 was adopted (the beginning of the period of adoption of Topic 842). Under this transition \nmethod, the entity shall apply the pending content that links to this paragraph to leases that \ncommence or are modified on or after the beginning of the period of its ad option of Topic \n842 and do not meet the conditions in paragraph 842 -10-25-8. \n2. Prospectively to leases that commence or are modified on or after the date that the entity \nfirst applies the pending content that links to this paragraph and do not meet the co nditions \nin paragraphs 842 -10-25-8. \nLessors that have adopted ASC 842 as of 19 July 2021 \nLessors that have adopted ASC 842 as of 19 July 2021, the date the amendments were issued, can \napply the amendments either retrospectively to leases that commenced or were modified on or after the \ndate of adoption of ASC 842 or prospectively to l eases that commence or are modified on o r after the \ndate the amendments are first applied. \nA lessor that applies the amendments retrospectively should apply the amendments to leases that \ncommenced or were modified on or after the date of adoption of ASC 842 and not on or after the date of \ninitia l application of ASC 842 ( e.g., a lessor that adopted ASC 842 on 1 January 2019 would apply the \namendments to leases that commenced or were modified on or after that date regardless of whether it \napplied ASC 842 as of the earliest period presented). \nFor le ssors that are (1) public business entities; (2) not -for-profit entities that have issued or are conduit \nbond obligors for securities that are traded, listed or quoted on an exchange or an over -the-counter \nmarket; or (3) employee benefit plans that file or furnish financial statements with or to the SEC, the \namendments are effective for annual reporting periods beginning after 15 December 2021 and interim \nperiods within these annual reporting periods. The guidance was effective for all other entities that h ave \nadopted ASC 842 as of 19 July 2021 for annual reporting periods beginning after 15 December 2021 \nand for interim periods within annual reporting periods beginning after 15 December 2022. Early \nadoption is permitted. \nWe believe a lessor may early adopt the amendments retrospectively in any period for which the financial \nstatements have not been issued. We also believe it would be acceptable for a lessor to early adopt the \namendments prospectively for (1) any leases that commenced or were modified (and th e modification is \nnot accounted for as a separate contract in accordance with paragraph 842 -10-25-8) on or after 19 July \n2021 or (2) any leases that commenced or were modified (and the modification is not accounted for as a \nseparate contract in accordance with paragraph 842 -10-25-8) on or after the beginning of any period for \nwhich the financial statements have not been issued ( e.g., 1 July 2021 for financial statements for the \ninterim period ending 30 September 2021). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 404}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 393 Lessors that have not adopted ASC 842 as of 19 July 2021 \nLessors that have not adopted ASC 842 as of 19 July 2021 are required to apply the amendments when \nthey adopt ASC 842 and follow the transition requirements in ASC 842. As a reminder, for these entities, \nASC 842 was effect ive for annual reporting periods beginning after 15 December 2021 and interim \nperiods in annual reporting periods beginning after 15 December 2022. \nDiscount Rate for Lessees That Are Not Public Business Enti ties (ASU 2021 -09) \nExcerpt from Accounting Standards Codification \nLeases — Overall \nTransition and Open Effective Date Information \nTransition Related to Accounting Standards Update No. 2021 -09, Leases (Topic 842): Discount \nRate for Lessees That Are Not Public Business Entities \n842-10-65-6 \nThe following repre sents the transition and effective date information related to Accounting Standards \nUpdate No. 2021 -09, Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities : \na. An entity that has not yet adopted the pending content that links to paragraph 842 -10-65-1 as of \n11/11/2021 shall apply the pending content that links to this paragraph to all new and existing \nleases when the entity first applies the pending content that links to paragraph 842 -10-65-1. \nThat entity shall apply the same transition method elected for the pending c ontent that links to \nparagraph 842 -10-65-1. \nb. An entity that has adopted the pending content that links to paragraph 842 -10-65-1 (as of \n11/11/ 2021 ) shall : \n1. Apply the pending content that links to this paragraph for financial statemen ts issued for \nfiscal years beginning after December 15, 2021, and interim periods within fiscal years \nbeginning after December 15, 2022. Earlier application is permitted as of the beginning of \nthe fiscal year of adoption. \n2. Apply the pending content that links to this parag raph on a modified retrospective basis to \nleases affected by the amendments existing as of the beginning of the fiscal year of adoption \nby adjusting the lease liability, which shall be calculated based on the discount rate and \nremaining lease term at the b eginning of the fiscal year of adoption. An entity shall \nrecognize the amount of the change in the lease liability as an adjustment to the \ncorresponding right -of-use asset, unless: \ni. The carrying amount of the right -of-use asset is reduced to zero, in whi ch case the entity \nshall recognize any remaining amount of the adjustment to opening retained earnings at \nthe beginning of the fiscal year of adoption. \nii. The adjustment would increase a right -of-use asset that was previously impaired, in \nwhich case the e ntity shall record the adjustment to opening retained earnings at the \nbeginning of the fiscal year of adoption. \nc. An entity within the scope of (b) shall not treat the adoption of the pending content that links to \nthis paragraph as an event that would req uire the entity to: \n1. Remeasure and reallocate the consideration in the contract in accordance with paragraph \n842-10-15-36. \n2. Reassess the lease term or a lessee option to purchase the underlying asset in accordance \nwith paragraph 842 -10-35-1. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 405}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 394 3. Remeasu re the lease payments in accordance with paragraph 842 -10-35-4. \n4. Reassess lease classification in accordance with paragraph 842 -10-25-1. \nFor an entity within the scope of (b), at the date of adoption of the pending content that links to this \nparagraph, the entity may choose to apply or discontinue using the risk -free rate for any class of \nunderlying asset. \nLessees that have not adopted ASC 842 as of 11 November 2021, the date the amendments were issued, are \nrequired to apply the amendments when they adopt ASC 842 and follow the transition requirements in ASC 842. \nLessees that have adopted ASC 842 as of 11 November 2021 are required to apply the amendme nts for \nannual periods beginning after 15 December 2021 and interim periods in annual periods beginning after \n15 December 2022. Early adoption is permitted . \nLessees that have adopted ASC 842 as of 11 November 2021 are required to apply the amendments on a \nmodified retrospective basis by adjusting the opening balances, as of the beginning of the year of \nadoption of ASU 2021 -09, of the affected lease liabilities and right -of-use assets for leases that e xisted \nat the beginning of the year of adoption. If the carrying amount of an ROU asset is reduced to zero, any \nremaining amount of the adjustment is recognized in opening retained earnings at the beginning of the \nfiscal year of adoption. The discount rate used in transition is determined based on the remaining lease \nterm at the beginning of the year of adoption. \nThe remeasurement of a lease liability that results from the initial application of the amendments is not \nconsidered an event that would require a lessee to remeasure and reallocate the consideration in the \ncontract (including lease payments) or reassess the lease term or classification. \nWhen they adopt the amendments, lessees that have already adopted ASC 842 also may choose to apply \nor discontinu e using the risk -free rate election for any class of underlying asset. For example, a lessee \nthat did not make the risk -free rate election when it adopted ASC 842 may make the election without \nevaluating the change in accounting policy under ASC 250, Accou nting Changes and Error Corrections . \nConversely, a lessee that made the risk -free rate election when it adopted ASC 842 may discontinue \nusing it for any class of underlying asset and instead use the incremental borrowing rate without \nevaluating the change in accounting policy under ASC 250. \nPractical expedient to use the written terms and conditions of an arrangement of a lease (ASU 2023 -01) \nExcerpt from Accounting Standards Codification \nLeases - Overall \nTransition and Open Effective Date Information \n842-10-65-7 \nThe following represents the transition and effective date information related to the practical \nexpedient in Accounting Standards Update No. 2023 -01, Leases (Topic 842): Common Control \nArrangements : \na. The pending content that links to this paragraph shall b e effective for fiscal years, including \ninterim periods within those fiscal years, beginning after December 15, 2023. Early adoption \nis permitted in any annual or interim period for which financial statements have not yet been \nmade available for issuance. If an entity adopts the pending content that links to this \nparagraph in an interim period, it shall adopt that pending content as of the beginning of the \nfiscal year that includes that interim period. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 406}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 395 b. An entity that adopts the pending content that links t o this paragraph concurrently with \nadopting the pending content that links to paragraph 842 -10-65-1 shall apply the pending \ncontent that links to this paragraph using the same transition method elected for the pending \ncontent that links to paragraph 842 -10-65-1. \nc. An entity that adopted the pending content that links to paragraph 842 -10-65-1 before \nadopting the pending content that links to this paragraph shall apply the pending content that \nlinks to this paragraph using either of the following two methods: \n1. Prospectively to arrangements that commence or are modified on or after the date that \nthe entity first applies the pending content that links to this paragraph. \n2. Retrospectively to the beginning of the period in which the pending content that links to \nparagraph 842 -10-65-1 was first applied. The pending content that links to this paragraph \nshall not be applicable for arrangements no longer in place at the date of adoption. Under \nthis transition method: \ni. If an arrangement previously considered to be a lease continues to be a lease after \napplying the pending content that links to this paragraph, an entity shall apply the \nrequirements in paragraphs 842 -10-25-9 through 25 -17 to any changes in the lease \nresulting from application of the practical expedient in th e pending content that links \nto this paragraph. Any amounts that otherwise would have been recognized in \nearnings shall be recognized as a cumulative -effect adjustment to opening retained \nearnings (or net assets of a not -for-profit entity) at the beginning of the earliest \nperiod presented in accordance with the pending content that links to paragraph 842 -\n10-65-1. \nii. If an arrangement previously not considered a lease becomes a lease after applying \nthe pending content that links to this paragraph, an entity s hall account for the \narrangement as a new lease. \nd. An entity may document any existing unwritten terms and conditions of an arrangement \nbetween entities under common control before the date on which the entity’s first interim (if \napplicable) or annual financial statements are available to be issued in accordance with the \npending content that links to this paragraph. \ne. An entity within the scope of (c) shall provide the applicable transition disclosures required by \nTopic 250 on accounting changes and erro r corrections, except for the requirements in \nparagraphs 250 -10-50-1(b)(2) and 250 -10-50-3. An entity that elects the transition method \nin (c)(2) shall provide the transition disclosures in paragraph 250 -10-50-1(b)(3) as of the \nbeginning of the earliest pe riod presented but not before the date on which the pending \ncontent that links to paragraph 842 -10-65-1 was adopted. \nf. An entity that elects the practical expedient(s) in paragraph 842 -10-65-1(f) or (g) is not \nrequired to apply either of those practical exp edients to common control arrangements for \nwhich the pending content that links to this paragraph is being applied. \nASU 2023 -01 is effective for all entities for fiscal years beginning after 15 December 2023, including \ninterim periods within those fiscal years. Early adoption is permitted for financial statements that have \nnot been made available for issuance in any interim or annual period as of the beginning of the related \nfiscal year. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 407}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 396 Entities that adopt ASU 2023 -01 concurrently with adopting ASC 842 are required to apply this portion of \nthe ASU using the same transition method used to adopt ASC 842. An entity that elects the “package of \npractical expedients”12 as part of adopting ASC 842 is not required to apply those expedients to common \ncontrol arran gements for which the entity elects to use the written terms and conditions to determine \nwhether a lease exists and to classify and account for the lease . \nEntities that adopt ASU 2023 -01 after they have adopted ASC 842 can apply this portion of the ASU \neither (1) prospectively to arrangements that commence or are modified on or after the date that the \nentity applies the new guidance or (2) retrospectively to the beginning of the period ASC 842 was first \napplied for arrangements that exist at the date of ado ption of this ASU. \nWhen electing this practical expedient, entities are permitted to document existing unwritten terms and \nconditions of common control arrangements before the date on which the entity’s first interim (if \napplicable) or annual financial st atements are available to be issued. \nIn the year of adoption, entities are required to provide certain transition disclosures under ASC 250 \nbased on the transition method elected. \nASC 842-10-65-7 does not provide guidance for a transition scenario when th e reporting entity 1) has \nalready adopted ASC 842, 2) elects to retrospectively apply the practical expedient to the beginning of \nthe period when ASC 842 was applied, and 3) has an arrangement that was previously a lease but is no \nlonger a lease after appl ying the practical expedient. In this scenario we believe that the derecognition \nguidance discussed in section 9. 1.1 should be applied. \nLessee amortization of l easehold improvements associated with a lease between entities under \ncommon control (ASU 2023 -01) \nExcerpt from Accounting Standards Codification \nLeases – Overall \nTransition and Open Effective Date Information \n842-10-65-8 \nThe following represents the transition and effective date information related to the accounting for \nleasehold improvements associated with leases between entities under common control in Accounting \nStandards Update No. 2023 -01, Leases (Topic 842): Common Control Arrangements : \na. The pending content that links to this paragraph shall be effective for fiscal years, including \ninterim periods within those fiscal years, beginning after December 15, 2023. Early adoption is \npermitted in any annual or interim period for which financial statements have not yet been made \navailable for issuance. If an entity adopts the pending content that links to this paragraph in an \ninterim period, it shall adopt that pending content as of the beginning of the fiscal year that \ninclud es that interim period. \nb. An entity that adopts the pending content that links to this paragraph concurrently with adopting \nthe pending content that links to paragraph 842 -10-65-1 may apply the pending content that links \nto this paragraph using the same tra nsition method elected for the pending content that links to \nparagraph 842 -10-65-1 or may apply the pending content that links to this paragraph using either \nof the prospective methods specified in (c)(1) and (c)(2) below. \n \n12 As part of adopting ASC 842, lessees and lessors are permitted to apply a package of practical expedients that allows them to not \nreassess the following for any expired or existing leases: whether contracts are or contain leases, lease classification and whether \ninitial direct costs qualify for capitalization. Entities are also permitted to use hindsight when determining lease term and \nassessing right -of-use assets for impairment (842 -10-65-1(f) through (g)). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 408}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 397 c. An entity that adopted the pending content that links to paragraph 842 -10-65-1 before adopting \nthe pending content that links to this paragraph shall apply the pending content that links to this \nparagraph using one of the following methods: \n1. Prospectively to all new leasehold improvements recognized on or after the date that the \nentity first applies the pending content that links to this paragraph. \n2. Prospectively to all new and existing leasehold improvements recognized on or after the date \nthat the entity first applies the pending content that links to this paragraph. An entity that elects \nthis transition approach shall amortize the remaining balance of leasehold improvements existing \nat the date of adoption of the pending content that links to this paragra ph over the remaining \nuseful life of those improvements to the common control group determined at that date. \n3. Retrospectively to the beginning of the period in which the pending content that links to \nparagraph 842 -10-65-1 was first applied. Any leasehold i mprovements previously amortized \nor impaired that otherwise would not have been amortized or impaired had the pending \ncontent that links to this paragraph been applicable shall be recognized through a cumulative -\neffect adjustment to the opening balance of retained earnings (or net assets of a not -for-profit \nentity) at the beginning of the earliest period presented in accordance with the pending \ncontent that links to paragraph 842 -10-65-1. \nd. An entity within the scope of (c) shall provide the applicable trans ition disclosures required by \nTopic 250 on accounting changes and error corrections, except for the requirements in \nparagraphs 250 -10-50-1(b)(2) and 250 -10-50-3. An entity that elects the transition method in \n(c)(3) shall provide the transition disclosures in paragraph 250 -10-50-1(b)(3) as of the beginning \nof the earliest period presented but not before the date on which the pending content that links to \nparagraph 842 -10-65-1 was adopted. \nASU 2023 -01 is effective for all entities for fiscal years beginning after 15 December 2023, including \ninterim periods within those fiscal years. Early adoption is permitted for finan cial statements that \nhave not been made available for issuance in any interim or annual period as of the beginning of the related \nfiscal yea r. \nEntities that adopt this ASU concurrently with adopting ASC 842 may apply this portion of the ASU using \nthe same transition method used to adopt ASC 842, or they may apply one of the prospective methods \ndescribed below. \nEntities that adopt ASU 2023 -01 after adopting ASC 842 may apply this portion of the ASU using one of \nthe following methods: \n• Prospectively to all new leasehold improvements recognized on or after the date an entity first \napplies the new guidance \n• Prospectively to all new and existing leasehold improvements recognized on or after the date an \nentity first applies new guidance, with the remaining balance of existing leasehold improvements \namortized over their remaining useful life to the common contro l group (i.e., in a manner similar to a \nchange in accounting estimate) \n• Retrospectively to the beginning of the period in which ASC 842 was first applied , with any leasehold \nimprovement amortization or impairment that would not have been required by this AS U recognized \nthrough a cumulative -effect adjustment to opening retained earnings (or net assets of a not -for-profit \nentity) at the beginning of the earliest period presented \nIn the year of adoption, lessees are required to provide certain transition discl osures under ASC 250 \nbased on the transition method elected. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 409}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 398 11.2.1 SEC reporting considerations (updated August 2023) \nRegistration statements in the year of adoption \nThe SEC staff has indicated that the date of initial application for purposes of the new leases standard \nwould not change if a registrant is required to provide financial statements for earlier periods when issuing \nretrospectively revised financial statements for a registration statement filed in the year of adoption.13 For \nexample, assume an entity adopts ASC 842 effective 1 January 2019, applies the transition provisions at the \nbeginning of the earliest comparative period presented ( i.e., 1 January 2017) and files its Form 10-Q for the \nfirst quarter in April 2019. That entity then files a new registration statement in May 2019 that includes the \nfinancial statements for the years ended 31 December 2016, 2017 and 2018. The SEC staff clarifie d that the \nentity would not be required to adjust its date of initial application to 1 January 2016 as a result of reissuing \nits 2016 financial statements in a new registration statement following adoption of the new guidance. \nWe believe an entity that applies the transition provisions at the beginning of the period of adoption \n(i.e., 1 January 2019) also would not be required to adjust its date of initial application to 1 January 2016. \nEffective date for certain PBEs \nExcerpt from Accounting Standards Codification \nLeases — Overall \nTransition and Open Effective Date Information \nSEC Staff Guidance \nSEC Staff Announcement: Transition Related to Accounting Standards Updates No. 2014 -09 and \n2016 -02 \n842-10-S65-1 \nThe following is the text of SEC Staff Announcement: Transition Related to Accounting Standards \nUpdates No. 2014 -09 and 2016 -02. \nFASB Accounting Standards Updates No. 2014 -09, Revenue from Contracts with Customers (Topic \n606) , issued in May 2014 and codified in ASC Topic 606, Revenue from Contracts with Customers, \nand No. 2016 -02, Leases (Topic 842) , issued in February 2016 and codi fied in ASC Topic 842, Leases, \nprovide effective dates that differ for (1) public business entities and certain other specified entities \nand (2) all other entities. The SEC staff has received inquiries from stakeholders regarding the application \nof the eff ective dates of ASC Topic 606 and ASC Topic 842 for a public business entityFN1 that otherwise \nwould not meet the definition of a public business entity except for a requirement to include or the \ninclusion of its financial statements or financial informati on in another entity’s filing with the SEC. \nThe transition provisions in ASC Topic 606 require that a public business entity and certain other \nspecified entities adopt ASC Topic 606 for annual reporting periods beginning after December 15, \n2017, including interim reporting periods within that reporting period. FN2 All other entities are \nrequired to adopt ASC Topic 606 for annual reporting periods beginning after December 15, 2018, \nand interim reporting periods within annual reporting periods beginning after December 15, 2019. \nThe transition provisions in ASC Topic 842 require that a public business entity and certain other specified \nentities adopt ASC Topic 842 for fiscal years beginning after December 15, 2018, and interim periods within \nthose fiscal years. FN3 All other entities are required to adopt ASC Topic 842 for fiscal years beginning after \nDecember 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. \n \n13 SEC Division of Corporation Finance Financial Reporting Manual, Section 11210.1. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 410}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 399 In response to the stakeholder inquiries outlined above, the SEC staf f would not object to a public \nbusiness entity that otherwise would not meet the definition of a public business entity except for a \nrequirement to include or the inclusion of its financial statements or financial information in another \nentity’s filing wit h the SEC adopting (1) ASC Topic 606 for annual reporting periods beginning after \nDecember 15, 2018, and interim reporting periods within annual reporting periods beginning after \nDecember 15, 2019, and (2) ASC Topic 842 for fiscal years beginning after Dec ember 15, 2019, and \ninterim periods within fiscal years beginning after December 15, 2020. \nA public business entity that otherwise would not meet the definition of a public business entity except \nfor a requirement to include or the inclusion of its financi al statements or financial information in \nanother entity’s filing with the SEC may still elect to adopt ASC Topic 606 and ASC Topic 842 \naccording to the public business entity effective dates outlined above. \nThis announcement is applicable only to public b usiness entities that otherwise would not meet the \ndefinition of a public business entity except for a requirement to include or the inclusion of its financial \nstatements or financial information in another entity’s filing with the SEC. This announcement i s not \napplicable to other public business entities. \nFN 1 The definition of Public Business Entity in the FASB’s ASC Master Glossary states, in part, the following: \n A public business entity is a business entity meeting any one of the criteria below ... \na. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish \nfinancial statements, or does file or furnish financial statements (including voluntary filers), \nwith the SEC (including other entities whose financial statements or financial information are \nrequired to be or are included in a filing) … \n An entity may meet the definition of a public business entity solely because its financial \nstatements or financial information is included in another entity’s filing with the SEC. In that \ncase, the entity is only a public business entity for purposes of financial statements that are \nfiled or furnished with the SEC. \nFN 2 Early adoption of ASC Topic 606 is permitted for public business entities and certain other \nspecified entities only as of annual reporting periods beginning after December 15, 2016, including \ninterim reporting periods within that reporting period. \nFN 3 Early adoption of ASC Topic 842 is permitted for public business entities and certain other \nspecified entities, as well as for all other entities. \nPursuant to ASC 842-10-S65-1, the SEC staff would not object if entities that meet the definition of a \nPBE only because their financial statements or financial information are included in another entity’s SEC \nfiling adopt the n ew leases standard using the effective date for nonpublic entities ( refer to section 11.1, \nEffective date ) rather than the effective date for public entities. \nThis relief generally would apply to PBEs whose financial statements or summarized financial inf ormation \nis included in a registrant’s filling under: \n• Rule 3 -05 of Regulation S -X, Financial statements of businesses acquired or to be acquired \n• Rule 3 -14 of Regulation S -X, Special instructions for financial statements of real estate operations \nacquired or to be acquired ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 411}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 400 • Rule 3 -09 of Regulation S -X, Separate financial statements of subsidiaries not consolidated and 50 \npercent or less owned persons \n• Rule 4 -08(g) of Regulation S -X, Summarized financial information of subsidiar ies not consolidated \nand 50 percent or less owned persons \nThe relief also generally would apply to PBEs that present summarized income statement information \nunder Rule 10 -01(b)(1) of Regulation S -X and to smaller reporting companies that present other entity \nfinancial statements and financial information under Article 8 of Regulation S -X. \nEmerging growth companies \nAn entity that qualifies as an emerging growth company ( EGC) may ele ct to adopt new or revised \naccounting standards (e.g., ASC 842) under the extended transition period available to nonpublic entities , \nas long as its EGC status is maintained. \nHowever, if a registrant loses its EGC status, the registrant is required to ado pt the standard in its next \nfiling. In these cases, the SEC staff does not expect the registrant to revise its previously issued annual \nfinancial statements for an earlier adoption date ( i.e., the public entity effective date). The registrant \nwould apply t he transition provisions of the standard as of the beginning of the year in which the \nregistrant lost its EGC status. \nFor example, if a calendar -year EGC completed its IPO in January 2020 and used the relief to defer adopting \nthe new leases standard ( ASC 842) until the effective date for private companies ( i.e., annual period \nbeginning on 1 January 2022 and interim periods within the annual period beginning on 1 January 2023 for \ncalendar -year entities) but lost its EGC status on 31 December 2021, either be cause it exceeded $1.07 billion \nin annual revenues in 2021 or because its public float as of 30 June 2021 (the last business day of its second \nquarter) exceeded $700 million, it would be required to adopt the new leases standard in its 2021 Form 10 -K. \n \nQuestion 11 -1 Should a non -EGC apply the public entity effective date when filing an IPO regi stration statement? \n(added August 2023) \nYes, t he non -EGC should apply the public entity effective date (i.e., 1 January 20 19 for a calendar year -\nend entity ) when including financial statements in an IPO registration statement. At a July 2020 CAQ \nSEC Regulations Committee joint meeting with the SEC staff, the SEC staff indicated its view that “an IPO \nregistration statement of a non -EGC should apply the PBE adop tion dates for all standards that apply the \nPBE definition, including Topic 842. However, if an entity believes it has a reasonable basis to support an \nalternative conclusion under GAAP and SEC rules and regulations, the staff is available for consultation .” \nFor example, if a calendar year -end non -EGC initially adopted ASC 842 as of 1 January 202 2 (i.e., non -\npublic entity adoption date), the financial statements included in its IPO registration statement should be \nupdated to reflect the adopti on of ASC 842 as of 1 January 2019. The entity should also reflect the \neffects of ASC 842 in all periods presented from that date. \nRefer to Question 11 -2 for guidance on the effective date of ASC 842 for an EGC that loses its status \nafter its IPO. \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 412}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 401 11.2.2 Transition practical expedients \nExcerpt from Accounting Standards Codification \nLeases — Overall \nTransition and Open Effective Date Information \n842-10-65-1 \nf. An entity may elect the following practical expedients, which must be elected as a package and \napplied consistently by an entity to all of its leases (including those for which the entity is a lessee \nor a lessor ), when applying the pending content that lin ks to this paragraph to leases that \ncommenced before the effective date: \n1. An entity need not reassess whether any expired or existing contracts are or contain leases . \n2. An entity need not reassess the lease classification for any expired or existing lea ses ( for \nexample , all existing leases that were classified as operating leases in accordance with \nTopic 840 will be classified as operating leases, and all existing leases that were classified as \ncapital leases in accordance with Topic 840 will be classifi ed as finance leases ). \n3. An entity need not reassess initial direct costs for any existing leases. \ng. An entity also may elect a practical expedient, which must be applied consistently by an entity to \nall of its leases (including those for which the entit y is a lessee or a lessor) to use hindsight in \ndetermining the lease term (that is, when considering lessee options to extend or terminate the \nlease and to purchase the underlying asset ) and in assessing impairment of the entity’s right -of-\nuse assets . This practical expedient may be elected separately or in conjunction with either one \nor both of the practical expedients in (f) and (gg). \ngg. An entity also may elect a practical expedient to not assess whether existing or expired land \neasements that were not previously accounted for as leases under Topic 840 are or contain a lease \nunder this Topic. For purposes of (gg), a land easement (also commonly referred to as a right of way) \nrefers to a right to use, access, or cross another entity’s land for a specified purpose. This practical \nexpedient shall be applied consistently by an entity to all its existing and expired land easements that \nwere not previously accounted for as leases under Topic 840. This practical expedient may be elected \nseparately or in conjunct ion with either one or both of the practical expedients in (f) and (g). An entity \nthat elects this practical expedient for existing or expired land easements shall apply the pending \ncontent that links to this paragraph to land easements entered into (or mo dified) on or after the date \nthat the entity first applies the pending content that links to this paragraph as described in (a) and (b). \nAn entity that previously accounted for existing or expired land easements as leases under Topic 840 \nshall not be eligi ble for this practical expedient for those land easements. \nThe package of practical expedients \nLessees and lessors are permitted to make an election to apply a package of practical expedients that \nallow them not to reassess: \n1. Whether any expired or existing contracts are or contain leases. Because ASC 840’s accounting for \noperating leases and service contracts is similar, entities may not have always focused on determining \nwhether an arrangement is or contains a lease or is a s ervice contract. Some entities may need to revisit \nassessments made under ASC 840 because, under ASC 842, most operating leases are recognized \non lessees’ balance sheets, and the effects of accounting for an arrangement as a service instead of \na lease may be material. The FASB noted in the Basis for Conclusions (BC 393 (a)) of ASU 2016 -02 \nthat the practic al expedient that permits entities not to reassess whether any expired or existing \ncontracts contain leases does not grandfather incorrect assessments made under ASC 840 ( i.e., the \npractical expedient applies only to arrangements that were appropriately as sessed under ASC 840). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 413}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 402 2. Lease classification for any expired or existing leases. \n3. Initial direct costs for any expired or existing leases ( i.e., whether those costs qualify for \ncapitalization under ASC 842). \nThese three practical expedients must be ele cted as a package and must be consistently applied to all leases. \nAn entity cannot choose which of the individual practical expedients to apply or which leases to apply them \nto (i.e., an entity must apply all three of these practical expedients to all leas es or apply none of them). \nThe hindsight practical expedient \nEntities are also permitted to make an election to use hindsight when determining lease term ( i.e., evaluating \na lessee’s option to renew or terminate the lease or to purchase the underlying asse t) and assessing \nimpairment of right -of-use assets (lessees only). \nEntities would consider all facts and circumstances that have changed, through the effective date, in \napplying hindsight. However, entities would not consider events that occurred after the effective date, but \nprior to the first time it issues its financial statements reflecting the adoption of ASC 842 ( i.e., hindsight \nonly extends to the effective date). The hindsight practical expedient may be elected separately or in \nconjunction with the package of practical expedients described above. An entity must apply this practical \nexpedient to all leases or apply it to none of them. \nEntities that apply the transition provisions as of the beginning of the earliest comparative period presented \nwould n ot apply the hindsight practical expedient to contract modifications that occur between the \nbeginning of the earliest comparative period presented and the effective date. For example, if between \nthe beginning of the earliest comparative period presented an d the effective date an entity modifies a \nlease to extend the term and the original lease did not include a renewal option, the entity would not \nadjust its lease term at the beginning of the earliest comparative period presented and would instead \naccount f or the lease modification when it occurs. \nIf the entity does not elect to apply the package of practical expedients, the assessment of lease \nclassification could be affected by a change in lease term if the entity elects to apply the hindsight practical \nexpedient. The use of the hindsight practical expedient only impacts lease classification if the package of \npractical expedients is not elected. \nIf an entity elects to apply the hindsight practical expedient, the revised lease term determines whether \nthe entity can apply short -term lease accounting to that lease if the policy election is made for the class \nof underlying asset to which the lease rel ates. If, as a result of applying hindsight, the entity concludes \nthe lease term is more than 12 months, the lessee would not apply short -term lease accounting. Lessees \ndetermine whether the lease qualifies as short -term at the commencement date (refer to section 4.1.1, \nShort -term leases ). That is, during transition, the remaining term on the date that the entity appl ies the \ntransition provisions does not determine the applicability of the expedient . For example, if the term of the \nlease was greater than 12 months at the commencement date but has less than 12 months remaining at \nthe date the entity applies the modified retrospective provisions ( e.g., 1 January 2019 for a calendar -\nyear public business entity or 1 January 2022 for a calendar -year non -public business entity that elects \nto apply the transition provisions as of the beginning of the year of adoption), the lease would not qualify \nas short -term. \nEasements practical expedient \nThe FASB issued a final ASU to provide an optional transition practical expedient that permits an entity to \ncontinue applying its ASC 840 policy for accounting for land easements that existed as of, or expired \nbefore, the effective date of ASC 842. An entity that elects th e practical expedient will apply it to all of its \nexisting or expired land easements that were not previously accounted for under legacy lease guidance. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 414}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 403 Entities that elect the practical expedient will still need to evaluate whether land easements entered into or \nmodified on or after the effective date meet the definition of a lease under ASC 842. The final ASU also \nclarifies that for all land easements not subject to the optional practical expedient, an entity will evaluate \nwhether land easements a re leases under ASC 842 before applying the intangible assets guidance in \nASC 350-30. The effective date and transition requirements are the same as those for ASC 842 (refer to \nsection 11.1, Effective date ). \n11.2.3 Reassessment of lease classification \nAn e ntity that does not elect to apply the package of practical expedients does the following as of the \nlease commencement date (or most recent modification that does not result in a separate new lease): \n• Reassesses lease classification by applying all of the g uidance in ASC 842 relevant to determining \nlease classification (refer to section 3, Lease classification ). \n• Applies the relevant transition provisions based on the lease classification under ASC 840 and \nASC 842. This may require the entity to apply concept s from both ASC 840 and ASC 842 (refer to \nsections 11.3, Lessee transition, and 11.4, Lessor transition ). \nThe discount rate used to determine lease classification may differ from the rate used to measure the \nlease liability for leases previously classified as operating leases, depending on the approach used by the \nentity ( i.e., the lessee may elect to determine the discount rate based on the remaining lease term from \nthe date of initial application or the full lease term). Refer to section 11.3.3b, Discount rates — leases \npreviously classified as operating leases under ASC 840 — lessee . \nAn entity may separately elect to apply the hindsight practical expedient to all leases (refer to section 11.2.2, \nTransition practical expedients) . If, as a result of applyin g hindsight the entity concludes the lease term \nshould change, the entity uses the revised lease term to reassess lease classification and for initial and \nsubsequent measurement. \n11.2.4 Impairment of right -of-use assets prior to the effective date \nQuestio ns have been raised about whether the lessee should reevaluate the asset group that includes the \noperating lease for impairment. At a November 2016 Board meeting, the Board stated that a right -of-use \nasset related to an operating lease need not be evaluate d for impairment under ASC 360-10 until the \neffective date of ASC 842, even though a right -of-use asset may be recognized on the beginning of the \nearliest period presented if that entity applies the transition provisions as of the beginning of the earliest \ncomparative period presented . As a result, lessees that apply the transition provisions as of the beginning \nof the earliest period presented should not reassess the measurement and allocation of impairment losses \nrecognized prior to the effective date when a right -of-use asset is recognized upon the adoption of ASC 842 \n(i.e., the amount of loss recognized within an asset group and the loss allocated to individual long -lived \nassets within the group would not change as a result of adopting ASC 842, e ven if the loss occurred after \nthe date of initial application and before the effective date). The FASB indicated that it intended to limit the \nneed for dual record -keeping during the transition period ( i.e., prior to the effective date). \nImpairment indica tors exist at the effective date \nRegardless of the date the entity first applies ASC 842, a t the effective date, a lessee’s right -of-use \nassets are subject to the impairment guidance in ASC 360-10. \nASC 360-10 requires an analysis of impairment indicators a t each reporting period for assets held for \nuse. The testing for and evaluation of impairment of a long -lived asset is performed at the asset or asset -\ngroup level depending on the facts and circumstances. If any indicators of impairment are present, a \nreco verability test using entity -specific undiscounted cash flows is performed. If the asset or asset group \nfails the recoverability test, ASC 360-10 requires a fair value test. Under ASC 842, if an impairment loss ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 415}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 404 is recognized for a right -of-use asset, the a djusted carrying amount of a right -of-use asset would be its \nnew accounting basis. Consistent with ASC 360-10, the testing for and evaluation of impairment for \nright -of-use assets often will be performed at an asset -group level with any impairment allocate d among \nthe long-lived assets . For guidance on testing a lessee’s right -of-use assets in operating and finance \nleases for impairment in accordance with ASC 360-10, refer to section 4.2.5, Impairment of right -of-use \nassets in operating leases , and 4.3.4, Impairment of right -of-use assets in finance leases , respectively. \nFor entities that elect to apply ASC 842’s transition provisions at the beginning of the period of adoption \n(e.g., 1 January 2019 for a calendar -year public business entity or 1 January 20 22 for a calendar -year \nnon-public business entity), if an indicator of impairment exists at the effective date and that indicator \nexisted immediately prior to the effective date, we believe that any resulting impairment loss recognized \nfor a newly recogniz ed right -of-use asset at transition can be recorded as an adjustment to equity or to \nprofit and loss at the beginning of the period of adoption . \nFor entities that elect to apply the transition provisions at the beginning of the earliest comparative \nperiod presented, if an indicator of impairment exists at the effective date and that indicator existed \nimmediately prior to the effective da te, we believe any resulting impairment loss recognized should be \nrecorded to profit and loss on the effective date ( e.g., 1 January 2019 for a calendar -year public \nbusiness entity or 1 January 2022 for a calendar -year non -public business entity). We believe this view is \nconsistent with the view expressed by the Board at the November 2016 Board meeting that lessees that \napply the transition provisions as of the beginning of the earliest period presented should not reassess \nthe measurement and allocation of impairment losses recognized prior to the effective date when a right -\nof-use asset is recognized upon the adoption of ASC 842. \nPreviously measured but unrecognized impairments \nUnder ASC 360-10, an impairment loss is measured as the amount by which the carrying amount of a n \nasset group exceeds its fair value. An asset group includes long -lived assets and may include other asse ts \nand liabilities such as inventory and accounts payable. Although other assets and liabilities may be \nincluded in an asset group, the impairment loss for an asset group must reduce only the carrying \namounts of the long -lived assets of the group. Also, the carrying amount of an individual long -lived asset \nmay not be reduced below its fair value. As a result, additional impairments may have been measured but \nnot recognized in the periods prior to the effective date of ASC 842. \nIn situations where an asset group would have included one or more right -of-use assets that were not \nrecognized under ASC 840, questions have arisen regarding whether a lessee would be permitted to push \nback a previously unrecognized impairment relating to a right -of-use asset to a period before the effective \ndate of ASC 842 if the condition or event giving rise to the impairment occurred before the effective date. \nThe FASB staff, through a technical inquiry, indicated that upon the adoption of ASC 842, an entity is \npermitted, but not required, to recognize the previously unrecogni zed impairment of a right -of-use asset \nin the period in which the impairment occurred. Th e impairment recognized would be limited to the lower \nof the following amounts : \n• The amount of any previously incurred but unrecognized impairments within the asset group that \nincludes the right -of-use asset \n• The amount of the right -of-use asset recognized at initial measurement (that is, for entities applying \nthe transition provisions at the begi nning of the period of adoption, the amount of the right -of-use \nasset recognized at the beginning of the period of adoption or for entities applying the transition \nprovisions at the beginning of the earliest comparative period presented, the amount of the right -of-\nuse asset recognized at the later of (1) the beginning of the earliest period presented and (2) the \ncommencement date of the lease ) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 416}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 405 For entities that elect to apply ASC 842’s transition provisions at the beginning of the period of adoption \n(i.e., the effective date), we believe this guidance generally only applies if no indicator of impairment \ncontinues to exist at the effective date. In that case, the previously unrecognized impairment should be \nrecorded as an adjustment to equity. \nFor entities th at elect to apply the transition provisions at the beginning of the earliest comparative \nperiod presented, the previously unrecognized impairment recognized should be recorded in profit or \nloss in the comparative period in which the impairment loss occurred. If the impairment loss occurred \nprior to the earliest period presented, the impairment recognized should be recorded as an adjustment to \nequity as of the beginning of the earliest period presented. \nA lessee would reduce only the carrying amount o f the newly recognized right -of-use assets in the asset \ngroup and would not reallocate the impairment recognized among the other long -lived assets in the asset \ngroup because the carrying amounts of the long -lived assets in the asset group would have been \nimpaired to the lowest allowable amount. \n11.2.4.1 Exit or disposal cost obligations under ASC 420 (‘cease -use‘ liabilities) \nThe new leases standard amended ASC 420 to exclude costs t o terminate a contract that is a lease from \nthe scope of ASC 420. Upon the adoption of ASC 842, guidance for accounting for terminations of all \nleases is included in ASC 842. \nPrior to adopting ASC 842, a lessee may have ceased using the rights conveyed by an operating lease and \nrecognized a liability in accordance with ASC 420. In this case, ASC 842’s transition provisions require the \nlessee to adjust the initial measurement of the right -of-use asset related to such an operating lease by the \ncarrying amount of an associated liability recognized in accordance with ASC 420. This gu idance applies \nregardless of whether the lease, previously classified as an operating lease under ASC 840, is classified as \nan operating or finance lease under ASC 842 (refer to section 11.3.3, Leases previously classified as \noperating leases under ASC 840 that are classified as operating leases under ASC 842 — lessee , and \nsection 11.3.3a, Leases previously classified as operating leases under ASC 840 that are classified as \nfinance leases under ASC 842 — lessee, for further guidance). However, for a lease p reviously classified as \nan operating lease under ASC 840 that is classified as an operating lease under ASC 842, the lessee \nsubsequently measures the right -of-use asset (after adjusting for the carrying amount of the ASC 420 \nliability) as if it had been impaired (refer to section 4.2.5.4, Accounting for an operating lease after an \nimpairment of right -of-use asse t (single lease cost) ). As a result, the expense recognized following the \nadoption of ASC 842 includes amortization of the right -of-use asset, generally on a straight -line basis, as \nwell as accretion of the lease liability, similar to the expense recognize d for a finance lease. \nWhen an entity ceased using the right conveyed by an operating lease contract within the scope of \nASC 420, the entity was required to recognize a liability at fair value for costs that would continue to be \nincurred under a contract f or its remaining term without economic benefit to the entity. In this case, \nASC 420 required the fair value at the cease -use date to be determined based on remaining lease \nrentals, adjusted for the effects of any prepaid or deferred items recognized under the lease, and \nreduced by estimated sublease rentals that could be reasonably obtained for the property, even if the \nentity did not intend to enter into a sublease. Therefore, under ASC 420 a lessee may have ceased using \nthe rights conveyed by an operating lease by abandoning the underlying asset or subleasing it. \nBecause the new leases standard amends ASC 420 to exclude costs to terminate a contract that is a lease \nfrom the scope of ASC 420, the concept of “cease -use liabilities ” for leases will no longer exist once an \nentity adopts ASC 842. Instead, the guidance in ASC 842 requires lessees evaluate operating and finance \nleases for impairment in accordance with ASC 360-10-35. If a lessee subleases an underlying asset, we \nbelieve the right -of-use asset shoul d be evaluated as held and used in accordance with ASC 360-10 because \nASC 842-10-15-17 states that economic benefits from using an asset includes subleasing the asset. That ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 417}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 406 is, we believe an asset that is subleased is held and used and has not been abandon ed by the sublessor. \nRefer to section 4.8.10 , Exit or disposal cost obligations under ASC 420 ( ‘cease -use’ liabilities) , for further \ndiscussion of how a lessee may evaluate exit or disposal cost obligations following the adoption of ASC 842. \nIn accordance with ASC 360-10, a long -lived asset to be disposed of by abandonment is considered held \nand used until the long -lived asset is abandoned. Because a decision to abandon a long -lived asset before the \nend of the lease term is akin to a decision to dispose of a long -lived asset before the initially intended date, \nthe decision to abandon the asset would be viewed as an indicator of impairment for a held and used long -\nlived asset. However, as noted in section 11.2.4, Impairment of right -of-use asset s prior to the effective \ndate, lessees that apply the transition provisions as of the beginning of the earliest period presented should \nnot reassess the measurement and allocation of previously recognized impairment losses that were recognized \nprior to the effective date when a right -of-use asset is recognized upon the adoption of ASC 842. A lessee \nthat commits to a plan to abandon a right -of-use asset in the future but before the end of the lease term \nshould update its estimate of the useful life of any re maining recognized right -of-use asset. As a reminder, \nwe believe an asset that is subleased is held and used and has not been abandoned by the sublessor. \nLessee elects to apply ASC 842’s transition provisions at the beginning of the period of adoption — \ncease use occurred prior to the beginning of the period of adoption \nIf a lessee elect s to apply ASC 842’s transition provisions at the beginning of the period of adoption \n(i.e., the effective date) , it initially measures the right -of-use asset for an existin g operating lease at the \nbeginning of the period of adoption, adjusting for the carrying amount of an associated liability \nrecognized in accordance with ASC 420 at that date. Unless the lessee elect s to use hindsight practical \nexpedient , the lessee would n ot adjust its lease term at the beginning of the period of adoption. \nHowever, if the lessee ceased using the rights conveyed by an operating lease by subleasing the \nunderlying asset and the asset continues to be subleased at the beginning of the period of adoption, we \nbelieve the lessee should consider whether any impairment indicators exist at the effective date and \nshould update its estimate of the useful life of any remaining recognized right -of-use asset in accordance \nwith ASC 360-10 unless the lessee continues to sublease the asset through the remaining lease term . If \nthe lessee ceased using the rights conveyed by an operating lease by abandoning the underlying asset \nbefore the beginning of the period of adoption, the remaining usefu l life of the right -of-use asset is zero. \nTherefore, if the abandoned right -of-use asset is measured at an amount greater than zero after applying \nthe transition guidance, we believe the carrying amount of the right -of-use asset should be reduced to \nzero a s of the effective date with an adjustment recorded to equity. \nLessee elects to apply ASC 842’s transition provisions at the beginning of the earliest comparative period \npresented — cease use occurred prior to the beginning of the earliest comparative peri od presented \nIf a lessee elects to apply ASC 842’s transition provisions at the beginning of the earliest comparative \nperiod presented , it initially measures its right -of-use asset for an existing operating lease at the later of \n(1) the beginning of the ea rliest comparative period presented or (2) the commencement date of the \nlease (prior to the effective date). Therefore, if a lessee ceased using the rights conveyed by an operating \nlease prior to the beginning of the earliest comparative period presented, it initially measures the right -\nof-use asset for an existing operating lease at the beginning of the earliest comparative period \npresented, adjusting for the carrying amount of an associated liability recognized in accordance with \nASC 420 at that date. Unl ess the lessee elect s to use hindsight practical expedient , the lessee would not \nadjust its lease term at the beginning of the earliest comparative period presented . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 418}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 407 However, if the lessee ceased using the rights conveyed by an operating lease by subleasin g the underlying \nasset and the asset continued to be subleased at the beginning of the earliest comparative period \npresented, we believe the lessee should update its estimate of the useful life of any remaining recognized \nright -of-use asset in accordance w ith the guidance in ASC 360-10 for long -lived assets that are held and \nused unless the lessee continued to sublease the asset through the remaining lease term . If the lessee \nceased using the rights conveyed by an operating lease by abandoning the underlyin g asset before the \nbeginning of the earliest comparative period presented, the remaining useful life of the right -of-use asset \nis zero. Therefore, if the abandoned right -of-use asset is measured at an amount greater than zero after \napplying the transition guidance, we believe the carrying amount of the right -of-use asset should be \nreduced to zero as of the beginning of the earliest period presented with an adjustment recorded to equity. \nLessee elects to apply ASC 842’s transition provisions at the beginning of the earliest comparative \nperiod presented — lease commenced prior to the beginning of the earliest comparative period \npresented and the cease use occurred after the beginning of the earliest comparative period \npresented and before the effective date \nIf an existing operating lease commenced prior to the beginning of the earliest comparative period \npresented, and the lessee ceased using the rights conveyed by an operating lease after the beginning of \nthe earliest comparative period presented and before the effective date, the lessee should reverse the \naccounting entries that were recorded during the comparative periods for the ASC 420 cease -use liability. \nIn this case, the lessee should initially measure its right -of-use asset at the beginning of the earliest \ncomparative period presented and subsequently account for the right -of-use asset (and lease liability) in \naccordance with ASC 842’s transition provisions. Unless the lessee elect s to use hind sight, the lessee \nwould not adjust its lease term at the beginning of the earliest comparative period presented . However, \nin accordance with ASC 360-10, we believe the lessee should update its estimate of the useful life of any \nremaining recognized right -of-use asset unless the lessee continues to sublease the asset through the \nremaining lease term. If the lessee ceased using the rights conveyed by an operating lease by \nabandoning the underlying asset, we believe the lessee should update its estimate of the useful life of any \nremaining recognized right -of-use asset at the later of the beginning of the earliest period presented and \nthe date when the lessee committed to a plan to abandon the right -of use asset . In this case, the right -of-\nuse asset should be am ortized to zero to the date of abandonment. \nLessee elects to apply ASC 842’s transition provisions at the beginning of the earliest comparative \nperiod presented — lease commenced after the beginning of the earliest period presented and the \ncease use occurr ed before the effective date \nIf an existing operating lease commenced after the beginning of the earliest comparative period presented but \nbefore the effective date, and the lessee ceased using the rights conveyed by the operating lease before the \neffectiv e date, the lessee should reverse the accounting entries that were recorded during the comparative \nperiods for the ASC 420 cease -use liability. In this case, the lessee should initially measure its right -of-use asset \nat the commencement date of the lease a nd subsequently account for the right -of-use asset (and lease liability) \nin accordance with ASC 842’s transition provisions. Unless the lessee elects to use hindsight, the lessee would \nnot adjust its lease term. However, in accordance with ASC 360-10, we b elieve the lessee should update its \nestimate of the useful life of any remaining recognized right -of-use asset unless the lessee continues to \nsublease the asset through the remaining lease term. If the lessee ceased using the rights conveyed by an \noperatin g lease by abandoning the underlying asset, we believe the lessee should update its estimate of the \nuseful life of any remaining recognized right -of-use asset when the lessee committed to a plan to abandon the \nright -of use asset. In this case, the right -of-use asset should be amortized to zero to the date of abandonment. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 419}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 408 11.2.5 Arrangements agreed to or committed to before the reporting period \nbeginning after 28 May 2003 \nUnder EITF 01 -8, Determining whether an arrangement contains a lease , arrangements that were agreed \nto or committed to before the beginning of the reporting period beginning after 28 May 2003 (and not \nsubsequently modified or acquired in a business combination) were grandfathered from determining \nwhether the arrangement co ntains a lease in the context of ASC 840. Although ASC 842 does not \nspecifically retain this exception, we believe if an entity elects to apply the package of practical expedients \nto all leases as discussed in section 11.2.2, Transition practical expedient s, the entity would not reassess \nwhether those grandfathered arrangements are or contain leases. If an entity does not elect to apply the \npackage of practical expedients, it is required to reassess all contracts using the provisions of ASC 842, \nincluding those grandfathered by EITF 01 -8, to determine if they are or contain lease s. \n11.2.6 Arrangements entered into before the effective date that commence after \nthe effective date \nASC 840 requires entities to determine whether an arrangement is or contains a lease and to assess \nlease classification at the inception date of an arrange ment. A lease is then accounted for beginning on \nits commencement date. The transition provisions in ASC 842 provide guidance for accounting for leases \nthat commenced prior to the effective date. \nThe guidance does not address how to account for leases that were classified on an inception date before \nthe effective date of ASC 842 but did not commence until after the effective date. For these leases, we \nbelieve the lease should be accounted for using the guidance in ASC 842 for leases that commence on or \nafter the effective date rather than the transition provisions of ASC 842. \n11.2.7 Application of ASC 842’s and ASC 606’s transition provisions for arrangements \nthat no longer qualify as a lease \nThis section assumes a lessor does not elect the package of practi cal expedients and applies the transition \nprovisions at the beginning of the earliest comparative period presented in the financial statements. \nQuestions have arisen about which revenue recognition guidance a lessor should apply to contracts that \nno longer meet the definition of a lease when it adopts ASC 842 if the lessor used the modified \nretrospective method to transition to ASC 606. We believe a lessor should apply the guidance in ASC 606 \nto these contracts beginning on the date it initially applied ASC 606. A lessor should apply the guidance \nin ASC 605 to contracts that no longer meet the definition of a lease before that date. \nFor example, Lessor adopted ASC 606 on 1 January 2018 using ASC 606’s modified retrospective \ntransition approach. Lessor applie s the guidance in ASC 606 to all contracts in 2018 ( i.e., the most \ncurrent period presented in the financial statements) and recognizes the cumulative effect of initially \napplying ASC 606 to equity on 1 January 2018 ( i.e., the date of initial application). \nLessor adopts ASC 842 on 1 January 2019 and elects to apply the standard’s transition provisions at the \nbeginning of the earliest comparative period presented in the financial statements ( i.e., 1 January 2017) \nand does not elect the package of practical e xpedients. Lessor concludes that certain existing arrangements \npreviously accounted for under ASC 840 do not meet the definition of a lease under ASC 842. Instead, \nLessor concludes that all of these arrangements are in the scope of the revenue recognition guidance. \nThe arrangements commenced before 2017. \nUpon the adoption of ASC 842, Lessor applies the guidance in ASC 605 to all of the new revenue arrangements \nin the 2017 comparative period wit h any cumulative effect of applying ASC 605 and ASC 842 on 1 January \n2017. However, Lessor applies ASC 606 to all of the existing revenue arrangements beginning in 2018 and \nrecognizes the cumulative effect of applying ASC 606 to those arrangements on 1 January 2018. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 420}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 409 11.2.8 Practical expedient to not separate lease and non -lease components \nLessor \nASC 842 provides a practical expedient that permits lessors to elect (by class of underlying asset) to not \nseparate lease and associated non -lease components if cer tain criteria are met (refer to section 1.4.2.4, \nPractical expedient to not separate lease and non -lease components — lessors ). A lessor that applies the \npractical expedient to not separate lease and associated non -lease components also must apply the \nprac tical expedient, by class of underlying asset, to all leases existing at the date the expedient is elected. \nLessee \nFor all leases entered into or modified after the effective date, ASC 842 provides a practical expedient that \npermits lessees to make an acco unting policy election (by class of underlying asset) to account for each \nseparate lease component of a contract and its associated non -lease components as a single lease component \n(refer to section 1.4.2.3, Practical expedient to not separate lease and no n-lease components — lessees ). We \nbelieve a lessee that elects to apply the practical expedient to not separate lease and associated non -lease \ncomponents to new or modified leases beginning on or after the effective date may, but is not required, to \napply the practical expedient to existing leases when it transitions to ASC 842. That is, a lessee may apply this \npolicy and allocate all of the consideration ( e.g., fixed payments) to the lease component for existing leases \nwhen it initially measures its leases in transition to the new standard (refer to section 11.2, Transition ). \n11.3 Lessee transition \nLessee transition when the package of practical expedients is elected \nThe flowchart below shows how a lessee that elects the package of practical expedients applies the \ntransition guidance. As discussed in section 11.2.2, Transition practical expedients , an entity that elects \nthe package of practical ex pedients does not reassess (1) whether the arrangement is or contains a lease, \n(2) lease classification and (3) whether previously capitalized costs continue to qualify as initial direct costs . \n \n1 As discussed in section 11.2.4, Impairment of right -of-use assets prior to the effective date , a lessee does not reassess the \nmeasurement and allocation of impairment losses recognized prior to the effective date when a right -of-use asset is recognized \nupon adoption of ASC 842. When we discuss the hindsight practical expedient throughout this sect ion, we are referring to the use \nof the hindsight practical expedient only to determine the lease term. \nBecause a lessee elects to apply the package of practical e xpedients, lease classification does not change in transition \n(i.e., a capital lease becomes a finance lease, and an operating lease remains an operating lease). \n• For leases previously classified as capital leases, refer to section 11.3.1, Leases previously classified as capital \nleases under ASC 840 that are classified as finance leases under ASC 842. \n• For leases previously classified as operating leases, refer to section 11.3.3, Leases previously classified as \noperating leases under ASC 840 that are classified as operating leases under ASC 842 — lessee. \nYes \nNo \n Did the entity elect to apply the hindsight practical expedient to determine the lease term?1 \n(Refer to section 11.2 .2, Transition practical expedients ) \nReassess the lease term based on all facts and circumstances through the effective date. \nAn entity that elects to apply the hindsight practical expedient considers all facts and circumstances that have \nchanged through the effective date to determine the lease term . \n(Refer to section 11.2.2, Transition practical expedients ) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 421}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 410 Lessee transition when the package of practical expedients is not elected \nThe flowchart below shows how a lessee that does not elect the package of prac tical expedients \n(discussed in section 11.2.2, Transition practical expedients ) applies the transition guidance. \n \n1 As discussed in section 11.2.4, Impairment of right -of-use assets prior to the effective date , a lessee does not reassess the \nmeasurement and allocation of impairment losses recognized prior to the effective date when a right -of-use asset is recognized \nupon adoption of ASC 842. When we discuss the hindsight practical expedient throughout this sect ion, we are referring to the use \nof the hindsight practical expedient only to determine the lease term. \nYes \nYes \n•For leases previously classified as capital leases, \nrefer to section 11.3.1, Leases previously \nclassified as capital leases unde r ASC 840 that are \nclassified as finance leases under ASC 842. \n•For leases previously classified as operating \nleases, refer to section 11.3.3, Leases previously \nclassified as operating leases under ASC 840 that \nare classified as operating leases under ASC 842 — \nlessee. \nYes \nReassess whether previously capitalized IDCs qualify for capitalization under ASC 842. \nWrite off any unamortized IDCs that do not meet the definition of an IDC in ASC 842. \n(Refer to section 2.6, Initial direct costs , and the applicable transition guidance reference d below) \nNo \nApply other US GAAP . \nReassess whether the contract is or contains a lease. \nIs the contract a lease or does it contain a lease based on the definition of a \nlease in ASC 842? \n(Refer to section 1.2, Determining whether an arrangement contains a lease ) \n•For leases previously classified as capital leases, \nrefer to section 11.3.2, Leases previously \nclassified as capital leases under ASC 840 that are \nclassified as operating leases under ASC 842. \n•For leases previously classified as operating \nleases, refer to section 11.3.3, Leases previously \nclassified as operating lea ses under ASC 840 that \nare classified as operating leases under \nASC 842 — lessee. \nReassess the lease term based on all known facts and circumstances through the effective date. \nAn entity that elects to apply the hindsight practical expedient considers all changes in facts and \ncircumstances through the effective date to determine the lease term. \n(Refer to section 11.2.2, Transition practical expedients ) \nNo \nNo \nDid the entity elect to apply the hindsight practical expedient to determine the lease term?1 \n(Refer to section 11.2.2, Transition practical expedients ) \nReassess lease classification based on the guidance in ASC 842. \nDid lease classification change as a result o f the reassessment? \n(Refer to section 11.2.3, Reassessment of lease classification ) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 422}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 411 11.3.1 Leases previously classified as capital leases under ASC 840 that are \nclassified as finance leases under ASC 842 \nExcerpt from Accounting Standard s Codification \nLeases — Overall \nTransition and Open Effective Date Information \n842-10-65-1 \nr. For each lease classified as a finance lease in accordance with this Topic, a lessee shall do all of \nthe following: \n1. Recognize a right -of-use asset and a lease liability at the carrying amount of the lease asset \nand the capital lease obligation in accordanc e with Topic 840 at the application date as \ndetermined in (c). \n2. Include any unamortized initial direct costs that meet the definition of initial direct costs in \nthis Topic in the measurement of the right -of-use asset established in (r)(1). \n3. If a lessee does not elect the practical expedients described in (f), write off any unamortized \ninitial direct costs that do not meet the definition of initial direct costs in this Topic and that \nare not included in the measurement of the capital lease asset under Topic 84 0 as an \nadjustment to equity unless the entity elects the transition method in (c)(1) and the costs \nwere incurred after the beginning of the earliest period presented, in which case those costs \nshall be written off as an adjustment to earnings in the perio d the costs were incurred. \n4. If an entity elects the transition method in (c)(1), subsequently measure the right -of-use asset \nand the lease liability in accordance with Section 840 -30-35 before the effective date. \n5. Regardless of the transition method selected in (c), apply the subsequent measurement \nguidance in paragraphs 842 -20-35-4 through 35 -5 and 842 -20-35-8 after the effective date. \nHowever, when applying the pending content in paragraph 842 -20-35-4, a lessee shall not \nremeasure the lease payments for amo unts probable of being owed under residual value \nguarantees in accordance with paragraph 842 -10-35-4(c)(3). \n6. Classify the assets and liabilities held under capital leases as right -of-use assets and lease \nliabilities arising from finance leases for the purpo ses of presentation and disclosure. \nt. If a modification to the contractual terms and conditions occurs on or after the effective date, and \nthe modification does not result in a separate contract in accordance with paragraph 842 -10-25-8, \nor the lessee is required to remeasure the lease liability in accordance with paragraph 842 -20-35-4, \nthe lessee shall subsequently account for the lease in ac cordance with the requirements in this \nTopic beginning on the effective date of the modification or the remeasurement date. \nLessee elects to apply the package of practical expedients \nIf an entity elects to apply the package of practical expedients, as des cribed in section 11.2.2, Transition \npractical expedients , capital leases under ASC 840 become finance leases under ASC 842 ( i.e., lease \nclassification is not reassessed in transition). \nLessee does not elect to apply the package of practical expedients \nAn entity that does not elect to apply the package of practical expedients reassesses (1) whether the \narrangement is or contains a lease, (2) lease classification and (3) whether previously capitalized costs \ncontinue to qualify as initial direct costs. The en tity applies, as of the lease commencement date (or most \nrecent modification that does not result in a separate new lease), all of the guidance in ASC 842 relevant ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 423}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 412 to determining lease classification . Refer to section 11.2.3, Reassessment of lease classifi cation, for \nfurther discussion. If lease classification changes from a capital lease to an operating lease, refer to \nsection 11.3.2, Leases previously classified as capital leases under ASC 840 that are classified as \noperating leases under ASC 842. \nIf the entity does not elect to apply the package of practical expedients, the assessment of lease classification \ncould be affected by a change in lease term if the entity elects to apply the hinds ight practical expedient \n(described in 11.2.2, Transition practical expedients). If lease classification changes from a capital lease \nto an operating lease, refer to section 11.3.2, Leases previously classified as capital leases under \nASC 840 that are clas sified as operating leases under ASC 842. The use of the hindsight practical \nexpedient might affect lease classification only if the package of practical expedients is not elected. \nSummary of transition provisions \nThe table below summarizes the guidance fo r leases that commenced before the effective date, were \npreviously classified as capital leases under ASC 840 and are classified as finance leases under ASC 842. \nWhile application of the initial measurement guidance in the transition provisions is the same for all \nentities, the amount of each entity’s cumulative effect adjustment to retained earnings could differ due \nto the timing of when the entity elects to apply the transition provisions. \nTransition date \nelection Lessee applies the transition provisions at the \nbeginning of the earliest comparative period Lessee applies the transition provisions \nat the beginning of the period of adoption \nInitial recognition \nLease liability The lessee recognizes a lease liability measured \nat the carrying amount of the capital lease \nobligation under ASC 840 at the later of (1) the \nbeginning of the earliest period presented and \n(2) the commencement date of the lease.1 \n(ASC 842-10-65-1(r)(1) and section 11.3.1.1, \nInitial measurement ) The lessee recognizes a lease liability \nmeasured at the carrying amount of the \ncapital lease obligation under ASC 840 at \nthe beginning of the period of adoption.1 \n(ASC 842-10-65-1(r)(1) and section \n11.3.1.1, Initial measurement ) \nRight -of-use \nasset The lessee recognizes a finance lease right -of-use asset1 as: \n• The carrying amount of the lease asset under ASC 840 \n• Unamortized initial direct costs \n(ASC 842-10-65-1(r)(1)(2) and section 11.3.1.1, Initial measurement ) \nInitial direct \ncosts If the lessee elects to apply the package of \npractical expedients, it does not reassess \nwhether initial direct costs qualify for \ncapitalization under ASC 842. \nIf the less ee does not elect to apply the package \nof practical expedients, it writes off unamortized \ninitial direct costs that do not qualify for \ncapitalization under ASC 842 as: \n• An adjustment to equity if the costs were \nincurred prior to the beginning of the \nearlies t comparative period presented \n• A charge to earnings in the comparative \nperiod for costs incurred on or after the \nbeginning of the earliest comparative period \npresented \n(ASC 842-10-65-1(r)(3) and section 11.3.1.1, \nInitial measurement ) If the lessee elects to apply the package of \npractical expedients, it does not reassess \nwhether initial direct costs qualify for \ncapitalization under ASC 842. \nIf the lessee does not elect to apply the \npackage of practical expedients, it writes \noff unamorti zed initial direct costs that do \nnot qualify for capitalization under \nASC 842 as an adjustment to equity in the \nperiod of adoption. \n(ASC 842-10-65-1(r)(3) and section \n11.3.1.1, Initial measurement ) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 424}), Document(page\_content='11 Effective dat e and transition \nFinancial reporting developments Lease accounting | 413 Transition date \nelection Lessee applies the transition p rovisions at the \nbeginning of the earliest comparative period Lessee applies the transition provisions \nat the beginning of the period of adoption \nSubsequent measurement before the effective date \nRight -of-use \nasset and lease \nliability The lessee accounts for the finance lease right -\nof-use asset and lease liability in accordance with \nthe subsequent measurement guidance for \ncapital leases in ASC 840. \n(ASC 842-10-65-1(r)(4), ASC 840-30-35 and \nsection 11.3.1.2, Subsequent measurement \nbefore the effective date) The lessee does not change its accounting \nbefore the effective date ( i.e., it continues \nto apply the guidance in ASC 840, \nincluding its disclosure requirements, in \nthe comparative periods presented). \n(Section 11.3.1.2, Subsequent \nmeasurement before the effective date ) \nExpense \nrecognition The lessee recognizes expense in accordance \nwith the subsequent measurement guidance in \nASC 840-30-35.1 \n(ASC 842-10-65-1(r)(4), ASC 840-30-35 and \nsection 11.3.1.2, Subsequent measurement \nbefore the effective date) \nLease \nmodifications The lessee follows t he lease modification \nguidance in ASC 840. \n(Section 11.3.1.2, Subsequent measurement \nbefore the effective date ) \nSubsequent measurement on or after the effective date \nRight -of-use asset and lease liability The lessee accounts for the finance lease \nright -of-use asset and lease liability in \naccordance with the subsequent \nmeasurement guidance in ASC 842 \nbeginning on the effective date. \n(Sections 11.3.1.3, Subsequent \nmeasurement on or after the effective \ndate, and 4.3.2, Subsequent \nmeasurement — finance l eases ) \nExpense recognition The lessee records expense1 in \naccordance with the subsequent \nmeasurement guidance in ASC 842. \n(ASC 842-10-65-1(t) and sections \n11.3.1.3, Subsequent measurement on or \nafter the effective date , and 4.3.3, \nExpense recognition — finance leases ) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 425}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 414 Transition date \nelection Lessee applies the transition provisions at the \nbeginning of the earliest comparative period Lessee applies the transition provisions \nat the beginning of the period of adoption \nSubsequent measurement on or after the effective date (continued) \nReassessment and remeasurement of the right -of-use asset and \nlease liability The lessee applies the reassessment \nguidance in ASC 842 when a triggering \nevent occurs on or after the effective date. \nHowever, unless the lease is remeasured \nfor other reasons, the lessee does not \nremeasure a finance lease right -of-use \nasset or lease liability for changes in the \namount that it is probable it will owe under \na residual value guarantee. This is because \nthe initial measurement of a capital lease \nobligation under ASC 840 includes the full \namount of a residual value guarantee \nrather than the amount probable of being \nowed. Therefore, after the eff ective date \nlessees do not remeasure the lease liability \nto reflect the amount probable of being \nowed for a residual value guarantee unless \nthere is a lease modification not accounted \nfor as a separate lease or the liability is \nreassessed for other reasons . \n(ASC 842-10-65-1(r)(5) and sections \n11.3.1.3, Subsequent measurement on or \nafter the effective date , and 11.3.4, \nReassessment of lease liabilities and right -\nof-use assets — transition considerations ) \nLease modifications If a modification occurs on or af ter the \neffective date, and the modification does \nnot result in a separate contract, the \nlessee applies the guidance in ASC 842 to \naccount for the lease modification. \n(ASC 842-10-65-1(r)(5), ASC 842-10-65-\n1(t) and sections 11.3.1.3, Subsequent \nmeasurement on or after the effective \ndate, and 4.6, Lease modifications ) \n \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \n1 If an entity elects the hindsight practical expedient and concludes that the lease term should change, we believe the entity adjusts \nthese amounts to reflect the amounts that would have been used under ASC 842 if the revised lease term had always been used . \nRefer to section 11.2.2, Transition practical expedients . \n11.3.1.1 Initial measurement \nThe guidance in this section applies to all leases previously classified as capital leases under ASC 840 \nthat are classified as finance leases under ASC 842, regardles s of when a lessee applies the transition \nprovisions (refer to section 11.2, Transition ). The date on which a lessee applies the transition provisions \naffects only the timing of recognition, not how the initial measurement guidance is applied. \nFor an exist ing capital lease that is classified as a finance lease under ASC 842: \n• The lessee initially recognizes a finance lease right -of-use asset and lease liability measured at the \ncarrying amount of the capital lease asset and capital lease obligation under ASC 840. If the entity applies \nthe transition provisions at the beginning of the earliest comparative period presented, the finance lease \nright -of-use asset and lease liability are recognized at the later of (1) the beginning of the earliest \ncomparative period presented and (2) the commencement date of the lease. If the lessee applies the \ntransition provisions at the beginning of the period of adoption, the finance lease right -of-use asset and \nlease liability are recognized at the beginning of the period of ado ption. Refer to section 11.2, Transition . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 426}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 415 • If the entity elected to apply the package of practical expedients (refer to section 11.2.2, Transition \npractical expedients ), the lessee recognizes, as part of the finance lease right -of-use asset, \nunamortized ini tial direct costs. The lessee does not reassess whether initial direct costs qualify for \ncapitalization under ASC 842. \n• If the entity has not elected to apply the package of practical expedients (refer to section 11.2.2, \nTransition practical expedients ) and applies the transition provisions at the beginning of the earliest \ncomparative period presented, any initial direct costs that do not qualify for capitalization under \nASC 842 are written off as: \n• An adjustment to equity if the costs were incurred prior to the beginning of the earliest comparative \nperiod presented \n• A charge to earnings in the comparative period for costs incurred on or after the beginning of \nthe earliest comparative period presented \n• If the lessee has not elected the package of practical expedients and applies the transition provisions \nat the beginnin g of the period of adoption, any initial direct costs that do not qualify for capitalization \nunder ASC 842 are written off as an adjustment to equity in the period of adoption. \nIf the entity elects to apply the hindsight practical expedient (refer to secti on 11.2.2, Transition practical \nexpedients ) and concludes that the lease term should change, we believe the entity adjusts the initial \nrecognition of the carrying amount of the finance lease right -of-use asset and lease liability to reflect the \namounts tha t would have been recorded under ASC 840 had the revised lease term always been used. To \ndetermine the capital lease obligation that would have been recorded, the entity adjusts its discount rate \nto reflect the revised lease term. \n11.3.1.2 Subsequent measu rement before the effective date \nThe guidance in this section only applies to a lessee that elects to apply the transition provisions at the \nbeginning of the earliest comparative period presented. If the lessee applies the transition provisions at the \nbeginning of the period of adoption, the entity does not change its accounting prior to the effective date \n(i.e., it continues to apply the guidance in ASC 840, including its disclosure requirements, in the \ncomparative periods presented). Refer to section 11.2 , Transition . \nRight -of-use asset and lease liability \nDuring the periods before the effective date, a lessee that applies the transition provisions at the beginning of \nthe earliest comparative period accounts for the finance lease right -of-use asset and lease liability in accordance \nwith the subsequent measur ement guidance for capital leases in ASC 840-30-35 (842 -10-65-1(r)(4)). \nExpense recognition and lease modifications \nThe FASB indicated in the Basis for Conclusions (BC 390) of ASU 2016 -02 that the practical effect of the \nmodified retrospective transition is that an entity “runs off” its accounting for certain leases that exist \nbefore the effective date when lease classification does not change in transition. This is the case even if \nthe entity did not elect to apply the package of practical expedients (refer to section 11.2.2, Transition \npractical expedients ), but lease classification did not change. Therefore, even if a lessee applies the \ntransition provisions at the beginning of th e earliest comparative period, it continues to recognize \nexpense in accordance with the subsequent measurement guidance in ASC 840-30-35. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 427}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 416 The lessee follows the guidance for lease modifications in ASC 840-10 and ASC 840-30 to assess \nwhether a lease modific ation has occurred and to account for the lease modification ( i.e., the lessee \nwould not revise its previous accounting for lease modifications that occurred prior to the effective date). \nIf the lessee elects to apply the hindsight practical expedient and concludes that the lease term should \nchange, the lessee recognizes expense using the adjusted lease term. \n11.3.1.3 Subsequent measurement on or after the effective date \nThe guidance in this section applies to all leases previously classified as capital lea ses under ASC 840 \nthat are classified as finance leases under ASC 842, regardless of when a lessee applies the transition \nprovisions (refer to section 11.2, Transition ). When a lessee applies the transition provisions affects only \nthe timing of recognition , not how the subsequent measurement guidance is applied. \nRight -of-use asset and lease liability \nBeginning on the effective date, a lessee accounts for the finance lease right -of-use asset and lease \nliability in accordance with the subsequent measurement g uidance in ASC 842. However, when applying \nASC 842’s remeasurement requirements, a lessee does not remeasure the finance lease right -of-use \nasset or lease liability for changes in the amount that it is probable it will owe under a residual value \nguarantee unless the lease liability is remeasured for other reasons. The initial measurement of a capital \nlease obligation under ASC 840 includes the full amount of a residual value guarantee rather than the \namount probable of being owed. Therefore, after the effec tive date lessees do not remeasure the lease \nliability to reflect the amount probable of being owed for a residual value guarantee unless there is a \nlease modification not accounted for as a separate lease or the liability is remeasured for other reasons. \nExpense recognition and lease modifications \nAs discussed in section 11.3.1.2, Subsequent measurement before the effective date , the practical effect \nof the modified retrospective transition method is that an entity “runs off” its accounting for certain \nleases that commence before the effective date until certain events occur on or after the effective date \n(BC 390 of ASU 2016 -02). Therefore, in periods following the effective date, the lessee “runs off” its \nexisting expense recognition under ASC 840 unless t he lease is modified and the modified lease is not \naccounted for as a separate contract or the lessee is otherwise required to remeasure its lease liability in \naccordance with ASC 842. I f the lessee elects to apply the hindsight practical expedient and con cludes that \nthe lease term should change, the lessee recognizes expense using the adjusted lease term. \nBeginning on the effective date, a lessee applies the lease modification guidance in ASC 842 to \ndetermine if a lease modification results in a separate c ontract or a change in the accounting for the \nexisting lease and to account for the lease modification. \nRefer to the following sections for further discussion of the expense recognition, reassessment and lease \nmodification guidance under ASC 842: \n• 4.3.2, Subsequent measurement — finance leases \n• 4.3.3, Expense recognition — finance leases \n• 11.3.4, Reassessment of lease liabilities and right -of-use assets — transition considerations \n• 4.5, Remeasurement of lease liabilities and right -of-use assets — operating and finance leases \n• 4.6, Lease modifications ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 428}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 417 11.3.2 Leases previously classified as capital leases under ASC 840 that are \nclassified as operating leases under ASC 842 \nExcerpt from Accounting Standards Codification \nLeases — Overall \nTransition and Open Effective Date Information \n842-10-65-1 \ns. For each lease classified as an operating lease in accordance with this Topic, a lessee shall do \nthe following: \n1. Derecognize the carrying amount of any capital lease asset and capital lease ob ligation in \naccordance with Topic 840 at the application date as determined in (c). Any difference \nbetween the carrying amount of the capital lease asset and the capital lease obligation shall \nbe accounted for in the same manner as prepaid or accrued rent. \n2. If an entity elects the transition method in (c)(1) and the lease commenced before the \nbeginning of the earliest period presented in the financial statements or if the entity elects \nthe transition method in (c)(2), recognize a right -of-use asset and a lease liability in \naccordance with paragraph 842 -20-35-3 at the application date as determined in (c). \n3. If an entity elects the transition method in (c)(1) and the lease commenced after the beginning of \nthe earliest period presented in the financial statements, recognize a right -of-use asset and a \nlease liability in accordance with paragraph 842 -20-30-1 at t he commencement date of the lease. \n4. Account for the operating lease in accordance with the guidance in Subtopic 842 -20 after \ninitial recognition in accordance with (s)(2) or (s)(3). \n5. Write off any unamortized initial direct costs that do not meet the d efinition of initial direct costs in \nthis Topic as an adjustment to equity unless the entity elects the transition method in (c)(1) and \nthe costs were incurred after the beginning of the earliest period presented, in which case those \ncosts shall be written off as an adjustment to earnings in the period the costs were incurred. \nt. If a modification to the contractual terms and conditions occurs on or after the effective date, and \nthe modification does not result in a separate contract in accordance with para graph 842 -10-25-\n8, or the lessee is required to remeasure the lease liability in accordance with paragraph 842 -20-35-\n4, the lessee shall subsequently account for the lease in accordance with the requirements in this \nTopic beginning on the effective date of the modification or the remeasurement date. \nLessee elects to apply the package of practical expedients \nIf an entity elects to apply the package of practical expedients described in section 11.2.2, Transition \npractical expedients , leases classified as cap ital leases under ASC 840 become finance leases under \nASC 842 ( i.e., lease classification is not reassessed in transition), and the guidance in this section is \nnot applicable. In that case, the guidance in section 11.3.1, Leases previously classified as ca pital leases \nunder ASC 840 that are classified as finance leases under ASC 842, is applicable. \nLessee does not elect to apply the package of practical expedients \nAn entity that does not elect to apply the package of practical expedients reassesses (1) whet her the \narrangement is or contains a lease, (2) lease classification and (3) whether previously capitalized costs continue \nto qualify as initial direct costs. The entity applies, as of the lease commencement date (or most recent \nmodification that does not result in a separate new lease), all of the guidance in ASC 842 relevant to determining \nlease classification. Refer to section 11.2.3, Reassessment of lease classification, for further discussion. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 429}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 418 If an entity does not elect to apply the package of practical expedients but does apply the hindsight \npractical expedient (refer to section 11.2.2, Transition practical expedients ) and concludes the lease term \nshould change, the effect of that change could impact both the classification and measurement of an \nexisting lease. If the lessee concludes the lease is now an operating lease, the change in lease term (and \ncorresponding change in lease payments and assessment of previous impairments of the right -of-use \nasset) affects the initial m easurement of the operating lease right -of-use asset and lease liability \nrecognized. If the lease becomes a finance lease, refer to section 11.3.1, Leases previously classified as \ncapital leases under ASC 840 that are classified as finance leases under ASC 842. \nSummary of transition provisions \nThe table below summarizes the guidance for leases that commence before the effective date, were \npreviously classified as capital leases under ASC 840 and are classified as operating leases under ASC 842. \nWhile application of the initial measurement guidance in the transition provisions is the same for all \nentities, the amount of each entity’s cumulative effect adjustment to retained earnings could d iffer due \nto the timing of when the entity elects to apply the transition provisions. \n Lessee applies the transition \nprovisions at the beginning of the \nearliest comparative period Lessee applies the transition provisions at the \nbeginning of the period of a doption \nInitial measurement \nLease liability The lessee derecognizes the carrying \namount of the capital lease obligation \nat the later of (1) the beginning of \nthe earliest comparative period \npresented or (2) the commencement \ndate of the lease. \nFor leases that commence before the \nbeginning of the earliest comparative \nperiod presented, the lessee \nrecognizes an operating lease liability \nin accordance with ASC 842’s \nsubsequent measurement guidance \n(refer to section 4.2.2.1, Subsequent \nmeasurement of lease liabilities — \noperating leases ). \nFor leases that commence after the \nbeginning of the earliest comparative \nperiod, the lessee recognizes an \noperating lease liability in accordance \nwith ASC 842’s initial measurement \nguidance (refer to section 4.2.1.1, \nInitial measurement of lease liabilities — \noperating leases ). \nThe initial measurement of the lease \nliability uses the following inputs as \ndefined in ASC 842: \n• Discount rate (refer to section \n2.5.2, Discount rate — lessees )1 \n• Lease payments (refer to section \n2.4, Lease payments )1 \n(ASC 842-10-65-1(s)(1) through 65 -\n1(s)(3) and section 11.3.2.1, Initial \nmeasurement ) The lessee derecognizes the carrying amount of the \ncapital lease obligation at the beginning of the period \nof adopti on. \nThe lessee recognizes an operating lease liability in \naccordance with ASC 842’s subsequent measurement \nguidance (refer to section 4.2.2.1, Subsequent \nmeasurement of lease liabilities — operating leases ). \nThe initial measurement of the lease liability u ses the \nfollowing inputs as defined in ASC 842: \n• Discount rate (refer to section 2.5.2, Discount \nrate — lessees )1 \n• Lease payments (refer to section 2.4, Lease \npayments )1 \n(ASC 842-10-65-1(s)(1) through 65 -1(s)(3) and \nsection 11.3.2.1, Initial measurement ) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 430}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 419 Lessee applies the transition \nprovisions at the beginning of the \nearliest comparative period Lessee applies the transition provisions at the \nbeginning of the period of a doption \nInitial measurement (continued) \nRight -of-use \nasset The lessee derecognizes the carrying \namount of the capital lease asset at \nthe later of (1) the beginning of \nthe earliest comparative period \npresented or (2) the commencement \ndate of the lease. \nAny difference between the carrying \namount of the capital lease asset and \nthe capital lease obligation is \naccounted for in the same manner as \nprepaid or accrued rent. \nFor leases that commence before the \nbeginning of the earliest comparative \nperiod presented, the lessee \nrecognizes a right -of-use asset1 in \naccordance wi th ASC 842’s \nsubsequent measurement guidance \n(refer to section 4.2.2.2, Subsequent \nmeasurement of right -of-use assets — \noperating leases ). \nFor leases that commence after the \nbeginning of the earliest comparative \nperiod, the lessee recognizes a right -\nof-use asset1 in accordance with \nASC 842’s initial measurement \nguidance (refer to section 4.2.1.2, Initial \nmeasurement of lease liabilities — \noperating leases ). \n(ASC 842-10-65-1(s)(1) through 65 -\n1(s)(3) and section 11.3.2.1, Initial \nmeasurement ) The lessee derec ognizes the carrying amount of the \ncapital lease asset at the beginning of the period of \nadoption . \nAny difference between the carrying amount of the \ncapital lease asset and the capital lease obligation is \naccounted for in the same manner as prepaid or \naccrued rent. \nThe lessee recognizes a right -of-use asset1 in \naccordance with ASC 842’s subsequent measurement \nguidance (refer to section 4.2.2.2, Subsequent \nmeasurement of right -of-use assets — operating \nleases ). \n(ASC 842-10-65-1(s)(1) through 65-1(s)(3) and \nsection 11.3.2.1, Initial measurement ) \nInitial direct \ncosts The lessee writes off unamortized \ninitial direct costs that do not qualify \nfor capitalization under ASC 842 as: \n• An adjustment to equity if the \ncosts were incurred prior to the \nbeginning of the earliest \ncomparative period presented \n• A charge to earnings in the \ncomparative period for costs \nincurred on or after the \nbeginning of the earliest \ncomparative period presented \n(ASC 842-10-65-1(s)(5) and section \n11.3.2.1, Initial measurement ) The lessee writes off unamortized initial direct costs \nthat do not qualify for capitalization under ASC 842 as \nan adjustment to equity in the period of adoption. \n(ASC 842-10-65-1(s)(5) and s ection 11.3.2.1, Initial \nmeasurement ) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 431}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 420 Lessee applies the transition \nprovisions at the beginning of the \nearliest comparative period Lessee applies the transition provisions at the \nbeginning of the period of a doption \nSubsequent measurement before and on or after the effective date2 \nRight -of-use \nasset and lease \nliability The lessee accounts for the right -of-use asset and lease liability in accordance with the \nsubsequent measurement guidance for operating leases in ASC 842-20. \n(ASC 842-10-65-1(s)(4), ASC 842-20 and sections 11.3.2.2, Subsequent measurement before \nand on or after the effective date , and 4.2.2, Subsequent measurement — operating leases ) \nExpense \nrecognition The lessee recognizes expense1 in accordance with the subsequent measurement guidance in \nASC 842-20. \n(ASC 842-10-65-1(s)(4), ASC 842-20 and section 11.3.2.2, Subsequent measurement before \nand on or after the effective date , and 4.2.3, Expense recognition — operating leases ) \nLease \nmodifications The lessee follows the lease modification guidance in ASC 842. \n(ASC 842-10-65-1(s)(4), ASC 842-10-65-1(t), ASC 842-10, ASC 842-20-35 and sections \n11.3.2.2, Subsequent measurement before and on or after the effective date , and 4.6, Lease \nmodifications ) \nReassessment \nand \nremeasurement \nof the right -of-\nuse asset and \nlease liability The lessee appl ies the reassessment guidance in ASC 842 when a triggering event occurs on or \nafter the effective date, including when there is a change in the amount it is probable the \nlessee will owe under a residual value guarantee. \nIf the lessee elects to apply the hindsight practical expedient, it considers all facts and \ncircumstances that have changed, through the effective date (but not after the effective date), \nto reassess the lease term in transition. As a result, significant e vents or significant changes in \nfacts and circumstances that occurred through the effective date would have already been \nconsidered in the initial recognition of the lease liability and right -of-use asset in transition, and \nthe lessee would apply ASC 842’s reassessment requirements to any significant events or \nsignificant changes in circumstances that occur following the effective date. \n(ASC 842-10-65-1(s)(4), ASC 842-10-65-1(t) and sections 11.3.4, Remeasurement of lease \nliabilities and right -of-use assets — transition considerations , and 4.5, Reassessment of lease \nliabilities and right -of-use assets — operating and finance leases ) \n \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \n1 If an entity elects the hindsight practical expedient and concludes that the lease term should change, we believe the entity adjusts \nthese amounts to reflect the amounts that would have been used under ASC 842 if the revised lease term had always been used . \nRefer to section 11.2.2, Transition practical expedients . \n2 A lessee that applies the transition provisions at the beginning of the period of adoption does not change its accounting prior to \nthe effective date ( i.e., it continues to apply the guidance in ASC 840, including its disclosure requirements, in the comparative \nperiods presented) . Beginning on the effective date, the lessee applies the guidance in the table above. \n11.3.2.1 Initial measurement \nLessee applies the transition provisions at the beginn ing of the earliest comparative period \nFor a capital lease that exists at the beginning of the earliest comparative period presented or commences \nbefore the effective date that is classified as an operating lease under ASC 842, the lessee: \n• Derecognizes the carrying amount of the capital lease asset and capital lease obligation at the later \nof (1) the beginning of the earliest comparative period presented or (2) the commencement date of \nthe lease (prior to the effective date) , and accounts for any difference between the carrying amount \nof the capital lease asset and the capital lease obligation as prepaid or accrued rent \n• Recognizes an operating lease right -of-use asset and lease liability in accordance with ASC 842’s \nsubsequent measurement guidance if the lease commenced before the beginning of the earliest \ncomparative period presented or in accordance with ASC 842’s initial measurement guidance if the \nlease commenced after the beginning of the earliest comparati ve period presented (refer to sections \n4.2.1, Initial measurement — operating leases , and 4.2.2, Subsequent measurement — operating leases ) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 432}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 421 • Writes off any unamortized initial direct costs that do not qualify for capitalization under ASC 842 at \nthe later of (1) the beginning of the earliest comparative period presented and (2) the \ncommencement date of the lease as: \n• An adjustment to equity if the costs were incurred prior to the beginning of the earliest \ncomparative period presented \n• A charge to earnings in th e comparative period for costs incurred on or after the beginning of \nthe earliest comparative period presented \nIf a lessee elects to apply the hindsight practical expedient and concludes that the lease term should \nchange, we believe the entity adjusts the recognition of the right -of-use asset and lease liability to reflect \nthe amounts that would have been used under ASC 842 if the revised lease term had always been used. \nLessee applies the transition provisions at the beginning of the period of adoption \nFor an existing capital lease that exists at the beginning of the period of adoption that is classified as an \noperating lease under ASC 842, the lessee: \n• Derecognizes the carrying amount of the capital lease asset and capital lease obligation at th e \nbeginning of the period of adoption and accounts for any difference between the carrying amount of \nthe capital lease asset and the capital lease obligation as prepaid or accrued rent \n• Recognizes an operating lease right -of-use asset and lease liability in accordance with ASC 842’s \nsubsequent measurement guidance (refer to section 4.2.2, Subsequent measurement — operating \nleases ) \n• Writes off any unamortized initial direct costs that do not qualify for capitalization under ASC 842 as \nan adjustment to equity i n the period of adoption \nIf a lessee elects to apply the hindsight practical expedient and concludes that the lease term should \nchange, we believe the entity adjusts the right -of-use asset and lease liability to reflect the amounts that \nwould have been use d under ASC 842 if the revised lease term had always been used. \n11.3.2.2 Subsequent measurement before and on or after effective date \nIf the lessee applies the transition provisions at the beginning of the earliest comparative period presented \n(refer to section 11.2, Transition ), when lease classification changes in transition ( e.g., a lease previously \nclassified as a capital lease under ASC 840 becomes an operating lease under ASC 842), the lessee does \nnot “run off” its previous lease accounting for certain leases as described in the Basis for Conclusions (BC \n390) of ASU 2016 -02. Instead, for all periods presented ( i.e., both before and after the effective date), the \nlessee applies ASC 842’s subsequent measurement guidance. This includes the guidance for subsequent \nmeasurement of the right -of-use asset and lease liability (including the reassessment requirements), \nexpense recognition and lease modifications. \nIf the lessee applies the transition provisions at the beginning of the period of adoption, it does not change \nits accounting for the periods before the effective date ( i.e., it continues to apply the guidance in ASC 840, \nincluding its disclosure requirements, in the comparative periods presented). Refer to section 11.2, \nTransition . Beginning on the effective date, the lessee applies ASC 842’s subsequent measurement \nguidance. This includes the guidance for subsequent measurement of the right -of-use asset and lease \nliability (including the reassessment requirements), expense recognition and lease modifications. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 433}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 422 Refer to the following sections for further details of the subsequent measurement of operating lease right -\nof-use assets and leas e liabilities, expense recognition, reassessment of lease liabilities and right -of-use \nassets and lease modifications under ASC 842: \n• 4.2.2, Subsequent measurement — operating leases \n• 4.2.3, Expense recognition — operating leases \n• 11.3.4, Reassessment of leas e liabilities and right -of-use assets — transition considerations \n• 4.5, Remeasurement of lease liabilities and right -of-use assets — operating and finance leases \n• 4.6, Lease modifications \nIf the lessee elects to apply the hindsight practical expedient (refer to section 11.2.2, Transition practical \nexpedients ), it considers all facts and circumstances that have changed, through the effective date (but \nnot after the effective date), in determining the lease term in transition. As a result, significant events or \nsignificant changes in facts and circumstances that occurred through the effective date have already \nbeen considered in the initial recognition of the lease liability and right -of-use asset in transition, and the \nlessee would apply ASC 842’s reassessment requirements to any significant events or significant \nchanges in circumstances that occur following the effective date. If the lessee concludes that the lease \nterm should change, the lessee recognizes expense using the adjusted lease term. \n11.3.3 Leases pr eviously classified as operating leases under ASC 840 that are classified \nas operating leases under ASC 842 — lessee \nExcerpt from Accounting Standards Codification \nLeases — Overall \nTransition and Open Effective Date Information \n842-10-65-1 \nk. A lessee shall initially recognize a right -of-use asset and a lease liability at the application date as \ndetermined in (c). \nl. Unless, on or after the effective date, the lease is modified (and that modification is not accounted \nfor as a separate contract in accordance with paragraph 842 -10-25-8) or the lease liability is \nrequired to be remeasured in accordance with paragraph 842 -20-35-4, a lessee shall measure the \nlease liability at the present value of the sum of the following, using a discount rate for t he lease \n(which, for entities that are not public business entities, can be a risk -free rate determined in \naccordance with paragraph 842 -20-30-3) established at the application date as determined in (c): \n1. The remaining minimum rental payments (as defined under Topic 840). \n2. Any amounts probable of being owed by the lessee under a residual value guarantee . \nm. For each lease classified as an operating lease in accordance with paragraphs 842 -10-25-2 \nthrough 25 -3, a lessee shall initially measure the right -of-use asset at the initial measurement of \nthe lease liability adjusted for both of the following: \n1. The items in paragraph 842 -20-35-3(b), as applicable. \n2. The carrying amount of any liability recognized in accordance with Topic 420 on exit or \ndisposal c ost obligations for the lease. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 434}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 423 n. For each lease classified as an operating lease in accordance with paragraphs 842 -10-25-2 \nthrough 25 -3, a lessee shall subsequently measure the right -of-use asset throughout the \nremaining lease term in accordance with paragraph 842 -20-35-3(b). If the initial measurement of \nthe right -of-use asset in (m) is adjusted for the carrying amount of a liability recognized in \naccordance with Topic 420 on exit or disposal cost obligations for the lease, the lessee shall apply \nthe recognition and subsequent measurement guidance in Sections 842 -20-25 and 842 -20-35, \nrespectively, when the right -of-use asset has been impaired. \np. If a lessee does not elect the practical expedients described in (f), any unamortized initial direct \ncosts that do not meet the definition of initial direct costs in this Topic shall be written off as an \nadjustment to equity unless the entity elects the transition method in (c)(1) and the costs were \nincurred after the beginning of the earliest period presented, in which case those costs shall be \nwritten off as an adjustment to earnings in the period the costs were incurred. \nq. If a modification to the contractual terms and conditions occurs on or after the effective date, and \nthe modification does not result in a separate contract in accordance with paragraph 842 -10-25-8, \nor the lessee is required to remeasure the lease liability for any reason (see paragraphs 842 -20-35-4 \nthrough 35 -5), the lessee shall follow the requirements in this Topic from the effective dat e of \nthe modification or the remeasurement date. \nLessee elects to apply the package of practical expedients \nIf an entity elects to apply the package of practical expedients (refer to section 11.2.2, Transition \npractical expedients ), operating leases under ASC 840 become operating leases under ASC 842 \n(i.e., lease classification is not reassessed in transition) . \nLessee does not elect to apply the package of practical expedients \nAn entity that does not elect to apply the package of p ractical expedients reassesses (1) whether the \narrangement is or contains a lease, (2) lease classification and (3) whether previously capitalized lease \ncosts continue to qualify as initial direct costs. That entity applies, as of the lease commencement da te \n(or most recent modification that does not result in a separate new lease), all of the guidance in ASC 842 \nrelevant to determining lease classification. Refer to section 11.2.3, Reassessment of lease classification , \nfor further discussion. If lease clas sification changes from an operating lease to a finance lease, refer to \nsection 11.3.3a, Leases previously classified as operating leases under ASC 840 that are classified as \nfinance leases under ASC 842 — lessee . \nIf the entity does not elect to apply the package of practical expedients, the assessment of lease classification \ncould also be impacted by a change in lease term if the entity elects to apply the hindsight practical expedient \n(refer to section 11.2.2, Transition practical expedients ). The use of the hindsight practical expedient may \nimpact lease classification only if the entity does not elect to apply the package of practical expedients. \nSummary of transition provisions \nThe table below summarizes the guidance for leases that commence before the e ffective date, were \npreviously classified as operating leases under ASC 840 and are classified as operating leases under \nASC 842. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 435}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 424 While application of the initial measurement guidance in the transition provisions is the same for all \nentities, the amount of each entity’s cumulative effect adjustment to retained earnings could differ due \nto the timing of when the entity elects to apply the transition provisions. \n Lessee applies the transition provisions \nat the beginning of the earliest \ncomparative pe riod Lessee applies the transition provisions at the \nbeginning of the period of adoption \nInitial measurement \nLease liability The lessee recognizes a lease liability at the \nlater of (1) the beginning of the earliest \nperiod presented in the financial statements \nand (2) the commencement date of the \nlease. \nThe components of initial measurement of \nthe lease liability include: \n• Discount rate (refer to section 11.3.3b, \nDiscount rates — leases previously \nclassified as operating leases under \nASC 840 — lessee )1 \n• Remaining minimum rental payments \n(refer to section 11.3.3c, Remaining \nminimum rental payments — leases \npreviously classified as operating leases \nunder ASC 840 — lessee )1 \n• Amounts it is probable a lessee will owe \nunder a residual value guarantee \n(ASC 842-10-65-1(k)(l) and section \n11.3.3.1, Initial measurement of leases \npreviously classified as operating leases \nunder ASC 840 — lessee ) The lessee recognizes a lease liability at the \nbeginning of the period of adoption. \nThe components of initial measu rement of the \nlease liability include: \n• Discount rate (refer to section 11.3.3b, \nDiscount rates — leases previously classified as \noperating leases under ASC 840 — lessee )1 \n• Remaining minimum rental payments (refer to \nsection 11.3.3c, Remaining minimum rental \npayments — leases previously classified as \noperating leases under ASC 840 — lessee )1 \n• Amounts it is probable a lessee will owe under \na residual value guarantee \n(ASC 842-10-65-1(k)(l) and section 11.3.3.1, \nInitial measurement of leases previously \nclassified as operating leases under ASC 840 — \nlessee ) \nRight -of-use \nasset The lessee records a right -of-use asset measured at an amount equal to the lease liability, \nadjusted for the following, as applicable: \n• Cumulative prepaid or accrued lease payments1 \n• Remaining balance of any lease incentives received,1 which is the amount of the gross lease \nincentives received net of amounts recognized previously as part of the single lease cost \ndescribed in ASC 842-20-25-6(a) \n• Unamortized initial direct costs1 \n• Unamorti zed balance of an asset or liability recognized in accordance with ASC 805 on \nbusiness combinations relating to favorable or unfavorable lease terms \n• Carrying amount of an exit or disposal cost ( ASC 420) liability \n(ASC 842-10-65-1(m) and section 11 .3.3.1, Initial measurement of leases previously classified \nas operating leases under ASC 840 — lessee . For leases denominated in a foreign currency, also \nrefer to section 11.3.3d, Foreign exchange rate — leases previously classified as operating \nleases under ASC 840 — lessee , for a discussion of remeasurement of the right -of-use asset). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 436}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 425 Lessee applies the transition provisions \nat the beginning of the earliest \ncomparative pe riod Lessee applies the transition provisions at the \nbeginning of the period of adoption \nInitial measurement (continued) \nInitial direct \ncosts If the lessee elects to apply the package of \npractical expedients, it does not reassess \nwhether initial direct costs qualify for \ncapitalization under ASC 842. \nIf the entity does not elect to apply the \npackage of practical expedients, it writes off \nunamorti zed initial direct costs that do not \nqualify for capitalization under ASC 842 as: \n• An adjustment to equity if the costs \nwere incurred prior to the beginning of the \nearliest period presented \n• A charge to earnings in the comparative \nperiod for costs incurred on or after the \nbeginning of the earliest period \npresented \n(ASC 842-10-65-1(p) and section \n11.3.3.1, Initial measurement of leases \npreviously classified as operating leases \nunder ASC 840 — lessee ) If the lessee elects to apply the package of \npract ical expedients, it does not reassess \nwhether initial direct costs qualify for \ncapitalization under ASC 842. \nIf the entity does not elect to apply the package \nof practical expedients, it writes off unamortized \ninitial direct costs that do not qualify for \ncapitalization under ASC 842 as an adjustment \nto equity in the period of adoption. \n(ASC 842-10-65-1(p) and section 11.3.3.1, \nInitial measurement of leases previously \nclassified as operating leases under ASC 840 — \nlessee ) \nSubsequent measurement before the effective date \nRight -of-use \nasset and lease \nliability The lessee continues to measure the lease \nliability as described above under the Initial \nmeasurement heading. \nThe lessee measures the right -of-use asset \nat the amount of the lease liability, \nadjus ted for the following: \n• Cumulative prepaid or accrued lease \npayments \n• Remaining balance of any lease \nincentives received, which is the amount of \nthe gross lease incentives received net of \namounts recognized previously as part of \nthe single lease cost described in \nASC 842-20-25-6(a) \n• Unamortized initial direct costs \n• Unamortized balance of an asset or \nliability recognized in ac cordance with \nASC 805 on business combinations \nrelating to favorable or unfavorable \nlease terms \n• Impairment of the right -of-use asset \nFor leases with an associated ASC 420 \nliability, a lessee follows ASC 842-20-25 \nand 842 -20-35 as if the right -of-use asset \nhas been impaired. \n(ASC 842-10-65-1(n), 842 -20-35-3(b) and \nsection 11.3.3.2, Subsequent measurement \nbefore the effective date — leases classified \nas operating leases under ASC 842 — lessee ) The lessee does not change its accounting prior \nto the effective d ate ( i.e., it continues to apply \nthe guidance in ASC 840, including its disclosure \nrequirements, in the comparative periods \npresented). \n(Section 11.3.3.2, Subsequent measurement \nbefore the effective date — leases classified as \noperating leases under ASC 842 — lessee ) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 437}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 426 Lessee applies the transition provisions \nat the beginning of the earliest \ncomparative pe riod Lessee applies the transition provisions at the \nbeginning of the period of adoption \nSubsequent measurement before the effective date (continued) \nExpense \nrecognition The lessee records expense consistent \nwith its existing recognition pattern under \nASC 840, inclusive of amortization related \nto the remaining balance of lease \nincentives received and unamortized initial \ndirect costs .1 \n(BC 390 of ASU 2016 -02, 840 -20 and \nsection 11.3.3.2, Subsequent \nmeasurement before the effective date — \nleases classified as operating leases under \nASC 842 — lessee ) \nLease \nmodifications The lessee follows the lease modification \nguidance in ASC 840. \n(BC 390 of ASU 2016 -02, ASC 840 and \nsection 11.3.3.2, Subsequent \nmeasurement before the effective date — \nleases classified as operating leases under \nASC 842 — lessee ) \nReassessment \nand \nremeasu rement \nof the right -of-\nuse asset and \nlease liability Not applicable — the lessee does not apply \nthe reassessment and remeasurement \nguidance until the effective date of \nASC 842. Refer to section 11.3.4, \nReassessment of lease liabilities and right -\nof-use assets — transition considerations , \nfor further discussion of the reassessment \nrequirements for leases that commence \nprior to the effective date. \nSubsequent measurement on or after the effective date \nRight -of-use \nasset and lease \nliability The lessee continues to measure the lease liability as described above under the Initial \nmeasurement heading. \nThe lessee continues to measure the right -of-use asset at the amount of the lease liability, \nadjusted for the following: \n• Cumulative prepaid or accrued lease payments \n• Remaining balance of any lease incentives received, which is the amount of the gross lease \nincentives received net of amounts recognized previously as part of the single lease cost \ndescribed in ASC 842-20-25-6(a) \n• Unamortized initial direct costs \n• Unamortized balance of an asset or liability recognized in accordance with ASC 805 on \nbusiness combinations relating to favorable or unfavorable lease terms \n• Impairment of the right -of-use asset \nFor leases w ith an associated ASC 420 liability, a lessee follows ASC 842-20-25 and 842 -20-35 as if the \nright-of-use asset has been impaired. \nIf the lease is modified on or after the effective date, and the modification does not result in a \nseparate contract (applying the guidance for lease modifications in ASC 842), or the lessee is required \nto remeasure the lease liability for any reason, the lessee applies all of the guidance in ASC 842. \n(ASC 842-10-65-1(n), 842 -10-65-1(q), 842 -20-35 and section 11.3.3.3, Subsequent \nmeasurement on or after the effective date — leases classified as operating leases under \nASC 842 — lessee ) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 438}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 427 Lessee applies the transition provisions \nat the beginning of the earliest \ncomparative pe riod Lessee applies the transition provisions at the \nbeginning of the period of adoption \nSubsequent measurement on or after the effective date (continued) \nExpense \nrecognition The lessee records expense1 consistent with its existing recognition pattern under ASC 840, inclusive \nof amortization related to the remaining balance of lease incentives received and unamortized \ninitial direct costs , unles s the lease is modified and the modified lease is not accounted for as a \nseparate contract or the lessee is required to remeasure its lease liability in accordance with ASC 842. \n(BC 390 of ASU 2016 -02 and section 11.3.3.3, Subsequent measurement on or afte r the \neffective date — leases classified as operating leases under ASC 842 — lessee ) \nLease \nmodifications The lessee follows the lease modification guidance in ASC 842. \n(ASC 842-10-65-1(q) and sections 11.3.3.3, Subsequent measurement on or after the effective \ndate — leases classified as operating leases under ASC 842 — lessee , and 4.6, Lease modifications ) \nReassessment \nand \nremeasurement \nof the right -of-\nuse asset and \nlease liability The lessee applies the reassessment guidance in ASC 842 ( i.e., any previous significant events or \nsignificant changes in circumstances that occur before the effective date would not require \nimmediate reassessment at the effective date). \nIf the lessee elect s to apply the hindsight practical expedient, it considers all facts and \ncircumstances that have changed, through the effective date (but not after the effective date), in \ndetermining the lease term in transition. As a result, significant events or signifi cant changes in \nfacts and circumstances that occurred through the effective date would have already been \nconsidered in the initial recognition of the lease liability and right -of-use asset in transition, and \nthe lessee would apply ASC 842’s reassessment re quirements to any significant events or \nsignificant changes in circumstances that occur following the effective date. \n(Sections 11.3.3.3, Subsequent measurement on or after the effective date — leases classified as \noperating leases under ASC 842 — lessee , 11.3.4, Remeasurement of lease liabilities and right -of-use \nassets — transition considerations , and 4.5, Remeasurement of lease liabilities and right -of-use assets — \noperating and finance leases ) \n \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \n1 If an entity elects the hindsight practical exp edient and concludes that the lease term should change, we believe the entity adjusts \nthese amounts to reflect the amount s that would have been determined had the revised lease term always been used. Refer to \nsection 11.2.2, Transition practical expedients . \n11.3.3.1 Initial measurement of leases previously classified as operating leases under ASC 840 — \nlessee \nLease liability \nIf the lessee applies the transition provisions at the beginning of the earliest comparative period \npresented, a lessee initially rec ognizes a right -of-use asset and lease liability for an existing operating \nlease at the later of (1) the beginning of the earliest comparative period presented or (2) the \ncommencement date of the lease (prior to the effective date). If the lessee applies t he transition \nprovisions at the beginning of the period of adoption, it initially recognizes the right -of-use asset and \nlease liability at the beginning of the period of adoption. Refer to section 11.2, Transition . \nThe lessee initially measures the lease l iability at the present value of the sum of the following items \nusing the discount rate for the lease (refer to section 11.3.3b , Discount rates — leases previously \nclassified as operating leases under ASC 840 — lessee ): \n• The remaining minimum rental payments as described under ASC 840 (refer to section 11.3.3c , Remaining \nminimum rental payments — leases previously classified as operating leases under ASC 840 — lessee). \n• Any amount it is probable a lessee will owe under a residual value guarantee. \nIf a lessee elects to apply the hindsight practical expedient for all leases, as described in section 11.2.2, \nTransition practical expedients , and concludes the lease term should change, we believe the entity \nadjusts the remaining minimum rental payments u sed to determine initial recognition of the lease liability \nto reflect the amount that would have been recorded had the revis ed lease term always been used. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 439}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 428 Right -of-use asset \nFor an operating lease that continues to be classified as an operating lease und er ASC 842 and has no \nassociated liability recognized in accordance with ASC 420, Exit or Disposal Cost Obligations , a lessee initially \nmeasures the right -of-use asset at an amount equal to the lease liability, adjusted for (1) cumulative prepaid \nor accrue d lease payments, (2) the remaining balance of any lease incentives received, (3) any unamortized \ninitial direct costs (the balance of which may depend on whether the lessee elects to apply the package of \npractical expedients), (4) the unamortized balance of an asset or liability recognized in accordance with \nASC 805 on business combinations relating to favorable or unfavorable lease terms (refer to section 11.5.2, \nAmounts previously recognized in a business combination ) and (5) impairment losses (which may be \nimpacted by whether the entity elects to use the hindsight practical expedient for all leases, as discussed \nin section 11.2.2, Transition practical expedients , when evaluating the right -of-use asset for impairment). \nWhen an operating lease that continu es to be classified as an operating lease under ASC 842 has an \nassociated liability recognized in accordance with ASC 420, in addition to applying the guidance above, \nthe lessee also includes the carrying value of the ASC 420 liability in the initial measurement of the right -\nof-use asset, and subsequently measures the right -of-use asset as if it had been impaired (refer t o \nsection 4.2.5, Impairment of right -of-use assets in operating leases ). As a result, the expense recognized \nfollowing adoption of ASC 842 includes amortization of the right -of-use asset, generally on a straight -line \nbasis, as well as accretion of the leas e liability, similar to expense recognized for a finance lease. \nIf the lessee elects to apply the package of practical expedients (refer to section 11.2.2, Transition practical \nexpedients ), it does not reassess whether initial direct costs qualify for capi talization under ASC 842. \nIf the lessee does not elect to apply the package of practical expedients (as described in section 11.2.2, \nTransition practical expedients ) and applies the transition provisions at the beginning of the earliest \ncomparative period presented, it writes off any unamortized initial direct costs that would not have \nqualified for capitalization under ASC 842 as: \n• An adjustment to equity if the costs were incurred before the beginning of the earliest comparative \nperiod presented \n• A charge t o earnings in the comparative period for costs incurred on or after the beginning of the \nearliest comparative period presented \nIf the lessee applies the transition provisions at the beginning of the period of adoption, it writes off any \nunamortized initial direct costs that would not have qualified for capitalization under ASC 842 as an \nadjustment to equity in the period of adoption. \nIf the lessee elects to apply the hindsight practical expedient for all leases, as described in section 11.2.2, \nTransition pr actical expedients , and concludes the lease term should change, we believe it should adjust \ncumulative prepaid or accrued lease payments, the remaining balance of lease incentives received and \nunamortized initial direct costs and the unamortized balance of an asset or liability recognized in accordance \nwith ASC 805 on business combinations relating to favorable or unfavorable lease terms , as applicable, \nto reflect the amounts that would have been recorded if the revised lease term had always been used. \nIn addition, the application of hindsight may affect the amortization of leasehold improvements. ASC 842’s \ntransition provisions do not address the accounting for existing leasehold improvements. However, if the \nentity elects the hindsight expedient and the le ase term is revised, we believe a lessee can adjust its \naccounting for leasehold improvements through either of the following methods: \n• Adjust leasehold improvements, with a cumulative effect adjustment to the beginning balance of \nretained earnings at the d ate of initial application, to reflect the amount of depreciation that would \nhave already been recognized if the revised lease term had always been used \n• Prospectively adjust amortization of leasehold improvements for the remainder of the revised lease \nterm or the remaining useful life of the leasehold improvement, if shorter ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 440}), Document(page\_content='11 Effective dat e and transition \nFinancial reporting developments Lease accounting | 429 Either method should be applied consistently and disclosed, if the amounts are material. \nIllustration 11-1: Initial measurement of leases previously classified as operating leases under \nASC 840 that are classified as operating leases under ASC 842 — lessee \nScenario A \nA lessee that is a calendar -year public business entity entered into a 10 -year lease of equipment that \ncommenced on 1 January 2017 and was classified as an operating lease under ASC 840. The lessee \nmakes annual payments that it pays in arrears on 31 Decembe r each year. The initial payment was \n$10,000, and the terms call for a $1,000 increase each year. \nThe deferred rent liability on 31 December 2018 is $8,000. The lessee incurred $7,500 of initial \ndirect costs (IDCs) and half of the remaining unamortized IDC s of $6,000 qualify for capitalization \nunder ASC 842 at lease commencement ( i.e., $3,000 of remaining unamortized IDCs qualify for \ncapitalization under ASC 842 at lease commencement) . \nThe lessee elects to apply the package of practical expedients at transi tion and does not elect to apply \nthe hindsight practical expedient . Therefore, lease classification and the remaining unamortized IDCs \nof $6,000 are not reassessed. The lessee cannot determine the rate implicit in the lease, and its \nincremental borrowing r ate (IBR) as of 1 January 2019 is 5%. Finally, the lessee elects to apply the \ntransition provisions at the beginning of the period of adoption ( i.e., 1 January 2019). \nAnalysis : In this example, the lessee records the following journal entry as of 1 January 2019 : \nRight -of-use asset $ 96,529 (1) \nDeferred rent liability 8,000 (2) \n Lease liability $ 98,529 (3) \n Capitalized IDCs 6,000 (4) \n(1) The ROU asset equals the lease liability determined in ( 3) less the deferred rent liability determined in (2) plus remaining \nunamortized IDCs ($98,529 — 8,000 + 6,000). \n(2) The deferred rent liability is the difference between the cash payments of $21,000 for 2017 and 2018 and cumulative \nstraight -line expense of $29,000 ($14,500 per year for 2017 and 2018). \n(3) The lease liability is the present value of the eight remaining rental payments discounted at the incremental borrowing rate of \n5% ($98,529). \n(4) The unamortized portion of IDCs capitalized under ASC 840 ($7,500 — 1,500 for two years of amortization). \nScenario B \nAssume the same fact as in Scenario A except t he lessee does not elect to apply the package of \npractical expedients at transition. As a result of the lessee reassessing lease classification by applying \nall of the guidance in ASC 842 relevant to determining lease classification, the lessee determines the \nlease is classified as an operating lease. \nAnalysis : In this example, the lessee records the following journal entry as of 1 January 2019 : \nRight -of-use asset $ 93,529 (1) \nDeferred rent liability 8,000 (2) \nCumulative -effect adjustment 3,000 (3) \n Lease liability $ 98,529 (4) \n Capitalized IDCs 6,000 (5) \n(1) The ROU asset equals the lease liability determined in (4) less the deferred rent liability determined in (2) pl us remaining \nunamortized IDCs that qualify for capitalization under ASC 842 ($98,529 — $8,000 + $3,000). \n(2) The deferred rent liability is the difference between the cash payments of $21,000 for 2017 and 2018 and cumulative \nstraight -line expense of $29,000 ($14,500 per year for 2017 and 2018). \n(3) The cumulative -effect adjustment is the portion of remaining unamortized IDCs that do not qualify for capitalization under \nASC 842 ($6,000 remaining unamortized IDCs [$7,500 — $1,500 for two years of amorti zation] x 50%). \n(4) The lease liability is the present value of the eight remaining rental payments discounted at the incremental borrowing rate of \n5% ($98,529). \n(5) The unamortized portion of IDCs capitalized under ASC 840 ($7,500 — $1,500 for two years of amortization) (half was included in \nthe measurement of the ROU asset, and the portion that does not qualify for capitalization under ASC 842 was adjusted in (3)). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 441}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 430 11.3.3.2 Subsequent measurement before the effective date — leases c lassified as operating leases \nunder ASC 842 — lessee \nThe guidance in this section applies only to a lessee that elects to apply the transition provisions at the \nbeginning of the earliest comparative period presented. A lessee that applies the transition pr ovisions at \nthe beginning of the period of adoption does not change its accounting for periods before the effective \ndate ( i.e., it continues to apply the guidance in ASC 840, including its disclosure requirements, in the \ncomparative periods presented). Ref er to section 11.2, Transition . \nIf the lessee applies the transition provisions at the beginning of the earliest comparative period presented , \nduring the periods prior to the effective date ( e.g., from the beginning of the earliest comparative period \nprese nted through the effective date), the lessee will subsequently measure the lease liability as the \npresent value of the remaining minimum rental payments as described under ASC 840 and the right -of-use \nasset at the amount of the lease liability (refer to se ction 11.3.3.1, Initial measurement of leases previously \nclassified as operating leases under ASC 840 — lessee ), adjusted for the following: \n• Cumulative prepaid or accrued lease payments \n• Remaining balance of any lease incentives received, which is the amoun t of the gross lease incentives \nreceived net of amounts recognized previously as part of the single lease cost described in ASC 842-\n20-25-6(a) \n• Unamortized initial direct costs \n• The unamortized balance of an asset or liability recognized in accordance with ASC 805 on business \ncombinations relating to favorable or unfavorable lease terms (refer to section 11.5.2, Amounts \npreviously recognized in a business combination ) \n• Impairment o f the right -of-use asset \nThe FASB indicated in the Basis for Conclusions (BC 390 ) of ASU 2016 -02 that the practical effect of the \nmodified retrospective transition is that an entity “runs off” its accounting for certain leases that exist prior \nto the effective date when lease classification does not change in transition. This is the case even if the \nentity did not elect to apply the package of practical expedients (refer to section 11.2.2, Transition practical \nexpedients ), but lease classification did not change ( e.g., classification of a lease previously classified as an \noperating lease under ASC 840 is reassessed and the entity determines the lease is an operating lease \nunder ASC 842). As a result, during the periods prior to the effective date, the lessee continues to “run off” \nits existing expense recognition under ASC 840, inclusive of amortization related to the remaining \nbalance of lease incentives received and unamortized initial direct costs . If the lessee elects to apply the \nhindsight practical expedient and concludes that the lease term should change, the lessee recognizes \nexpense using the ad justed lease term. \nA lessee continues to follow the guidance for lease modifications in ASC 840-10 and ASC 840-30 to \nassess whether a lease modification has occurred and to account for the lease modification. For example, \nif an existing operating lease is renewed or extended beyond the original lease term (if the renewal \noption was not already included as part of the original lease term), this renewal or extension results in a \nnew lease agreement for accounting purposes (refer to section 4.3.7, Renewal or e xtension of an \noperating lease , within our FRD, Lease accounting: Accounting Standards Codification 840, Leases ). \nWhen an op erating lease that continues to be classified as an operating lease under ASC 842 has an \nassociated liability recognized in accordance with ASC 420, the lessee subsequently measures the right -\nof-use asset as if it had been impaired (refer to section 4.2.5, Impairment of right -of-use assets in \noperating leases ). As a result, the expense recognized following adoption of ASC 842 includes \namortization of the right -of-use asset, generally on a straight -line basis, as well as accretion of the lease \nliability, sim ilar to expense recognized for a finance lease ( i.e., the lessee no longer accounts for the \nlease using a run -off of its prior ASC 840 accounting). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 442}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 431 11.3.3.3 Subsequent measurement on or after the effective date — leases classified as operating \nleases under ASC 842 — lessee \nThe guidance in this section applies to all lessees with leases previously classified as operating leases \nunder ASC 840 that are classified as operating leases under ASC 842, regardless of when a lessee \napplies the transition provisions (refer to section 11.2, Transition ). When a lessee applies the transition \nprovisions affects only the timing of recognition, not how the subsequent measurement guidance is applied. \nFollowing the effective date, the lessee continues to measure the lease liability as described in section \n11.3.3.1, Initial measurement of leases previously classified as operating leases under ASC 840 — lessee . \nThe lessee also continues to measure the right -of-use asset at the amount of the lease liability (refer to \nsection 11.3.3.1, Initial measurement of leases previously classified as operating leases under ASC 840 — \nlessee ), adjusted for the following: \n• Cumulative prepaid or accrued lease payments \n• Remaining balance of any lease incenti ves received, which is the amount of the gross lease incentives \nreceived net of amounts recognized previously as part of the single lease cost described in ASC 842-\n20-25-6(a) \n• Unamortized initial direct costs \n• The unamortized balance of an asset or liability recognized in accordance with ASC 805 on business \ncombinations relating to favorable or unfavorable lease terms (refer to section 11.5.2, Amounts \npreviously recognized in a business combination ) \n• Impairment of the right -of-use asset \nAs discussed in section 11.3.3.2, Subsequent measurement before the effective date — leases classified \nas operating leases under ASC 842 — lessee , the practical effect of the modified retrospective transition \nmethod is that an entity “runs off” its accounting for certain leases that commence prior to the effective \ndate until certain events occur on or after the effective date (BC 390 of ASU 2016 -02). Therefore, in \nperiods following the effective date, the lessee “runs off” its existing expense recognition under \nASC 840, inclusive of amortization related to the remaining balance of lease incentives received and \nunamortized initial direct costs, unless the lease is modified and the modified lease is not accounted for \nas a separate contract or the lessee is otherwise required to reme asure its lease liability in accordance \nwith ASC 842. Beginning on the effective date, a lessee applies the lease modification guidance in \nASC 842 to determine whether a lease modification results in a separate contract or a change in the \naccounting for th e existing lease. The lessee follows the expense recognition guidance in ASC 842 from \nthe effective date of the modification or remeasurement. \nIf the lessee elects to apply the hindsight practical expedient and concludes that the lease term should \nchange, the lessee recognizes expense using the adjusted lease term. \nRefer to the following sections for further discussion of the expense recognition, reassessment and lease \nmodification guidance in ASC 842: \n• 4.2.3, Expense recognition — operating leases \n• 11.3.4, Reassessment of lease liabilities and right -of-use assets — transition considerations \n• 4.5, Remeasurement of lease liabilities and right -of-use assets — operating and finance leases \n• 4.6, Lease modifications \nIn addition, the lessee also applies the i mpairment guidance in ASC 360-10 to right -of-use assets after \nthe effective date. Refer to section 4.2.3, Expense recognition — operating leases , for further discussion. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 443}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 432 11.3.3a Leases previously classified as operating leases under ASC 840 that are classi fied \nas finance leases under ASC 842 — lessee \nExcerpt from Accounting Standards Codification \nLeases — Overall \nTransition and Open Effective Date Information \n842-10-65-1 \nk. A lessee shall initially recognize a right -of-use asset and a lease liability at the application date as \ndetermined in (c). \nl. Unless, on or after the effective date, the lease is modified (and that modification is not accounted \nfor as a separate contract in accordance with paragraph 842 -10-25-8) or the lease liability is \nrequired to be remeasured in accordance with paragraph 842 -20-35-4, a lessee shall measure the \nlease liability at the present value of the sum of the following, using a discount rate for t he lease \n(which, for entities that are not public business entities, can be a risk -free rate determined in \naccordance with paragraph 842 -20-30-3) established at the application date as determined in (c): \n1. The remaining minimum rental payments (as defined un der Topic 840). \n2. Any amounts probable of being owed by the lessee under a residual value guarantee . \no. For each lease classified as a finance lease in accordance with paragraph 842 -10-25-2, a lessee \nshall measure the right -of-use asset as the applicable pro portion of the lease liability at the \ncommencement date, which can be imputed from the lease liability determined in accordance \nwith (l). The applicable proportion is the remaining lease term at the application date as \ndetermined in (c) relative to the tot al lease term. A lessee shall adjust the right -of-use asset \nrecognized by the carrying amount of any prepaid or accrued lease payments and the carrying \namount of any liability recognized in accordance with Topic 420 for the lease. \np. If a lessee does not elect the practical expedients described in (f), any unamortized initial direct \ncosts that do not meet the definition of initial direct costs in this Topic shall be written off as an \nadjustment to equity unless the entity elects the transition method in (c )(1) and the costs were \nincurred after the beginning of the earliest period presented, in which case those costs shall be \nwritten off as an adjustment to earnings in the period the costs were incurred. \nq. If a modification to the contractual terms and conditi ons occurs on or after the effective date, and \nthe modification does not result in a separate contract in accordance with paragraph 842 -10-25-8, \nor the lessee is required to remeasure the lease liability for any reason (see paragraphs 842 -20-35-4 \nthrough 3 5-5), the lessee shall follow the requirements in this Topic from the effective date of the \nmodification or the remeasurement date. \nLessee elects to apply the package of practical expedients \nIf an entity elects to apply the package of practical expedients (refer to section 11.2.2, Transition practical \nexpedients ), operating leases under ASC 840 become operating leases under ASC 842 (i.e., lease \nclassification is not reassessed in transition) and the guidance in this section is not applicable. In that case, \nthe guidance in section 11.3.3, Leases previously classified as operating leases under ASC 840 that are \nclassified as operating leases under ASC 842 — lessee , is applicable. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 444}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 433 Lessee does not e lect to apply the package of practical expedients \nAn entity that does not elect to apply the package of practical expedients reassesses (1) whether the \narrangement is or contains a lease, (2) lease classification and (3) whether previously capitalized leas e \ncosts continue to qualify as initial direct costs. The entity applies, as of the lease commencement date (or \nmost recent modification that does not result in a separate new lease), all of the guidance in ASC 842 \nrelevant to determining lease classificati on. Refer to section 11.2.3, Reassessment of lease classification , \nfor further discussion. \nIf the entity does not elect to apply the package of practical expedients, the assessment of lease classification \ncould also be affected by a change in lease term if the entity elects to apply the hindsight practical expedient \n(refer to section 11.2.2, Transition practical expedients ). The use of the hindsight practical expedient may \naffect lease classification only if the entity does not elect to apply the package of practical expedients. If the \nlease becomes an operating lease, refer to section 11.3.3, Leases previously classified as o perating leases \nunder ASC 840 that are classified as operating leases under ASC 842 — lessee . \nSummary of transition provisions \nThe table below summarizes the guidance for leases that commence before the effective date, were \npreviously classified as operati ng leases under ASC 840 and are classified as finance leases under ASC 842. \nWhile application of the initial measurement guidance in the transition provisions is the same for all \nentities, the amount of each entity’s cumulative effect adjustment to retaine d earnings could differ due \nto the timing of when the entity elects to apply the transition provisions. \n Lessee applies the transition provisions \nat the beginning of the earliest \ncomparative period Lessee applies the transition provisions at the \nbeginning of the period of adoption \nInitial measurement \nLease liability The lessee recognizes a lease liability at the \nlater of (1) the beginning of the earliest \nperiod presented in the financial \nstatements and (2) the commencement \ndate of the lease. \nThe components of initial measurement of \nthe lease liability include: \n• Discount rate1 (refer to section \n11.3.3b, Discount rates — leases \npreviously classified as operating leases \nunder ASC 840 — lessee ) \n• Remaining minimum rental payments1 \n(refer to section 11.3.3c, Remaining \nminimum rental payments — leases \npreviously classified as operating leases \nunder ASC 840 — lessee ) \n• Amounts it is probable a lessee will owe \nunder a residual value guarantee \n(ASC 842-10-65-1(k)(l) and section \n11.3.3a.1, Initial measurement for leases \npreviously classified as operating leases \nunder ASC 840 — lessee ) The lessee recognizes a lease liability at the \nbeginning of the period of adoption. \nThe components of initial measurement of the \nlease liability include: \n• Discount rate1 (refer to section 11.3.3b, \nDiscount rates — leases previously classified as \noperating leases under ASC 840 — lessee ) \n• Remaining minimum rental payments1 (refer to \nsection 11.3.3c, Remaining minimum rental \npayments — leases previously classified a s \noperating leases under ASC 840 — lessee ) \n• Amounts it is probable a lessee will owe under a \nresidual value guarantee \n(ASC 842-10-65-1(k)(l) and section 11.3.3a.1, \nInitial measurement for leases previously classified \nas operating leases under ASC 840 — lessee) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 445}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 434 Lessee applies the transition provisions \nat the beginning of the earliest \ncomparative period Lessee applies the transition provisions at the \nbeginning of the period of adoption \nInitial measurement (continued) \nRight -of-use \nasset The lessee records a right -of-use asset measured as the applicable proportion of the lease \nliability at commencement, adjusted for the following, as applicable: \n• Cumulative prepaid or accrued lease payments1 \n• Remaining balance of any lease incentives received1 \n• Unamortized initial direct costs1 \n• Unamortized balance of an asset or liability recognized in accordance with ASC 805 on \nbusiness combinations relating to favorable or unfavorable lease ter ms1 \n• Carrying amount of an exit or disposal cost ( ASC 420) liability \n(ASC 842-10-65-1(o) and s ection 11.3.3a.1, Initial measurement for leases previously classified \nas operating leases under ASC 840 — lessee . For leases denominated in a foreign currency, al so \nrefer to section 11.3.3d, Foreign exchange rate — leases previously classified as operating \nleases under ASC 840 — lessee , for a discussion of remeasurement of the right -of-use asset.) \nInitial direct \ncosts The lessee writes off unamortized initial \ndirect costs that do not qualify for \ncapitalization under ASC 842 as: \n• An adjustment to equity if the costs \nwere incurred prior to the beginning of \nthe earliest period presented \n• A charge to earnings in the comparati ve \nperiod for costs incurred on or after the \nbeginning of the earliest period presented \n(ASC 842-10-65-1(p) and section \n11.3.3a.1, Initial measurement for leases \npreviously classified as operating leases \nunder ASC 840 — lessee ) The lessee writes off unamortized initial direct \ncosts that do not qualify for capitalization under \nASC 842 as an adjustment to equity in the period \nof adoption. \n(ASC 842-10-65-1(p) and section 11.3.3a.1, \nInitial measurement for leases previously classifie d \nas operating leases under ASC 840 — lessee ) \nSubsequent measurement before and on or after the effective date \nRight -of-use \nasset and lease \nliability We believe the lessee applies the subsequent measurement guidance in ASC 842. \n(Sections 11.3.3a.2, Subsequent measurement before and on or after the effective date — leases \nclassified as finance leases under ASC 842, and 4.3.2, Subsequent measurement — finance leases ) \nExpense \nrecognition We believe the lessee recognizes expense1 in accordance with the subsequent measurement \nguidance in ASC 842. \n(Sections 11.3.3a.2, Subsequent measurement before and on or after the effective date — leases \nclassified as finance leases under ASC 842, and 4.3.3, Expense recognition — finance leases ) \nLease \nmodifications The lessee applies the modification guidance in ASC 842. \n(Sections 11.3.3a.2, Subsequent measurement before and on or after the effective date — \nleases classified as finance leases under ASC 842, and 4.6, Lease modifications ) \nReassessment \nand \nremeasurement \nof the right -of-\nuse asset and \nlease liability We believe the lessee applies the reassessment and remeasurement guidance in ASC 842. \nIf the lessee elects to apply the hindsight practical expedient, it considers all facts and \ncircumstances that have changed, through the effective date (but not after the effective date), \nin determining the lease term in transition. As a result, significant events or significant changes \nin facts and circumstances that occurred before the effective date would have already been \nconsidered in the initial recognition of the le ase liability and right -of-use asset in transition, and \nthe lessee would apply ASC 842’s reassessment requirements to any significant events or \nsignificant changes in circumstances that occur following the effective date. \n(Sections 11.3.3a.2, Subsequent me asurement before and on or after the effective date — \nleases classified as finance leases under ASC 842, 11.3.4, Reassessment of lease liabilities and \nright -of-use assets — transition considerations , and 4.5, Remeasurement of lease liabilities and \nright -of-use assets — operating and finance leases ) \n \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \n1 If an entity elects the hindsight practical expedient and concludes that the lease term should change, we believe the entity adjusts \nthese amounts to reflect the amount s that would have been determined if the revised lease term had always been used . Refer to \nsection 11.2.2, Transition practical expedients . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 446}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 435 11.3.3a.1 Initial measurement for leases previously classified as operating leases under ASC 840 — \nlessee \nLease liability \nIf a lessee applies the transition provisions at the beginning of the earliest comparative period presented, \nthe lessee initially recognizes a right -of-use asset and lease liability for an existing operating lease at the \nlater of (1) the beginning of the earliest comparative peri od presented or (2) the commencement date of \nthe lease (before the effective date). If the lessee applies the transition provisions as of the beginning of \nthe period of adoption, the lessee initially recognizes a right -of-use asset and lease liability are \nrecognized at the beginning of the period of adoption. Refer to section 11.2, Transition . \nThe lessee initially measures the lease liability at the present value of the sum of the following items \nusing the discount rate for the lease (refer to section 11.3. 3b, Discount rates — leases previously \nclassified as operating leases under ASC 840 — lessee ): \n• The remaining minimum rental payments as described under ASC 840 (refer to section 11.3.3c , \nRemaining minimum rental payments — leases previously classified as o perating leases under \nASC 840 — lessee) \n• Any amount it is probable the lessee will owe under a residual value guarantee \nIf the lessee elects to apply the hindsight practical expedient for all leases, as described in section 11.2.2, \nTransition practical expe dients , and concludes the lease term should change, we believe the entity \nadjusts the remaining minimum rental payments used to determine initial recognition of the lease liability \nand reflects the amount that would have been recorded if the revised lease term had always been used. \nRight -of-use asset \nFor a lease previously classified as an operating lease under ASC 840 that is classified as a finance lease \nunder ASC 842, a lessee does the following: \n• Measures the right -of-use asset as the applicable proporti on of the lease liability at the commencement \ndate (which could precede the beginning of the earliest comparative period presented) that can be \nimputed ( i.e., calculated) from the lease liability determined based on the guidance above \n• Adjusts the right -of-use asset for: \n• Cumulative prepaid or accrued lease payments \n• Remaining balance of any lease incentives received \n• Unamortized initial direct costs \n• Unamortized balance of an asset or liability recognized in accordance with ASC 805 on business \ncombinations relating to favorable or unfavorable lease terms \n• Carrying amount of an exit or disposal cost ( ASC 420) liability \nWe believe the applicable proportio n of the lease liability is the amount that would have been recognized \nat commencement of the lease if ASC 842 had always been applied, multiplied by the remaining \nproportion of the original lease term. For example, assume that a lease with an original ter m of 10 years \nhas a remaining term of eight years at the beginning of the earliest comparative period presented. If the \noriginal lease liability would have been calculated as $100,000 at lease commencement (assuming the \nprovisions of ASC 842 had always bee n applied), the right -of-use asset recognized would be $80,000 \n(calculated as $100,000 original lease liability divided by the 10 -year lease term multiplied by eight \nyears remaining at the beginning of earliest comparative period presented). The right -of-use asset would \nthen be adjusted for any prepaid or accrued rent, remaining balance of any lease incentives received, ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 447}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 436 unamortized initial direct costs, unamortized balance of an ASC 805 asset or liability relating to favorable \nor unfavorable lease terms (re fer to section 11.5.2, Amounts previously recognized in a business \ncombination ) and the carrying amount of an exit or disposal cost ( ASC 420) liability . \nWhen the lessee does not elect to apply the package of practical expedients (as described in section 11 .2.2, \nTransition practical expedients ) and applies the transition provisions at the beginning of the earliest \ncomparative period presented, it writes off any unamortized initial direct costs that would not have \nqualified for capitalization under ASC 842 as : \n• An adjustment to equity if the costs were incurred prior to the beginning of the earliest comparative \nperiod presented \n• A charge to earnings in the comparative period for costs incurred on or after the beginning of the \nearliest comparative period presented \nIf the lessee applies the transition provisions at the beginning of the period of adoption, it writes off any \nunamortized initial direct costs that would not have qualified for capitalization under ASC 842 as an \nadjustment to equity in th e period of adoption. \nIf the lessee elects to apply the hindsight practical expedient for all leases, as described in section 11.2.2, \nTransition practical expedients , and concludes the lease term should change, we believe the applicable \nproportion of the l ease liability used to measure the right -of-use asset for a finance lease, the remaining \nbalance of any lease incentives received, any unamortized initial direct costs and any unamortized \nbalance of an asset or liability recognized in accordance with ASC 805 on business combinations relating \nto favorable or unfavorable lease terms are adjusted to reflect the amounts that would have been \nrecognized if the revised lease term had always been used. \nIn addition, the application of hindsight may affect the amorti zation of leasehold improvements. If the \nlease term is revised, we believe a lessee adjusts its accounting for leasehold improvements in one of the \nfollowing ways: \n• Adjust leasehold improvements, with a cumulative effect adjustment to the beginning balance of \nretained earnings at the date of initial application, to reflect the amounts that would remain if the \nrevised lease term had always been used \n• Prospectively adjust amortization of leasehold improvements for the remainder of the revised lease \nterm or the remaining useful life of the leasehold improvements, if shorter \nIllustration 11-2: Initial measurement of leases previously classified as operating leases under \nASC 840 that are classified as finance leases under ASC 842 — lessee \nA lessee that is a calendar -year public business entity entered into a 10 -year lease of equipment that \ncommenced on 1 January 2017 and was classified as an operating lease under ASC 840. The l essee \nmakes annual payments that it pays in arrears on 31 December each year. The initial payment was \n$10,000, and the terms call for a $1,000 increase each year. The deferred rent liability on 31 December \n2018 is $8,000. The lessee incurred $7,500 of init ial direct costs (IDCs) and half of the remaining \nunamortized IDCs of $6,000 quality for capitalization under ASC 842 at lease commencement ( i.e., $3,000 \nof remaining unamortized IDCs qualify for capitalization under ASC 842 at lease commencement) . \nThe lessee does not elect to apply the package of practical expedients or the hindsight practical \nexpedient at transition . As a result of the lessee reassessing lease classification by applying all of the \nguidance in ASC 842 relevant to determining lease c lassification, the lessee determines the lease is \nclassified as a finance lease. The lessee cannot determine the rate implicit in the lease, and its \nincremental borrowing rate (IBR) as of 1 January 2019 is 5%. Finally, the lessee elects to apply the \ntransi tion provisions at the beginning of the period of adoption ( i.e., 1 January 2019). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 448}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 437 Analysis : In this example, the lessee records the following journal entry as of 1 January 2019 : \nRight -of-use asset $ 82,096 (1) \nDeferred rent liability 8,000 (2) \nCumulative -effect adjustment 14,433 (3) \n Lease liability $ 98,529 (4) \n Capitalized IDCs 6,000 (5) \n(1) The ROU asset equals the assumed lease liability at the lease commencement date ($108,869) divided by the 10 -year lease \nterm multiplied by the eigh t-year remaining term less the deferred rent liability plus IDCs that quality for capitalization under \nASC 842 [(($108,869/10) x 8)) — $8,000 + $3,000]. \n(2) The deferred rent liability is the difference between the cash payments of $21,000 for 2017 and 201 8 and cumulative \nstraight -line expense of $29,000 ($14,500 per year for 2017 and 2018). \n(3) The cumulative -effect adjustment is the portion of the unamortized IDCs that do no t quali fy for capitalization under ASC 842 \n($3,000) less the difference between th e portion of the ROU asset imputed from the hypothetical lease liability determined at \nlease commencement ($87,096 [$108,869 x 8/10 remaining lease term]) and the lease liability recognized at the beginning \nof the earliest comparative period presented ($98 ,529). \n(4) The lease liability is the present value of the eight remaining rental payments discounted at the incremental borrowing rate of \n5% ($98,529). \n(5) The unamortized portion of IDCs capitalized under ASC 840 ($7,500 — $1,500 for two years of amortization). \n11.3.3a.2 Subsequent measurement before and on or after the effective date — leases classified as \nfinance leases under ASC 842 \nIf the lessee applies the transition provisions at the beginning of the earliest comparative period presented, \nwhen lease classification changes in transition ( e.g., a lease previously classified as an oper ating lease \nunder ASC 840 becomes a finance lease under ASC 842), we believe the lessee applies ASC 842’s \nsubsequent measurement guidance, which includes evaluating modifications and remeasurements in \naccordance with ASC 842. \nIf the lessee applies the tran sition provisions at the beginning of the period of adoption, it does not change \nits accounting prior to the effective date ( i.e., it continues to apply the guidance in ASC 840, including its \ndisclosure requirements, in the comparative periods presented). After the effective date, the lessee applies \nASC 842’s subsequent measurement guidance, which includes evaluating modifications and \nremeasurements in accordance with ASC 842. \nIf the lessee elects to apply the hindsight practical expedient and concludes tha t the lease term should \nchange, the lessee recognizes expense using the adjusted lease term. \nRefer to the following sections for further details of the subsequent measurement of finance lease right -of-\nuse assets and lease liabilities, expense recognition, remeasurement of lease liabilities and lease \nmodifications under ASC 842: \n• 4.3.2, Subsequent measurement — finance leases \n• 4.3.3, Expense recognition — finance leases \n• 11.3.4, Reassessment of lease liabilities and right -of-use assets — transition consideratio ns \n• 4.5, Remeasurement of lease liabilities and right -of-use assets — operating and finance leases \n• 4.6, Lease modifications ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 449}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 438 If the lessee elects to apply the hindsight practical expedient (refer to section 11.2.2, Transition practical \nexpedients ), it consid ers all facts and circumstances that have changed, through the effective date (but \nnot after the effective date), in determining the lease term in transition. As a result, significant events or \nsignificant changes in facts and circumstances that occurred t hrough the effective date would have \nalready been considered in the initial recognition of the lease liability and right -of-use asset in transition, \nand the lessee would apply ASC 842’s reassessment requirements to any significant events or significant \nchanges in circumstances that occur after the effective date. \n11.3.3b Discount rates — leases previously classified as operating leases under ASC 840 — \nlessee \nIf the lessee applies the transition provisions at the beginning of the earliest comparative period \npresented, a lessee uses a discount rate for the lease established at the later of (1) the beginning of the \nearliest comparative period presented or (2) the commencement date of the lease. If the lessee applies \nthe transition provisions at the effective date, it uses a discount rate for the lease established at that \ndate. Refer to section 11.2, Transition . \nFor leases that exist prior to the date of initial ap plication (and were previously classified as operating \nleases), questions have arisen regarding the lease term an entity should use to determine the discount \nrate. In response to a technical inquiry, the FASB staff said a lessee can elect to use either of the \nfollowing periods to measure its discount rate : \n• The total lease term measured at lease inception under ASC 840 \n• The remaining lease term as of the date of init ial application \nThis is consistent with the views expressed by the SEC staff at the 2017 AICPA Conference on Current \nSEC and PCAOB Developments.14 The SEC staff stated that it would not object to a registrant’s \nconsistent application of an incremental borr owing rate in transition that is based on either the original \nlease term or the remaining lease term. \nFor example, assume a lessee enter ed into an operating lease for a 20 -year term commencing on \n1 January 2005 and the date of initial application is 1 Janu ary 2017. In this case, the entity could elect \nto determine its incremental borrowing rate, as of 1 January 2017, based on a 20 -year term ( i.e., the \ntotal lease term) or on an eight -year term ( i.e., the remaining lease term as of the date of initial applic ation). \nAssume the same facts except the 20 -year lease has a five -year renewal option that was previously \nexcluded from the lease term because the lessee determined that it wasn’t reasonably assured of exercising \nthe option. The lessee also elects the hind sight practical expedient and concludes that the lease term is \n25 years. In that case, the entity could elect to determine its incremental borrowing, as of 1 January 2017, \nbased on a 25 -year term ( i.e., the total lease term) or based on a 13 -year term ( i.e., the remaining lease \nterm as of the date of initial application). \nThe election should be applied consistently to all of the lessee’s leases previously classified as operating leases. \nThe lease payments and lease term used to measure the incremental borro wing rate should be consistent \n(e.g., an entity that elects to measure the discount rate using the total lease term also should measure \nthe discount rate using lease payments over the total lease term). Refer to section 2.5, Discount rates , \nfor further dis cussion of determining discount rates under ASC 842. \n \n14 Speech by Michael P. Berrigan, 4 December 2017. Refer to the SEC website at https://www.sec.gov/news/speech/berrigan -\naicpa -2017 -conference -sec-pcaob -developments . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 450}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 439 11.3.3c Remaining minimum rental payments — leases previously classified as operating \nleases under ASC 840 — lessee \nASC 842-10-65-1(l) requires a lessee to use its “minimum rental payments (as defined under Topic \n840) ” as an input to measure its lease liability for leases previously classified as operating leases under \nASC 840. However, ASC 840 does not define minimum rental payments. Under ASC 840, some lessees \ninclude executory costs ( i.e., insurance, taxes, maintenance) when determining minimum rental \npayments. In response to a technical inquiry, for purposes of applying ASC 842’s transition provisions, \nthe FASB staff said a lessee should follow its existing policy under ASC 840 to include or exclude \nexecutory costs when determining its minimum rental payments. \nThe FASB staff also said an entity that wants to change its existing policy under ASC 840 to include or \nexclude executory costs ( e.g., maintenance, taxes, insurance) when determining its minimum rental \npayments must evaluate the change in accordance with ASC 250, Accounting Changes and Error \nCorrections (refer to our FRD, Accounting changes and error corrections ). In a speech,15 a member of the \nSEC staff reiterated the views expressed by the FASB staff. \nAlso r efer to section 11.2.8, Practical expedient to not separate lease and non -lease components , for a \ndiscussion of a circumstance when we believe lease and non -lease components ( e.g., maintenance) may \nbe combined in transition when an entity elects to apply the practical expedient to not separate lease and \nnon-lease components to all lea ses entered into and modified after the effective date of the new leases standar d. \nWhen a lease includes payments based on an index or rate, questions also arise about the date a lessee \nshould use to determine the index or rate to measure minimum rental pa yments in transition. In response \nto a technical inquiry, the FASB staff said a lessee should use the index or rate as of the later of (1) the \nlease inception date or (2) the effective date of the most recent lease modification to measure its minimum \nrenta l payments in transition. That is, for a lease with an inception date or that was modified before the \ndate of initial application, the lessee would not remeasure its minimum rental payments at the date of \ninitial application in transition to ASC 842. \nHowev er, in a speech ,16 the SEC staff stated that it would not object if a company that has a historical \npolicy of updating the base rate in its disclosure of minimum rental payments under ASC 840 to reflect a \nchange in index or rate since inception of the leas e uses the index or rate at the date of transition for the \ninitial measurement of those leases upon the adoption of ASC 842. However, the SEC staff stated that an \nentity that does not have a historical policy of updating the base rate and wishes to change its policy is \nrequired to evaluate the cha nge in accordance with ASC 250. \n11.3.3d Foreign exchange rate — leases previously classified as operating leases \nunder ASC 840 — lessee \nWhen a lessee initially recognizes a right -of-use asset for an existing operating lease that is denominated \nin a foreign currency, the lessee determines the appropriate foreign exchange rate to use to p rospectively \nremeasure the right -of-use asset to its functional currency. We believe a lessee should use the foreign \nexchange rate at the date the lessee first recognizes the right -of-use asset on its balance sheet to remeasure \na right -of-use asset. This a pproach is consistent with ASC 830-20-30-1, which requires initial measurement \nof a foreign currency -denominated asset using the exchange rate in effect at the date of initial recognition. \n \n15 Speech by Michael P. Berrigan, 4 December 2017. Refer to the SEC website at https://www.sec.gov/news/speech/berrigan -\naicpa -2017 -conference -sec-pcaob -developments . \n16 Speech by Andrew W. Pidgeon, 10 December 2018. Refer to the SEC web site at https://www.sec.gov/news/speech/speech -\npidgeon -121018 . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 451}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 440 ASC 842’s transition provisions do not address foreign currency gains or losses in the comparative periods . \nHowever, we believe the general transition guidance in ASC 842-10-65-1(d) applies. Therefore, w hen a \nlessee applies the transition provisions at the beginning of the earliest comp arative period, we believe a \nlessee recognize s foreign currency gains or losses on lease -related monetary assets and liabilities for a \nlessee’s operating leases in income during the comparative periods presented ( e.g., 2017 and 2018 for a \ncalendar year -end entity). \n11.3.4 Reassessment of lease liabilities and right -of-use assets — transition \nconsiderations \nExcerpt from Accounting Standards Codification \nLeases — Overall \nTransition and Open Effective Date Information \n842-10-65-1 \nLeases previously classified as operating leases under Topic 840 \nq. If a modification to the contractual terms and conditions occurs on or after the effective date, and \nthe modification does not result in a separate contract in accordance with paragraph 842-10-25-8, \nor the lessee is required to remeasure the lease liability for any reason (see paragraphs 842 -20-35-4 \nthrough 35 -5), the lessee shall follow the requirements in this Topic from the effective date of \nthe modification or the remeasurement date. \nLeases previously classified as capital leases under Topic 840 \nt. If a modification to the contractual terms and conditions occurs on or after the effective date, and \nthe modification does not result in a separate contract in accordance with paragraph 842 -10-25-8, \nor the lessee is required to remeasure the lease liability in accordance with paragraph 842 -20-35-4, \nthe lessee shall subsequently account for the lease in accordance with the requirements in this \nTopic beginning on the effective date of the modif ication or the remeasurement date. \nASC 842’s transition provisions generally allow for a lessee to run out its existing accounting under ASC 840 \nwhen lease classification does not change in transition ( i.e., leases previously classified as operating \nlease s under ASC 840 remain operating leases under ASC 842, and leases previously classified as capital \nleases under ASC 840 become finance leases under ASC 842). However, after the effective date, a \nlessee applies the guidance in ASC 842 to such leases when th ere is a lease modification ( i.e., a change \nto the terms and conditions of the contract that results in a change in the scope of or the consideration \nfor the lease) that is not accounted for as a separate contract. Refer to section 4.6, Lease modifications . \nThe lessee is also required to apply the guidance in ASC 842 and remeasure finance and operating lease \nliabilities when any of the following occurs: \n• A resolution of a contingency that is unrelated to a change in reference index or rate and that results \nin some or all of the payments allocated to the lease component that were previously determined to \nbe variable meeting the definition of a lease payment ( e.g., an event occurs that results in variable \npayments that were linked to the performance or use of t he underlying asset becoming fixed payments \nfor the remainder of the lease term) \n• A change in any of the following: \n• The lease term (refer to section 2.3.1, Lease term ) \n• The assessment of whether a lessee is reasonably certain to exercise an option to purchase the \nunderlying asset (refer to section 2.3.2, Purchase options ) \n• The amount it is probable the lessee will owe under a residual value guarantee (refer to section \n2.4.6, Amounts it is probable that a lessee will owe under residual value guarantees — lessees only ) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 452}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 441 The last criterion above does not immediately apply to leases previously classified as capital leases under \nASC 840 that become finance leases under ASC 842. The initial measurement of a capital lease obligation \nunder ASC 840 includes the full amount of a residual value guarantee rather than the amount probable \nof being owed. That is, after the effective date lessees do not remeasure the lease liability to r eflect the \namount probable of being owed for a residual value guarantee until there is a lease modification not \naccounted for as a separate lease or the liability is reassessed for other reasons described above. Refer to \nsection 3.5.1, Summary of lease rea ssessment and remeasurement requirements, for further discussion. \nASC 842 does not address how an entity applies the lease term reassessment requirements (including \nrequirements to reassess purchase and termination options) to leases that exist before and continue to \nexist after the effective date when the lessee has not elected to apply the hindsight practical expedient \n(refer to section 11.2.2, Transition practical expedients ). As a result, questions have arisen about whether \nsuch lessees should apply the lease term reassessment requirements in ASC 842-10-65-1(q) and (t) \nimmediately at the effective date or when the next triggering event occurs following the effective date. \nWe believe a lessee reassesses the lease term only when a significant event or sign ificant change in \ncircumstances within the lessee’s control occurs on or after the effective date ( e.g., construction of leasehold \nimprovements). Consequently, any significant events or significant changes in circumstances that occurred \nbefore the effectiv e date do not result in a lease term reassessment at the effective date. However, if and when \na lessee reassesses its lease liability after the effective date, we believe it should consider all cumulative \nchanges in facts and circumstances through the date of reassessment. That is, changes in facts and \ncircumstances that occurred before the effective date are considered in addition to the significant change in \nfacts and circumstances after the effective date in the reassessment of whether the lessee is reas onably certain \nto exercise an option to extend the lease term, not terminate the lease or purchase the underlying asset. \nIf a lessee elects to apply the hindsight practical expedient discussed in section 11.2.2, Transition practical \nexpedients , it consider s all facts and circumstances that have changed through the effective date (but not \nafter the effective date) when determining the lease term in transition. As a result, significant events or \nsignificant changes in facts and circumstances that occurred bef ore the effective date would have already \nbeen considered in the initial recognition of the lease liability and right -of-use asset in transition. An entity \nthat elects to apply the hindsight practical expedient continues to monitor for additional significa nt events \nor significant changes in facts and circumstances on or after the effective date. \nThe following illustration shows the application of the reassessment guidance to a lease for an entity that \ndid not elect to apply the hindsight practical expedient . \nIllustration 11 -3: Reassessment of the lease term after the effective date (hindsight practical \nexpedient is not elected) \nLessee A enters into a 10 -year operating lease of space in an office building that commences on \n1 January 2015. The lease includes an option for the lessee to extend the term for an additional five \nyears. At lease inception, when Lessee A applied the guidance in ASC 840, it determined that it was \nnot reasonably assured of exercising the extension option. On 1 March 2018, Lessee A appr oves a \nplan to construct significant leasehold improvements to its office space, and construction is completed \non 1 December 2018. The improvements are expected to have significant economic value to Lessee A \nwhen its renewal option is exercisable. \nLessee A adopts ASC 842 effective 1 January 2019. Lessee A applies the transition provisions at the \nbeginning of the earliest comparative period presented ( i.e., as of 1 January 2017) and does not elect to \napply the hindsight practical expedient. On 1 March 2020, Lessee A approves a plan to move its corporate \nheadquarters to this office space. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 453}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 442 Analysis: When Lessee A adopts the guidance in ASC 842, it recognizes it s operating lease liability and \nright -of-use asset based on the remaining lease term of eight years as of 1 January 2017 (the beginning of \nthe earliest comparative period presented). On 1 March 2020 when it approves the plan to relocate its \ncorporate headq uarters to the leased space, Lessee A concludes this is a significant event within its control \nthat requires it to reassess its lease term. Lessee A considers both the relocation and the expected value of \npreviously constructed leasehold improvements in it s reassessment of the lease term and might conclude \nthat it is now reasonably certain to exercise the extension option. If so, Lessee A reassesses its lease \nclassification as a result of the revised lease term and concludes that the lease remains an operat ing lease, \nand it remeasures its lease liability and right -of-use asset based on the revised remaining lease term. \nIn this scenario, the construction of the leasehold improvements in 2018 does not affect the lease \nterm at the effective date, but it would b e considered in determining whether the lessee is reasonably \ncertain to exercise the renewal upon the next reassessment event ( i.e., on 1 March 2020). \nJudgment may be required to determine whether the reassessment requirements of ASC 842 should be \napplie d at the effective date when there are significant events or changes in circumstances in progress at \nthat date. For example, if a lessee begins construction related to significant improvements to its leased \nspace before the effective date, and construction is substantially complete at the effective date, the \nlessee may conclude that a significant change in circumstances related to these improvements has not \noccurred on or after the effective date. Alternatively, if the construction is not substantially comp lete at \nthe effective date and the lessee makes modifications to its planned improvements, the lessee may \ndetermine that the modifications to its in -process improvements represent a significant change in \ncircumstances requiring reassessment. \n11.3.5 Lessee transition — examples \n11.3.5.1 Leases previously classified as capital leases under ASC 840 \nASC 842 includes the following example to illustrate the application of ASC 842’s lessee transition \nguidance for existing capital leases. \nExcerpt from Accounting St andards Codification \nLeases — Overall \nImplementation Guidance and Illustrations \nIllustrations of Transition \nIllustration of Lessee Transition —Existing Capital Lease \n842-10-55-243 \nExample 28 illustrates lessee accounting for the transition of existing capital leases when an entity \nelects the transition method in paragraph 842 -10-65-1(c)(1). \nExample 28 — Lessee Transition — Existing Capital Lease \n842-10-55-244 \nThe effective date of the guidance in this Topic for Lessee is January 1, 20X4. Lessee enters into a 7 -\nyear lease of an asset on January 1, 20X1, with annual lease payments of $25,000 payable at the end \nof each year. The lease includes a residual value guarantee by Lessee of $8,190. Lessee’s incremental \nborrowing rate on the date of commenc ement was 6 percent. Lessee accounts for the lease as a \ncapital lease. At lease commencement, Lessee defers initial direct costs of $2,800, which will be \namortized over the lease term. On January 1, 20X2 (and before transition adjustments), Lessee has a \nlease liability of $128,707, a lease asset of $124,434, and unamortized initial direct costs of $2,400. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 454}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 443 842-10-55-245 \nJanuary 1, 20X2 is the beginning of the earliest comparative period presented in the financial \nstatements in which Lessee first applies the guidance in this Topic. Lessee has elected the package of \npractical expedients in paragraph 842 -10-65-1(f). As such, Lessee accounts for the lease as a finance \nlease, without reassessing whether the contract contains a lease or whether classifi cation of the lease \nwould be different in accordance with this Topic. Lessee also does not reassess whether the \nunamortized initial direct costs on January 1, 20X2, would have met the definition of initial direct \ncosts in this Topic at lease commencement. \n842-10-55-246 \nOn January 1, 20X2, Lessee recognizes a lease liability at the carrying amount of the capital lease \nobligation on December 31, 20X1, of $128,707 and a right -of-use asset at the carrying amount of the \ncapital lease asset of $126,834 (which inc ludes unamortized initial direct costs of $2,400 that were \nincluded in the capital lease asset). Lessee subsequently measures the lease liability and the right -of-\nuse asset in accordance with Subtopic 840 -30 until the effective date. \n842-10-55-247 \nBeginnin g on the effective date, Lessee applies the subsequent measurement guidance in Section 842 -\n20-35, including the reassessment requirements, except for the requirement to reassess amounts \nprobable of being owed under residual value guarantees. Such amounts w ill only be reassessed if there \nis a remeasurement of the lease liability for another reason, including as a result of a lease \nmodification (that is, not accounted for as a separate contract). \n11.3.5.2 Leases previously classified as operating leases under ASC 840 \nASC 842 includes the following example to illustrate the application of ASC 842’s lessee transition \nguidance for existing operating leases. \nExcerpt from Accounting Standards Codification \nLease s — Overall \nImplementation Guidance and Illustrations \nIllustrations of Transition \nIllustration of Lessee Transition —Existing Operating Lease \n842-10-55-248 \nExample 29 illustrates lessee accounting for the transition of existing operating leases when an entity \nelects the transition method in paragraph 842 -10-65-1(c)(1). \nExample 29 — Lessee Transition — Existing Operating Lease \n842-10-55-249 \nThe effective date of the guidance in this Topic for Lessee is January 1, 20X4. Lessee enters into a \nfive-year lease of an asset on January 1, 20X1, with annual lease payments payable at the end of each \nyear. Lessee accounts for the lease as an operating lease. At lease commencement, Lessee defers \ninitial direct costs of $500, which will be amortized over the lease term . On January 1, 20X2 (and \nbefore transition adjustments), Lessee has an accrued rent liability of $1,200 for the lease, reflecting \nrent that was previously recognized as an expense but was not yet paid as of that date. Four lease \npayments (1 payment of $31 ,000 followed by 3 payments of $33,000) and unamortized initial direct \ncosts of $400 remain. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 455}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 444 842-10-55-250 \nJanuary 1, 20X2 is the beginning of the earliest comparative period presented in the financial statements \nin which Lessee first applies the guidance in this Topic. On January 1, 20X2, Lessee’s incremental \nborrowing rate is 6 percent. Lessee has elected the package of practical expedients in paragraph 842 -10-\n65-1(f). As such, Lessee accounts for the lease as an operating lease, without reassessing wheth er the \ncontract contains a lease or whether classification of the lease would be different in accordance with this \nTopic. Lessee also does not reassess whether the unamortized initial direct costs on January 1, 20X2, \nwould have met the definition of initia l direct costs in this Topic at lease commencement. \n842-10-55-251 \nOn January 1, 20X2, Lessee measures the lease liability at $112,462, which is the present value of \n1 payment of $31,000 and 3 payments of $33,000 discounted using the rate of 6 percent. The right -\nof-use asset is equal to the lease liability before adjustment for accrued rent and unamortized initial \ndirect costs, which were not reassessed because Lessee elected the practical expedients in paragraph \n842-10-65-1(f). \n842-10-55-252 \nOn January 1, 2 0X2, Lessee recognizes a lease liability of $112,462 and a right -of-use asset of \n$111,662 ($112,462 — $1,200 + $400). \n842-10-55-253 \nFrom the transition date (January 1, 20X2) on, Lessee will continue to measure and recognize the \nlease liability at the pres ent value of the sum of the remaining minimum rental payments (as that term \nwas applied under Topic 840) and the right -of-use asset in accordance with this Topic. \n842-10-55-254 \nBeginning on the effective date of January 1, 20X4, Lessee applies the subseque nt measurement \nguidance in Section 842 -20-35, including the reassessment requirements. \n11.3.6 Lessee involvement in asset construction (‘build -to-suit’ transactions) \nExcerpt from Accounting Standards Codification \nLeases — Overall \nTransition and Open Effective Date Information \n842-10-65-1 \nu. A lessee shall apply a modified retrospective transition approach for leases accounted for as \nbuild -to-suit arrangements under Topic 840 that are existing at, or entered into after, the \nbeginning of the earliest comparative period presented in the financial statements (if an entity \nelects the transition method in (c)(1)) or that are existing at the beginning of the reporting period \nin which the entity first applies the pending content that links to this p aragraph (if an entity elects \nthe transition method in (c)(2)) as follows: \n1. If an entity has recognized assets and liabilities solely as a result of a transaction’s build -to-\nsuit designation in accordance with Topic 840, the entity shall do the following : \ni. If an entity elects the transition method in (c)(1), the entity shall derecognize those \nassets and liabilities at the later of the beginning of the earliest comparative period \npresented in the financial statements and the date that the lessee is determin ed to be \nthe accounting owner of the asset in accordance with Topic 840. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 456}), Document(page\_content='11 Effective dat e and transition \nFinancial reporting developments Lease accounting | 445 ii. If an entity elects the transition method in (c)(2), the entity shall derecognize those \nassets and liabilities at the beginning of the reporting period in which the entity first \nappli es the pending content that links to this paragraph. \niii. Any difference in (i) or (ii) shall be recorded as an adjustment to equity at the date that \nthose assets and liabilities were derecognized in accordance with (u)(1)(i) or (ii). \niv. The lessee shall apply the lessee transition requirements in (k) through (t) to the lease. \n2. If the construction period of the build -to-suit lease concluded before the beginning of the \nearliest comparative period presented in the financial statements (if the entity elects the \ntransition method in (c)(1)) or if it concluded before the beginning of the reporting period in \nwhich the entity first applies the pending content that links to this paragraph (if the entity \nelects the transition method in (c)(2)), and the transaction qualifie d as a sale and leaseback \ntransaction in accordance with Subtopic 840 -40 before that date, the entity shall follow the \ngeneral lessee transition requirements for the lease. \nASC 842 significantly changes the guidance for lessee involvement in asset construction. The guidance in \nASC 842 focuses on whether the lessee controls the asset being constructed rather than whether the \nlessee has substantially all of the risks during the con struction period. Refer to section 7.7, Lessee \ninvolvement in asset construction (‘build -to-suit’ transactions) , for further discussion of the evaluation and \naccounting for build -to-suit transactions under ASC 842. \nThe accounting by entities that recognized assets and liabilities solely as a result of the build -to-suit \nguidance in ASC 840 will depend upon whether the construction project is complete as of the effective date. \nConstruction is completed before the effective date \nIf an entity recognized assets and liabilities solely as a result of the build -to-suit guidance in ASC 840 and \nconstruction of the asset was com pleted prior to the effective date, the entity is required to derecognize \nthose assets and liabilities. This guidance applies even if the entity would conclude it controls the asset \nbeing constructed by applying ASC 842’s guidance on lessee involvement in asset construction. For an \nentity that elects to apply the transition provisions at the beginning of the earliest period presented, this \nguidance also applies to all assets and liabilities recognized solely as a result of ASC 840’s build -to-suit \nguidance, even if the entity achieved sale -leaseback accounting during the comparative periods presented. \nIf the entity applies the transition provisions at the beginning of the period of adoption (i.e., the effective \ndate) , it derecognizes the assets and liabilitie s at that date. Any difference between the assets and \nliabilities derecognized is recorded as an adjustment to equity at that date. \nIf the entity applies the transition provisions at the beginning of the earliest comparative period \npresented, it derecognizes the assets and liabilities at the later of (1) the beginning of the earliest period \npresented in the financial statements and (2) the date that the lessee is determined to be the accounting \nowner of the asset (generally the date construction of the asset commenced ). If the entity derecognizes \nthe assets and liabilities at the beginning of the earliest period presented, any differenc e between the \nassets and liabilities derecognized is recorded as an adjustment to equity at that date. If the entity applies \nthe transition provisions at the beginning of the earliest comparative period presented and initially \nrecognized build -to-suit assets and liabilities in accordance with ASC 840 after the beginning of the earliest \nperiod presented, we believe it should reverse any of the accounting entries that were reco rded during the \ncomparative periods for the respective line items ( e.g., capitaliza tion of the constructed asset and the \nrelated liability, depreciat ion expense, interest expense) rather than as an adjustment to equity . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 457}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 446 Following derecognition of the assets and liabilities, the lessee recognize s the lease in accordance with \nASC 842. If t he entity applies the transition provisions at the beginning of the period of adoption ( e.g., 1 \nJanuary 2019 for calendar -year public business entities), it recognizes the lease at that date. If the entity \napplies the transition provisions at the beginning of the earliest comparative period presented, it \nrecognizes the lease at the later of the beginning of the earliest comparative period presented and the \ncommencement date of the lease (generally at the completion of construction). \nThe transition guidance does not address how an entity that derecognizes assets and liabilities previously \nrecognized solely as a result of the build -to-suit guidance in ASC 840 would classify its lease in transition. \nFor purposes of applying ASC 842’s transition provisions, if an entity did not elect the package of \npractical expedients (and therefore is reassessing lease classification for all existing leases), we believe \nthe entity could apply ASC 842 to classify the lease either: \n• At the date the underlying asset was available for use by the lessee (generally the date construction \nwas completed) \n• At the later of (1) the date the underlying asset was available for use by the lessee and (2) the date \nthe entity applies the standard’s transition provis ions ( e.g., 1 January 2019 for a calendar -year \npublic business entity or 1 January 2022 for a calendar -year non -public business entity that applies \nthe transition provisions at the beginning of the period of adoption) \nIf an entity elects the package of pra ctical expedients (and therefore is not reassessing lease classification \nfor all existing leases), we believe to initially classify the lease the entity could do one of the following: \n• Apply ASC 840 to classify the lease as if it had always been accounted f or as a lease ( i.e., it would \napply ASC 840’s classification guidance at the lease inception date) \n• Apply ASC 842 to classify the lease as if it had always been accounted for as a lease ( i.e., it would \napply ASC 842’s classification guidance at the date the underlying asset was available for use by the \nlessee (generally the date construction was completed)) \n• Apply ASC 842 to classify the lease at the later of (1) the date the underlying asset was available for \nuse by the lessee and (2) the date the entity app lies the standard’s transition provisions ( e.g., 1 \nJanuary 2019 for a calendar -year public business entity or 1 January 2022 for a calendar -year non -\npublic business entity that applies the standard’s transition provisions at the beginning of the period \nof adoption) \nIn accordance with ASC 842-10-65-1(u)(2), if the construction period of the build -to-suit lease concluded \nbefore the beginning of the earliest comparative period presented in the financial statements (if the \nentity elects to apply the transition provisions at the beginning of the earliest period presented) or if it \nconcluded before the beginning of the period of adoption (if the entity elects the transition provisions at \nthe beginning of the period of adoption) and the transaction qualified as a s ale and leaseback transaction \nin accordance with Subtopic 840 -40 before that date, the entity follow s the general lessee transition \nrequirements for the lease. That is, in these situations, the entity does not follow the transition provisions \nfor build -to-suit transactions and would apply the transition provisions in ASC 842-10-65-1(k) through (y) \nand (dd) through (ee) for the leaseback (refer to section 11.5.1, Sale and leaseback transition ). For \nexample, assume a public business entity that recognized build -to-suit assets and liabilities in accordance \nwith ASC 840 elects to apply the transition provisions on 1 January 2019. Also assume construction of \nthe underlying asset concluded and the transaction qualified as a sale -leaseback under ASC 840-40 \nbefor e 1 January 2019. In this example, the entity would apply the general lessee transition provisions \nfor the lease (and thus the guidance above is not applicable). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 458}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 447 Construction is ongoing at the effective date \nIf an entity previously determined it was the deemed owner of an asset during construction following the \nguidance in ASC 840 and the construction project is ongoing at the effective date, the entity would \nderecognize the assets and liabilities. If the enti ty applies the transition provisions at the beginning of the \nearliest comparative period presented, it derecognizes the assets and liabilities at the later of (1) the \nbeginning of the earliest period presented in the financial statements or (2) the date co nstruction of the \nassets commenced. If the entity applies the transition provisions at the beginning of the period of adoption, \nit derecognizes the assets and liabilities at that date. At the effective date, the entity will evaluate ASC 842’s \nguidance for lessee involvement in asset construction to determine if it controls the underlying asset. If \nthe entity concludes it controls the asset, it will again recognize the asset under construction with a \nrelated financing obligation. Refer to section 7.7, Lessee involvement in asset construction (‘build -to-suit’ \ntransactions), for further discussion of determining whether a lessee controls an asset under construction \nand the accounting when the lessee is the deemed owner. \nIn some circumstances, an entity may have determined that it was not the deemed owner of the asset \nduring construction applying ASC 840 ( i.e., the entity did not bear substantially all of the construction \nperiod risk); however, applying the guidance in ASC 842, the entity determines that it contr ols the asset \nunder construction at the effective date. In those cases, we believe the lessee would recognize the asset \nand financing obligation as of the effective date. If the lessee applies the transition provisions at the \nbeginning of the earliest comp arative period presented, it could also choose to recognize that asset and \nfinancing obligation as of the beginning of construction. \nLessors are required to follow ASC 842’s guidance on lessee involvement in asset construction for any \nconstruction project that is in progress or commences on or after the effective date of ASC 842. Refer to \nsection 7.7, Lessee involvement in asset construction (‘build -to-suit’ transactions) . \n11.4 Lessor transition \nThe FASB issued ASU 2018 -20, Narrow -Scope Improvements for Le ssors , which amended ASC 842 to allow \nlessors to make an accounting policy election not to evaluate whether sales taxes and similar taxes imposed \nby a governmental authority on a specific lease revenue -producing transaction and collected by the lessor \nfrom the lessee are the primary obligation of the lessor as owner of the underlying leased asset. A lessor that \nmakes this election must exclude from the consideration in the contract and from variable payments not \nincluded in the consideration in the contract all taxes within the scope of the election and make additional \ndisclosures. The amendments also require a lessor to exclude lessor costs paid directly by a lessee to \nthird parties on the lessor’s behalf from variable payments, but lessor costs that are pa id by the lessor \nand reimbursed by the lessee are required to be included in variable payments. Refer to section 1.4.4, \nDetermining, allocating and reassessing the consideration in the contract — lessors , for further discussion. \nThe amendments also clarify that when lessors allocate variable payments to lease and non -lease \ncomponents they are required to follow the recognition guidance in ASC 842 for the lease component \nand other applicable guidance, such as ASC 606, for the non -lease component. Refer to section 1.4.4.3, \nAllocating variable payments — lessors . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 459}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 448 The FASB also issued ASU 2019 -01, Codification Improvements, which added guidance to ASC 842 that \nis similar to the guidance in ASC 840-10-55-44 and states that, for lessors that are not manufacturers or \ndealers, the fair value of the underlying asset is their cost, less any volume or trade discounts. However, \nif there is a significant amount of time between the acquisition of the underlying asset and lease \ncommencement, a les sor would have to measure the fair value using the guidance in ASC 820, Fair Value \nMeasurement. Refer to section 2.8, Fair value , for further discussion. \nThe amendments also clarified that lessors in the scope of ASC 942, Financial Services — Depository an d \nLending, must classify principal payments received from sales -type and direct financing leases in investing \nactivities in the statement of cash flows. Refer to section 5.8, Presentation , for further discussion. \nLessor transition when the package of pract ical expedients is elected \nThe flowchart below shows how a lessor that elects the package of practical expedients applies the \ntransition guidance. As discussed in section 11.2.2, Transition practical expedients , an entity that elects \nthe package of practic al expedients does not reassess whether the arrangement is or contains a lease, \nlease classification and whether previously capitalized costs continue to qualify as initial direct costs. \n \nBecause a lessor elects to apply the package of practical expedien ts, lease classification \ndoes not change in transition ( i.e., a sales -type or direct financing lease remains a sales -type \nor direct financing lease, and an operating lease remains an operating lease). \n•For leases previously classified as sales -type or dir ect financing l eases, refer to section 11. 4.1, Leases previously \nclassified as sales -type or direct financing leases under ASC 840 that are classified as sales -type or direct \nfinancing leases under ASC 842. \n•For leases previously classified as operating leases, refer to section 11. 4.3, Leases previously classified as \noperating leases under ASC 840 that continue to be classified as operating le ases under ASC 842 — lessors. \nYes \nNo \nDid the entity elect to apply the hindsight practical expedient to determine the lease term? \n(Refer to section 11.2.2, Transition practical expedients ) \nReassess the lease term based on all known facts and circumstances through the effective date. \nAn entity that elects to apply the hindsight practical expedient considers all facts and circumstances that have \nchanged through the effective date to determine the lease term. \n(Refer to section 11.2.2, Transition practical expedients ) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 460}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 449 Lessor transition when the package of practical expedients is not elected \nThe flowchart below shows how a lessor that does not elect the package of practical expedients (discussed in section \n11.2.2, Transition practical expedients ) applies the transition guidance. \n \nYes \nIs the contract a lease or does it contain a lease based upon \nthe definition of a lease in ASC 842? \n(Refer to section 1.2, Determining whether an arrangement contains a lease ) \nYes \n•For leases previously classified as sales -type or \ndirect financing leases, refer to section 11. 4.1, \nLeases previously classified as sales -type or \ndirect financing leases under ASC 840 that are \nclassified as sales -type or direct financing leases \nunder ASC 842. \n•For leases previously classified as operating \nleases, refer to section 11. 4.3, Leases previously \nclassified as operating leases under ASC 840 that \ncontinue to be classified as operating leases \nunder ASC 842 — lessors . \nYes \nReassess whether previously capitalized IDCs qualify for capitalization under ASC 842. \nWrite off any unamortized IDCs that do not meet the definition in ASC 842. \n(Refer to section 2.6, Initial direct costs , and the applicable transition guidance reference d below) \nNo \nApply other US GAAP \n•For leases previously classified as sales -type or \ndirect financing leases, refer to section 11. 4.2, \nLeases previously classified as sales -type or direct \nfinancing leases under ASC 840 that are classified \nas operating leases under ASC 842. \n•For leases previously classified as operating \nleases, refer to section 11. 4.4, Leases previously \nclassified as operating leases under ASC 840 that \nare classified as sales -type or direct financing \nleases under ASC 842. \nReassess the lease term based on all known facts and circumstances through the effective date. \nAn e ntity that elects the hindsight practical expedient is required to consider all facts and circumstances that \nhave changed or occurred, through the effective date, in determining the lease term. \n(Refer to section 11.2.2, Transition practical expedients ) \nNo \nNo \nDid the entity elect to apply the hindsight practical expedient to determine the lease term? \n(Refer to section 11.2.2, Transition practical expedients ) \nReassess lease classification based on the guidance in ASC 842. \nDid lease classification chan ge as a result of the reassessment? \n(Refer to section 11.2.3, Reassessment of lease classification ) \nWas the lease previously classified as a sales -type or direct financing lease under ASC 840 that continues to \nbe classified as a sales -type or a direct financing lease under ASC 842? \n(Refer to section 11.4.1, Leases previously classified as sales -type or direct financing leases under ASC 840 \nthat are classified as sales -type or direct financing leases under ASC 842) \nYes \nNo ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 461}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 450 11.4.1 Leases previously classified as sales -type or direct financing leases under \nASC 840 that are classified as sales -type or direct financing leases under \nASC 842 \nExcerpt from Accounting Standards Codification \nLeases — Overall \nTransition and Open Effective Da te Information \n842-10-65-1 \nx. For each lease classified as a direct financing lease or a sales -type lease in accordance with this \nTopic, do all of the following: \n1. Continue to recognize a net investment in the lease at the application date as determined in \n(c) at the carrying amount of the net investment at that date. This would include any \nunamortized initial direct costs capitalized as part of the lessor’s net investment in the lease \nin accordance with Topic 840. \n2. If an entity elects the tr ansition method in (c)(1), before the effective date, a lessor shall \naccount for the lease in accordance with Topic 840. \n3. Regardless of the transition method selected in (c), beginning on the effective date, a lessor \nshall account for the lease in accord ance with the recognition, subsequent measurement, \npresentation, and disclosure guidance in Subtopic 842 -30. \n4. Beginning on the effective date, if a lessor modifies the lease (and the modification is not \naccounted for as a separate contract in accordance with paragraph 842 -10-25-8), it shall \naccount for the modified lease in accordance with paragraph 842 -10-25-16 if the lease is \nclassified as a direct financing lease before the modification or paragraph 842 -10-25-17 if the \nlease is classified as a sales -type lease before the modification. A lessor shall not remeasure \nthe net investment in the lease on or after the effective date unless the lease is modified \n(and the modification is not accounted for as a separate contract in accordance with \nparagrap h 842 -10-25-8). \nLessor elects to apply the package of practical expedients \nIf an entity elects to apply the package of practical expedients, as described in section 11.2.2, Transition \npractical expedients , sales -type leases and direct financing leases und er ASC 840 remain sales -type \nleases and direct financing leases, respectively, under ASC 842 ( i.e., lease classification is not reassessed \nin transition). \nLessor does not elect to apply the package of practical expedients \nFor these leases, an entity that d oes not elect to apply the package of practical expedients reassesses (1) \nwhether the arrangement is or contains a lease and (2) lease classification. That entity applies, as of the \nlease commencement date (or most recent modification that does not result in a separate new lease), all \nof the guidance in ASC 842 relevant to determining lease classification. Refer to section 11.2.3, \nReassessment of lease classification , for further discussion. If lease classification changes from a sales -\ntype or direct financ ing lease to an operating lease, refer to section 11.4.2, Leases previously classified as \nsales -type or direct financing leases under ASC 840 that are classified as operating leases under ASC 842. \nIf the entity does not elect to apply the package of practical expedients, reassessment of lease classification \ncould also be impacted by a change in lease term if the entity elects to apply the hindsight practical \nexpedient (described in 11.2.2, Transition practical expedients). The use of the hindsight pra ctical \nexpedient may impact lease classification only if the package of practical expedients is not elected. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 462}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 451 Summary of transition provisions \nThe table below summarizes the guidance for leases that commence before the effective date, were \npreviously classi fied as sales -type or direct financing leases under ASC 840 and continue to be classified \nas sales -type or direct financing leases under ASC 842. Even if classification changes from a sales -type \nlease to a direct financing lease or from a direct financing lease to a sales -type lease, a lessor continues \nto run out its accounting under ASC 840 as more fully described in this section. \nWhile application of the initial measurement guidance in the transition provisions is the same for all \nentities, the amount of each entity’s cumulative effect adjustment to retained earnings could differ due \nto the timing of when the entity elects to apply the transition provisions. \n Lessor applies the transition provisions \nat the beginning of the earliest \ncomparative period Lessor applies the transition provisions at \nthe beginning of the period of adoption \nInitial recognition \nNet investment \nin the lease The lessor continues to recognize a net \ninvestment in the lease at the later of \n(1) the beginning of the earliest comparative \nperiod presented or (2) the commencement \ndate of the lease, measured at the carrying \namount of the net investment in the lease \nunder ASC 840, including any unamortized \ninitial direct costs capitalized as part of the \nlessor’s net investment in the lease under \nASC 840.1 \n(ASC 842-10-65-1(x)(1) and section 11.4.1.1, \nInitial measurement ) The lessor continues to recognize a net \ninvestment in the lease measured at the \ncarrying amount of the net investment in the \nlease under ASC 840, including any \nunamortized initial direct costs capitalized as \npart of the lessor’s net investment in the lease \nunder ASC 840, at the beginning of the period \nof adoption.1 \n(ASC 842-10-65-1(x)(1) and section 11.4.1.1, \nInitial measurement ) \nInitial direct \ncosts For existing direct financing leases, the lessor continues to recognize unamortized initial direct \ncosts capitalized in accordance with ASC 840 ( i.e., reassessment of initial direct costs under \nASC 842 is not permitted, even if the package of practical exp edients is not elected). Existing \nsales -type leases would not have capitalized initial direct costs because ASC 840 requires initial \ndirect costs incurred by the lessor to be expensed as part of the gain on sale in a sales -type lease. \n(ASC 842-10-65-1(x)(1 ) and section 11.4.1.1, Initial measurement ) \nSubsequent measurement before the effective date \nNet investment \nin the lease and \nincome \nrecognition The lessor accounts for the lease in \naccordance with ASC 840 and recognizes \nincome consistent with its existing \nrecognition pattern under ASC 840.1 \n (ASC 842-10-65-1(x)(2) and section \n11.4.1.2, Subsequent measurement before \nthe effective date ) A lessor does not change its accounting prior to \nthe effective date ( i.e., it continues to apply the \nguidance in ASC 840, including its disclosure \nrequirements, in the comparative periods \npresented). \n(Section 11.4. 1.2, Subsequent measurement \nbefore the effective date ) \nLease \nmodifications The lessor follows the lease modification \nguidance in ASC 840. \n(ASC 842-10-65-1(x)(2) and section \n11.4.1.2, Subsequent measurement before \nthe effective date ) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 463}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 452 Lessor applies the transition provisions \nat the beginning of the earliest \ncomparative period Lessor applies the transition provisions at \nthe beginning of the period of adoption \nSubsequent measurement on or after the effective date \nNet investment \nin the lease and \nincome \nrecognition The lessor accounts for the net investment in the lease and recognizes income1 in accordance \nwith the subsequent measurement guidance in ASC 842-30. \n(ASC 842-10-65-1(x)(3), ASC 842-30 and sections 11.4.1.3, Subsequent measurement on or \nafter the effective date , 5.2.2, Subsequent measurement — sales -type leases, and 5.3.2, \nSubsequent measurement — direct financing leases ) \nLease \nmodifications If a modification occurs on or after the effective date (and the modification is not accounted for \nas a separate contract in accordance with ASC 842-10-25-8), the lessee applies the following \nguidance: \n• ASC 842-10-25-16 if the lease is classified as a direc t financing lease before the \nmodification (refer to section 5.6.3.2, Modification to a direct financing lease that is not \naccounted for as a separate contract ) \n• ASC 842-10-25-17 if the lease is classified as a sales -type lease before the modification \n(refer to section 5.6.3.3, Modification to a sales -type lease that is not accounted for as a \nseparate contract ) \n(ASC 842-10-65-1(x)(4) and sections 11.4.1.3, Subsequent m easurement on or after the \neffective date , 5.6, Lease modifications and 2.3.6.2, Reassessment of the lease term and \npurchase options — lessors ) \n \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \n1 If the entity elects to apply the hindsight practical expedient and concludes that the lease term should ch ange, we believe the \nentity adjusts the se amounts to reflect the amounts that would have been recorded if the revised lease term had always been \nused. Refer to section 11.2.2, Transition practical expedients . \n11.4.1.1 Initial measurement \nFor existing sales -type and direct financing leases that continue to be classified as sales -type leases or \ndirect financing leases under ASC 842, a lessor continues to recognize a net investment in the lease \nmeasured at the carrying amount of the net inves tment in the lease under ASC 840, including any \nunamortized initial direct costs capitalized as part of the lessor’s net investment in the lease under \nASC 840 ( i.e., no reassessment of initial direct costs under ASC 842 is permitted even if the entity does \nnot elect to apply the package of practical expedients). \nIf the entity elects to apply the hindsight practical expedient, as discussed in section 11.2.2, Transition \npractical expedients , and concludes that the lease term should change, we believe the entity adjusts the \ncarrying amount of the initial measurement of the net investment in the lease measured under ASC 840 \nfor the change in the lease term to reflect how the lease would have b een recorded under ASC 840 had \nthe revised lease term always been applied. As discussed above, use of the hindsight practical expedient \ncan only affect lease classification if the package of practical expedients is not elected. \n11.4.1.2 Subsequent measurem ent before the effective date \nThe guidance in this section applies only to a lessor that applies the transition provisions at the beginning of \nthe earliest comparative period presented. If the lessor applies the transition provisions at the beginning of \nthe period of adoption, it does not change its accounting for the periods before the effective date ( i.e., it \ncontinues to apply the guidance in ASC 840, including its disclosure requirements, in the comparative \nperiods presented). Refer to section 11.2, Transition . \nNet investment in the lease and income recognition \nThe FASB indicated in the Basis for Conclusions (BC 390 ) of ASU 2016 -02 that the practical effect of the \nmodified retrospective transition is that an entity “runs off” its accounting for certain l eases that existed \nbefore the effective date when lease classification does not change in transition. This is the case even if \nthe entity did not elect to apply the package of practical expedients (refer to section 11.2.2, Transition ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 464}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 453 practical expedients ), but lease classification did not change ( e.g., the classification of a lease previously \nclassified as a sales -type or direct financing lease under ASC 840 is reassessed, and the entity \ndetermines that the lease is a sales -type or direct financing lease un der ASC 842). \nAs a result, during the periods before the effective dat e, the lessor accounts for the net investment in the \nlease in accordance with the subsequent measurement guidance for sales -type or direct financing leases \nin ASC 840 and records income consistent with its existing recognition pattern under ASC 840. If the \nlessor elects to apply the hindsight practical expedient and concludes that the lease term changes, the \nlessor adjusts its income prospectively ( i.e., from the later of (1) the beginning of the earliest \ncomparative period presented or (2) the commencement date of the lease). \nLease modifications \nThe lessor follows the guidance for lease modifications in ASC 840 to assess whether a lease modification \nhas occurred and to account for the lease modification. \nPresentation of lease payments in the statement of cash flows \nNeither ASC 230 nor ASC 840 addresses the presentation of lease payments received from a direct \nfinancing or sales -type lease in the statement of cash flows under ASC 840. Under ASC 840, s ome \nentities present ed principal payments received as an operating activity because the lease represents a \nrevenue -generating activity. Other entities consider ed these types of leases to be a financing transaction \nand therefore present ed the principal payments received as an investing activity. Upon transition, it is \nunclear whether a lessor that applies the transition provisions at the beginning of the earliest \ncomparative period presented and presents lease payments received under ASC 840 as an investing \nactivity should adjust comparative information in the statement of cash flows. We believe that a lessor \nshould apply the cash flow classification guidance in ASC 842-30, which requires a lessor to classify \nreceipt of lease payments withi n operating activities to all comparative periods presented. However, \nlessors in the scope of ASC 942 would generally continue to classify principal payments received under \nsales -type and direct financing leases in investing activities in the statement of cash flows. Refer to \nsection 5. 8, Presentation , for further discussion of classification of lease payments by lessors. \n11.4.1.3 Subsequent measurement on or after the effective date \nThe guidance in this section applies to all lessors with leases previously classified as sales -type or direct \nfinancing leases under ASC 840 that continue to be classified as sales -type or direct financing leases \nunder ASC 842, regardless of when the lessee applies the transition provisions (refer to section 11.2, \nTransition ). When a less or applies the transition provisions affects only the timing of recognition, not how \nthe subsequent measurement guidance is applied. \nNet investment in the lease and income recognition \nBeginning on the effective date ( i.e., 1 January 2019 for cal endar -year PBEs that do not adopt early), \nthe lessor applies the subsequent measurement guidance in ASC 842 to account for the net investment \nin the lease and to recognize income. If the entity applies the hindsight practical expedient and concludes \nthe le ase term should change, the lessor measures the net investment in the lease and recognizes \nincome based on the revised lease term. \nLease modifications \nBeginning on the effective date, a lessor applies the guidance in ASC 842 to determine whether a lease \nmodification has occurred and whether the modification results in a separate contract or a change in the \naccounting for the existing lease. The lessor al so applies the guidance in ASC 842 to determine whether \nthe exercise of an option to extend the lease or purchase the underlying asset by a lessee must be \naccounted for as a modification. Following the effective date of the modification, the lessor applies the \nsubsequent measurement guidance in ASC 842. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 465}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 454 In addition, following the effective date, a lessor evaluates the net investment in a sales -type or a direct \nfinancing lease for impairment using the guidance for receivables in ASC 310 (before the adoption of \nASU 2016 -13, Measurement of Credit Losses on Financial Instruments ) or ASC 326 (after the adoption \nof ASU 2016 -13). Refer to section 2.11.3, Leases , of our FRD, Credit impairment under ASC 326, for \nadditional details. \nRefer to the following sections for further discussion of subsequent measurement and lease modification \nguidance to apply following the effective date: \n• 5.2, Sales-type leases \n• 5.3, Direct financing leases \n• 5.6, Lease modifications \n• 2.3.6.2, Reassessment of the lease term and purchase options — lessors \n11.4.2 Leases previously classified as sales -type or direct financing leases under \nASC 840 that are classified as operating leases under ASC 842 \nExcerpt from Accounting Standards Codification \nLeases — Overall \nTransition and Open Effective Date Information \n842-10-65-1 \ny. For each lease classified as an operating lease in accordance with this Topic, the objective is to \naccount for the lease, beginning on the application date as determined in (c), as if it had always \nbeen accounted for as an operat ing lease in accordance with this Topic. Consequently, a lessor shall \ndo all of the following: \n1. Recognize the underlying asset at what the carrying amount would have been had the lease \nbeen classified as an operating lease under Topic 840. \n2. Derecognize the carrying amount of the net investment in the lease. \n3. Record any difference between the amounts in (y)(1) and (y)(2) as follows: \ni. If an entity elects the transition method in (c)(1), as an adjustment to equity (if the \ncommencement date of the lease was before the beginning of the earliest period presented or \nif the lease was acquired as part of a business combination) or earnings (if the commencement \ndate of the lease was on or after the beginning of the earliest period presented). \nii. If an entity elects the transition method in (c)(2), as an adjustment to equity. \n4. Subsequently account for the operating lease in accordance with this Topic and the \nunderlying asset in accordance with other Topics. \nLessor elects to apply the package of practical expedients \nIf an entity elects to apply the package of practical expedients described in section 11.2.2, Transition \npractical expedients , sales -type and direct financing leases under ASC 840 remain sales -type and direct \nfinancing leases, respecti vely, under ASC 842 ( i.e., lease classification is not reassessed in transition), \nand the guidance in this section is not applicable. In that case, the guidance in section 11.4.1, Leases \npreviously classified as sales -type or direct financing leases under ASC 840 that are classified as sales -\ntype or direct financing leases under ASC 842, is applicable. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 466}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 455 Lessor does not elect to apply the package of practical expedients \nAn entity that does not elect to apply the package of practical expedients reassesses (1) whether the \narrangement is or contains a lease, (2) lease classification and (3) whether previously capitalized costs continue \nto qualify as initial direct costs. That entity applies, as of the lease commencement date (or most recent \nmodification that does not result in a separate new lease), all of the guidance in ASC 842 relevant to determining \nlease classification. Refer to section 11.2.3, Reassessment of lease classification, for further discussion. \nIf the entity does not elect to apply the package of practical expedients, the assessment of lease classification \ncould be affected by a change in lease term if the entity elects to apply the hindsight practical expedient \n(described in 11.2.2, Transition practical expedients). The use o f the hindsight practical expedient might \naffect lease classification only if the package of practical expedients is not elected. \nSummary of transition provisions \nThe table below summarizes the guidance for leases that commence before the effective date, w ere \npreviously classified as sales -type or direct financing leases under ASC 840 and are classified as \noperating leases under ASC 842. \nWhile application of the initial measurement guidance in the transition provisions is the same for all \nentities, the amou nt of each entity’s cumulative effect adjustment to retained earnings could differ due \nto the timing of when the entity elects to apply the transition provisions. \n Lessor applies the transition provisions \nat the beginning of the earliest \ncomparative period Lessor applies the transition provisions at \nthe beginning of the period of adoption \nInitial measurement \nUnderlying asset \nand any lease \nassets and \nliabilities At the later of (1) the beginning of the earliest \ncomparative period presented or (2) the \ncommencement date of the lease, the lessor: \n• Derecognizes the carrying amount of the \nnet investment in the lease \n• Recognizes the underlying asset at what \nthe carrying amount would have been \nhad the lease been classifi ed as an \noperating lease under ASC 840 (refer to \nsection 11.4.2.1, Initial measurement , for \nleases denominated in a foreign currency) \nWe also believe a lessor: \n• Recognizes any lease -related assets or \nliabilities at the amounts that would have \nbeen recognized as if the lease had \nalways been accounted for as an \noperating lease under ASC 8421 \n• Recognizes initial direct costs as if \nASC 842 had always been applied1 At the beginning of the period of adoption, \nthe lessor: \n• Derecognizes the carrying amount of the net \ninvestment in the lease \n• Recognizes the underlying asset at what the \ncarrying amount would have been if the lease \nhad been classified as an operating lease \nunder ASC 840 (refer to section 11.4.2.1, \nInitial measurement , for leases denominated \nin a foreign currency)1 \nWe also believe a lessor: \n• Recognizes any lease -related assets or \nliabilities at the amounts that would have \nbeen recognized as if the lease had always \nbeen accounted for as an operating lease \nunder ASC 8421 \n• Recognizes initial direct costs as if ASC 842 \nhad always been applied1 \n• Records any difference between the carrying \namount of the net investment in the lease \nand the carrying amount of the underlying \nasset and any lease -related assets or \nliabilities as an adjustment to equity in the \nperiod of adoption \n(ASC 842-10-65-1(y)(1)(2)(3) and section \n11.4.2.1, Initial measurement ) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 467}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 456 Lessor applies the transition provisions \nat the beginning of the earliest \ncomparative period Lessor applies the transition provisions at \nthe beginning of the period of adoption \nInitial measurement (continued) \n • Records any difference between the \ncarrying amount of the net investment in \nthe lease and the carrying amount of the \nunderlying asset and any lease -related \nassets or liabilities as: \n• An adjustment to equity if the lease \ncommenced before the beginning of \nthe earliest comparative period \npresen ted \n• An adjustment to earnings in the \ncomparative period if the lease \ncommenced on or after the beginning \nof the earliest comparative period \npresented \n(ASC 842-10-65-1(y)(1)(2)(3) and section \n11.4.2.1, Initial measurement ) \nSubsequent measurement before and on or after the effective date1 \nUnderlying asset \nand lease \nincome The lessor accounts for the operating lease in accordance with the subsequent measurement \nguidance for operating leases in ASC 8421 and the underlying asset in accord ance with \nASC 360. \n(ASC 842-10-65-1(y)(4), ASC 842 and sections 11.4.2.2, Subsequent measurement before \nand on or after the effective date , and 5.4, Operating leases ) \nLease \nmodifications The lessor follows the lease modification guidance in ASC 842. \n(ASC 842-10-65-1(y)(4), and sections 11.4.2.2, Subsequent measurement before and on or \nafter the effective date , and 5.6, Lease modifications ) \n \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \n1 If an entity elects to apply the hindsight practical expedient and concludes that the lease term should change, we believe th e \nentity adjusts these amounts to reflect the amounts that would have been determined if the revised lease term had always been \nused. Refer to section 11.2.2, Transition practical expedients . \n11.4.2.1 Initial measurement \nA lessor accounts for an existing lease previously classified as a sales -type lease or direct financing lease \nunder ASC 840 that is classified as an operating lease u nder ASC 842 as if it had always been accounted \nfor as an operating lease under ASC 842. That is, a lessor: \n• Derecognizes the carrying amount of the net investment in the lease \n• Recognizes the underlying asset at what the carrying amount would have been had the lease been classified \nas an operating lease under ASC 840 (which as discussed below could be impacted if the lessor elects \nto use the hindsight practical expedient as discussed in section 11.2.2, Transition practical expedients ) \nWe also believe a lesso r: \n• Recognizes any lease -related assets or liabilities at the amounts that would have been recognized as \nif the lease had always been accounted for as an operating lease under ASC 842 \n• Recognizes initial direct costs as if ASC 842 had always been applied ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 468}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 457 If the lessor applies the transition provisions at the beginning of the earliest comparative period presented, \nit would derecognize the net investment in the lease and underlying asset and recognize lease -related \nassets or liabilities and initial direct costs at the later of (1) the beginning of the earliest comparative \nperiod presented or (2) the commencement dat e of the lease. If the lessor applies the transition provisions \nto the beginning of the period of adoption, it would derecognize the net investment in the lease and \nunderlying asset and recognize lease -related assets or liabilities and initial direct costs at that date. \nIf the lessor applies the transition provisions at the beginning of the earliest comparative period \npresented, the lessor records an adjustment for any difference between the carrying amount of the net \ninvestment in the lease and the carryin g amount of the underlying asset and any lease -related assets or \nliabilities as: \n• An adjustment to equity if the lease commenced before the beginning of the earliest comparative \nperiod presented \n• An adjustment to earnings in the comparative period if the lea se commenced after the beginning of \nthe earliest comparative period presented \nIf the lessor applies the transition provisions to the beginning of the period of adoption, any difference \nbetween the carrying amount of the net investment in the lease and the carrying amount in the underlying \nasset and any lease -related assets or liabilities is recorded as an adjustment to equity at that date. \nWhen a lessor recognizes an underlying asset for a lease previously classified as a sales -type or direct \nfinancing leas e under ASC 840 that is classified as an operating lease under ASC 842, the lessor determines \nthe appropriate foreign exchange rate to translate the underlying asset to its functional currency. We \nbelieve a lessor should use the foreign exchange rate at th e date the underlying asset was originally \nacquired. This approach is consistent with ASC 830-20-30-1, which requires initial measurement of a \nforeign currency -denominated asset using the exchange rate in effect at the date of initial recognition. \nIf the e ntity elects to apply the hindsight practical expedient, as discussed in section 11.2.2, Transition \npractical expedients , and concludes the lease term should change, the entity recognizes lease -related \nassets or liabilities ( e.g., prepaid or accrued rent, initial direct costs) in transition based on the revised \nlease term. The use of the hindsight practical expedient could also affect lease classification but only if \nthe package of practical expedients is not elected. \n11.4.2.2 Subsequent measurement before and on or after the effective date \nIf the lessor applies the transition provisions at the beginning of the earliest comparative period presented, when \nlease classification changes in transition ( e.g., a lease previously classified as a sales -type or direct financing \nlease under ASC 840 becomes an operating lease under ASC 842), the lessor no longer “runs off” its previous \nlease accounting for certain leases as described in the Basis for Conclusions (BC 390) of ASU 2016 -02. Instead, \nfor all periods presented ( i.e., both prior to and following the effective date), the lessor subsequently accounts \nfor the operating lease in accordance with ASC 842 and the underlying asset in accordance with ASC 360. \nThe lessor recognizes income under ASC 842 as if it had always applied that guidance. \nIf the lessor applies the transition provisions at the beginning of the period of adoption, it does not \nchange it s accounting in the comparative period presented. The lessor accounts for the sales -type or \ndirect financing lease under ASC 840 in the comparative periods presented and subsequently accounts \nfor the operating lease in accordance with ASC 842 at the beginn ing of the period of adoption. Refer to \nsection 11.2, Transition. After the effective date, the lessor accounts for the operating lease in \naccordance with ASC 842 and the underlying asset in accordance with ASC 360. Beginning on the \neffective date, the les sor recognizes income under ASC 842 as if it had always applied that guidance. \nIf the entity elects to apply the hindsight practical expedient and concludes the lease term should change, \nthe lessor recognizes income based on the revised lease term. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 469}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 458 The les sor applies the guidance in ASC 842 to determine whether a lease modification results in a separate \ncontract or a change in the accounting for the existing lease (refer to section 5.6, Lease modifications ). \nWhen a lessee exercises an option to extend the l ease or purchase the underlying asset and the exercise of \nthe option is inconsistent with the existing lease term determination, the lessor accounts for the exercise of \nthat option in the same manner as a lease modification under ASC 842. Following the eff ective date of the \nmodification, the lessor applies the subsequent measurement guidance in ASC 842. \nRefer to the following sections for further discussion of the guidance on subsequent measurement, \nincome recognition and lease modification to apply followi ng the effective date: \n• 5.4, Operating leases \n• 5.6, Lease modifications \n• 5.6.3.1, Modification to an operating lease that is not accounted for as a separate contract \n• 2.3.6.2, Reassessment of the lease term and purchase options — lessors \n11.4.3 Leases previously classified as operating leases under ASC 840 that \ncontinue to be classified as operating leases under ASC 842 — lessors \nExcerpt from Accounting Standards Codification \nLeases — Overall \nTransition and Open Effective Date Information \n842-10-65-1 \nv. For each lease classified as an operating lease in accordance with this Topic, a lessor shall do all \nof the following: \n1. Continue to recognize the carrying amount of the underlying asset and any lease assets or \nliabilities at the a pplication date as determined in (c) as the same amounts recognized by the \nlessor immediately before that date in accordance with Topic 840. \n2. Account for previously recognized securitized receivables as secured borrowings in \naccordance with other Topics. \n3. If a lessor does not elect the practical expedients described in (f), write off any unamortized \ninitial direct costs that do not meet the definition of initial direct costs in this Topic as an \nadjustment to equity unless the entity elects the transition meth od in (c)(1) and the costs were \nincurred after the beginning of the earliest period presented, in which case those costs shall be \nwritten off as an adjustment to earnings in the period the costs were incurred. \nLessor elects to apply the package of practical expedients \nIf an entity elects to apply the package of practical expedients, as described in section 11.2.2, Transition \npractical expedients , operating leases under ASC 840 remain operating leases under ASC 842 ( i.e., lease \nclassification is not reassessed in transition). \nLessor does not elect to apply the package of practical expedients \nAn entity that does not elect to apply the package of practical expedients reassesses (1) whether the \narrangement is or contains a lease, (2) lease classification and (3) whether previously deferred costs \ncontinue to qualify as initial direct costs under ASC 842. That entity applies, as of the lease commencement \ndate (or most recent modification that does not result in a separate new lease), all of the guidance in \nASC 842 relevant to determining lease classification. Refer to section 11.2.3, Reassessment of lease ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 470}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 459 classification , for further discussion. If classif ication changes from an operating lease to a sales -type or \ndirect financing lease, refer to section 11.4.4, Leases previously classified as operating leases under \nASC 840 that are classified as sales -type or direct financing leases under ASC 842. \nIf the en tity does not elect to apply the package of practical expedients, the assessment of lease \nclassification may change if the entity elects to apply the hindsight practical expedient (described in \nsection 11.2.2, Transition practical expedients ). The use of t he hindsight practical expedient impacts \nclassification of the lease only if use of the package of practical expedients is not elected. \nSummary of transition provisions \nThe table below summarizes the guidance for leases that commence before the effective d ate, were \npreviously classified as operating leases under ASC 840 and continue to be classified as operating leases \nunder ASC 842. \nWhile application of the initial measurement guidance in the transition provisions is the same for all \nentities, the amount o f each entity’s cumulative effect adjustment to retained earnings could differ due \nto the timing of when the entity elects to apply the transition provisions. \n Lessor applies the transition provisions \nat the beginning of the earliest \ncomparative period Lessor applies the transition provisions at the \nbeginning of the period of adoption \nInitial recognition \nUnderlying asset \nand any lease \nassets or \nliabilities The carrying amounts of the underlying asset and any lease assets or liabilities (e.g., prepaid or \naccrued rent)1 are the same as those recognized under ASC 840. \nSecured borrowings continue to be recognized in accordance with other US GAAP. \n(ASC 842-10-65-1(v)(1)(2) and section 11.4.3.1, Initial measurement — lessors ) \nInitial direct \ncosts If the lessor elects to apply the package \nof practical expedients, it does not \nreassess whether initial direct costs \nqualify for capitalization under ASC 842. \nIf the lessor does not elect to apply the \npackage of practical expedients, it writes off \nunamorti zed initial direct costs that do not \nqualify for capitalization under ASC 842 as: \n• An adjustment to equity if the costs \nwere incurred prior to the beginning of \nthe earliest comparative period \npresented \n• A charge to earnings in the \ncomparative period for cost s incurred \non or after the beginning of the earliest \ncomparative period presented \n(ASC 842-10-65-1(v)(3) and section \n11.4.3.1, Initial measurement — lessors ) If the lessor elects to apply the package of \npractical expedients, it does not reassess whether \ninitial direct costs qualify for capitalization under \nASC 842. \nIf the lessor does not elect to apply the package of \npractical expedients, it writes off unamortized \ninitial direct costs that do not qualify for \ncapitalization under ASC 842 as an adjustment to \nequity in the period of adoption. \n(ASC 842-10-65-1(v)(3) and section 11.4.3.1, \nInitial measurement — lessors ) \nSubsequent measurement before the effective date \nUnderlying asset \nand any lease \nassets or \nliabilities and \nlease income The lessor continues to account for the \noperating lease1 in accordance with the \nsubsequent measurement guidance for \noperating leases in ASC 840 and the \nunderlying asset in accordance with \nASC 360. \n(ASC 842-10-65-1(v)(1) and section \n11.4.3.2, Subsequent measurement \nbefore the effective date — lessors ) A lessor does not change its accounting prior to \nthe effective date ( i.e., it continues to apply the \nguidance in ASC 840, including its disclosure \nrequirements, in the comparative periods \npresented). \n(Section 11.4.3.2, Subsequent measurement \nbefore the effective date — lessors ) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 471}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 460 Lessor applies the transition provisions \nat the beginning of the earliest \ncomparative period Lessor applies the transition provisions at the \nbeginning of the period of adoption \nLease \nmodifications The lessor follows the lease modification \nguidance in ASC 840. \n(Section 11.4.3.2, Subsequent \nmeasurement before the effective date — \nlessors ) \nSubsequent measurement on or after the effective date \nUnderlying asset \nand any lease \nassets or \nliabilities and \nlease income The lessor accounts for the operating lease in accordance with the subsequent measurement \nguidance for operating leases in ASC 8421 and the underlying asset in accordance with ASC 360. \n(Sections 11.4.3.3, Subsequent measurement on or after the effective date — lessors , and 5.4, \nOperating leases ) \nLease \nmodifications The lessor follows the lease modification guidance in ASC 842. \n(Sections 11.4.3.3, Subsequent measur ement on or after the effective date — lessors , 5.6, \nLease modifications , 5.6.3.1, Modification to an operating lease that is not accounted for as a \nseparate contract , and 2.3.6.2, Reassessment of the lease term and pur chase options — lessors ) \n \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \n1 If the lessor elects the hindsight practical expedient and concludes the lease term should change, we believe the entity adju sts \nthese amounts to reflect the amounts that would have been recorded if the revised lease term had always been used. Refer to \nsection 11.2.2, Transition practical expedients . \n11.4.3.1 Initial measurement — lessors \nFor existing operating leases, the carrying amounts of the underlying asset and any lease assets or \nliabilities ( e.g., prepaid or accrued rent) are the same as those recognized under ASC 840, which are \nadjusted for the change in the lease term if the hindsight practical expedient is elected, as discussed in \nsection 11.2.2, Transition practical expedients . \nIf the lessor ele cts to apply the package of practical expedients (refer to section 11.2.2, Transition practical \nexpedients ), it does not reassess whether initial direct costs qualify for capitalization under ASC 842. \nIf the lessor does not elect to apply the package of pr actical expedients but applies the transition \nprovisions at the beginning of the earliest period presented (refer to section 11.2.2, Transition practical \nexpedients ), the lessor writes off any unamortized initial direct costs that would not have qualified for \ncapitalization under ASC 842 as: \n• An adjustment to equity if the costs were incurred before the beginning of the earliest comparative \nperiod presented \n• A charge to earnings in the comparative period for costs incurred on or after the beginning of the \nearliest comparative period presented \nIf the lessor applies the transition provisions at the beginning of the period of adoption, any initial direct costs \nthat do not qualify for capitalization under ASC 842 are written off as an adjustment to equity at that date. \nA lessor accounts for previously recognized securitized receivables as secured borrowings in accordance \nwith other US GAAP. \n11.4.3.2 Subsequent measurement before the effective date — lessors \nThe guidance in this section applies only to a lessor that applies the transition provisions at the beginning of \nthe earliest comparative period presented. If the lessor applies the transition provisions at the beginning of \nthe period of adoption, it does not change its accounting for periods before the effective date ( i.e., it \ncontinues to apply the guidance in ASC 840, including its disclosure requirements, in the comparative \nperiods presented). Refer to section 11.2, Transition . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 472}), Document(page\_content='11 Effective dat e and transition \nFinancial reporting developments Lease accounting | 461 Underlying asset and lease assets or liabilities \nThe FASB indicated in the Basis for Conclusions (BC 390 ) of ASU 2016 -02 that the practical effect of the \nmodified retrospective transition is that an entity “runs off” its accounting for certain leases that exist \nbefore the effective date when lease classification does not change in transition. This is the case even if \nthe entity did n ot elect to apply the package of practical expedients (refer to section 11.2.2, Transition \npractical expedients ), but lease classification did not change ( e.g., a lease previously classified as an \noperating lease under ASC 840 is reassessed, and the entity determines the lease remains an operating \nlease under ASC 842). \nAs a result, during the periods prior to the effective date, the lessor accounts for the operating lease, \nincluding any lease -related assets or liabilities ( e.g., advanced payments or deferre d rent, initial direct \ncosts), in accordance with the subsequent measurement guidance for operating leases in ASC 840 and \nrecords income consistent with its existing recognition pattern under ASC 840. If the lessor elects to \napply the hindsight practical e xpedient and concludes that the lease term should change, the lessor \nrecognizes income using the adjusted lease term. \nLease modifications \nThe lessor applies the guidance for lease modifications in ASC 840 to assess whether a lease modification \nhas occurred and to account for the lease modification. \n11.4.3.3 Subsequent measurement on or after the effective date — lessors \nThe guidance in this section applies to all lessors with leases previously classified as operating leases under \nASC 840 that continue to be classified as operating leases under ASC 842, regardless of when a lessee \napplies the transition provisions (refer to section 11.2, Transition ). When a less or applies the transition \nprovisions affects only the timing of recognition, not how the initial measurement guidance is applied. \nUnderlying asset and lease assets or liabilities and income recognition \nBeginning on the effective date, the lessor applies the subsequent measurement guidance in ASC 842 to \naccount for an operating lea se. If the lessor applies the hindsight practical expedient and concludes that \nthe lease term should change, the lessor recognizes income using the adjusted lease term. \nLease modifications \nA lessor applies the guidance in ASC 842 to determine whether a lea se modification results in a separate \ncontract or a change in the accounting for the existing lease and to account for the lease modification, \nincluding when a lessee exercises an option to extend or terminate the lease or purchase the underlying \nasset and the exercise of the option is inconsistent with the existing lease term determination. \nRefer to the following sections for further discussion of the guidance on subsequent measurement, \nincome recognition and lease modification in ASC 842: \n• 5.4, Operating l eases \n• 5.6, Lease modifications \n• 2.3.6.2, Reassessment of the lease term and purchase options — lessors ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 473}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 462 11.4.4 Leases previously classified as operating leases under ASC 840 that are \nclassified as sales -type or direct financing leases under ASC 842 \nExcerpt from Accounting Standards Codification \nLeases — Overall \nTransition and Open Effective Date Information \n842-10-65-1 \nw. For each lease classified as a direct financing or a sales -type lease in accordance with this Topic, the \nobjective is to account for the lease, beginning on the application date as determined in (c) as if it \nhad always been accounted for as a direct financing lease or a sales -type lease in acc ordance with \nthis Topic. Consequently, a lessor shall do all of the following: \n1. Derecognize the carrying amount of the underlying asset at the application date as determined in (c). \n2. Recognize a net investment in the lease at the application date as determin ed in (c) as if the \nlease had been accounted for as a direct financing lease or a sales -type lease in accordance \nwith Subtopic 842 -30 since lease commencement. \n3. Record any difference between the amounts in (w)(1) and (w)(2) as follows: \ni. If an entity elects the transition method in (c)(1), as an adjustment to equity (if the \ncommencement date of the lease was before the beginning of the earliest period \npresented or if the lease was acquired as part of a business combination; see also \n(h)(3)) or earnings (if the commencement date of the lease was on or after the \nbeginning of the earliest period presented). \nii. If an entity elects the transition method in (c)(2), as an adjustment to equity. \n4. Account for the lease in accordance with this Topic after the applicat ion date as determined in (c). \nLessor elects to apply the package of practical expedients \nIf an entity elects to apply the package of practical expedients described in section 11.2.2, Transition \npractical expedients , operating leases under ASC 840 remain operating leases under ASC 842 ( i.e., lease \nclassification is not reassessed in transition), and the guidance in this section is not applicable. In that case, \nthe guidance in section 11.4.3, Leases previously classified as operating leases under ASC 840 th at \ncontinue to be classified as operating leases under ASC 842 — lessors , is applicable. \nLessor does not elect to apply the package of practical expedients \nAn entity that does not elect to apply the package of practical expedients reassesses (1) whether th e \narrangement is or contains a lease, (2) lease classification and (3) whether previously capitalized costs \ncontinue to qualify as initial direct costs under the definition in ASC 842. That entity applies, as of the \nlease commencement date (or most recent modification that does not result in a separate new lease), all \nof the guidance in ASC 842 relevant to determining lease classification. Refer to section 11.2.3, \nReassessment of lease classification, for further discussion. \nIf the entity does not elect to apply the package of practical expedients, the assessment of lease \nclassification could be affected by a change in lease term if the entity elects to apply the hindsight practical \nexpedient (described in 11.2.2, Transition practical expedients ). The use of the hindsight practical \nexpedient might affect lease classification only if the package of practical expedients is not elected. \nSummary of transition provisions \nThe table below summarizes the guidance for leases that commence before the effective date, were \npreviously classified as operating leases under ASC 840 and are classified as sales -type or direct \nfinancing leases under ASC 842. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 474}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 463 While application of the initial measurement guidance in the transition provisions is the same for all \nentities, the amount of each entity’s cumulative effect adjustment to retained earnings could differ due \nto the timing of when the entity elects to apply the transition provisions. \n Lessor applies the transition provisions \nat the beginning of the earliest \ncomparativ e period Lessor applies the transition provisions at the \nbeginning of the period of adoption \nInitial measurement \nNet investment \nin the lease At the later of (1) the beginning of the \nearliest comparative period presented or \n(2) the commencement date of the lease, \nthe lessor: \n• Derecognizes the carrying amount of \nthe underlying asset and any asset for \naccrued rent or liability for prepaid \nrent \n• Recognizes a net investment in the \nlease as if the sales -type or direct \nfinancing lease had al ways been \naccounted for under ASC 842 \n(including initial direct costs that \nqualify for capitalization under \nASC 842).1 \nAny difference between the carrying \namount of the net investment in the lease \nand the carrying amount of the underlying \nasset and any lea se-related asset or liability \nis recorded as: \n• An adjustment to equity if the lease \ncommenced before the beginning of \nthe earliest comparative period \npresented \n• An adjustment to earnings in the \ncomparative period for leases that \ncommenced on or after the beg inning \nof the earliest comparative period \npresented \n(ASC 842-10-65-1(w)(1)(2)(3) and sections \n11.4.4.1, Initial measurement , 5.2, Sales -\ntype leases , and 5.3, Direct financing leases ) At the beginning of the period of adoption, the \nlessor: \n• Derecognizes the carrying amount of the \nunderlying asset and any asset for accrued \nrent or liability for prepaid rent \n• Recognizes a net investment in the lease as \nif the sales -type or direct financing lease had \nalways been accounted for under ASC 842 \n(inclu ding initial direct costs that qualify for \ncapitalization under ASC 842).1 \nAny difference between the carrying amount of \nthe net investment in the lease and the carrying \namount of the underlying asset and any lease -\nrelated asset or liability is recorded as an \nadjustment to equity. \n(ASC 842-10-65-1(w)(1)(2)(3) and sections \n11.4.4.1, Initial measurement , 5.2, Sales -type \nleases , and 5.3, Direct financing leases ) \nSubsequent measurement before and on or after the effective date2 \nNet investment \nin the lease and \nincome \nrecognition The lessor accounts for the net investment in the lease and recognizes income in accordance \nwith the subsequent measurement guidance in ASC 842-30.1 \n(ASC 842-10-65-1(w)(4), ASC 842-30 and sections 11.4.4.2, Subsequent measureme nt before \nand on or after the effective date , 5.2.2, Subsequent measurement — sales -type leases , and \n5.3.2, Subsequent measurement — direct financing leases ) \nLease \nmodifications The lessor follows the lease modification guidance in ASC 842. \n(ASC 842-10-65-1(w)(4), ASC 842-30 and sections 11. 4.4.2 , Subsequent measurement \nbefore and on or after the effective date , 5.6, Lease modifications , and 2.3.6.2, Reassessment \nof the lease term and purchase options — lessors ) \n \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ \n1 If the lessor elects to apply the hindsight practical expedient and concludes the lease term should change, the lessor adjusts these \namounts to reflect the amounts that would have been recorded if the revised lease term had always been used. Refer to secti on \n11.2.2, Transition practical expedients . \n2 A lessor that elects to apply the transition provisions at the beginning of the period of adoption does not change its accoun ting for \nperiods before the effective date ( i.e., it continues to apply the guidance in ASC 840, including its disclosure requirements, in the \ncomparative periods presented). Beginning on the effective date, the lessor applies the guidance as described in the table above . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 475}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 464 11.4.4.1 Initial measurement \nA lessor accounts for an existing lease that is classified as an operating lease under ASC 840 and is \nclassified as sales -type or direct financing lease under ASC 842 as if it had always been accounted for as \na sales -type or direct financing lease under ASC 842. That is, a lessor: \n• Derecognizes the carrying amount of the underlying asset and any asset for accrued rent or liability \nfor prepaid rent \n• Recognizes a net investment in the lease as if the sales -type or direct financing lease had always \nbeen accounte d for under ASC 842 (including initial direct costs that qualify for capitalization under \nASC 842), which is adjusted for the change in the lease term if the hindsight practical expedient, as \ndiscussed in section 11.2.2, Transition practical expedients . \nIf the lessor applies the transition provisions at the beginning of the earliest comparative period \npresented, the lessor would take the steps above at the later of (1) the beginning of the earliest \ncomparative period presented or (2) the commencement date o f the lease. If the lessor applies the \ntransition provisions at the beginning of the period of adoption, these steps would be taken at the \nbeginning of the period of adoption. Refer to section 11.2, Transition. \nIf the lessor applies the transition provisions at the beginning of the earliest comparative period \npresented, the lessor records an adjustment for any difference between those two amounts as : \n• An adjustment to equity if the lease commenced before the beginning of the earliest compa rative \nperiod presented \n• An adjustment to earnings in the comparative period for leases that commenced on or after the \nbeginning of the earliest comparative period presented \n• If the lessor applies the transition provisions at the beginning of the period of a doption, the \nadjustment for any difference between those two amounts is recorded to equity at that date. \n• If the lessor applies the hindsight practical expedient and concludes the lease term should change, \nwe believe the lessor adjusts the net investment in the lease to reflect the amount that would have \nbeen recorded if the revised lease term had always been used. \n11.4.4.2 Subsequent measurement before and on or after the effective date \nNet investment in the lease and income recognition \nIf the lessor applie s the transition provisions at the beginning of the earliest comparative period presented, \nat the later of lease commencement or the beginning of the earliest comparative period presented, a \nlessor subsequently accounts for the sales -type or direct financi ng lease in accordance with ASC 842. \nIf the lessor applies the transition provisions at the beginning of the period of adoption, it does not \nchange its accounting for periods before the effective date ( i.e., it continues to apply ASC 840, including \nits dis closure requirements, in the comparative periods presented). After the effective date, the lessor \nsubsequently accounts for the sales -type or direct financing lease in accordance with ASC 842. Refer to \nsection 5.2, Sales -type leases , and section 5.3, Direc t financing leases . \nIf the lessor elects to apply the hindsight practical expedient and concludes that the lease term should \nchange, the lessor recognizes income using the adjusted lease term. \nLease modifications \nA lessor applies the guidance in ASC 842 to determine whether a lease modification results in a separate \ncontract or a change in the accounting for the existing lease, including when a lessee exercises an option \nto extend or terminate the lease or purchase the underlying asset, and the exerci se of the option is \ninconsistent with the existing lease term determination. Following the effective date of the modification, \nthe lessor applies the subsequent measurement guidance in ASC 842. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 476}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 465 In addition, following the effective date, a lessor evaluates the net investment in a sales -type or a direct \nfinancing lease for impairment using the guidance for receivables in ASC 310 (before the adoption of \nASU 2016 -13, Measurement of Credit Losses on Financial Instruments ) or ASC 326 (after the adoption \nof ASU 2016-13). Refer to section 2.11.3, Leases , of our FRD, Credit impairment under ASC 326, for \nadditional details. \nRefer to the fo llowing sections for further discussion of the income recognition and lease modification \nguidance in ASC 842: \n• 5.2, Sales -type leases \n• 5.3, Direct financing leases \n• 5.6, Lease modifications \n• 2.3.6.2, Reassessment of the lease term and purchase options — lessors \n11.4.5 Leases previously classified as leveraged leases under ASC 840 \nExcerpt from Accounting Standards Codification \nLeases — Overall \nTransition and Open Effective Date Information \n842-10-65-1 \nz. For leases that were classified as leveraged leases in accordance with Topic 840, and for which \nthe commencement date is before the effective date, a lessor shall apply the requirements in \nSubtopic 842 -50. If a leveraged lease is modified on or after the e ffective date, it shall be \naccounted for as a new lease as of the effective date of the modification in accordance with the \nguidance in Subtopics 842 -10 and 842 -30. \n1. A lessor shall apply the pending content that links to this paragraph to a leverage d lea se that \nmeets the criteria in (z) that is acquired in a business combination or an acquisition by a not -\nfor-profit entity on or after the effective date. \nASC 842 eliminates leveraged lease accounting for leases that commence on or after its effective date . \nHowever, leveraged leases that commenced prior to the effective date are grandfathered. As a result, \nASC 842 retains ASC 840’s recognition, measurement, presentation and disclosure guidance for \ngrandfathered leveraged leases. We believe lessors will also apply the leveraged lease accounting \nguidance to an unmodified leveraged lease acquired in a business combination or an acquisition by a not -\nfor-profit entity after the effective date. \nIf the entity applies the transition provisions at the beginning of th e earliest comparative period (refer to \nsection 11.2, Transition ) and a leveraged lease that commenced prior to the effective date is modified \n(i.e., a change to the terms and conditions of a contract that results in a change in the scope of or the \nconside ration for a lease) prior to the effective date but after the beginning of the earliest comparative \nperiod presented , the lessor applies the provisions of ASC 842-50 for the modification. Refer to section 10, \nLeveraged leases . The transition guidance in ASC 842 does not generally address how to account for lease \nmodifications that occur after the beginning of the earliest comparative period presented, but before the \neffective date. However, it is clear that modifications of leveraged leases are accounted for under the \nmodification guidance in ASC 842. \nIf a leveraged lease that commenced prior to the effective date is modified on or after the effective date, it \nshould be accounted for as a new leas e as of the effective date of the modification in accordance with ASC 842’s \nrecognition and measurement guidance for all other leases. Refer to section 5.7.5, Leveraged leases . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 477}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 466 Refer to section 10, Leveraged leases, for an in -depth discussion of the accoun ting for leveraged leases. \n11.5 Other considerations \n11.5.1 Sale and leaseback transition \nExcerpt from Accounting Standards Codification \nLeases — Overall \nTransition and Open Effective Date Information \n842-10-65-1 \naa. If a previous sale and leaseback transaction was accounted for as a sale and a leaseback in \naccordance with Topic 840, an entity shall not reassess the transaction to determine whether \nthe transfer of the asset would have been a sale in accordance with paragraphs 842 -40-25-1 \nthrough 25 -3. \nbb. If a previous sale and leaseback transaction was accounted for as a failed sale and leaseback \ntransaction in accordance with Topic 840 and remains a failed sale at the effective date: \n1. If an entity elects the transition method in (c)(1), t he entity shall reassess whether a sale \nwould have occurred at any point on or after the beginning of the earliest period presented \nin the financial statements in accordance with paragraphs 842 -40-25-1 through 25 -3. The \nsale and leaseback transaction shall be accounted for on a modified retrospective basis from \nthe date a sale is determined to have occurred. \n2. If an entity elects the transition method in (c)(2), the entity shall reassess whether a sale \nwould have occurred at the beginning of the reporting period in which the entity first applies \nthe pending content that links to this paragraph in accordance with paragraphs 842 -40-25-1 \nthrough 25 -3 and recognize the sale as an adjustment to equity. The entity shall then \naccount for the leaseback in accordanc e with the guidance in Subtopic 842 -20 after the \nbeginning of the reporting period in which the entity first applies the pending content that \nlinks to this paragraph. \ncc. An entity shall account for the leaseback in accordance with the lessee and lessor tr ansition \nrequirements in (k) through (y). \ndd. If a previous sale and leaseback transaction was accounted for as a sale and capital leaseback in \naccordance with Topic 840, the transferor shall continue to recognize any deferred gain or loss \nthat exists at the later of the beginning of the earliest comparative period presented in the \nfinancial statements and the date of the sale of the underlying asset (if an entity elects the \ntransition method in (c)(1)) or that exists at the beginning of the repo rting period in which the \nentity first applies the pending content that links to this paragraph (if an entity elects the \ntransition method in (c)(2)), as follows: \n1. If the underlying asset is land only, straight line over the remaining lease term. \n2. If the underlying asset is not land only and the leaseback is a finance lease, in proportion to \nthe amortization of the right -of-use asset. \n3. If the underlying asset is not land only and the leaseback is an operating lease, in proportion \nto the recognition in profit or loss of the total lease cost. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 478}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 467 ee. If a previous sale and leaseback transaction was accounted for as a sale and operating leaseback \nin accordance with Topic 840, the transferor shall do the following: \n1. Recognize any deferred gain or loss not resulting from off -market terms (that is, where the \nconsideration for the sale of the asset is not at fair value or the lease payments are not at \nmarket rates) as a cumulative -effect adjustment to equity unless the entity elects the \ntransition method in (c)(1) and the date of sale is after the beginning of the earliest period \npresented, in which case any deferred gain or loss not resulting from off -market terms shall \nbe recognized in earnings in the period the sale occurred. \n2. Recognize any def erred loss resulting from the consideration for the sale of the asset not \nbeing at fair value or the lease payments not being at market rates as an adjustment to the \nleaseback right -of-use asset at the later of the beginning of the earliest comparative per iod \npresented in the financial statements and the date of the sale of the underlying asset (if an \nentity elects the transition method in (c)(1)) or at the beginning of the reporting period in \nwhich the entity first applies the pending content that links to this paragraph (if an entity \nelects the transition method in (c)(2)). \n3. Recognize any deferred gain resulting from the consideration for the sale of the asset not \nbeing at fair value or the lease payments not being at market rates as a financial liabilit y at \nthe later of the beginning of the earliest comparative period presented in the financial \nstatements and the date of the sale of the underlying asset (if an entity elects the transition \nmethod in (c)(1)) or at the beginning of the reporting period in w hich the entity first applies the \npending content that links to this paragraph (if an entity elects the transition method in (c)(2)). \nFailed sale and leaseback transactions under ASC 840 that continue to be failed sale and leaseback \ntransactions under ASC 840 at the effective date \nEntities reassess whether there would have been a sale under ASC 842’s sale and leaseback guidance \nonly if the existing sale and leaseback transaction is not being accounted for as a sale and leaseback \nunder ASC 840 at the effec tive date. If assets and liabilities recognized solely as a result of ASC 840’s \nbuild -to-suit guidance are derecognized in transition (refer to section 11.3.6, Lessee involvement in asset \nconstruction (‘build -to-suit’ transactions) ), the entity does not re assess whether there would have been a \nsale under ASC 842. That is, only failed sale and leaseback transactions that were not subject to the \napplication of ASC 840’s build -to-suit guidance are reassessed during transition. \nWhen the transaction was a failed sale and leaseback under ASC 840 but would qualify as a sale and \nleaseback under ASC 842’s sale and leaseback guidance, the seller -lessee (or buyer -lessor) i s required to \napply the transition provisions in ASC 842-10-65-1(bb) and (cc). \nIn accordance with those paragraphs, if an entity applies the transition provisions at the beginning of the \nearliest comparative period presented, it must reassess whether a sale would have occurred at any point \non or after the beginning of the earliest period presented in t he financial statements by applying the \nrelevant revenue recognition guidance in ASC 606 and the additional criteria in ASC 842 (refer to section \n7, Sale and leaseback transactio ns). If the relevant revenue recognition guidance in ASC 606 and the \ncriteria in ASC 842-40 are met as of the beginning of the earliest period presented, the gain or loss on \nsale (as adjusted for off -market terms) is recognized as an adjustment to equity at tha t date. If the \nrelevant revenue recognition guidance in ASC 606 and the criteria in ASC 842-40 are met after the \nbeginning of the earliest period presented, the gain or loss on sale (as adjusted for off -market terms) is \nrecognized in profit or loss in the period the sale criteria are met. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 479}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 468 If an entity applies the transition provisions at the beginning of the period of adoption ( i.e., the effective \ndate), it must reassess whether a sale would have occurred at the beginning of the period of adoption by \napplyi ng the relevant revenue recognition guidance in ASC 606 and the additional criteria in ASC 842-40. \nIn this case, the gain or loss on sale (adjusted for off -market terms) is recognized as an adjustment to equity. \nThe transition guidance does not address how an entity that achieves sale accounting pursuant to \nASC 842-40 would classify its lease in transition. \nFor purposes of applying ASC 842’s transition provisions, if an entity did not elect the package of \npractica l expedients (and therefore is reassessing lease classification for all existing leases), we believe \nthe entity could apply ASC 842 to classify the lease either:17 \n• At the date the underlying asset was available for use by the lessee (generally the date the sale \nwas achieved) \n• At the later of (1) the date the underlying asset was available for use by the lessee and (2) the date \nthe entity applies the standard’s transition provisions ( e.g., 1 January 2019 for a calendar -year \npublic business entity or 1 January 2022 for a calendar -year non -public business entity that applies \nthe transition provisions at the beginning of the period of adoption) \nIf an entity elects the package of practical expedients (and therefore is not reassessing lease classification \nfor all existing leases), we believe to initially classify the lease the entity could do one of the following: \n• Apply ASC 840 to classify the leas e as if it had always been accounted for as a lease ( i.e., it \nwould apply ASC 840’s classification guidance at the lease inception date) \n• Apply ASC 842 to classify the lease as if it had always been accounted for as a lease ( i.e., it \nwould apply ASC 842’s c lassification guidance at the date the underlying asset was available for \nuse by the lessee (generally the date the sale was achieved)) \n• Apply ASC 842’s classification guidance at the later of (1) the date the underlying asset was \navailable for use by the l essee and (2) the date the entity applies the standard’s transition \nprovisions ( e.g., 1 January 2019 for a calendar -year public business entity or 1 January 2022 \nfor a calendar -year non -public business entity that applies the standard’s transition provisio ns at \nthe beginning of the period of adoption) \nA seller -lessee and a buyer -lessor account for the leaseback in accordance with the lessee and lessor \ntransition requirements discussed in sections 11.3, Lessee transition , and 11.4, Lessor transition , respect ively. \nTransactions that previously qualified as a sale and leaseback using the guidance in ASC 840 \nA transaction previously accounted for as a sale and leaseback under ASC 840 is not reassessed as to \nwhether the transfer of the asset would have been a sal e under ASC 842. \nA seller -lessee accounts for any deferred gain or loss on a transaction previously accounted for as a sale \nand leaseback as follows: \n• For leasebacks previously classified as capital leases under ASC 840, the seller -lessee continues to \nrecog nize any deferred gain or loss that exists at the later of (1) the beginning of the earliest comparative \nperiod presented or (2) the date of the sale of the underlying asset if it applies the transition provisions \n \n17 This guidance applies only to a transaction that was a failed sale and leaseback under ASC 840 but would qualify as a sal e and \nleaseback under ASC 842’s sale and leaseback guidance . For guidance on reassessing lease classification for existing ASC 840 \nleases at transition when an entity does not elect the package of practical expedients, refer to section 11.2.3, Reassessment of \nlease classification . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 480}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 469 at the beginning of the earliest comparative period. If it applies the transition provisions at the beginning \nof the period of adoption, it continues to recognize any deferred gain or loss at that date. Refer to \nsection 11.2, Transition . The seller -lessee amortizes any deferred gain or lo ss that exists as follows: \n• If the underlying asset is land only, on a straight -line basis over the remaining lease term \n• If the underlying asset includes more than just land and the leaseback is a finance lease under \nASC 842, in proportion to the amortizati on of the right -of-use asset \n• If the underlying asset includes more than just land and the leaseback is an operating lease under \nASC 842, in proportion to the recognition in profit or loss of the total lease cost \n• For leasebacks previously classified as oper ating leases under ASC 840, a seller -lessee that applies \nthe transition provisions at the beginning of the earliest comparative period recognizes any deferred \ngain or loss not resulting from off -market terms at the later of the beginning of the earliest co mparative \nperiod presented or the date of sale. This gain or loss is recognized as a cumulative effect adjustment to \nequity at the beginning of the earliest comparative period presented or to earnings of the comparative \nperiod presented at the date of sale . Any deferred amount that is the result of off -market terms is \nrecognized as an adjustment to the right -of-use asset if the amount is a loss or as a financial liability \nif it is a gain. \n• For leasebacks previously classified as operating leases under ASC 840, a seller -lessee that applies \nthe transition provisions at the beginning of the period of adoption recognizes any deferred gain or \nloss not resulting from off -market terms at that date. This gain or loss is recognized as a cumulative \neffect adjustment to equity at the beginning of the period of adoption. Any deferred amount that is \nthe result of off -market terms is recognized as an adjustment to the right -of-use asset if the amount \nis a loss or as a financial liability if it is a gain. \nA seller -lessee and a buyer -lessor account for the leaseback in accordance with the lessee and lessor \ntransition requirements discussed in sections 11.3, Lessee transition , and 11.4, Lessor transition , respectively. \nFor transactions that previously qualified as a sale and le aseback using the guidance in ASC 840, entities are \nalso permitted to apply the package of practical expedients and/or the hindsight practical expedient to classify \n(as applicable) and account for the leaseback transaction. Electing not to apply the packag e of practical \nexpedients could impact the accounting in transition. For example, if a seller -lessee had a previous sale and \nleaseback transaction involving land and other assets ( e.g., leasehold improvements) that was accounted for \nas a sale and capital l easeback in accordance with Topic 840, the amortization of any deferred gain would \nbe impacted by the new lease classification (842 -10-65-1(dd)). Conversely, the reassessment of lease \nclassification for a sale and leaseback that was accounted for as a sale and operating leaseback in accordance \nwith ASC 840 does not affect the subsequent amortization of any deferred gain ( ASC 842-10-65-1(ee)). \nHowever, we believe the practical expedients are not applicable for a seller -lessee that reassessed a \nfailed sale -leaseback under ASC 840 but after applying the relevant revenue recognition guidance in \nASC 606 and the additional concepts in ASC 842 concludes the transaction qualifies as a sale. This is \nbecause the seller -lessee will be applying lease accounting for the first time at time the requirements for \nsale accounting are met. That is, there is not a preexisting lease to reassess using the practical \nexpedients. Refer to 11.2.2, Transition practical expedients , for a further discussion on the use of \npractical expedients in transition. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 481}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 470 11.5.2 Amounts previously recognized in a business combination \nExcerpt from Accounting Standards Codification \nLeases — Overall \nTransition and Open Effective Date Information \n842-10-65-1 \nh. If an entity has previously recognized an asset or a liability in accordance with Topic 805 on \nbusiness combinations relating to favorable or unfavorable terms of an operating lease acquired as \npart of a business combination, the entity shall do all of the following: \n1. Derecognize that asset and liability (except for those arising from leases that are classified \nas operating leases in accordance with Topic 842 for which the entity is a lessor). \n2. Adjust t he carrying amount of the right -of-use asset by a corresponding amount if the entity \nis a lessee. \n3. Make a corresponding adjustment to equity if assets or liabilities arise from leases that are \nclassified as sales -type leases or direct financing leases in accordance with Topic 842 for \nwhich the entity is a lessor. Also see (w). \nIf an entity has previously recognized an asset or a liability related to favorable or unfavorable ( i.e., off-\nmarket) terms of an operating lease acquired as part of a business combination, the entity will derecognize \nthat asset a nd liability (unless they arose from operating leases in which the entity is a lessor) with a \ncorresponding adjustment to the right -of-use asset if the entity is a lessee. \nThe transition guidance in ASC 842-10-65-1(h) appears to address only the favorable or unfavorable off -\nmarket terms recognized for existing operating leases. We believe that the in -place intangible asset \nrecognized for an operating lease would be bifurcated and not derecognized. \nASU 2018 -10 clarified that paragraph ASC 842-10-65-1(h)(3) a pplies when a lessor does not elect the \npackage of practical expedients and when an operating lease acquired as part of a previous business \ncombination is classified as a direct financing lease or a sales -type lease. ASU 2018 -10 also clarifies that \nwhen a lessor applies paragraph ASC 842-10-65-1(h)(3) and paragraph ASC 842-10-65-1(w) for an \noperating lease acquired as part of a business combination that becomes a sales -type lease or direct \nfinancing lease under ASC 842, the adjustments that result from applying these paragraphs retrospectively, \nas of the business combination date, would effectively offset one another. For example, the effect of \nderecognizing an asset subject to an operating lease and any related intangible would be offset by the initial \nrecognition of the net investment in the lease for the sales -type or direct financing lease. \n11.6 Disclosures \nExcerpt from Accounting Standards Codification \nLeases — Overall \nTransition and Open Effective Date Information \n842-10-65-1 \ni. An entity shall provide the transition disclosures required by Topic 250 on accounting changes and \nerror corrections, except for the requirements in paragraph 250 -10-50-1(b)(2) and paragraph 250 -10-\n50-3. An entity that elects the transition method in (c)(2 ) shall provide the transition disclosures in \nparagraph 250 -10-50-1(b)(3) as of the beginning of the period of adoption rather than at the beginning \nof the earliest period presented. \nNote: See paragraph 250 -10-S99-6 on disclosure of the impact that recentl y issued accounting \nstandards will have on the financial statements of a registrant. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 482}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 471 j. If an entity uses one or more of the practical expedients in (f), (g), and (gg), it shall disclose that fact . \njj. An entity electing the transition method in (c)(2) sha ll provide the required Topic 840 disclosures \nfor all periods that continue to be in accordance with Topic 840. \nTransition Related to Accounting Standards Update No. 2021 -05, Leases (Topic 842): Lessors —\nCertain Leases with Variable Lease Payments \n842-10-65-5 \ne. An entity within the scope of (b) or (c) that elects the transition method in (d)(1) shall provide the \nfollowing transition disclosures: \n1. The applicable transition disclosures required by Topic 250 on accounting changes and error \ncorrections, except for the requirements in paragraph 250 -10-50-1(b)(2) and paragraph \n250-10-50-3 \n2. The transition disclosures in paragraph 250 -10-50-1(b)(3) as of the beginning of the earliest \nperiod presented but not before the date in which the pending content that links to \nparagraph 842 -10-65-1 was adopted. \nf. An entity within the scope of (b) or (c) that elects the transition method in (d)(2) shall provide the \nfollowing transition disclosures: \n1. The nature of and reason for the change in accounting p rinciple \n2. The transition method \n3. A qualitative description of the financial statement line items affected by the change . \nTransition Related to Accounting Standards Update No. 2021 -09, Leases (Topic 842): Discount \nRate for Lessees That Are Not Public Bu siness Entities \n842-10-65-6 \nd. An entity within the scope of (b) that has adopted the pending content that links to this paragraph \nshall disclose the following as of the beginning of the fiscal year of adoption (rather than at the \nbeginning of the earliest period presented): \n1. The information required by paragraph 250 -10-50-1(a) and (b)(3), if applicable \n2. The recognized amount of change s in lease liabilit ies and corresponding right -of-use asset s \nresulting from the transition adjustment. \nLessees and lessors are required to provide transition disclosures in accordance with ASC 250, Accounting \nChanges and Error Correction s, except for the disclosure of the effect of the change on income from \ncontin uing operations, net income, any other affected financial statement line item and any affected per -\nshare amounts for the current period and any prior periods that are adjusted. A lessee or a lessor that \nmakes an election to apply the practical expedients d iscussed in section 11.2.2, Transition practical \nexpedients , is required to disclose that fact. \nLessors that have adopted ASC 842 as of 19 July 2021 and apply ASU 2021 -05 retrospectively are \nrequired to provide certain disclosures required by ASC 250, Acco unting Changes and Error Corrections . \nLessors that have adopted ASC 842 as of 19 July 2021 and apply ASU 2021 -05 prospectively are \nrequired to disclose the nature of and reason for the change in accounting principle, the transition \nmethod applied and a qualitative description of the financial statement line items affected by the change. \nA lessee that applies ASU 2021 -09 is required to disclose the nature of and reason for the change in \naccounting principle, the cumulative effect of the change on retained earnings, if any, and the amount of \nthe change in its lease liabilities and corresponding right -of-use assets resulting from the amendments. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 483}), Document(page\_content='11 Effective date and transition \nFinancial reporting developments Lease accounting | 472 11.6.1 Interim disclosures in the year of adoption (updated August 2022 ) \nWhen a registrant adopts a new accounting standard in an interim period, the SEC staff expects the \nregistrant to provide both the annual and the interim period financial statement disclosures required by \nthe standard, without duplicating any information .18 Registrants are expected to continue to provide \nthese disclosures in interim financial statements until the accounting change is reflected in audited \nannual financial statements. These expectations are based on Article 10 of Regulation S -X, which \nrequires disclosures in interim period financial statements about material matters that were not disclosed \nin the most recent annual financial statements. Refer to section 4.10, Disclosure , for lessee annual \ndisclosure requirements and section 5.9, Disclosure, for lessor annual and interim disclosure req uirements. \nWith the issuance of ASU 2019 -01, Codification Improvements , the FASB clarified that entities are not \nsubject to the transition disclosure requirements in ASC 250-10-50-3 related to the effect of an \naccounting change on certain interim period financial information . \nIf an entity applies the transition provisions at the beginning of the period of adoption, it should continue \nto apply ASC 840, including any required disclosures , for the comparative periods presented in the year \nof adoption . Because ASC 840 does not require interim disclosures , the company does not need to \nprovide ASC 840 disclosures for the comparative interim periods in the year of adoption (refer to \nsection 11.2, Transition ). \n \nQuestion 11 -2 Is a nonpublic entity or EGC that begins presenting interim periods under ASC 842 in its second year \nof adoption required to include comparative interim financial information under ASC 842? \nNo. We believe a nonpublic entity or EGC would not be required to inc lude comparative interim financial \ninformation in the year ASC 842 is first required to be applied to interim financial statements. \nFor example, consider a nonpublic entity that adopted the standard for annual reporting periods \nbeginning after 15 December 2021 (i.e., the 2022 fiscal year). Such an entity would present both interim \nand annual financial information under ASC 842 in its 2023 fiscal year financial statements ( i.e., in the \nsecond year of adoption), but would not be required to present comparativ e interim financial information \n(i.e., 2022 interim periods) under ASC 842. However, we believe it would be acceptable for the entity to \nprovide comparative ASC 842 interim information if it chooses to do so. \nWhile this is not required, the SEC staff encou rages EGCs that elect to follow the nonpublic entity \neffective date to present the comparative interim financial information under ASC 842. \nHowever, i f an EGC loses its EGC status, it is required to adopt ASC 842 in its next filing and to include \ncomparative interim financial information for the year ASC 842 is first required to be applied to interim \nfinancial statements. For example, if an EGC loses its status on 31 December 2022, the company would \nbe required to adopt ASC 842 in its 2 022 Form 10 -K (i.e., retroactively adopt it as of 1 January 2022) and \npresent subsequent interim and comparative financial information under ASC 842 in its interim financial \nstatements (i.e., both Q1 2022 and Q1 2023 interim financial information disclosed in Form 10 -Q for the \nfirst quarter of 2023 would reflect the adoption of ASC 842). However, the company would not be \nrequired to amend previously filed 2022 Form 10-Qs. \n \n \n18 SEC Division of Corporation Finance Financial Reporting Manual, Section 1 500. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 484}), Document(page\_content=' \nFinancial reporting developments Lease accounting | A-1 A Abbreviations used in this publication \nAbbreviation FASB Accounting Standa rds Codification \nASC 210 FASB ASC Topic 2 10, Balance Sheet \nASC 220-20 FASB ASC Subtopic 22 0-20, Income Statement — Reporting Comprehensive \nIncome — Unusual or Infrequently Occurring Items \nASC 230 FASB ASC Topic 230, Statement of Cash Flows \nASC 250 FASB ASC Topic 250, Accounting Changes and Error Corrections \nASC 270 FASB ASC Topic 270, Interim Reporting \nASC 310 FASB ASC Topic 310, Receivables \nASC 326 FASB ASC Topic 326, Financial Instruments — Credit Losses \nASC 326-20 FASB ASC Subt opic 326, Financial Instruments — Credit Losses — Measured at \nAmortized Cost \nASC 330 FASB ASC Topic 330, Inventory \nASC 340-40 FASB ASC Subtopic 340 -40, Other Assets and Deferred Costs — Contracts with \nCustomers \nASC 350 FASB ASC Topic 350, Intangibles — Goodwill and Other \nASC 350-30 FASB ASC Subtopic 350-30, Intangibles — Goodwill and Other — General Intangibles \nOther Than Goodwill \nASC 360 FASB ASC Topic 360, Property, Plant, and Equipment \nASC 405-20 FASB ASC Subtopic 405 -20, Liabilities — Extinguishments of Liabilities \nASC 410-20 FASB ASC Subtopic 410 -20, Asset Retirement and Environmental Obligations — \nAsset Retirement Obligations \nASC 410-30 FASB ASC Subtopic 410 -30, Asset Retirement and Environmental Obligations — \nEnvironmental Obligations \nASC 420 FASB ASC Topic 420, Exit or Disposal Cost Obligations \nASC 440 FASB ASC Topic 440, Commitments \nASC 450 FASB ASC Topic 450, Contingencies \nASC 460 FASB ASC Topic 460, Guarantees \nASC 470 FASB ASC Topic 470, Debt \nASC 605 FASB ASC Topic 605, Revenue Recognition \nASC 606 FASB ASC Topic 606, Revenue from Contracts with Customers \nASC 610-20 FASB ASC Subtopic 610 -20, Other Income — Gains and Losses from the \nDerecognition of Nonfinancial Assets \nASC 720-15 FASB ASC Subtopic 720 -15, Other Expenses — Start -Up Costs \nASC 730 FASB ASC Topic 7 30, Research and Development \nASC 740 FASB ASC Topic 740, Income Taxes \nASC 805 FASB ASC Topic 805, Business Combinations \nASC 810 FASB ASC Topic 810, Consolidation \nASC 815 FASB ASC Topic 815, Derivatives and Hedging \nASC 815-15 FASB ASC Subtopic 815 -15, Derivatives and Hedging — Embedded Derivatives \nASC 820 FASB ASC Topic 820, Fair Value Measurement \nASC 830 FASB ASC Topic 830, Foreign Currency Matters ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 485}), Document(page\_content='A Abbreviations used in this publication \nFinancial reporting developments Lease accounting | A-2 Abbreviation FASB Accounting Standa rds Codification \nASC 835-20 FASB ASC Subtopic 835 -20, Interest — Capitalization of Interest \nASC 835-30 FASB ASC Subtopic 835 -30, Interest — Imputation of Interest \nASC 840 FASB ASC Topic 840, Leases \nASC 842 FASB ASC Topic 842, Leases \nASC 848 FASB ASC Topic 848, Reference Rate Reform \nASC 850 FASB ASC Topic 850, Related Party Disclosures \nASC 852 FASB ASC Topic 85 2, Reorganizations \nASC 853 FASB ASC Topic 853, Service Concession Arrangements \nASC 860 FASB ASC Topic 860, Transfers and Servicing \nASC 942 FASB ASC Topic 942, Financial Services — Depository and Lending \nASC 958-605 FASB ASC Subtopic 9 58-605, Not-for-Profit Entities — Revenue Recognition \nASC 970-360 FASB ASC Subtopic 970 -360, Real Estate — General — Property, Plant, and Equipment \nASC 978 FASB ASC Topic 978, Real Estate — Time -Sharing Activities \nASC 980 FASB ASC Topic 980 , Regulated Operations \nASU 2014 -09 FASB Accounting Standards Update No. 2014 -09, Revenue from Contracts with \nCustomers (Topic 606) \nASU 2016 -02 FASB Accounting Standards Update No. 2016 -02, Leases (Topic 842) \nASU 2016 -13 FASB Accounting Standards Update No. 2016 -13, Financial Instruments — Credit \nLosses (Topic 326): Measurement of Credit Losses on Financial Instruments \nASU 2018 -01 FASB Acco unting Standards Update No. 2018 -01, Leases (Topic 842): Land \nEasement Practical Expedient for Transition to Topic 842 \nASU 2018 -10 FASB Acco unting Standards Update No. 2018 -10, Codification Improveme nts to \nTopic 842, Leases \nASU 2018 -11 FASB Acco unting Standards Update No. 2018 -11, Leases (Topic 842): Targeted \nImprovements \nASU 2018 -19 FASB Accounting Standards Update No. 2018 -19, Codification Improvements to \nTopic 326, Financial Instruments — Credit Losses \nASU 2018 -20 FASB Acco unting Standards Update No. 2018 -20, Leases (Topic 842): Narrow -\nScope Improvements for Lessors \nASU 2019 -01 FASB Acco unting Standards Update No. 2019 -01, Leases (Topic 842): \nCodification Improvements \nASU 2019 -10 FASB Accounting Standards Update No. 2019 -10, Financial Instruments — Credit \nLosses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842) : \nEffective Dates \nASU 2020 -04 FASB Accounting Standards Update No. 2020 -04, Reference Rate Reform (Topic \n848) : Facilitation of the Effects of Reference Rate Reform on Financial Reporting \nASU 2020 -05 FASB Accounting Standards Update No. 2020 -05, Revenue from Contracts with \nCustomers ( Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities \nASU 2021 -01 FASB Accounting Standards Update No. 2021 -01, Reference Rate Reform (Topic \n848): Scope \nASU 2021 -05 FASB Accounting Standards Update No. 2021 -05, Leases (Topic 842): Lessors — \nCertain Leases with Variable Lease Payments \nASU 2021 -09 FASB Accounting Standards Update No. 2021 -09, Leases (Topic 842): Discount \nRate for Lessees That Are Not Public Business E ntities \nASU 2023 -01 FASB Accounting Standards Update No. 2023 -01, Leases (Topic 842) : Common \nControl Arrangements \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 486}), Document(page\_content='A Abbreviations used in this publication \nFinancial reporting developments Lease accounting | A-3 Abbreviation Other Authoritative Standards \nIAS 16 International Accounting Standard 16 , Property, Plant and Equipment \nIAS 2 0 International Accounting Standard 2 0, Accounting for Government Grants and \nDisclosure of Government Assistance \nIAS 24 International Accounting Standard 24, Related Party Disclosures \nIAS 38 International Accounting Standard 38, Intangible Assets \nIFRS 9 International Financial Reporting Standard 9 , Financial Instruments \nIFRS 15 International Financial Reporting Standard 15, Revenue from Contracts with \nCustomers \nIFRS 16 International Financial Reporting Standard 16, Leases \nGASB 13 Governmen tal Accounting Standards Board Statement No. 13, Accounting for \nOperating Leases with Scheduled Rent Increases \nGASB 87 Governmen tal Accounting Standards Board Statement No. 87, Leases \nGASB 95 Governmen tal Accounting Standards Board Statement N o. 95, Postponement of the \nEffective Dates of Certain Authoritative Guidance \nNCGA 5 National Council on Governmental Accounting Statement No. 5, Accounting and \nFinancial Reporting Principles for Lease Agreements of State and Local Governments \nSAB Topic 11.M SEC Staff Accounting Bulletin Topic 11.M, Miscellaneous Disclosure — Disclosure Of \nThe Impact That Recently Issued Accounting Standards Will Have On The Financial \nStatements Of The Registrant When Adopted In A Future Period \n \nAbbreviation Non-authoritative Standards \nEITF 01 -8 EITF Issue No. 01 -8, Determining Whether an Arrangement Contains a Lease \nIAS 17 International Accounting Standard 17 , Leases \nStatement 13 FASB Statement No. 13, Accounting for Leases \nStatement 109 FASB Statement No. 109, Accounting for Income Taxes \nStatement 1 33 FASB Statement No. 1 33, Accounting for Derivative Instruments and Hedging \nActivities \nStatement 144 FASB Statement No. 144, Accounting for the Impairment or Disposal of Long -Lived \nAssets \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 487}), Document(page\_content=" \nFinancial reporting developments Lease accounting | B-1 B Index of ASC references in this \npublication \nASC paragraph Section \n230-10-50-2 4.9 Presentation \n230-10-50-3 4.10 Disclosure \n250-10-50-3 1A Amendments to ASC 842 \n250-10-50-3 11.6.1 Interim disclosures in the year of adoption \n250-10-S99-6 11.1.1 Disclosure before adoption \n270-10-50-6A 5.9 Disclosure \n270-10-S99-1 4.10 Disclosure \n340-40-25-5 5.1.6 Fulfillment costs incurred by a lessor \n360-10-25-2 1.7 Acquisition of lease residual values \n360-10-25-3 1.7 Acquisition of lease residual values \n360-10-25-4 1.7 Acquisition of lease residual values \n360-10-30-3 1.7 Acquisition of lease residual values \n360-10-30-4 1.7 Acquisition of lease residual values \n360-10-35-13 1.7 Acquisition of lease residual values \n360-10-35-14 1.7 Acquisition of lease residual values \n360-10-35-28 4.2.5. 4 Accounting for an operating lease after an impairment of a right -of-\nuse asset (single lease cost) \n360-10-40-4 4.7.3.4 Lessee amortization of leasehold improvements associated with a \nlease between entities under common control \n405-20-40-1 4.8.1 Lease termination \n405-20-40-2 6.1.1 The original lessee is relieved of the primary obligation — not a sublease \n405-20-55-3 \nthrough 55 -4 4.8.1 Lease termination \n410-20-15-3 2.4.8 Lessee's obligations for asset retirement obligations (AROs) \n420-10-15-3 4.8.10 Exit or disposal cost obligations under ASC 420 ( ‘cease -use’ \nliabilities) \n450-20-25-2 5.4 Operating leases \n460-10-15-4 5.7.7 Sales of equipment with guaranteed minimum resale amount \n460-10-15-4(c) 2.4.9 Tax indemnifications in lease agreements \n460-10-15-7(c) 2.4.9 Tax indemnifications in lease agreements \n460-10-25-1 2.10.6 Third -party guarantee of lease payments or residual value \n606-10-25-1 \nthrough 25 -8 7.2 Determining whether the transfer of an asset is a sale \n606-10-25-27 7.7.2 Determining whether the lessee controls the underlying asset being \nconstructed \n606-10-25-30 5.7.7 Sales of equipment with guaranteed minimum resale amount \n606-10-25-30 7.2 Determining whether the transfer of an asset is a sale \n606-10-25-30 7.2.3 Seller -lessee guarantee of the residual value — effect on sale accounting ", metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 488}), Document(page\_content='B Index of ASC references in this publication \nFinancial reporting developments Lease accounting | B-2 ASC paragraph Section \n606-10-25-30 7.9 Transfer of tax benefits \n606-10-32-2 \nthrough 32 -27 7.3 Transactions in which the transfer of an asset is a sale \n606-10-32-5 \nthrough 32 -9 7.3.2.1 Variable lease payments — assessment of off -market terms in sale \nand leaseback transactions \n606-10-32-28 1.4.4.3 Allocating variable payments — lessors \n606-10-32-28 \nthrough 32 -41 1.4.4.2 Allocating the consideration in the contract — lessors \n606-10-32-40 1.4.4.3 Allocating variable payments — lessors \n606-10-32-40 Appendix D Summary of key differences from IFRS \n606-10-32-42 \nthrough 32 -45 1.4.4.5 Reassessment: determining and allocating the consideration in the \ncontract — lessors \n606-10-32-42 \nthrough 32 -45 3.5.1 Summary of lease reassessment and remeasurement requirements \n606-10-55-30 \nthrough 55 -35 1.4.2.2 Guarantees of performance of underlying asset \n606-10-55-66 \nthrough 55 -78 5.7.7 Sales of equipment with guaranteed minimum resale amount \n606-10-55-68 3.2.2 Lease classification for certain sales that include a residual value \nguarantee in the form of a repurchase option (lessors only) \n606-10-55-68 5.7.7 Sales of equipment with 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\n853-10-05-2 1.8 Service concession arrangements ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 505}), Document(page\_content='B Index of ASC references in this publication \nFinancial reporting developments Lease accounting | B-19 ASC paragraph Section \n853-10-15-1 \nthrough 15 -3 1.8 Service concession arrangements \n853-10-15-4 1.8.1 Service concession arrangements in regulated operations \n860-10-55-6 5.7.1.1 Sales or securitizations of lease receivables associated with sales -\ntype and direct financing leases \n860-10-55-6 5.7.1.2 Accounting for a guaranteed residual value \n860-20-55-26 5.7.1.1 Sales or securitizations of lease receivables associated with sales -\ntype and direct financing leases \n860-20-55-58 \nthrough 55 -59 5.7.1.1 Sales or securitizations of lease receivables associated with sales -\ntype and direct financing leases \n980-842-05-1 7.6 Sale and leasebacks by entities with 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Refer to section 1.2, \nDetermining whether a n arrangement contains a lease . \nC1 Example 1 — Rail cars \nExcerpt from Accounting Standards Codification \nExample 1 — Rail Cars \nCase A — Contract Contains a Lease \n842-10-55-42 \nA contract between Customer and a freight carrier (Supplier) provides Customer with the use of 10 rail \ncars of a particular type for 5 years. The contract specifies the rail cars; the cars are owned by \nSupplier. Customer determines when, where, and which goods are to be transported using the cars. \nWhen the cars are not in use, they are kept at Customer’s premises. Customer can use the cars for \nanother purpose (for example, storage) if it so chooses. However, the contract specifies that Customer \ncannot transport partic ular types of cargo (for example, explosives). If a particular car needs to be \nserviced or repaired, Supplier is required to substitute a car of the same type. Otherwise, and other \nthan on default by Customer, Supplier cannot retrieve the cars during the f ive-year period. \n842-10-55-43 \nThe contract also requires Supplier to provide an engine and a driver when requested by Customer. \nSupplier keeps the engines at its premises and provides instructions to the driver detailing Customer’s \nrequests to transport go ods. Supplier can choose to use any one of a number of engines to fulfill each \nof Customer’s requests, and one engine could be used to transport not only Customer’s goods, but \nalso the goods of other customers (for example, if other customers require the t ransport of goods to \ndestinations close to the destination requested by Customer and within a similar timeframe, Supplier \ncan choose to attach up to 100 rail cars to the engine). \n842-10-55-44 \nThe contract contains leases of rail cars. Customer has the right to use 10 rail cars for 5 years. \n842-10-55-45 \nThere are 10 identified cars. The cars are explicitly specified in the contract. Once delivered to \nCustomer, the cars can be substituted only when they need to be serviced or repaired. The engine \nused to transport the rail cars is not an identified asset because it is neither explicitly specified nor \nimplicitly specified in the contract. \n842-10-55-46 \nCustomer has the right to control the use of the 10 rail cars throughout the 5 -year period of use \nbecause: \na. Customer has the right to obtain substantially all of the economic benefits from use of the cars \nover the five -year period of use. Customer has exclusive use of the cars throughout the period of \nuse, including when they are not being used to transport Customer’s goods. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 507}), Document(page\_content='C Illustrations from ASC 842 on the application of the definition of a lease \nFinancial reporting developments Lease accounting | C-2 b. Customer has the right to direct the use of the cars. The contractual restrictions on the cargo \nthat can be transported by the cars are protective rights of Supplier and define the scope of \nCustomer’s right to use the cars. Within the scope of its right of use defined in the contract, \nCustomer makes the relevant decisions about how and for what purpose the cars are used by \nbeing able to decide when and where the rail cars will be used and which goods are transported \nusing the cars. Cus tomer also determines whether and how the cars will be used when not being \nused to transport its goods (for example, whether and when they will be used for storage). \nCustomer has the right to change these decisions during the five -year period of use. \n842-10-55-47 \nAlthough having an engine and driver (controlled by Supplier) to transport the rail cars is essential to \nthe efficient use of the cars, Supplier’s decisions in this regard do not give it the right to direct how and \nfor what purpose the rail cars ar e used. Consequently, Supplier does not control the use of the cars \nduring the period of use. \nCase B — Contract Does Not Contain a Lease \n842-10-55-48 \nThe contract between Customer and Supplier requires Supplier to transport a specified quantity of \ngoods by using a specified type of rail car in accordance with a stated timetable for a period of five \nyears. The timetable and quantity of goods specified are equivalent to Customer having the use of \n10 rail cars for 5 years. Supplier provides the rail cars, driv er, and engine as part of the contract. The \ncontract states the nature and quantity of the goods to be transported (and the type of rail car to be \nused to transport the goods). Supplier has a large pool of similar cars that can be used to fulfill the \nrequi rements of the contract. Similarly, Supplier can choose to use any one of a number of engines to \nfulfill each of Customer’s requests, and one engine could be used to transport not only Customer’s \ngoods, but also the goods of other customers. The cars and e ngines are stored at Supplier’s premises \nwhen not being used to transport goods. \n842-10-55-49 \nThe contract does not contain a lease of rail cars or of an engine. \n842-10-55-50 \nThe rail cars and the engines used to transport Customer’s goods are not identified assets. Supplier \nhas the substantive right to substitute the rail cars and engine because: \na. Supplier has the practical ability to substitute each car and the engine throughout the period of \nuse. Alternative cars and engines are readily availa ble to Supplier, and Supplier can substitute \neach car and the engine without Customer’s approval. \nb. Supplier would benefit economically from substituting each car and the engine. There would be \nminimal, if any, cost associated with substituting each car or the engine because the cars and \nengines are stored at Supplier’s premises and Supplier has a large pool of similar cars and \nengines. Supplier benefits from substituting each car or the engine in contracts of this nature \nbecause substitution allows Suppl ier to, for example, (1) use cars or an engine to fulfill a task for \nwhich the cars or engine are already positioned to perform (for example, a task at a rail yard close \nto the point of origin) or (2) use cars or an engine that would otherwise be sitting i dle because \nthey are not being used by a customer. \n842-10-55-51 \nAccordingly, Customer does not direct the use and does not have the right to obtain substantially all of \nthe economic benefits from use of an identified car or an engine. Supplier directs the use of the rail \ncars and engine by selecting which cars and engine are used for each particular delivery and obtains \nsubstantially all of the economic benefits from use of the rail cars and engine. Supplier is only providing \nfreight capacity. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 508}), Document(page\_content='C Illustrations from ASC 842 on the application of the definition of a lease \nFinancial reporting developments Lease accounting | C-3 C2 Example 2 — Concession space \nExcerpt from Accounting Standards Codification \nExample 2 — Concession Space \n842-10-55-52 \nA coffee company (Customer) enters into a contract with an airport operator (Supplier) to use a space \nin the airport to sell its goods for a three -year period. The contract states the amount of space and \nthat the space may be located at any one of several boarding areas within the airport. Supplier has the \nright to change the location of the space allocated to Customer at any time during the pe riod of use. \nThere are minimal costs to Supplier associated with changing the space for the Customer: Customer \nuses a kiosk (that it owns) that can be moved easily to sell its goods. There are many areas in the \nairport that are available and that would mee t the specifications for the space in the contract. \n842-10-55-53 \nThe contract does not contain a lease. \n842-10-55-54 \nAlthough the amount of space Customer uses is specified in the contract, there is no identified asset. \nCustomer controls its owned kiosk. H owever, the contract is for space in the airport, and this space \ncan change at the discretion of Supplier. Supplier has the substantive right to substitute the space \nCustomer uses because: \na. Supplier has the practical ability to change the space used by Customer throughout the period of \nuse. There are many areas in the airport that meet the specifications for the space in the contract, \nand Supplier has the right to change the location of the space to other space that meets the \nspecifications at any tim e without Customer’s approval. \nb. Supplier would benefit economically from substituting the space. There would be minimal cost \nassociated with changing the space used by Customer because the kiosk can be moved easily. \nSupplier benefits from substituting t he space in the airport because substitution allows Supplier \nto make the most effective use of the space at boarding areas in the airport to meet changing \ncircumstances. \nC3 Example 3 — Fiber -optic cable \nExcerpt from Accounting Standards Codification \nExample 3 — Fiber -Optic Cable \nCase A — Contract Contains a Lease \n842-10-55-55 \nCustomer enters into a 15 -year contract with a utilities company (Supplier) for the right to use 3 \nspecified, physically distinct dark fibers within a larger cable connecting Hon g Kong to Tokyo. \nCustomer makes the decisions about the use of the fibers by connecting each end of the fibers to its \nelectronic equipment (for example, Customer “lights” the fibers and decides what data and how much \ndata those fibers will transport). If t he fibers are damaged, Supplier is responsible for the repairs and \nmaintenance. Supplier owns extra fibers but can substitute those for Customer’s fibers only for \nreasons of repairs, maintenance, or malfunction (and is obliged to substitute the fibers in t hese cases). \n842-10-55-56 \nThe contract contains a lease of dark fibers. Customer has the right to use the 3 dark fibers for 15 years. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 509}), Document(page\_content='C Illustrations from ASC 842 on the applicatio n of the definition of a lease \nFinancial reporting developments Lease accounting | C-4 842-10-55-57 \nThere are three identified fibers. The fibers are explicitly specified in the contract and are physically \ndistinct from other fibers within the cable. Supplier cannot substitute the fibers other than for reasons \nof repairs, maintenance, or malfunction. \n842-10-55-58 \nCustomer has the right to control the use of the fibers throughout the 15 -year period of use becaus e: \na. Customer has the right to obtain substantially all of the economic benefits from use of the fibers \nover the 15 -year period of use. Customer has exclusive use of the fibers throughout the period \nof use. \nb. Customer has the right to direct the use of the fibers. Customer makes the relevant decisions \nabout how and for what purpose the fibers are used by deciding when and whether to light the \nfibers and when and how much output the fibers will produce (that is, what data and how much \ndata those fibers w ill transport). Customer has the right to change these decisions during the 15 -\nyear period of use. \n842-10-55-59 \nAlthough Supplier’s decisions about repairing and maintaining the fibers are essential to their efficient \nuse, those decisions do not give Supplier the right to direct how and for what purpose the fibers are \nused. Consequently, Supplier does not control the use of the fibers during the period of use. \nCase B — Contract Does Not Contain a Lease \n842-10-55-60 \nCustomer enters into a 15 -year contra ct with Supplier for the right to use a specified amount of \ncapacity within a cable connecting Hong Kong to Tokyo. The specified amount is equivalent to \nCustomer having the use of the full capacity of 3 strands within the cable (the cable contains 15 fiber s \nwith similar capacities). Supplier makes decisions about the transmission of data (that is, Supplier \nlights the fibers and makes decisions about which fibers are used to transmit Customer’s traffic and \nabout the electronic equipment that Supplier owns an d connects to the fibers). \n842-10-55-61 \nThe contract does not contain a lease. \n842-10-55-62 \nSupplier makes all decisions about the transmission of its customers’ data, which requires the use of \nonly a portion of the capacity of the cable for each customer. The capacity portion that will be provided \nto Customer is not physically distinct from the remaining capacity of the cable and does not represent \nsubstantially all of the capacity of the cable. Consequently, Customer does not have the right to use an \nidentified asset. \nC4 Example 4 — Retail unit \nExcerpt from Accounting Standards Codification \nExample 4 — Retail Unit \n842-10-55-63 \nCustomer enters into a contract with property owner (Supplier) to use Retail Unit A for a five -year \nperiod. Retail Unit A is part of a larger retail space with many retail units. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 510}), Document(page\_content='C Illustrations from ASC 842 on the application of the definition of a lease \nFinancial reporting developments Lease accounting | C-5 842-10-55-64 \nCustomer is granted the right to use Retail Unit A. Supplier can require Customer to relocate to \nanother retail unit. In that case, Supplier is required to provide Customer with a retail un it of similar \nquality and specifications to Retail Unit A and to pay for Customer’s relocation costs. Supplier would \nbenefit economically from relocating Customer only if a major new tenant were to decide to occupy a \nlarge amount of retail space at a rate sufficiently favorable to cover the costs of relocating Customer \nand other tenants in the retail space that the new tenant will occupy. However, although it is possible \nthat those circumstances will arise, at inception of the contract, it is not likely tha t those circumstances \nwill arise. For example, whether a major new tenant will decide to lease a large amount of retail space \nat a rate that would be sufficiently favorable to cover the costs of relocating Customer is highly \nsusceptible to factors outside Supplier’s influence. \n842-10-55-65 \nThe contract requires Customer to use Retail Unit A to operate its well -known store brand to sell its \ngoods during the hours that the larger retail space is open. Customer makes all of the decisions about \nthe use of the r etail unit during the period of use. For example, Customer decides on the mix of goods \nsold from the unit, the pricing of the goods sold, and the quantities of inventory held. Customer also \ncontrols physical access to the unit throughout the five -year peri od of use. \n842-10-55-66 \nThe contract requires Customer to make fixed payments to Supplier as well as variable payments that \nare a percentage of sales from Retail Unit A. \n842-10-55-67 \nSupplier provides cleaning and security services as well as advertising s ervices as part of the contract. \n842-10-55-68 \nThe contract contains a lease of retail space. Customer has the right to use Retail Unit A for five years. \n842-10-55-69 \nRetail Unit A is an identified asset. It is explicitly specified in the contract. Supplier has the practical \nability to substitute the retail unit, but could benefit economically from substitution only in specific \ncircumstances. Supplier’s substitution rig ht is not substantive because, at inception of the contract, \nthose circumstances are not considered likely to arise. \n842-10-55-70 \nCustomer has the right to control the use of Retail Unit A throughout the five -year period of use because: \na. Customer has th e right to obtain substantially all of the economic benefits from use of Retail Unit \nA over the five -year period of use. Customer has exclusive use of Retail Unit A throughout the \nperiod of use. Although a portion of the cash flows derived from sales from Retail Unit A will flow \nfrom Customer to Supplier, this represents consideration that Customer pays Supplier for the \nright to use the retail unit. It does not prevent Customer from having the right to obtain \nsubstantially all of the economic benefits from use of Retail Unit A. \nb. Customer has the right to direct the use of Retail Unit A. The contractual restrictions on the \ngoods that can be sold from Retail Unit A and when Retail Unit A is open define the scope of \nCustomer’s right to use Retail Unit A. Wit hin the scope of its right of use defined in the contract, \nCustomer makes the relevant decisions about how and for what purpose Retail Unit A is used by \nbeing able to decide, for example, the mix of products that will be sold in the retail unit and the \nsale price for those products. Customer has the right to change these decisions during the five -\nyear period of use. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 511}), Document(page\_content='C Illustrations from ASC 842 on the application of the definition of a lease \nFinancial reporting developments Lease accounting | C-6 842-10-55-71 \nAlthough cleaning, security, and advertising services are essential to the efficient use of Retail Unit A, \nSupplier’s decisions in this regard do not give it the right to direct how and for what purpose Retail Unit \nA is used. Consequently, Supplier does not control the use of Retail Unit A during the period of use, \nand Supplier’s decisions do not affect Customer’s control of the use of Retail Unit A. \nC5 Example 5 — Truck rental \nExcerpt from Accounting Standards Codification \nExample 5 — Truck Rental \n842-10-55-72 \nCustomer enters into a contract with Supplier for the use of a truck for one week to transport cargo \nfrom New York to San Francisco. Supplier does not have substitution rights. Only cargo specified in the \ncontract is permitted to be transported on this truck for the period of the contract. The contract \nspecifies a maximum distance that the truck can be driven. Customer is able to choose the details of \nthe journey (speed, route, rest stops, and so forth) within the parameters of the contract. Customer \ndoes not have the right to continue using the truck after the specified trip is complete. \n842-10-55-73 \nThe cargo to be trans ported and the timing and location of pickup in New York and delivery in San \nFrancisco are specified in the contract. \n842-10-55-74 \nCustomer is responsible for driving the truck from New York to San Francisco. \n842-10-55-75 \nThe contract contains a lease of a truck. Customer has the right to use the truck for the duration of the \nspecified trip. \n842-10-55-76 \nThere is an identified asset. The truck is explicitly specified in the contract, and Supplier does not have \nthe right to substitute the truck. \n842-10-55-77 \nCustomer has the right to control the use of the truck throughout the period of use because: \na. Customer has the right to obtain substantially all of the economic benefits from the use of the \ntruck over the period of use. Customer has exclusive use of the truck throughout the period of use. \nb. Customer has the right to direct the use of the truck. H ow and for what purpose the truck will be \nused (that is, the transport of specified cargo from New York to San Francisco within a specified \ntime frame) are predetermined in the contract. Customer directs the use of the truck because it \nhas the right to ope rate the truck (for example, speed, route, and rest stops) throughout the \nperiod of use. Customer makes all of the decisions about the use of the truck that can be made \nduring the period of use through its control of the operations of the truck. \n842-10-55-78 \nBecause the duration of the contract is one week, this lease meets the definition of a short -term lease. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 512}), Document(page\_content='C Illustrations from ASC 8 42 on the application of the definition of a lease \nFinancial reporting developments Lease accounting | C-7 C6 Example 6 — Ship \nExcerpt from Accounting Standards Codification \nExample 6 — Ship \nCase A — Contract Does Not Contain a Lease \n842-10-55-79 \nCustomer enters into a contract with a ship owner (Supplier) for the transport of cargo from \nRotterdam to Sydney on a specified ship. The ship is explicitly specified in the contract, and Supplier \ndoes not have substitution rights. The cargo w ill occupy substantially all of the capacity of the ship. \nThe contract specifies the cargo to be transported on the ship and the dates of pickup and delivery. \n842-10-55-80 \nSupplier operates and maintains the ship and is responsible for the safe passage of the cargo onboard \nthe ship. Customer is prohibited from hiring another operator for the ship or operating the ship itself \nduring the term of the contract. \n842-10-55-81 \nThe contract does not contain a lease. \n842-10-55-82 \nThere is an identified asset. The sh ip is explicitly specified in the contract, and Supplier does not have \nthe right to substitute that specified ship. \n842-10-55-83 \nCustomer has the right to obtain substantially all of the economic benefits from use of the ship over \nthe period of use. Its ca rgo will occupy substantially all of the capacity of the ship, thereby preventing \nother parties from obtaining economic benefits from use of the ship. \n842-10-55-84 \nHowever, Customer does not have the right to control the use of the ship because it does not have the \nright to direct its use. Customer does not have the right to direct how and for what purpose the ship is \nused. How and for what purpose the ship will be used (that is, the transport of specified cargo from \nRotterdam to Sydney within a specifie d time frame) are predetermined in the contract. Customer has \nno right to change how and for what purpose the ship is used during the period of use. Customer has \nno other decision -making rights about the use of the ship during the period of use (for exampl e, it does \nnot have the right to operate the ship) and did not design the ship. Customer has the same rights \nregarding the use of the ship as if it were one of multiple customers transporting cargo on the ship. \nCase B — Contract Contains a Lease \n842-10-55-85 \nCustomer enters into a contract with Supplier for the use of a specified ship for a five -year period. The \nship is explicitly specified in the contract, and Supplier does not have substitution rights. \n842-10-55-86 \nCustomer decides what cargo will be tran sported and whether, when, and to which ports the ship will \nsail, throughout the five -year period of use, subject to restrictions specified in the contract. Those \nrestrictions prevent Customer from sailing the ship into waters at a high risk of piracy or c arrying \nhazardous materials as cargo. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 513}), Document(page\_content='C Illustrations from ASC 842 on the application of the definition of a lease \nFinancial reporting developments Lease accounting | C-8 842-10-55-87 \nSupplier operates and maintains the ship and is responsible for the safe passage of the cargo onboard \nthe ship. Customer is prohibited from hiring another operator for the ship or operating the ship itself \nduring the term of the contract. \n842-10-55-88 \nThe contract contains a lease. Customer has the right to use the ship for five years. \n842-10-55-89 \nThere is an identified asset. The ship is explicitly specified in the contract, and Supplier does not have \nthe right to substitute that specified ship. \n842-10-55-90 \nCustomer has the right to control the use of the ship throughout the five -year period of use because: \na. Customer has the right to obtain substantially all of the economic benefits from use of the ship \nover the five -year period of use. Customer has exclusive use of the ship throughout the period \nof use. \nb. Customer has the right to direct the use of the ship. The contractual restrictions about where the \nship can sail and the cargo to be transported by the ship define the scope of Customer’s right to \nuse the ship. They are protective rights that protect Supplier’s investment in the ship and \nSupplier’s personnel. Within the scope of its right of use, Customer makes the relevant decisions \nabout how and for what purpose the ship is used throughout the five -year period of use because it \ndecides whether, where, and when the ship sails, as well as the cargo it will transport. Customer \nhas the right to change these decisions throughout the five -year period o f use. \n842-10-55-91 \nAlthough the operation and maintenance of the ship are essential to its efficient use, Supplier’s \ndecisions in this regard do not give it the right to direct how and for what purpose the ship is used. \nInstead, Supplier’s decisions are d ependent on Customer’s decisions about how and for what purpose \nthe ship is used. \nC7 Example 7 — Aircraft \nExcerpt from Accounting Standards Codification \nExample 7 — Aircraft \n842-10-55-92 \nCustomer enters into a contract with an aircraft owner (Supplier) for the use of an explicitly specified \naircraft for a two -year period. The contract details the interior and exterior specifications for the aircraft. \n842-10-55-93 \nThere are contractual and legal restrictions in the contract on where the aircraft can fly. Subject to \nthose restrictions, Customer determines where and when the aircraft will fly and which passengers and \ncargo will be transported on the aircraft. \n842-10-55-94 \nSupplier is responsib le for operating the aircraft, using its own crew. Customer is prohibited from \nhiring another operator for the aircraft or operating the aircraft itself during the term of the contract. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 514}), Document(page\_content='C Illustrations from ASC 842 on the application of the definition of a lease \nFinancial reporting developments Lease accounting | C-9 842-10-55-95 \nSupplier is permitted to substitute the aircraft at any time during the two -year period and must \nsubstitute the aircraft if it is not working. Any substitute aircraft must meet the interior and exterior \nspecifications in the contract. There are significant costs involved in outfitting an aircraft in Supplie r’s \nfleet to meet Customer’s specifications. \n842-10-55-96 \nThe contract contains a lease. Customer has the right to use the aircraft for two years. \n842-10-55-97 \nThere is an identified asset. The aircraft is explicitly specified in the contract, and although Supplier \ncan substitute the aircraft, its substitution right is not substantive. Supplier’s substitution right is not \nsubstantive because of the significant costs involved in outfitting another aircraft to meet the \nspecifications required by the contract such that Supplier is not expected to benefit economically from \nsubstituting the aircraft. \n842-10-55-98 \nCustomer has the right to control the use of the aircraft throughout the two -year period of use \nbecause: \na. Customer has the right to obtain substantia lly all of the economic benefits from use of the aircraft \nover the two -year period of use. Customer has exclusive use of the aircraft throughout the period \nof use. \nb. Customer has the right to direct the use of the aircraft. The restrictions on where the aircraft can \nfly define the scope of Customer’s right to use the aircraft. Within the scope of its right of use, \nCustomer makes the relevant decisions about how and for what purpose the aircraft is used \nthroughout the two -year period of use because it deci des whether, where, and when the aircraft \ntravels as well as the passengers and cargo it will transport. Customer has the right to change \nthese decisions throughout the two -year period of use. \n842-10-55-99 \nAlthough the operation of the aircraft is essentia l to its efficient use, Supplier’s decisions in this regard \ndo not give it the right to direct how and for what purpose the aircraft is used. Consequently, Supplier \ndoes not control the use of the aircraft during the period of use, and Supplier’s decisions do not affect \nCustomer’s control of the use of the aircraft. \nC8 Example 8 — Contract for shirts \nExcerpt from Accounting Standards Codification \nExample 8 — Contract for Shirts \n842-10-55-100 \nCustomer enters into a contract with a manufacturer (Supplier) to purchase a particular type, quality, \nand quantity of shirts for a three -year period. The type, quality, and quantity of shirts are specified in \nthe contract. \n842-10-55-101 \nSupplier has only one factory that can meet the needs of Customer. Sup plier is unable to supply the \nshirts from another factory or source the shirts from a third -party supplier. The capacity of the factory \nexceeds the output for which Customer has contracted (that is, Customer has not contracted for \nsubstantially all of the capacity of the factory). ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 515}), Document(page\_content='C Illustrations from ASC 842 on the application of the definition of a lease \nFinancial reporting developments Lease accounting | C-10 842-10-55-102 \nSupplier makes all decisions about the operations of the factory, including the production level at \nwhich to run the factory and which customer contracts to fulfill with the output of the factory that is \nnot used to fulfill Customer’s contract. \n842-10-55-103 \nThe contract does not contain a lease. \n842-10-55-104 \nThe factory is an identified asset. The factory is implicitly specified because Supplier can fulfill the \ncontract only through the use of this asset. \n842-10-55-105 \nHowever, Customer does not control the use of the factory because it does not have the right to obtain \nsubstantially all of the economic benefits from use of the factory. This is because Supplier could decide \nto use the factory to fulfill other custome r contracts during the period of use. \n842-10-55-106 \nCustomer also does not control the use of the factory because it does not have the right to direct the \nuse of the factory. Customer does not have the right to direct how and for what purpose the factory i s \nused during the three -year period of use. Customer’s rights are limited to specifying output from the \nfactory in the contract with Supplier. Customer has the same rights regarding the use of the factory as \nother customers purchasing shirts from the facto ry. Supplier has the right to direct the use of the \nfactory because Supplier can decide how and for what purpose the factory is used (that is, Supplier has \nthe right to decide the production level at which to run the factory and which customer contracts to \nfulfill with the output produced). \n842-10-55-107 \nEither the fact that Customer does not have the right to obtain substantially all of the economic benefits \nfrom use of the factory or the fact that Customer does not have the right to direct the use of the factory \nwould be sufficient in isolation to conclude that Customer does not control the use of the factory. \nC9 Example 9 — Contract for network services \nExcerpt from Accounting Standards Codification \nExample 10 — Contract for Network Services \nCase A — Contract Does Not Contain a Lease \n842-10-55-124 \nCustomer enters into a contract with a telecommunications company (Supplier) for network services \nfor two years. The contract requires Supplier to supply network services that meet a specified quality \nlevel. To provide the services, Supplier installs and configures servers at Customer’s premises; \nSupplier determines the speed and quality of data transportation in the network using the servers. \nSupplier can reconfigure or replace the servers when needed to c ontinuously provide the quality of \nnetwork services defined in the contract. Customer does not operate the servers or make any \nsignificant decisions about their use. \n842-10-55-125 \nThe contract does not contain a lease. Instead, the contract is a service contract in which Supplier uses \nthe equipment to meet the level of network services determined by Customer. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 516}), Document(page\_content='C Illustrations from ASC 842 on the application of the definition of a lease \nFinancial reporting developments Lease accounting | C-11 842-10-55-126 \nCustomer does not control the use of the servers because Cu stomer’s only decision -making rights \nrelate to deciding on the level of network services (the output of the servers) before the period of \nuse — the level of network services cannot be changed during the period of use without modifying the \ncontract. For exa mple, even though Customer produces the data to be transported, that activity does \nnot directly affect the configuration of the network services and, thus, it does not affect how and for \nwhat purpose the servers are used. Supplier is the only party that ca n make decisions about the use of \nthe servers during the period of use. Supplier has the right to decide how data are transported using \nthe servers, whether to reconfigure the servers, and whether to use the servers for another purpose. \nAccordingly, Suppli er controls the use of the servers in providing network services to Customer. There \nis no need to assess whether the servers are identified assets because Customer does not have the \nright to control the use of the servers. \nCase B — Contract Contains a Leas e \n842-10-55-127 \nCustomer enters into a contract with an information technology company (Supplier) for the use of an \nidentified server for three years. Supplier delivers and installs the server at Customer’s premises in \naccordance with Customer’s instructio ns and provides repair and maintenance services for the server, \nas needed, throughout the period of use. Supplier substitutes the server only in the case of \nmalfunction. Customer decides which data to store on the server and how to integrate the server \nwithin its operations. Customer can change its decisions in this regard throughout the period of use. \n842-10-55-128 \nThe contract contains a lease. Customer has the right to use the server for three years. \n842-10-55-129 \nThere is an identified asset. The server is explicitly specified in the contract. Supplier can substitute \nthe server only if it is malfunctioning. \n842-10-55-130 \nCustomer has the right to control the use of the server throughout the three -year period of use because: \na. Customer has the right to obtain substantially all of the economic benefits from use of the server \nover the three -year period of use. Customer has exclusive use of the server throughout the \nperiod of use. \nb. Customer has the right to direct the use of the server. Customer makes the relevant decisions \nabout how and for what purpose the server is used because it has the right to decide which aspect \nof its operations the server is used to support and which data it stores on the server. Customer is \nthe only party that can make decisions about the use of the server during the period of use. \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 517}), Document(page\_content=' \nFinancial reporting developments Lease accounting | D-1 D Summary of key differences from IFRS \n(updated August 2023) \nThe FASB issued ASC 842 after joint deliberations with the IASB, which issued a similar standard, IFRS 16 , \nLeases . While ASC 842 and IFRS 16 both require lessees to put most leases on their balance sheets, there \nare a number of differences between the standards. The following chart summarizes the key differences \nand includes references to the FASB and IASB’s discussion of the di fferences in the Basis for Conclusions of \neach standard ( i.e., ASC 842 and IFRS 16): \n US GAAP IFRS \nScope and measurement exemptions \nLow-value asset exemption19 There is no recognition exemption for \nleases based on the value of the \nunderlying asset. Lessees may elect, on a lease -by-lease \nbasis, not to recognize leases when the \nvalue of the underlying asset is low \n(e.g., US$5,000 or less when new). \nScope exemption for \nintangible assets20 All leases of intangible assets are \nexcluded from the scope of ASC 842. \nRefer to section 1.1, Scope and scope \nexceptions . Lessees may apply IFRS 16 to leases of \nintangible assets other than rights held \nby a lessee under licensing agreements \nwithin the sco pe of International \nAccounting Standard ( IAS) 38, Intangible \nAssets , for items such as motion picture \nfilms, video recordings, plays, \nmanuscripts, patents and copyrights. \nLessors are required to apply IFRS 16 \nto leases of intangible assets, except \nfor licenses of intellectual property that \nare in the scope of IFRS 15, Revenue \nfrom Contr acts with Customers . \nKey concepts \nLease liability — reassessment \nof variable lease payments21 Changes in variable lease payments \nbased on an index or rate result in a \nremeasurement of the lease liability \nwhen the lease liability is remeasured \nfor another reason ( e.g., a change in \nthe lease term). \nRefer to section 2.4.2, Variable lease \npayments that depend on an index or rate . Changes in variable lease payments \nbased on an index or rate result in a \nremeasurement of the lease liability \nwhenever there is a c hange in the cash \nflows ( i.e., when the adjustment to the \nlease payment s takes effect). \nDetermination of the \ndiscount rate Lessees and lessors determine the \ndiscount rate at the lease \ncommencement date. \nRefer to section 2.5 , Discount rates . Lessees determine the discount rate at \nlease commencement , but lessors \ndetermine the rate implicit in the lease \nat the lease inception date. That is \nbecause a lessor determines lease \nclassification at the lease inception date. \n \n19 ASC 842 BC 421 and IFRS 16 BC 308. \n20 ASC 842 BC 431. \n21 ASC 842 BC 425 and IFRS 16 BC 309. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 518}), Document(page\_content='D Summary of key differences from IFRS (updated August 2023) \nFinancial reporting developments Lease accounting | D-2 US GAAP IFRS \nDetermination of a lessee’s \nincremen tal borrowing rate A lessee may consider the effect of lease \nterm options (e.g., purchase and \nrenewal options) that are not included \nin the lease term. Refer to section \n2.5.2, Discount rate — lessees . \nEntities that are not PBEs may elect to \nuse a risk -free rate by class of underlying \nasset for initial and subsequent \nmeasurements of the lease liability. \nHowever, a lessee is required to use \nthe rate implicit in the lease when it is \nreadily determinable, even if they make \nthe risk –free rate election. Refer to \nsection 2.5.2, Discount rate — lessees . IFRS 16 does not address whether a \nlessee may consider the effect of lease \nterm options (e.g., purchase and renewal \noptions) that are not included in the \nlease term. \nIFRS 16 does not provide accounting \nalternatives for private companies. \nInitial direct costs (IDCs ) IDCs are incremental costs that would \nnot have been incurred if the lease had \nnot been obtained. Lessors expense \nIDCs for sales -type leases if the fair \nvalue of the underlying asset is \ndiffer ent from the carrying amount of \nthe underlying asset at lease \ncommencement . Refer to section s 2.6, \nInitial direct costs , and 2.8 , Fair value . IDCs are incremental costs of obtaining a \nlease that would not have been incurred if \nthe lease had not been obtain ed. However, \ncosts incurred by a manufacturer or \ndealer lessor in connection with a \nfinance lease are expensed as incurred . \nLease classification \nLessee lease classification22 Recognized leases are classified as either \nfinance or operating. Lessees classify \nleases at the lease commencement date. \nRefer to section 3.1, Criteria for lease \nclassification — lessees . All recognized leases are accounted for \nsimilarly to finance leases under \nASC 842. \nLessor lease classification Leases are classified as operating, \ndirect financing or sales -type leases at \nthe lease commencement date. Refer \nto section 3.2, Criteria for lease \nclassification — lessors . Leases are classified as operating or \nfinance leases at the inception date of \nthe lease. \nLessor — lease classification \ncriteria Each classification criterion is \ndeterminative. After the adoption of \nASU 2021 -05, l essors are also required \nto classify a lease as an operating lease \nif the lease ha s variable lease payments \nthat do not depend on an index or rate \nand would result in a selling loss if the \nlease were to be classified as a sales -\ntype or direct financing lease \notherwise . Refer to section 3.2, Criteria \nfor lease classification — lessors . All classification criteria can be considered \nindividually or in combination. IFRS 16 \nprovides examples and indicators of \nsituations that can be considered \nindividually, or in combination, and would \nresult in a lease being classi fied as a \nfinance lease. Meeting a single criterion \ndoes not automatically result in the lease \nbeing classified as a finance lease. IFRS 16 \ndoes not include additional guidance for \na lessor’s classification of a lease that \nresults in a selling loss. \nLesso r – reassessment of \nlease classification Lessors are required to reassess lease \nclassification if lessee s exercise an \nexisting option to renew the lease \n(i.e., change in assessment of lease \nterm) or to purchase the underlying \nasset when it was previously \ndetermined it was not reasonably \ncertain to do so. Refer to section 3. 5, \nReassessment of lease classification . Lessors do not reassess lease \nclassification if lessees exercise an \nexisting option to renew the lease \n(i.e., change in assessment of lease \nterm) or to purchase the underlying \nasset when it was previously determined \nit was not reasonably certain to do so. \nLease classification is determined at \nlease inception and reassessed only if \nthere is a lease modification that is not \naccounted for as a se parate contract. \n \n22 ASC 842 BC 420 and IFRS 16 BC 304. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 519}), Document(page\_content='D Summary of key differences from IFRS (updated August 2023) \nFinancial reporting developments Lease accounting | D-3 US GAAP IFRS \nCollectibility Collectibility of lease payments is \nconsidered when determining whether a \nlease is classified as a direct financing or \nan operating lease. Refer to section 3.2, \nCriteria for lease classification — lessors . IFRS 16 does not include explicit \nguidance for considering collectibility of \nlease pay ments. \nSubleases When classifying a sublease, the \nsublessor classifies the sublease based \non the underlying asset rather than the \nright -of-use asset on the head lease. \nRefer to section 3.4.10, Classification \nof subleases . When classifying a sublease, a \nsublessor classifies the sublease based \non the right -of-use asset recognized as \npart of the head lease rather than the \nunderlying asset subject to the sublease . \nLessee accounting \nShort -term leases — \nexistence of a purchase \noption A lease does not qualify as a short -term \nlease if it includes a purchase option \nthat is reasonably certain to be \nexercised. Refer to section 4.1.1, \nShort -term leases . A lease does not qualify as a short -term \nlease if it includes a purchase option, \nregardless of whether the lessee is \nreasonably certain to exercise the option. \nShort -term leases — change \nin lease term A lease no longer qualif ies as a short -\nterm lease when there is a change in a \nlessee’s assessment of either of the \nfollowing: \n• The lease term so that, after the \nchange, the remaining lease term \nextends more than 12 months \nfrom the end of the previously \ndetermined lease term \n• Whether the lessee is reasonably \ncertain to exercise an option to \npurchase the underlying asset \nRefer to section 4.1.1, Short -term leases A change in the terms of a short -term \nlease creates a new lease. If that new \nlease has a lease term greater than \n12 months, it cannot qualify as a short -\nterm lease. \nAllocating variable \nconsideration not dependent \non an index or rate between \nlease and non -lease \ncomponents of a contract Lessees allocate variable consideration \nnot dependent on an index or rate to \nthe lease and non -lease components of \na contract on a relative standalone \nprice basis . Refer to section 1.4.3.2, \nAllocating the consideration in th e \ncontract — lessees . Lessees may allocate variable \nconsideration not dependent on an \nindex or rate entirely to a non -lease \ncomponent of a contract. Refer to IFRS \n16’s Illustrative Examples - Example 12. \nLease modifications that do \nnot result in a separate \ncontract and shorten the \ncontractual lease term Lease modifications that do not result \nin a separate contract and shorten the \ncontractual lease term do not result in \nthe recognition of a gain or loss. A \nlessee recognizes the amount of the \nremeasurement of the lease liability as \nan adjustment to the corresponding \nright -of-use asset without affecting \nprofit or loss. However, if the right -of-\nuse asset is reduced to zero, a lessee \nwould recognize any remaini ng amount \nin profit or loss. Refer to section 4.5, \nRemeasurement of lease liabilities and \nright -of-use assets — operating and \nfinance leases . Lease modifications that do not result \nin a separate contract and shorten the \ncontractual lease term result in the \nrecognition of a gain or loss for the \ndifference between the decrease in the \nlease liability and the proportionate \ndecrease in the right -of-use asset. \nRefer to IFRS 16’s Illustrative Examples \n- Example 18. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 520}), Document(page\_content='D Summary of key differences from IFRS (updated August 2023) \nFinancial reporting developments Lease accounting | D-4 US GAAP IFRS \nReallo cation of consideration \nin the contract upon a \nchange in the lease term , the \nassessment of whether a \npurchase option is \nreasonably certain to be \nexercised , or the amounts \nprobable of being owed \nunder a residual value \nguarantee The consideration in the cont ract is \nreallocated when a lease is modified or \na lease liability is remeasured. \nTherefore, the revised lease payments \nare allocated based on the standalone \nprice of the lease and non -lease \ncomponents at the date of \nremeasurement (or effective date of \nthe modification). Refer to section 4.5, \nRemeasurement of lease liabilities and \nright -of-use assets — operating and \nfinance leases . The consideration in the contract is \nreallocated only when a lease is \nmodified . Therefore, when a lease \nliability is remeasured for other reasons \n(e.g., a change in lease term ), the \nrevised lease payments are allocated \nbased on the standalone price of the \nlease and non -lease components at \nlease commencement. \nComponentization Component depreciation is permitted \nbut not common. A lessee applies the depreciation \nrequirements in IAS 16, Property, Plant \nand Equipment, in depreciating ROU \nassets, which requires that each item of \nproperty, plant and equipment with a \ncost that is significant in relation to th e \ntotal cost of the item be separately \ndepreciated ( i.e., a component \napproach). \nCapitalization of lease costs \nduring the construction of a \nlessee asset ASC 842-10-55-21 prohibits an entity \nfrom capitalizing lease costs during the \nconstruction of a lessee asset, unless \nan entity is able to capitalize those \ncosts under ASC 970 on real estate \nprojects for sale or rental. IFRS 16 does not provide similar \nguidance on the capitalization of lease \ncosts during the construction of a \nlessee asset. \nAmortization o f leasehold \nimprovements associated \nwith a lease between entities \nunder common control A lessee is required to amortize \nleasehold improvements associated with \ncommon control leases over their useful \nlife to the common control group, as \nlong as the lessee c ontrols the use of the \nunderlying asset through a lease. Refer \nto section 4.7.3.4, Lessee a mortization \nof leasehold improvements associated \nwith a lease between entities under \ncommon control . IFRS 16 does not provide similar \nguidance on a mortization of leasehold \nimprovements associated with a lease \nbetween entities under common \ncontrol . \nLessor accounting \nPractical expedient to not \nseparate lease and non -lease \ncomponents A lessor can elect, by class of underlying \nasset, not to separate lease and related \nnon-lease components if certain \ncriteria are met. Additionally, i f the \nnon-lease component is the \npredominant component of the \ncombined component , the combined \ncomponent is accounted for in \naccordance with ASC 606. Refer to \nsection 1.4.2.4, Practical expedient to \nnot separate lease and non -lease \ncomponents — lessors . IFRS 16 does not include a similar \npractical expedient for lessors. \nRecognition of selling profit \nfor direct financing leases23 Selling profit on direct financing leases \nis deferred at lease commencement \nand amortized into income over the \nlease term. Refer to section 5.1.3, \nSelling profit or selling loss . IFRS 16 does not distinguish between \nsales -type and dire ct financing leases. \nSelling profit on finance leases is \nrecognized at lease commencement. \n \n23 ASC 842 BC 427. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 521}), Document(page\_content='D Summary of key differences from IFRS (updated August 2023) \nFinancial reporting developments Lease accounting | D-5 US GAAP IFRS \nCollectibility — sales -type \nleases and operating leases Collectibility of the lease payments is \nassessed for purposes of initial \nrecognition and measurement of sales -\ntype leases. It is also evaluated to \ndetermine the income recognition \npattern of operating leases. Refer to \nsection 5.1.4, Collectibility . IFRS 16 does not incl ude explicit \nguidance for considering collectibility of \nlease payments. \nModification of a sales -type \nor direct financing lease24 \n(under US GAAP ) or a \nfinance lease (under IFRS) \nthat does not result in a \nseparate contract If the modification of a sales -type or \ndirect financing lease is not accounted \nfor as a separate contract, the entity \nreassesses the classification of the \nlease as of the effective date of the \nmodification based on the modified \nterms and conditions, and the facts and \ncircumstances as of that date. ASC 842 \nthen specifies how to account for the \nmodified lease based on the classification \nof the modified lease. Refer to section \n5.6, Lease modifications . If the modifi cation of a finance lease is \nnot accounted for as a separate \ncontract, the accounting for the \nmodification depends on whether the \nfinance lease would have been \nclassified as an operating lease had the \nmodification been in effect at lease \ninception. IFRS 16 then specifies how to \naccount for the modified lease based on \nthat classification. \nAllocating variable \nconsideration not dependent \non an index or rate between \nlease and non -lease \ncomponents of a contract If the terms of a variable payment that is \nnot dependent on an index or rate \nrelate, even partially, to the lease \ncomponent, the lessor will recognize \nthose payments (allocated to the lease \ncomponent) as income in profit or loss in \nthe period when the changes in facts \nand circumstances on which the var iable \npayment is based occur ( e.g., when the \nlessee’s sales on which the amount of \nthe variable payment depends occur). \nWhen the changes in facts and \ncircumstances on which the variable \npayment is based occur, the lessor will \nallocate those payments to the lease \nand non -lease components of the \ncontract. The allocation is on the same \nbasis as the initial allocation of the \nconsideration in the contract or the \nmost recent modification not accounted \nfor as a separate contract unless the \nvariable payment meets t he criteria in \nASC 606-10-32-40 to be allocated only \nto the lease component(s). IFRS 16 does not include similar \nguidance for variable consideration \nrelat ed to the lease component. \nLessors would allocate the \nconsideration in the contract based on \nthe guid ance in IFRS 15 .73 through 90, \nwhich is to allocate the transaction \nprice to each performance obligation \n(or distinct good or service) in an \namount that depicts the amount of \nconsideration to which the entity \nexpects to be entitled in exchange for \ntransfer ring the promised goods or \nservices to the customer . \nSale of lease receivables \nwhen the lessor retains an \ninterest in the unguaranteed \nresidual asset If a lessor sells substantially all of the \nlease receivable associated with a sales -\ntype lease or a direc t financing lease and \nretains an interest in the unguaranteed \nresidual asset, the lessor no longer \naccrete s the unguaranteed residual \nasset to its estimated value over the \nremaining lease term under ASC 842. \nInstead, the lessor reports any remaining \nunguaranteed residual asset at its carrying \namount at the date of the sale of the \nlease receivable and applies ASC 360 to \ndetermine whether the unguaranteed \nresidual asset is impaired. Refer to \nsection 5. 7.1, Sale of lease receivables . IFRS 16 do es not include similar \nguidance. The lessor’s net investment \nin the lease, which includes any \nunguaranteed residual value, is subject \nto the derecognition and impairment \nrequirements in IFRS 9. \n \n24 ASC 842 BC 429 and IFRS 16 Paragraph 80. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 522}), Document(page\_content='D Summary of key differences from IFRS (updated August 2023) \nFinancial reporting developments Lease accounting | D-6 US GAAP IFRS \nSale and leaseback transactions \nAssessing whether a transfer \nof an asset is a sale and \npurchase in a sale and \nleaseback transaction To determine whether an asset transfer \nis a sale and purchase, a seller -lessee and \na buyer -lessor consider the following: \n• Whether the transfer meets the \nsale criteria under ASC 606 \n(however, certain fair value \nrepurchase options would not \nresult in a failed sale) \n• Whether the leaseback would be \nclassified as a sales -type lease by \nthe buyer -lessor or a finance lease \nby the seller -lessee (i.e., a sale and \npurchase do es not occur when the \nleaseback is classified as a sales -\ntype lease by the buyer -lessor or \nas a finance lease by the seller -\nlessee ) \nRefer to section 7.2, Determining \nwhether the transfer of an asset is a sale. To determine whether the transfer of \nan asset is accounted for as a sale and \npurchase , a seller -lessee and a buyer -\nlessor apply the requirements in IFRS 15 \n(including those for repurchase \nagreements) to assess whether the buyer -\nlessor has obtained control of the asset . \nIFRS 16 does not contain the same \nlease classification criteria included in \nUS GAAP, which precludes sale \naccounting if the leaseback would be \nclassified as a sales -type lease by the \nbuyer -lessor or a finance lease by the \nseller -lessee. However, entities should \ncarefully consider the requi rements in \nIFRS 15 (i.e., whether the buyer -lessor \nobtains control of the asset) to \ndetermine whether the transfer of an \nasset is accounted for as a sale and \npurchase. Entities may often reach \nsimilar conclusions on whether a sale \nand purchase have occurre d under \nboth standards. \nGain or loss recognition in \nsale and leaseback \ntransactions25 The seller -lessee recognizes any gain \nor loss, adjusted for off -market terms, \nimmediately. Refer to section 7.3, \nTransactions in which the transfer of an \nasset is a sal e. The seller -lessee recognizes only the \namount of any gain or loss, adjusted for \noff-market terms, that relates to the \nrights transferred to the buyer -lessor. \nFailed sales — seller/lessee Asset transfers that do not qualify as \nsales should be accounted for as \nfinancings by the lessor and lessee. \nASC 842 provides additional guidance \non adjusting the interest rate in certain \ncircumstances ( e.g., to ensure there is \nnot a built -in loss). Refer to section 7.4, \nTransactions in which the transfer of an \nasset is not a sale . Asset transfers that do not qualify as \nsales should be accounted for as \nfinancings in accordance with IFRS 9 , \nFinancial Instruments , by the lessor and \nlessee . IFRS 16 does not pr ovide \nadditional guidance on interest rate \nadjustment s. \nOther considerations \nRelated party transactions Entities classify and account for related \nparty leases (including sale and leaseback \ntransactions) based on the legally \nenforceable terms and conditions of the \nlease. Disclosure of related party \ntransactions is required. Refer to section \n9.1, Related party leasing transactions . IFRS 16 does not address related party \nlease transactions. IAS 24 , Related \nParty Disclosures , contains guidance on \nrelated party disclosures. \nPractical expedient to use \nthe written terms and \nconditions of common \ncontrol arrangement Private companies and certain not -for-\nprofit entities can elect a practical \nexpedient to use the written terms and \nconditions of a common control \narrangement to determine whether a \nlease exists and to classify and account \nfor the lease . Refer to section 9.1.1, \nPractical expedient to use the written \nterms and conditions of common \ncontrol arrangement . IFRS does not includ e a similar p ractical \nexpedient for common control \narrangements. \n \n25 ASC 842 BC 430 and IFRS 16 BC 306. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 523}), Document(page\_content='D Summary of key differences from IFRS (updated August 2023) \nFinancial reporting developments Lease accounting | D-7 US GAAP IFRS \nRent concessions related to \nthe COVID -19 pandemic In a Q&A document, the FASB staff said \nthat entities can elect to not evaluate \nwhether a concession provided by a \nlessor due to COVID -19 is a lease \nmodification. An entity that makes this \nelection can then elect whether to apply \nthe modification guidance ( i.e., assume \nthe concession was always contemplated \nby the contract or assume the concession \nwas not contemplated by the contract). \nThe FAS B staff said both lessees and \nlessors could make these elections. Refer to \nsection G, Accounting for rent concessions \nrelated to the COVID -19 pandemic. The IASB amended IFRS 16 to provide \nrelief to lessees to elect not to assess \nwhether a COVID -19-related rent \nconcession from a lessor is a lease \nmodification when certain conditions are \nmet. A lessee that makes this election \naccounts for any change in leas e \npayments resulting from the COVID -19-\nrelated rent concession the same way it \nwould account for the change under \nIFRS 16, if the change were not a lease \nmodification. The practical expedient is \nnot available to lessors. \nEffective date and transition \nEffective date For PBEs and certain other entities , \nASC 842 was effective for annual periods \nbeginning after 15 December 2018. \nFor certain not -for-profit entities, ASC 842 \nwas effective for annual periods \nbeginning after 15 December 2019. \nFor other entities , ASC 842 was \neffective for annual periods beginning \nafter 15 December 20 21. \nRefer to section 11.1, Effective date . For all entities, IFRS 16 was effective \nfor annual reporting periods beginning \non or after 1 January 2019. \nEarly adoption Early adoption is permitted in all cases. \nRefer to section 11.1, Effective date . Early adoption is permitted for entities \nthat apply IFRS 15 at or before the date \nof the initial application of IFRS 16. \nModified retrospective \ntransition — application to \ncomparative periods ASC 842 provides an option to apply \nthe transition provisions as of the \nbeginning of the earliest comparative \nperiod presented in the financial \nstatements or as of the effective date. \nComparative periods are adjusted when \nan entity elects to apply the tra nsition \nprovisions as of the earliest comparative \nperiod presented in the financial \nstatements. Comparative periods are not \nadjusted when an entity elects to apply the \ntransition provisions as of the effective \ndate. Refer to section 11.2, Transition . Comp arative periods are not adjusted. \nModified retrospective \ntransition — specific \ntransition guidance Specific transition guidance is provided \nfor all leases depending on the lease \nclassification before and after \napplication of ASC 842. Refer to \nsection 11.2, Transition . Transition guidance primarily addresses \nlessees’ leases previously classified as \nopera ting leases under IAS 17 , Leases . \nFull retrospective transition This is prohibited under US GAAP. This is permitted under IFRS. \nLeveraged leases Leveraged lease accounting is \neliminated for leases that commence \non or after the effective date of \nASC 842. However, leveraged leases \nthat commenced before the effective \ndate are grandfathered. If an existing \nleveraged lease is modified on or after \nthe effective date, the lease would no \nlonger be accounted for as a leveraged \nlease but would instead be accounted \nfor under ASC 842. Refer to section \n11.4.5, Leases previously classified as \nleveraged leases under ASC 840. Leveraged lease accounting is not \npermitted under IFRS 16. \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 524}), Document(page\_content=' \nFinancial reporting developments Lease accounting | E-1 E Summary of important changes \nThe following highlights the topics for which substantive updates have been made in recent editions of \nthis publication. Other non -substantive or clarifying changes are not listed. \nSection 1: Scope and scope exceptions \n• Section 1A was updated to summarize recent standard setting. (Aug ust 2023) \n• Section 1.2.1.1 was updated to include a question and answer on whe ther a contract contain s a \nlease when the supplier has substitution rights that are not substantive throughout the entire period \nof use . (August 2023) \n• Section 1.4.2. 3 was updated for considerations for applying the less ee practical expedient to a \ncontract manufacturing arrangement. (August 2022) \n• Section 1.4.2.4 was updated for considerations for applying the lessor practical expedient to a \ncontract manufacturing arrang ement. (August 2022) \nSection 2: Key concepts \n• Section 2.3.6.1 was updated to include illustrative examples of market -based factors that are not in \nthe lessee’s control, and, therefore, would not by themselves trigger a reassessment. (August 2022) \n• Section 2.4.1 .2 was updated to include illustrative examples of a lessor accounting for lease \nincentives that are either paid or contingent at the lease commencement date under a sale s-type \nlease . (August 2023) \n• Section 2.4.10 was updated for ASU 2023 -01, which amended ASC 842 to state that lease \npayments do not include leasehold improvements that are transferred from the lessee to a lessor \nthat is under common control when the lessee no longer controls the use of the underlying asset . \n(August 2023) \n• Section 2.5.2 w as updated for the SEC staff’s view s on calculating significance under Regulation S -X \nfor an acquired non-PBE that uses a risk -free rate as its discount rate and on the use of the risk free \nrate for a PBE that is only a PBE because it s financial statements are included in another entity’s SEC \nfiling . (August 2022) This section was also updated to provide considerations for a non -PBE that may \nbecome a PBE in the future when deciding whether to elect the accounting policy to use the risk -free \nrate. (August 2023) \n• Section 2.9.1 was updated to include an illustrative example of lessee accounting for f ixed lease \npayments for a portion of the contract and only variable lease payments for the remaining term of \nthe lease . (Aug ust 2023) \n• Section 2.9. 2 was updated to include an illustrative example of lessor accounting for f ixed lease \npayments for a portion of the contract and only variable lease payments for the remaining term . \n(Aug ust 2023) \n• Section 2.9.3 was updated to clarify that an entity needs to consider the scope exceptions to \nderivative accounting to determine whether an embedded derivative needs to be bifurcated and \naccounted for separately from the host contract . (August 2022) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 525}), Document(page\_content='E Summary of important changes \nFinancial reporting developments Lease accounting | E-2 Sectio n 4: Lessee accounting \n• Section 4.2.5 was updated to clarify considerations for grouping long -lived assets. (August 2023) \n• Section 4.3.4 was updated to clarify additional considerations for grouping long -lived assets. \n(August 2023) \n• Section 4.6 was updated t o include examples of lease modification s. (August 2023) \n• Section 4.6.2 was updated to include a question and answer to clarify that a modification that both \ngrants an additional right of use and makes other changes to existing right s of use should not be \naccounted for as a separate contract . (August 2023) \n• Section 4.6.3 was updated to include an illustrative example of a lessee ’s account ing for a partial \ntermination . (August 2022) \n• Section 4.6.3.1 was updated to reflect final amendment s to the FASB’s guidance on contract \nmodifications due to reference rate reform . (August 2023) \n• Section 4.6.5.2 was updated to include an illustrative example of a lessee’s accounting when a \nmodification decreases the lease term resulting in a change in lea se classification. (August 2023) \n• Section 4.7.3.4 was added for ASU 2023 -01, which provide s guidance on l essee amortization of \nleasehold improvements associated with a lease between entities under common control. (August 2023) \n• Section 4.8.1 was updated to address situations in which the parties agree that a lease will be \nterminated before the expiration of the lease term but the termination will be effective at a future \ndate . (August 2022) \n• Section 4.8.1 3 was added to address lessee accounting for contract manufacturing arrangements . \n(August 2022) \n• Section 4. 9 was updated to include an illustrative example of presentation in the statement of cash \nflows for a n operating lease and a finance lease . (August 2022) \n• Section 4.10 was updated for ASU 2023 -01, which requires disclosures for leasehold improvements \nassociated with a lease between entities under common control. (August 2023) \nSection 5: Lessor accounting \n• Section 5.1.2 was updated to clarify that after the adoption of ASU 2021 -05, if a lease modif ication \nresults in variable lease payments that were previously fixed or results in a selling loss , a lessor need s \nto assess whether the modified lease should be classified as an operating lease . (August 2 023) \n• Section 5. 2.3 was updated to address guidance provided by the FASB staff during a Credit Losses \nTransition Resource Group meeting that expected cash flows from the disposal of underlying asset s \nshould be included in the estimate of expected credit losses on net investments in leas es in the scope of \nASC 326-20. (August 2022) \n• Section 5.2. 5 was updated to include an illustrative example of lessor’s accounting for a sales -type lease \nwhen collectability is not probable. (August 2023) \n• Section 5.6 was updated to include examples of lease modification s. (August 2023) \n• Section 5.6.3.4 was updated to reflect final amendments to the FASB’s guidance on contract \nmodifications due to reference rate reform . (August 2023) \n• Section 5.7.3 was updated to address situations in which the parties agree that a lease will be \nterminated before the expiration of the lease term but the termination will be effective at a future \ndate . (August 2022) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 526}), Document(page\_content='E Summary of important changes \nFinancial reporting developments Lease accounting | E-3 Section 7: Sale and leaseback transactions \n• Section 7.1 was updated to include a table summariz ing the accounting for sale and leaseback \ntransactions for the seller -lessee and the buyer -lessor. (Aug ust 2022) \n• Section 7.2 was updated to include questions and an swers on the unit of account for evaluati ng \nwhether the transfer of an asset is a sale when there are multiple components . (Aug ust 2022) \n• Section 7.7.4 was updated to include a question and answer on accounting for land when a lessee \ncontrol s a building being constructed but does not have an exist ing contractual lease to use the land \non which the building is being constructed. (August 2023) \nSection 9: Other considerations \n• Section 9.1.1 was added for ASU 2023 -01, which allows private companies and certain not -for-profit \nentities to elect a practica l expedient to use the written terms and conditions of a common control \narrangement to determine whether a lease exists and to classify and account for the lease . \n(August 2023) \nSection 11: Effective date and transition \n• Section 11.1 .2 was updated to remove considerations for when an entity may adopt ASC 842 before \nit adopts ASC 606. (August 2022) \n• Section 11.2 was updated to include the effective date of ASU 202 3-01, which allows private \ncompanies and certain not-for-profit entities to elect a practical expedient to use the written terms \nand conditions of a common control arrangement to determine whether a lease exists and to classify \nand account for the lease. ASU 2023 -01 also requires all lessees, including public business entities, \nto amor tize leasehold improvements associated with common control leases over their useful life to \nthe common control group, as long as the lessee controls the use of the underlying asset through a \nlease. (August 2023) \n• Section 11.2.1 was updated to add a question and answer on the effective date of ASC 842 for a non -\nEGC iss uing an IPO registration statement . (August 2023) \n• Section 11.6.1 was updated to include a question and answer on presenting comparative interim \ninformation for nonpublic entities and EG Cs. (Aug ust 2022) \nAppendix D: Summary of key differences from IFRS \n• Appendix D was updated for additional differences between ASC 842 and IFRS 16 . (August 202 3) \nAppendix H: Glossary \n• Appendix H was added to provide a list of terms defined in the ASC Master Glossary that are used in \nthis pu blication . (August 2022) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 527}), Document(page\_content=' \nFinancial reporting developments Lease accounting | F-1 F Variable payments — lessor \nThis illustration assumes the contract has separate lease and non -lease components and that the lessor \n(1) does not make an accounting policy election (by class of underlying asset) to use the optional practical \nexpedient to not separate lease and associated non -lease components or (2) makes the accounting policy \nelection but has at least one non -lease component that does not qualify for the expedient. Refer to \nsection 1.4.2.4, Practical expedient to not separate lease and non -lease components — lessors . \n \n1 Apply the guidance in ASC 842-10-15-38 through 15-42A to allocate consideration in the contract generally on a relative standalone selling price basis. \nRefer to section 1.4.4, Determining, allocating and reassessing the consideration in the contract — lessors , and 1.4.4.2, Allocating the consideration \nin the contract — lessors . \n2 Refer to section 1.4.2, Identifying and separating lease from non -lease components of a contract. \nDoes the arrangement include variable \nlease payments (excluding payments that, \nin form, appear to contain variability, \nbut are, in effect, unavoidable)? \nThe payments are fixed (or in -\nsubstance fixed) payments and \nare included as consideration in \nthe contract.1, 4 \nDo the variable payments relate to an \nitem or activity that transfers a good or \nservice (including a right to use an asset) \nto the lessee?2 \nYes \nNo \nThe item or activity is a non-\ncomponent and the variable \npayments are excluded from \nconsideration in the contract.3 \nNo \nYes \nDo the variable payments depend \non an index or a rate?5 \nNo \n Yes \nYes \nThe payments are variable lease \npayments that depend on an index \nor rate and are included \nas consideration in the contract \nusing the prevailing index or rate \nat the measurement date.1 \nB \nWould the variable payme nt amounts both \n(1) be included in the transaction price in \naccordance with ASC 606 and (2) relate \nspecifically to the non -lease component(s) \n(i.e., the variable payments do not relate, \neven partially, to the lease components)?6 \nNo \nThe variable \npayment \namounts are \nnot includ ed as \nconsideration in \nthe contract.7 \nThe variable \npayment \namounts are \nincluded as \nconsideration in \nthe contract.7 \nA \n A \n B ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 528}), Document(page\_content='F Variable payments — lessor \nFinancial reporting developments Lease accounting | F-2 3 Refer to section 1.4.2.1, Executory costs . See Example 12 — Activities or Costs That Are Not Components of a Contract, Case A — Payments for \nTaxes and Insurance Are Variable . \n4 Refer to section 2.4.1.1, In-substance fixed lease payments . \n5 Refer to section 2.4.2, Variable lease payments that depend on an index or rate . \n6 Refer to section 1.4.4, Determining, allocating and reassessing the consideration in the contract — lessors . \n7 Refer to section 1.4.4.3, Allocating variable payments — lessors . \n \n1 The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance ob ligation (or distinct good \nor service) in an amount that depicts the amount of cons ideration to which the entity expects to be entitled in exchange for transferring the promised \ngoods or services to the customer. Refer to section 1.4.4.3, Allocating variable payments — lessors . \n2 Variable payment amounts allocated to non -lease component( s) are recognized in accordance with other guidance ( e.g., the guidance on the satisfaction \nof performance obligations in ASC 606). Refer to Example 14 , Determining the Consideration in the Contract — Variable Payments, Case C — \nAllocating Variable Payments Entirely to a Nonlease Component in ASC 842 (refer to section 1.4.5 , Examples — identifying and separating \ncomponents of a contract and determining and allocating the consideration in the contract) . \n3 Apply the guidance in ASC 842-10-15-38 through 1 5-42 to allocate consideration in the contract. Refer to section s 1.4.4, Determining, allocating \nand reassessing the consideration in the contract — lessors , and 1.4.4.2, Allocating the consideration in the contract — lessors . Variab le payment \namounts allocated to the lease component(s) are recognized as income in profit or loss in accordance with ASC 842. Variable payment amounts \nallocated to non -lease component(s) are recognized in accordance with other guidance ( e.g., the guidance on the satisfaction of performance \nobligations in ASC 606). Refer to Example 14, Determining the Consideration in the Contract — Variable Payments, Case B — Variable Payments That \nRelate Specifically to a Nonlease Component , in ASC 842 (refer to section 1.4.5, Examples — identifying and separating components of a contract and \ndetermining and allocating the consideration in the contract ). \n \nNo \n Yes \nA \nThe variable payment \namounts are allocated \nentirely to the non -lease \ncomponent(s) to which \nthe variable payment \nspecifically relates.2 \nThe variable payment \namounts are allocated \ngenerally on a relative \nstandalone selling \nprice basis.3 \nDoes the variable payment amount specifically relate to the efforts or \noutcome of its performance of the non -lease component(s) and would \nallocating the variable payment amounts entirely to that non -lease \ncomponent(s) be consistent with the transaction pri ce \nallocation objective ( ASC 606-10-32-28)?1 \nNo \n Yes \nB \nWhen the changes in \nfacts and circumstances \non which the variable \npayment is b ased \noccur, the variable \npayment amounts are \nallocated entirely to the \nlease component(s) \nto which the variable \npayment amounts \nspecifically relate.2 \nWhen the changes in \nfacts and circumstances \non which the variable \npayment is based occur, \nthe variable p ayment \namounts are allocated \ngenerally on a relative \nstandalone selling \nprice basis.3 \nDoes the variable payment amount specifically relate to \na lease component(s) and would allocating the variable \npayment amounts entirely to that lease component(s) \nmeet the criteria in ASC 606-10-32-40?1 ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 529}), Document(page\_content='F Variable payments — lessor \nFinancial reporting developments Lease accounting | F-3 1 Apply the guidance in ASC 842-10-15-40. Refer to s ection 1.4.4. 3, Allocating variable payments — lessors . If the variable payments meet the criteria \nin ASC 606-10-32-40, the entity allocates the variable amount (and subsequent changes to that amount) entirely to a performance obligation or to a \ndistinct good or service that forms part of a single performance obligation in accordance with ASC 606-10-25-14(b) i f both of the following criteria \nare met: (1) the terms of a variable payment relate specifically to the entity’s efforts to satisfy the performance obligatio n or transfer the distinct \ngood or service (or to a specific outcome from satisfying the performan ce obligation or transferring the distinct good or service) and (2) allocating \nthe variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent wit h the allocation objective \nin ASC 606-10-32-28 when considering all of the performance obligations and payment terms in the contract. Refer to section 6.3, Allocating \nvariable consideration , in our FRD, Revenue from contracts with customers ( ASC 606) . \n2 Variable payment amounts allocated to the lease component(s) are recognized as income in profit or loss in accordance with ASC 842. Refer to \nsection 5, Lessor accounting . \n3 Apply the guidance in ASC 842-10-15-38 through 1 5-42 to allocate consideration in the contract. Refer to section 1.4.4, Determining, allocating and \nreassessing the consideration in the contract — lessors , and 1.4.4.2, Allocating the consideration in the contrac t — lessors . Variable payment amounts \nallocated to the lease component(s) are recognized as income in profit or loss in accordance with ASC 842. Variable payment amounts allocated to \nnon-lease component(s) are recognized in accordance with other guidance ( e.g., the guidance on the satisfaction of performance obligations in \nASC 606). See Example 14 , Determining the Consideration in the Contract — Variable Payments, Case A — Variable Payments that Relate to the Lease \nComponent and the Nonlease Component ( refer to section 1.4.5 , Examples — identifying and separating components of a contract and determining \nand allocating the consideration in the contract). In accordance with ASC 842-10-15-40A, a lessor excludes from variable payments lessor costs paid \nby a lessee directly to a third party. In accordance with ASC 842-10-15-39A, a lessor may also make an accounting policy election to exclude from \nthe consideration in the contract and from variable payments not included in the consideration in the contract all taxes assessed by a governmental \nauthority that are both imposed on and concurrent with a specific lease revenue -producing transaction and collected by the lessor from a lessee \n(e.g., sales, us e, value added and some excise taxes). A lessor that makes this election exclude s from the consideration in the contract and from \nvariable payments not included in the consideration in the contract all taxes within the scope of the election and shall comp ly with the disclosure \nrequirements in ASC 842-30-50-14. Refer to Section 1.4.4, Determining, allocating and reassessing the consideration in the contract — lessors . \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 530}), Document(page\_content=' \nFinancial reporting developments Lease accounting | G-1 G Accounting for rent concessions \nrelated to the COVID -19 pandemic \nG.1 Overview \nSome lessors may provide or be required to provide rent concessions (e.g., deferral of lease payments, \ncash payments, reduced future lease payments) to existing lessees to help mitigate the economic fallout \nfrom the COVID -19 pandemic on the lessee’s operat ions. The FASB staff has provided accounting \nelections for entities that provide or receive rent concessions due to the COVID -19 pandemic. These \nelections are described in a question -and-answer document (Q&A) the FASB staff posted on the FASB \nwebsite. They are intended to reduce the operational challenges and complexity of accounting for leases \nat a time when many busines ses were ordered to close or have seen their revenue drop due to the effect \nof the COVID -19 pandemic. \nThe accounting interpretation the FASB staff has provided allows entities to elect to not evaluate \nwhether a concession provided by a lessor due to COVID -19 is a lease modification. An entity that makes \nthis election can then elect whether to apply the modification guidance ( i.e., assume the concession was \nalways contemplated by the contract or assume the concession was not contemplated by the contract). \nThe FASB staff said both lessees and lessors could make these elections , and these elections should be \napplied consistently to leases with similar characteristics and in similar circumstances, consistent with \nthe overall objective described in ASC 842-10-10-1. We believe an entity that is both a lessee and a \nlessor can make different elections for contracts in which it is the lessee and for contracts in which it is \nthe lessor. \nEntities may make the elections for any lessor -provided COVID -19-related concession that does not \nresult in a substantial increase in the rights of the lessor or the obligations of the lessee. The FASB staff \ncited as examples concessions that would result in the total payments of the modified lease being \nsubstantially t he same as or less than the total payments of the existing lease. \nThe FASB staff did not specify which payments should be used to evaluat e whether total payments are \n“substantially the same as or less than ” but note d that it expect s an entity to exercise reasonable \njudgment in making those decisions. We believe it would be acceptable for an entity to include in its \nevaluation all lease payments and all variable payments that do not depend on an index or a rate that are \nexpected to be made or received during the lease term . We also believe that an entity can evaluate these \npayments on either a discounted or an undiscounted basis. \nEvaluating whether and how to apply the modification guidance can be operationally challenging, particularly \nfor entities with large portfolios of contracts that have various rights and obligations. That’s because \nASC 842 requires entities to evaluate the enforceable rights and obligations of each lease and, if certain \nconditions are met, account for changes to such rights and obligations ( e.g., a reduction in lease payments) \nas a lease modification. The lease modification guidance requires both the lessee and lessor to remeasure \nand reallocate the consideration in the contract, reassess the lease term and reassess le ase classification, \nand the lessee to update the lease liability, including the discount rate, if the modification is not accounted \nfor as a separate contract. For more information on lessee and lessor accounting for lease modifications, \nrefer to section 4 .6, Lease modifications , and section 5.6, Lease modifications , respectively. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 531}), Document(page\_content='G Accounting for rent concessions related to the COVID -19 pandemic \nFinancial reporting developments Lease accounting | G-2 Making the elections would simplify the accounting for both lessees and lessors. For example, a lessee \nthat is not required by the lessor to pay one month’s rent due to the COVID -19 pandemic and makes the \nelection would not be required to evaluate the cont ract terms. If it chose not to apply the lease modification \nguidance, the lessee could account for the reduction in lease payments as if it were part of the enforceable \nrights and obligations of the existing contract ( e.g., like a negative variable lease p ayment). Refer to section \nG.6, Accounting for a concession that is not accounted for as a lease modification , for further discussion. \nA concession provided by a lessor can take many forms. For example, a lessor may defer the due dates \nfor certain lease payments, forgive certain lease obligations or provide a cash payment to the lessee. \nRelief may also be provided by a government entity. This type of relief would not affect the lease \naccounting. Refer to section G.7, Accounting for relief provided b y a government agency , for a discussion \non government grants. \nThe following flowchart depicts the decision -making process for determining how to account for a COVID -\n19-related concession provided by a lessor. \n \nQuestions have arisen about whether rent concessions prov ided by a lessor in certain situations would \npreclude an entity from qualifying for the elections described by the FASB staff. We believe that a rent \nconcession provided by a lessor in the situations described below would not, by itself, preclude an entity \nfrom qualifying for the elections. However, an entity would need to consider each situation to determine \nwhether, based on the facts and circumstances, the total payments of the modified lease are \nsubstantially the same as or less than the total payments of the existing lease. \n• Multiple concessions — If multiple concessions are granted under the same contract at different \ntimes, an entity should consider whether the effects of the concessions on total payments of the \nmodified contract should be combined or evaluated separately. We believe that an entit y should \nmake this determination using the contract combination guidance in ASC 842 (refer to section 1.5, \nContract combinations ). If that guidance requires the concessions to be combined, an entity should \nYes \nNo (concession qualifies \nfor the elect ion) \nNo \nDoes the entity intend to make the elect ion to not \nevaluate whether a COVID -19-related concession \nprovided by a lessor is a lease modification? \nYes \nNo \nDoes the concession result in a substantial increase in \nthe rights of the lessor or the obligations of the lessee \n(e.g., total payments of the modified lease are not \nsubstantially the same as or less than the total \npayments in the existing lease)? \nYes ( concession does not \nqualify for the election) \nYes \nEvaluate whether the concession qualifies \nfor the election \nDoes the entity elect to account for \nthe concession as a modification? \nNo \n No \nYes \nAccount for concession as a lease modification . \nRefer to section G.5, Accounting for a concession \nas a lease modification . \nDo not account for concession as a lease modification . \nRefer to section G.6, Accounting for a concession that is \nnot accounted for as a lease modification . \nHave any other changes to the lease that \nwere not contemplated by the contract been \nmade along with the concession? \nDo the rights and obligations of the existing lease \n(including laws governing the lease) \ncontemplate the concession ? \nEvaluate whether the concession provided is \na lease modification ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 532}), Document(page\_content='G Accounting for rent concessions related to the COVID -19 pa ndemic \nFinancial reporting developments Lease accounting | G-3 evaluate the effects of the concessions on total p ayments in the aggregate. If the guidance does not \nrequire the concessions to be combined, an entity should evaluate the effects of each concession on \ntotal payments of the modified lease . \n• Lease term extension — If a lease term is extended ( e.g., by changi ng the contractual term or adding \na renewal option that the lessee is reasonably certain to exercise) in connection with a lessor -\nprovided rent concession, we believe an entity should include all payments resulting from the lease -\nterm extension in the dete rmination of the total payments of the modified contract (including \npayments during a renewal period, if the lessee is reasonably certain to exercise the renewal option). \n• Removal or revision of a co -tenancy clause — If a co -tenancy clause in the existing lease contract is \nremoved in connection with a lessor -provided rent concession, an entity would include any payments \nthat are or were expected to be made or received in accordance with the co -tenancy clause in the \ndetermination of total payments of the exi sting contract. However, if the clause is revised, these \npayments, and any payments that are expected to be made or received in accordance with the \nrevised clause, would be included in the determination of total payments of the existing and modified \ncontra cts, respectively. Refer to section 2.4.11.1, Subsequent remeasurement of lease payments — \nlessees , for further discussion of co -tenancy clauses. \n• Contract contains both a lease and non -lease component that are not combined — If a rent \nconcession was provid ed for a contract that contains both a lease and a non -lease component, an \nentity should allocate the concession to both the lease and non -lease component s. The entity may \nthen evaluate whether the concession allocated to the lease component qualifies for the elections \nprovided by the FASB staff and should apply other guidance ( e.g., ASC 606) to account for the \nconcession allocated to the non -lease component. \n• Lease and non -lease components are combined — lessors — Lessors that elect to combine lease and \nnon-lease components (using the related practical expedient) may evaluate whether the concession \nqualifies for the elections if the predominant component is the lease component. If the non -lease \ncomponent is the predominant component, the elections do not apply because the combined \ncomponent would be accounted for under other guidance ( e.g., ASC 606). \nIf an entity concludes , after performing the evaluation s discussed above, that the total payments of the \nmodified contract are not “substantially the same as or less than” the total payments of the existing \ncontract, the rent concession would not qualify for the elections. \nG.2 Accounting for concessions without the elections \nAn entity that does not use the elections described by the FASB staff will have to carefully evaluate the \nenforceable rights and obligations of each lease to determine whether to account for a concession as a \nlease modification ( i.e., a change to the terms and conditions of a contract that results in a change in the \nscope of or the consi deration for a lease) in accordance with ASC 842. \nIf the enforceable terms of the lease contemplate the concession provided to the lessee and there are no \nother changes to the contract that were not contemplated in the existing lease, any concession provid ed \nwould not be considered a lease modification. For example, entities may determine that a concession is \ncontemplated in a contract if it includes a force majeure provision that requires the lessor to defer or \nforgive certain lease payments in the case of a pandemic, such as COVID -19. That would be the case \neven if the amount, timing or type of concession is contemplated but not stipulated in the contract and, \ntherefore, the amount, timing or type must be negotiated between the lessor and the lessee. \nAn en forceable right to a concession does not need to be explicitly stated in the lease contract for an \nenforceable right to exist. For example, the rights of parties to a lease contract, including the right to a \nconcession, can be enforceable by the laws gover ning the applicable jurisdiction of the lease contract. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 533}), Document(page\_content='G Accounting for rent concessions related to the COVID -19 pandemic \nFinancial reporting developments Lease accounting | G-4 If the enforceable terms of the existing lease do not contemplate a concession or if other changes to the \nlease that were not contemplated in the existing contract are made along with the concession t hat is \nrequired under the existing enforceable terms of the contract, ASC 842’s lease modification guidance \nwould apply. For example, if the lessee and lessor agree on the amount, timing or type of rent concession \nas required by a force majeure provision b ut separately agree to extend the lease term, the change would \nbe accounted for as a lease modification. \nThere may be diversity in practice in accounting for short -term deferrals of lease payments. While some \nentities may consider short -term deferrals to b e lease modifications, other entities may conclude that the \nlease has not been modified because there is no substantial change to the consideration in the lease due \nto the change in timing of payment. \nG.3 Short payments \nSome lessees affected by the economi c effect of the COVID -19 pandemic have chosen not to pay certain \nlease obligations as they become due even though a rent concession has not been granted by the lessor. \nThis is called a short payment. In some cases, lessees intend to make those payments at a later date. In \nother cases, they have stated they do not intend to pay those obligations ( i.e., they are seeking rent \nforgiveness from the lessor). \nIf a lessee is not contractually permitted to defer payment or withhold rent (either through the \nenforceab le rights and obligations of the existing lease or a lease modification agreed to by both the \nlessee and the lessor), both the lessee and lessor would continue to account for the lease following the \nrights and obligations of the existing lease. That is, th e lessee and lessor would not account for the short \npayment as a lease modification because none of the enforceable terms or conditions in the lease have \nchanged. In this case, a lessee is still obligated to make the rent payments and, therefore, would con tinue \nto recognize lease expense but would not reduce its liability to the lessor for any unpaid amounts. \nA lessor’s accounting for lease revenue may also be unchanged when it receives a short payment. For \nexample, for an operating lease, the lessor may continue to recognize lease revenue and adjust prepaid or \naccrued rent for the unpaid amounts. However, a lessor should evaluate whether a lessee’s short payment \naffects the evaluation of collectibility of lease payments (and any residual value guarantee) for an operating \nlease or impairment of a net investment in the lease for a sales -type lease or direct financing lease. Refer to \nsections 5.4, Operating leases ; 5.2.3, Impairment of the net investment in the lease — sales -type leases ; and \n5.3.3, Impairment of the net investment in the lease — direct financing leases, for further discussion. \nG.4 Examples of evaluating what accounting guidance to apply to rent concessions \nThe following examples illustrate how an entity evaluates what accounting guidance to ap ply to rent \nconcessions related to COVID -19. \nIllustration G-1: Accounting by a lessee and lessor for concessions that are not contemplated \nin the lease \nRetailer A makes monthly payments to Real Estate Lessor Z for a 10 -year lease of retail space in a \nshopping center. The lease, which commenced on 1 January 2018, requires Retailer A to make \nmonthly payments at the beginning of each month. The payments are based on a percentage of sales \nand are subject to a monthly minimum of $1,500 ( i.e., an in -substanc e fixed minimum payment that \nRetailer A includes in the measurement of its lease liability). There are no non -lease components in the \ncontract, and both Retailer A and Real Estate Lessor Z have classified the lease as an operating lease. \nThe contract does not include enforceable provisions that would require concessions to be provided to \nRetailer A for any event related to a pandemic, such as COVID -19. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 534}), Document(page\_content='G Accounting for rent concessions related to the COVID -19 pandemic \nFinancial reporting developments Lease accounting | G-5 During the COVID -19 pandemic, the curtailment of social and commercial activity results in a drop in \nRetai ler A’s sales. Real Estate Lessor Z notifies Retailer A that, as a result of the effect of COVID -19 on \nretail operations, its rental payments for April through December 2020 are now due on 1 January \n2021. That is, while Retailer A is still obligated to mak e rental payments that would have been due \nApril through December 2020, those payments are now due on 1 January 2021. No other changes \nare made to the rights and obligations of the contract. \nAnalysis \nLessee and lessor do not elect to not evaluate whether a concession is a modification . \nRetailer A and Real Estate Lessor Z review the rights and obligations of the existing lease and \ndetermine that the contract does not include enforceable provisions that would require concessions to \nbe provided to Ret ailer A for any event related to a pandemic , such as COVID -19. Therefore, both \nparties conclude that the lessor’s deferral of rental payments is a lease modification because it was not \ncontemplated by the rights and obligations of the existing lease. \nRefer to section G.5, Accounting for a concession as a lease modification , for illustrations of how to \napply the accounting in this fact pattern. \nLessee and lessor elect to not evaluate whether a concession is a modification . \nRetailer A and Real Estate Lessor Z elect to not evaluate whether a concession is a modification . They \nwould elect to account for the concession either as a lease modification or not as a lease modification. \nIf they elect to account for the concession as a lease modification, refer to secti on G.5, Accounting for a \nconcession as a lease modification . If they elect to not account for the concession as a lease modification, \nrefer to section G.6, Accounting for a concession that is not accounted for as a lease modification . \nRetailer A and Real Estate Lessor Z could make this election because the concessions are related to \nthe effects of the COVID -19 pandemic and total payments of the modified lease are substantially the \nsame as the total payments of the existing lease. \n \nIllustration G-2: Accounting by a lessee and a lessor for concessions that are contemplated in \nthe lease \nRestaurant B leases restaurant space from Lessor Y, and the lease commences on \n1 January 2020. Both Restaurant B and Lessor Y classify the lease a s an operating lease. \nOn 31 March 2020, Restaurant B closes its dining area to patrons temporarily as a result of the \nCOVID -19 pandemic. The lease contract contains a force majeure clause t hat requires the lessor to \nforgive the lessee ’s lease obligations for the period that Restaurant B’s use of the restaurant space is \nlimited due to events related to a pandemic, such as COVID -19. Assume that the COVID -19 pandemic \nqualifies as a force majeure in accordance with the enforceable terms and conditions of this lease . No \nother changes are made to the rights and obligations of the contract. \nAnalysis \nLessee and lessor do not elect to not evaluate whether a concession is a m odification . \nRestaurant B and Lessor Y review the rights and obligations of the existing lease and determine that \nthe lease contract contains a force majeure clause that requires the lessor to forgive the lessee’s lease \nobligations for the period that Rest aurant B’s use of the restaurant space is limited due to events \nrelated to a pandemic, such as COVID -19. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 535}), Document(page\_content='G Accounting for rent concessions related to the COVID -19 pandemic \nFinancial reporting developments Leas e accounting | G-6 Restaurant B and Lessor Y conclude that the limits on the use of the dining area due to the COVID -19 \npandemic result in the lessee qualifying for concessions. Therefore, Restaurant B and Lessor Y conclude \nthat the concessions provided to the lessee are contemplated by the existing lease ( i.e., through the \nforce majeure clause) and do not account for the rent forgiveness as a lease modification. \nRefer to section G.6, Accounting for a concession that is not accounted for as a lease modification , for \nillustrations of how to apply the accounting in this fact pattern. \nLessee and lessor elect to not evaluate whether a concession is a modification . \nRestaurant B and Lessor Y elect to not evaluate whether a con cession is a modification . They would \nelect to account for the concession either as a lease modification or not as a lease modification. If they \nelect to account for the concession as a lease modification, refer to section G.5, Accounting for a \nconcession as a lease modification . If they elect to not account for the concession as a lease modification, \nrefer to section G.6, Accounting for a concession that is not accounted for as a lease modification . \nRestaurant B and Lessor Y could make this election becaus e the concessions are related to the COVID -\n19 pandemic and total payments of the modified lease are less than the total payments of the existing \nlease. \n \nIllustration G-3: Accounting by a lessee and lessor for consideration received that is not \ncontemplated in the lease \nRetailer C leases space from Lessor X and makes monthly fixed payments, due on the first of the \nmonth, for its use of the space. Retailer C temporarily closes its store as a result of the COVID -19 \npandemic. There are no explicit enforceable terms or conditions in the contract that require Lessor X \nto provide concessions to Retailer C in the event of circumstances such as COVID -19. However, the \ncontract is subject to local laws. \nThe local jurisdiction provides government a ssistance to Lessor X to compensate for the effects of \nCOVID -19 on local operations. The local government authority does not require the consideration to be \nshared with lessees. However, Lessor X chooses to provide a cash payment to Retailer C to compensat e \nit for the effects of COVID -19. No other changes are made to the rights and obligations of the contract. \nAnalysis \nLessee and lessor do not elect to not evaluate whether a concession is a modification . \nLessor X review s the rights and obligations of the ex isting lease and concludes that the cash paid to \nRetailer C was not contemplated by the rights and obligations of the existing lease. The contract is \nsubject to local law, which does not require it to share the consideration it receives with l essees. \nThere fore, Lessor X accounts for the cash payment to the lessee as a lease modification. Refer to \nsection G.5, Accounting for a concession as a lease modification , for further discussion. \nIn addition, Lessor X evaluates whether to account for consideration received as a government grant . \nRefer to section G.7, Accounting for relief provided by a government agency , for further discussion. \nRetailer C review s the rights and obligations of the e xisting lease and concludes that the cash payment \nit receives from the lessor (which was passed along from government assistance provided to the \nlessor) was not contemplated by the rights and obligations of the existing lease. The contract is subject \nto lo cal law, which does not require any consideration provided to Lessor X to be shared with lessees. \nTherefore, Retailer C accounts for the cash payment received as a lease modification. Refer to section G.5, \nAccounting for a concession as a lease modificatio n, for further discussion. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 536}), Document(page\_content='G Accounting for rent concessions related to the COVID -19 pandemic \nFinancial reporting developments Lease accounting | G-7 Lessee and lessor elect to not evaluate whether a concession is a modification . \nRetailer C and Lessor X elect to not evaluate whether a concession is a modification . They would elect \nto account for the concession either as a leas e modification or not as a lease modification. If they elect \nto account for the concession as a lease modification, refer to section G.5, Accounting for a concession \nas a lease modification . If they elect to not account for the concession as a lease modification, refer to \nsection G.6, Accounting for a concession that is not accounted for as a lease modification . \nRetailer C and Lessor X could make this election because it is related to the CO VID-19 pandemic and \ntotal payments of the modified lease (including the payment the lessor makes to the lessee) are less \nthan th e total payment s of the existing lease. \nIn addition, Lessor X evaluates whether to account for consideration received as a gover nment grant . \nRefer to section G.7, Accounting for relief provided by a government agency , for further discussion. \nG.5 Accounting for a concession as a lease modification \nThe lessee or lessor may conclude a rent concession is a modification because of any of the following: \n• The entity does not elect to not evaluate whether a concession is a modification and determines that \nthe enforceable rights and obligations of the contract (and related governing law) do not \ncontemplate t he concession provided by the lessor. \n• The rent concession does not qualify for the election to not evaluate whether a concession is a \nmodification (e.g., because the total payments of the modified lease are not substantially the same \nas or less than the to tal payments of the existing lease, additional modifications unrelated to COVID -19 \nare included in the changes to the contract) and the enforceable rights and obligations of the contract \n(and related governing law) do not contemplate the concession provide d by the lessor. \n• The entity elects to not evaluate whether a concession is a modification (the rent concession \nqualifies) , and the entity chooses to adopt a policy to account for the lease as a lease modification. \nIf a lease is modified, the modified contr act is evaluated to determine whether it still is or still contains a \nlease. If a lease continues to exist, a lease modification can result in either a separate contract or a change \nin the accounting for the existing lease ( i.e., not a separate contract). \nIn most cases, concessions provided to a lessee will change the accounting for the existing lease and not \nresult in a separate contract. That’s because ASC 842 requires a modification to be accounted for as a \nseparate contract only when the less ee receives an additional right of use and agrees to provide \nadditional lease payments commensurate with the standalone price of that additional right of use. \nIf the modification does not result in a separate contract, the entity does the following as of t he effective \ndate of the modification: \n• Remeasures and reallocates the remaining consideration in the contract (reallocation is performed \nwhen there are multiple lease and non -lease components) \n• Reassesses the lease term \n• Reassesses the classification of t he lease at the effective date of the modification, using the modified \nrights and obligations and the facts and circumstances as of that date, including: \n• The remaining economic life of the underlying asset on that date \n• The fair value of the underlying as set on that date ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 537}), Document(page\_content='G Accounting for rent concessions related to the COVID -19 pandemic \nFinancial reporting developments Lease accounting | G-8 • The discount rate for the lease on that date \n• The remeasured and reallocated remaining consideration in the contract on that date \n• The remeasured lease term and assessment of any lessee options to purchase the underlying \nasset as of that date \n• Accounts for any initial direct costs, lease incentives and other payments made to or by the lessor \nG.5.1 Lessee accounting \nA lessee will gene rally recognize the amount of the remeasurement of the lease liability as an adjustment \nto the corresponding ROU asset without affecting profit or loss, unless the modification fully or partially \nterminates an existing lease ( e.g., reduces the square foota ge of leased space). If the modification does \nnot fully or partially terminate an existing lease but the corresponding adjustment to the ROU asset \nreduces the ROU asset to zero, the lessee would recognize any remaining amount of the adjustment in \nprofit or loss. If the modification fully or partially terminates an existing lease, the lessee decreases the \ncarrying amount of the ROU asset in proportion to the full or partial termination of the lease and \nrecognizes in profit or loss any difference between the adjustment to the lease liability and the \ncorresponding adjustment to the ROU asset. \nLessees will remeasure the lease liability using a discount rate ( i.e., their incremental borrowing rate \nwhen the rate implicit in the lease is not readily determinable) d etermined at the effective date of the \nmodification. For lessees using the incremental borrowing rate, determining a revised rate at the \neffective date of the modification may be challenging due to the number of contracts that may be \nmodified. In addition, determining the incremental borrowing rate will require judgment considering \nrecent overall market volatility, the decline in interest rates set by central banks and changes to an \nentity’s credit risk as a result of the COVID -19 pandemic. \nRefer to section 4.6.3, Lessee accounting for a modification that is not accounted for as a separate \ncontract , for further discussion . \nThe following example illustrate s both a deferral of payments and rent forgiveness accounted for as a \nlease modification. \nIllustration G-4: Lessee accounting for a lease modification \nAssume the same facts as in Illustration G-1. This illustration assumes Retailer A made the election to \nnot evaluate whether a concession is a modification and adopt ed a policy to account for the \nconcession as a lease modification , but the accounting illustrated would be the same if the election \nwas not made (or the concession did not qualify) and the concession is not contemplated by the lease . \nRetailer A concludes that the modified operating lease continues to contain a lease and does not result \nin a separate contract. Further, the lease includes a renewal option that Retailer A concluded that it \nwas not reasonably certain to exercise at lease c ommencement. Retailer A also concludes that its ROU \nasset has not been impaired before or during any of the periods illustrated. \nAnalysis \nRetailer A does all the following as of the effective date of the modification: \n• Remeasure s the remaining consideration in the contract (but does not have to reallocate it \nbecause there is only one lease component in this illustration) \n• Reassesses the lease term ( e.g., reassesses whether it is reasonably certain to exercise the \nrenewal option in the contract that it previou sly excluded from the lease term) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 538}), Document(page\_content='G Accounting for rent concessions related to the COVID -19 pandemic \nFinancial reporting developments Lease accounti ng | G-9 • Reassess es the classification of the lease at the effective date of the modification, using the \nmodified rights and obligations and the facts and circumstances as of that date, including: \n• The remaining economic life of the underlying asset on that date \n• The fair value of the underlying asset on that date \n• The discount rate for the lease on that date (i.e., its incremental borrowing rate) \n• The remeasured lease term and assessment of any lessee options to purchase the underlying \nasset as of that date \n• The remeasured remaining consideration in the contract on that date \n• Account s for any initial direct costs, lease incentives and other payments made to or by the lessor \nAs part of its evaluation, Retailer A concludes that there are no changes to its assessment about \nwhether it will exercise renewal, termination or purchase options ( i.e., the lease term does not \nchange), and the modification does not fully or partially terminate the existing lease. \nRetailer A concludes that total consideration in the contract remains the same because the total lease \npayments have not changed (only the timing of payments has changed). The lease continues to \ncontain only a single lease component, and there are no lease incentives or other payments ma de to \nor by the lessor ( i.e., the modification does not add a non -lease component and only changes the \ntiming of payments ). Retailer A also concludes that its ROU asset has not been impaired. \nIn this case, lease expense recognized each period will not chan ge because the lease remains an \noperating lease that has not been impaired, the lease continues to contain only a single lease \ncomponent and there is no change to the lease term or the total consideration in the contract. \nTo account for the modification, R etailer A will remeasure its lease liability (using the revised payment \nschedule and an updated incremental borrowing rate) with a corresponding adjustment to the ROU \nasset , without affecting profit or loss . \nIf we changed the facts in Illustration G-1 such that the lease had been modified to reduce (i.e., forgive) \ncertain of Retailer A’s payments instead of deferring them, total consideration in the contract would \nchange. In this case, Retailer A would remeasure its lease liability, based on the revised lea se \npayments and updated discount rate, with a corresponding adjustment to the ROU asset. Retailer A \nwould recognize the total revised consideration over the remaining lease term ( i.e., straight -line lease \nexpense recognized each period would be less than t he lease expense recognized before the \nmodification). \nG.5.2 Lessor accounting \nA lessor’s accounting depends on the classification of the lease before and after the modification. \nAssuming the lessor concludes that the lease modification does not change classification, it accounts for \nthe modification as follows: \n• A lessor that concludes that an operating lease continues to be classified as an operating lease \naccou nts for the modifie d lease like it is a new lease. In this case, the lessor recognizes the lease \npayments to be made under the modified lease, adjusted for any prepaid or accrued rent from the \nexisting lease, generally on a straight -line basis over the remaining lease term. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 539}), Document(page\_content='G Accounting for rent concessions related to the COVID -19 pandemic \nFinancial reporting developments Lease accounting | G-10 • A lessor that concludes that a direct financing lease continues to be classified as a direct financing lease \nor that a sales -type lease continues to be classified as a sales -type lease adjusts the discount rate in the \nmeasurement of the modified lease so t hat the initial net investment in the modified lease equals the \ncarrying amount of the net investment in the existing lease immediately before the effective date of the \nmodification, plus any capitalized initial direct costs incurred in connection with the modification. \nRefer to section 5.6.3, Lessor accounting for a modification that is not accounted for as a separate \ncontract , for further discussion of lessor accounting for modifications. \nIf the lease does not change classification, the lessor does not im mediately recognize any gain or loss, \nunless the payments (and any residual value guarantee) of an operating lease are no longer probable of \ncollection or there is an impairment of a net investment in the lease for a sales -type or direct financing \nlease, i n which case a loss is recognized. Lessors should consider whether it is probable that they will \ncollect operating lease payments and whether there are indicators of impairment for a net investment in \na lease when a COVID -19-related concession is provided. Refer to sections 5.4, Operating leases ; 5.2.3, \nImpairment of the net investment in the lease — sales -type leases ; and 5.3.3, Impairment of the net \ninvestment in the lease — direct financing leases , for further discussion on impairment. \nThe following exa mple illustrates a lessor’s accounting for both a deferral of payments and rent \nforgiveness accounted for as a lease modification. \nIllustration G-5: Lessor accounting for a lease modification of an operating lease that \ncontinues to be classified as an ope rating lease \nAssume the same facts as in I llustration s G-1 and G-4. This illustration assumes the lessor made the \nelection to not evaluate whether a concession is a modification and adopt ed a policy to account for the \nconcession as a lease modification , but the accounting illustrated would be the same if the election \nwere not made (or the concession did not qualify) and the concession is not contemplated by the lease. \nReal Estate Lessor Z concludes that the modified operating lea se continues to contain a lease \nclassified as an operating lease and does not result in a separate contract ( i.e., it is accounted for as a \nmodification of the existing lease contract). In addition, assume that Real Estate Lessor Z concludes \nthat lease pay ments for the operating lease have been and remain collectible for all the periods illustrated. \nAnalysis \nReal Estate Lessor Z does all the following as of the effective date of the modification: \n• Remeasures the remaining consideration in the contract (but d oes not reallocate it because there \nis only one lease component in this illustration) \n• Reassesses the lease term ( e.g., reassesses whether Retailer A is reasonably certain to exercise \nthe renewal option in the contract that it previously excluded from the l ease term) \n• Reassesses the classification of the lease at the effective date of the modification, using the \nmodified rights and obligations and the facts and circumstances as of that date, including : \n• The remaining economic life of the underlying asset on that date \n• The fair value of the underlying asset on that date \n• The discount rate for the lease on that date ( i.e., the rate implicit in the lease ) \n• The remeasured lease term and assessment of any lessee options to purchase the underlying \nasset as of that dat e \n• The remeasured remaining consideration in the contract on that date \n• Accounts for any initial direct costs, lease incentives and other payments made to or by the lessor ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 540}), Document(page\_content='G Accounting for rent concessions related to the COVID -19 pandemic \nFinancial reporting developments Lease accounting | G-11 As part of its evaluation, Real Estate Lessor Z concludes that there are no changes to whether Retailer \nA will exercise renewal, termination or purchase options ( i.e., the lease term does not change). \nReal Estate Lessor Z also concludes that total consideration in the contract remains the same because \nthe total lease payments have not changed (only the timing of payments has changed). The lease \ncontinues to only contain a single lease component , and there are no lease incentives or other \npayme nts made to or by the lessor ( i.e., the modification does not add a non -lease component and \nonly changes the timing of payments). In addition, Real Estate Lessor Z concludes that lease payments \nfor the operating lease remain collectible . \nBecause the modifi ed lease is still an operating lease that only contains a single lease component and total \nconsideration in the contract, adjusted for any prepaid or accrued rent from the pre -existing lease, remains \nthe same, lease income recognized in each period will no t change. However, Real Estate Lessor Z may \nrecognize a monthly adjustment to prepaid or accrued rent to reflect the accrued but not yet paid lease \npayments ( i.e., similar to the accounting for rent holidays provided to lessees at lease commencement). \nIn contrast, if we changed the facts and the lease was modified to reduce Retailer A’s payments \n(i.e., forgive certain payments) , total consideration in the contract would change. In this case, Real \nEstate Lessor Z would recognize the remaining consideration for the modified lease, adjusted for any \nprepaid or accrued rent from the pre-existing lease , over the remaining modified lease term ( i.e., lease \nincome recognized each period would be less than lease income recognized before the modification ). \nIn both case s, Real Estate Lessor Z evaluates whether the change in facts and circumstances affects its \nevaluation of the collectibility of lease payments for its operating lease. Refer to section 5.4, \nOperating leases , for further discussion. \nG.6 Accounting for a concession that is not accounted for as a lease modification \nThe lessee or lessor may conclude that a rent concession is not a modification for any of the following \nreasons: \n• The entity elects to not evaluate whether a concession is a modi fication (the rent concession qualifies), \nand the entity chooses to adopt a policy to not account for the concession as a lease modification. \n• The entity does not make the election and determines that the enforceable rights and obligations of \nthe contract ( and related governing law) contemplate the concession provided by the lessor. \n• The rent concession does not qualify for the election (e.g., because the total payments of the \nmodified lease exceed the total payment s of the existing lease), but the entity det ermines that the \nenforceable rights and obligations of the contract (and related governing law) contemplate the \nconcession provided by the lessor. \nG.6.1 Lessee accounting \nWe believe there are several approaches for accounting for a rent concession that is not accounted for as \na lease modification, including: \n• Accounting for a concession in the form of a deferral of payments as if the lease is unchanged \n(Approach 1) \n• Accounting for a concession like a resolution of a contingency that fixes previously variable lease \npayments (Approach 2) \n• Accounting for a concession like a negative variable lease payment (Approach 3) ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 541}), Document(page\_content='G Accounting for rent concessions related to the COVID -19 pandemic \nFinancial reporting developments Lease accounting | G-12 Accounting for a concession in the form of a deferral of payments as if the lease is unchanged \nWhen a lessor permits a lessee to defer a rental paym ent, we believe the lessee may account for the \nconcession by continuing to account for the lease liability and ROU asset using the rights and obligations \nof the existing lease and recognizing a short -term lease payable (that does not accrue interest) in th e \nperiod that the cash payment is owed. In this case, the lessee would relieve the short -term lease payable \nwhen it makes the rental payment at the revised payment date. \nAs shown in Illustration G-6 below, t his approach of recording a short -term lease paya ble for the future \npayment would allow the lease liability to be accreted using the original incremental borrowing rate and \nwould result in a lease liability balance of zero at the end of the lease term ( i.e., the lessee would not \nneed to revisit the accre tion of its lease liability based on the revised timing of payments). In many cases, \nthis will allow a lessee to use its existing systems to account for the lease liability using the existing \npayment schedule and discount rate. \nAccounting for a concession like a resolution of a contingency that fixes previously variable lease payments \nWe believe that a lessee may account for a rent concession in the same manner as it would account for a \nresolution of a contingency that fixes previously variable lease payments. In this case, the lessee would \nremeasure the remaining consideration in the contract and, if the contract contains multiple lease and \nnon-lease components, reallocate the consideration to the lease and non -lease components. The lessee \nwould not r eassess lease classification and would not update the discount rate used to measure the lease \nliability. Therefore, the lessee would remeasure its lease liability, with a corresponding adjustment to the \nROU asset, using the remeasured consideration ( e.g., reflecting the rent reduction or rent deferral \nprovided by the lessor). \nAccounting for a concession like a negative variable lease payment \nWhen a lessor grants a concession that contractually releases a lessee from certain lease payments or \ndefers lease payments, we believe a lessee may account for the concession as a negative variable lease \npayment in a manner similar to how a lessor recognizes variable lease income. That is, the lessee should \nrecognize negative variable lease expense in the period when the rent concession ( e.g., reduced \npayments) becomes accruable ( i.e., when changes in facts and circumstances on which the variable lease \npayments are based occur). \nThe following example illustrates how a lessee may account for rent forgiveness and r ent deferrals for an \noperating lease following Approaches 1 and 3 described above ( i.e., assuming the lessee does not \naccount for the concession as a lease modification or in the same manner as a resolution of a \ncontingency that fixes previously variable l ease payments (as described in Approach 2 above)). \nIllustration G-6: Lessee accounting for lease payments that are forgiven or deferred on an \noperating lease \nAssume the same facts as in Illustration G-2. That is, Restaurant B leases restaurant space from \nLessor Y, and the lease commences on 1 January 2020. Both Restaurant B and Lessor Y conclude \nthat the lease is an operating lease. This illustration assumes Restaurant B made the election to not \nevaluate whether a concession is a modification and adopt ed a policy to not account for the \nconcession as a lease modification , but the accounting illustrated would be the same if the election \nwere not made (or the concession did not qualify) and the concession is contemplated by the lease . \nAlso assume that, under the terms of the existing lease, Restaurant B agreed to make the following \npayments at the beginning of each month: $10,000 per month in 2020, $12,000 per month in 2021 and \n$14,000 per month in 2022. For simplicity, there are no purchase options, initial d irect costs, payments \nto the lessor before the lease commencement date, variable payments based on an index or rate , or lease \nincentives from the lessor. Restaurant B’s incremental borrowing rate at 1 January 2020 is 4.235%. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 542}), Document(page\_content='G Accoun ting for rent concessions related to the COVID -19 pandemic \nFinancial reporting developments Lease accounting | G-13 Also assume that Restaurant B’s ROU asset is not impaired before or during the periods described in \nthe Illustration. \nAnalysis \nInitial measurement \nThe initial measurement of the lease liability on 1 January 2020 is $394,534 using a discount rate of \n4.235%. The initial measurement of the ROU asset is $404,534 ( i.e., the $394,534 lease liability, plus \nthe $10,000 monthly lease payment made on 1 January 2020). Restaurant B calculates monthly \nstraight -line lease expense of $12,000 [($10,000 per month in 2020 + $12,000 per month in 2021 + \n$14,000 per month in 2022) ÷ 3]. \nRestaurant B records the following entries in March 2020: \nLease expense $ 12,000 \n ROU asset (accrued rent) $ 2,000 \n Cash 10,000 \nTo record lease expense and adjust the ROU asset for the difference between the monthly payment \nowed and straight -line lease expense ( i.e., accrued rent). \nLease liability $ 8,668 \n ROU asset $ 8,668 \nTo adjust the lease liability to the present value of the remaining lease payments with an offset to the \nROU asset. The adjustment of $ 8,668 is calculated as the lease liability as of 29 February 2020 \n($387,288 ) less the present value of remaining lease pa yments as of 31 March 2020 ($378,620 ). \nAs of 31 March 2020, Restaurant B’s remaining lease liability and ROU asset are $ 378,620 and \n$372,620 , respectively. \nRent forgiveness \nIn April 2020, Lessor Y forgives the $10,000 April rent obligation of Restaurant B. \nWe believe one approach to accounting for the rent forgiveness is as a negative variable lease \npayment (Approach 3). \nUnder this approach, Restaurant B records the following entries in April 2020: \nLease expense $ 12,000 \n ROU asset (accrued rent) $ 2,000 \n Short -term payable (or clearing account) 10,000 \nTo record lease expense and adjust the ROU asset for the difference between the monthly payment \nowed (forgiven in this example) and straight -line lease expense ( i.e., accru ed rent). \nLease liability $ 8,699 \n ROU asset $ 8,699 \nTo adjust the lease liability to the present value of the remaining lease payments with an offset to the \nROU asset. The adjustment of $8, 699 is calculated as the lease liability as of 31 March 2020 \n($378,620 ) less the present value of remaining lease payments as of 30 April 2020 ($369,921). As a \nresult, the lease liability is reduced for the April rent concession. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 543}), Document(page\_content='G Accounting for rent concessions related to the COVID -19 pandemic \nFinancial reporting developments Lease accounting | G-14 Short -term payable (or clearing account) $ 10,000 \n Lease expense $ 10,000 \nTo recognize negative variable lease expense for the April rent payment that is forgiven. \nRestaurant B would record similar entries in May 2020 if, at that time, Lessor Y provides an additional \nrent concession. That is when the $10,000 in this case would be a ccruable, similar to how a lessor \nrecognizes variable payments not based on an index or rate ( i.e., in the period in which the changes in \nthe facts and circumstances on which the variable lease payments are based occur). \nA summary of Restaurant B’s account ing for this lease in the income statement (assuming a May rent \nconcession is provided) is as follows: \nAmounts in thousands Jan. Feb. Mar. Apr. May \nPeriodic lease expense (straight -line) $ 12 $ 12 $ 12 $ 12 $ 12 \nNegative variable lease expense ($ 10) ($ 10) \nTotal lease expense $ 12 $ 12 $ 12 $ 2 $ 2 \n \nDeferral of rental payments (lease payments are not forgiven) \nAssume all of the same facts as above except that Lessor Y defers the due date of Restaurant B’s April \nrental payment. The deferred rental payment is now due in October 2020. In this case, the affected \nlease payments are not forgiven. \nOne possible approach, described by the FASB staff in the Q&A , is to account for the April rent \ndeferral as if the lease is unchanged (Approach 1). \nThe lessee records th e same initial measurement and March 2020 entries as shown above. \nUnder this approach, Restaurant B record s the following entries in April 2020: \nLease e xpense $ 12,000 \n ROU asset (accrued rent) $ 2,000 \n Short -term lease payable 10,000 \nTo record lease expense and adjust the ROU asset for the difference between cash payments owed \n(i.e., short -term lease payable) and straight -line lease expense ( i.e., accrued rent). Note: The credit to \nshort -term lease payable would not accrue interest. \nLease liability $ 8,699 \n ROU asset $ 8,699 \nTo adjust the lease liability to the present value of the remaining lease payments with an offset to the \nROU asset. Th e adjustment of $8, 699 is calculated as the lease liability as of 31 March 2020 \n($378,620 ), less the present value of remaining lease payments as of 30 April 2020 ($ 369,921 ). As a \nresult, the lease liability is reduced for the April rent deferral . The less ee records another entry (shown \nabove ) to recognize a short -term lease payable for its future payment of April rent. \nIn October 2020 (when the April payment is due), Restaurant B will make a payment for April rent and \nrecord the following entry: \nShort -term lease payable $ 10,000 \n Cash $ 10,000 \nTo record payment of April deferred rent. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 544}), Document(page\_content='G Accounting for rent concessions related to the COVID -19 pandemic \nFinancial reporting developments Lease accounting | G-15 A summary of Restaurant B’s accounting for this lease in the income statement is as follows: \nAmounts in thousands Jan. Feb. Mar. Apr. When \npayment \nmade \nPeriodic lease expense (straight -line) $ 12 $ 12 $ 12 $ 12 $ 12 \nNegative variable lease expense $ 0 $ 0 \nTotal lease expense $ 12 $ 12 $ 12 $ 12 $ 12 \nAnother possible approach, described by the FASB staff in the Q&A , is to account for the rent deferral as \na negative variable lease payment (Approach 3). \nThe lessee records th e same initial measurement and March 2020 entries as shown above. \nUnder this appr oach, Restaurant B record s the following entries in April 2020: \nLease expense $ 12,000 \n ROU asset (accrued rent) $ 2,000 \n Short -term lease payable (or clearing account) 10,000 \nTo record lease expense and adjust the ROU asset for the difference between cash payments owed \n(i.e., short -term lease payable) and straight -line lease expense ( i.e., accrued rent). \nLease liability $ 8,699 \n ROU asset $ 8,699 \nTo adjust the lease liability to the present value of the remaining lease payments with an offset to the \nROU asset. The adjustment of $8, 699 is calculated as the lease liability as of 31 March 2020 \n($378,620 ), less the present value of remaining lease payments as of 30 April 2020 ($36 9,921). As a \nresult, the lease liability is reduced for the April rent deferral. \nShort -term payable (or clearing account) $ 10,000 \n Lease expense $ 10,000 \nTo recognize negative variable lease expense for the April rent deferral. \nIn October 2020 (when the April payment is due), Restaurant B will make a payment for April rent and \nrecord the following entry: \nLease expense $ 10,000 \n Cash $ 10,000 \nTo record payment of April deferred rent. \nThis approach of recording negative variable lease expense for a rent deferral results in a reduction of \nthe lease -related liability, even though a payment has not been made. It effectively converts a fixed \nlease payment into a variable lease payment ( i.e., the payment to be made at a later date). Variable \npayments that are not based on an index or rate are not included in the measurement of the lease \nliability. However, we believe those payments may be required to be disclosed, if material, along with \nlease and other commitments in the financial statements , similar to commitments related to leases that \nhave not yet commenced. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 545}), Document(page\_content='G Accounting for r ent concessions related to the COVID -19 pandemic \nFinancial reporting developments Lease accounting | G-16 A summary of Restaurant B’s accounting for this lease in the income statement is as follows: \nAmounts in thousands Jan. Feb. Mar. Apr. When \npayment \nmade \nPeriodic lease expense (straight -line) $ 12 $ 12 $ 12 $ 12 $ 12 \n(Negative ) variable lease expense ($ 10) $ 10 \nTotal lease expense $ 12 $ 12 $ 12 $ 2 $ 22 \n \nImpairment considerations \nIn all cases, Restaurant B should evaluate whether there is an indicator of impairment for its ROU \nasset. Refer to sections 4.2.5, Impairment of right -of-use assets in operating leases , and 4.3.4, \nImpairment of right -of-use assets in finance leases , for fu rther discussion. \nG.6.2 Lessor accounting \nWe believe there are several approaches for accounting for a rent concession that is not accounted for as \na lease modification, including: \n• Accounting for a concession in the form of a deferral of payments as if the lease is unchanged \n(Approach A) \n• Accounting for a concession like a negative variable lease payment (Approach B) \nAccounting for a concession in the form of a deferral of payments as if the lease is unchanged \nWhen a lessor permits a lessee to defer rental payments, we believe a lessor with an operating lease may \naccount for the concession by continuing to recognize a receivable until the rental payment is received \nfrom the lessee at t he revised payment date. \nWe believe a lessor with a direct financing or sales -type lease may account for the concession by \ncontinuing to account for the net investment in the lease as if the payment were made and recognizing a \nshort -term lease receivable ( that does not accrue interest) in the period that the cash payment is owed. \nThe lessor would relieve the short -term lease receivable when the lessee makes the rental payment at \nthe revised payment date. \nThis approach of recording a short -term lease receiva ble for the future payment would allow the lessor to \naccount for its net investment in the lease and related interest income using the original discount rate \nand would result in a net investment in the lease balance of zero at the end of the lease term ( i.e., the \nlessor would not need to revisit the interest recognized based on the revised timing of payments). In \nmany cases, this will allow a lessor to use its existing systems to account for the net investment in the \nlease using the existing payment schedul e and discount rate. \nAccounting for a concession like a negative variable lease payment \nWhen a lessor contractually releases the lessee from the obligation to make certain lease payments, \ndefers payments or pays cash to the lessee, we believe a lessor may account for the concession as a \nnegative variable lease payment, similar to how a lessee recognizes variable lease expense. The lessor \nshould recognize negative variable lease income in the period in which the achievement of the specified \ntarget that trigg ers the payment becomes probable ( i.e., when it becomes probable that the future event \nwill occur). Judgment may be required to determine the amount of negative variable lease income when \nthe concessions are not agreed upon between the lessee and lessor, o therwise specified in the lease \ncontract or in accordance with local laws or regulations. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 546}), Document(page\_content='G Accounting for rent concessions related to the COVID -19 pandemic \nFinancial reporting developments Lease accounting | G-17 However, if a lessor forgives lease payments for an operating lease, it should recognize the negative \nvariable lease income in the period the forgiven payment would h ave been recognized as a receivable \ninstead of the period in which the achievement of the specified target that triggers the payment ( e.g., the \nconditions of the force majeure clause) becomes probable. That’s because a lessor cannot derecognize \nan operatin g lease receivable (from forgiving the payment) before it is recognized. \nA lessor with an operating lease would recognize negative variable lease income for forgiven rent with an \noffsetting entry to rent receivable (or cash, if the lessor paid the lessee) . A lessor with a sales -type or \ndirect financing lease would recognize negative variable lease income for forgiven rent with an offsetting \nentry to the net investment in the lease (or cash, if lessor paid the lessee). \nThe following example illustrates how a lessor with an operating lease may account for changes in lease \nconsideration, both when certain lease payments are forgiven and when lease payments are deferred \n(and not forgiven). \nIllustration G-7: Lessor accounting for lease payments that are forgive n or deferred on an \noperating lease \nAssume the same facts for an operating lease as in Illustrations G-2 and G-6. This illustration assumes \nthe lessor made the election to not evaluate whether a concession is a modification and adopt ed a \npolicy to not account for the concession as a lease modification , but the accounting illustrated would \nbe the same if the election were not made (or the concession did not qualify) and the concession is \ncontemplated by the lease . \nAnalysis \nRent forgivene ss \nLessor Y records the following entry in March 2020: \nCash $ 10,000 \nRent receivable 2,000 \n Lease income $ 12,000 \nTo record lease income and rent receivable for the difference between cash pa yments owed and \nstraight -line lease income . \nIn April 2020, Lessor Y forgives the $10,000 April rent obligation of Restaurant B. \nWe believe one approach is to account for the rent forgiveness as a negative variable lease payment \n(Approach B). \nUnder this approach, Lessor Y records the following entr ies in Apri l 2020: \nRent receivable $ 12,000 \n Lease income $ 12,000 \nTo record lease income and rent receivable for straight -line lease income . \nLease income $ 10,000 \n Rent receivable $ 10,000 \nTo recognize negative variable lease income for the April rent concession. \nLessor Y would record similar entries in May 2020 if, at that time, it concludes a rent concession is probable. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 547}), Document(page\_content='G Accounting for rent concessions related to the COVID -19 pandemic \nFinancial reporting developments Lease accounting | G-18 A summary of Lessor Y’s accounting for this lease in the income statement (assuming a May rent \nconcession is provided) is as follows : \nAmounts in thousands Jan. Feb. Mar. Apr. May \nLease income (straight -line) $ 12 $ 12 $ 12 $ 12 $ 12 \nNegative variable lease income ($ 10) ($ 10) \nTotal lease income $ 12 $ 12 $ 12 $ 2 $ 2 \n \nDeferral of rental payments \nAssume all of the same facts as above except that Lessor Y defers the due date of Restaurant B’s April \nrent payment. The deferred rent payment is now due in October 2020. In this case, the affected lease \npayments are not forgiven. \nOne possible approach, de scribed by the FASB staff, is to account for the rent deferral as if the lease is \nunchanged (Approach A). \nUnder this approach, Lessor Y record s the following entr y in April 2020: \nRent receivable $ 12,000 \n Lease income $ 12,000 \nTo record lease income and rent receivable. \nAlternatively, a lessor may choose to record the $10,000 rent receivable to another short -term rent \nreceivable account if its system is set up to recognize the difference between expected cash payments \nand straight -line lease in come ( i.e., $2,000 in this example ). This approach is shown through the \nfollowing entry: \nRent receivable $ 2,000 \nShort -term rent receivable 10,000 \n Lease income $ 12,000 \nUnder either alternative, in October 2020 (when the April payment is due), Restaura nt B will make a \npayment for April rent, and Lessor Y will record the following entry: \nCash $ 20,000 \nRent receivable 2,000 \n Rent receivable or short -term rent receivable $ 10,000 \n Lease income 12,000 \nTo record monthly lease income and rent receivable ( i.e., cash of $10,000, accrued rent of $2,000 and lease \nincome of $1 2,000, plus the additional cash from April of $10,000). \nA summary of Lessor Y’s accounting for this lease in the income statement is as follows: \nAmounts in thousands Jan. Feb. Mar. Apr. When \npayment \nreceived \nLease income (straight -line) $ 12 $ 12 $ 12 $ 12 $ 12 \nNegative variable lease income $ 0 $ 0 \nTotal lease income $ 12 $ 12 $ 12 $ 12 $ 12 \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 548}), Document(page\_content='G Accounting for rent conces sions related to the COVID -19 pandemic \nFinancial reporting developments Lease accounting | G-19 Another possible approach, described by the FASB staff, is to account for the rent deferral as a \nnegative variable lease payment (Approach B). \nUnder this approach, Lessor Y record s the following entr ies in April 2020: \nRent receivable $ 12,000 \n Lease income $ 12,000 \nTo record lease income and rent recei vable. \nLease income $ 10,000 \n Rent receivable $ 10,000 \nTo recognize negative variable lease income for the April rent deferral. \nThis approach of recording negative variable lease income for a rent deferral results in a reduction of \nthe rent receivable, even though a payment is owed and will be due in the future. Lessor Y does not \nrecognize lease income or a lease receivable for the $10,000 ( i.e., the amount of the receivable that would \notherwise be due), but it still recognizes lease income for the straight -line rent adjustment of $2,000. \nIn October 2020 (when the April payment is due), Restaurant B will make a payment for April rent, and \nLessor Y will record the following entry: \nCash $ 20,000 \nRent receivable 2,000 \n Lease income $ 22,000 \nTo record monthly lease income and rent receivable ( i.e., cash of $10,000, accrued rent of $2,000 and lease \nincome of $10,000, plus the additional cash and inc ome from April of $10,000). \nA summary of Lessor Y’s accounting for this lease in the income statement is as follows: \nAmounts in thousands Jan. Feb. Mar. Apr. When \npayment \nreceived \nLease income (straight -line) $ 12 $ 12 $ 12 $ 12 $ 12 \n(Negative) v ariable lease income ($ 10) $ 10 \nTotal lease expense $ 12 $ 12 $ 12 $ 2 $ 22 \nCollectibility \nIn all cases, Lessor Y should evaluate whether changes in the facts and circumstances relating to the \nCOVID -19 pandemic affect its evaluation of the collectibility of lease payments (and any residual value \nguarantee) for its operating lease . Refer to section 5.4, Operating leases , for further discussion . \nG.7 Accounting for relief provided by a government agency \nIn some jurisdictions, authorities have provided subsidies to lessees or lessors to help mitigate the \neconomic effects of COVID -19 on local operations. Lessees and lessors that receive consideration from a \ngovernment agency (or a lessee that receives consideration from a lessor that was required to pass it on) \nshould evaluate whether the consideration received is a loan, a payment for goods or services, or an \nincome tax credit , before concluding that the assistance is a grant o r a contrib ution . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 549}), Document(page\_content='G Accounting for rent concessions related to the COVID -19 pandemic \nFinancial reporting developments Lease accounting | G-20 There is no US GAAP guidance for for -profit business entities that receive government grants; therefore, \nbusiness entit ies must determine the appropriate accounting treatment by analogy to other guidance . When \nthe assistance received is in the form of a government grant and is not an income tax credit or loan and does \nnot represent revenue from a contract with a customer , we generally believe a business entity should \naccount for it by analogy to IAS 20, Accounting for Government Grants and Disclosure of Government \nAssistance , of IFRS. However, analogies to other guidance also may be appropriate . A not -for-profit entity \nthat receives a government grant should apply ASC 958-605, Not-for-Profit Entities — Revenue Recognition . \nRefer to our Technical Line, Accounting and reporting considerations for the effects of the coronavirus \noutbreak , for further discussion of accounting for government assistance. \nG.8 Disclosure \nEntities should consider the disclosure objectives26 in ASC 842 and provide disclosures that enable users \nto understand the nature and financial effect of material concessions provided or granted related to the \neffects of the COVID -19 pandemic. Entities that are SEC registrants should also consider the SEC staff’s \nguidance27 on disclosing the effects of the COVID -19 pandemic and related risks. For example, we believe \nentities should disclose both their accounting policies for elections that have a material effect on the \nfinancial statements and the effects of those elections. \n \n26 ASC 842-20-50-1 (lessee disclosure objective); ASC 842-30-50-1 (lessor disclosure objective). \n27 The SEC’s Division of Corporation Finance issued Disclosure Guidance Topic No. 9, Coronavirus (COVID -19), which provides the \nSEC staff’s views on disclosure and other securities law obligations that registrants should consider with respect to COVID -19 and \nits effects on their operations and financial condition. Refer to our To the Point, SEC extends relief and issues staff guida nce on \nCOVID -19 disclosures , for more information . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 550}), Document(page\_content=' \nFinancial reporting developments Lease accounting | H-1 H Glossary (added August 2022) \nExcerpt from Accounting Standards Codification \nMaster Glossary \nAcquirer \nThe entity that obtains control of the acquiree . However, in a business combination in which a \nvariable interest entity (VIE) is acquired, the primary beneficiary of that entity always is the acquirer. \nAcquisition by a Not -for-Profit Entity \nA transaction or other event in which a not -for-profit acquirer obtains control of one or more nonprofit \nactivities or businesses and initially recognizes their assets and liabi lities in the acquirer’s financial \nstatements. When applicable guidance in Topic 805 is applied by a not-for-profit entity , the term \nbusiness combination has the same meaning as this term has for a for -profit entity. Likewise, a \nreference to business combi nations in guidance that links to Topic 805 has the same meaning as a \nreference to acquisitions by not -for-profit entities. \nAdvance Refunding \nA transaction involving the issuance of new debt to replace existing debt with the proceeds from the \nnew debt plac ed in trust or otherwise restricted to retire the existing debt at a determinable future \ndate or dates. \nBusiness \nParagraphs 805 -10-55-3A through 55 -6 and 805 -10-55-8 through 55 -9 define what is considered \na business. \nBusiness Combination \nA transaction or o ther event in which an acquirer obtains control of one or more businesses . \nTransactions sometimes referred to as true mergers or mergers of equals also are business \ncombinations. See also Acquisition by a Not -for-Profit Entity . \nCommencement Date of the Lease (Commencement Date) \nThe date on which a lessor makes an underlying asset available for use by a lessee . See paragraphs \n842-10-55-19 through 55 -21 for implementation guidance on the commencement date. \nConsideration in the Contract \nSee paragraph 842 -10-15-35 for what constitutes the consideration in the contract for lessees and \nparagraph 842 -10-15-39 for what constitutes consideration in the contract for lessors . \nContract \nAn agreement between two or more parties that creates enforceable rights and obligations. \nDelayed Equity Investment \nIn leveraged lease transacti ons that have been structured with terms such that the lessee ’s rent \npayments begin one to two years after lease inception , equity contributions the lessor agrees to \nmake (in the lease agreement or a separate binding contract ) that are used to service the nonrecourse \ndebt during this brief period. The total amount of the lessor ’s contributions is specifically limited by \nthe agreements. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 551}), Document(page\_content='H Glossary (added August 2022) \nFinancial reporting developments Lease accounting | H-2 Direct Financing Lease \nFrom the perspective of a lessor , a lease that meets none of the criteria in paragraph 842 -10-25-2 but \nmeets the criteria in paragraph 842 -10-25-3(b) and is not an operating lease in accordance with \nparagraph 842 -10-25-3A. \nDiscount Rate for the Lease \nFor a lessee , the discount rate for the lease is the rate implicit in the lease unless that rate cannot b e \nreadily determined. In that case, the lessee is required to use its incremental borrowing rate . \nFor a lessor , the discount rate for the lease is the rate implicit in the lease. \nEconomic Life \nEither the period over which an asset is expected to be economi cally usable by one or more users or \nthe number of production or similar units expected to be obtained from an asset by one or more users. \nEffective Date of the Modification \nThe date that a lease modification is approved by both the lessee and the lessor . \nEstimated Residual Value \nThe estimated fair value of the leased property at the end of the lease term . \nFair Value \nThe price that would be received to sell an asset or paid to transfer a liability in an orderly transaction \nbetween market participants at the measurement date. \nFinance Lease \nFrom the perspective of a lessee , a lease that meets one or more of the criteria in paragraph 842 -10-\n25-2. \nFiscal Funding Clause \nA provision by which the lease is cancelable if the legislature or other funding authority does not \nappropriate the funds necessary for the governmental unit to fulfill its obligations under the lease \nagreement. \nIncremental Borrowing Rate \nThe rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar \nterm an amount equal to the lease payments in a similar economic environment. \nInitial Direct Costs \nIncremental costs of a lease that would not have been incurred if the lease had not been obtained. \nInventory \nThe aggregate of those items of tangible personal property that have any of the following characteristics: \na. Held for sale in th e ordinary course of business \nb. In process of production for such sale \nc. To be currently consumed in the production of goods or services to be available for sale. \nThe term inventory embraces goods awaiting sale (the merchandise of a trading concern and t he \nfinished goods of a manufacturer), goods in the course of production (work in process), and goods to \nbe consumed directly or indirectly in production (raw materials and supplies). This definition of \ninventories excludes long -term assets subject to depre ciation accounting, or goods which, when put \ninto use, will be so classified. The fact that a depreciable asset is retired from regular use and held for ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 552}), Document(page\_content='H Glossary (added August 2022) \nFinancial reporting developments Lease accounting | H-3 sale does not indicate that the item should be classified as part of the inventory. Raw materials and \nsupplies purchased for production may be used or consumed for the construction of long -term assets \nor other purposes not related to production, but the fact that inventory items representing a small \nportion of the total may not be absorbed ultimately in the production process does not require \nseparate classification. By trade practice, operating materials and supplies of certain types of entities \nsuch as oil producers are usually treated as inventory. \nLease \nA contract , or part of a contract, that conveys the right to control the use of identified property, plant, \nor equipment (an identified asset) for a period of time in exchange for consideration. \nLease Inception \nThe date of the lease agreement or commitment, if earlier. For purposes of this definition, a commitment \nshall be in writing, signed by the parties in interest to the transaction, and shall specifically set forth the \nprincipal provisions of the transaction . If any of the principal provisions are yet to be negotiated, such a \npreliminary agreement or commitment does not qualify for purposes of this definition. \nLease Liability \nA lessee’s obligation to make the lease payments arising from a lease , measured on a discounted basis. \nLease Modification \nA change to the terms and conditions of a contract that results in a change in the scope of or the \nconsideration for a lease (for example, a change to the terms and conditions of the contract that adds \nor terminates th e right to use one or more underlying assets or extends or shortens the contractual \nlease term). \nLease Payments \nSee paragraph 842 -10-30-5 for what constitutes lease payments from the perspective of a lessee and \na lessor . \nLease Receivable \nA lessor’s right t o receive lease payments arising from a sales -type lease or a direct financing lease \nplus any amount that a lessor expects to derive from the underlying asset following the end of the \nlease term to the extent that it is guaranteed by the lessee or any other third party unrelated to the \nlessor, measured on a discounted basis. \nLease Term \nThe noncancellable period for which a lessee has the right to use an underlying asset , together with \nall of the following: \na. Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise \nthat option \nb. Periods covered by a n option to terminate the lease if the lessee is reasonably certain not to \nexercise that option \nc. Periods covered by an option to extend (or not to terminate) the lease in which exercise of the \noption is controlled by the lessor . \nLegal Entity \nAny legal st ructure used to conduct activities or to hold assets. Some examples of such structures are \ncorporations, partnerships, limited liability companies, grantor trusts, and other trusts. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 553}), Document(page\_content='H Glossary ( added August 2022) \nFinancial reporting developments Lease accounting | H-4 Lessee \nAn entity that enters into a contract to obtain the right to use an underlying asset for a period of time \nin exchange for consideration. \nLessor \nAn entity that enters into a contract to provide the right to use an underlying asset for a period of \ntime in exchange for consideration. \nLeveraged L ease \nFrom the perspective of a lessor , a lease that was classified as a leveraged lease in accordance with \nthe leases guidance in effect before the effective date and for which the commencement date is \nbefore the effective date. \nMarket Participants \nBuyers and sellers in the principal (or most advantageous) market for the asset or liability that have all \nof the following characteristics: \na. They are independent of each other, that is, they are not related parties , although the price in a \nrelated -party transa ction may be used as an input to a fair value measurement if the reporting \nentity has evidence that the transaction was entered into at market terms \nb. They are knowledgeable, having a reasonable understanding about the asset or liability and the \ntransacti on using all available information, including information that might be obtained through \ndue diligence efforts that are usual and customary \nc. They are able to enter into a transaction for the asset or liability \nd. They are willing to enter into a transac tion for the asset or liability, that is, they are motivated but \nnot forced or otherwise compelled to do so. \nMinimum Lease Payments [EY note: This definition is only used for leveraged leases.] \nMinimum lease payments comprise the payments that the lessee is obligated to make or can be \nrequired to make in connection with the leased property, excluding both of the following: \na. Contingent rentals \nb. Any guarantee by the lessee of the lessor’s debt and the lessee’s oblig ation to pay (apart from the \nrental payments) executory costs such as insurance, maintenance, and taxes in connection with \nthe leased property. \nIf the lease contains a bargain purchase option, only the minimum rental payments over the lease term \nand the pa yment called for by the bargain purchase option are required to be included in the minimum \nlease payments. Otherwise, minimum lease payments include all of the following: \na. The minimum rental payments called for by the lease over the lease term. \nb. Any gu arantee of the residual value at the expiration of the lease term, whether or not payment \nof the guarantee constitutes a purchase of the leased property or of rental payments beyond the \nlease term by the lessee (including a third party related to the lesse e) or a third party unrelated to \neither the lessee or the lessor, provided the third party is financially capable of discharging the \nobligations that may arise from the guarantee. If the lessor has the right to require the lessee to \npurchase the property a t termination of the lease for a certain or determinable amount, that \namount is required to be considered a lessee guarantee of the residual value. If the lessee agrees \nto make up any deficiency below a stated amount in the lessor’s realization of the resi dual value, \nthe residual value guarantee to be included in the minimum lease payments is required to be the \nstated amount, rather than an estimate of the deficiency to be made up. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 554}), Document(page\_content='H Glossary (added August 2022) \nFinancial reporting developments Lease accounting | H-5 c. Any payment that the lessee must make or can be required to make upon failure to renew or \nextend the lease at the expiration of the lease term, whether or not the payment would constitute \na purchase of the leased property. Note that the definition of lease term includes all periods, if \nany, for which failure to renew the lease imposes a penalty on the lessee in an amount such that \nrenewal appears, at lease inception, to be reasonably assured. If the lease term has been extended \nbecause of that provision, th e related penalty is not included in minimum lease payments. \nd. Payments made before the beginning of the lease term. The lessee is required to use the same \ninterest rate to accrete payments to be made before the beginning of the lease term that it uses \nto discount lease payments to be made during the lease term. \ne. Fees that are paid by the lessee to the owners of the special -purpose entity for structuring the \nlease transaction. Such fees are required to be included as part of minimum lease payments (but \nnot included in the fair value of the leased property). \nLease payments that depend on a factor directly related to the future use of the leased property, such \nas machine hours of use or sales volume during the lease term, are contingent rentals and, \naccord ingly, are excluded from minimum lease payments in their entirety. However, lease payments \nthat depend on an existing index or rate, such as the Consumer Price Index or the prime interest rate, \nare required to be included in minimum lease payments based on the index or rate existing at lease \ninception; any increases or decreases in lease payments that result from subsequent changes in the \nindex or rate are contingent rentals and, thus, affect the determination of income as accruable. \nMonetary Liability \nAn o bligation to pay a sum of money the amount of which is fixed or determinable without reference to \nfuture prices of specific goods and services. \nNet Investment in the Lease \nFor a sales -type lease , the sum of the lease receivable and the unguaranteed residual asset . \nFor a direct financing lease , the sum of the lease receivable and the unguaranteed residual asset, net \nof any deferred selling profit. \nNot-for-Profit Entity \nAn entity that possesses the following characteristics, in varying deg rees, that distinguish it from a \nbusiness entity: \na. Contributions of significant amounts of resources from resource providers who do not expect \ncommensurate or proportionate pecuniary return \nb. Operating purposes other than to provide goods or services a t a profit \nc. Absence of ownership interests like those of business entities. \nEntities that clearly fall outside this definition include the following: \na. All investor -owned entities \nb. Entities that provide dividends, lower costs, or other economic benefits directly and \nproportionately to their owners, members, or participants, such as mutual insurance entities, \ncredit unions, farm and rural electric cooperatives, and employee benefit plans. \nOperating Lease \nFrom the perspective of a lessee , any lease other than a finance lease . \nFrom the perspective of a lessor , any lease other than a sales -type lease or a direct financing lease . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 555}), Document(page\_content='H Glossary (added August 2022) \nFinancial reporting developments Lease accounting | H-6 Orderly Transaction \nA transaction that assumes exposure to the market for a period before the measurement date to a llow \nfor marketing activities that are usual and customary for transactions involving such assets or \nliabilities; it is not a forced transaction (for example, a forced liquidation or distress sale). \nPenalty \nAny requirement that is imposed or can be imposed on the lessee by the lease agreement or by \nfactors outside the lease agreement to do any of the following: \na. Disburse cash \nb. Incur or assume a liability \nc. Perform services \nd. Surrender or transfer an asset or rights to an asset or otherwise forego an e conomic benefit, or \nsuffer an economic detriment. Factors to consider in determining whether an economic detriment \nmay be incurred include, but are not limited to, all of the following: \n1. The uniqueness of purpose or location of the underlying asset \n2. The availability of a comparable replacement asset \n3. The relative importance or significance of the underlying asset to the continuation of the \nlessee ’s line of business or service to its cu stomers \n4. The existence of leasehold improvements or other assets whose value would be impaired by \nthe lessee vacating or discontinuing use of the underlying asset \n5. Adverse tax consequences \n6. The ability or willingness of the lessee to bear the cost associated with relocation or \nreplacement of the underlying asset at market rental rates or to tolerate other parties using \nthe underlying asset. \nPeriod of Use \nThe total period of time that an asset is used to fulfill a contract with a customer (inclu ding the sum of \nany nonconsecutive periods of time). \nProbable \nThe future event or events are likely to occur. \nPublic Business Entity \nA public business entity is a business entity meeting any one of the criteria below. Neither a not-for-\nprofit entity nor an employee benefit plan is a business entity. \na. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial \nstatements, or does file or furnish financial statements (including voluntary filers), with the SEC \n(including other entities whose financial statements or financial information are required to be or \nare included in a filing). \nb. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or \nregulations promulgated under the Act, to file o r furnish financial statements with a regulatory \nagency other than the SEC. \nc. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in \npreparation for the sale of or for purposes of issuing securities that are not subject to contractual \nrestrictions on transfer. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 556}), Document(page\_content='H Glossary (added August 2022) \nFinancial reporting developments Lease accounting | H-7 d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an \nexchange or an over -the-counter market. \ne. It has one or more securities that are not subject to contractual restrictions on transfer, and it is \nrequired by law, contract, or regulation to prepare U.S. GAAP financial statements (including \nnotes) and make them publicly available on a periodic basis (for example, interim or annual \nperiods). A n entity must meet both of these conditions to meet this criterion. \nAn entity may meet the definition of a public business entity solely because its financial statements or \nfinancial information is included in another entity’s filing with the SEC. In that case, the entity is only a \npublic business entity for purposes of financial statements that are filed or furnished with the SEC. \nRate Implicit in the Lease \nThe rate of interest that, at a given date, causes the aggregate present value of (a) the lease \npayments and (b) the amount that a lessor expects to derive from the underlying asset following the \nend of the lease term to equal the sum of (1) the fair value of the underlying asset minus any related \ninvestment tax credit retained and expected to be re alized by the lessor and (2) any deferred initial \ndirect costs of the lessor. However, if the rate determined in accordance with the preceding sentence \nis less than zero, a rate implicit in the lease of zero shall be used. \nRelated Parties \nRelated parties i nclude: \na. Affiliates of the entity \nb. Entities for which investments in their equity securities would be required, absent the election of \nthe fair value option under the Fair Value Option Subsection of Section 825 -10-15, to be \naccounted for by the equity method by the investing entity \nc. Trusts for the benefit of employees, such as pension and profit -sharing trusts that are managed \nby or under the trusteeship of management \nd. Principal owners of the entity and members of their immediate families \ne. Managem ent of the entity and members of their immediate families \nf. Other parties with which the entity may deal if one party controls or can significantly influence \nthe management or operating policies of the other to an extent that one of the transacting partie s \nmight be prevented from fully pursuing its own separate interests \ng. Other parties that can significantly influence the management or operating policies of the \ntransacting parties or that have an ownership interest in one of the transacting parties and c an \nsignificantly influence the other to an extent that one or more of the transacting parties might be \nprevented from fully pursuing its own separate interests. \nRemote \nThe chance of the future event or events occurring is slight. \nResidual Value Guarantee \nA guarantee made to a lessor that the value of an underlying asset returned to the lessor at the end of \na lease will be at least a specified amount. \nRight -of-Use Asset \nAn asset that represents a lessee’s right to use an underlying asset for the lease term . ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 557}), Document(page\_content='H Glossary (added August 2022) \nFinancial reporting developments Lease accounting | H-8 Sales -Type Lease \nFrom the perspective of a lessor , a lease that meets one or more of the criteria in paragraph 842 -10-\n25-2 and is not an operating lease in accordance with paragraph 842 -10-25-3A. \nSelling Profit or Selling Loss \nAt the commencement date , selling profit or selling loss equals: \na. The fair value of the underlying asset or the sum of (1) the lease receivable and (2) any lease \npayments prepaid by the lessee, if lower; minus \nb. The carrying amount of the underlying asset net of any unguaranteed residual asset ; minus \nc. Any deferred initial direct costs of the lessor. \nShort -Term Lease \nA lease that, at the commencement date , has a lease term of 12 months or less and does not includ e \nan option to purchase the underlying asset that the lessee is reasonably certain to exercise. \nStandalone Price \nThe price at which a customer would purchase a component of a contract separately. \nSublease \nA transaction in which an underlying asset is re-leased by the lessee (or intermediate lessor ) to a third \nparty (the sublessee) and the original (or head) lease between the lessor and the lessee remains in effect. \nUnderlying Asset \nAn asset that is the subject of a lease for which a right to use that asset has been conveyed to a \nlessee . The underlying asset could be a physically distinct portion of a single asset. \nUnguaranteed Residual Asset \nThe amount that a lessor expects to derive from the underlying asset following the end of the lease \nterm that is not g uaranteed by the lessee or any other third party unrelated to the lessor, measured \non a discounted basis. \nUseful Life \nThe period over which an asset is expected to contribute directly or indirectly to future cash flows. \nVariable Interest Entity \nA legal entity subject to consolidation according to the provisions of the Variable Interest Entities \nSubsections of Subtopic 810 -10. \nVariable Lease Payments \nPayments made by a lessee to a lessor for the right to use an underlying asset that vary because of changes \nin facts or circumstances occurring after the commencement date , other than the passage of time. \nWarranty \nA guarantee for which the underlying is related to the performance (regarding function, not price) of \nnonfinancial asset s that are owned by the guaranteed party. The obligation may be incurred in \nconnection with the sale of goods or services; if so, it may require further performance by the seller \nafter the sale has taken place. \n ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 558}), Document(page\_content=' \n EY | Building a better working world \nEY exists to build a better working world, helping to \ncreate long -term value for clients, people and society \nand build trust in the capital markets. \nEnabled by data and technology, diverse EY teams in \nover 150 countries provide trust through assurance \nand help clients grow, transform and operate. \nWorking across assurance, consulting, law, strategy, \ntax and transactions, EY teams ask better questions to \nfind new answers for the complex issues facing our \nworld today. \nEY refers to the global organization, an d may refer to one or more, \nof the member firms of Ernst & Young Global Limited, each of which is \na separate legal entity. Ernst & Young Global Limited, a UK company \nlimited by guarantee, does not provide services to clients. Information \nabout how EY colle cts and uses personal data and a description of the \nrights individuals have under data protection legislation are available \nvia ey.com/privacy . EY member firms do not practice law where \nprohibited by local laws. Fo r more information about our organization, \nplease vis it ey.com . \nErnst & Young LLP is a client -serving member firm of Ernst & Young \nGlobal Limited operating in the US. \n© 202 3 Ernst & Young LLP. \nAll Rights Reserved. \nSCORE no. 00195 -171US \n(Revised August 2023) \nThis and many of the publications produced by our US Professional \nPractice Group are available free on AccountingLink at \ney.com/en\_us/assurance/ac countinglink . \nThis material has been prepared for general informational purposes only and is not \nintended to be relied upon as accounting, tax , legal or other professional advice. Please \nrefer to your advisors for specific advice. ', metadata={'source': 'PDFs\_and\_TXT\\EY\_Financial\_Reporting\_Developments\_Lease\_Accounting\_08\_31\_2023.pdf', 'page': 559}), Document(page\_content=' \nLeases \n \nHandbook \n \n \n \nUS GAAP \n \nMay 2023 \n\_\_\_\_\_\_ \nfrv.kpmg.us ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 0}), Document(page\_content='Contents \nForeword ............................................................................................................... 1 \nAbout this publication ........................................................................................... 2 \n1. Executive summary ........................................................................................ 5 \n2. Scope ........................................................................................................... 15 \n3. 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Effective dates and transition: comparative method ............................. 1111 \nGlossary .......................................................................................................... 1252 \nIndex of changes ............................................................................................ 1261 \nKPMG Financial Reporting View ..................................................................... 1263 \nAcknowledgments .......................................................................................... 1265 \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1}), Document(page\_content='Leases 1 \nForeword \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Your guide to lease \naccounting \nCalendar year -end private entities were required to adopt the leases standard \n(Topic 842) on January 1, 2022. Non- calendar year -end private entities adopt ed \non the first day of their fiscal year beginning after December 15, 2021 (e.g. April \n1, 2022 for a private entity with a March 31 year -end). As of the date of this \nedition, many private entities have now issued financial statements reflecting \nthe adoption of Topic 842, while those private entities that have not yet done \nso, soon will . \nTopic 842 has affected organizations , public and private, across all industries \nthat use leases for real estate, equipment, fleet and automobiles, among \nothers. And while the lessor accounting requirements are similar to those under \nthe legacy leasing guidance ( Topic 840) in most respects, there are more than a \nfew important changes and new disclosure requirem ents. Meanwhile, the \naccounting for more complex transactions, such as sale- leasebacks and build -to-\nsuit leasing arrangements, is significantly changed. \nOrganized in a Q&A format, t his hand book is intended to help you focus \neffectively and efficiently on the accounting requirements of Topic 842, and \nanswer s key questions that continue to arise in practice about their application . \nOur periodic updates address new questions as they arise, as well as standard \nsetting and regulatory changes and developments. We give examples and \nobservations to help explain key concepts. \n \n \n Kimber Bascom and Sc ott Muir \nDepartment of Professional Practice, KPMG LLP \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 2}), Document(page\_content='Leases 2 \nAbout this publication \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. About this publication \nThe purpose of this Handbook is to assist you in understanding Topic 842, \nLeases . \nAccounting literature \nUnless otherwise stated, references to the leases standard and/or Topic 842 \ncomprise all of the following Account ing Standards Updates (ASUs) : \n— No. 2016- 02, Leases (Topic 842) \n— No. 2018- 01, Leases (Topic 842): Land Easement Practical Expedient for \nTransition to Topic 842 \n— No. 2018- 10, Codification Improvements to Topic 842, Leases \n— No. 2018- 11, Leases ( Topic 842): Targeted Improvements \n— No. 2018- 20, Leases (Topic 842): Narrow- Scope Improvements for Lessors \n— No. 2019- 01, Leases (Topic 842): Codification Improvements \n— No. 2019- 10, Financial Instruments —Credit Losses (Topic 326), Derivatives \nand Hedging (Topic 815), and Leases (Topic 842): Effective Dates \n— No. 2020- 02, Financial Instruments —Credit Losses (Topic 326) and Leases \n(Topic 842): Amendments to SEC Paragraphs Pursuant to SEC Staff \nAccounting Bulletin No. 119 and Update to SEC Section on Effective Date \nRelated to Accounting Standards Update No. 2016- 02, Leases (Topic 842) \n— No. 2020- 05, Revenue from Contracts with Customers (Topic 606) and \nLeases (Topic 842): Effective Dates for Certain Entities \n— No. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with Variable \nLease Payments \n— No. 2021- 09, Leases (Topic 842): Discount Rate for Lessees That Are Not \nPublic Business Entities \n— No. 2023- 01, Leases (Topic 842): Common Control Arrangements \nOrganization of the text \nEach chapter of this Handbook includes excerpts from the FASB’s Accounting \nStandards Codification® and overviews of the relevant requirements. Our in -\ndepth guidance is explained through Q&As that reflect the questions we are \nencountering in practice. We include observa tions and examples to explain key \nconcepts, and we explain the changes from legacy US GAAP (Topic 840) . \nOur commentary is referenced to the Codification and to other literature, where \napplicable. The following are examples: \n— 842-10-25-1 is paragraph 25- 1 of ASC Subtopic 842- 10. \n— ASU 2016- 02.BC160 is paragraph 160 of the basis for c onclusions to \nASU 2016- 02. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 3}), Document(page\_content='Leases 3 \nAbout this publication \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — TRG 11- 16.56 is agenda paper no. 56 from the meeting of the FASB and \nthe IASB’s Joint Transition Resource Group for Revenue Recognition (TRG) \nheld in November 2016. \n— SAB Topic 11.M is SEC Staff Accounting Bulletin Topic 11.M. \nInteraction with revenue recognition \nAs you use this Handbook, you may be surprised by the level of interaction \nbetween the requirements for lessors under Topic 842 and the requirements \nfor suppliers under FASB ASC Topic 606, Revenue from Contracts with \nCustomers . This link between the two Topics acknowledges the Board’s view \nthat leasing is, fundamentally , a revenue -generating activity for lessors. \nFor an in- depth understanding of the requirements of Topic 606, see the KPMG \nHandbook s, Revenue recognition and Revenue for software and SaaS , and the \nlatest news on KPMG Financial Reporting View . \nMay 2023 edition \nThe May 2023 edition of our Handbook includes new and updated \ninterpretations and examples . These come from our experiences with \ncompanies applying Topic 842; discussions with industry , preparer and peer \ngroups ; and discussions with the FASB and SEC staffs . This edition also \nincludes new material addressing the amendments to Topic 842 enacted by \nASU 202 3-01. \nNew Questions and Examples added in this edition are identified in the \nHandbook with \*\* and items that have been significant ly updated or revised are \nidentified with #. Questions and Examples included in previous editions \n(regardless of when added or updated), and those that have not been \nsignificantly updated in this edition, are no longer marked. \nThe Index of changes lists the additio ns and changes made in this edition to \nassist you in locating recently added or updated content . \nFuture developments \nAlthough all entities have now adopted Topic 842 and most have issued \nfinancial statements thereunder , questions remain and interpretation s of Topic \n842 continue to evolve. This means that some positions may change over time, \nand positions on new issues will emerge. \nFor the Questions in this Handbook where we are aware of ongoing \ndiscussions and the potential for a position to change, we have indicated that in \nour interpretive response. \nAbbreviations \nWe use the following abbreviations in this Handbook: \nCPI Consumer P rice Index \nROU Right -of-use (asset) \nTRG The IASB and the FASB’s Joint Transition Resource Group for \nRevenue Recognition ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 4}), Document(page\_content='Leases 4 \nAbout this publication \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. We use the following additional abbreviations in the charts and diagrams in this \nHandbook: \nFV Fair value \nIDC Initial direct cost \nIBR Incremental borrowing rate \nPP&E Property, plant and equipment \nPV Present value \nRVG Residual value guarantee ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 5}), Document(page\_content='Leases 5 \n1. Executive summary \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 1. Executive summary \nTransparency and comparability \nTopic 842 was developed to provide financial statement users with more \ninformation about an entity’s leasing activities. \n— Lessees recognize all leases, including operating leases, with a term \ngreater than 12 months on- balance sheet . \n— Lessees and lessors disclose key information about their leasing \ntransactions. \nEffective date \nPublic business entities apply Topic 842 for interim and annual periods in fiscal \nyears beginning after December 15, 2018. \nNot-for-profit entities that have issued or are conduit bond obligors for securities \nthat are traded, listed or quoted on an exchange or an over -the-counter market, \nthat ha d not yet issued GAAP -compliant financial statements reflecting the \nadoption of Topic 842 before June 3, 2020 apply Topic 842 for interim and annual periods in fiscal years beginning after December 15, 2019. \nAll other entities apply Topic 842 for annual periods in fiscal years beginning \nafter December 15, 20 21, and interim periods in fiscal years beginning \none year later. \nCertain public business entities, those who would not meet the definition of a \npublic business entity other than because their financial statements or summa-\nrized financial information are included in another entity’s SEC filing, are permit-\nted to use the adoption dates for ‘other entities’. \nEarly adoption is permitted for all entities. \nA lessee’s perspective – leases on balance sheet \n \nThe debits and credits \nA lessee recognizes a lease liability and an ROU asset for all leases, including \noperating leases, with a term greater than 12 months, which will significantly \nincrease reported assets and liabilities for some lessees. \nThe critical accounting determination is whether a contract is or contains a \nlease , the new on -/off-balance sheet test . Lease classification criteria affect \nhow lessees measure and present lease expense and cash flows – not whether \nthe lease is on- or off -balance sheet as they did under legacy US GAAP (Topic \n840). \nFor all leases, the lease liability is measured as shown below, both initially and subsequently. Lease payments exclude contingent payments other than those \nthat are in -substance fixed. The discount rate for the lease is generally the \nlessee’s incremental borrowing rate unless the lessor’s rate implicit in the lease \nis readily determinable, in which case it is used . Private entities can elect , by \nclass of underlying leased asset, to use a risk -free discount rate. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 6}), Document(page\_content='Leases 6 \n1. Executive summary \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Lease liabilityPV of unpaid \nlease \npayments\n \nFor all leases, on initial recognition the ROU asset is derived from the \ncalculation of the lease liability. Topic 842 has a narrow definition of initial direct \ncosts, and s ome costs incurred in negotiating and arranging a lease that were \ncapitalized under Topic 840 are now expensed as incurred. \n \nThe measurement of the ROU asset subsequent to initial recognition depends \non whether the lease is a finance lease or an operating lease. \nFor finance leases: \n \nNote: \n1. The ROU asset in a finance lease is generally amortized on a straight -line basis. \nFor operating leases , there are two approa ches to subsequent measurement, \nwhich yield the same result . \nMethod 1 derives the carrying amount of the ROU asset from the \nmeasurement of the lease liability at each reporting date. \n \nMethod 2 amortizes the ROU asset, and the periodic amortization is the \ndifference between the straight -line total lease cost for the period (including \namortization of initial direct costs) and the periodic accretion of the lease liability \nusing the effective interest method. \nAccumulated \namortizationROU assetBeginning \nbalanceHidden shape \nto keep sizing \nconsistent Prepaid lease \npaymentsInitial \nmeasurement \nof the lease \nliability Lease \nincentives \nreceivedInitial direct \ncosts\nAccumulated \namortization1 ROU assetAccumulated \nimpairment \nlossesBeginning \nbalance\nPrepaid /\n(accrued )\n lease \npaymentsLease \nliability \ncarrying \namountUnamortized \nbalance of \nlease \nincentives \nreceivedUnamortized \ninitial \ndirect costsor', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 7}), Document(page\_content='Leases 7 \n1. Executive summary \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The ROU asset (for finance and operating leases) is subject to impairment \ntesting under Topic 360 (property, plant and equipment). \nOnce an operating lease ROU asset is impaired, the two methods above no \nlonger apply. Instead, subsequent amortization of the ROU asset is calculated in \nthe same way as for finance lease ROU assets – generally on a straight -line \nbasis over the remaining lease term. However, the ROU asset amortization and \nlease liability accretion continue to be accounted for as a single, operating \nlease cost. \nMore frequent revisions to lease accounting require \nprocesses and controls \n— The lease is modified and that \nmodification is not accounted for as a separate contract .\n— There is a change in the assessment of :\n- the lease term ; or\n- a purchase option being exercised .\n— There is a change in the amount probable of being owed under a RVG .\n— A contingency is resolved that \nresults in some or all variable lease payments becoming fixed payments .\nA lease liability is remeasured when :The lease term and purchase options \nare reassessed when :\n— There is a significant event or \nsignificant change in circumstances \nthat is within the lessee ’s control \nand directly affects the assessment \nof whether the lessee is reasonably certain to exercise an option \n(extension , termination , purchase ).\n— The lessee elects to exercise an option even though the entity has \npreviously determined that the \nlessee was not reasonably certain \nto do so – or vice versa .\n \nBuild -to-suit guidance substantially revised \nTopic 842 eliminates the legacy build- to-suit lease accounting guidance, and \ninstead stipulates that a lessee is the accounting owner of an asset under \nconstruction when it controls that asset before the lease commencement date. \nTopic 842 does not consider exposure to construction period risks, nor does it \nexplicitly prohibit certain activities. Because Topic 842 changes the underlying \nprinciple to determine when a lessee is the accounting owner of an asset under \nconstruction, some differen t accounting outcomes result as compared with \nTopic 840 . \nWhen a lessee is deemed to be the accounting owner of an asset under \nconstruction, t he changes to the sale- leaseback guidance generally make it \neasier for lessees to remove real estate assets recognized during the \nconstruction period from their balance sheets . \nThe transition provisions of Topic 842 result ed in many entities derecogniz ing \nbuild- to-suit assets and liabilities that were on the balance sheet after the end of \nthe construction period under Topic 840. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 8}), Document(page\_content='Leases 8 \n1. Executive summary \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. A lessor’s perspective – the devil is in the detail s \nOverall model substantially unchanged \nA lessor classif ies leases using criteria similar to those under Topic 840, as (1) \nsales- type, (2) direct financing, or (3) operating leases. However, the elimination \nof lessor -specific classification criteria related to collectibility and \nunreimbursable costs will result in a different classification for some leases \nclassified as operating leases under Topic 840. Leveraged lease classification is \neliminated prospectively. \nOnce classified, the accounting model applied to each t ype of lease is \nsubstantially similar to the lessor account ing model under Topic 840. \nSales -type \nand direct \nfinancing \nleases\nOperating \nleasesBalance sheetIncome \nstatementCash flow \nstatement\n— Recognize net \ninvestment in the \nlease\n— Derecognize the underlying asset— Selling profit \n(loss)1 \n— Interest income \nover the lease \ntermCash received \nfrom leases classified as operating cash \nflows\n2\nContinue to \nrecognize the underlying assetLease income \ngenerally on a straight -line \nbasis over the lease termCash received \nfrom leases classified as \noperating cash \nflows \nNote s: \n1. Selling profit is recognized at lease commencement for sales -type leases and over the \nlease term for direct financing leases. Selling losses are recognized at lease \ncommencement for both sales- type and direct financing leases. \n2. Lessors that are depository or lending institutions in the scope of Topic 942 (depository \nand lending institutions) classify the principal portion of cash payments received from \nleases as investing cash flows; the interest portion is classified as operating cash flows. \nKey concepts and definitions mostly consistent with \nlegacy US GAAP \nAlong with the basic lessor accounting model remaining substantially \nunchanged from Topic 840, most of the key definitions and concepts relevant to \nlessor accounting are also consistent with legacy US GAAP. The following are \nexamples. \nTerm Equals \nNet investment in the lease: Lease receivable + unguaranteed residual asset \nLease receivable: PV of the lease payments \n+ PV of guaranteed portion of estimated residual value ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 9}), Document(page\_content='Leases 9 \n1. Executive summary \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Term Equals \nUnguaranteed residual \nasset: PV of unguaranteed portion of estimated residual value \nLease payments: Undiscounted fixed (including in- substance fixed) \npayments \n+ optional payments that are reasonably certain to be \npaid \nDiscount rate for the lease: Rate implicit in the lease, which is … \nThe rate that causes the PV of lease payments + PV of \nestimated residual value = FV of the underlying asset \n(net of related investment tax credits) + capitalizable \ninitial direct costs \nBut a change in the treatment of collectibility \nuncertainties \nUnlike under Topic 840, a lease with collectibility uncertainties can be classified \nas a sales- type lease. If collectibility of the lease payments, plus any amount \nnecessary to satisfy a lessee residual value guarantee, is not probable for a \nsales- type lease, lease payments received (includin g variable lease payments) \nare recognized as a deposit liability (i.e. not recognized as lease income) and the \nunderlying asset generally is not derecognized until collectibility of the \nremaining amounts becomes probable. \nWhen c ollectibility is not probabl e for a lease that otherwise would be a direct \nfinancing lease , it is classified as an operating lease. Lease income recognized \nfor operating leases when collectibility is not probable is limited to cash \nreceived from the lessee until collectibility of sub stantially all the remaining \nlease payments becomes probable. \nIssues arising from significant variable lease \npayments \nLeases with variable lease payments for which a Day 1 loss would result if \nclassified as sales- type or direct financing are required to be clas sified as \noperating leases. This is generally consistent with how such leases were \nclassified under Topic 840. \nAnd a narrower definition of initial direct costs \nThe new definition of initial direct costs includes only those incremental costs \nof a lease tha t would not have been incurred if the lease had not been obtained, \nwhich is narrower t han legacy US GAAP. Some costs, like legal fees and \nallocated internal cos ts, that an entity wa s permitted to capitalize as initial direct \ncosts under Topic 840 are expensed as incurred under Topic 842. For some \nlessors, this may result in recognizing more expenses before the start of a lease \nand higher margins on lease income earned over the lease term. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 10}), Document(page\_content='Leases 10 \n1. Executive summary \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Typical initial direct costs\nInclude Exclude \n— Commissions\n— Payments made to an \nexisting tenant to incentivize \nthat tenant to terminate the lease— Legal fees\n— Costs of evaluating the \nprospective lessee ’s financial \ncondition \n— Costs of negotiating lease \nterms and conditions\n— General overheads \n \nApplicable to both lessees and lessors \nAllocating consideration to lease and non -lease \ncomponents \nTopic 842 only governs the accounting for leases. If there are both lease and \nnon-lease components (e.g. services), an entity applies Topic 842 to the lease \ncomponent (s) and other US GA AP to the non -lease component (s). \nContract\nLease components Non-lease components Not a component\nAllocate consideration in the contractActivities (or lessor \ncosts ) that do not \ntransfer a good or \nservice to the lessee \nThe consideration in the contract is allocated in a way that maximizes the use of \nobservable information. The lessee performs the allocation on a relative stand-\nalone price basis. The lessor follows the transaction price allocation guidance in \nTopic 606 (revenue from contracts with customers) . \nAs the diagram shows, lessee payments of lessor executory costs do not \nrepresent payments for a good or service, and therefore are not non- lease \ncomponents . Examples include payments to cover the lessor’s costs of \nownership, such as property taxes or insurance. Lessee payments of those \ncosts are allocated to the lease and non -lease components in the same manner \nas all other payments in the contract. \nConsequently, those payments are not excluded from lease accounting a s they \nwere under Topic 840. However, a n exception arises for lessors if the lessee’s \npayments of those costs are made directly to a third party (e.g. a taxing authority or insurer) . In those cases, the costs and the lessee’s payments \nthereof are excluded from the lessor’s accounting for the lease. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 11}), Document(page\_content='Leases 11 \n1. Executive summary \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Lessor p ractical expedient for sales and other similar taxes \nLessors may elect to present all funds collected from lessees for sales and \nother similar taxes net of the related sales tax expense . This is an entity -wide \naccounting policy election made for all of the lessor’s leases. \nPractical expedients not to separat e lease and non -lease components \nLessees may elect to account for non- lease components as part of the lease \ncomponent to which they relate. This election is made by class of underlying asset, and the combined component is accounted for a single lease component . \nLessors have a similar option with two main differences: \n— the lease and non- lease components must meet specified criteria to qualify \nto be combined; and \n— the combined component is accounted for under Topic 606 (i.e. as a single \nperformance obligation), rather than under Topic 842 if the non- lease \nelement(s) of the combined component is (are) ‘predominant’; otherwise, \nthe combined component is accounted for as an operating lease. \nSale-leaseback accounting substantially changed \nTopic 842 eliminates sal e-leaseback transactions as an off -balance sheet \nfinancing proposition for lessees. This is because seller -lessees recognize a n \nROU asset and a lease liability in place of the underlying asset (and any asset \nfinancing repaid with the sale proceeds). Unlike Topic 840, the sale -leaseback \nguidance is the same for real estate assets as it is for all other assets (e.g. \nequipment). \nTopic 606 is used by both the seller -lessee and the buyer -lessor to assess \nwhether a sale of the asset from the seller -lessee to the buyer -lessor has \noccurred. Purchase options generally preclude sale accounting, unless (1) the strike price of the repurchase opt ion is the fair value of the asset at the option \nexercise date, and (2) assets that are substantially the same as the underlying \nasset are readily available in the marketplace. This second requirement \nprecludes real estate sale -leaseback transactions with re purchase options from \nqualifying for sale accounting. \nIn addition, sale and finance (previously, capital) leasebacks no longer exist; a \nconclusion that a leaseback would be a finance (sales- type) lease result s in a \nconclusion that the sale- leaseback transaction does not qualify as a sale (seller -\nlessee)/purchase (buyer -lessor) . \nHas there been a sale of the underlying asset ?\nApply sale -leaseback \naccountingAccount for the entire \ntransaction as a \nfinancingYes No ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 12}), Document(page\_content='Leases 12 \n1. Executive summary \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. If the sale- leaseback transaction does not qualify as a sale /purchase, both the \nseller -lessee and the buyer -lessor account for the transaction as a financing \narrangement. The seller -lessee recognizes a financial liabil ity and continues to \nrecognize and depreciate the asset, while the buyer -lessor recognizes a \nfinancial asset (i.e. a receivable). \nIf the sale- leaseback transaction does qualify as a sale /purchase of the \nunderlying asset, the seller -lessee recognizes the entire gain from the sale, \nsubject to a djustment for off- market terms, at the time of sale rather than over \nthe leaseback term ; this was typically the result under legacy US GAAP. The \nbuyer -lessor accounts for the purchase of the underlying asset in the same \nmanner as any other purchase of a nonfinancial asset, subject to a requirement \nto adjust the purchase price of the underl ying asset for off -market terms . \nExpanded qualitative and quantitative disclosures \nTopic 842 requires lessees and lessors to disclose significant qualitative and \nquantitative information about their leases . Entities need to maintain appropriate \nsyste ms, processes and internal controls to completely and accurately capture \nthe lease data necessary to provide these disclosures. \nThe following are examples. \nQualitative disclosures \nLessees Lessors \n— Significant judgments and \nassumptions, such as whether a \ncontract contains a lease, stand -\nalone prices for lease and non -lease \ncomponents, and the discount rate \nfor the entity’s leases \n— Information about the nature of \nleases, such as the terms and \nconditions of variable lease \npayments, extension and termination \noptions, purchase options, and \nresidual value guarantees — Significant accounting judgments \nand estimates \n— Information about the nature of \nleases, such as the nature of variable \npayment arrangements, and termination, renewal, and purchase \noptions \n— Information about how the lessor \nmanages residual asset risk, \nincluding information about residual \nvalue guarantees and other means of \nlimiting that risk. \n \nQuantitative disclosures \nLessees Lessors \n— Operating lease cost \n— Amortization of finance lease right -\nof- use assets and interest on \nfinance lease liabilities \n— Variable lease cost \n— Weighted- average remaining lease \nterm, and weighted- average \ndiscount rate \n— Maturity analysis of lease liabilities — Maturity analysis of lease \nreceivables for sales -type and direct \nfinancing leases and of lease \npayments for operating leases \n— Selling profit (or loss) recognized at lease commencement and interest \nincome for sales -type and direct \nfinancing leases \n— Operating lease income \n— Variable lease income ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 13}), Document(page\_content='Leases 13 \n1. Executive summary \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Modified retrospective transition, with two options \nfor date of initial application \nTopic 842 requires a modified retrospective transition, with the cumulative \neffect of transition, including initial recognition by lessees of lease (right -of-use) \nassets and lease liabilities for existing operating leases, as of either: \n— the effective date (the ‘effective date method’); or \n— the beginning of the earliest comparative period pr esented (the \n‘comparative method’). \nUnder the effective date method, the entity’s comparative period reporting is \nunchanged. Comparative reporting periods are presented in accordance with \nTopic 840, while periods subsequent to the effective date are presented in \naccordance with Topic 842. The following timeline illustrates this . \nComparative period\nTopic 840Comparative period\nTopic 840Current period\nTopic 842December 31, 2019Effective date \n(date of adoption )\nJanuary 1, 2019 January 1, 2018Beginning of earliest \nperiod presented\nJanuary 1, 2017\n \nIn contrast , under the comparative method, the entity’s date of initial application \nis the beginning of the earliest comparative period presented. The Topic 842 \ntransition guidance is then applied to all comparative periods presented. \nIf a calendar year -end public business entity adopts Topic 842 using the \ncomparative method, then the following are the relevant dates. \nComparative periods\n(Apply Topic 842 transition provisions )Current period\n(Apply Topic 842 )December 31, 2019Effective date \n(date of adoption )\nJanuary 1, 2019 January 1, 2018Beginning of earliest \nperiod presented \n(date of initial application )\nJanuary 1, 2017\n \nUnder either transition method, Topic 842 includes practical expedients \nintended to ease the burden of adoption on preparers. \nPackage of practical \nexpedients (all or \nnothing)1 Use of hindsight2 Land easements \nAn entity may elect not to \nreassess: \n— whether expired or \nexisting contracts \ncontain leases under An entity may use \nhindsight in determining \nthe lease term, and in \nassessing the likelihood that a lessee purchase \noption will be exercised. An entity may elect not to reassess whether land \neasements meet the \ndefinition of a lease if they were not accounted for as \nleases under Topic 840. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 14}), Document(page\_content='Leases 14 \n1. Executive summary \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Package of practical \nexpedients (all or \nnothing)1 Use of hindsight2 Land easements \nthe new definition of \na lease; \n— lease classification for \nexpired or existing \nleases; and \n— whether previously capitalized initial \ndirect costs would \nqualify for \ncapitalization under \nTopic 842. \nEach of the three practical expedients may be elected separately from the other two practical expedients. \nPractical expedients are applied consistently to all leases – i.e. all leases for which the \nentity is a lessee or a lessor – for leases that commence before the effective date. \nNotes: \n1. The practical expedients do not grandfather previous errors in the application of Topic \n840 – e.g. in identifying leases or in lease classification. \n2. Applies to estimates and judgments in applying lease accounting, but does not apply to \nchanges in fact s such as those resulting from changes to the terms and conditions of a \nlease , or changes to indices or rates. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 15}), Document(page\_content='Leases 15 \n2. Scope \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 2. Scope \nDetailed contents \nHow the standard works \n2.1 Explicit scope exclusions \nObservation \nAssets under construction are outside the scope of Topic 842 \nQuestions \n2.1.10 Natural resources scope exclusion – production and \ndevelopment activities \n2.1.15 Natural resources scope exclusion – rights of use in addition \nto the natural resources rights \n2.1.20 Natural resources scope exclusion – different parties own \nthe mineral rights and the land \n2.1.30 Natural resources scope exclusion – adjacent land rights \n2.1.40 Applicability of Topic 842 to ‘bearer plants’ \nExample \n2.1.10 Natural resources scope exclusion – various scenarios \n2.2 Interaction with other standards \n2.2.1 Derivative instruments \n2.2.2 Service concession arrangements \nQuestion \n2.2.10 Accounting for a foreign exchange component in an \noperating lease contract \n2.3 In the scope of Topic 842 \n2.3.1 Non- core assets \n2.3.2 Long -term leases of land \n2.3.3 Certain sales with repurchase rights – supplier’s perspective \nObservation \nLeases of non -core assets are in scope \nQuestions \n2.3.10 Land easements \n2.3.20 Sales of out -of-scope nonfinancial assets with a seller \nrepurchase right or obligation \n2.3.30 Accounting for sales with repurchase rights by suppliers and customers\n \n2.3.40 Heat supply contracts for nuclear fuel ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 16}), Document(page\_content='Leases 16 \n2. Scope \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 2.4 Differences/changes in scope \nComparison to legacy US GAAP \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 17}), Document(page\_content='Leases 17 \n2. Scope \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. How the standard works \nTopic 842 applies to arrangements that meet the definition of a lease except as \notherwise indicated in section 2.1. Leases of the following are in the scope of \nTopic 842: \n— non-core assets; \n— long-term leases of land; and \n— certain sales with repurchase rights (from the supplier’s perspective). \nAn operating entity’s involvement with a grantor’s infrastructure in a service concession arrangement in the scope of Topic 853 (service concession \narrangements ) is not a lease in the scope of Topic 842. \nWe believe the scope of Topic 842 was intended to be consistent with that of \nTopic 840. \n[ASU 2016- 02.BC110] \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 18}), Document(page\_content='Leases 18 \n2. Scope \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 2.1 Explicit s cope exclusions \n Excerpt from ASC 842-10 \n15 Scope and Scope Exceptions \nGeneral \n15-1 An entity shall apply this Topic to all leases , including subleases . Because \na lease is defined as a contract , or part of a contract, that conveys the right to \ncontrol the use of identified property, plant, or equipment (an identified asset) \nfor a period of time in exchange for consideration, this Topic does not apply to \nany of the following: \na. Leases of intangible assets (see Topic 350, Intangibles —Goodwill and \nOther). \nb. Leases to explore for or use minerals, oil, natural gas, and similar \nnonregenerative res ources (see Topics 930, Extractive Activities— Mining, \nand 932, Extractive Activities—Oil and Gas). This includes the intangible \nright to explore for those natural resources and rights to use the land in \nwhich those natural resources are contained (that is, unless those rights of \nuse include more than the right to explore for natural resources), but not \nequipment used to explore for the natural resources. \nc. Leases of biological assets, including timber (see Topic 905, Agriculture). \nd. Leases of inventory (see T opic 330, Inventory). \ne. Leases of assets under construction (see Topic 360, Property, Plant, and \nEquipment). \n \n2.1.10 Topic 842 is an inclusive standard, and applies to all leases (including \nsubleases) unless it is specifically excluded from its scope . The following are the \nspecific scope exclusions from Topic 842. [842- 10-15-1] \nExcludes leases of/to … Commentary \nIntangible assets Intangible assets and rights to use intangible assets \ncontinue to be accounted for under Topic 350 (goodwill \nand other intangibles ). \nExplore for or use non-\nregenerative resources \n(e.g. minerals, oil or \nnatural gas) — The scope exclusion includes the intangible right to \nexplore for those natural resources, and rights t o use \nthe land in which those natural resources are \ncontained, unless those rights of use include more \nthan the right to explore for natural resources (e.g. \nthe right to explore and/or develop land) . \n— Rights to us e equipment used to explore for natural \nresources are in the scope of Topic 842. \nBiological assets \n(e.g. crops) The scope exclusion includes leases of timber , to be \nconsistent with Topic 840. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 19}), Document(page\_content='Leases 19 \n2. Scope \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Excludes leases of/to … Commentary \nInventory Inventory is a defined term in US GAAP; only leases of \nassets that meet that definition are excluded from the \nscope of Topic 842. However, consider the following: \n— A determination of whether the asset is ‘inventory’ \nshould be from the perspective of the cus tomer \n(lessee) – i.e. whether the asset would be inventory \nor instead an item of property, plant or equipment for the customer (lessee). The arrangement should not \nbe scoped out of Topic 842 solely because the asset \nwas classified as inventory by the suppl ier (lessor). \nManufacturers and dealers frequently lease assets, \nsuch as vehicles or machinery, that they classify as \n‘inventory’ because they both sell and lease it to \ncustomers. \n— The description of an asset as ‘inventory’ does not in \nitself mean that a l ease of that asset is outside the \nscope of Topic 842. For example, sometimes entities \nrefer to a collection of assets, such as spare parts, as inventory. If those spare parts are depreciable assets \nunder other accounting guidance, a right to use those \nassets is in the scope of Topic 842. \nAssets under \nconstruction — If a lessee controls the asset under construction \nbefore the commencement date of the lease, the \ntransaction is in the scope of the sale -leaseback \nguidance. \n— Topic 842 includes guidance (and examples) about \nwhen a lessee controls an asset that is under \nconstruction before lease commencement, and \nguidance on accounting for costs associated with the \nconstruction or design of the underlying asset in a \nlease. \nSection 9.4 discusses determining when a lessee controls \nan asset that is under construction and the resulting \naccounting. \n \n Observation \nAssets under construction are outside the scope of \nTopic 842 \n2.1.20 The Board observed that there was no clear conceptual basis for \nstipulating that an entity cannot lease an asset that is under construction. \nHowever, the Board concluded that the additional complexity that this concept \nwould introduce into lease accounting was not justified by the relatively few \nsituations (in relation to the overall volume of leases in the scope of Topic 842) \nin which those leases would exist. In reaching its conclusion, the Board further \nnoted that in many cases it might be difficult to distinguish when a lessee \ncontrols the asset that is under construction itself, or controls the right to use \nthat asset before construction is complete. [ASU 2016- 02.BC110(e) ] \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 20}), Document(page\_content='Leases 20 \n2. Scope \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 2.1.10 \nNatural resources scope exclusion – production and \ndevelopment activities \nIs a right granted to use land for production and \ndevelopment activities of natural resources outside the \nscope of Topic 842? \nBackground: The natural resources scope exclusion in Topic 842 refers only to \n“leases to explore for or use minerals, oil…” [emphasis added]. Therefore, the \nquestion has arisen about whether the right to use an entity’s land for purposes \nthat include production and development of natural resources is outside the \nscope of Topic 842. [842- 10-15-1(b)] \nInterpretive response: Yes, provided the contract does not al so give the \ngrantee rights to use the land that are unrelated to exploring for, producing, developing, or using the natural resources contained in the land. We believe the \nnatural resources scope exclusion applies to land use rights that permit the \ngrantee to undertake production and development activities related to minerals, \noil, natural gas and similar non- generative resources. The basis for conclusions \nto ASU 2016 -02 suggests that the natural resources scope exclusion is \nintended to be consistent with that in Topic 840, which historically considered \nland use arrangements such as these to be outside its scope.\n [ASU 2016-\n02.BC110( b)] \n \n Question 2.1.15 \nNatural resources scope exclusion – rights of use in \naddition to the natural resources rights \nIf natural resources rights are bundled with additional land-\nuse rights, are the natural resource rights still excluded from the scope of Topic 842? \nBackground: The natural resources scope exclusion in Topic 842 states that \nintangible rights to explore for natural resources and the right to use the land in \nwhich those natural resources are contained are excluded from the scope of \nTopic 842 “unless those rights of use include more than the right to explore for natural resources.” \n[842- 10-15-1(b)] \nTherefore, the question has arisen about whether this means that a grantee’s \nright to explore for, produce, develop or use natural resources is outside the scope of Topic 842 when the contract also includes additional land- use rights. \nInterpretive response: Yes. If a n entity’s land -use rights include natural \nresource rights and other land- use rights, the natural resource rights remain \noutside the scope of Topic 842. Some have questioned whether the quotation in the background means that land- use rights that include na tural resource \nrights and other land- use rights are in the scope of Topic 842 in their entirety. \nHowever, we believe that language was intended to ensure that only natural \nresource rights were excluded from the scope of Topic 842, and that the natural \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 21}), Document(page\_content='Leases 21 \n2. Scope \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. resources scope exclusion could not be misused to avoid lease accounting for \nother land- use rights with which natural resource rights could be bundled. \nThis conclusion means that natural resource rights bundled with other land -use \nrights (assuming those other land -use rights meet the definition of a lease) \nshould be accounted for as a non- lease component. \n— If the non- separation practical expedient is not elected, the natural \nresources non- lease component will be separated from the other land -use \nrights granted. \n— If the non- separation practical expedient is elected (see section 4.4.1): \n– lessees will combine the natural resource non- lease component with \nthe other land- use rights and account for the combined component as a \nsingle lease component; and \n – lessors will assess whether the natural resource non- lease \ncomponent qualifies for combination with the other land- use rights (see \nparagraph 4.4.51) and if so, account for the combined component under \nTopic 842 or Topic 606, as appropriate (see paragraphs 4.4.53 – 4.4.55). \n \n Question 2.1.20 \nNatural resources scope exclusion – different \nparties own the mineral rights and the land \nIs a right to use land that contains natural resources to \nwhich the entity has mineral rights outside the scope of \nTopic 842 if the landowner is a different party from the \nowner of the mineral rights? \nBackground: The owner of the land that contains the natural resources (e.g. oil \nor natural gas) may not be the holder of the rights to those natural resources. \nAn entity may e nter into separate contracts with (1) a holder of rights to explore \nfor, develop and produce those natural resources and (2) the landowner for \nrights to use the land that contains the natural resources. \nIn this scenario, the question has arisen about whet her the contract with \nthe owner of the land that contains the natural resources is in the scope of \nTopic 842. \nInterpretive response: Yes. Topic 842 states that the natural resources scope \nexclusion “includes the intangible right to explore for those natura l resources \nand rights to use the land in which those natural resources are contained.” \nThere is nothing in Topic 842 (or the basis for conclusions to ASU 2016- 02) that \nsuggests this scope exclusion is affected either by (1) who the landowner is (e.g. a pa rty different from the mineral rights owner) or (2) the fact that the party \ngranting the right to use the land that contains the minerals is different from the party granting the intangible right to explore for or use the natural resources. \n[842- 10-15-1(b)] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 22}), Document(page\_content='Leases 22 \n2. Scope \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 2.1.30 \nNatural resources scope exclusion – adjacent land \nrights \nIs a right to use land to access a property that contains \nnatural resources outside the scope of Topic 842? \nBackground: An entity may have rights to explore for or use natural resources \non a given property. To access that property, the entity may enter into a \ncontract with an adjacent landowner for rights to cross or otherwise use that \nlandowner’s property to access the property that contains the natural resources \nto which the entity has rights. \nIn this scenario, the question has arisen about whether the contract to use the \nadjacent property is outside the scope of Topic 842 because of the natural resources scope exclusion. \nInterpretive response: No. The natural resources scope exclusion applies only \nto rights to use the land that contains the natural resources to which the entity has exploration or usage rights. A right to use land that does not contain natural \nresources to which the grantee has exploration or usage rights, such as the adjacent property described in the background, is not subject to the natural \nresources scope exclusion. Therefore, that right of use must be assessed to determine whether it is a lease (see c hapter 3). \nA right to cross or otherwise use a third party’s land to access a property that contains natural resources to which the entity has rights may be a land \neasement (see Question 2.3.10). \n \n Example 2.1.10 \nNatural resources scope exclusion – various \nscenarios \nScenario 1: Natural resources depleted unexpectedly before end of \ncontract \nABC Corp. is a mining company that mines numerous properties throughout the \nUnited States for various minerals (e.g. gold, si lver and aggregate rock). ABC \nhas long -term rights (40 years) to explore for, develop and produce minerals \nfrom a property. \nAt inception, ABC reasonably expected to explore for, develop and produce \nminerals for most or all of the 40- year term. However, 25 years after inception \nof those rights, ABC believes all of the minerals that existed on the property, or \nthat can be mined cost effectively, have been extracted. Therefore, ABC is no \nlonger mining the land – i.e. no longer exploring for, developing or pro ducing \nminerals from the property. ABC continues to pay land use rights to the property owner under the non- cancellable agreement, but is now using the land \nsolely for storing stockpiles of the extracted minerals. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 23}), Document(page\_content='Leases 23 \n2. Scope \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The natural resources scope exclusion app lies to the arrangement initially. It \ncontinues to apply at the end of Year 25 because the terms and the conditions \nof the contract have not been changed, and an entity would reassess whether a \ncontract is or contains a lease only when the terms and condit ions of the \ncontract are changed. \nScenario 2: No intention to mine the natural resources (1) \nAssume the same facts as Scenario 1 except that, similar to other \narrangements ABC has entered into, at inception of the contract, ABC has no \nintention to mine the land. ABC has entered into this agreement for ‘protective’ \npurposes – i.e. so competitors cannot mine the land. There is nothing in the \nagreement that either requires ABC to mine the land or precludes it from \ndoing so. \nThe natural resources scope exclusion applies. This is because the lease \nidentification guidance in Topic 842 does not differentiate between economic \nbenefits derived from using the identified asset (e.g. using the land to mine) and \neconomic benefits derived from holding the asset (e.g. for protective reasons). \nApplicability of the scope exclusion is not based on how the grantee chooses to \nderive economic benefit from its rights. \nScenario 3: No intention to mine the natural resources (2) \nDEF Corp. enters into a 40- year contract with Landowner that grants DEF the \nright to construct a shopping mall. DEF does not have mining operations and \nhistorically has not entered into mineral rights arrangements for the purpose of \nsubleasing those rights. Additionally, there is no evidence that the property or \nsurrounding areas contain meaningful mineral deposits. However, DEF and \nLandowner include in the contract a provision granting DEF the right to explore \nfor, develop and produce whatever minerals exist in the land for the duration of the contrac t. \nThe natural resources scope exclusion does not apply. In this scenario, the \ncontract between DEF and Landowner is not ‘to explore for or use minerals, oil, \nnatural gas, and similar nonregenerative resources’, and DEF’s rights of use \nclearly include more than the right to explore for, produce or develop natural \nresources. Instead, the contract is principally to permit DEF to construct a shopping mall on the property. To the extent there are substantive mineral \nexploration and use rights in the arrangement , DEF should account for those \nrights as a non- lease component of the contract. \nScenario 4: Some of the land restricted as to grantee’s use \nGHI Corp. enters into a contract that grants it rights to explore for, develop and \nproduce minerals from a property. The contract stipulates that a specified \nsection of the property may not be mined because of its close proximity to the \ngrantor’s farm – mining there could affect the grantor’s crops. \nBecause of the restriction, there are two units of account. \n— The natura l resources scope exclusion applies to the non- restricted section \nof the property because GHI has the right to explore for, develop and \nproduce minerals from that section. \n— The accounting for the restricted section of the property depends on GHI’s \nrights over it. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 24}), Document(page\_content='Leases 24 \n2. Scope \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. GHI has no rights to use the restricted section of the property. In that case, \nthere is no accounting by GHI related to the restricted section of the property. \nGHI has rights to use the restricted section of the land. The rights to use the \nrestricted land do not qualify for the natural resources scope exclusion. Even \nthough there is a single contract and a single landowner/grantor, this situation is \nnot substantively different from that in Question 2.1.30. The fact that the land \nmay contain natural resources (unlike the fact pattern in Question 2.1.30) is not relevant because GHI is not permitted to explore for, develop or produce those \nresources. GHI would assess whether its rights to use the restricted section of the land meet the definition of a l ease (see chapter 3) \n \n Question 2.1.40 \nApplicability of Topic 842 to ‘bearer plants’ \nAre leases of ‘bearer plants’ outside the scope of Topic 842? \nBackground: Topic 842 and IFRS 16 both exclude leases of biological assets \nfrom their scope. However, IFRS 16 refers to biological assets that are in the scope of the relevant standard on agriculture (IAS 41). \n[842- 10-15-1(c), IFRS 16.3(b)] \nBearer plants are excluded from the scope of IAS 41, and therefore are not \nsubject to the biological assets scope exception in IFRS 16. IFRS® Accounting \nStandards define a ‘bearer plant’ as a living plant that: [IAS 41.5] \n— is used in the production or supply of agricultural produce; \n— is expected to bear produce for more than one period; and \n— has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales. \nUS GAAP does not define ‘biological asset’ or ‘bearer plant’. However, because \nTopic 842 includes the biologica l assets scope exception in Topic 842 principally \nfor reasons of convergence with IFRS 16, questions have arisen about whether \nbearer plants qualify for this scope exception. \nInterpretive response: Yes, leases of plants that would meet the definition of a \nbearer plant under IFRS Accounting Standards are outside the scope of Topic \n842. The following considerations support this conclusion. \n— While US GAAP does not define a biological asset, the basis for conclusions \nto ASU 2016 -02 refers to ‘plants and living animals’ as biological assets, \nwithout distinguishing between types of plants. \n[ASU 2016- 02.BC110(c)] \n— The basis for conclusions to ASU 2016- 02 also discusses that the Board \nwanted the accounting requirements for biological assets to be contained in \na single Topic – i.e. Topic 905 (agriculture). Topic 905 applies to the \nactivities of growing fruits including citrus, grapes, berries, other fruits, and nuts, which frequently involve the use of plants that meet the definition of \nbearer plants under IFRS Accounting Standards . \n[ASU 2016- 02.BC110(c)] \n— When the Board first decided that it would exclude biological assets from \nthe scope of Topic 842 (i.e. before issuance of the FASB’s 2009 Discussion \nPaper on leases), bearer plants were not yet scoped out of IAS 41; and \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 25}), Document(page\_content='Leases 25 \n2. Scope \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. when IAS 41 was am ended subsequently, the Board did not consider \nsimilar amendments to US GAAP. \n \n2.2 Interaction with other s tandards \n Excerpt from ASC 842 -10 \n> Other Considerations \n15-43 Paragraph 815 -10-15-79 explains that leases that are within the scope of \nthis Topic are not derivative instruments subject to Subtopic 815- 10 on \nderivatives and hedging although a derivative instrument embedded in a lease \nmay be subject to the requirements of Section 815- 15-25. Paragraph 815- 10-\n15-80 explains that residual value guarantees that are subject to the guidance \nin this Topic are not subject to the guidance in Subtopic 815- 10. Paragraph 815-\n10-15-81 requires that a third- party residual value guarantor consider the \nguidance in Subtopic 815- 10 for all residual value guarantees that it provides to \ndetermine whether they are derivative instruments and whether they qualify \nfor any of the scope exceptions in that Subtopic . \n \n Excerpt from ASC 815 -10 \n>>> Leases \n15-79 Leases that are within the scope of Topic 842 are not derivative \ninstruments subject to this Subtopic, although a derivative instrument embedded \nin a lease may be subject to the requirements of paragraph 815-15-25-1. \n>>> Residual Value Guarantees \n15-80 Residual value guarantees that are subject to the requirements of \nTopic 842 on leases are not subject to the requirements of this Subtopic. \n15-81 A third -party residual value guarantor shall consider the guidance in this \nSubtopic for all residual value guarantees that it provides to determine whether \nthey are derivative instruments and whether they qualify for any of the scope \nexceptions in th is Subtopic. The guarantees described in paragraph 842- 10-15-\n43 for which the exceptions of paragraphs 460- 10-15-7(b) and 460- 10-25-1(a) \ndo not apply are subject to the initial recognition, initial measurement, and \ndisclosure requirements of Topic 460. \n \n2.2.1 Derivative instruments \n2.2.10 Leases that are within the scope of Topic 842 are not derivative \ninstruments. Residual value guarantees that are subject to the guidance in ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 26}), Document(page\_content='Leases 26 \n2. Scope \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Topic 842 are not subject to the guidance in Topic 815 (derivatives and \nhedging) ; residual value guarantees are disc ussed in section 5.4. 6. [842- 10-15-43] \n2.2.20 However, a derivative instrument embedded in a lease may be subject to \nthe requirements of Topic 815. For example, a third- party residual value \nguarantor is required to consider the guidance in Subtopic 815- 10 for all \nresidual value guarantees that it provides to determine whether they (1) are \nderivative instruments, and (2) qualify for any of the scope exceptions under \nSubtopic 815-10. [815- 10-15-80 – 15-81] \n \n Question 2.2.10 \nAccounting for a foreign exchange component in an \noperating lease contract \nIs an embedded foreign exchange component separated \nfrom an operating lease as an embedded derivative? \nBackground: Consider a scenario in which Lessee LE, a US company whose \nfunctional currency is the US dollar, enters into a lease for a building from \nLessor LR, a foreign- owned company whose functional currency is the \nJapanese yen. The lease payments due to LR are payable in euros, which is not the currency in which the price of an aircraft lease is routine ly denominated in \ninternational commerce. The lease is classified as an operating lease. \nInterpretive response: It depends. There are differing views about this \nquestion. In the absence of further or changed guidance from the FASB or SEC \nstaff, we believe either of the following views is reasonable. \nView A: No – Topic 815 scope exception applies by analogy \nUnder Subtopic 815 -15, foreign currency transactions are not considered to \ncontain embedded foreign currency derivatives if the transactions are: \n[815- 15-15-\n5] \na. monetary items; \nb. have principal payments, interest payments or both denominated in a \nforeign cur rency; and \nc. are subject to the requirement in Subtopic 830- 20 to recognize any foreign \ncurrency transaction gain or loss in earnings. \nBased on discussions with the FASB staff, we believe that when criteria (a) and (c) are met, it is reasonable for a lessee to conclude that criterion (b) is also met \nby analogy when the operating lease payments are denominated in a foreign \ncurrency, despite that those payments do not include explicit principal or \ninterest elements. \n(a) Monetary item \nThe lease liability is a monetary liability (see paragraph 6.4.240). Therefore, an \noperating lease transaction gives rise to a monetary item and meets criterion \n(a). \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 27}), Document(page\_content='Leases 27 \n2. Scope \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. (c) Foreign currency transaction gains or losses in earnings \nForeign currency transaction gains or l osses resulting from remeasuring the \nlease liability and ROU asset into the lessee’s functional currency (see \nparagraph 6.4.240) each period are recognized in current period earnings. \nTherefore, criterion (c) is met. \nView B: It depends – Topic 815 scope exception does not apply \nUnder this view, the paragraph 815- 15-15-5 scope exception does not apply; it \napplies only to derivatives embedded in financial instruments. Instead, \nconsistent with Example 13 (Case S) in Subtopic 815- 15, a lessee should apply \nparag raph 815- 15-15-10 to determine if an operating lease includes an \nembedded foreign exchange derivative. Depending on that evaluation, the \nlessee may or may not be required to bifurcate an embedded foreign exchange \nderivative. [815- 15-15-10, 55 -213 – 55-215] \nApplying View B to the background example, Lessee LE would bifurcate an \nembedded foreign exchange derivative. \n \n2.2.2 Service concession arrangements \n Excerpt from ASC 853 -10 \n> Entities \n15-2 The guidance in this Topic applies to the accounting by operating entities \nof a service concession arrangement under which a public -sector entity grantor \nenters into a contract with an operating entity to operate the grantor’s \ninfrastructure. The operating entity also may provide the construction, \nupgrading, or maintenance services of the grantor’s infrastructure. \n> The Operating Entity’s Rights over the Infrastructure \n25-2 The infrastructure that is the subject of a service concession arrangement \nwithin the scope of this Topic shall not be recognized as property, plant, and \nequipment of the operating entity. Service concession arrangements within the \nscope of this Topic are not within the scope of Topic 842 on leases. \n \n2.2.30 A service concession arrangement in the scope of Topic 853 is an \narrangement between a public -sector entity grantor and an operating entity \nunder which the operating entity operates the grantor’s infrastructure (e.g. \nairports, roads and bridges) and may al so provide construction, upgrade or \nmaintenance services. [853- 10-15-2] \n2.2.40 Although there is no scope exclusion for service concession \narrangements in Topic 842 itself, the consequential amendments to Topic 853 \nare explicit that the right to use the i nfrastructure in a service concession \narrangement is not in the scope of Topic 842. [853- 10-25-2] \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 28}), Document(page\_content='Leases 28 \n2. Scope \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 2.3 In the s cope of Topic 842 \n2.3.1 Non-core assets \n2.3.10 Non- core assets, such as a corporate jet or an administrative office, are \nnot used in an entity’s primary operations. However, leases of non- core assets \nare not excluded from the scope of Topic 842. \n \n Observation \nLeases of non- core assets are in scope \n2.3.20 The Board decided not to exclude non- core assets from the scope of \nTopic 842 for the following reasons . [ASU 2016 -02.BC111 –BC112] \n— US GAAP does not distinguish core and non -core assets that are purchase d \n(or otherwise acquired) for purposes of recognition and measurement; \ntherefore, it would be inconsistent to create such a distinction for leased \nassets. \n— Conceptually, the lease of a non- core asset creates no less of a ROU asset \nor lease liability than the lease of a core asset; the same thinking applies to non-core assets that an organization purchases on a financed basis. \nExcluding leases of non -core assets from the scope of Topic 842 would \nhave left material ROU assets and lease liabilities unrecognized. \n \n2.3.2 Long -term leases of land \n2.3.30 The scope of Topic 842 does not exclude long- term leases of land (e.g. \n99- or 999- year leases). Although there is an argument that such long- term \nleases are economically similar to the purchase or sale of land, the Board \ndecided against a scope exclusion. This was principally because there is no \nconceptual basis for differentiating long- term leases of land from leases of other \nassets, and inevitably any definition of a long- term lease of land would be \narbitrary. [ASU 2016 -02.BC113] \n \n Question 2.3.10 \nLand easements \nAre land easements in the scope of Topic 842 ? \nBackground: A land easement is, in general, a right to use and/or enter (or \ncross) land owned by another party for a specific purpose, for which the rights vary depending on the easement. Land easements may be perpetual or for a \ndefined term, may be prepaid or paid over tim e, and may provide for exclusive \nor nonexclusive (shared) use of the land. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 29}), Document(page\_content='Leases 29 \n2. Scope \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Land easements are used in a variety of industries, but are especially common \nin the energy, utilities, transportation and telecom industries . Pre-Topic 842, \ndiversity in practice exist ed in the accounting for land easements . Some entities \napplied Topic 840, and others account ed for land easements under other \nguidance (e.g. as an intangible asset in the scope of Topic 350 or as part of the \ncost of property, plant or equipment in the scope of Topic 360). Th e view that a \nland easement is an intangible asset was based on Example 10 in Subtopic 350-\n30, which, before ASU 2018- 01, describe d the perpetual land easements in that \nexample as intangible assets without reference to evaluating whether the \neasements meet the definition of a lease. [350- 30-55-29 – 55-32] \nInterpretive response: Yes. The Board has affirmed that land easements are in \nthe scope of Topic 842 because an easement is, by nature, a right to use \nidentified property. Therefore, a land easement should be accounted for as a lease if it meets the definition of a lease. Land easements should be accounted \nfor under other guidance (e.g. Topics 350 or 360) only if they do not meet the \nTopic 842 definition of a lease. Questions 3.1.10, 3.2.20 and 3.3.90 discuss \nrelevant considerations for determining whether land easements meet the definition of a lease. \n[842- 10-15-1] \nTo clarify that land easements cannot be accounted for as intangible assets \nunless they do not meet the Topic 842 definition of a lease, the Board issued \nASU 2018 -01, which amends Example 10 in Subtopic 350- 30. The amendment \nclarifies that the perpetual easements in the example were first determined not to meet the definition of a lease before being accounted for as intangible assets. \nTransition practical expedient \nIn ASU 2018- 01, the Board also amended Topic 842 to provide a transition \npractical expedient that allows an entity to grandfather its accounting for land \neasements that commence before the effective date. Entities electing this \nexpedient will continue to account for those land easements in the same \nmanner as they did before adoption of Topic 842 until they expire, unless they \nare modified on or after the effective date. For further discussion, see \nsections 13A.2 .4 and 13B.2 .4. \n \n2.3.3 Certain sales with repurchase rights – supplier’s \nperspective \n2.3.40 In addition to those transactions in the scope of Topic 842, some \narrangements in the scope of Topic 606 or Topic 610 (other income) , in which \nan entity sells a nonfinancial asset to another party, but with the right or \nobligation to repurchase that asset from the customer, are accounted for as \nleases by the supplier. [606- 10-55-66 – 55-78, ASU 2014 -09.BC427] \n— Forward or call option. If an entity sells an asset and also has an \nobligation or a right to repurchase the ass et, the entity accounts for the \narrangement as a lease if it can or must repurchase the asset for an amount \nthat is less than its original selling price. However, i f a call option is non-\nsubstantive, it should be ignored; this is for consistency with the general \nrequirement for any non- substantive term in a contract. [606- 10-55-68, \nASU 2014- 09.BC427] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 30}), Document(page\_content='Leases 30 \n2. Scope \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — Put option. If an entity sells an asset and also has an obligation to \nrepurchase the asset at the customer’s request, the entity acc ounts for the \narrangement as a lease if the customer has a ‘significant economic \nincentive’ to require the entity to repurchase the asset. [606- 10-55-72] \n2.3.50 The Board’s rationale for requiring these arrangements to be accounted \nfor as leases by the supplier is that the combined effect of the sale and repurchase agreement in each case is that the entity does not transfer control \nof the asset to the customer. I nstead, the arrangement merely permits the \ncustomer to control the use of the asset for a period of time (which may not be \ndefined) in exchange for consideration. \n[ASU 2014- 09.BC424– BC431] \n \n Question 2.3.20 \nSales of out-of-scope nonfinancial assets with a \nseller repurchase right or obligation \nShould sales of assets, which if leased would be outside the \nscope of Topic 842, subject to a seller repurchase right or obligation be considered leases by analogy? \nInterpretive response: The repurchase agreements guidance in Topic 606 \napplies to the sale of any nonfinancial asset, which includes assets that, if \nleased, would be outside the scope of Topic 842 – e.g. intangible or \nbiological assets. \nTherefore, it is unclear whether the Board intends for entities in this scenario to \nanalogize to the leases guidance for sales of such assets or whether those \nrequirements do not apply to arrangements for the sale of such assets. \n \n Question 2.3.30 \nAccount ing for sales with repurchase rights by \nsuppliers and customers \nHow might the accounting for sales with repurchase rights \nbe different for suppliers vs. customers? \nInterpretive response: Topic 606 and Topic 610 do not apply to the customer \nin a sale transact ion. Consequently, the customer in a sale transaction that will \nbe accounted for as a lease by the supplier will not account for that transaction \nas a lease unless the arrangement meets the definition of a lease in Topic 842 (see chapter 3). \nCustomers will generally apply ot her guidance – e.g. Topic 360 ( property, plant \nand equipment) or Topic 330 (inventory) – in determining whether, and how, to \naccount for the purchase. Because there is limited guidance in US GAAP about \nwhether a purchase of an asset has occurred, we believe customers in these \narrangements with repurchase provisions may still conclude that they have \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 31}), Document(page\_content='Leases 31 \n2. Scope \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. purchased the asset even if Topic 606 or Topic 610 requires the supplier to \naccount for the transaction as a lease. \n \n Question 2.3.40 \nHeat supply contracts for nuclear fuel \nAre heat supply contracts for nuclear fuel in the scope of \nTopic 842? \nBackground: Heat supply contracts, sometimes called ‘burn up’ contracts or \nnuclear fuel leases, are contracts that provide for payment by the user -lessee \nbased on nuclear fuel usage in the period plus a charge for the unrecovered \ncost base. \nInterpretive response: Topic 840 explicitly include d heat supply contracts for \nnuclear fuel that meet the definition of a lease within the scope of the lease \naccounting requirements, while the guidance in Topic 842 does not. However, \nbecause we believe the scope of Topic 842 was intended to be consistent with \nthat of Topic 840, and because nuclear fuel leases are not explicitly excluded \nfrom the scope of Topic 84 2, entities will have to consider whether such \narrangements meet the definition of a lease (see chapter 3). [840- 10-15-9, 55- 7] \n \n2.4 Differences/changes in s cope \n2.4.10 The Board decided to fundamentally retain the scope of the legacy leasing \nguidance in its new leasing guidance, which means that there are only minor \ndifferences in scope between Topic 842 and Topic 840. [ASU 2016- 02.BC110] \n \n Comparison to legacy US GAAP \nNo major changes to the scope of the leases topic \n2.4.20 The scope of Topic 842 is substantially the same as Topic 840. Both \nTopics ’ scopes include leases of tangible assets, long- term leases of land, \nsubleases and sale -leaseback transactions. \nSale of an asset with a seller -provided res ale value guarantee \n2.4.30 Before the adoption of Topic 606, arrangements in which the seller of an \nasset provided a guarantee of the asset’s future res ale value to the buyer were \naccounted for as leases by the seller, regardless of whether the buyer has to \nreturn the asset to the seller to receive a guarantee payment. [840- 10-55-14 (before \nASU 2014- 09)] \n2.4.40 Under Topic 842, a seller res ale value guarantee does not necessarily \npreclude sale accounting by the seller , and therefore does not require the seller \nto accou nt for the transaction as a lease. As a result, some arrangements \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 32}), Document(page\_content='Leases 32 \n2. Scope \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. involving seller res ale value guarantees that are accounted for as leases under \nTopic 840 will no longer be accounted for as leases once Topic 606 is adopted \n(see Question 7.2.10) . [842- 30-55-1 – 55-15] \n2.4.50 An arrangement in which the seller has the right or the obligation (i.e. call \noption or forward) to reacquire the asset may be accounted for as a lease by the \nseller depending on the terms of the repurchase agreement. The arrangement \nwould be accounted for as a lease if the seller can or must repurchase the asset \nfor an amount that is less than the price at which the asset was sold (unless the \ncontract is part of a sale -leaseback transaction). A vendor (or supplier) with an \narrangement of this nature will need to consider the guidance in Topic 842 and the repurchase agreements guidance in Topic 606. \n[606- 10-55-66 – 55-78] \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 33}), Document(page\_content='Leases 33 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 3. Definition of a l ease \nDetailed contents \nNew item added to this chapter: \*\* \nHow the standard works \n3.1 Overview \n3.1.1 Joint operating agreements \n3.1.2 Common control arrangements \*\* \nObservations \nLeases are identified at contract inception \nLease definition similar but not the same \nA straightforward analysis in most cases \nLease definition is the new on- /off-balance sheet test \nQuestions \n3.1.10 Perpetual land easements \n3.1.20 Meaning of ‘consideration’ \n3.1.30 When to determine the ‘period of use’ \n3.1.40 Period of use vs. contract term \nExample \n3.1.10 Oil drilling joint operation \n3.2 Is there an identified asset? \n3.2.1 Is the asset specified in the contract? \n3.2.2 Is the asset physically distinct? \n3.2.3 Does supplier have a substantive substitution right? \nObservations \nMost capacity portions are not identified assets \nSubstantive substitution rights change the substance of the \narrangement \nQuestions \n3.2.10 Identified asset vs. separate lease components \n3.2.20 Floating (or roving) easements \n3.2.30 ‘Last mile’ scenarios \n3.2.40 An asset’s primary use ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 34}), Document(page\_content='Leases 34 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 3.2.50 Right of first refusal \n3.2.55 Substitution rights that do not exist throughout the period \nof use \n3.2.60 Supplier’s practical ability to subs titute alternative assets \n3.2.70 Substitution rights that are not economically beneficial throughout the period of use \*\* \nExamples \n3.2.10 Assessing whether there is a physically distinct asset \n3.2.15 Rooftop space asset identification \*\* \n3.2.20 Substitution rights \n3.2.30 Supplier substitution right – evaluation of economic benefits \n3.2.40 Assessing what is (are) the identified asset(s) \n3.2.50 Infrastructure -as-a-Service – identified assets \n3.2.60 Implicitly specified land asset with substitution rights \nComparison to legacy US GAAP\n \n3.3 Does the customer control the use of the identified asset? \n3.3.1 Step 1: What is the scope of the customer’s right of use \nwithin the cont ract? \n3.3.2 Step 2: What are the economic benefits from use of the \nidentified asset? \n3.3.3 Step 3: Does the customer have the right to obtain \nsubstantially all of the economic benefits from use of the \nidentified asset? \n3.3.4 Step 4: Does the customer have the right to direct the use \nof the asset? \n3.3.5 Step 4: Control when the ‘how and for what purpose’ \ndecisions are predetermined \nObservations \nA lease is different from a service \nGovernment priorities can drive whether there is a lease \nPayment of portion of cash flows from an asset to the supplier (or another party)\n \n‘Relevant decisions’ affect how and for what purpose an asset is used \nDecisions abo ut how and for what purpose the asset is used are \npredetermined in the contract \nQuestions \n3.3.10 Relevance of the control concept in Topic 810 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 35}), Document(page\_content='Leases 35 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 3.3.20 Contractual restrictions affecting whether or not there is a \nlease \n3.3.30 Evaluating the substance of economic benefits from use \n3.3.39 Analyzing economic benefits from use of an asset \n3.3.40 Total economic benefits from use of an asset \n3.3.42 Data about customer’s use of the asset \n3.3.45 Supplier use of the identified asset \n3.3.50 Tax attributes \n3.3.60 Meaning of ‘substantially all’ \n3.3.70 Fixed economic return from use of an identified asset \n3.3.80 Changes to the customer’s right to obtain the economic \nbenefits from use during the period of use \n3.3.90 Time -based land easements \n3.3.100 Operational decisions \n3.3.110 Functional independence \n3.3.120 Customer -premise identified assets dedicated to the \ncustomer \n3.3.130 Leases when the supplier has physical possession of, \noperates and maintains the identif ied asset \n3.3.140 Control over the use of pipeline laterals \n3.3.150 Control over the use of identified ‘last mile’ assets \n3.3.160 Evaluating the customer design criterion in renewable \nenergy power purchase agreements \nExamples \n3.3.10 Right to obtain the economic benefits from use – \noutsourcing arrangement \n3.3.20 Internet service agreement \n3.3.30 Directing the use of identified assets – truck and trailers \n3.3.40 Infrastructure -as-a-Service – control over the use of the \nidentified asset \n3.3.50 Construction services contract \n3.3.60 Right to direct the use of the identified asset – outsourcing \narrangement \n3.3.62 Construction subcontractor arrangement (1) – scaffolding \n3.3.65 Right to direct the use of the identified asset – shipping spot \ncharter \n3.3.70 Right to direct the use of the identified asset – storage \nwarehouse(s) ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 36}), Document(page\_content='Leases 36 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 3.3.75 Right to direct the use of the identified asset – advertising \non a bus \n3.3.76 Right to direct the use of the identified asset – billboards \n3.3.80 All relevant how and for what purpose decisions are \npredetermined – outsourcing arrangement \n3.3.90 Right to direct the use of the identified asset is predetermined – storage warehouse \n3.3.95 Construction subcontractor arrangement (2) – perimeter \nfencing \n3.3.100 Outsourcing arrangement that was a lease under Topic 840 but is not under Topic 842 \nComparison to lega cy US GAAP ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 37}), Document(page\_content='Leases 37 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. How the standard works \nAn entity assesses at contract inception whether a contract is, or contains, a \nlease. A contract is, or contains, a lease if the contract conveys the right to \ncontrol the use of an identified asset (land or a depreciabl e asset) for a period of \ntime in exchange for consideration. \nThe following are the key elements of the definition. \nIs there an i dentified asset ?\nDoes Customer have the \nright to obtain substantially \nall of the economic benefits \nfrom use of the identified \nasset ?\nDoes Customer have the \nright to direct the use of the \nidentified asset ?\nContract is or contains a \nleaseContract does\nnot contain a \nlease Does \nCustomer \ncontrol the \nuse of the \nidentified \nasset \nthroughout \nthe period of \nuse?Yes\nYes\nYesNo\nNo\nNo \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 38}), Document(page\_content='Leases 38 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 3.1 Overview \n Excerpt from ASC 842 -10 \n15 Scope and Scope Exceptions \nGeneral \n> Identifying a Lease \n15-2 At inception of a contract , an entity shall determine whether that contract \nis or contains a lease. \n15-3 A contract is or contains a lease if the contract conveys the right to \ncontrol the use of identified property, plant, or equipment (an identified \nasset) for a period of time in exchange for consideration. A period of time \nmay be described in terms of the amount of use of an identified asset (for \nexample, the number of production units that an item of equipment will be \nused to produce). \n15-4 To deter mine whether a contract conveys the right to control the use of \nan identified asset (see paragraphs 842- 10-15-17 through 15- 26) for a period of \ntime, an entity shall assess whether, throughout the period of use , the \ncustomer has both of the following: \na. The right to obtain substantially all of the economic benefits from use of \nthe identified asset (see paragraphs 842- 10-15-17 through 15- 19) \nb. The right to direct the use of the identified asset (see paragraphs 842- 10-\n15-20 through 15- 26). \nIf the customer in the contract is a joint operation or a joint arrangement, an \nentity shall consider whether the joint operation or joint arrangement has the \nright to control the use of an identified asset throughout the period of use. \n15-5 If the customer has the right to control the use of an identified asset for \nonly a portion of the term of the contract, the contract contains a lease for that \nportion of the term. \n15-6 An entity shall reassess whether a contract is or contains a lease only if \nthe terms and conditions of the contract are changed. \n15-7 In making the determination about whether a contract is or contains a \nlease, an entity shall consider all rel evant facts and circumstances. \n15-8 Paragraph 842- 10-55-1 includes a flowchart that depicts the decision \nprocess for evaluating whether a contract is or contains a lease. \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance \n>> Identifying a Lease \n55-1 The following flowchart depicts the decision process to follow in \nidentifying whether a contract is or contains a lease. The flowchart does not \ninclude all of the guidance on identifying a lease in this Subtopic and is not \nintended as a substitute for the guidance on identifying a lease in this Subtopic. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 39}), Document(page\_content='Leases 39 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Is there an identified asset ? Consider \nparagraphs 842-10-15-9 through 15-16\nDoes the customer have the right to \nobtain substantially all of the economic \nbenefits from use of the asset throughout \nthe period of use ? Consider paragraphs \n842-10-15-17 through 15-19\nDoes the customer or the supplier have \nthe right to direct how and for what \npurpose the identified asset is used \nthroughout the period of use ? Consider \nparagraphs 842-10-15-20(a) and 842-10-\n15-24 though 15-26\nDoes the customer have the right to \noperate the asset throughout the period \nof use without the supplier having the \nright to change those operating \ninstructions ?\nDid the customer design the asset (or \nspecific aspects of the asset ) in a way \nthat predetermines how and for what \npurpose the asset will be used throughout \nthe period of use ?\nThe contract contains a \nleaseThe contract does not \ncontain a leaseYes\nYes\nYesNoNeither ; how and for \nwhat purpose the \nasset will be used is predeterminedNo\nNo\nNoSupplier Customer\nYesStart\n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 40}), Document(page\_content='Leases 40 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 3.1.10 A lease is a contract (or part of a contract) that conveys the right to \ncontrol the use of identified property, plant or equipment (an identified asset) \nfor a period of time in exchange for consideration. A period of time may be \ndescribed in terms of a specified amount of use of an identified asset . For \nexample, the period of time a lessee will control the use of an identifi ed asset \nmay be defined in terms of the number of production units an item of \nequipment will be used to produce or a specific task (or tasks) the identified \nasset will complete – e.g. the lease of an oil drilling rig may be for the period of \ntime necessary to drill a specified number of wells . [842-10-15-3] \n \n Question 3.1.1 0 \nPerpetual land easements \nDoes a perpetual land easement meet the defin ition of a \nlease? \nBackground: A land easement is, in general, a right to use and/or enter (or \ncross) land owned by another party for a specified purpose, for which the rights \nvary depending on the easement. Land easements are used in a variety of \nindustries, but are especially common in the energy (oil and gas), utilities, \ntransportation (e.g. rail) and telecom industries. \nFor example, in the energy industry, a land easement may involve a grantor \nconveying rights to a grantee to pass a pipeline underneath or above specified farmland while allowing the grantor to continue farming the land. Alternatively, \nan easement may convey the right to pass an asset (e.g. a pipeline or fiber -optic \ncable) through an existing body of water or over a specified stretch of land. \nLand easements may be perpetual or for a defined term , and may be prepaid or \npaid over time. \nAs discussed in Question 2.3.10 , land easements are in the scope of Topic 842 \nand therefore must be assessed to determine whether they meet the definition \nof a lease. Questions 3.2.20 and 3.3.90 address whether floating (or roving) land \neasements and time- based (i.e. non- perpetual) land easements, respectively, \nmeet the definition of a lease. \nInterpretive response: No. This is because a lease conveys the right to control \nthe use of identified pr operty, plant or equipment for a period of time in \nexchange for consideration. Because the right to use the land granted by the easement is perpetual, we believe it lacks an essential characteristic of a lease \n– i.e. that the gr antee controls a right to use the land only for a period of time. \nRather, a perpetual land easement is, in effect, a form of ownership of a portion \nof the land. Amended Example 10 in Section 350- 30-55 and the basis for \nconclusions to ASU 2018- 01 provide support for this view. \n[350- 30-55-30, ASU 2018-\n01.BC13] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 41}), Document(page\_content='Leases 41 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 3.1.20 \nMeaning of ‘consideration’ \nIf there is no stated consideration in the contract for the right \nto use an identified asset or the consideration is noncash or \nin-kind, does that mean there is no lease? \nInterpretive response: No. The existence of a lease does not depend on there \nbeing st ated consideration for the right to use the underlying asset or that the \nconsideration for the lease be in the form of cash. Sometimes consideration is \neither (or both) not stated in the contract or is noncash in nature. \nFor example, assuming the two conditions in paragraph 3.1.40 are met, a lease \ncould exist in any of the following circumstances (not exhaustive). \n— The only consideration stated in the contract is a per unit fee for \nconsumables used in the operation of the underlying asset – i.e. there is no \nstated contractual consideration for the lease of the underl ying asset. \n— The customer will provide services to the supplier or pay in a commodity. \n— The consideration for the lease is in- kind – i.e. the two entities exchange \nrights to use each other’s assets – e.g. Entity A grants Entity B a right to \nuse Entity A’s land in exchange for a right to use Entity B’s land. \n3.1.20 Both parties to a contract (the customer and the supplier) evaluate at \ninception of the contract whether it is or contains a lease. An entity does not \nreassess whether a contract is or contains a lease unless the terms and \nconditions of the contract are changed. [842- 10-15-2, 15- 6 – 15-7] \n \n Observation \nLeases are identified at contract inception \n3.1.30 Determining whether a contract is or contains a lease occurs at contract \ninception for practical reasons. Because Topic 842 uses the lease \ncommencement date for recognition and measurement of a lease , while other \nTopics use different dates (e.g. Topic 606 measures and allocates the \ntransaction price to performance obligations at contract inception), it is \nnecessary to identify whether a contract includes one or more leases at \ncontract inception to know whether the lease’ s recognition and measurement \nguidance applies , and if so, which guidance (i.e. Topic 842 and/or another \nTopic) governs. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 42}), Document(page\_content='Leases 42 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 3.1.40 The following diagram highlights the two conditions required to meet the \ndefinition of a lease, plus the specific tests that must be passed to meet those \nconditions, which are discussed in this chapter. \n \nControl over the \nuse of the \nidentified asset \n(see section 3.3)Identified asset \n(see section 3.2)Lease\nAsset is explicitly or \nimplicitly specified in \nthe contract \n(see section 3.2.1)Customer has right \nto obtain \nsubstantially all \neconomic benefits \nfrom use of \nthe asset \n(see section 3.3.3)\nAsset is physically \ndistinct or customer \nhas rights to \nsubstantially all of \nthe asset ’s capacity \n(see section 3.2.2)Customer has right \nto direct the use of \nthe asset \n(see sections 3.3.4 \nand 3.3.5)\nSupplier does not \nhave a substantive \nsubstitution right (see \nsection 3.2.3) \n3.1.50 To meet th e definition of a lease under Topic 84 2: \n— there must be an identified asset in the contract that is land or a \ndepreciable asset – i.e. property, plant or equipment; and \n— the customer must have the right to control the use of the identified asset. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 43}), Document(page\_content='Leases 43 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Observation \nLease definition s imilar but not the same \n3.1.60 While the two conditions in paragraph 3.1.50 appear similar to the \nrequirements for identifying a lease under Topic 840, important details have \nchanged. \n3.1.70 Most notably, the second condition (i.e. the customer must have the right \nto control the use of the identified asset) is now more closely aligned with how \ncontrol is defined and applied in Topic 810 ( consolidation) and Topic 606. This is \nbecause, while an entity ha d to consider the customer’s right to obtain the \noutput or other utility from use of the identified asset under Topic 840 (which is \nsimilar to evaluating the customer’s right to obtain the economic benefits from \nuse of the underlying asset under Topic 842), the concept of evaluating whether \nthe customer has the right to direct the use of the identified asset (a ‘power’ \nelement of control) is new to Topic 842. \n3.1.80 In most cases, a customer will have the right to direct the use of an \nidentified asset if it can direct (and change) ‘how and for what purpose’ the \nasset will be used throughout the ‘period of use’ (see section 3.3.4). However, \nif how and for what purpose the asset will be used is determined before the \nbeginning of the period of use (e.g. predetermined in the contract or by the \ndesign of the asset), a customer still directs the use of the asset if it has either \n(1) operational control over the asset, or (2) had control over the design of those \naspects of the asset that predetermine how and f or what purpose it will be \nused (see section 3.3.5) . \n \n Observation \nA straightforward analysis in most cases \n3.1.90 In the Board’s view, assessing whether a lease exists will be \nstraightforward in most cases. A contract will either fail to meet, or will clearly \nmeet, the definition of a lease without the need for significant judgment. The new definition will likely continue to easily capture most common lease \narrangements – e.g. leases of vehicles, office equipment and real estate. \n3.1.100 However, for more complicated scenarios, the Board added guidance to \nassist entities in their evaluations. Examples of more complicated lease \nidentification scenarios may include some outsourcing arrangements, a nd other \narrangements in which both the customer and the supplier have decision-making rights about the use of an asset . This includes some equipment \narrangements where the customer makes most or all of the decisions about how and for what purpose the asset will be used (see section 3.3), but the \nsupplier retains the decision- making rights over operations and/or maintenance \nof the equipment. \n[ASU 2016- 02.BC127] \n3.1.110 Determining whether a contract is or contains a lease is an important \nstep under Topic 842. When a contract is o r contains a lease, the core principle \nof Topic 842 is that the customer (lessee) should recognize both a lease liability for its obligation to make lease payments to the supplier (lessor) and a n ROU \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 44}), Document(page\_content='Leases 44 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. asset reflecting its right to use the underlying asset during the lease term. \nWhether a contract is or contains a lease also triggers specific disclosure \nrequirements for lessees and lessors. Consequently, properly identifying leases \nis important to all entities, regardless of their role as customer or supplier in \nthe arrangement. \n \n Observation \nLease definition is the new on -/off-balance sheet \ntest \n3.1.120 Under Topic 840, the critical determination in lessee accounting was lease \nclassification , because lease assets and lease liabilities were recognized only for \ncapital leases. In contrast, under Topic 842 a lessee recognizes lease assets and lease liabilities for all leases other than ‘short -term leases’ (see section 6.3.1), \nwhether classified a s operating or finance leases. Lease identification is therefore \nthe new test to determine whether an arrangement is on- or off -balance sheet for \nthe customer. While the lease classification distinction continues to exist in Topic 842, it now affects how l essees measure and present lease expense and \ncash flows – not whether the lease is on - or off -balance sheet. \n3.1.130 Throughout this chapter, the ‘period of use’ is referred to in looking at \nthe economic benefits to which the customer has rights, and the customer’s \npower to control the use of the asset. The period of use is the total period of time that an asset is used to fulfill a contract with a customer, including the \nsum of any non -consecutive periods of time. \n[842 Glossary] \n \n Question 3.1.30 \nWhen to determine the ‘period of use’ \nIs the ‘period of use’ determined before assessing whether \nthere is an identified asset and whether the customer controls the use of an identified asset? \nInterpretive response: Yes. The ‘period of use’ is determined before assessing \nwhether the two conditions in paragraph 3.1.40 are met; the period of use is, in \neffect, an input to lease identification. This is because, for example: \n— for there to be a lease, a customer must have both (1) the right to obtain \nsubstantia lly all of the economic benefits from use (see section 3.3.3), and \n(2) the right to direct the use of an identified asset throughout the period of use (see section 3.3.4). \n— for a supplier substitution right to be substantive, and therefore result in a \nconc lusion that there is not an identified asset, the supplier must have that \nright throughout the period of use (see section 3.2.3). \nBecause the period of use is used to evaluate whether the two conditions in \nparagraph 3.1.40 are met, if the period of use were also considered to be the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 45}), Document(page\_content='Leases 45 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. period of time that these conditions are met, the definition of a lease would be \ncircular. Therefore, the period of use is established before concluding whether a \nlease exists. \nWe do not believe the definition of period of use refers to the total period of \ntime that an identified asset is used to fulfill a contract with a customer. \nInstead, the period of use merely refers to the period of time, potentially within \na longer overall contract term, t hat an item of property, plant or equipment is \nnecessary to fulfill the contract. For example, even though Example 1 Case B \nand Example 2 in Subtopic 842- 10 both conclude that there is not an ‘identified \nasset’ (i.e. no lease exists), the periods of use in those examples are five years \nand three years, respectively. The five - and three- year periods are the periods of \nuse in each example because they represent the periods of time during which \nrail cars (Example 1 Case B) and physical floor space within the airport \n(Example 2) – i.e. items of property, plant or equipment – will be used to fulfill \nthe contract with the customer. [842- 10-55-48 – 55-54] \nParagraph 3.2.140, and Questions 3.2.55 and 3.3.80 address specific application \nissues related to the intera ction of the period of use with the lease identification \ncriteria in paragraph 3.1.40. \n \n Question 3.1.4 0 \nPeriod of use vs. contract term \nFor a lease to exist, must the customer have the right to \ncontrol the use of an identified asset throughout the term of the contract that contains the potential lease? \nInterpretive response: Not necessarily. For a lease to exist, the customer must \nhave the right to control the use of (see section 3.3) the identified asset (see \nsection 3.2) throughout the ‘ period of use’. Period of use is a defined term in \nTopic 842 that may be different from the overall contract term. \nBecause of how period of use is defined and used in the guidance on \nidentifying a lease, an arrangement to use or that depends on an identified \nasset would not fail the definition of a lease solely because it is either contained \nwithin a contract with a longer overall term than the period of use, or contains \nintermittent periods during the contract term during which the customer does \nnot have the right to control the use of the asset. \nFor example, a sports team that has the right to use an identified stadium for \nthe months of September through January each year (during its playing season) \nfor a period of 10 years would have a lease if it has the right to control the use \nof the stadium during the 10 five- month periods, even though it does not have \nthe right to control the use of the stadium during the other seven months each \nyear of the 10- year term of the contract. The period of use when evaluating \ncontrol is the 50 non- concurrent months. Similarly, a 10 -year service contract \ncan contain a lease regardless of the fact that it involves the supplier granting \nthe customer the right to use an identified asset for only the first five years of \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 46}), Document(page\_content='Leases 46 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. that contract – e.g. until the customer builds its own asset that will be used in \nfulfilling the arrangement. \n \n3.1.1 Joint operating agreements \n3.1.140 Entities often enter into joint arrangements in the normal course of \nbusiness. A joint arrangement, which may or may not be a legal entity , is \nconsidered to be the customer when assessing whether a lease exists, and in \naccounting for the lease, when the contract is: \n— entered into by the joint arrangement itself – e.g. if the joint arrangement is \na legal entity, such as a joint venture ; \n— entered into by all of the parties to the joint arrangement ; or \n— signed by one or more of the parties to the joint arrangement expressly on \nbehalf of (i.e. as an agent of) the joint arrangement. \n3.1.15 0 Provided that one or more of the above conditions are met, the joint \narrangement , and not the individual parties to the joint arrangement , is \nconsidered to be the customer when assessing whether the contract contains a \nlease. In this situation, it would not be appropriate to c onclude that a contract \ndoes not contain a lease on the grounds that the parties to the joint \narrangement, individually : \n— only o btain a capacity portion of the asset that is not physically distinct; \n— only o btain a portion of the economic benefits from use of the asset; or \n— do not have the right to direct the use of the asset. \n3.1.16 0 When the joint arrangement is the customer, the contract contains a \nlease if the parties to the joint arrangement collectively have the right to control \nthe use of an identified asset throughout the period of use – e.g. a joint \noperating committee makes the relevant decisions about how to deploy the \nasset . [842- 10-15-4] \n3.1.17 0 A joint arrangement is frequently not a legal entity, rather it is simply a \njoint operating agreement (JOA) between two or more legal entities. And \ntypically, the individua l parties do not jointly enter into the contract with the \nasset supplier and the supplier may have no knowledge of the joint \narrangement. Rather, one party assumes the role of operator of the JOA and is \nthe primary obligor to the contract with the asset supplier. In those cases, the \nrights of the operator are considered in determining if there is a lease and, if \nthere is a lease, the operator will be the lessee. \n3.1.18 0 If a lease exists and the operator of the JOA is determined to be the \nlessee, a s ublease may exist between the operator and the JOA – i.e. the \noperator may surrender its right to control the use of the underlying asset to the \nJOA – and this may be the case even if the JOA controls the use of the asset \nfor only a portion of the operator’s lease term. The operator would account \nfor the sublease in the same manner as it would any other sublease (see \nchapter 8), with the exception that the operator’s accounting for the sublease \nwould be restricted to the other parties’ share in the JOA because the operator \ncannot record a sublease to itself , while the accounti ng by the parties to the \nJOA may differ depending on industry -specific US GAAP – e.g. pro rata \nconsolidation guidance in the oil and gas industry. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 47}), Document(page\_content='Leases 47 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 3.1.10 \nOil drilling joint operation \nCompanies X, Y and Z enter into a joint operating agreement (J OA) to explore \na mineral interest. Company X is appointed as the operator of JOA – i.e. \nCompany X manages the day -to-day operations of JOA – while Companies Y \nand Z are non- operators. \nCompany X, in its own name, enters into a four -year contract with Supplier for \nthe use of a drilling rig necessary for exploration activities. The drilling rig is \nexplicitly specified in the contract and Supplier has no substitution rights. \nSupplier is responsible for manning, maintenance and safety of the rig. In \naccord ance with the contract, Company X makes all decisions about when and \nwhere to use the rig, including which geological targets to test. \nCompany X is involved in a number of projects at various stages of \ndevelopment. Company X allocates the drilling rig to JOA for an initial two- year \nperiod, after which Company X has it earmarked for another, unrelated project . \nJoint Operating \nArrangement (JOA)Company X\n(Operator )Company Y Company Z\nSupplierDrilling rig \ncontract \nCompany X is the customer to the contract with Supplier because Company X \nenters into the contract and the contract grants Company X, not JOA, the rights \nto use the rig. The contract contains a lease because: \n— the drilling rig is an identified asset – i.e. it is specified in the contract and \nSupplier does not have the right to substitute the asset during the four -year \ncontract term ; \n— Company X has the right to obtain substantially all of the economic benefits \nfrom using the drilling rig – by using it to explore its mineral interests and \nobtaining reimbursements from Companies Y and Z for their share of the \ncosts; and \n— Company X has the right to direct the use of the rig because it can decide \nwhen, where and how to use the rig. \nCompany X is the lessee of the drilling rig lease with Supplier . Consequently, \nCompany X recognizes the entire ROU asset and lease liability on its \nbalance sheet. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 48}), Document(page\_content='Leases 48 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. In addition, Company X will need to determine whether it has entered into a \nsublease of the drilling rig with JOA , in which Company X would be the \nsublessor and JOA the sublessee. When determining whether there is such a \nsublease, JOA (including Company X’s share in JOA ) is assessed as the \ncustomer. A sublease from Company X to JOA would exist if Company X \nconveys its right to control the use of the drilling rig to JOA. For example, \nCompany X may convey to JOA (via a joint operating committee compris ing \nrepresentatives of Compa nies X, Y and Z ) the right to decide when, where and \nhow to use the rig. \n— If there is a sublease, then Company X would apply lessor accounting for \nthe sublease. However, unlike the evaluation of whether there is a \nsublease, lessor accounting for the subleas e would be restricted to \nCompany Y’s and Company Z’s share in JOA because Company X cannot \nrecord a sublease to itself. Companies Y and Z would account for their \nrespective shares in the sublease between Company X and JOA . \n— If there is not a sublease (e.g. because there is no collective control over \nthe rig during the two- year period), then Company X (as receiver) and \nCompanies Y and Z (as payers) would account for reimbursements related \nto the drilling rig in accordance with other GAAP – e.g. Topic 808 \n(collaborative arrangements) . \n \n3.1.2 Common control arrangements \*\* \n Excerpt from ASC 842 -10 \n> Identifying a Lease \n15-3A As a practical expedient, an entity that is not a public business entity ; a \nnot-for-profit entity that has issued or is a conduit bond obligor for securities \nthat are traded, listed, or quoted on an exchange or an over -the-counter \nmarket; or an employee benefit plan that files or furnishes financial statements \nwith or to the U.S. Securities and Exchange Commission may use the written \nterms and conditions of a related party arrangement between entities under \ncommon control to determine whether that arrangement is or contains a lease. \nFor purposes of determining whether a lease exists under this practica l \nexpedient, an entity shall determine whether written terms and conditions \nconvey the practical (as opposed to enforceable) right to control the use of an \nidentified asset for a period of time in exchange for consideration. If an entity \ndetermines that a lease exists, the entity shall classify and account for that \nlease on the basis of those written terms and conditions. An entity may elect \nthe practical expedient on an arrangement -by-arrangement basis. \n15-3B If no written terms or conditions exist, an ent ity shall not apply the \npractical expedient in paragraph 842- 10-15-3A. Rather, the entity shall \ndetermine whether the related party arrangement between entities under \ncommon control is or contains a lease in accordance with paragraph 842- 10-15-\n3 and, if so, classify and account for that lease on the basis of its legally \nenforceable terms and conditions in accordance with paragraph 842- 10-55-12. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 49}), Document(page\_content='Leases 49 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 15-3C If after an entity has applied the practical expedient in paragraph 842 -10-\n15-3A an arrangement is no longer between entities under common control, \nthe entity shall determine whether a lease exists in accordance with paragraph \n842-10-15-3. \na. If the arrangement was previously determined to be a lease and continues \nto be a lease, the entity shall classify and accoun t for the lease on the basis \nof the enforceable terms and conditions. If the enforceable terms and \nconditions differ from the written terms and conditions previously used to \napply paragraph 842- 10-15-3A, the entity shall apply the modification \nrequirements in paragraphs 842- 10-25-9 through 25- 17 using the \nenforceable terms and conditions. If the enforceable terms and conditions \nare the same as the written terms and conditions previously used to apply \nparagraph 842- 10-15-3A, the modification requirements in those \nparagraphs are not applicable. \nb. If the arrangement was previously not determined to be a lease and is \ndetermined to be a lease, the entity shall account for the arrangement as a \nnew lease. \nc. If the arrangement was previously determined to be a lease and the lease \nceases to exist: \n1. A lessee shall apply the derecognition requirements for fully terminated \nleases in paragraph 842 -20-40-1. \n2. A lessor with a lease previously classified as a sales -type lease or a \ndirect financing lease shall apply the derecognition requirements for \nterminated leases in paragraph 842- 30-40-2. \n3. A lessor with a lease previously classified as an operating lease shall \nderecognize any amounts that would not exist if the arrangement was \nnot accounted for as a l ease and account for the arrangement in \naccordance with other generally accepted accounting principles \n(GAAP ). \n \n3.1.190 For arrangements that exist between related parties under common \ncontrol, an entity may elect, on an arrangement -by-arrangement basis, a \npractical expedient to use the written terms and conditions of a common \ncontrol leasing arrangement (without regard to enforceability) to determine \nwhether a lease exists and, if so, the classification of and accounting for that \nlease . This practical expedient is available to an entity that is not: [842- 10-15-3A] \n— a public business entity; \n— a not -for-profit entity that has issued or is a conduit bond obligor for \nsecurities that are traded, listed, or quoted on an exchange or an over -the-\ncounter market; or \n— an employee benefit plan that files or furnishes financial statements with or to the US Securities and Exchange Commissi on. \n3.1.200 If the written terms and conditions convey the practical (as opposed to \nenforceable) right to control the use of an identified asset for a period of time in exchange for consideration , the entity classif ies and account s for that lease on \nthe basis of those written terms and conditions. \n[842- 10-15-3A] \n3.1.21 0 If there are no written terms and conditions, the entity cannot use the \npractical expedient; instead, it identifies the legally enforceable terms and ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 50}), Document(page\_content='Leases 50 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. conditions to determine whether a lease exists and, if so, uses those terms and \nconditi ons in applying Topic 842. [842- 10-15-3B] \n3.1.22 0 If an arrangement to which the practical expedient has been applied \nceases to be between entities under common control, the entity is no longer allowed to use the practical expedient to account for the arra ngement. The \nfollowing table highlights the accounting. \n [842- 10-15-3C] \nFact pattern Accounting \nWhen applying \nthe practical \nexpedient, t he \narrangement was \ndetermined to be \n(or contain) a \nlease and continues to be a \nlease . The enforceable terms \nand conditions are the \nsame as the written \nterms and conditions previously used. There is no practical change to the \naccounting for the lease. \nThe legally enforceable \nterms and conditions are \nnot the same as the \nwritten terms and \nconditions previously \nused . The entity appl ies the lease \nmodification guidance. See sections \n6.7 (lessee) and 7.6 (lessor). \nWhen applying \nthe practical \nexpedient, t he \narrangement was \ndetermined to be \na lease and is now \ndetermined not to \nbe a lease . The entity is a lessee . A lessee applies the derecognition \nrequirements for fully terminated leases . See section 6.8. \nThe entity is a lessor . A lessor with a lease previously \nclassified as a sales -type or direct \nfinancing lease applies the \nderecognition requirements for \nterminated leases. See paragraphs \n7.3.440 and 7.3.450. \nA lessor with a lease previously \nclassified as an operating lease \nderecognizes a ny amounts that \nwould not have existed if the \narrangement was not accounted for \nas a lease and prospectively accounts for the arrangement in \naccordance with other US GAAP . \nWhen applying the practical expedient, t he \narrangement was determined not to be a \nlease and is now determined to be a lease. The entity accounts for the arrangement as a new lease. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 51}), Document(page\_content='Leases 51 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 3.2 Is there an i dentified a sset? \nThe following flowchart takes the diagram in paragraph 3.1.40, and highlights in \ngreater detail the key considerations in determining whether there is an \nidentified asset – i.e. whether the first requirement for there being a lease is \nmet. [842- 10-15-9 – 15-16] \nIs the asset physically distinct? \nOr if not physically distinct, does it \nrepresent substantially all of the \ncapacity of that asset?Is the asset specified in the \ncontract (whether explicitly or \nimplicitly)?\nSTOP. \nContract does not contain a lease. \nApply other GAAP.\nDoes Supplier have \nsubstitution rights?There is an identified asset. \nProceed to section 3.3.\nAre alternative assets readily \navailable or could be sourced by \nSupplier within a reasonable \nperiod of time?\nWould Supplier benefit \neconomically from exercising its \nright of substitution (i.e. economic \nbenefits exceed costs)?Supplier does not have \nsubstantive substitution right. \nContract depends on an identified \nasset. Proceed to section 3.3.\nSTOP. Supplier has \nsubstantive substitution right. \nContract does not contain a lease. \nApply other GAAP.Yes\nYes\nYes\nYes\nYesNo\nNo\nNo\nNo1\nNo1 \nNote: \n1. Or it is impracti cal for the customer to make this determination. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 52}), Document(page\_content='Leases 52 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 3.2.1 0 \nIdentified asset vs. separate lease components \nIs the unit of account for lease identification each separate \nlease component or each identified asset? \nInterpretive response: Each identified asset. Paragraph 842- 10-15-28 states, \n“After determining that a contract contains a lease in accordance with \nparagraphs 842-10-15-2 through 15- 27, an entity shall identify the separate \nlease components within the contract.” Therefore, an entity identifies the \nleases that exist before identifying which leases are separate lease \ncomponents. \nIn disc ussions about the guidance in paragraph 842- 10-15-28, the FASB staff \nstated that an entity should not evaluate whether components of a single, \nintegrated asset are separate leased assets. That is, an entity does not ‘break \napart’ a single, integrated asset such as an airplane, a ship or a building and \nevaluate lease identification for the assets that were integrated to create the single asset. The FASB staff observed that Examples 6 to 9 in Subtopic 842-10 \nevaluate whether or not there is a lease for the sh ip, the aircraft, the factory and \nthe power plant, respectively, rather than for the components of those assets. \n[842- 10-55-79 – 55-123] \nConversely, in Example 10 Case A of Subtopic 842- 10 (substantially the same \nas Example 3.2.50 ), the multiple servers are not a single, integrated asset (each \nserver is a conventionally separable asset) such that each server could be an \nidentified asset. Consistent with the preceding paragraph however, an entity \nwould not evaluate whether the components of each server (e.g. the \nprocessors and the chipset) are leased assets. [842- 10-55-124 – 55-126] \nAccordingly, we believe the intent of the lease identification guidance in Topic 842 is to evaluate assets that can be sold, used or re- leased in their \npresent form (e.g. computer servers, cars, aircraft), and not to evaluate assets \nthat, as a result of their integration with other assets, would require substantial \nre-work to be sold, used or re- leased – e.g. separation from the other assets \nwith which they are integrated. \n \n3.2.1 Is the a sset specified in the contract? \n Excerpt from ASC 842 -10 \n>> Identified Asset \n15-9 An asset typically is identified by being explicitly specified in a contract. \nHowever, an asset also can be identified by being implicitly specified at the \ntime that the asset is made available for use by the customer. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 53}), Document(page\_content='Leases 53 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 3.2.10 An identified asset may be explicitly or implicitly specified in a contract. In \nmost cases, the asset that is the subject of the lease will be explicitly specified \nin a contract – e.g. by serial number, or a specified floor of a building. In that \ncase, the re is an identified asset unless the supplier has a substantive right to \nsubstitute the specified asset (see section 3.2.3). [842- 10-15-9] \n3.2.20 An asset is implicitly specified in a contract if fulfillment of the contract \ndepends on an item of property, plant or equipment (e.g. a piece of equipment) \nand the supplier does not have a substantive right to substitute alternative \nassets to fulfill the contract – e.g. the supplier has only one piece of equipment \nor facility to fulfill the contract. [842- 10-15-9, ASU 2016- 02.BC128] \n3.2.30 An asset can be implicitly specified even if the customer does not know \nwhether the supplier has multiple assets or only one asset to fulfill the contract \n– i.e. whether the supplier has the practical ability to substitute an alternative \nasset. For there to be an identified asset , an entity only needs to conclude that \nfulfillment of the contract depends on an item of property, plant or equipment \n(e.g. a piece of equipment) and that substitution of that asset would not be \neconomically beneficial to the supplier or that there isn’t enough information to \nmake the determination as discussed in paragraph 3.2.40. [ASU 2016- 02.BC128] \n3.2.40 If the customer cannot readily determine either whether substitution \nwould be (1) practicable or (2) economically beneficial to the supplier, the \ncustomer should assume any substitution right is not substantive. [842- 10-15-15] \n \n Question 3.2.2 0 \nFloatin g (or roving) easements \nIs there an identified asset when a property owner grants a \nfloating (or roving) easement? \nBackground: A floating (or roving) easement exists when there is no fixed \nlocation, method, route or limit to the right of way. For example, a right of way \nmay cross a field, without any specified or discernible path, or permit exit \nthrough another structure for evacuation purposes. A floating easement may, \nhowever, become fixed after a period of time or a specified event – e.g. the \ninitiation of construction. \nInterpretive response: In general, no. We believe it is acceptable to conclude \nthat a floating (or roving) easement does not meet the definition of a lease \nbecause there is no identified asset . The absence of a fixed location, method, \nroute or limit means no item of property, plant or equipment is explicitly \nspecified in the contract between the grantor and the grantee. Meanwhile, \nassuming there are alternate locations, methods, routes or limits – e.g. multiple \npossible paths through which to exit a building or multiple paths through a field \n– no physically distinct piece of land is implicitly specified either. \nWe do not believe it would be consistent with the other guidance on identifying \nassets, such as that in Example 2 in Subtopic 842- 10 on airport concession \nspace, to consider the entire field or building (i.e. where the floating easement grants multiple possible paths through the field or paths of egress through the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 54}), Document(page\_content='Leases 54 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. building) as the identified asset. However, even if the entir e field or building \nwere the identified asset, it may frequently be the case that a lease would still \nnot exist because the grantee does not have the right to obtain substantially all \nthe economic benefits from use, or direct the use, of that entire identi fied \nasset. [842- 10-55-52 – 55-54] \nIf a particular piece of land subject to an easement becomes specified – e.g. the \npath/route a pipeline or telecommunications conduit will transit becomes fixed once it is installed or when construction/installation s tarts and therefore \nspecifies the path/route – the easement ceases to be floating (or roving). In that \ncase, Questions 3.1.10 and 3.3.90 for perpetual and time- based easements, \nrespectively, should be considered. \n \n3.2.2 Is the a sset physically distinct? \n Excerpt from ASC 842 -10 \n>>> Portions of Assets \n15-16 A capacity portion of an asset is an identified asset if it is physically \ndistinct (for example, a floor of a building or a segment of a pipeline that \nconnects a single customer to the larger pipeline). A capacity or other portion \nof an asset that is not physically distinct (for example, a capacity portion of a \nfiber optic cable) is not an identified asset, unless it represents substantially all \nof the capacity of the asset and thereby provides the customer with the right \nto obtain substantially all of the economic benefits from use of the asset. \n55 Implementation Guidance and Illustrations \nGeneral \n> Illustrations \n>> Illustration of Identifying a Lease \n>>> Example 3— Fiber -Optic Cable \n>>>> Case A —Contract Contains a Lease \n55-55 Customer enters into a 15- year contract with a utilities company \n(Supplier) for the right to use 3 specified, physically distinct dark fibers within a \nlarger cable connecting Hong Kong to Tokyo. Customer m akes the decisions \nabout the use of the fibers by connecting each end of the fibers to its \nelectronic equipment (for example, Customer “lights” the fibers and decides \nwhat data and how much data those fibers will transport). If the fibers are \ndamaged, Supp lier is responsible for the repairs and maintenance. Supplier \nowns extra fibers but can substitute those for Customer’s fibers only for \nreasons of repairs, maintenance, or malfunction (and is obliged to substitute \nthe fibers in these cases). \n55-56 The contract contains a lease of dark fibers. Customer has the right to \nuse the 3 dark fibers for 15 years. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 55}), Document(page\_content='Leases 55 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 55-57 There are three identified fibers. The fibers are explicitly specified in the \ncontract and are physically distinct from other fibers within the cable. Supplier \ncannot substitute the fibers other than for reasons of repairs, maintenance, or \nmalfunction. \n55-58 Customer has the right to control the use of the fibers throughout the \n15-year period of use because: \na. Customer has the right to obtain substantially all of the economic benefits \nfrom use of the fibers over the 15- year period of use. Customer has \nexclusive use of the fibers throughout the period of use. \nb. Customer has the right to direct the use of the fibers. Customer m akes the \nrelevant decisions about how and for what purpose the fibers are used by \ndeciding when and whether to light the fibers and when and how much \noutput the fibers will produce (that is, what data and how much data those \nfibers will transport). Customer has the right to change these decisions \nduring the 15- year period of use. \n55-59 Although Supplier’s decisions about repairing and maintaining the fibers \nare essential to their efficient use, those decisions do not give Supplier the \nright to direct how and for what purpose the fibers are used. Consequently, \nSupplier does not control the use of the fibers during the period of use. \n>>>> Case B —Contract Does Not Contain a Lease \n55-60 Customer enters into a 15- year contract with Supplier for the right to use \na specified amount of capacity within a cable connecting Hong Kong to Tokyo. \nThe specified amount is equivalent to Customer having the use of the full \ncapacity of 3 strands within the cable (the cable contains 15 fibers with similar \ncapacities). Supplier makes decisions about the transmission of data (that is, \nSupplier lights the fibers and makes decisions about which fibers are used to \ntransmit Customer’s traffic and about the electronic equipment that Supplier \nowns and connects to the fi bers). \n55-61 The cont ract does not contain a lease. \n55-62 Supplier makes all decisions about the transmission of its customers’ \ndata, which requires the use of only a portion of the capacity of the cable for \neach customer. The capacity portion that will be provided to Customer is not \nphysically distinct from the remaining capacity of the cable and does not \nrepresent substantially all of the capacity of the cable. Consequently, Customer \ndoes not have the right to use an identifie d asset. \n3.2.50 In most cases, the asset will be a complete asset and therefore easy to \nidentify – e.g. a building or a piece of equipment. However, a capacity portion of \nan asset can also be an identified asset if: [842- 10-15-16] \n— it is physically distinct – e.g. the floor of a building, a specified strand of a \nfiber-optic cable, or a distinct segment of a pipeline; or \n— it is not physically distinct, but the customer has the right to receive \nsubstantially all (see Question 3.3.6 0) of the capacity of the asset – e.g. \nsubstantially all of the data capacity of a fiber -optic cable. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 56}), Document(page\_content='Leases 56 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Observation \nMost capacity portions are not identified assets \n3.2.60 In deciding on the requirements in paragraph 3.2.50, the Board reasoned \nthat a customer is unlikely to have the right to control the use of a capacity \nportion of an asset that is not physically distinct or that is less than substantially \nall of the capacity of the asset, because the relevant decisions about an asset’ s \nuse are generally made at the whole asset level. That is, having rights to only a capacity portion of an asset (that is not substantially all of the asset’s capacity), \na customer will generally not have decision- making rights as to how the asset is \nused. \n[ASU 2016- 02.BC133] \n3.2.70 Therefore, the Board decided not to broaden the concept of an identified \nasset to the use of any capacity portion of a larger asset, because it may have \nforced entities to analyze all contracts for goods or services in which a \ncustomer obtains some amount of capacity from an asset as possible leases, \nonly to then conclude that they were not leases because the customer does \nnot have the relevant decision- making rights about the asset’s use. [ASU 2016-\n02.BC133] \n \n Example 3.2.10 \nAssessing whether there is a physically distinct \nasset \nScenario 1: Rights to a capacity portion – not physically distinct \nCustomer enters into an arrangement with Supplier for the right to store its \nproducts in a specified climate -controlled storage warehouse (storage \nwarehouse 3C). \nSupplier has no substitution rights. However, the arrangement allows Supplier \nto store products from other customers in storage warehouse 3C. The exact \nspace to be used by Customer within storage warehouse 3C is not specified. \nInstead, Supplier decides where each customer’s products are stored within storage warehouse 3C and can relocate them at its sole discretion. \nAt inception of the contract, Customer has storage rights that permit it to use \nup to 60% of the capacity of storage warehouse 3C throughout the term of the \ncontract. Supplier can use the other 40% of the warehouse as it sees fit. \nWarehouse 3C\nStorage rights \nof CustomerExpected \nusage by other \ncustomers \nIn this scenario, there is not an identified asset because Customer has rights \nonly to a capacity portion of storage warehouse 3C that is not physically distinct \nfrom the remainder of the warehouse. In addition, the capacity of the storage \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 57}), Document(page\_content='Leases 57 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. warehouse that Customer has the right to use does not represent substantially \nall of the capacity of storage warehouse 3C. Because there is not an identified \nasset, the contract does not contain a lease. \nScenario 2: Rights to a capacity portion – physically distinct \nChanging the facts of Scenario 1, the contract provides Customer the right to use \nrooms A, B and C within storage warehouse 3C, and Supplier has no substantive \nright to substitute alternative space in place of rooms A, B and C. Rooms A, B \nand C represent only 60% of storage warehouse 3C’s total capacity. \nRoom \nARoom \nBRoom \nCRoom \nDRoom \nE\nReserved for usage \nby CustomerWarehouse 3C\n \nIn this scenario, there is an identified asset even though rooms A, B and C \nrepresent only 60% of storage warehouse 3C’s total capacity. This is because \nthe rooms are specified in the contract, are physically distinct from other \nstorage locations within the wa rehouse and Supplier has no substantive \nsubstitution right. \nAccordingly, the next step is for Customer to determine whether it has the right \nto control the use of rooms A, B and C (see section 3.3) to determine if there is \na lease. \n \n Question 3.2.3 0 \n‘Last mile’ scenarios \nIs the ‘last mile’ of a single, contiguous asse t a physically \ndistinct asset? \nBackground: Paragraph 842- 10-15-16 is explicit that a segment of a pipeline \nthat connects a single customer to the larger pipeline (i.e. a pipeline ‘lateral’) is a \nphysically distinct asset (see paragraph 3.2.50). At a May 2017 public meeting, \nFASB members confirmed t heir view that a pipeline segment, which is \nconstructed off of a main (or primary) pipeline, is a physically distinct asset under Topic 842; see Quest ion 3.3.140 for considerations relative to whether \nsuch laterals meet the definition of a lease. \nThere are other circumstances in which the end (e.g. the last mile) of a single, \ncontiguous asset serves only a single customer. For example, a train track may \nterminate at a customer location (e.g. a distribution center or manufacturing \nfacility) such that the portion of the track from that customer’s location to the \nnext stop on the track, even if not physically separable, exclusively serves the \ncustomer (i.e. transports its goods or supplies). Alternatively, the end of a \npower or telephone line to a house or t o a single -tenant facility may only carry \npower or signal to the resident/tenant of that house or facility. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 58}), Document(page\_content='Leases 58 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Interpretive response: It depends. In general, we believe the last mile of a \nsingle, contiguous asset like those discussed in the background is itself a \nphysically distinct asset only if it is mechanically separable from the remainder \nof the asset – e.g. if there is a switch that would permit a train to turn away \nfrom the last mile without transiting it, or a breaker that permits an entity to \nshut off the flow of electricity or signal to a power or telephone line. \nIf there is no mechanical separat ion, the last mile is not physically distinct from \nthe remainder of the larger asset and cannot be an identified asset that \nis leased. \nIf the last mile is mec hanically separable such that it is physically distinct, there \nwill typically be an identified asset because the supplier will generally not have a \nsubstantive substitution right – i.e. the supplier will typically not have the \npractical ability to substitu te the last mile asset and would not economically \nbenefit from doing so even if practicable. \nQuestion 3.3.150 addresses considerati ons about whether the customer \ncontrols the use of an identified last mile asset. \n \n Question 3.2.4 0 \nAn asset’s primary use \nDoes an asset’s primary use affect whether a lease exists? \nBackground : Entities frequently permit other entities to share use of their \nproperty, plant and equipment . For example, an asset owner or lessee may \npermit another entity to place an advertisement on the side of its owned or \nleased building, vehicle (e.g. a bus), or shelter (e.g. a bus stop shelter). Similarly, \na utility company may permit another entity to attach its wires or equipment to \nthe utility company’s pol e or antenna. \nIn either case, an entity may conclude that the primary use of the asset is its function as a bu ilding, mode of transportation or shelter – or as a means for \nthe utility company to provide its core service (e.g. providing electricity or \ntelecommunications services) – and that the asset’s ability to provide a \nspace for advertising or for other entities to attach their wires/cables is a \nsecondary use. \nInterpretive response: It depends. Influencing our consideration of this \nquestion is our awareness that the Boards discussed the concept of primary \nversus secondary use during deliberations of Topic 842, and we understand they decided that whether the customer’s use of an asset was its primary or a \nsecondary use should not be determinative as to whether there is a lease. But \nalthough not determinative, we believe consideration of an asset’s primary use \nmay be relevant in some cases when identifying the asset (i.e. the item or \nportion of property, plant or equipment) that should be evaluated. \nConsider an arr angement between a cable television provider and a n electric \nutility whereby the cable company will pay for the right to attach its c able wires \nto the utility’s distribution poles – used for hanging the utility’s electrical wires \nto transport elec tricity to its customers – for seven year s. The specific spot on \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 59}), Document(page\_content='Leases 59 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. each pole may not be explicitly specified (although there may be a requirement \nthat the cables are attached only above a certain height and/or are not attached \nto the top of the utility poles ). Regardless, the spots may be implicitly specified \nonce the cables are attached, and because the utility company generally will not \neconomically benefit from disconnecting and then reattaching the cables to a \ndifferent spot on the utility pole, the implicitly specified spot on the pole is an \nidentified asset (see paragraph 3.2.30). Therefore, one view is that the specific \nspot on each utility pole where the cable is attached is an identified asset that the cable company may control the use of (see section 3.3). \nAn alternative view is that the entire utility pole is a single asset – i.e. whatever \nportion of the pole the cable company’s wire will hang from is not a physically \ndistinct, identifiable asset. In addition to the fact that the portion of the util ity \npole used by the cable company is not physically or mechanically separated from the remainder of the pole (see Question 3.2.30), this view also considers \nthe purpose of the utility pole to be relevant when evaluating its separability into \nphysically di stinct assets. That is, the pole is not physically or mechanically \nseparated into distinct units because its primary purpose is not to serve as a \nmulti- tenanted hosting device. \nWe believe either view is acceptable – i.e. that there is an identified asset or \nthat there is not. \nThe view that the entire utility pole is the identified asset to be evaluated \ndifferentiates the utility pole from a multi -tenant office building, a cellular tower \nor a satellite with multiple transponders. At least partly, this is bec ause the \nutility pole’s primary use (or purpose) is to permit the utility company to provide \nits core service of supplying electricity; the utility’s ability to generate economic \nbenefit from the sale of excess pole space is secondary to its primary econom ic \nbenefit. In contrast, for the multi -tenant office building, the cellular tower and \nthe satellite, not only are the individual floors, rungs and transponders typically \nboth physically and mechanically separable, but the larger asset has been \nconstructed (or subsequently re- purposed) for the primary purpose of being \nsubdivided and providing economic benefits from use to different parties \nsimultaneously . \nThe analysis of the arrangements in the following chart follows the view that \nthe primary use of the asset should inform the decision about the asset to \nevaluate under the lease definition. The following arrangements are examples; \nthe principle illustrated may also apply to other arrangements. \nArrangement Identified \nasset?1 Rationale \nUtility pole \nattachments No See above discussion. \nOffice (or retail) space in a multi-tenant building Yes Consistent with the above discussion, the \ndesignated office or retail space is an identified \nasset if the supplier does not have a substantive \nsubstitution right (see section 3.2.3) . If the \ncustomer controls its use (see section 3.3), there \nis a lease. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 60}), Document(page\_content='Leases 60 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Arrangement Identified \nasset?1 Rationale \nUse of a specific \nspot on a cell \ntower Yes Consistent with the above discussion, the \ndesignated cell ular tower space is an identified \nasset if the supplier does not have a substantive \nsubstitution right (see section 3.2.3) . If the \ncustomer controls its use (see section 3.3), there \nis a lease. \nSatellite \ntransponder Yes Consistent with the above discussio n, the \ndesignated transponder is an identified asset if the \nsupplier does not have a substantive substitution \nright (see section 3.2.3) . If the customer controls \nits use (see section 3.3), there is a lease. \nUse of space on \nthe side of a \nbuilding for \nadver tising No The primary purpose of the side of the building is \nto enclose the interior of the building; the use of \nthe outside of the wall to display advertising is \nsecondary to the wall’s primary purpose. This \ninforms why the outside aspect (i.e. layer) of the \nwall, where the advertising will be displayed, is \nnot physically or mechanically separable from the remainder of that wall, which is being used, \nprimarily, to protect/support the building. \nTherefore, the space where the advertising is displayed is not an identi fied asset, and no lease \nexists because the advertising space customer is \nnot obtaining substantially all of the economic \nbenefits from use of the larger identified asset. \nEven though the space on the wall where the \nadvertising is placed is not an identifi ed asset, if \nthe building owner attaches a frame or billboard to \nthe building that is itself an item of property, plant \nor equipment, that frame or billboard can be \nleased (see item – ‘Use of a billboard’). \nUse of space on \nthe side of a bus stop shelter for \nadvertising No The primary purpose of the side of the shelter is \nto enclose the space within it; the use of the \noutside of the shelter to display advertising is \nsecondary to the shelter’s primary purpose. This \ninforms why the outside of the shelter wal l, \nwhere the advertising will be displayed, is not \nphysically or mechanically separable from the \nremainder of that wall, which is being used, \nprimarily, to protect bus customers from the \nweather. \nTherefore, the space where the advertising is \ndisplayed is n ot an identified asset, and no lease \nexists because the advertising space customer is \nnot obtaining substantially all of the economic \nbenefits from use of the larger identified asset. \nEven though the space on the side of a bus stop \nshelter where the advert ising is placed is not an \nidentified asset, if the bus stop shelter owner \nattaches a frame or billboard to the bus stop ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 61}), Document(page\_content='Leases 61 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Arrangement Identified \nasset?1 Rationale \nshelter that is itself an item of property, plant or \nequipment, that frame or billboard can be leased \n(see next item – ‘Use of a billboa rd’). \nUse of a billboard Yes The billboard is itself a capitalizable item of \nproperty, plant and equipment, and therefore it is an identifiable asset that can be leased. If an \nentity owns the billboard and grants a customer \nexclusive rights to use that billboard and the right \nto decide (and change) what advertising goes on \nthe billboard during the period of use (even if \nsubject to restrictions), the customer is leasing the identified billboard. \nUse of a building \nrooftop Yes In most cases, we believ e a rooftop is akin to the \ntop floor of the building (albeit without a roof) – i.e. \nencompassing not just the surface of the roof, but \nthe useful space above that surface where, for \nexample, an entity may operate a rooftop bar or \nrestaurant, or use as outdoor space for residential \ntenants. These uses are generally the primary use \nof that space. An entity may also primarily use \nthat space to place valuable equipment (antennae, \ncellular towers, solar panels). Specific facts and \ncircumstances will need to be c onsidered when \nevaluating rooftop scenarios. \nNote : \n1. In general, regardless of the conclusion reached for each of the examples in this table, \nwe believe it is acceptable to conclude that the item (i.e. the portion of the larger asset) \nis an identifi able asset . If the supplier does not have a substantive substitution right (see \nsection 3.2.3) , the asset will be identified. In that case, a lease exists if the customer \ncontrols its use (see section 3.3). \n \n Example 3.2.15\*\* \nRooftop space asset identification \nThe following scenarios illustrate how to apply Question 3.2.40 to two \nscenarios in which a solar power producer obtains the right to use an unrelated \nthird party’s rooftop space to place solar power generating equipment. These \nare not the only scenarios that exist. The conclusions reached in each of these \nscenarios are based on the totality of the facts and circumstances; no single \nfact or circumstance should be taken as individually determinative. \nScenario 1: Rooftop supplier is solar powe r offtaker \nRetailer operates retail stores across the US. To support those operations, it also owns a number of distribution centers, one of which is located in the Southwest (Southwest Distribution Center or the Center). \nRetailer enters into a ‘Power Pur chase Agreement’ (PPA) with Solar Supplier \nunder which Solar Supplier will install, maintain and operate a solar power generating system at the Center from which Retailer will purchase all of the ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 62}), Document(page\_content='Leases 62 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. electricity generated. The PPA includes a specific clause that permits Solar \nSupplier to install the solar system equipment on a portion of the Center’s \nrooftop space and access that space as necessary to operate and maintain the \nequipment for the 15- year term of the PPA. \nAssume that in appropriately applying Topic 842, Retailer and Solar Supplier \neach conclude that Retailer is not leasing the solar system equipment from \nSolar Supplier. \nNext, each party evaluates whether Solar Supplier’s right to use the Center rooftop space constitutes a lease of that space from R etailer to Solar Supplier \n(i.e. to permit Solar Supplier to provide its electricity supply service). In this \nevaluation, Retailer and Solar Supplier principally consider the following points. \n— Retailer’s primary business is its retail operations, and the Center is key thereto. Retailer is not in the business of acquiring and developing real estate properties for rental income or investment return. \n— Retailer’s primary use of the Center is to support retail operations, and the \nCenter’s roof is integral to protecting Retailer’s equipment, inventory, \ndistribution center personnel and continuity of distribution center operations. \n— Retailer uses significant amounts of electricity to operate the Center; the \nPPA will (1) supply needed electricity, (2) further Retailer ’s carbon \ncommitments and (3) comply with renewable energy usage regulations of \nthe jurisdiction in which the distribution center resides. \n— Retailer is purchasing all of the output generated by the solar system equipment; none of that output is being provided to other parties. \nIn this scenario, Retailer and Solar Supplier conclude there is not a lease of the \nrooftop space. Each concludes that the rooftop is not , in effect, a leasable \nspace (i.e. akin to a second floor of the Center) on the basis that Retailer is not \nin the business of leasing or otherwise monetizing its real estate property. The primary purpose and function of the Center’s roof is, as an integral component \nof the Center, to protect the Center’s equipment, inventory, personnel and \nopera tions. \nConsequently, each determines that it is reasonable to conclude that the \nrooftop space where the solar system equipment will be installed is not a \nseparately identifiable asset under Topic 842 from the roof as a whole, the \nentirety of which is neces sary to fulfill its defined primary purpose. Because \nSolar Supplier does not obtain substantially all of the economic benefits from \nuse of the identified roof as a whole – i.e. Retailer obtains substantial economic \nbenefits from the roof’s fulfillment of i ts primary purpose – the roof is not being \nleased to Solar Supplier. \nScenario 2: Rooftop supplier is a real estate owner and lessor not taking \nthe solar power \nReal Estate Developer (RED) owns numerous office and industrial buildings. It \nowns those buildings as investment property and leases space therein to \ntenants for rental income. \nRED enters into a 15- year ‘Lease Agreement’ with Solar Supplier that permits \nSolar Supplier to install, operate, monitor and maintain solar power generating ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 63}), Document(page\_content='Leases 63 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. equipment on the r ooftop of one of RED’s buildings. RED will receive a fixed \npayment each year for these rights under the agreement. RED has no rights to \nrequire Solar Supplier to relocate the equipment during the 15- year agreement \nterm. \nThe Lease Agreement refers to a power purchase agreement (PPA) between \nSolar Supplier and a third- party utility company unrelated to either RED or Solar \nSupplier. RED is not a party to this PPA. RED will take none of the electricity generated by the solar equipment installed on its building roof; the utility \ncompany will take and resell all of the electricity generated to its customers. RED’s tenants in the building are not parties to the Lease Agreement or the \nPPA. \nBecause RED is taking none of the output from the solar equipment installed on \nits roof, RED is not leasing the solar system equipment from Solar Supplier (i.e. \nRED does not have the right to obtain substantially all of the equipment’s \neconomic benefits from use). Therefore, each party then evaluates whether \nSolar Supplier’s right to use the building rooftop space to place Solar Supplier’s \nsolar system equipment constitutes a lease of that space from RED to Solar \nSupplier. \nIn making this evaluation, RED and Solar Supplier consider that RED’s primary \nbusiness is that of a real estat e owner and lessor. As observable from its \npublicly available promotional, marketing and informational material, RED acquires investment property like the building in this arrangement for the \nprimary purpose of earning a return on that property, inclusive of property \nappreciation and rental income over the time period it owns the property. RED \nearns rental income from all available sources at each of its properties, including interior and exterior space. \nBecause RED’s primary use of the building is as a tenanted rental property, \nearning rental income from all leasable space, the rooftop space that will be occupied by Solar Supplier’s equipment in this scenario is , in contrast to \nScenario 1, a leasable space (i.e. akin to a top floor of the building and the \ninterior space within the building). And because RED has no substitution rights, \nthat space is an identified asset. \nRED and Solar Supplier further conclude that Solar Supplier controls the use of \nthe identified rooftop space throughout the period of use, a nd therefore that a \nlease exists, because: \n— Solar Supplier has exclusive use of the identified rooftop space; that is, no \nother entity can place equipment or make substantive use of that space for \neconomic benefit while Solar Supplier’s equipment occupies i t. \n— Solar Supplier has the right to direct the use of the rooftop space. While all \nof the how and for what purpose decisions about the use of the space are \neffectively pre- determined by the agreement (i.e. that it will be used solely \nfor the placement of So lar Supplier’s solar system equipment), Solar \nSupplier is deemed to operate the space because it will solely install, \nmaintain and (if necessary) replace the solar system equipment that will \noccupy the space. \nNote that although RED is not an offtaker of the solar power generated by the \nsolar system equipment installed on its roof in this scenario, the conclusion that ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 64}), Document(page\_content='Leases 64 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. it is leasing the rooftop space on which the equipment is installed to Solar \nSupplier does not depend on that fact. \n \n Question 3.2.5 0 \nRight o f first refusal \nIs a customer’s right of first refusal over a portion of the \ncapacity of an asset considered when assessing whether a \ncapacity portion represents substantially all of the capacity of \nthat asset ? \nInterpretive response: Yes, provided it is substantive. In some contracts, a \nsupplier commits to making all of the capacity of an asset available to a \ncustomer, but may sell any unused capacity to third parties if the customer \nagrees. In these cases, the customer has the right t o use substantially all of the \ncapacity of the asset such that there is an identified asset. \nFor example, Customer enters into a 10- year contract with Supplier for \nspecialized widgets. The supply contract does not specify the asset that will be \nused by Su pplier to fulfill the contract, but Supplier’s facility is implicitly \nspecified because it is Supplier’s only facility that is capable of manufacturing the specialized widgets , and it is specially designed for that purpose. \nCustomer’s order is expected to consume approximately 70 percent of the capacity of the facility. B efore Supplier is permitted to use the remaining \ncapacity to produce specialized widgets for other customers, Supplier must notify Customer , and Customer has the right to take the remaining production \ncapacity of the facility. \nIn this example , Customer is entitled to substantially all of the capacity of \nSupplier’s manufacturing facility on the basis that it is contracted to use \n70 percent of the capacity of the facility and has a right of f irst refusal for the \nother 30 percent. Therefore, and in consideration of the fact that the specially \ndesigned nature of the facility means it is not practicable for Supplier to \nsubstitute an alternative facility, the manufacturing facility is an identified asset. \nNote: The right of first refusal would not be considered substantive if , to use \nthe additional 30 percent of capacity , Customer was required to pay an \nincremental amount that was so high that it would be commercial ly \nunreasonable for Customer to purchase that additional capacity. In that case, \nCustomer would not have the right to obtain substantially all of the capacity \nfrom the facility , and therefore there would not be an identified asset. Further, \ngiven Customer’s substantive right to o\nnly 70 percent of the facility’s capacity, \nthe arrangement would also not contain a lease because Customer would not \nhave the right to obtain substantially all of the economic benefits from its use \n(see section 3.3.3 ). \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 65}), Document(page\_content='Leases 65 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 3.2.3 Does supplier have a substantive substitution right? \n Excerpt from ASC 842 -10 \n>>> Substantive Substitution Rights \n15-10 Even if an asset is specified, a customer does not have the right to use \nan identified asset if the supplier has the substantive right to substitute the \nasset throughout the period of use. A supplier’s right to substitute an asset is \nsubstantive only if both of the following conditions exist: \na. The supplier has the practical ability to substitute alternative assets \nthroughout the period of use (for example, the customer cannot prevent \nthe supplier from substituting an asset, and alternative assets are readil y \navailable to the supplier or could be sourced by the supplier within a \nreasonable period of time). \nb. The supplier would benefit economically from the exercise of its right to \nsubstitute the asset (that is, the economic benefits associated with \nsubstituting the asset are expected to exceed the costs associated with \nsubstituting the asset). \n15-11 An entity’s evaluation of whether a supplier’s substitution right is \nsubstantive is based on facts and circumstances at inception of the contract \nand shall exclude consideration of future events that, at inception, are not \nconsidered likely to occur. Examples of future events that, at inception of the \ncontract, would not be considered likely to occur and, thus, should be excluded \nfrom the evaluation include, but are not limited to, the following: \na. An agreement by a future customer to pay an above- market rate for use of \nthe asset \nb. The introduction of new technology that is not substantially developed at \ninception of the contract \nc. A substantial difference between the customer’s use of the asset, or the \nperformance of the asset and the use or performance considered likely at \ninception of the contract \nd. A substantial difference between the market price of the asset during the \nperiod of use and the market price considered likely at inception of the \ncontract. \n15-12 If the asset is located at the customer’s premises or elsewhere, the \ncosts associated with substitution are generally higher than when located at \nthe supplier’s premises and, therefore, are more likely to exceed the benefits \nassociated with substituting the asset. \n15-13 If the supplier has a right or an obligation to substitute t he asset only on \nor after either a particular date or the occurrence of a specified event, the \nsupplier does not have the practical ability to substitute alternative assets \nthroughout the period of use. \n15-14 The supplier’s right or obligation to substitut e an asset for repairs or \nmaintenance, if the asset is not operating properly, or if a technical upgrade \nbecomes available, does not preclude the customer from having the right to \nuse an identified asset. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 66}), Document(page\_content='Leases 66 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 15-15 If the customer cannot readily determine whet her the supplier has a \nsubstantive substitution right, the customer shall presume that any substitution \nright is not substantive. \n55 Implementation Guidance and Illustrations \nGeneral \n> Illustrations \n>> Illustration of Identifying a Lease \n>>> Example 1— Rail Cars \n>>>> Case A —Contract Contains a Lease \n55-42 A contract between Customer and a freight carrier (Supplier) provides \nCustomer with the use of 10 rail cars of a particular type for 5 years. The \ncontract specifies the rail ca rs; the cars are owned by Supplier. Customer \ndetermines when, where, and which goods are to be transported using the \ncars. When the cars are not in use, they are kept at Customer’s premises. \nCustomer can use the cars for another purpose (for example, stora ge) if it so \nchooses. However, the contract specifies that Customer cannot transport \nparticular types of cargo (for example, explosives). If a particular car needs to \nbe serviced or repaired, Supplier is required to substitute a car of the same \ntype. Other wise, and other than on default by Customer, Supplier cannot \nretrieve the cars during the five- year period. \n55-43 The contract also requires Supplier to provide an engine and a driver \nwhen requested by Customer. Supplier keeps the engines at its premises and \nprovides instructions to the driver detailing Customer’s requests to transport \ngoods. Supplier can choose to use any one of a number of engines to fulfill \neach of Customer’s requests, and one engine could be used to transport not \nonly Customer ’s goods, but also the goods of other customers (for example, if \nother customers require the transport of goods to destinations close to the \ndestination requested by Customer and within a similar timeframe, Supplier \ncan choose to attach up to 100 rail cars to the engine). \n55-44 The contract contains leases of rail cars. Customer has the right to use \n10 rail cars for 5 years. \n55-45 There are 10 identified cars. The cars are explicitly specified in the \ncontract. Once delivered to Customer, the ca rs can be substituted only when \nthey need to be serviced or repaired. The engine used to transport the rail cars \nis not an identified asset because it is neither explicitly specified nor implicitly \nspecified in the contract. \n55-46 Customer has the ri ght to control the use of the 10 rail cars throughout \nthe 5- year period of use because: \na. Customer has the right to obtain substantially all of the economic benefits \nfrom use of the cars over the five- year period of use. Customer has \nexclusive use of the ca rs throughout the period of use, including when \nthey are not being used to transport Customer’s goods. \nb. Customer has the right to direct the use of the cars. The contractual \nrestrictions on the cargo that can be transported by the cars are protective \nrights of Supplier and define the scope of Customer’s right to use the cars. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 67}), Document(page\_content='Leases 67 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Within the scope of its right of use defined in the contract, Customer \nmakes the relevant decisions about how and for what purpose the cars are \nused by being able to decide when and wh ere the rail cars will be used and \nwhich goods are transported using the cars. Customer also determines \nwhether and how the cars will be used when not being used to transport \nits goods (for example, whether and when they will be used for storage). \nCustomer has the right to change these decisions during the five- year \nperiod of use. \n55-47 Although having an engine and driver (controlled by Supplier) to transport \nthe rail cars is essential to the efficient use of the cars, Supplier’s decisions in \nthis r egard do not give it the right to direct how and for what purpose the rail \ncars are used. Consequently, Supplier does not control the use of the cars \nduring the period of use. \n>>>> Case B —Contract Does Not Contain a Lease \n55-48 The contract between Customer and Supplier requires Supplier to \ntransport a specified quantity of goods by using a specified type of rail car in \naccordance with a stated timetable for a period of five years. The timetable and \nquantity of goods specified are equivalent to C ustomer having the use of 10 rail \ncars for 5 years. Supplier provides the rail cars, driver, and engine as part of the \ncontract. The contract states the nature and quantity of the goods to be \ntransported (and the type of rail car to be used to transport th e goods). Supplier \nhas a large pool of similar cars that can be used to fulfill the requirements of \nthe contract. Similarly, Supplier can choose to use any one of a number of \nengines to fulfill each of Customer’s requests, and one engine could be used \nto transport not only Customer’s goods, but also the goods of other \ncustomers. The cars and engines are stored at Supplier’s premises when not \nbeing used to transport goods. \n55-49 The contract does not contain a lease of rail cars or of an engine. \n55-50 The rail cars and the engines used to transport Customer’s goods are \nnot identified assets. Supplier has the substantive right to substitute the rail \ncars and engine because: \na. Supplier has the practical ability to substitute each car and the engine \nthroughout the period of use. Alternative cars and engines are readily \navailable to Supplier, and Supplier can substitute each car and the engine \nwithout Customer’s approval. \nb. Supplier would benefit economically from substituting each car and the \nengine. Th ere would be minimal, if any, cost associated with substituting \neach car or the engine because the cars and engines are stored at \nSupplier’s premises and Supplier has a large pool of similar cars and \nengines. Supplier benefits from substituting each car or the engine in \ncontracts of this nature because substitution allows Supplier to, for \nexample, (1) use cars or an engine to fulfill a task for which the cars or \nengine are already positioned to perform (for example, a task at a rail yard \nclose to the point of origin) or (2) use cars or an engine that would \notherwise be sitting idle because they are not being used by a customer. \n55-51 Accordingly, Customer does not direct the use and does not have the \nright to obtain substantially all of the economic b enefits from use of an \nidentified car or an engine. Supplier directs the use of the rail cars and engine ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 68}), Document(page\_content='Leases 68 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. by selecting which cars and engine are used for each particular delivery and \nobtains substantially all of the economic benefits from use of the rail ca rs and \nengine. Supplier is only providing freight capacity. \n>>> Example 2— Concession Space \n55-52 A coffee company (Customer) enters into a contract with an airport \noperator (Supplier) to use a space in the airport to sell its goods for a three- year \nperiod. The contract states the amount of space and that the space may be \nlocated at any one of several boarding areas within the airport. Supplier has the \nright to change the location of the space allocated to Customer at any time \nduring the period of use. There are minimal costs to Supplier associated with \nchanging the space for the Customer: Customer uses a kiosk (that it owns) \nthat can be moved easily to sell its goods. There are many areas in the airport \nthat are available and that would meet the specifications for the space in \nthe contract. \n55-53 The contract does not contain a lease. \n55-54 Although the amount of space Customer uses is specified in the \ncontract, there is no identified asset. Customer controls its owned kiosk. \nHowever, the contract is for space in the airport, and this space can change at \nthe discretion of Supplier. Supplier has the substantive right to substitute the \nspace Customer uses because: \na. Supplier has the practical ability to change the space used by Customer \nthroughout the period of use. There are many areas in the airport that meet \nthe specifications for the space in the contract, and Supplier has the right \nto change the location of the s pace to other space that meets the \nspecifications at any time without Customer’s approval. \nb. Supplier would benefit economically from substituting the space. There \nwould be minimal cost associated with changing the space used by \nCustomer because the kiosk c an be moved easily. Supplier benefits from \nsubstituting the space in the airport because substitution allows Supplier to \nmake the most effective use of the space at boarding areas in the airport \nto meet changing circumstances. \n>>> Example 4— Retail Un it \n55-63 Customer enters into a contract with property owner (Supplier) to use \nRetail Unit A for a five -year period. Retail Unit A is part of a larger retail space \nwith many retail units. \n55-64 Customer is granted the right to use Retail Unit A. Supplier can require \nCustomer to relocate to another retail unit. In that case, Supplier is required to \nprovide Customer with a retail unit of similar quality and specifications to Retail \nUnit A and to pay for Customer’s relocation costs. Supplier would benefit \neconom ically from relocating Customer only if a major new tenant were to \ndecide to occupy a large amount of retail space at a rate sufficiently favorable \nto cover the costs of relocating Customer and other tenants in the retail space \nthat the new tenant will occ upy. However, although it is possible that those \ncircumstances will arise, at inception of the contract, it is not likely that those \ncircumstances will arise. For example, whether a major new tenant will decide \nto lease a large amount of retail space at a rate that would be sufficiently ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 69}), Document(page\_content='Leases 69 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. favorable to cover the costs of relocating Customer is highly susceptible to \nfactors outside Supplier’s influence. \n55-65 The contract requires Customer to use Retail Unit A to operate its well -\nknown store brand to sel l its goods during the hours that the larger retail space \nis open. Customer makes all of the decisions about the use of the retail unit \nduring the period of use. For example, Customer decides on the mix of goods \nsold from the unit, the pricing of the goods sold, and the quantities of inventory \nheld. Customer also controls physical access to the unit throughout the five-\nyear period of use. \n55-66 The contract requires Customer to make fixed payments to Supplier as \nwell as variable payments that are a pe rcentage of sales from Retail Unit A. \n55-67 Supplier provides cleaning and security services as well as advertising \nservices as part of the contract. \n55-68 The contract contains a lease of retail space. Customer has the right to \nuse Retail Uni t A for five years. \n55-69 Retail Unit A is an identified asset. It is explicitly specified in the \ncontract. Supplier has the practical ability to substitute the retail unit, but could \nbenefit economically from substitution only in specific circumsta nces. \nSupplier’s substitution right is not substantive because, at inception of the \ncontract, those circumstances are not considered likely to arise. \n55-70 Customer has the right to control the use of Retail Unit A throughout the \nfive-year period of use because: \na. Customer has the right to obtain substantially all of the economic benefits \nfrom use of Retail Unit A over the five- year period of use. Customer has \nexclusive use of Retail Unit A throughout the period of use. Although a \nportion of the cash flows derived from sales from Retail Unit A will flow \nfrom Customer to Supplier, this represents consideration that Customer \npays Supplier for the right to use the retail unit. It does not prevent \nCustomer from having the right to obtain substantially all of the economic \nbenefits from use of Retail Unit A. \nb. Customer has the right to direct the use of Retail Unit A. The contractual \nrestrictions on the goods that can be sold from Retail Unit A and when \nRetail Unit A is open define the scope of Customer’s right to use Retail \nUnit A. Within the scope of its right of use defined in the contract, \nCustomer makes the relevant decisions about how and for what purpose \nRetail Unit A is used by being able to decide, for example, the mix of \nproducts that will be sold in the retail unit and the sale price for those \nproducts. Customer has the right to change these decisions during the \nfive-year period of use. \n55-71 Although cleaning, security, and advertising services are essential to the \nefficient use of Retail Unit A, Supplier’s decisions in this regard do not give it \nthe right to direct how and for what purpose Retail Unit A is used. \nConsequently, Supplier does not control the use of Retail Unit A during the \nperiod of use, and Supplier’s decisions do not affect Customer’s control of the \nuse of Retail Unit A. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 70}), Document(page\_content='Leases 70 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 3.2.80 Even if an asset is explicitly specified, there is no identified asset (and \ntherefore the contract does not contain a lease) if the supplier has a substantive \nright to substitute the asset throughout the period of use. A substitution right is \nsubstantive when the supplier: [842- 10-15-10] \n— has the practical ability to substitute alternative assets throughout the period of use; and \n— would benefit economically from the exercise of its substitution right – i.e. \nthe economic benefits that will be derived from substituting the asset \nexceed t he costs of the substitution; for example, costs to \ntransport/relocate the original and the alternative asset, and associated \nlabor costs. \n \n Observation \nSubstantive substitution rights change the \nsubstance of the arrangement \n3.2.90 Evaluating whether a supplier substitution right is substantive is \neffectively a test to determine whether the supplier (rather than the customer) \ncontrols the use of the asset because it can substitute that asset throughout \nthe period of use. When a subst itution right is substantive, meaning that the \nsupplier can substitute and redeploy that asset as it sees fit, the supplier has the right to decide how and for what purpose the asset is used, and therefore \ndirects its use. A substantive substitution right changes the substance of the arrangement – i.e. there is not an identified asset. \n[ASU 2016- 02.BC128– BC129] \n3.2.100 The Board believes that it will be clear in many situations whether a \nsubstitution right is substantive. However , it may sometimes be difficult for a \ncustomer to make that determination. For example, a customer may not have \nsufficient information to perform the evaluation – e.g. assessing the supplier’s \ncosts and potential economic benefits from substituting the asset may be particularly difficult in many cases. This is why the Board included the \npresumption that substitution rights are not substantive when the customer \ncannot readily make that determination. Accordingly, a customer does not have \nto exert undue effort to prove that a substitution right is not substantive. \n[ASU 2016- 02.BC130 –BC132] \n3.2.110 The specific guidance on substitution rights, especially the condition that \nthe supplier must benefit economically from substituting the asset for a substit ution right to be substantive (see paragraph 3.2.80), may mitigate \nstructuring opportunities to include substitution clauses solely to avoid having \nan identified asset in the contract. \n3.2.120 In considering whether the supplier has the practical ability to substitute \nalternative assets, an entity considers whether the customer can prevent substitution and, if not, whether the supplier has ready access to an alternative \nasset or could source an alternative asset within a reasonable period. \n[842- 10-15-10(a)] \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 71}), Document(page\_content='Leases 71 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 3.2.130 An entity evaluates whether a supplier substitution right is substantive \nbased on the facts and circumstances at inception of the contract. This \nevaluation excludes consideration of future events that, at inception, ar e not \n‘likely to occur ’.1, 2 For example: [842- 10-15-11, 55- 64] \n— an agreement by a future customer to pay an above- market rate for use of \nthe asset; \n— the introduction of new technology not substantially developed at contract \ninception; \n— a substantial difference between the customer’s use of the asset, or the \nperformance of the asset and the use or performance considered likely at \ninception of the contract; and/or \n— a substantial difference between the market price of the asset during the \nperiod of use and the market price considered likely at inception of the \ncontract. \nNotes: \n1. Under US GAAP, ‘probable’ is defined as “the future event or events are likely to occur.” \nTherefore, we believe ‘likely to occur’ is effectively the same threshold as ‘probable’ . \n[842 Glossary] \n2. Example 4 in Subtopic 842 -10 indicates that the Board views facts and circumstances \nthat are “highly susceptible to factors outside of the supplier’s influence” as not likely to occur.\n [842- 10-55-63 – 55-71] \n3.2.140 Topic 842 provides additional guidance to assist entities in determining \nwhether a supplier substitution right is substantive, including the following. \n— When the asset is located at the customer’s premises (or somewhere other \nthan the supplier’s premises), the costs of substituting the asset are \ngenerally higher than when located at the supplier’s premises. Accordingly, \nthose costs are more likely to exceed the economic benefits of \nsubstitution. [842- 10-15-12] \n— When a supplier has a right or an obligation to substitute the asset only \nbefore, on or after (see diagram s below) either (1) a particular date within \nthe period of use or (2) the occurrence of a specified event, the supplier \ndoes not have the practical ability to substitute alternative assets \nthroughout the period of use. Therefore, the substitution right is not \nsubstantive. As a result, there is an identified asset for the entire period of \nuse (see Question 3.1.30 on determining the period of use) , unless or until \nthe identified asset is substituted by the supplier. [842- 10-15-13, ASU 2016-\n02.BC131] \nPeriod of use\nSupplier substitution right after \nspecified date or future event\nContract depends on an identified asset ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 72}), Document(page\_content='Leases 72 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Period of use\nSupplier substitution right \nbefore specified date or future \nevent\nContract depends on an identified asset \n— A supplier right or obligation to substitute the asset for repairs and \nmaintenance, because the asset is not operating properly, or because a \ntechnical upgrade becomes available, does not preclude the customer from having the right to use an identified asset. \n[842- 10-15-14] \n3.2.15 0 If a customer cannot readily determine whether a supplier substitution \nright is substantive, it should presume that the substitution right is not \nsubstantive. [842- 10-15-15, ASU 2016- 02.BC132] \n \n Question 3.2.55 \nSubstitution rights that do not ex ist throughout the \nperiod of use \nDoes a lease exist only for the portion(s) of the ‘period of use’ \nfor which a substitution right does not exist? \nBackground: As illustrated in paragraph 3.2.140, a substitution right may not \nexist throughout the established ‘period of use’; see Questions 3.1.30 and 3.1.40 about determining the period of use. For example, a substitution right \nmay exist only: \n— at the beginning of the period of use (front -loaded ); \n— at the end of the period of use (back -loaded) ; or \n— during a discrete period(s) within the period of use. \nA question arises as to whet her, in those cases, a lease exi sts only for those \nperiods of time for which the supplier does not have a substitution right. \nSpecifically: \n— In a ‘front -loaded’ substitution right scenario, does a lease exist only after \nthe substitution right expires – i.e. the lease would commence on exp iration \nof the substitution right ? \n— In a ‘back- loaded’ substitution right scenario, does a lease exist only for the \nperiod of time before the right becomes operative? \n— In a discrete period(s) scenario, does a lease exist only during those periods \nfor which a substitution right does not exist ? \nInterpretive response: No. We believe the guidance in Topic 842 and the basis \nfor conclusions to ASU 2016- 02 are explicit that a substitution right that does \nnot exist ‘throughout the period of use’ is not substantive . In other words, a \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 73}), Document(page\_content='Leases 73 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. substitution right that exists for only a portion of the period of use (whether \nfront -loaded, back -loaded or for a discrete period (or periods) during the \nestablished period of use) is not substantive. And only a substantive \nsubstitution r ight affects lease identification. Therefore, based on the guidance \ndescribed in paragraph 3.2.140, substitution rights that exist for only a portion of the period of use are effectively ignored when deciding whether or not a lease \nexists. \n[842- 10-15-13, A SU 2016 -02.BC128– BC129, BC131] \nIn addition, we do not believe a supplier’s substitution rights affect (i.e. change) \nthe period of use. For example, the period of use is not determined by the \nperiods for which the supplier does not have a substantive substi tution right. \nThis is because, a s explained in Question 3.1.30, the period of use is an input to \nthe lease identification criteria in paragraph 3. 1.40. It is therefore determined \nbefore, and independent of , the entity’s evaluation of those criteria; it is not \ndetermined or affected by the evaluation of those criteria. \n \n Question 3.2.6 0 \nSupplier’s practical ability to substitute alternative \nassets \nHow does the guidance in paragraph 842 -10-15-11 interact \nwith the guidance in paragraph 842 -10-15-13 when evaluating \nwhether a supplier substitution right is substantive? \nInterpretive response: Paragraph 842- 10-15-13 addresses whether a supplier \nhas the practical ability to substitute alternative assets throughout the period of \nuse. As discussed in paragraph 3.2.1 40, if the supplier has the right or obligation \nto substitute an alternative asset only on or after a specified date, or after the \noccurrence of a specified event, the substitution right is not substantive \nbecause it does not encompass the entire period of use. No consideration of \nthe guidance in paragraph 842- 10-15-11 is needed when a supplier substitution \nright does not encompass the entire peri od of use. [842- 10-15-13] \nParagraph 842- 10-15-11 applies when the supplier has the practical ability to \nsubstitute an alternative asset throughout the period of use and the entity \n(customer or supplier) is considering whether exercising that right will \neconomically benefit the supplier. If a supplier with the practical ability to \nexercise a substitution right will only benefit economically from exercising that \nright under circumstances that are not ‘likely to occur’, that substitution right is \nnot substa ntive. [842- 10-15-11] \nConsider the following contrasting scenarios. \n— A supplier leases a group of similar assets maintained at its premises \nto a customer. The supplier has the right, throughout the period of use, to \nsubstitute the leased assets and has a pool of readily available alternative \nassets. Relevant experience demonstrates that (1) the supplier benefits \neconomically from being able to deploy alternative assets as necessary to \nfulfill customer needs, and (2) the conditions that make substitution \neconomically beneficial (e.g. the nature and mix of different customer \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 74}), Document(page\_content='Leases 74 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. needs for the supplier’s assets) are likely to continue throughout the period \nof use. In this scenario, the supplier’s substitution right is substantive. \n— A supplier leases a piece of equ ipment to a customer. The supplier has \nthe right at any time throughout the period of use to substitute an alternative, but generally equivalent, piece of equipment and has readily \navailable alternative assets. However, the supplier will only benefit \neconomically from doing so if events and circumstances change from those \nat lease commencement; for example, a new customer wants to lease or \nbuy the specific piece of equipment being leased and is willing to pay a \npremium to get it. The necessary circumstance in this case is not ‘likely to \noccur’ because it depends on factors substantially outside of the supplier’s \ncontrol and there is not relevant history to suggest this is likely to occur. In \nthis scenario, the supplier’s substitution right is not substantive . \n \n Question 3.2.70\*\* \nSubstitution rights that are not economically \nbeneficial throughout the period of use \nIs a substitution right substantive if the supplier would not \nbenefit economically from the exercise of its right throughout the period of use? \nBackground: Consider the following scenario to illustrate the question. \nCustomer enters into a 10- year contract with Supplier for the use of 50 similar \nassets that are new at lease commencement. Supplier has the contractual right \nand practical abilit y to substitute alternative assets, and is required to maintain \nthe assets for no incremental consideration, throughout the 10- year period of \nuse. Supplier expects to benefit economically from substituting used assets \n(which require more maintenance) with new ones and redeploying the used \nassets to a different class of customer. Given the economic life and expected \ndegradation of the assets, Supplier is not expected to benefit economically from \nsubstituting any of these assets before the end of Year 3 but i s expected to \nbenefit economically after that time. \nParagraph 842- 10-15-11 (see Question 3.2.60 for additional guidance relevant to \nthis paragraph) states that, in the context of evaluating the substance of \nsupplier substitution rights, future events shoul d only be considered if ‘likely to \noccur’. [842- 10-15-11] \nMeanwhile, paragraph 842 -10-15-10 states that “a customer does not have the \nright to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use.” \n[842- 10-15-10] \nTherefore, in the above scenario the question arises whether the supplier’s substitution right is substantive given that it is likely that the supplier will be \nable to benefit economically from substitution, but not ‘throughout the [ 10-year] \nperiod of use’ – i.e. at least not for the first three years. \nInterpretive response: We believe it depends, in general, on the significance \nof the portion of the period of use during which it is unlikely that events or \ncircumstances will arise fro m which the supplier can benefit economically. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 75}), Document(page\_content='Leases 75 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. For example, in the background scenario, we believe Supplier’s substitution \nright is not substantive because it is unlikely that events or circumstances will \narise from which Supplier would benefit economical ly from substitution for \nthree years of the 10 -year period of use. \nBy contrast, consider Examples 1B and 2 (on railcars and airport concession \nspace, respectively) in Subtopic 842- 10 in which the supplier is determined to \nhave a substantive substitution ri ght. While not explicitly stated in either \nexample, we believe those scenarios imply that it is unlikely events or \ncircumstances would arise from which the supplier would benefit economically \nfrom substitution either: [842- 10-55-42 – 55-54] \n— immediately (or nearly immediately) after commencement (e.g. from \nmoving an airport kiosk operator immediately after initially assigning them a terminal space); or \n— for some period of time after substituting a terminal space or railcar; it appears some time would logical ly need to pass before changed events or \ncircumstances would again make substitution economically beneficial to the \nsupplier. \nIn addition, we believe it would generally be the case (i.e. in most scenarios) \nthat near the end of the lease term, substitution would no longer be \neconomically beneficial for a supplier; for example, if the supplier would soon \nafter such substitution need to incur costs to retrieve the underlying asset at \nthe end of the lease. \nBased on the above altogether, and considering that the existence of paragraph \n842-10-15-11 clearly indicates that the supplier does not have to be able to \nbenefit economically from making a substitution “at all points in time” during the period of use for its substitution right to be substantive,\n1 we believe a \nsupplier substitution right is substantive only when the ‘likely to occur’ events and circumstances that would give rise to net economic benefits from \nsubstitution can feasibly arise at substantially any time during the period of use. \nWe believe a scena rio meets this ‘at substantially any time’ test if the only time \nperiods during which those events and circumstances are unlikely to arise \nduring the period of use are (1) shortly after commencement, (2) shortly after a \nsubstitution occurs or (3) near the end of the lease term. By contrast, we \nbelieve any scenario, such as that in the background, in which there is a \nsignificant, identifiable portion of the period of use during which those events or circumstances are unlikely to occur does not. \nNote: \n1. An “at all points in time” interpretation of ‘throughout the period of use’ would \neffectively nullify paragraph 842 -10-15-11; that is, if a supplier must benefit economically \nfrom substitution at all points in time during the period of use, then why would an enti ty \nneed to consider whether future events are ‘likely to occur’? [842-10-15-10(b), 15- 11] \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 76}), Document(page\_content='Leases 76 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 3.2.20 \nSubstitution rights \nScenario 1: Supplier has substantive substitution right \nCustomer enters into an arrangement with Supplier for a climate -controlled \nstorage warehouse to store its coffee beans. \nSupplier has the right to substitute the storage warehouse without Customer’s \nconsent throughout the term of the contract. The following additional facts are \nrelevant. \n— Supplier has many identi cal storage warehouses that are maintained in a \nsingle, accessible location and Supplier could easily substitute another storage warehouse for the one specified in the contract at a nominal cost. \n— Supplier would benefit economically from substituting the st orage \nwarehouse because substitution allows it to make the most effective use of its storage warehouse portfolio to meet regularly changing circumstances, which are likely to continue throughout the period of use. \nIn this scenario, there is not an identifi ed asset, because Supplier’s substitution \nright is substantive. Accordingly, the contract does not contain a lease. \nScenario 2: Supplier has substitution right that is not substantive – the \nunderlying asset is significantly customized \nChanging the facts of Scenario 1, although Supplier has the right to substitute \nthe storage warehouse without Customer’s consent throughout the period of use, there are no other similarly customized warehouses in Supplier’s portfolio or readily available from other suppliers. \nIn this scenario, the substitution right is not substantive because a similarly \ncustomized storage warehouse is not readily available – i.e. Supplier does not \nhave the practical ability to substitute the storage warehouse.\n1 Therefore, there \nis an identified asset. The next step is for the parties to determine whether \nCustomer has the right to control the use of the warehouse (see section 3.3) to \ndetermine if there is a lease. \nNote : \n1. Even if Supplier could customize an alternative warehouse in its portfolio within a \nreasonable period of time, the cost of customizing and providing a similar alternative \nstorage warehouse would likely exceed the economic benefits that would be realized \nfrom substitution – i.e. while Supplier would not obtain additional payments from \nCustomer for the substitution, Supplier would incur potentially significant costs to \ncustomize an alternative warehouse to Customer’s needs and to relocate Customer’s \ninventory to the alternative warehouse. In that case, Supplier’s substitution right would \nnot be substantive because it would not benefit economically from the exercise of its \nsubstitution right. \nScenario 3: Customer unable to determine whether supplier substitution \nright is substantive \nChanging the facts of Scenario 2, Customer is unable to determine whether the \nsubstitution right is substantive. In particular, Customer is unable to determine \nwhether a similarly customized storage warehouse is readily available, or \nwhether the economic benefits that would result from substitution exceed the \nexpected costs of making the substitution. In this scenario, Customer does not ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 77}), Document(page\_content='Leases 77 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. know whether Supplier has alternative warehouses or could source one in a \nreasonable period of time, and also does not know if Supplier would \neconomically benefit from substituting the warehouse. \nIn this scenario, Customer presumes that the substitution right is not \nsubstantive, and therefore that there is an identified asset. The next step is \nfor Customer to determine whether it has the right to control the use of the \nwarehouse (see section 3.3) to determine if there is a lease. \n \n Example 3.2.30 \nSupplier substitution right – evaluation of economic \nbenefits \nCustomer enters into a three- year lease of a multi -function copier/printer. The \ncontract provides Customer with the right to determine how to use the \nmachine during the three- year term (subject to the limitations of its design). \nSupplier is required to provide an equivalent machine if the one originally \ndelivered ceases to operate prop erly. Supplier may also substitute an equivalent \nmachine at any time during the period of use at its expense and without \nCustomer’s approval. \nRegarding Supplier’s right of substitution, Supplier has other equivalent \nmachines readily available. However, it is not likely that events or \ncircumstances will arise from which Supplier would be able to generate more rental income by substituting an equivalent machine for the original machine \nthan it would by leaving the original machine in place. Suppli er would incur \ncosts both to transport and install an equivalent machine at Customer’s \nlocation, and to remove and transport the original machine to storage or to another customer’s location. \nIn this example, Supplier’s substitution right is not substantiv e, because the \neconomic benefits from substituting the original machine for an alternate machine would not exceed the costs of the substitution. Therefore, there is an \nidentified asset. The next step is for the parties to determine whether \nCustomer has the right to control the use of the machine (see section 3.3) to \ndetermine if there is a lease. \n \n Example 3.2.40 \nAssessing what is (are) the identified asset(s) \nScenario 1: Storage facility \nStorage Company owns a large storage facility that has 100 individual storage \nunits of varying sizes and specifications – e.g. some are climate- controlled. \nSome customers desire second floor rather than first floor units, to protect \nagainst the potential f or flooding. \nStorage Company enters into a contract with Customer that permits Customer to select 10 storage units (that are not specified at contract inception) once it ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 78}), Document(page\_content='Leases 78 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. determines its storage needs – e.g. Customer may decide that it wants some \nunits to b e adjoining to store complementary items, some units to be climate-\ncontrolled. \nThose 10 units, once selected by Customer, will not comprise substantially all \nthe storage capacity of the facility. In this Scenario, storage capacity is the only \nsubstantive economic benefit from use of the facility. \nJust as if the storage units were selected at the time the contract was entered \ninto, each unit, once it is selected by Customer, is an identified asset. Each of \nthe 10 units is physically distinct and Storage Company cannot substitute that \nunit without Customer’s permission – i.e. willingness to relocate to a different \nunit. \nCustomer controls the use of each unit because Customer: \n— has the right to obtain substantially all of the economic benefits from use of each unit – i.e. Customer has exclusive use of the storage capacity of each \nunit; and \n— directs its use – i.e. Customer generally decides, once selected, what and \nhow much is stored in each unit . \nTherefore, this contract contains 10 leases (one for each storage unit). \nScenario 2: Car fleet \nCar Company owns a fleet of more than 2,000 cars of different makes and \nmodels. Customer enters into a master lease agreement on January 1, 20X4 with Car Company for the right to use up to 50 cars until four years from the \nmaster lease agreement inception date. Customer will pay a monthly lease \npayment to Car Company for each car, once selected, based on the make \nand model. \nJust as if cars wer e selected at the time the master lease agreement was \nentered into, each car, once it is selected by Customer, is an identified asset. \nEach of the 50 cars is physically distinct and Car Company cannot substitute \nthat car for another car without Customer’s permission. In any event, Car \nCompany would be unlikely to benefit economically from doing so because the \ncars will be in Customer’s possession (see paragraph 3.2.140). \nCustomer controls the use of each car because Customer: \n— has the right to obtain substa ntially all of the economic benefits from use of \neach car – i.e. Customer has exclusive use of each car; and \n— directs its use – i.e. Customer generally decides, once selected, where and \nwhen each car is used, and for what purpose. \nTherefore, assuming Cust omer takes all 50 cars, this contract contains \n50 leases (one for each c ar). \nScenario 3: Land plots that result in leases \nA landowner (Supplier) enters into an arrangement with a power company \n(Customer) for the right to select sites and construct 100 wind turbines on a \n500-acre plot of land that is specified in the contract. Each wind turbine will \noccupy an area of 3 0 square yards to which Customer will have exclusive \nuse rights. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 79}), Document(page\_content='Leases 79 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Supplier retains the right to use the remainder of the 500- acre property – i.e. \nthe portions of the property not encompassed by one of the 3 0 square yard \nplots. However, Supplier is not permitted to make use of the land within each \n30 square yard plot – e.g. farm, allow cattle to graze, or construct a road across \nthe land. This is the case regardless of whether Customer chooses to restrict \naccess to those plots – e.g. by installing a fence around each one. \nSupplier has no substitution rights – i.e. it cannot require Customer to relocate \nan installed wind turbine to another 3 0 squa re yard plot. The economic benefit \nassociated with the use of the 100 3 0-square yard plots for the wind turbines \ndoes not represent substantially all of the economic benefit s associated with \nthe use of the entire 500- acre plot of land. \nIn this s cenario, once selected, each 30 square yard plot of land is an identified \nasset , just as if the contract, at inception, had granted Customer the right to use \n100 specifically identified plots . Each of the 100 plots represents implicitly -\nspecified land that is physically distinct from any other of the 100 plots or from \nthe remainder of the 500- acre property and Supplier has no substitution rights. \nCustomer controls the use of each 3 0 square yard plot because Customer: \n— has the right to obtain substantially all of the economic benefits from use of \neach individual plot of land – i.e. it has exclusive use of each plot; neither \nSupplier nor any other party can use the land within each 3 0 square yard \nplot; and \n— directs its use – i.e. the relevant how and for what purpose decisions are \npredetermined by the contract (Customer can only use the plots to install \nwind turbines), but Customer operates the plot within those predetermined \nrights of use because Customer will install and operate the wind turbines (see section 3.3.5) . \nTherefore, this contract contains 100 leases (one for each plot of land). If \npayments for the plots are made before the plots are selected, those payments are prepayments for the plot leases. \nScenario 4: Land plots that do not necessarily result in leases \nAssume the same facts as Scenario 3, except that the contract does not restrict \nSupplier’s ability to make use of the 500- acre plot of land – i.e. there are no \nplots of land around each of the 100 wind turbines that Supplier is not permitted \nto use. \nThere are no contractual , or otherwise enforceable, limitations on Supplier’s \nright to access or make use of the land all the way up to where the bases of the \nturbines are installed in the ground. For example, Supplier’s cattle are permitted \nto graze right up to the base of each wind turbine, which would include doing \nso underneath each turbine’s blades. \nThe base of each wind turbine occupies a small, but clearly defined, place on \nthe land – e.g. one foot × one foot. \nOne view is that the one square foot area occupied by the base of each wind \nturbine is an identified asset and that Customer has exclusive use of that land – \ni.e. has the right to obtain substantially all of the economic benefits from use of \nthat land beca use there is no alternative use for that land once the wind turbine \nis installed. Consistent with Scenario 3, Customer also directs the use of each ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 80}), Document(page\_content='Leases 80 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. plot where a turbine is installed by virtue of operating the wind turbine because \nall of the relevant decisi ons about how and for what purpose the plot will be \nused are predetermined – see section 3.3.5). Consequently, Supplier may \nconclude that the contract contains 100 leases – e.g. one for each 1 square foot \nplot of land. \nAn alternative view that we believe would be acceptable in these specific facts \nand circumstances is that the land occupied by the base of each wind turbine \n(e.g. each 1 square foot plot) is not physically distinct from the land surrounding \nthe base under the turbine blades. Thi s total land area is determined to be a \nsingle unit of account for lease evaluation because the land beneath the turbine \nblades is significantly restricted as to its available uses by virtue of being \nunderneath the turbine blades – i.e. it cannot be used f or any purpose that \nwould interfere with the operation of the turbine. However, there are still substantive economic benefits that can be derived from using the remaining \nland (e.g. for farming or grazing cattle) and Supplier has the enforceable right to \nobtain those substantive, remaining economic benefits from use. Consequently, \nCustomer does not have the right to obtain substantially all of the economic benefits from use of the identified unit of account – i.e. the land in which the \nturbine is installed and over which the turbine’s blades operate – and no \nlease exists. \n \n Example 3.2.50 \nInfrastructure -as-a-Service – identified assets \nCustomer enters into a contract with Supplier to obtain specified network \nservices that are provided through the use of 10 servers and various other \nnetworking equipment for five years. The network services provided by Supplier \ninvolve assets (servers and other equipment) located at Customer’ s premises. \nThe contract between Customer and Supplier requires Supplier to provide \nnetwork services that meet a specified quality level, which if not met result in \nservice -level penalties – i.e. credits aga inst amounts owed by Customer to \nSupplier. Customer controls how and how much it uses the network services, \nbut cannot ( under the terms of the contract ) change the configuration or \nspecifications of the network ( or ‘turn off ’ the network ). \nThe servers and the networki ng equipment to fulfill the network services are \nselected by Supplier, and then explicitly specified in the final cont ract. All of the \nspecified equipment is dedicated to servicing Customer . \nSupplier has the right to substitute the servers and other equipment at any time \nas long as the network services are not interrupted. However, because the \nservers and other equipment are located at Customer’s premises, Supplier’s substitution right is not substantive (see paragraph 3.2.140). That is, even \nthough Supplier has alternative assets it could substitute (i.e. it has the practical \nability to substitute alternative assets), it will not economically benefit from \nsubstituting the servers or equipment with other assets not presently dedicated \nto providing the network services to Customer. Accordingly, there are identified \nassets in the arrangement. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 81}), Document(page\_content='Leases 81 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. When evaluating whether a lease exists, consistent with the response to \nQuestion 3.2.10 , each server and piece of equipment is an identified asset. \nCustomer and Supplier do not evaluate the servers and other equipment as a \ncombined unit of account (i.e. as a network). \nExample 3.3.40 continues this example, determining whether Customer is \nleasing the identified servers and equipment. \n \n Example 3.2.60 \nImplicitly specified land asset with substitution \nrights \nABC Co rp. enters into a contract with a State Department of Transportation \n(SDOT) to allow ABC to place its owned signs on the side of state highways. \nThis is to advertise restaurants, hotels and gas stations located off of each \nhighway exit. \nSDOT decides where al ong each interstate the signs are to be placed and sets \nthe parameters for what can be advertised. For example, SDOT only permits ABC to sell advertising space to food, lodging and fuel operators; ABC cannot \nsell space on its signs to any customers it choo ses. SDOT also restricts the \nprice ABC can charge for advertising space on its signs because SDOT \nwants food, lodging and fuel operator information to be available to state \nhighway drivers. \nSDOT has the contractual right to require ABC to relocate its signs. \n— If SDOT requires the signs to be moved because of ABC’s noncompliance with the terms and conditions of the contract, ABC is required to absorb the \ncost of moving the signs. \n— However, i f the signs are moved solely at the discretion of SDOT, the state \nwill absorb the costs of moving the signs – i.e. SDOT will either move the \nsigns itself or reimburse ABC for its costs incurred. \nIt is possible that SDOT might economically benefit from relocating one of \nABC’s signs – e.g. if the state approves a highway lane expansion or changes to \na highway exit that will produce economic benefits for the state that exceed the \ncosts of sign relocation. However, those circumstances are not ‘likely to occur’ \nat contract inception (see paragraph 3.2.130, Question 3.2.60 and \nExample 3.2.30). \nIn this example, even though the ultimate locations of ABC’s signs are not, and \nwill not be, specified in the contract between SDOT and ABC, there is an \nimplicitly specified land asset for each plot of state- owned land on which ABC \nplaces one of its signs for advertising. Consistent with paragraph 3.2.20, fulfillment of the contract depends on SDOT providing land for ABC’s \nplacement of its signs and SDOT’s right to substitute the land once ABC’ s signs \nare placed is not substantive – i.e. it is not likely SDOT will be able to benefit \neconomically from its substitution rights . \nFor each implicitly specified plot of land, ABC has the right to obtain substantially all of its economic benefits from use. This is because each plot of ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 82}), Document(page\_content='Leases 82 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. land will be exclusively used for the placement of ABC’s sign. And while the \nrelevant how and for what purpose decisions are predetermined by the contract \n(ABC can only use the plots to install signs), ABC operates the plot within those \npredetermined rights of use because ABC will insta ll and operate the signs – i.e. \nby negotiating and selling advertising space on the signs to customers (see \nsection 3.3.5). Therefore, ABC directs the use of each plot. \nConsequently, the contr act between ABC and SDOT contains leases of the \nimplicitly specified plots of land on which ABC will install its signs. \n \n Comparison to legacy US GAAP \nIdentified asset concept aligns with Topic 840 guidance \n3.2.160 The concept of an identified asset is generally consistent with the \nconcept of a specified asset under Topic 840. This includes the concept that an \nasset is implicitly identified if the supplier does not have a substantive \nsubstitution right. The Board dec ided not to revise this concept because it \nworks well in practice. However, because concluding that a contract is or \ncontains a lease has a more significant effect on customers’ accounting \ncompared to Topic 840, the Board also decided to provide additional guidance about when there is, or is not, an identified asset; in particular, providing \nsignificant additional guidance about how to evaluate whether a substitution \nright is substantive. \n[840- 10-15-15] \nDetermining whether substitution rights are substantive \n3.2.170 The explicit requirement that a substitution right must economically \nbenefit the supplier – i.e. the economic benefits associated with substitution \nmust exceed the corresponding costs – to be substantive is new to Topic 842. \nHowever, Topic 840 also provided that a contract depended on specified property, plant or equipment if it was not ‘economically feasible’ (i.e. it was \n‘uneconomical’) to use an alternative asset. Therefore, appl ying the \nrequirements in Topic 842 should not represent a substantial change from how \nTopic 840 should also have been applied. \n[840- 10-15-5, 55 -32(a), ASU 2016- 02.BC129] \n \n3.3 Does the c ustomer c ontrol the use of the \nidentified a sset? \n3.3.10 If an entity determines that a contract depends on the use of an identified \nasset (see section 3.2), it then evaluates whether the customer has the right to \ncontrol the use of that asset for a period of time. This occurs when the customer has the right, throughout the period of use, to: \n[842- 10-15-4] \n— obtain substantially all of the economic benefits from the use of the \nidentified asset; and \n— direct the use of the identified asset. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 83}), Document(page\_content='Leases 83 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 3.3.20 Topic 842 introduces important concepts to determine whether a \ncustomer controls the use of an identified asset. The following flow chart \ndepicts the decision process that an entity considers in this evaluation. \n[842- 10-15-4, 15- 20] \nDetermine the scope of Customer’s \nright of use within the contract \n(see section 3.3.1)Step \n1\nIdentify the economic benefits from \nuse of the identified asset \n(see section 3.3.2)Step \n2\nDoes Customer have the right to \nobtain substantially all of the \neconomic benefits from use of the \nidentified asset ? (see section 3.3.3)Step \n3\nDoes Customer have the right to \ndirect the use of the asset ? \n(see sections 3.3.4 and 3.3.5)Step \n4\nContract is or \ncontains a lease .STOP . Contract \ndoes not contain \na lease . Apply \nother GAAP .Yes\nYesNo\nNo \n3.3.30 In many situations, this analysis will be straightforward and will require \nlittle to no judgment. However, for more complex situations, significant \njudgment may be needed. \n \n Observation \nA lease is different from a service \n3.3.40 Who has control over the use of an asset is part of what differentiates a \nlease from a service . A lease exists when a customer has the right to make \nthose decisions about the use of an asset that significantly affect the economic \nbenefits to be derived from its use in a manner similar to the way in which an \nentity can make decisions about its owned property, plant and equipment. This concept of control, which is based on two elements (power over directing the \nuse of the asset, and control of the economic benefits to be derived from use \nof the asset), is similar to how control is defined in Topic 606. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 84}), Document(page\_content='Leases 84 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 3.3.50 The Board observed that control of the use of the asset requires the \ncustomer to have decision- making rights over the use of the asset to influence \nthe economic benefits derived from use of the asset – and this must be \nthroughout the period of use. Without these rights, the Board concluded that \nthe customer would have no more rights than if it were simply buying supplies \nor services, and the customer would not control the asset. This may be a \nchange for certain arrangements that are currently accounted for as leases only \nbecause the customer obtains substantially all of the output (or other utility) \nfrom an asset. [ASU 2016- 02.BC134] \nLease Service\nOff- \nbalance \nsheetOn- \nbalance \nsheet \n \n \n Question 3.3.1 0 \nRelevance of t he control concept in Topic 810 \nIs the control concept in Topic 842 equivalent to the \ncontrolling financial interest concept in Topic 810? \nInterpretive response: No. However, there are significant similarities between \nsome aspects of the control concept in Topic 842 and the controlling financial \ninterest concept in Topic 810. Both concepts comprise a power and a benefits \ncharacteristic. The power characteristic in Topic 810 is highly consistent with \nthat in Topic 842, but the benefits characteristics are significantly different. \nWe believe one of the aspects of the power characteristic in Topic 810 that is \nparticularly relevant to Topic 842 is when some, but not all, decisions t hat \nsignificantly affect economic performance are shared. Topic 810 requires one \nparty to be identified as the party with power in these situations. We believe \nthis is essentially the same approach that the Board decided to require in \nTopic 842 when some, but not all, of the relevant decisions that affect the \neconomic benefits to be derived from use of the underlying asset are \npredetermined. [810- 10-25-38E] \nUnder Topic 842, either the supplier or the customer is identified as the party \nwith power in those c ircumstances – i.e. the guidance in paragraph 842- 10-15-\n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 85}), Document(page\_content='Leases 85 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 20(b) on how to identify whether the customer has power when the relevant \ndecisions about how and for what purpose an asset is used are predetermined \ndoes not apply. For further discussion about how t o determine whether the \ncustomer has control when some or all of the how and for what purpose decisions are predetermined, see section s 3.3.4 and 3.3.5, respectively . \n \n3.3.1 Step 1: What is the s cope of the customer’s right of \nuse within the contract ? \n Excerpt from ASC 842 -10 \n>>> Right to Obtain the Economic Benefits from the Use of the Identified \nAsset \n15-18 When assessing the right to obtain substantially all of the economic \nbenefits from use of an asset, an entity shall consider the economic benefits \nthat result from use of the asset within the defined scope of a customer’s right \nto use the asset in the contract (see paragraph 842- 10-15-23). For example: \na. If a contract limits the use of a motor vehicle to only one particular territory \nduring the period of use, an entity shall consider only the economic \nbenefits from use of the motor vehicle within that territory and not beyond. \nb. If a contract specifies that a customer can drive a motor vehicle only up to \na particular number of miles during the period of use, an entity shall \nconsider only the economic benefits from use of the motor vehicle for the \npermitted mileage and not beyond. \n>>> Right to Direct the Us e of the Identified Asset \n>>>> Protective Rights \n15-23 A contract may include terms and conditions designed to protect the \nsupplier’s interest in the asset or other assets, to protect its personnel, or to \nensure the supplier’s compliance with laws or regulations. These are examples \nof protective rights. For example, a contract may specify the maximum amount \nof use of an asset or limit where or when the customer can use the asset, may \nrequire a customer to follow particular operating practices, or may requi re a \ncustomer to inform the supplier of changes in how an asset will be used. \nProtective rights typically define the scope of the customer’s right of use but \ndo not, in isolation, prevent the customer from having the right to direct the \nuse of an asset. \n55 Implementation Guidance and Illustrations \nGeneral \n> Illustrations \n>> Illustration of Identifying a Lease ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 86}), Document(page\_content='Leases 86 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. >>> Example 4— Retail Unit \n55-63 Customer enters into a contract with property owner (Supplier) to use \nRetail Unit A for a five -year period. Retail Unit A is part of a larger retail space \nwith many retail units. \n55-64 Customer is granted the right to use Retail Unit A. Supplier can require \nCustomer to relocate to another retail unit. In that case, Supplier is required to \nprovide Customer with a retail unit of similar quality and specifications to Retail \nUnit A and to pay for Customer’s relocation costs. Supplier would benefit \neconom ically from relocating Customer only if a major new tenant were to \ndecide to occupy a large amount of retail space at a rate sufficiently favorable \nto cover the costs of relocating Customer and other tenants in the retail space \nthat the new tenant will occ upy. However, although it is possible that those \ncircumstances will arise, at inception of the contract, it is not likely that those \ncircumstances will arise. For example, whether a major new tenant will decide \nto lease a large amount of retail space at a rate that would be sufficiently \nfavorable to cover the costs of relocating Customer is highly susceptible to \nfactors outside Supplier’s influence. \n55-65 The contract requires Customer to use Retail Unit A to operate its well -\nknown store brand to sel l its goods during the hours that the larger retail space \nis open. Customer makes all of the decisions about the use of the retail unit \nduring the period of use. For example, Customer decides on the mix of goods \nsold from the unit, the pricing of the goods sold, and the quantities of \ninventory held. Customer also controls physical access to the unit throughout \nthe five- year period of use. \n55-66 The contract requires Customer to make fixed payments to Supplier as \nwell as variable payments that are a percentage of sales from Retail Unit A. \n55-67 Supplier provides cleaning and security services as well as advertising \nservices as part of the contract. \n55-68 The contract contains a lease of retail space. Customer has the right to \nuse Retail U nit A for five years. \n55-69 Retail Unit A is an identified asset. It is explicitly specified in the \ncontract. Supplier has the practical ability to substitute the retail unit, but could \nbenefit economically from substitution only in specific circums tances. \nSupplier’s substitution right is not substantive because, at inception of the \ncontract, those circumstances are not considered likely to arise. \n55-70 Customer has the right to control the use of Retail Unit A throughout the \nfive-year period of use because: \na. Customer has the right to obtain substantially all of the economic benefits \nfrom use of Retail Unit A over the five- year period of use. Customer has \nexclusive use of Retail Unit A throughout the period of use. Although a \nportion of the cas h flows derived from sales from Retail Unit A will flow \nfrom Customer to Supplier, this represents consideration that Customer \npays Supplier for the right to use the retail unit. It does not prevent \nCustomer from having the right to obtain substantially al l of the economic \nbenefits from use of Retail Unit A. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 87}), Document(page\_content='Leases 87 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. b. Customer has the right to direct the use of Retail Unit A. The contractual \nrestrictions on the goods that can be sold from Retail Unit A and when \nRetail Unit A is open define the scope of Customer’s right to use Retail \nUnit A. Within the scope of its right of use defined in the contract, \nCustomer makes the relevant decisions about how and for what purpose \nRetail Unit A is used by being able to decide, for example, the mix of \nproducts that will be sold in the retail unit and the sale price for those \nproducts . Customer has the right to change these decisions during the \nfive-year period of use. \n55-71 Although cleaning, security, and advertising services are essential to the \nefficient use of Retail Unit A, Supplier’s decisions in this regard do not give i t \nthe right to direct how and for what purpose Retail Unit A is used. \nConsequently, Supplier does not control the use of Retail Unit A during the \nperiod of use, and Supplier’s decisions do not affect Customer’s control of the \nuse of Retail Unit A. \n>>> Example 6— Ship \n>>>> Case B —Contract Contains a Lease \n55-85 Customer enters into a contract with Supplier for the use of a specified \nship for a five- year period. The ship is explicitly specified in the contract, and \nSupplier does not have substitution rights. \n55-86 Customer decides what cargo will be transported and whether, when, \nand to which ports the ship will sail, throughout the five- year period of use, \nsubject to restrictions specified in the contract. Those restrictions prevent \nCustomer from sailing the ship into waters at a high risk of piracy or carrying \nhazardous materials as cargo. \n55-87 Supplier operates and maintains the ship and is responsible for the safe \npassage of the cargo onboard the ship. Customer is prohibited from hiring \nanother operator for the ship or operating the ship itself during the term of the \ncontract. \n55-88 The contract contains a lease. Customer has the right to use the ship for \nfive years. \n55-89 There is an identified asset. The ship is explicitly specified in the \ncontract, and Supplier does not have the right to substitute that specified ship. \n55-90 Customer has the right to control the use of the ship throughout the \nfive-year period of use because: \na. Customer has the right to o btain substantially all of the economic benefits \nfrom use of the ship over the five- year period of use. Customer has \nexclusive use of the ship throughout the period of use. \nb. Customer has the right to direct the use of the ship. The contractual \nrestrictions about where the ship can sail and the cargo to be transported \nby the ship define the scope of Customer’s right to use the ship. They are \nprotective rights that protect Supplier’s investment in the ship and \nSupplier’s personnel. Within the scope of its right of use, Customer makes \nthe relevant decisions about how and for what purpose the ship is used \nthroughout the five- year period of use because it decides whether, where, \nand when the ship sails, as well as the cargo it will transport. Customer ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 88}), Document(page\_content='Leases 88 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. has the rig ht to change these decisions throughout the five -year period \nof use. \n55-91 Although the operation and maintenance of the ship are essential to its \nefficient use, Supplier’s decisions in this regard do not give it the right to direct \nhow and for what purpose the ship is used. Instead, Supplier’s decisions are \ndependent on Customer’s decisions about how and for what purpose the ship \nis used. \n>>> Example 7— Aircraft \n55-92 Customer enters into a contract with an aircraft owner (Supplier) for the \nuse of an explicitly specified aircraft for a two -year period. The contract details \nthe interior and exterior specifications for the aircraft. \n55-93 There are contractual and legal restrictions in the contract on where the \naircraft can fly. Subject to those restrictions, Customer determines where and \nwhen the aircraft will fly and which passengers and cargo will be transported \non the aircraft. \n55-94 Supplier is responsible for operating the aircraft, using its own crew. \nCustomer is prohibited from hiring another operator for the aircraft or operating \nthe aircraft itself during the term of the contract. \n55-95 Supplier is permitted to substitute the aircraft at any time during the \ntwo-year period and must substitute t he aircraft if it is not working. Any \nsubstitute aircraft must meet the interior and exterior specifications in the \ncontract. There are significant costs involved in outfitting an aircraft in \nSupplier’s fleet to meet Customer’s specifications. \n55-96 The contract contains a lease. Customer has the right to use the aircraft \nfor two years. \n55-97 There is an identified asset. The aircraft is explicitly specified in the \ncontract, and although Supplier can substitute the aircraft, its substitution rig ht \nis not substantive. Supplier’s substitution right is not substantive because of \nthe significant costs involved in outfitting another aircraft to meet the \nspecifications required by the contract such that Supplier is not expected to \nbenefit economically from substituting the aircraft. \n55-98 Customer has the right to control the use of the aircraft throughout the \ntwo-year period of use because: \na. Customer has the right to obtain substantially all of the economic benefits \nfrom use of the aircraft over the two- year period of use. Customer has \nexclusive use of the aircraft throughout the period of use. \nb. Customer has the right to direct the use of the aircraft. The restrictions on \nwhere the aircraft can fly define the scope of Customer’s right to use the \naircraft. Within the scope of its right of use, Customer makes the relevant \ndecisions about how and for what purpose the aircraft is used throughout \nthe two- year period of use because it decides whether, where, and when \nthe aircraft travels as well as the passengers and cargo it will transport. \nCustomer has the right to change these decisions throughout the two- year \nperiod of use. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 89}), Document(page\_content='Leases 89 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 55-99 Although the operation of the aircraft is essential to its efficient use, \nSupplier’s decisions in this regard do not give it the right to direct how and for \nwhat purpose the aircraft is used. Consequently, Supplier does not control the \nuse of the aircraft during the period of use, and Supplier’s decisions do not \naffect Customer’s control of the use of the aircraft. \n3.3.60 A lease may not grant a customer an unlimited or unrestricted right to \nuse an asset. For example, a contract may limit the customer’s use of a motor \nvehicle or an aircraft to only one particular territory, or up to a particular number \nof miles, during the period of use. These limits or restrictions define the scope \nof the customer’s right to use the identified asset. While limits or restrictions of this nature affect what economic benefits can be derived from use of the asset \nduring the period of use, a lease still exists if: \n[842- 10-15-4, 15- 18] \n— the customer has the right to obtain substantially all of those economic benefits; and \n— substantive relevant decision- making rights about the use of the asset that \nthe customer controls (e.g. when and where the moto r vehicle or aircraft \ntravels within the unrestricted territory) remain unrestricted. \n3.3.70 A contract may include terms and conditions designed to protect the \nsupplier. Protective rights are provisions in the contract that, for example, are \ninten ded to: [842- 10-15-23] \n— protect the supplier’s interest in the underlying asset (e.g. by preventing a customer from transporting particular types of goods, such as explosives) \nor other of its owned assets (e.g. a larger asset of which the identified \nasset is a physically distinct portion); \n— protect its personnel (e.g. restrictions preventing the customer from sailing a ship in high risk waters when the supplier’s personnel operate the asset); \nor \n— ensure the supplier complies with laws and regulations (e.g. legal \nrestrictions on where an aircraft can fly). \n3.3.80 The Board concluded that protective rights generally define the scope of \nthe rights a customer obtains rather than affecting the existence of a right to \nuse an asset. Contractua l restrictions of this nature are known and agreed to by \nthe customer and are an inherent part of the contract pricing – i.e. the \ncontractual consideration reflects the economic substance of the right of use. \n[ASU 2016- 02.BC141] \n3.3.90 Example 4, Ex ample 6 Case B, and Example 7 in Subtopic 842- 10 each \nillustrate scenarios where a lease is determined to exist even though there are \nsubstantive restrictions about how and for what purpose the lessee may use the identified asset. \n[842- 10-55-63 – 55-71, 55-85 – 55-99] \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 90}), Document(page\_content='Leases 90 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 3.3.2 0 \nContractual restrictions affecting whether or not \nthere is a lease \nCan contractual restrictions limiting the scope of a customer’s \nrights to use an underlying asset be so restrictive that a lease \ndoes not exist? \nBackground: Topic 842 describes rights to specify the maximum amount of \nuse of an asset or where or when the customer can use the asset as supplier \nprotective rights; however, it also describes similar rights as examples of \ndecision -making rights that gran t the customer the right to direct how and for \nwhat purpose the underlying asset is used. Accordingly, at various points during the Board’s project, some suggested that an entity would need to evaluate \nwhether restrictions in a contract are merely protecti ve in nature or whether \nthey are so restrictive that they preclude the customer from controlling the use \nof the underlying asset. \n[842- 10-15-23, 15- 25] \nInterpretive response: Yes. However, we expect such circumstances to be \nrare. It is possible that in an extreme circumstance, the restrictions imposed on \nthe customer could be so restrictive that they leave the customer with no \nsubstantive decision- making authority over the use of the asset. In that case , \nthere is no lease. \nIn general , we believe contractual restrictions define the scope of the \ncustomer’s right to use the underlying asset, and that restrictions on the use of the asset agreed to by the customer and the supplier reflect just another form \nof predetermined decision. Therefore, in the vast majority of arrangements, \nincluding those with significant contractual restrictions, the customer ha s the \nright to direct the use of the asset if there are substantive decisions about the \nuse of the asset that are still available to be made and the customer controls \nthose available decisions that will most significantly affect the economic \nbenefits to be derived from use of the asset during the period of use (see sections 3.3.4 and 3.3.5). \n3.3.100 The following scenarios illustrate the principle of looking only at the \nrights that are within the scope of the contract. [842- 10-15-18, 15-24 – 15-25] \n— In Scenario 1, none of the possible, relevant decision- making rights in \nrelation to the underlying asset are predetermined – e.g. by restrictions in \nthe contract or the design of the asset . Therefore, in assessing whether the \ncustomer controls the use of the asset, all of these rights are considered; \nthis does not mean, however, that the customer must have all of those \ndecision -making rights for there to be a lease (see section 3.3.4 ). \n— In Scenario 2, the customer’s decision -making rights in the contract \nencompass only what the underlying asset can be used for – i.e. what \noutput the asset can produce. Therefore, in assessing whether the \ncustomer controls the use of the asset, only these rights are considered. \nThis scenario assumes that the ‘what’ decisions are substantive and \nsignificantly affect the economic benefits that can be derived from the use \nof the as set. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 91}), Document(page\_content='Leases 91 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. How\nWhen\nWhat\nWhereWhetherWhatWhen\nHow\nWhere\nWhetherScenario 1 Scenario 2\nXXUniverse of relevant decision -making rights \nrelated to the use of an underlying asset\nScope of the contract \n \n3.3.2 Step 2: What are the economic benefits from use of \nthe identified asset? \n Excerpt from ASC 842 -10 \n>>> Right to Obtain the Economic Benefits from the Use of the Identified \nAsset \n15-17 To control the use of an identified asset, a customer is required to have \nthe right to obtain substantially all of the economic benefits from use of the \nasset throughout the period of use (for example, by having exclusive use of the \nasset throughout that period). A customer can obtain economic benefits from \nuse of an asset directly or indirectly in many ways, such as by using, holding, \nor subleasing the asset. The economic be nefits from use of an asset include its \nprimary output and by -products (including potential cash flows derived from \nthese items) and other economic benefits from using the asset that could be \nrealized from a commercial transaction with a third party. \n \n3.3.110 Once the scope of a customer’s right to use an asset is determined (see \nsection 3.3.1), an entity should only consider, when determining whether the \ncustomer has the right to control the use of the identified asset, the economic \nbenefits arising from the use of that asset. Topic 842 explains that this includes \ndirect benefits (e.g. from using, holding or subleasing the asset) and other \neconomic benefits related to the use of the asset (e.g. renewable energy credits received, or byproducts arising from the use of an asset) that could be \nrealized in a commercial (arm’s length) transaction. \n[842- 10-15-17, ASU 2016-\n02.BC135] \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 92}), Document(page\_content='Leases 92 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 3.3.3 0 \nEvaluating the substance of e conomic benefits from \nuse \nDo the economic benefits from use of an identified ass et \ninclude those that are unlikely to accrue? \nInterpretive response: No. When determining the economic benefits from use \nof an identified asset, an entity should not consider economic benefits that are \nunlikely to be realized; such rights are not substantive. \nFor example, assume a landowner grants an entity the right to use its land \nlocated in the desert (e.g. to construct a solar plant), but the contract permits \nthe landowner to farm the land surrounding the plant. In this scenario, if the \ndesert land is not arable, the farming rights are not substantive and are not \nconsidered when determining whether the customer has the right to obtain \nsubstantially all of the economic benefits from use of the land throughout the \nperiod of use. \n \n Question 3.3.39 \nAnalyzing economic benefits from use of an asset \nWhat are the economic benefits that can be derived from the \nuse of an asset? \nBackground: Topic 842 does not provide significant guidance on what does \nand does not constitute an economic benefit from use. Further, how to apply \nthe term ‘economic benefits from use’ – e.g. whether to apply that term broadly \nor narrowly – was not a significant topic of public discussion by the FASB and \nthe IASB during the development of Topic 842. The lack of guidance in \nTopic 842, or public discussion by the Boards, around this topic is giving rise to \na number of questions in practice. [842- 10-15-17, ASU 2016 -02.BC135] \nImproper identification of the economic benefits from use of an identified asset \nmay result in an improper conclusion about whether the customer has the right \nto obtain substantially all of the economic benefits from use of the asset over the period of use (see Question 3.3.80), and therefore potentially about whether a lease exists. \nInterpretive res ponse: In general, we believe the most relevant consideration \nin deciding whether an economic benefit is an economic benefit from use may \nbe whether operation of the asset is necessary to generate the benefit and, if \nso, whether decisions about how much the asset is operated significantly affect \nthe amount of benefit generated. If not, it is likely that the economic benefit in question is not an economic benefit from use of the asset. \nThe following are two examples and our analysis. Further examples are \nincluded in Questions 3.3.42 and 3.3.45. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 93}), Document(page\_content='Leases 93 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Brand/image benefits stemming from the supplier’s logo being displayed \nin a prominent location on the asset in a public location \nIn general, we do not believe that the perceived brand/image (or advertising) \nbenefit resulting from an asset having the supplier’s brand or logo displayed on \nit is an economic benefit from use. \nThis is because the branding that is displayed on the asset is a characteristic of \nthe asset’s appearance, rather than a characteristic of its funct ionality. \nCharacteristics of functionality are what give rise to the potential economic \nbenefits that an asset can produce from its use . Conversely, the appearance of \nan asset does not affect the potential economic benefits that the asset can produce from being used because those potential benefits generally accrue \nregardless of when, whether or how much the asset is used. Those benefits may also more aptly be described as benefits from ownership, rather than from \nuse, if the supplier’s branding is a result of the asset’s design that cannot be \nchanged and is unaffected by who the customer is or their use of the asset . \nTherefore, any perceived brand/image (or advertising) benefit resulting from an \nasset’s appearance (including the branding imagery displayed on the asset) \nshould be excluded from the analysis of the economic benefits generated from the asset’s use. \nCash f lows from the sale of consumables used in operating or used to \n‘stock’ the asset \nCash flows may be derived from the sale of consumables used in operating the \nasset (e.g. ink toner used in a photocopier), or from the sale of products used as \ninventory of t he asset (e.g. candy in a vending machine). \nIn some cases, payment to the supplier for the purchased consumables is not contingent on those consumables being used or on them being ‘sold through’ \nto an end -customer. For example, the supplier may be entitled to the \ntransaction price for the consumables regardless of whether the customer uses the ink toner or whether the candy in the vending machine is ever purchased by \nan end customer. In such cases, we believe the economic benefits to the \nsupplier from the s ale of those consumables derive from the transfer of the \nconsumables to the customer, and do not derive from the use of the machine; therefore, those economic benefits are not considered when assessing the \neconomic benefits from use of the machine. \nIn other cases, payment to the supplier is due only on use or sell -through of the \nconsumables – e.g. the supplier gets a percentage of the selling price of candy \nsold from the vending machine. In any of these cases, the economic benefits \nrealized from use of the machine (i.e. the outputs produced, such as \nphotocopied pages from the photocopier, or the cash flows from sale of the \ncandy from the vending machine) are economic benefits from use. However, \nwe believe those economic benefits from use accrue to the custo mer, rather \nthan the supplier. The payments to the supplier for the consumables are not economic benefits from use, but rather payments for the right to use the \nmachine and/or the consumables (see paragraphs 3.3.150 – 3.3.160). \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 94}), Document(page\_content='Leases 94 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 3.3.40 \nTotal economic benefits from use of an asset \nIs the capacity of an asset to produce outputs the only \neconomic benefit that can be derived from use of the asset? \nInterpretive response: No. Example 3.3.10 considers the facility’s capacity to \nproduce airbags as the only substantive means to derive economic benefits \nfrom use of the facility. However, a facility’s capacity to produce output may not \nbe the only means by which to derive economic benefits from its use. For \nexample, the economic benefits that an entity can derive from a renewable \nenergy power plant include more than the electricity produced if the plant’s \npower production also gives rise to renewable energy credits. \nAnother example might be a production facility such as that in Example 3.3.10, but where the steam from the manufacturing process is sold as a by -product to \na power generation company (third party unrelated to the customer). In that \ncase, the economic benefits to be derived from the facility include those related \nto the facility’s capaci ty to produce airbags and those that can be realized from \nthe facility’s production of steam as a by -product. \n \n Question 3.3.42 \nData about customer’s use of the asset \nIs data collected from a customer’s use of an identified asset \nan economic benefit from use that affects lease identification? \nBackground: A vendor may supply an asset to a customer and then gather data \nfrom or about the customer’s use of the asset that the vendor can use internally \nor sell to a third party. For example, a vehicl e manufacturer provides a customer \nwith the use of a vehicle that includes smart -driving technology, which collects \ndata about how or where the vehicle is operated and communicates that data \nback to the manufacturer. That data may then be used by the manuf acturer \n(e.g. to update its mapping software) and/or monetized by the manufacturer \nthrough sales to third parties. \nInterpretive response: It depends. We believe an entity first should consider \nthe asset’s role in, for example, collecting, organizing or tra nsmitting the data to \nother parties. In general, if the functionality of the underlying asset (i.e. its use) is essential to deriving economic benefit from the data – i.e. the data is an \noutput of utilizing that functionality , the economic benefits to be d erived from \nuse of the underlying asset may include those that can be realized from the sale \nor use of the data. \nIn contrast, if the underlying asset has no functional role in, for example, \ncollecting, organizing or transmitting the usage data, we believe economic \nbenefits derived from the sale or use of the data are not economic benefits \nfrom use of the underlying asset. Rather, as an example, they may be economic \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 95}), Document(page\_content='Leases 95 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. benefits of ownership if the asset owner obtains and/or has rights to the data \nby virtue of i ts ownership of the underlying asset. Economic benefits derived \nfrom ownership, rather than from use, of the underlying asset are not \nconsidered in deciding whether a lease exists. [ASU 2016- 02.BC135] \nThe following are examples. \nFact pattern Analysis \nA vehicle manufacturer provides a \ncustomer with the use of a vehicle that \nincludes smart -driving technology, which \ncollects data about how/where the \nvehicle is operated and communicates \nthat data back to the manufacturer. \nThis data may include i nformation about \nthe frequency and time of use, speed, \ndistance and/or the roadways on which \nthe vehicle travels. \nThat data is then used by the \nmanufacturer (e.g. to update its mapping \nsoftware) and/or monetized by the \nmanufacturer through sales to third \nparties. If the software that is an integral \ncomponent of the vehicle is responsible for the collection of vehicle use and \nmapping data and for communicating that \nback to the manufacturer, the economic \nbenefits derived from the data collected \nand transmitted back t o the vehicle \nmanufacturer by the functionality of the \nvehicle’s software would likely be \nconsidered economic benefits from use \nof the vehicle (see Customer ownership \nof data ). \nA telecommunications company \nprovides customers with the use of \nvarious custom er premise equipment \n(CPE). For example, In the residential space, CPE may include television set -\ntop boxes, internet modems and routers. \nAs a result of providing its services, the company obtains data about its \ncustomers, such as their viewing habits, \nthat it can sell to third parties or use for \nits own economic benefit – e.g. in \ndeciding when and where to place \nadvertisements or in marketing \nadvertising slots to its customers. The analysis of this example is generally \nconsistent with that for the vehicle manufacturer. \nIf the CPE is responsible for the \ncollection of the relevant customer data \nand communicating that back to the telecommunications provider, the \neconomic benefits derived from the data \ncollected and transmitted by the \nfunctionality of the app licable CPE would \nlikely be considered economic benefits \nfrom use of the applicable CPE (see \nCustomer ownership of data ). \nA shopping mall owner has data about \nits customers’ sales because the \ncustomers’ payments to the shopping \nmall owner are based on a percentage of \nthe stores’ sales. \nThat data may be used by the owner in \npricing and advertising the space or \nsimilar spaces The customer sales data obtained by the \nshopping mall owner is not collected, \norganized or communicated to the \nshopping mall owner by the rented retail \nspace. Rather, the data is obtained as a \nresult of the shopping mall owner’s right \nto receive lease payments as the owner \nof the underlying asset. \nTherefore, any economic benefits the \nshopping mall owner can derive from use \nof that data are economic benefits \nresulting from the mall owner’s ownership, rather than from use, of the \nunderlying asset ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 96}), Document(page\_content='Leases 96 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Customer ownership of data \nIf the customer legally owns and must grant permission for the vehicle \nmanufacturer to either obtain or make use of the data (e.g. due to customer \nprivacy laws), we believe the customer’s action of releasing the data for the \nsupplier’s use is effectively an additional, noncash payment to the manufacturer \nof a portion of the economic benefits from use of the asset. It is similar in \nnature to making a payment of a portion of the cash flows derived from use of \nthe asset to the asset supplier (see paragraphs 3.3.15 0 – 3.3.16 0). \nIn that case, the benefits of the data would not be allocated to the supplier (e.g. \nthe vehicle m anufacturer or the telecommunications provider in the background \nexamples), but rather to the customer, when deciding whether the customer has the right to obtain substantially all the economic benefits from use of the \nidentified asset. \n \n Question 3.3.45 \nSupplier use of the identified asset \nAre economic benefits from use of an identified asset that \naccrue to the supplier factored into determining whether the \ncustomer has the right to obtain substantially all the \neconomic benefits from use of the as set? \nBackground: An asset may be able to serve multiple entities (e.g. multiple \ncustomers) at the same time (see Example 3.3.20). And some assets are able \nto perform multiple functions, and therefore serve multiple entities because of \nthose multiple functi onalities, simultaneously. The following are examples. \n— As described in Question 3.3.40, a manufacturing facility may produce both products and steam (as a by -product). Different customers may benefit \nfrom the facility’s production of each – i.e. the manufa cturer may sell the \nproducts to one customer and the steam to another. Alternatively, the \nmanufacturer may be able to use the steam itself – e.g. to power another \nadjacent facility it operates – such that it does not need to obtain electricity \nfrom a third party to power that facility. \n— A piece of equipment may simultaneously permit a customer to connect to \na supplier’s database or network and provide data to the supplier about the \ndatabase or network’s operating performance, and/or serve as a gateway for th e supplier to perform troubleshooting of its network. And the \nequipment may be capable of performing these functions for the supplier both when the customer is actively using it, and when the customer is not \nusing it – e.g. as long as the equipment remains switched on or connected \nto a power source and connected to the supplier’s network. The \nequipment’s functionality permitting the supplier to monitor and \ntroubleshoot its broader network may mean that the supplier does not have \nto use other equipment or personnel to perform those functions, or it may \npermit the supplier to perform those functions with fewer personnel or \nalternative, less expensive resources. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 97}), Document(page\_content='Leases 97 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. In scenarios such as these, there is a question about whether the economic \nbenefits the supplier has the right to obtain from the use of the asset should \nfactor into the ‘economic benefits from use’ test – i.e. whether the customer \nhas the right to obtain substantially all the economic benefits from the use of \nthe asset over the period of use. \nInterpreti ve response: In general, an identified asset providing economic \nbenefits from its use to both the supplier and the customer is no different from \nthe asset providing economic benefits from its use to multiple customers (see \nExample 3.3.20). \nIf, as describe d in the background, outputs from use of the asset provide utility \nto both the supplier and the customer (i.e. the identified asset serves as a tool \nto both the supplier and the customer) the economic benefits the supplier \nderives from that utility should be factored into the economic benefits from use \ntest. This is regardless of whether those economic benefits are realized \nthrough: \n— monetization of the outputs in a transaction with a third party – e.g. sale of \nthe steam in the manufacturing facility background example to an unrelated \nmanufacturer or power producer; or \n— through the use of the outputs by the supplier itself – e.g. use of the steam \nin the manufacturing facility example to power the manufacturer’s adjacent \nfacility or use of the inherent functionality of the equipment in the \ntelecommunications example to monitor or troubleshoot its network. \nQuantifying supplier or other n on-customer rights to economic benefits \nfrom use \nTopic 842 requires that the customer have the right to obtain ‘substantially all’, not all, of the economic benefits from use of the identified asset over the period \nof use (see Questions 3.3.60 and 3.3.80). Therefore, an asset providing \neconomic benefits from its use to the supplier (or another entity) as well as the \ncustomer, does not mean a lease cannot exist (if the other lease identification \ncriteria are met). Rather, for a lease not to exist based on the ‘economic \nbenefits from use‘ test, entities (including the supplier) other than the customer \nmust have the right to obtain a more- than- insignificant portion of the economic \nbenefits from use of the asset over the course of the ‘period of use’. \nWhen ther e are shared economic benefits from use, it may be necessary to \nquantify both (1) the total potential economic benefits from use of the identified asset over the course of the period of use and (2) the portion of the economic \nbenefits from use to which eac h entity – i.e. the customer and the supplier or \nthe customer and another entity – has rights over that period of time. In some \ncases, there may be significant judgment and/or complexity involved in \nperforming the evaluation. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 98}), Document(page\_content='Leases 98 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 3.3.5 0 \nTax attributes \nDo the economic benefits that can be derived from use of the \nasset include tax attributes? \nInterpretive response: No. The Board reasoned that a lease conveys a right to \nuse the underlying asset; it does not convey ownership. Accordingly, benefi ts \nderived from ownership of the asset (e.g. income tax credits) are excluded from \nthe evaluation. [ASU 2016- 02.BC135] \nWhile certain tax credits may be indirectly related to the underlying asset’s use \n(e.g. production tax credits), we believe all benefits related to tax attributes \nshould be excluded from the population of economic benefits to be considered in determining w hether there is a lease. \n \n Observation \nGovernment priorities can drive whether there is a \nlease \n3.3.120 Governments establish and change incentives or subsidies, such as \nrenewable energy credits, for reasons that may often be unrelated to the value \nof the output produced by an asset. These governmentally established \nincentives or subsidies are not a result of the underlying asset’s utility and are \nartificial – i.e. because they can be established, revoked or changed by \ngovernment at any time. \n3.3.130 Therefore, we believe that over time, equivalent arrangements granting \na customer the right to use an asset could meet or not meet the definition of a lease based solely on government priorities (e.g. whether government is \ncurrently trying to encourage one activity or another) at contract inception . \n \n3.3.3 Step 3: Does the customer have the right to o btain \nsubstantially all of the economic benefits from use of \nthe identified asset ? \n Excerpt from ASC 842 -10 \n>>> Right to Obtain the Economic Benefits from the Use of the Identified \nAsset \n15-17 To control the use of an identified asset, a customer is required to have \nthe right to obtain substantially all of the economic benefits from use of the \nasset throughout the period of use (for example, by having exclusive use of the \nasset throughout that period). A customer can obtain economic benefits from \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 99}), Document(page\_content='Leases 99 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. use of an asset directly or indirectly in many ways, such as by using, holding, \nor subleasing the asset. The economic be nefits from use of an asset include its \nprimary output and by -products (including potential cash flows derived from \nthese items) and other economic benefits from using the asset that could be \nrealized from a commercial transaction with a third party. \n15-19 If a contract requires a customer to pay the supplier or another party a \nportion of the cash flows derived from use of an asset as consideration, those \ncash flows paid as consideration shall be considered to be part of the \neconomic benefits that the cust omer obtains from use of the asset. For \nexample, if a customer is required to pay the supplier a percentage of sales \nfrom use of retail space as consideration for that use, that requirement does \nnot prevent the customer from having the right to obtain subs tantially all of the \neconomic benefits from use of the retail space. That is because the cash flows \narising from those sales are considered to be economic benefits that the \ncustomer obtains from use of the retail space, a portion of which it then pays \nto the supplier as consideration for the right to use that space. \n55 Implementation Guidance and Illustrations \nGeneral \n> Illustrations \n>> Illustration of Identifying a Lease \n>>> Example 8— Contract for Shirts \n55-100 Customer enters into a contract with a manufacturer (Supplier) to \npurchase a particular type, quality, and quantity of shirts for a three- year period. \nThe type, quality, and quantity of shirts are specified in the contract. \n55-101 Supplier has only one factory that can meet the needs of Customer. \nSupplier is unable to supply the shirts from another factory or source the shirts \nfrom a third -party supplier. The capacity of the factory exceeds the output for \nwhich Customer has contracted (that is, Customer has not contr acted for \nsubstantially all of the capacity of the factory). \n55-102 Supplier makes all decisions about the operations of the factory, \nincluding the production level at which to run the factory and which customer \ncontracts to fulfill with the output of the factory that is not used to fulfill \nCustomer’s contract. \n55-103 The contract does not contain a lease. \n55-104 The factory is an identified asset. The factory is implicitly specified \nbecause Supplier can fulfill the contract only through the use of this asset. \n55-105 However, Customer does not control the use of the factory because it \ndoes not have the right to obtain substantially all of the economic benefits from \nuse of the factory. This is because Supplier could decide to use the factory to \nfulfill other customer contracts during the period of use. \n55-106 Customer also does not control the use of the factory because it does \nnot have the right to direct the use of the factory. Customer does not have \nthe right to direct how and for what purpose the factory is used during the \nthree -year period of use. Customer’s rights are limited to specifying output ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 100}), Document(page\_content='Leases 100 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. from the factory in the contract with Supplier. Customer has the same rights \nregarding the use of the factory as other customers purchasing shirts from the \nfactory. Supplier has the right to direct the use of the factory because Supplier \ncan decide how and for what purpose the factory is used (that is, Supplier has \nthe right to decide the production level at which to run the factory and which \ncustomer contracts to ful fill with the output produced). \n55-107 Either the fact that Customer does not have the right to obtain \nsubstantially all of the economic benefits from use of the factory or the fact \nthat Customer does not have the right to direct the use of the factory would \nbe sufficient in isolation to conclude that Customer does not control the use of \nthe factory. \n \n3.3.14 0 Evaluating whether a customer has the right to obtain substantially all of \nthe economic benefits from use of an asset throughout the period of use will be \nstraightforward in many situations, generally because the customer in a lease \nfrequently has exclusi ve use of the asset. However, in some situations, a \ncontract may provide a party other than the customer the right to more than a minor amount of the economic benefits from use of the same asset. \n \n Question 3.3.6 0 \nMeaning of ‘substantially all’ \nWhat does ‘substantially all’ mean in the context of whether \nthe customer has the right to obtain substantially all of the economic benefits from use of the identified asset? \nInterpretive response: The Board did not define what ‘substantially all’ means \nin the context of the definition of a lease. However, Topic 842 uses the same \nterminology in one of the criteria used to determine lease classification: \nwhether the present value of the sum of the lease payments and residual value \nguaranteed by the lessee equals or exceeds substantially all of the fair value of \nthe asset ( see section 6.2). In that case, Subtopic 842- 10 includes \nimplementation guidance that states that one acceptable approach to assessing \nthat c riterion is to conclude that 90 percent or more of the fair value of the \nunderlying asset amounts to substantially all the fair value of the underlying \nasset. [842- 10-55-2(c)] \nIn addition, ‘substantially all’ is used elsewhere in US GAAP and is usually \ninterpreted to mean 90 percent. As a result, we believe an entity should \ngenerally use 90 percent as its benchmark in evaluating whether the customer \nhas the right to obtain substantially all of the economic benefits from use of \nan asset. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 101}), Document(page\_content='Leases 101 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 3.3.10 \nRight to obtain the economic benefits from use – \noutsourcing arrangement \nScenario 1: Supplier can use the factory to supply other customers \nCustomer enters into a 10- year agreement with Supplier to purchase a \nparticular type and quantity of airbags. The following facts are relevant. \n— Supplier has only one factory that can meet the needs of Customer. \n— Supplier is unable to supply the airbags from another factory and does not \nhave the right or ability to source the airbags from a third- party supplier. \n— The capacity of the factory significantly exceeds the output for which \nCustomer has contracted, and the factory is used to fulfill contracts with a \nnumber of Supplier’s customers. \n— There are no substantive economic benefits that can be derived from use of the faci lity other than those that are derived from its production of airbags. \nIn this scenario , Customer does not control the use of the factory because it \ndoes not have the right to obtain substantially all of the economic benefits from use of the factory. This is because Supplier can obtain more than an \ninsignificant portion of the economic benefits from use of the factory by producing parts and selling them to other customers. Therefore, the \narrangement is not a lease of the factory that will produce the airbags. \nScenario 2: Supplier cannot use the factory to supply other customers \nChanging the facts of Scenario 1, Supplier designed and constructed the factory that will produce the airbags specifically to meet Customer’s demand. The \nfactory is sp ecified in the contract and Supplier does not have the practical \nability to source the airbags from another factory. The factory’s capacity to \nproduce airbags is the only way in which the factory can produce economic \nbenefits from its use. \nThe existing capacity of the factory will be used to produce only the particular type and qua ntity of airbags requested by Customer, and Customer has the \nright to purchase all of the airbags produced by the facility – i.e. Supplier cannot \nuse the factory to supply other customers. S upplier has the right to expand the \nfacility in the future if it wishes to, and therefore expand its capacity; however, \nat contract inception it is not likely that it will do so. \nIn this example, Customer has the right to obtain substantially all of the \neconomic benefits from use of the factory. Supplier’s right to expand the \nfacility, at which point the facility would be able to generate additional economic \nbenefits from use that Customer might not control, is not considered in arriving \nat this conclusion. This is because an expanded facility would be a different \nasset from the one identified in the contract. Therefore, the arrangement is a lease if Customer also has the right to direct the use of the factory throughout \nthe period of use (see section 3.3.4 and Example 3.3.60 ). \n3.3.15 0 A contract may require a customer to pay a portion of the cash flows \nderived from the use of an asset to the supplier (or another party) as ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 102}), Document(page\_content='Leases 102 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. consideration; this does not prevent the customer from obtaining substantially \nall of the economic benefits from use of that asset. For example, a customer \nmay be required to pay the supplier a percentage of sales as consideration for use of retail space. The cash flows from those sales are considered economic \nbenefits that the custom er receives, a portion of which it then pays to the \nsupplier as consideration for the right to use the retail space. \n[842- 10-15-19] \n \n Observation \nPayment of portion of cash flows from an asset to \nthe supplier (or another party) \n3.3.160 We believe the Board ’s intent with the provision outlined in \nparagraph 3.3.150 was to establish that the customer obtaining the economic \nbenefits from use of the asset (e.g. the cash flows obtained from selling \nproducts in a leased retail store) generally is separate from its payment of a \nportion of those cash flows to the supplier as additional rent. Variable payments \nof this nature should not affect the identification of a lease any differently from \nfixed payments that are often made with cash f lows generated from use of the \nasset. Fixed or variable payments may be significant compared to the economic benefits generated by use of the asset (e.g. in high- rent locations), and we \nbelieve the Board intended that the amount of the payments for the right to use the asset ( even if significant as compared to the economic benefits to be \nderived from the use of that asset) generally should not affect the conclusion \nabout whether a lease exists. \n \n Question 3.3.7 0 \nFixed economic return from use of an identif ied \nasset \nDoes an entity have the right to obtain substantially all the \neconomic benefits from use of an identified asset if the \neconomic benefits it retains are fixed while the asset owner’s \nare variable? \nBackground: An entity may obtain a fixed rate of return from the use of an \nasset, while the asset owner (or another party) receives/absorbs all of the \nvariability in net operating profits. For example, a hotel or casino operation may \npermit an entity to operate the property, but pay that entity a fixed fee for those \noperations, while the property owner (or another party, such as an investor) \nreceives the net operating profits of the hotel or casino operation. \nInterpretive response: Not necessarily. An entity (i.e. the potential lessee) may \nnot hav e the right to obtain substantially all the economic benefits from use of \nan identified asset if it obtains a fixed rate of return and the asset owner (or \nanother party) receives/absorbs all of the variability in net operating profits, \nparticularly if the owner also receives most of the economic benefits from use \nof the asset; for example, most of the cash flows from the use of the asset, such as from a casino or hotel operation. In that situation, we believe careful \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 103}), Document(page\_content='Leases 103 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. consideration should be given to the substance of the contract, including the \nnature of the arrangement between the parties, when determining whether the \nentity has the right to obtain substantially all of the economic benefits from use \nof the identified asset; for example, whether the nature of the arrangement is \nthat the entity is in effect an agent (or service provider) of the asset owner \nrather than the principal in the operation that is using the asset. \nIn general, we do not believe paragraph 842- 10-15-19 was intended to capture \nsituations where the potential lessee receives only a fixed return on the use of \nthe identified asset or has only minimal exposure/upside from the use of the \nasset. In such cases, we generally believe the entity does not have the right to \nobtain substantially all of t he economic benefits from use of the asset, and \ntherefore there is not a lease. \nFurther, if the entity is receiving only a fixed, or substantially fixed, return on the \nuse of the asset, and the asset owner retains all (or substantially all) of the \nrisks/r ewards from the use of the asset, the owner will typically also have the \nright to direct the use of the asset – i.e. control the most important decisions \nabout how and for what purpose the asset is used (see section 3.3.4). If the \nowner is subject to the s ignificant economic variability from use of the asset, \nwhile it may outsource operational aspects of the asset’s use, it is unlikely to forfeit rights to key decisions about, for example, when and whether the asset \noperates that most significantly affect t he economic benefits that can be \nderived from the asset’s use. \nHowever, because facts and circumstances can vary widely, careful \nconsideration should be given to the substance of the contract, including the \nnature of the arrangement between the parties – e.g. whether the customer is \nin effect an agent of the supplier rather than the principal in the operation that is using the asset – when determining whether the customer has the right to \ncontrol the use of the asset in a contract of this nature. \n \n Question 3.3.80 \nChanges to the customer’s right to obtain the \neconomic benefits from use during the period of \nuse \nIf the customer does not have the right to obtain substantially \nall of the economic benefits from use of an identified asset for \na portion of the period of use, can there be a lease? \nBackground : In Example 3.3.10, Customer entered into a 10- year agreement \nwith Supplier to purchase a particular type and quantity of airbags. That \nexample considered the facility’s capacity to produce ai rbags as the only \nsubstantive means to derive economic benefits from use of the facility (see \nQuestion 3.3.40). \nContinuing that example, assume instead that the economic benefits to be derived from use of the facility include not just the facility’s capaci ty to produce \nairbags, but also the facility’s production of steam as a manufacturing by -\nproduct. In addition, under a pre- existing contract, Supplier will sell all of the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 104}), Document(page\_content='Leases 104 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. facility’s steam production to a third party unrelated to Customer for the first \nthree years of the contract with Customer. After those three years, Customer \nwill have the exclusive right to the steam produced by the facility. \nThe steam constitutes a more than insignificant (15%) portion of the total \neconomic benefits available from use of the facility in a given year, and the \nremainder (85%) is associated with the facility’s production of airbags. As such, \nin Years 1– 3 and in Years 4– 10, the portion of the total economic benefits from \nuse to which Customer has rights is 85% and 100% , respectively. \nInterpretive response: Yes. In the background example, when evaluating \nwhether Customer has the right to obtain substantially all of the economic benefits from use of the facility throughout the 10- year period of use, we \nbelieve ‘throughout the period of use’ means ‘over the course of the period of \nuse’. Accordingly, because Customer has the right to approximately 96% of the \ntotal economic benefits expected from use of the facility over the total 10- year \nperiod of use, Customer has the right to obtain substantially all of the economic benefits from use of the facility throughout the period of use, and the contract \nwill meet the definition of a lease with a 10- year lease term if Customer also \nhas the right to direct the use of the asset (see sections 3.3.4 and 3.3.5). This is \ngenerally consistent with how entities evaluated under Topic 840 whether it \nwas remote that one or more parties other than the customer would take more \nthan a minor amount of the output or other utility that would be produced or \ngenerated by the property, plant or equipment during the term of the \narrangement . \n[840- 10-15-6(c)] \nWe do not believe an entity should define the period of use to exclude those \nperiods during the contract term during which the customer does not have the \nright to obtain substantially all of the economic benefits from use of the asset. \nIn the background ex ample, doing so would result in a 7- year period of use, and \nconsequently a 7- year lease (i.e. a lease that exists in Years 4 -10 only) if \nCustomer has the right to direct the use of the asset throughout that 7- year \nperiod. Consistent with our responses to Q uestions 3.1.30 and 3.2.55, we \nbelieve this would inappropriately treat the evaluation of the ‘right to obtain \nsubstantially all the economic benefits from use’ lease identification criterion as \nan input to determining the period of use rather than treating the period of use \nas an input to determining whether the customer ‘has the right to obtain \nsubstantially all of the economic benefits from use of the asset throughout the \nperiod of use ’ (emphasis added). \n \n Question 3.3.90 \nTime -based land easements \nDoes a time- based land easement meet the definition of a \nlease? \nBackground: See Questions 2.3.10, 3.1.10 and 3.2.20 for additional discussion \nabout land easements . As discussed in Question 2.3.10, land easements are in \nthe scope of Topic 842. Questi on 3.1.10 highlights that a perpetual land \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 105}), Document(page\_content='Leases 105 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. easement does not meet the definition of a lease, and Question 3.2.20 \ndiscusses considerations for roving (or floating) easements . \nInterpretive response: We believe the analysis of whether a lease exists \ndiffers depending on whether the easement grants the right to use surface or \nsubsurface (i.e. underground) land. \nSurface land rights \nIf an easement grants a lessee rights to use surface land, that land is the unit of \naccount for evaluating whether a lease exists. This is regardless of whether \nanother entity has rights to use the subsurface land (e.g. to bury a \ntelecommunications cable or a pipeline). \nTherefore, i f the grantee has exclusive rights to use the identified surface land, \nwe believe a land easement will typically meet the definition of a lease. If the \ngrantee has the exclusive right to the substantive uses of the land (see \nQuestion 3.3.30) subject to the easement, the grantee will also typically have \nthe right to direct the use of the asset because either: \n— the grantee has the right to direct how and for what purpose the land to \nwhich it has exclusive use rights is used; or \n— if those rights are predetermined (e.g. the easement specifies how the land \nmust be used, such as solely for the construction of a pipeline or the laying \nof telecommunications cable or conduit), the grantee will operate the land from the perspective of undertaking the predetermined activity. \nIn contrast, if the easement grants only nonexclusive rights to use the identified \nsurface land (see Example 3.2.40, Scenario 4), a lease does not exist. \nSubsurface land rights \nMany land easements give the grantee only rights to use land that is \nunderground. For example, an easement may permit the grantee to construct \nan underground pipeline or bury telecommunications cable or conduit, but also permit the grantor or another party rights to use the land surface – e.g. to farm \non the land or to install a cellular tower. \nFor subsurface land easements of this nature, there are pr esently mixed views \nabout whether a lease exists. In the absence of further guidance from the FASB \nor the SEC staff, we will accept either view, applied consistently . \nView 1: Subsurface land is identifiable and can be leased \nUnder this view, the land should be subdivided by surface rights and subsurface \nrights , which may be further subdivided into multiple subsurface rights by \ndepth. \nIn applying this view, the grantee may have exclusive rights to the substantive \nuses of an identified s ubsurface portion of the land even if other entities (or the \ngrantor) have rights to use other identified surface or subsurface portions of the \nland. For example, the grantee has exclusive rights to bury a telecom cable \nbetween a depth of 10– 20 feet below the surface at a specified latitude and \nlongitude, while the grantor has the right to farm the surface of the land and a \nthird party has the right to bury an underground pipeline at a depth of more than \n20 feet below the surface. For the same reasons as fo r surface land rights, if ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 106}), Document(page\_content='Leases 106 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the grantee has exclusive use of that identified subsurface land, the easement \nwould typically meet the definition of a lease. \nView 2: Rights to use subsurface land akin to air rights \nThis view equates subsurface land easements s uch as those described in the \nexample under View 1 – i.e. in general, where the subsurface land subject to \nthe easement is not inhabited or generally accessible – to air -use rights. \nAir-use rights are explicitly identified in US GAAP as an example of a contract-\nbased intangible asset; therefore, such rights (or a lease of such rights) are \noutside the scope of Topic 842. Consequently, under this view, because these \nsubsurface land easements are considered to be substantially equivalent to air -\nuse rights, th ey are also considered to be outside the scope of Topic 842. \n[805- 20-55-37, 842- 10-15-1(a)] \nImportantly, this view does not equate all subsurface land easements to air -use \nrights. For example, rights to use underground land for a retail or other similar \nstore (e.g. in a subway station), which will be used in a manner consistent with \nsurface land, are not analogous to air -use rights. \nContract grants both surface and subsurface land rights \nA contract that grants explicit rights to use both the surface of the identified \nland and defined subsurface space may include two units of account. \nAn entity that applies View 1 for the subsurface land rights would conclude that \nthere are two units of ac count: the surface land rights and the subsurface land \nrights. This is unless the effect of separate accounting is insignificant (see section 4.1.2) – e.g. because the rights are co- terminus and each lease would \nbe classified as an operating lease if classified separately. \nAn entity that applies View 2 for the subsurface land rights would conclude that \nthere are two units of account: a separate lease component for the rights to use \nthe surface land, and a non -lease component for the right to use the subsurf ace \nland. This is unless the entity elects (and, if a lessor, meets the criteria to apply) the practical expedient not to separate lease and non- lease components (see \nsection 4.4.1). \nWe do not believe an entity should infer that subsurface rights exist in a \ncontract that explicitly grants surface land use rights only, unless subsurface rights are explicitly granted. In other words, it would be inappropriate for an \nentity to assign a portion of its fixed payments for the surface land lease to an \nimplicit sub surface rights component. \n \n Example 3.3.20 \nInternet service agreement \nCustomer enters into a contract with a telecommunications company (Supplier) for high-speed internet access. Supplier deliver s the high- speed internet access \nvia an internet router that is specified in the contract by serial number. The \ninternet router contains two antennae: one antenna broadcasts wireless \ninternet via a secure signal to Customer (i.e. Customer can secure with \na password so no one else can access the signal), while the other ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 107}), Document(page\_content='Leases 107 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. antenna broadcasts internet to any other devices of other high- speed \ninternet customers . \nThe internet service contract includes an identified asset , the internet router \n(which is specified in the contract), and Supplier would not economica lly benefit \nfrom substituting a similar asset . However, Customer does not have exclusive \nuse of the output from the router. Therefore, unless the economic benefits that \ncan be derived from use of the second antenna are insignificant in relation to \nthe econ omic benefits that can be derived from use of the router overall, there \nis not a lease because Customer does not have the right to obtain substantially \nall of the economic benefits from use of the router. \n \n3.3.4 Step 4: Does the customer have the right to d irect \nthe use of the asset? \n Excerpt from ASC 842 -10 \n>>> Right to Direct the Use of the Identified Asset \n15-20 A customer has the right to direct the use of an identified asset \nthroughout the period of use in either of the following situations: \na. The customer has the right to direct how and for what purpose the asset is \nused throughout the period of use (as described in paragraphs 842- 10-15-\n24 through 15- 26). \nb. The relevant decisions about how and for what purpose the asset is used \nare predetermined (see paragraph 842- 10-15-21) and at least one of the \nfollowing conditions exists: \n1. The customer has the right to operate the asset (or to direct others to \noperate the asset in a manner that it determines) throughout the period \nof use without the supplier having the right to change those operating \ninstructions. \n2. The customer designed the asset (or specific aspects of the asset) in a \nway that predetermines how and for what purpose the asset will be \nused throughout the period of use. \n15-21 The relevant decis ions about how and for what purpose an asset is used \ncan be predetermined in a number of ways. For example, the relevant \ndecisions can be predetermined by the design of the asset or by contractual \nrestrictions on the use of the asset. \n15-22 In assessing w hether a customer has the right to direct the use of an \nasset, an entity shall consider only rights to make decisions about the use of \nthe asset during the period of use unless the customer designed the asset (or \nspecific aspects of the asset) in accordance with paragraph 842- 10-15-20(b)(2). \nConsequently, unless that condition exists, an entity shall not consider \ndecisions that are predetermined before the period of use. For example, if a \ncustomer is able only to specify the output of an asset before the period of \nuse, the customer does not have the right to direct the use of that asset. The \nability to specify the output in a contract before the period of use, without any ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 108}), Document(page\_content='Leases 108 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. other decision -making rights relating to the use of the asset, gives a customer \nthe sam e rights as any customer that purchases goods or services. \n>>>> How and for What Purpose an Asset Is Used \n15-24 A customer has the right to direct how and for what purpose an asset is \nused throughout the period of use if, within the scope of its right of use \ndefined in the contract, it can change how and for what purpose the asset is \nused throughout that period. In making this assessment, an entity considers \nthe decision- making rights that are most relevant to changing how and for \nwhat purpose an asset is used throughout the period of use. Decision -making \nrights are relevant when they affect the economic benefits to be derived from \nuse. The decision- making rights that are most relevant are likely to be different \nfor different contracts, depending on the na ture of the asset and the terms and \nconditions of the contract. \n15-25 Examples of decision -making rights that, depending on the \ncircumstances, grant the right to direct how and for what purpose an asset is \nused, within the defined scope of the customer’s r ight of use, include the \nfollowing: \na. The right to change the type of output that is produced by the asset (for \nexample, deciding whether to use a shipping container to transport goods \nor for storage, or deciding on the mix of products sold from a retail uni t) \nb. The right to change when the output is produced (for example, deciding \nwhen an item of machinery or a power plant will be used) \nc. The right to change where the output is produced (for example, deciding \non the destination of a truck or a ship or deciding where a piece of \nequipment is used or deployed) \nd. The right to change whether the output is produced and the quantity of \nthat output (for example, deciding whether to produce energy from a \npower plant and how much energy to produce from that power plant). \n15-26 Examples of decision -making rights that do not grant the right to direct \nhow and for what purpose an asset is used include rights that are limited to \noperating or maintaining the asset. Although rights such as those to operate or \nmaintain an asset often are essential to the efficient use of an asset, they are \nnot rights to direct how and for what purpose the asset is used and often are \ndependent on the decisions about how and for what purpose the asset is used. \nSuch rights (that is, to operate or maintain the asset) can be held by the \ncustomer or the supplier. The supplier often holds those rights to protect its \ninvestment in the asset. However, rights to operate an asset may grant the \ncustomer the right to direct the use of the asset if the relevant decisions \nabout how and for what purpose the asset is used are predetermined (see \nparagraph 842-10-15-20(b)(1)). \n55 Implementation Guidance and Illustrations \nGeneral \n> Illustrations \n>> Illustration of Identifying a Lease ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 109}), Document(page\_content='Leases 109 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. >>> Example 9— Contract for Energy/Power \n>>>> Case B —Contract Does Not Contain a Lease \n55-112 Customer enters into a contract with Supplier to purchase all of the \npower produced by an explicitly specified power plant for three years. The \npower plant is owned and operated by Supplier. Supplier is unable to provide \npower to Customer from another plant. The contract sets out the quantity and \ntiming of power that the power plant will produce throughout the period of \nuse, which cannot be changed in the absenc e of extraordinary circumstances \n(for example, emergency situations). Supplier operates and maintains the plant \non a daily basis in accordance with industry -approved operating practices. \nSupplier designed the power plant when it was constructed some years before \nentering into the contract with Customer; Customer had no involvement in \nthat design. \n55-113 The contract does not contain a lease. \n55-114 There is an identified asset because the power plant is explicitly \nspecified in the contract, and Supplier does not have the right to substitute the \nspecified plant. \n55-115 Customer has the right to obtain substantially all of the economic \nbenefits from use of the identified power plant over the three- year period of \nuse. Customer will take all of the power produced by the power plant over the \nthree- year term of the contract. \n55-116 However, Customer does not have the right to control the use of the \npower plant because it does not have the right to direct its use. Customer does \nnot have the right to direct how and for what purpose the plant is used. How \nand for what purpose the plant is used (that is, whether, when, and how much \npower the plant will produce) are predetermined in the contract. Customer has \nno right to change how and for what purpose the plant is used during the \nperiod of use, nor does it have any other decision- making rights about the use \nof the power plant during the period of use (for example, it does not operate \nthe power plant) and did not design the plant. Supplier is th e only party that can \nmake decisions about the plant during the period of use by making the \ndecisions about how the plant is operated and maintained. Customer has the \nsame rights regarding the use of the plant as if it were one of many customers \nobtaining power from the plant. \n>>>> Case C —Contract Contains a Lease \n55-117 Customer enters into a contract with Supplier to purchase all of the \npower produced by an explicitly specified power plant for 10 years. The \ncontract states that Customer has rig hts to all of the power produced by the \nplant (that is, Supplier cannot use the plant to fulfill other contracts). \n55-118 Customer issues instructions to Supplier about the quantity and timing \nof the delivery of power. If the plant is not producing p ower for Customer, it \ndoes not operate. \n55-119 Supplier operates and maintains the plant on a daily basis in accordance \nwith industry -approved operating practices. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 110}), Document(page\_content='Leases 110 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 55-120 The contract contains a lease. Customer has the right to use the power \nplant for 10 years. \n55-121 There is an identified asset. The power plant is explicitly specified in \nthe contract, and Supplier does not have the right to substitute the \nspecified plant. \n55-122 Customer has the right to control the use of the po wer plant \nthroughout the 10- year period of use because: \na. Customer has the right to obtain substantially all of the economic benefits \nfrom use of the power plant over the 10 -year period of use. Customer has \nexclusive use of the power plant; it has rights to all of the power produced \nby the power plant throughout the 10- year period of use. \nb. Customer has the right to direct the use of the power plant. Customer \nmakes the relevant decisions about how and for what purpose the power \nplant is used because it has the right to determine whether, when, and \nhow much power th e plant will produce (that is, the timing and quantity, if \nany, of power produced) throughout the period of use. Because Supplier is \nprevented from using the power plant for another purpose, Customer’s \ndecision making about the timing and quantity of power produced, in \neffect, determines when and whether the plant produces output. \n55-123 Although the operation and maintenance of the power plant are \nessential to its efficient use, Supplier’s decisions in this regard do not give it \nthe right to direct how and for what purpose the power plant is used. \nConsequently, Supplier does not control the use of the power plant during the \nperiod of use. Instead, Supplier’s decisions are dependent on Customer’s \ndecisions about how and for what purpose the power plant is used. \n>>> Example 10 —Contract for Network Services \n>>>> Case A —Contract Does Not Contain a Lease \n55-124 Customer enters into a contract with a telecommunications company \n(Supplier) for network services for two years. The contract requires Supplier to \nsupply network services that meet a specified quality level. To provide the \nservices, Supplier installs and configures servers at Customer’s premises; \nSupplier determines the speed and quality of data transportation in the net work \nusing the servers. Supplier can reconfigure or replace the servers when \nneeded to continuously provide the quality of network services defined in the \ncontract. Customer does not operate the servers or make any significant \ndecisions about their use. \n55-125 The contract does not contain a lease. Instead, the contract is a service \ncontract in which Supplier uses the equipment to meet the level of network \nservices determined by Customer. \n55-126 Customer does not control the use of the servers because Customer’s \nonly decision -making rights relate to deciding on the level of network services \n(the output of the servers) before the period of use—the level of network \nservices cannot be changed during the period of use without modifying the \ncontract. For example, even though Customer produces the data to be \ntransported, that activity does not directly affect the configuration of the \nnetwork services and, thus, it does not affect how and for what purpose the ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 111}), Document(page\_content='Leases 111 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. servers are used. Supplier is the only party that can make decisions about the \nuse of the servers during the period of use. Supplier has the right to decide \nhow data are transported using the servers, whether to reconfigure the \nservers, and whether to use the servers for another purpose. Accordingly, \nSupplier controls the use of the servers in providing network services to \nCustomer. There is no need to assess whether the servers are identified \nassets because Customer does not have the right to control the use of \nthe servers. \n>>>> Case B —Contract Contains a Lease \n55-127 Customer enters into a contract with an information technology \ncompany (Supplier) for the use of an identified server for three years. Supplier \ndelivers and installs the server at Customer’s premises in accordance with \nCustomer’s instructions and provides repair and maintenance services for the \nserver, as needed, throughout the period of use. Supplier substitutes the \nserver only in the case of malfunction. Customer decides which data to store \non the server and how to integrate the server within its operations. Customer \ncan change its decisions in this regard throughout the period of use. \n55-128 The contract contains a lease. Customer has the right to use the server \nfor thre e years. \n55-129 There is an identified asset. The server is explicitly specified in the \ncontract. Supplier can substitute the serve r only if it is malfunctioning. \n55-130 Customer has the right to control the use of the server throughout the \nthree- year period of use because: \na. Customer has the right to obtain substantially all of the economic benefits \nfrom use of the server over the three- year period of use. Customer has \nexclusive use of the server throughout the period of use. \nb. Customer has the right to direct the use of the server. Customer makes \nthe relevant decisions about how and for what purpose the server is used \nbecause it has the right to decide which aspect of its operations the server \nis used to support and which data it stores on the server. Customer is the \nonly party that can make decisions about the use of the server during the \nperiod of use. \n3.3.17 0 This section looks at the general considerations relevant in determining \nwhether the customer or the supplier has the right to direct the use of the asset \nthroughout the period of use, while section 3.3.5 looks more closely at \nsituations in which the substantive decision making about how and for what \npurpose the asset will be used is predetermined. \n3.3.18 0 A customer has the right to direct the use of an identified asset when it \nhas control over those decision- making rights about the use of the asset that \nare most relevant to (i .e. those that most significantly aff ect) the economic \nbenefits that can be derived from the asset’s use. Conversely, the supplier has \nthe right to direct the use of the identified asset if it controls those decision-\nmaking rights. The decisions that are m ost relevant will vary by contract. \n3.3.190 Decisions about how and for what purpose the asset is used during the \nperiod of use are most relevant to the economic benefits that can be derived from the asset’s use. Therefore, a customer has the right to direct the use of an ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 112}), Document(page\_content='Leases 112 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. identified asset when it has the right to direct (and change) how and for what \npurpose the asset is used throughout the period of use; for example, the ability \nto decide how leased space in a retail unit is used, or where and when a leased \nship sail s and what cargo it transports because those ‘r elevant decisions’ are \nthose that most significantly affect the economic benefits to be derived from \nuse of the asset . [842- 10-15-20, 15- 24] \n3.3.200 Topic 842 provides examples of decision -making rights that do and do \nnot grant an entity the right to direct how and for what purpose an identified \nasset is used ( in the scope of its right of use). [842- 10-15-25 – 15-26] \nRights in the contract\nExample rights to direct how and for \nwhat purpose asset is used \nthroughout period of useOther rights\nRight to change \nthe type of output \nproduced by the \nassetRight to change \nwhen the output\n is producedSupplier protective \nrightsMaintaining \nthe asset\nRight to change \nwhether output is \nproduced and , \nif so, quantity \nproducedRight to change \nwhere the output\n is producedInsuring the assetOperating the \nasset1 \nNote : \n1. Decisions about when or whether to operate the asset may be relevant ‘how and for \nwhat purpose ’ decisions (see Question 3.3.1 00). In addition, a customer’s right to make \nother operational decisions affects whether the customer has the right to direct the use of the asset if all of the relevant how and for what purpose decisions are predetermined \n(see section 3.3.5).\n \n3.3.21 0 A contract may include provisions that are intended to protect the \nsupplier’s interest in the asset or other assets, protect its personnel, or \ncomply with laws or regulations – ‘supplier protective rights’ in the chart in \nparagraph 3.3.200. [842-10-15-23] \n3.3.22 0 Such rights typically define the scope of the customer’s right to use the \nasset but do not, in isolation, prevent the customer from having the right to \ndirect the use of the asset (see paragraph 3.3.60). [ASU 2016- 02.BC141] \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 113}), Document(page\_content='Leases 113 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Observation \n‘Relevant decisions’ affect how and for what \npurpose an asset is used \n3.3.230 The basis for conclusions to ASU 2016- 02 explains that ‘r elevant \ndecisions ’ about the use of an asset are those that affect what and how much \neconomic benefit is derived from the asset’s use. The Board concluded that \ndecisions about how and for what purpose an asset is used are more important \nin determining who has control over the use of an asset than other decision-\nmaking rights (such as maintenance or operat ional decisions) that depend on, \nand typically subordinate to, the decisions about how and for what purpose an \nasset is used. [ASU 2016- 02.BC137] \n \n Question 3.3.10 0 \nOperational decisions \nCan decisions about the operation of an asset be relevant \n‘how and for what purpose’ decisions about the use of the \nidentified asset? \nInterpretive response: It depends on what is consider ed an ‘operational \ndecision’, which is not defined in Topic 842. \nBased on the discussion in paragraph 842- 10-15-26 and paragraph BC 137 in the \nbasis for conclusions to ASU 2016- 02, we believe the Board considered \noperational decisions to be limited to those that affect the efficiency of an \nentity’s use of the asset – e.g. the route the ship takes, the angle at which the \ndrilling rig un dertakes drilling or the driving of the truck; but do not affect what, \nwhen, whether or how much the asset is operated. That is, operational \ndecisions are decisions subject to, and do not include, broader decisions about \nwhat, when, whether or how much the asset is operated. \nHowever, if whether or when to operate the asset (e.g. when or whether to \nturn a piece of equipment on or off) is considered an operational decision, then \nthose decisions about whether or when to operate the asset are, in accordance \nwith paragraph 842- 10-15-25, relevant decisions that affect the economic \nbenefits that will be derived from use of the asset. Those decisions would therefore be considered along with other relevant decisions about how and for \nwhat purpose the asset will be used that are available to be made during the \nperiod of use – e.g. decisions about what output the asset will produce – when \ndetermining who has the right to direct the use of the identified asset. \nOther decisions about operating the asset that do not affect what, when, \nwhether or how much the asset is operated are not relevant decisions ( unless \nall of the relevant how and for what purpose decisions are predetermined – see \nsection 3.3.5). \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 114}), Document(page\_content='Leases 114 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 3.3.240 The customer or the supplier may have the right to dir ect how and for \nwhat purpose the identified asset is used. In other cases, the relevant decisions \nabout how and for what purpose the asset is used may be predetermined – e.g. \nthrough restrictions or other provisions in the contract. [842-10-15-20, 55-1] \nWho has the right to direct ‘how and for what purpose ’ \nthe asset is used ?\nCustomer\nContract is or \ncontains a lease1Predetermined\nFurther analysis \nrequired \n(see section 3.3.270)Supplier\nContract does not \ncontain a lease\n \nNote: \n1. If other criteria are met (see sections 3.2 and 3.3. 3). \n3.3.25 0 An entity should only consider which party (i.e. the customer or the \nsupplier) has the right to make decisions about the use of the asset during the \nperiod of use – i.e. in evaluating whether a lease exists or not, an entity ignores \ndecisions that are predetermined in the contract – unless the customer \ndesigned the asset or specific aspects thereof (see section 3.3.5 ). [842-10-15-22] \n3.3.260 When all of the relevant decisions about how and for what purpose the \nasset will be used throughout the perio d of use are predetermined, an entity \napplies the guidance in section 3.3.5 to determine if the customer directs the \nuse of the identified asset. If only some of the relevant decisions about how \nand for what purpose the asset will be used are predetermined , an entity \nconsiders whether the customer has the right to make those remaining (i.e. \navailable) , relevant ‘how and for what purpose’ decisions throughout the period \nof use. The following diagram illustrates this point. \nContract 1 Contract 2\nRelevant decision -making rights that \nare predetermined\nRelevant decision -making rights \navailable to be made during the \nperiod of use :Relevant decision -making rights \navailable to be made during the \nperiod of use : NoneRelevant decision -making rights that \nare predetermined\nWhere What\nWhen How WhetherWhere What\nWhen How Whether\nApply paragraphs 842-20-15-20(a) and \n15-24 – 15-26 (see section 3.3.4)Apply paragraphs 842-10-15-20(b) and \n15-21 (see section 3.3.5)\n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 115}), Document(page\_content='Leases 115 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 3.3.30 \nDirecting the use of identified assets – truck and \ntrailers \nSupplier provides Customer with a truck and three trailers for its exclusive use \nfor three years. The following facts are relevant. \n— Supplier cannot substitute the truck or any of the trailers except for \nservicing or repair. \n— Customer keeps the truck and trailers at its location when not in transit or at a delivery point so that it can use the trailers that are not in transit. For \nexample, Customer can load one of the trailers not in transit with cargo so it \nis ready for transit on return of the truck. \n— Customer can use the truck with a trailer not provided by Supplier, and any \none of the trailers with a truck not provided by Supplier. \n— Customer is responsible for providing a driver for the truck and can decide \nwhen and where the truck and trailers go. \n— The contract limits Customer’s use of the truck to 120,000 miles over the three- year period of use. \n— The contract prohibits Customer from using any trailers with Supplier ’s \ntruck that are l arger than those provided by Supplier or hauling loads above \na certain weight. \nIn this example, the contract contains a lease of the truck and three trailers . The \ntruck and the trailers are explicitly specified assets that cannot be substituted \nexcept for reasons of servicing or repair – i.e. they are each identified assets. \nCustomer has the right to control the use of the truck and each of the three \ntrailers during the contract term in the scope of its right of use defined in the \ncontract. Customer has the right to obtain substantially all of the economic benefits from use of the truck and each of the three trailers because it has \nexclusive use of those assets. Customer also has the right to direct how and for \nwhat purpose the truck and trailers are used ( i.e. when and where the truck and \nthe trailers go or what they transport) in the scope of the contractually agreed \nright of use (i.e. subject to Supplier’s protective rights). The contractual limits on \ntruck usage are inherent features of the usage rights conveyed by the contract \nand do not prevent Customer from having the right to direct the use of the truck \nand trailers. \n \n Question 3.3.11 0 \nFunctional independence \nIf an asset does not function independently of other supplier -\nowned or supplier -leased assets, is that asset still capable of \nbeing leased? \nInterpretive response: Yes. The Board considered whether to specify that a \ncustomer controls the use of a n underlying asset only if the asset has stand -\nalone utility to the customer; that is, only if the customer has the ability to \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 116}), Document(page\_content='Leases 116 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. derive the economic benefits from use of an asset, either on its own or \ntogether with other resources that could be sourced in a reasonable period of \ntime. The Board decided that such a requirement should not be part of the \ndefinition of a lease. [ASU 2016- 02.BC142(c)] \nTherefore, an asset’s dependency on one or more other assets for the \ncustomer to be able to derive economic benefits from use of the asset does not \ndetermine whether there is or is not a lease. For example, a contract between \nan office building owner and a tenant for exclusive use of the 23rd floor can still \nmeet the definition of a lease even though the customer’s ability to derive \nbenefit from use of the 23rd floor depends on, for example, floors 1– 22, the \nelevators used to access the 23rd floor, and the common areas through which \nall occupants of the building (and their visitors) must transit to access their office space. \nSimilarly, an equipment asset’s dependency on a larger network or plant does not preclude there being a lease of that equipment asset . \n \n Question 3.3.12 0 \nCustomer -premise identified assets dedicated to \nthe customer \nDoes a lease always exist when the identified asset will \nfunction at the customer’s pre mises and the asset exclusively \nserves the customer? \nInterpretive response: No. Even though it frequently will be the case that a \nlease exists in those circumstances – i.e. when the asset resides at the \ncustomer’s premises and the customer has either exclu sive use of the asset or \nthe asset is dedicated to providing the customer a service – a lease does not \nnecessarily exist . This is because the customer may not have the right to direct \nthe use of the identified asset even if it does have the right to obtain \nsubstantially all of the economic benefits from its use. \nSubtopic 842 -10 includes an example (Example 10 Case A) of computer servers \nlocated at the customer’s premises to provide a dedicated service to the \ncustomer, and Example 3.3.40 provides a similar, but more detailed example. In \neach case, it is determined that a lease does not exist because the supplier has \nthe right to direct the use of the identified assets even though they are located at the customer’s premises and exclusively serve the customer. \nAn example substantially the same as Example 3.3.4 0 was discussed with the \nFASB and SEC staffs, who concurred with the conclusion that the example did \nnot contain a lease. As part of those discussions, the FASB staff indicated that \nthe outcome in arrangements of the nature described in this question will \nrequire careful application of the lease identific ation model. Proper \ndetermination of (1) the identified asset(s), (2) what relevant decisions are \navailable to be made during the period of use and (3) who controls those \ndecisions will be key to reaching the appropriate conclusion. \nThe specific facts and circumstances of the arrangement should be considered; \nhowever, with respect to Example 10 Case A (in Topic 842) and Example 3.3.40 \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 117}), Document(page\_content='Leases 117 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. specifically, we believe the fact that there are multiple identified assets and that \neach has multiple potential uses withi n the network services arrangement are \nimportant to the conclusion reached. Because there are multiple identified \nassets in each of those two scenarios, which could be deployed in multiple \nways at the supplier’s sole discretion, it is appropriate to conclude that the supplier, rather than the customer, controls how and for what purpose the \nidentified assets are used – i.e. directs the use of the identified assets. \nIn contrast, in a scenario that involves only a single identified asset, and particularly if that asset is designed to perform a single function, it may be that \nthe supplier does not have substantive decision- making rights about how and \nfor what purpose the identified asset is used during the period of use. Rather, it may be that either (1) the customer controls the most relevant how and for \nwhat purpose decisions that are available to be made, or (2) all of the relevant \nhow and for what purpose decisions are predetermined and the guidance \noutlined beginning at section 3.3.5 must be applied. \n \n Example 3.3.40 \nInfrastructure -as-a-Service – control over the use of \nthe identified asset \nThis example continues from Example 3.2.5 0; for ease of reference, we have \nincluded the full fact pattern in this example as well. \nCustomer enters into a contract with Supplier to obtain specified network \nservices that are provided through the use of 10 servers and various other \nnetworking equipment for five years. The network services provided by Supplier \ninvolve assets (servers and other equipment) located at Customer’ s premises. \nThe contract between Customer and Supplier requires Supplier to provide network services that meet a specified quality level, which if not met, result in \nservice -level penalties – i.e. credits aga inst amounts owed by Customer to \nSupplier. Customer controls how and how much it uses the network services, \nbut Customer cannot (under the terms of the contract ) change the configuration \nor specifications of the network ( or ‘turn off ’ the network ). \nThe ser vers and the networki ng equipment to fulfill the network services are \nselected by Supplier, and then explicitly specified in the final contract. All of the \nspecified equipment is dedicated to servicing Customer . \nBecause of this arrangement, Customer chooses not to set up its own \nnetwork/data center (e.g. acquiring servers and equipment of its own, or \npotentially hiring IT personnel) or to operate its own network. \nExample 3.2.50 concluded that there are identified assets in the arrangement; \neach server and piece of equipment is an identified asset. Therefore, Customer \nand Supplier do not evaluate the servers and other equipment as a combined \nunit of account (i.e. as a network). This example explores whether Customer is \nleasing the identified servers and equi pment. \nCustomer has no rights to change how the servers or other equipment used to \nprovi de the network services are used. It cannot, for example, redirect a server \nor another piece of equipment from the network services to another use or ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 118}), Document(page\_content='Leases 118 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. direct (or change) the role the servers play in the network – e.g. Customer \ncannot change Server X1’s r ole in the network architecture from hosting \nSoftware Y to being configured in another way to host Software X . Supplier \nsolely has the right to change how the equipment is used within the network \nservices agreement with Customer , which it will often do to optimize network \nperformance (particularly over a longer -term arrangement). \nThe identified assets (i.e. the servers and the other equipment) are not being \nleased to Customer because Supplier, rather than Customer, controls their use. \nThis conclusion is based on the following. \n— Supplier controls how the identified assets are used. Even though the \nidentified assets are fully dedicated to Customer ’s network services, \nlimiting their potential uses to Supplier, the servers each have multiple roles \nthey can play within the network architecture; for example, Server X1 could \nhost Software X or Software Y, be configured to perform Function A or Function B, or process or store data. Customer, in contrast, has no rights to \ndecide (or change) , or prevent Supplier from changing (as long as the \nnetwork services are not interrupted), how the servers are used. That is, \nalthough Customer decides how and when it uses the network , Customer’s \ndecisions do not affect how each identified asset (i.e. each server or other piece of equipment) that comprises the network is used. \n— Supplier controls when, whether and how much the identified assets \nare used. Supplier, at its sole discretion, may decide that an identified asset \nis extraneous to the network and remove it from network service to reduce operating/maintenance costs, or decide that the identified asset be \nemployed to its full capacity. Customer, in contrast, has no ri ght to change \nwhether or when an identified asset is producing output because each identified asset is constantly performing its function within the network \nunless Supplier decides otherwise. Further, Customer cannot decide to \nspecifically use an identifie d asset. Customer’s use of the network (e.g. \naccessing a particular hosted application or functionality or stored data) \ndoesn’t necessarily employ, for example, Server X1 or Server X2. The \nnetwork services permit Customer to use the network (e.g. access \nApplication A, perform function B and store/transmit data), but Customer \nhas no right to decide that, for example, Server X1 will host Application A or Server X2 will perform function B. By choosing to, for example, access \nApplication A, Customer does not al so choose to use Server X1 because it \nis Supplier that decides (and can change) which of the identified servers (X1–X10) hosts Application A. Put another way, Customer’s decisions are \nabout when, whether and how much to use the network, not one (or some) \nof the identified assets used to create the network. \n \n Example 3.3.50 \nConstruction services contract \nABC Construction Company enters into a contract with Customer to construct a \nbuilding and a parking garage designed by Customer on Customer’s property. \nThe project is expected to take 15– 20 months to complete. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 119}), Document(page\_content='Leases 119 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The nature of the construction services is such that ABC will use a variety of \nconstruction equipment it owns to fulfill the contract. During the construction \nperiod, the various pieces of equipment are implicitly specified because ABC \nwill not, under circumstances likely to occur or exist throughout the period of \nuse, economically benefit from substituting the equipment it commits to the \nproject for equivalent equipment during the construction period (the period of \nuse) – see paragraphs 3.2.20 – 3.2.30. Therefore, the pieces of equipment are \nidentified assets. \nWhile the pieces of equipment are identified assets, and implicitly specified to Customer’s construction project, Customer does not control their use. At no \npoint during the period of use does Customer have the right to direct how and \nfor what purpose any of the identified equipment is used. While Customer has \nspecified an output from the equipment as a unit , Customer has no rights to \ndecide how ABC employs any individual piece of equipment to fulfill the \nconstruction contract. Rather, it is ABC that, throughout the period of use, will \nsolely decide how each piece of equipment is used to complete the numerous \ntasks necessary to fulfill the contract. \n \n Question 3.3.13 0 \nLeases when the supplier has physical possession \nof, operates and maintains the identified asset \nDoes a lease exist if a supplier has physical possession of, \noperates and maintains the identified asset? \nBackground : Question 3.3.120 and Examples 3.3.40 and 3.3.50 focus on \nsituations in which an asset located at the customer’s premises and dedicated \nto the customer may not result in a lease. In contrast, this question and \nExamples 3.3.60 and 3.3.7 0 focus on situations where the supplier retains \npossession of the asset and typically operates and maintains the asset. \nInterpretive response : It depends. Example 9 Case C in Subtopic 842 -10 \nillustrates a scenario where a customer leases a power plant that the power \nplant owner (i.e. the supplier) controls physical access to, operates and \nmaintains. Therefore, it is clear that a lease can exist in such circu mstances. \n[842- 10-55-117 – 55-123] \nIn that example, the customer controls when, whether and how much \nelectricity the power plant produces, and those ‘how and for what purpose’ \ndecisions most significantly affect the economic benefits that will be derived from use of the power plant. \nA customer may have similar rights to control the use of an identified factory or \ndedicated production line in some contract manufacturing scenarios. The \nfactory or dedicated production line may be operated, maintained and controlled \nas to physical access by the manufacturer, but the customer may have the right \nto control the economic benefits derived from use of the identified asset by \nvirtue of having the right to dictate when, whether and how much the factory or \nthe line produces. For example, a factory or a dedicated production line may \ncomprise integrated, specialized equipment for the production of the \ncustomer’s product and may only produce the customer’s product on the basis, \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 120}), Document(page\_content='Leases 120 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. and only to the extent, of customer purchase orders issued each month or \nquarter during the contract period. \nAs another example, the fact that the computer server in Example 10 Case B in \nSubtopic 842-10 is leased does not depend on the fact that it resides at the \ncustomer’s premises. A customized or specialized server maintained at the supplier’s premises could also be an identified asset, and the customer could \nbe deemed to control that asset if it had the right to direct (and change), for \nexample, what software the server would host or what functions it was \nconfigured to perform throughout the period of use. \nIn more complex scenarios, the asset owner and the customer may each have \nsubstantive decision- making rights. For example, the contract manufacturer in \nthe factory/production line discussion may have the right to decide when to \noperate the factory or the line – i.e. the manufacturer may receive orders from \nthe customer dictating the total quantity to be produced – but have flexibility to \ndecide whether to produce those orders immediately by runni ng the factory or \nthe line at maximum capacity until the order is fulfilled or continuing to run the asset at normal capacity. \nHowever, in that type of scenario, we would generally consider decisions about \nwhen to produce output, which the manufacturer controls, as being less \nrelevant than decisions about whether to produce output and how much output \nto produce, which the customer controls. And in some cases, the customer \nmay be able to implicitly control the ‘when’ as well as the ‘whether’ and ‘how \nmuch’ decisions if it can, in effect, dictate the level and timing of production by \nits orders – e.g. if the customer can issue purchase orders of a quantity or \nsubject to a deadline that overrides the manufacturer’s nominal right to decide \nwhen to fulfill the c ustomer’s orders. \nSignificant judgment may be required in these types of scenarios, including \ncareful consideration of which decisions each party controls and which of those \ndecisions are most relevant – i.e. most significantly affect the economic \nbenefits that can be derived from use of the asset. \n \n Example 3.3.60 \nRight to direct the use of the identified asset – \noutsourcing arrangement \nScenario 1: Customer can change the mix and quantity of output during \nthe period of use \nContinuing Example 3.3.10 , Scenario 2, Supplier designed and constructed \nthe factory that will produce the airbags specifically to meet Customer’s \ndemand. The factory is a single, integrated asset of the nature described in \nQuestion 3.2.10 ; it is specified in the contract and Supplier does not have the \npractical ability to source the airbags from another factory. \nIn addition, the factory is designed to manufacture airbags of various types and \nquality and Customer has the right to direct (and change) the mix and quantity \nof airb ags that the factory produces during the period of use. Because ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 121}), Document(page\_content='Leases 121 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Customer controls the mix and quantity of airbags produced, it also implicitly \ncontrols when the factory produces airbags. \nCustomer has the right to direct the use of the factory because it di rects (and \ncan change) how and for what purpose the factory is used – Customer can \nchange the type and quantity of output produced by the factory. Because the \nfactory is an identified asset and Customer also has the right to obtain \nsubstantially all of the economic benefits from the use of the factory (see \nExample 3.3.10 , Scenario 2), the arrangement contains a lease. \nScenario 2: Customer can change the output quantity only during the \nperiod of use \nChanging the facts of Scenario 1, the factory, as designed, can only produce the \nparticular type and quality of airbag requested by Customer in the contract – i.e. \nthe factory cannot produce other types of output. However, consistent with the \nfacts in Scenario 1, Customer has the right to decide (and change) the quantity \nof airbags produced by the factory during the period of use. Supplier controls \nwhen it produces the airbags Customer orders – e.g. whether it runs the factory \nat maximum capacity for 12 hours per day to fulfill Customer’s orders or at a \nlesser capacity for 16 hours per day – subject to meeting contractually agreed \nproduction timelines. \nNeither Customer nor Supplier can change what the factory produces because \nthe factory was designed to produce only the particular type and quality of \nairbags request ed by Customer in the contract. However, Customer decides \nwhether and how much output the factory will produce, which are the relevant \ndecisions about how and for what purpose the asset will be used that are available to be made during the period of use. \nSupplier nominally controls when to produce the airbags as long as it meets \ncontractuall y agreed delivery requirements. However, those decisions are less \nrelevant to the economic benefits that can be derived from use of the factory \nthan the decisions about whether and how much output the factory will \nproduce that Customer controls. In addition, Customer can effectively override \nSupplier’s decisi on-making rights about when to run the factory by issuing \npurchase orders that effectively require Supplier to run the factory at maximum \ncapacity to meet the agreed production timeline. \nBecause Customer has the right to make the most relevant decisions about \nhow and for what purpose the factory will be used throughout the period of use \nthat are not predetermined by t he design of the factory, Customer has the right \nto direct the use of the factory. The factory is an identified asset and Customer \ncontrols its use – i.e. it has the right to both direct its use and obtain \nsubstantially all of the economic benefits from it s use , therefore, the \narrangement contains a lease. \nThe conclusion to this scenario is significantly similar to that reached in Example 9 Case C in Subtopic 842- 10. \n[842- 10-55-117 – 55-123] \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 122}), Document(page\_content='Leases 122 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 3.3.62 \nConstruction subcontractor arrangement (1) – \nscaffolding \nABC Construction (Customer), the primary contractor on the construction of an \noffice building, enters into a contract with a subcontractor (Supplier) to provide a \nspecified quantity of scaffolding, to be erected as and where needed in active \nareas of construction throughout the construction period. \nSupplier provides the scaffolding and all services to maintain, erect and remove \nthe scaffolding. As construction progresses, Customer has the right to change \nwhere and whether the scaffolding is erected. At the end of the construction \nperiod, Supplier will remove all of the scaffolding from the construction site. \nCustomer and Supplier each analyze whether the contract contains a lease of \nthe scaffolding. They first conclude that the scaffolding is an identified asset because: \n— it is a physically distinct item of property, plant or equipment; and \n— once delivered to the constructi on site, Supplier will not benefit \neconomically from substituting equivalent scaffolding. \nCustomer and Supplier next consider whether Customer controls the use of the \nscaffolding. \n— They first determine that Customer has the right to obtain substantially al l \nof the economic benefits from use of the scaffolding. This is because there \nare no other parties that will benefit from its use during the construction of \nthe building. The scaffolding will solely be used to complete Customer’s \nconstruction project and i ts use in that task is its sole economic benefit \nfrom use. \n— They then evaluate whether Customer or Supplier has the right to direct \nand change how and for what purpose the scaffolding is used, or whether \nsuch decisions are predetermined. \nRelevant \nhow and for \nwhat \npurpose \ndecisions Considerations Who controls the \nrelevant decision \nor is it \npredetermined? \nWhere The scaffolding will be used only at the \nCustomer’s construction site, but can be deployed at various places on the site. Customer controls the part of the project to which \nthe scaffolding is deployed. \nWhat The scaffolding will be used solely for \nconstruction purposes at Customer’s construction site. However, decisions remain \nabout what part of the overall project Supplier’s scaffolding will be used in. Customer controls the part of the project to which \nthe scaffolding is \ndeployed. \nWhen, \nwhether and how much The scaffolding may not be erected an d in use \nthroughout the entire construction period – \ne.g. it may remain idle between various stages \nof the project. Customer decides \nwhen and whether \nto erect, take down \nand move the ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 123}), Document(page\_content='Leases 123 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Relevant \nhow and for \nwhat \npurpose \ndecisions Considerations Who controls the \nrelevant decision \nor is it \npredetermined? \nscaffolding; and on \nwhich parts of the \noverall construction \nproject to us e it. \nBased on this analysis, there are relevant how and for what purpose \ndecisions available to be made and changed during the period of use, and \nCustomer controls those relevant decision- making rights. Therefore, \nCustomer has the right to direct the use of the scaffolding. \nBecause the scaffolding is an identified asset and Customer controls its use, \nCustomer is leasing the scaffolding in this example. \n \n Example 3.3.65 \nRight to direct the use of the identified asset – \nshipping spot charter \nShip Co (supplier) enters into a contract with Oil Co (customer) to transport Oil \nCo’s unrefined oil from the US coast of the Gulf of Mexico to East Asia aboard a \nspecified tanker ship that cannot be substituted by Ship Co without Oil Co’s \npermission. The duration of the contract is a single voyage between these \ntwo regions. \nThe tanker ship has a defined capacity that cannot be exceeded and the ship is designed to transport petroleum products; it is not suitable for other types of \ncargo. \nThe following are relevant facts about each party’s rights and obligations under \nthe contract. \nFees Oil Co will pay Ship Co a minimum fee for the voyage. That fee \ncan increase if Oil Co exercises one or more of its various rights \nto change the voyage – e.g. extend the length of the voyage. \nOperation and \nmaintenance Ship Co will operate and maintain the ship. Oil Co has no right to \neither operate or maintain the ship itself or to replace Ship Co \nwith another operator. \nLoad port Oil Co has the right to select any one of four Gulf of Mexico \nports in the United States as the load point for the voyage, and \ncan change that decision up until the ship is within one day of \nthe then- selected load port. However, if Oil Co’s changes to the \nload port delay loading beyond the date range speci fied in the \ncontract, Oil Co must pay Ship Co incremental fees. \nOil Co has storage facilities at each of the four ports where it stores oil from its exploration and production (E&P) operations. \nAt any point in time, Oil Co’s facilities at a given port may be \nmore or less stocked with product and different ports may have ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 124}), Document(page\_content='Leases 124 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. different product stored – e.g. heavier versus lighter, sweeter \ncrude oil. \nDischarge port Oil Co has the right to select from one of a select number of \nEast Asia ports as the unloading (i. e. discharge) point for the \nvoyage, and can change that decision up until the ship is within \none day of the then- selected discharge port. Similar to the \nrequirements for the load port, if Oil Co’s changes to the \ndischarge port extend the duration of the vo yage, Oil Co must \npay Ship Co incremental fees. \nCargo Oil Co is permitted to load Ship Co’s ship with either one or two \ngrades of unrefined oil. However, the tanker ship is not outfitted to transport cargo other than oil or more than two grades of oil \nat the same time. Oil Co is prohibited under the terms of the \ncontract from transporting certain grades of oil for supplier \nprotective reasons. \nLoading and \nunloading Once the ship reaches the final load or discharge port, Oil Co \nhas three days’ lay -time to load or discharge its cargo. Oil Co can \nchoose to delay loading or unloading beyond the three days on \neither end of the voyage, but Oil Co will owe Ship Co a charge \nfor detaining the ship (i.e. demurrage). \nCapacity Oil Co is permitted to use as much of the ship’s cargo capacity \nas it chooses; however, as a practical matter, Oil Co would not \nuse less than the ship’s capacity because its fee to Ship Co does \nnot change based on how much of the ship’s cargo capacity Oil \nCo uses during the voya ge. \nIn this example, both parties conclude that the contract contains a lease of the \ntanker ship. This conclusion is based on the analysis that follows. \nIs there an identified asset? \nYes. The tanker ship is explicitly specified in the contract and cannot be substituted without Oil Co’s permission. \nDoes Oil Co (customer) have the right to obtain substantially all the \neconomic benefits from use of the identified ship? \nYes. The economic benefits from use of the tanker ship are those derived from \nthe ship’s ability to store and transport petroleum products. \nFrom the later of the following dates, no other entity (including Ship Co) may \nuse the identified tanker ship to store or transport its petroleum products: \n— the discharge date of the previous Ship Co custom er; and \n— inception of the spot charter contract between Ship Co and Oil Co. \nTherefore, Oil Co has exclusive access to the tanker ship’s economic benefits \nfrom use. \nDoes Oil Co (customer) have the right to direct the use of the identified \nship? \nYes. In reaching this conclusion, Ship Co and Oil Co first evaluate whether there \nare relevant ‘how and for what purpose’ decisions available to be made during ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 125}), Document(page\_content='Leases 125 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the period of use; or instead, whether all of the relevant how and for what \npurpose decisions about the use of the ship are predetermined. \nThe following table evaluates whether there are ‘how and for what purpose’ \ndecisions available to be made during the period of use (see paragraph 3.3.260) \nand whether those decisions are both relevant (see paragr aphs 3.3.180 – \n3.3.190 and 3.3.230) and substantive (see Question 3.3.30). \nHow and for what \npurpose examples \nin Topic 842 (see \nparagraph 3.3.200) How and for what purpose decision-making rights \navailable to be made during the period of use \nThe right to \nchange the type of \noutput that is \nproduced by the \nasset Yes, but limited. Decisions about what output the ship will \nproduce are mostly predetermined by the design of the ship \n(can only transport petroleum products) or the contract (limits \nthe petroleum products Oil Co can transport using the ship). \nHowever, what output the ship will produce is not entirely predetermined because Oil Co can select from a range, albeit \nlimited, of petroleum products to transport (i.e. Oil Co is not \nlimited to transporting onl y one grade of crude oil) and has the \noption to transport one or two grades of oil. Oil Co’s decision -\nmaking rights in this regard end after the ship is loaded – i.e. \nOil Co cannot change the cargo once it has been loaded – but \nit can be changed until that time. \nWhile the cargo flexibility is limited, the flexibility in terms of \ngrade and whether to load a single grade or two grades affects \nthe economic benefits from use of the ship because Oil Co \ncan use that flexibility to manage its resources and/or arbi trage \nbetween different prices of grades of oil. \nThese relevant decision- making rights are substantive. While \nShip Co is unable to know what decisions Oil Co will make, customers of Ship Co (and others) frequently exercise their \nright to select from multip le types of product or to transport \ntwo grades of oil versus only one. \nThe right to \nchange when the \noutput is \nproduced Yes, but limited. Oil Co has only limited rights to change when \nthe output is produced – i.e. within a relatively narrow date \nrange. For example: \n— For additional fees, Oil Co can affect the time to load or \ndischarge product from the ship. \n— For additional fees, Oil Co could direct the ship to lay idle during the voyage and thereby extend its duration. \n— Oil Co is permitted to instruc t Ship Co to speed up or slow \ndown the ship (within a narrow range), which could \nshorten or lengthen the duration of the voyage. \nOil Co does not have the practical ability to extend or shorten \nthe voyage significantly – e.g. by weeks or months. \nOil Co’s ec onomic benefits from use of the ship are affected if \nit must pay additional fees to Ship Co based on these \ndecisions. Further, the available decisions may affect Oil Co’s \nability to sell the oil to a particular customer and/or its ability to \neffectively su pply its refineries. Customers frequently exercise \nthese rights and the effect of these decisions on a customer’s \neconomic benefits from use is substantive. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 126}), Document(page\_content='Leases 126 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. How and for what \npurpose examples \nin Topic 842 (see \nparagraph 3.3.200) How and for what purpose decision-making rights \navailable to be made during the period of use \nThe right to \nchange whether \nthe output is \nproduced and the \nquantity of that \noutput Yes. Legally, Oil Co has the right to transport an amount of oil \nthat does not use the full capacity of the ship. \nThis is not a substantive decision- making right (see \nQuest ion 3.3.30). While Oil Co could choose to sail the ship \nempty or under capacity, it is not practically a viable economic \ndecision. Therefore, while relevant, because non- substantive, \ndecisions about whether and how much output the ship will produce are eff ectively predetermined by the design of the \nship. \nThe right to \nchange where the output is \nproduced \n Yes. Oil Co has the right to direct and change the load and \ndischarge ports for the voyage. \nThese decisions are substantive as evidenced by customers’ \nfrequent exercise of these decision- making rights. \nFurthermore, they are relevant based on the following. \n— Having multiple discharge options, even if limited to a particular region or a single country, together with the \nfluctuating nature of the price of oil, permits customers \nadditional flexibility to trade the oil (e.g. expands their \npopulation of possible customers) or to direct the cargo to \nits own facilities based on current supply needs. \n— Having multiple load options, even if also limited to a \nparticular region or a single country, may permit the \ncustomer to select from different grades of oil (if the \ncontract, such as the one between Ship Co and Oil Co, \npermits that) and match transport with production output \nand supply needs. \nBased on the a nalysis, there are substantive, relevant how and for what \npurpose decisions available to be made d uring the period of use. Oil Co controls \nthose decisions in each case; Ship Co does not control any of the available \ndecisions. Consequently, Oil Co has the r ight to direct the use of the identified \ntanker ship. \n \n Example 3.3.70 \nRight to direct the use of the identified asset – \nstorage warehouse(s) \nScenario 1: Continuation of Example 3.2.20 \nContinuing Example 3. 2.20, Customer enters into a five- year arrangement with \nSupplier for a climate- controlled storage warehouse in which to store its coffee \nbeans and/or other products. The storage warehouse is specified in the contract (storage warehouse 3C), Customer has exclus ive use of the warehouse, and \nSupplier has no right to substitute it. Therefore, there is an identified asset. \nA warehouse is typically a warehouse by design; it could not be a retail unit or \noffice building without substantially modifying the asset. Therefore, its output is ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 127}), Document(page\_content='Leases 127 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. storage and the relevant how and for what purpose decisions – i.e. those that \nsignificantly affect the economic benefits to be derived from use – are what the \nwarehouse stores and when, whether and how much the warehouse stores. \nCustom er determines throughout the period of use what to store in the \nwarehouse (e.g. coffee and/or tea, subject to a restriction on the storage of \nhazardous materials), the quantity to be stored (up to a maximum quantity), and \nhow much of the warehouse it will use. Supplier operates and maintains the storage warehouse. \nThe contract contains a lease. Customer has the right to obtain substantially all \nof the economic benefits from the use of the identified storage warehouse \nbecause it has exclusive use of it. Cust omer also has the right to direct the use \nof the storage warehouse because it has the right to direct how and for what purpose it is used throughout the period of use. That is, Customer has the \nright to determine the type and quantity of output that the as set produces \nthroughout the period of use, which in the case of the warehouse is what it \nstores (even if that is restricted by the contract – e.g. restrictions may exist \non things like hazardous or flammable materials) and when and how much \nit stores. \nScen ario 2 : Multiple warehouses \nIn this scenario, Supplier agrees to dedicate multiple discrete warehouses for \nCustomer’s use. Supplier can decide what Customer goods are stored in which \nof the dedicated warehouses, as well as the storage location of Customer’ s \ngoods within the selected warehouse. Likewise, Supplier has full discretion to move items both within and among the dedicated warehouses without \nCustomer’s knowledge or consent as long as doing so in no way restricts Customer’s ability to access its stor ed items. \nThe contract contains a lease. Customer can still control what is stored by \ndeciding, for example, to only store one type of good in the warehouses, and \nalso still controls when, whether and how much is stored – e.g. Customer can \ndecide when, wh ether and how much all of the dedicated warehouses are used \nby storing enough goods to require such usage. \n \n Example 3.3.75 \nRight to direct the use of the identified asset – \nadvertising on a bus \nABC Advertising Company enters into a contract with a transit authority to place \nadvertising on the sides of city buses. The advertising may be attached to the \nsides of the buses adhesively (i.e. ‘wrapped’) or may be placed in frames \nowned by ABC that are then affixed to the buses. \nABC also ent ers into a contract with Customer to display Customer’s \nadvertising on the sides of city buses. The following facts are relevant to ABC’s \ncontract with Customer: \n— ABC an d the transit authority have the right to approve the advertising \ncontent; ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 128}), Document(page\_content='Leases 128 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — The contract stipulates the number of buses on which the advertising will \nbe placed, but ABC determines which specific buses get the advertising \nand the related routes th ose buses will run; \n— ABC makes no express or implied promise or commitment that Customer’s advertising will be displayed on any specific bus or bus route; \n— ABC solely determines whether the advertising will be wrapped or placed in \nan affixed frame; \n— ABC has the discretion to move Customer’s advertising onto different \nbuses and r outes and to ch ange how the advertisements are attached to \nthe buses (i.e. wrapped v ersus frame). \nEvaluation of ABC as lessee of the advertising space \nABC’s contract with the transit authority is not a lease because ABC does not \ncontrol the use of an identified asset in this contract. Consistent with the \ndiscussion in Question 3.2.40, ABC concludes that the side of a bus where ABC \nhas the right to display customers’ advertising is not a physically distinct, \nidentifiable asset. Rather, the bus is the identified asset and A BC does not \nthrough this contract have the right to control its use – i.e. either (1) obtain \nsubstantially all of its economic benefits from use, or (2) direct its use. \nEvaluation of ABC as lessor of the advertising space \nScenario 1: Advertising is wrapped \nIn the scenario where ABC wraps Customer’s advertising on the side of a bus, \nthe contract between ABC and Customer does not contain a lease. This is \nbecause ABC neither owns the bus (i.e. the transit authority does), nor is it \nleasing the advertising space on the side of the bus from the transit authority (see Evaluation of ABC as lessee of the advertising space). Because ABC does \nnot own or lease the advertising space itself, it cannot lease or sublease that \nspace to Cus tomer. ABC is effectively reselling the service it is receiving from \nthe transit authority of providing advertising space on the transit authority’s \nbuses to Customer. \nScenario 2: Advertising is placed in an affixed frame \nABC’s decision about whether to wrap or affix Customer’s advertising to a transit authority bus in a frame does not alter the fact that neither ABC (from \ntransit authority) nor Customer (from ABC) is leasing the side of that bus. \nHowever, if ABC affixes Customer’s advertising to the bus in a frame that ABC \nowns, there is an identifiable item of equipment (i.e. the ABC -owned frame) – \nsee Question 3.2.40. \nEven though ABC owns the frame, the advertising contract between ABC and Customer does not contain a lease of the frame by Customer. Thi s is because \nCustomer has no right to direct how and for what purpose the frame is used. \nCustomer cannot require ABC to change the advertising in the frame and, in \nfact, cannot require ABC to continue to use that frame at all. ABC retains the \nsole ability at all times to decide whether the frame is used for Customer’s advertising, for another customer’s advertising, or not at all. \nFurthermore, the frame may not even be an identified asset. Although the \nframe is identifiable , ABC may, depending on the facts and circumstances, have ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 129}), Document(page\_content='Leases 129 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. a substantive substitution right. This is because ABC regularly changes how and \nwhere it places advertisements to maximize its use of the space (sides of \nbuses) it obtains from the transit authority. Circumstances in which ABC woul d \neconomically benefit from such changes may be considered ‘likely to occur’ (see paragraph 3.2.130 and Example 3.2.30), especially given the low costs of \nmaking the changes. And when ABC does so, it has no obligation to continue to \npresent the customer’s advertising in the same frame (or in a frame at all). \n \n Example 3.3.76 \nRight to direct the use of the identified asset – \nbillboards \nScenario 1: Stationary traditional billboard \nABC Corp. (Customer) enters into a three- year contract with XYZ Stadium Corp. \n(Supplier) to display its advertisement on a stationary, traditional (i.e. non -digital) \nbillboard owned by Supplier and located in Supplier’s baseball stadium. \nThe billboard is specified in the contract, and Supplier does not have any substi tution rights. Customer has exclusive use of the billboard, and can \nunilaterally decide (and change) what content is displayed on the billboard throughout the contract period, subject to provisions that preclude Customer \nfrom displaying certain content – e.g. political or religious messages, support for \nother sports teams, inappropriate material. \nBoth parties conclude that there is a lease of the billboard based on the following. \n— There is an identified asset. The billboard is explicitly specified in the contract and Supplier does not have any substitution rights. \n— Customer has the right to obtain all of the economic benefits from use of \nthe billboard during the period of use. The economic benefits from use are \nsolely its output of displaying advertising. C ustomer has exclusive rights to \nthat output throughout the contract period. \n— Customer has the right to direct the use of the billboard throughout the \nperiod of use. This is because it determines and can change, throughout \nthe period of use, when, whether and what the billboard displays. The contractual restrictions on the content Customer can display are protective \nin nature, and not so restrictive that they preclude Customer from directing \nthe use of the billboard (see Question 3.3.20). \nScenario 2: Digital billboard \nAssume the same facts as in Scenario 1, except the billboard is digital rather \nthan traditional. Whether the billboard is digital or traditional has no bearing on \nits own on the evaluation of whether a lease exists. Therefore, for the same \nreaso ns as Scenario 1, a lease exists. \nScenario 3: Sub -divided traditional billboard \nAssume the same facts as in Scenario 1, except that Customer has the right to \nonly one- third of the billboard’s display space, and that third is specified in the \ncontract. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 130}), Document(page\_content='Leases 130 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Supplier has the contractual right to substitute an alternative section of the \nbillboard. However, that right is not substantive because it is not likely that \nSupplier would economically benefit from substituting one homogenous section \nof the billboard for an other. That is, it is not likely that another customer would \nbe willing to pay more to obtain rights to display on Customer’s section of the \nbillboard versus a homogenous alternative section. \nCustomer has exclusive use of its specified section of the billboard, and can \nsolely decide (and change) what content is displayed on the billboard \nthroughout the contract period, subject to the same restrictive provisions \noutlined in Scenario 1. \nBoth parties conclude that there is a lease of the specified billboard section based on the following. \n— There is an identified asset. The specified section of the billboard is \nexplicitly specified in the contract\n1 and Supplier does not have a substantive \nsubstitution right. In reaching this conclusion, the parties also consider that the billboard’s primary purpose is to display advertising and has been \ndesigned to permit multiple customers to use the billboard’s available \ndisplay space (see Question 3.2.40). \nNote: The conclusion that there is an identified asset would not change if \nthe section of the billboard to be used by Customer was not explicitly \nspecified in the contract, but rather becomes specified at the time \nCustomer is first ready to display an advertisement on the billboard. \n— Customer has the right to obtain all of the economic benefits from use of \nthe billboard section during the period of use. These economic benefits are \nsolely its output of displaying advertising. Customer has exclusive rights to \nthat output throughout the contract period. \n— Customer has the right to d irect the use of the billboard section throughout \nthe period of use. This is because it determines, throughout the period of use, when, whether and what the billboard section displays . The \ncontractual restrictions on the content Customer can display do not affect \nthis conclusion for the same reasons explained in Scenario 1. \nScenario 4: Rotating digital billboard (1) \nAssume the same digital billboard as in Scenario 2 with the following additional facts. \n— The billboard displays advertising only while there are events playing at the \nstadium. \n— Customer has the right to 1 minute of display time each 10 minutes during \nthe event – i.e. on a rotating basis . \n— Supplier retains the right to sell the other 9 minutes to other customers (in \nany increments it chooses) or to use that time itself (e.g. to advertise \nupcoming events). \n— The total number of minutes of display time is not known because the total \nnumber of baseball games and other stadium events is not known, and the \nduration of events can vary significantly. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 131}), Document(page\_content='Leases 131 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — Supplier controls the order in which it displays content during each 10-\nminute interval, and can change the order as it sees fit. As a practical \nmatter, however, it does not typically change the order during a single event. \n— Supplier can replace the digita l billboard, but would not economically benefit \nfrom doing so absent malfunction. Supplier cannot relocate the billboard \nfrom its prominent location or move Customer from that billboard to \nanother one without Customer ’s permission. \nBoth parties conclude that there is a lease based on the following. \n— There is an identified asset. The billboard is explicitly specified in the contract and Supplier does not have a substantive substitution right. \n— Customer has the right to obtain all of the economic benefits from use of \nthe billboard during the non-consecutive period of use. These economic \nbenefits are solely its output of displaying advertising. Customer has exclusive rights to that output throughout the period of use, which is the \nsum of the non- consecutive 1- minute display periods allotted to Customer \nunder the contract (see Question 5.3.90). \n— Customer has the right to direct the use of the billboard throughout the \nnon-consecutive period of use. This is because it determines and can \nchange, th roughout that period of use, whether and what the billboard \ndisplays. While Supplier can decide (and change) which 1- minute slot \nCustomer gets during each 10- minute rotation, those decisions are less \nrelevant than the how and for what purpose decisions Cus tomer controls. \nThe contractual restrictions on the content Customer can display do not affect this conclusion for the same reasons explained in Scenario 1. \nScenario 5: Rotating digital billboard (2) \nAssume the same digital billboard as in Scenario 4 except that Customer has \nthe right to a total of 3 minutes of display time at each stadium event, and \nSupplier decides (and can change) what 3 minutes Customer gets during any \ngame or event. \nDespite this difference from Scenario 4, both parties still conclude t here is a \nlease of the digital billboard. \nThey conclude there is an identified asset and that Customer has the right to \nobtain all of the economic benefits from use of the billboard during the non-\nconsecutive period of use for the same reasons as in Scena rio 4. \nThey also conclude Customer has the right to direct the use of the billboard \nthroughout the non-consecutive period of use. Supplier’s control over which \ncontent is displayed at which times during stadium events is more meaningful \nthan in Scenario 4 – i.e. because Customer’s (and similar customers’) \nadvertising does not rotate on a continuous cycle throughout the event. However, Supplier’s control over when Customer’s period of use occurs during \neach event does not change that Customer’s decisions about whether to \ndisplay content and what content to display during its period of use more \nsignificantly affect the economic benefits from use of the digital billboard during \nthe non- consecutive period of use and therefore are more relevant (see \nparagraph 3.3.180). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 132}), Document(page\_content='Leases 132 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. In addition, the parties note that if different game or event display slots \ncommanded differential pricing, customers (including Customer) would not be \nindifferent to the slot they were provided and Supplier would not have unlimited \ndiscretion to c hange Customer’s 3- minute display slot from event to event. This \nreinforces that Customer’s decision- making rights about whether to display \ncontent during its slot at each event, and what that content is, means Customer \ncontrols how and for what purpose th e billboard is used throughout the non-\nconsecutive period of use. \n \n Question 3.3.14 0 \nControl over the use of pipeline laterals \nDoes a customer control the use of an identified pipeline \nlateral? \nBackground: As discussed in Question 3.2.30 , pipeline laterals are physically \ndistinct, identified assets. \nInterpretive response: It depends. A customer’s measure of control over a \npipeline lateral can vary significantly from one contract to another, and typically \nthe contract refers to the pipeline owner’s obligation to transport product (e.g. \nnatural gas, oil) on the latera l up to the maximum commitment in the contract \nand makes no reference to the lateral. \nIn some transportation contracts, even though a physically distinct lateral is constructed to serve the customer (who may be a downstream or upstream \ncustomer), the pipeline owner retains the right to control the flow of product into and out of the lateral. Consequently, the pipeline owner is able to store \nproduct in the lateral and call on that product either to manage use of the \npipeline network as a whole – e.g. to manage the overall compression of a \nnatural gas pipeline network, the pipeline owner may push or pull gas into or out of a lateral – or to supply another customer. The pipeline owner may also \nhave the right to construct new laterals off the existing lateral without the \ncustomer’s consent. \nIn such cases, we do not believe the transportation customer has the right to \ncontrol the use of the lateral. That is, the pipeline owner has the ri ght to both: \n— obtain significant economic benefits from use of the lateral – the pipeline \nowner gets significant economic benefits from being able to use the lateral \nfor its own pipeline management and storage purposes. \n— direct the use of the lateral – even if the customer does not call or send \nproduct, the pipeline owner has the right, at its sole discretion, to decide \nwhen, whether and how much product is stored in or transits the lateral. \nIn other transportation contracts, the customer may control when, whether and \nhow much product enters, transits, and/or is stored in the lateral. For example, \nthe customer may control the valve (or similar mechanism) that permits product \nto enter and transit the lateral. If the customer has dispatch rights of that nature \nand has exclusive rights to the product it calls, the lateral scenario is \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 133}), Document(page\_content='Leases 133 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. substantially equivalent to that of the power plant in Example 9 Case C in \nSubtopic 842-10. In that example, there is a lease of the power plant to the \ncustomer because the customer decides when, whether and how much \nelectricity the plant will produce and has rights to all such electricity produced. \n[842- 10-55-117 – 55-123] \nThe Board discus sed pipeline lateral lease considerations at a May 2017 public \nmeeting, the Board members’ v iews were consistent with this interpretive \nresponse. \n \n Question 3.3.15 0 \nControl over the use of identified ‘last mile’ assets \nWhen does a customer control the use of an identified last \nmile asset? \nBackground: Question 3.2.30 discussed when the last mile of a single, \ncontiguous asset would be a physically distinct, identified asset. \nInterpretive response: It depends. Consistent with the discussion in \nQuestion 3.3.140 on pipeline laterals, it may be that the customer at the end of \nthe identified last mile asset controls when, whether and how much that asset \nis used – i.e. in effect has dispatch rights to decide how much electricity, data \nor traffic transits the last mile asset. \nFor example, customer control of the switch/valve/ breaker that mechanically \nseparates the last mile asset (see Question 3.2.30 ) – which may or may not \ninvolve the customer actually operating the switch/valve/breaker – may provide \nthe customer with the dispatch rights. In such cases, the customer has the \nright to direct the use of the last mile asset because it directs (and can change) \nhow and for what purpose the asset is used. \nIn contrast, if the asset owner controls when, whether and how much the asset \nis used – e.g. because it controls the switch/valve/ breaker that mechanically \nseparates the identified last mile asset, there is no lease of the last mile asset \nbecause the customer does not direct the asset’s use. Rather, the asset owner \ndirects its use. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 134}), Document(page\_content='Leases 134 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 3.3.5 Step 4: Control when the ‘how and for what \npurpose ’ decisions are predetermined \n Excerpt from ASC 842 -10 \n55 Implementation Guidance and Illustrations \nGeneral \n> Illustrations \n>> Illustration of Identifying a Lease \n>>> Example 5—Truck Rental \n55-72 Customer enters into a contract with Supplier for the use of a truck for \none week to transport cargo from New York to San Francisco. Supplier does \nnot have substitution rights. Only cargo specified in the contract is permitted to \nbe transported on this truck for the period of the contract. The contract \nspecifies a maximum distance that the truck can be driven. Customer is able to \nchoose the details of the journey (speed, route, rest stops, and so forth) within \nthe parameters of the contract. Customer does not have the right to continue \nusing the truck after the specified trip is complete. \n55-73 The cargo to be transported and the timing and location of pickup in \nNew York and delivery in San Francisco are specified in the contract. \n55-74 Customer is responsible for driv ing the truck from New York to San \nFrancisco. \n55-75 The contract contains a lease of a truck. Customer has the right to use \nthe truck for the duration of the specified trip. \n55-76 There is an identified asset. The truck is explicitly specified in the \ncontract, and Supplier does not have the right to substitute the truck. \n55-77 Customer has the right to control the use of the truck throughout the \nperiod of use because: \na. Customer has the right to obtain substantially all of the economic benefits \nfrom the use of the truck over the period of use. Customer has exclusive \nuse of the truck throughout the period of use. \nb. Customer has the right to direct the use of the truck. How and for what \npurpose the truck will be used (that is, the transport of specified cargo \nfrom New York to San Francisco within a specified time frame) are \npredetermined in the contract. Customer directs the use of the truck \nbecause it has the right to operate the truck (for example, speed, route, \nand rest stops) throughout the period of use. Customer makes all of the \ndecisions about the use of the truck that can be made during the period of \nuse through its control of the operations of the truck. \n55-78 Because the duration of the contract is one week, this lease m eets the \ndefinition of a short -term lease. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 135}), Document(page\_content='Leases 135 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. >>> Example 6— Ship \n>>>> Case A —Contract Does Not Contain a Lease \n55-79 Customer enters into a contract with a ship owner (Supplier) for the \ntransport of cargo from Rotterdam to Sydney on a specified ship. The ship is \nexplicitly specified in the contract, and Supplier does not have substitution \nrights. The cargo will occupy substantially all of the capacity of the ship. The \ncontract specifies the cargo to be transported on the ship and the da tes of \npickup and delivery. \n55-80 Supplier operates and maintains the ship and is responsible for the safe \npassage of the cargo onboard the ship. Customer is prohibited from hiring \nanother operator for the ship or operating the ship itself during the term of \nthe contract. \n55-81 The contract does not contain a lease. \n55-82 There is an identified asset. The ship is explicitly specified in the \ncontract, and Supplier does not have the right to substitute that specified ship. \n55-83 Customer has the right to obtain substantially all of the economic \nbenefits from use of the ship over the period of use. Its cargo will occupy \nsubstantially all of the capacity of the ship, thereby preventing other parties \nfrom obtaining economic benefits from use of the ship. \n55-84 However, Customer does not have the right to control the use of the \nship because it does not have the right to direct its use. Customer does not \nhave the right to direct how and for what purpose the ship is used. How and \nfor what purpose the ship will be used (that is, the transport of specified cargo \nfrom Rotterdam to Sydney within a specified time frame) are predetermined in \nthe contract. Customer has no right to change how and for what purpose the \nship is used duri ng the period of use. Customer has no other decision- making \nrights about the use of the ship during the period of use (for example, it does \nnot have the right to operate the ship) and did not design the ship. Customer \nhas the same rights regarding the use of the ship as if it were one of multiple \ncustomers transporting cargo on the ship. \n>>> Example 9— Contract for Energy/Power \n>>>> Case A —Contract Contains a Lease \n55-108 A utility company (Customer) enters into a contract with a power \ncompany (Supplier) to purchase all of the electricity produced by a new solar \nfarm for 20 years. The solar farm is explicitly specified in the contract, and \nSupplier has no substitution right s. The solar farm is owned by Supplier, and \nthe energy cannot be provided to Customer from another asset. Customer \ndesigned the solar farm before it was constructed— Customer hired experts in \nsolar energy to assist in determining the location of the farm and the \nengineering of the equipment to be used. Supplier is responsible for building \nthe solar farm to Customer’s specifications and then operating and maintaining \nit. There are no decisions to be made about whether, when, or how much \nelectricity will be pr oduced because the design of the asset has predetermined \nthese decisions. Supplier will receive tax credits relating to the construction \nand ownership of the solar farm, while Customer receives renewable energy ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 136}), Document(page\_content='Leases 136 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. credits that accrue from use of the solar far m. \n55-109 The contract contains a lease. Customer has the right to use the solar \nfarm for 20 years. \n55-110 There is an identified asset because the solar farm is explicitly specified \nin the contract, and Supplier does not have the right to subs titute the specified \nsolar farm. \n55-111 Customer has the right to control the use of the solar farm throughout \nthe 20- year period of use because: \na. Customer has the right to obtain substantially all of the economic benefits \nfrom use of the solar farm over the 20- year period of use. Customer has \nexclusive use of the solar farm; it takes all of the electricity produced by \nthe farm over the 20- year period of use as well as the renewable energy \ncredits that are a by -product from use of the solar farm. Alt hough Supplier \nwill be receiving economic benefits from the solar farm in the form of tax \ncredits, those economic benefits relate to the ownership of the solar \nfarm rather than the use of the solar farm and, thus, are not considered in \nthis assessment. \nb. Customer has the right to direct the use of the solar farm. Neither \nCustomer nor Supplier decides how and for what purpose the solar farm is \nused during the period of use because those decisions are predetermined \nby the design of the asset (that is, the desi gn of the solar farm has, in \neffect, programmed into the asset any relevant decision- making rights \nabout how and for what purpose the solar farm is used throughout the \nperiod of use). Customer does not operate the solar farm; Supplier makes \nthe decisions a bout the operation of the solar farm. However, Customer’s \ndesign of the solar farm has given it the right to direct the use of the farm \n(as described in paragraph 842- 10-15-20(b)(2)). Because the design of the \nsolar farm has predetermined how and for what purpose the asset will be \nused throughout the period of use, Customer’s control over that design is \nsubstantively no different from Customer controlling those decisions. \n \n3.3.27 0 It is possible that neither the customer, nor the supplier, controls \nrelevant decisions (i.e. those decisions that can significantly affect the \neconomic benefits to be derived from use of the asset) about how and for what \npurpose an identified asset will be used throughout the period of use because \nthose decisions are predetermined. In that case, the customer nevertheless has \nthe right to direct the use of the asset if: [842- 10-15-20(b) ] \n— it has the right to operate the asset or direct others to operate it in a \nmanner it determines throughout the period of use (and the supplier has no right to change those operating decisions); or \n— it designed the asset (or specific aspects of the asset) in a way that \npredetermines how and for what purpose the asset will be used throughout the period of use. \n3.3.28 0 The relevant decisions about how and for what purpose an asset is used \ncan be predetermined in a number of ways – e.g. by the design of the asset or \nby the terms of the contract, such as through contractual restrictions on the use \nof the asset. [842-10-15-21] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 137}), Document(page\_content='Leases 137 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Observation \nDecisions about how and for what purpose the asset \nis used are predetermined in the contract \n3.3.290 The Board expects relatively few cases in which all of the substantive \ndecisions about how and for what purpose the asset will be used will be \npredetermined in the contract. During deliberations of Topic 842, some Board \nmembers observed that someone must control the use of an asset; therefore, if \nall of the substantive how and for what purpose decisions have been \npredetermined, it is reasonable to ascribe control over the use of the asset to the customer if it effectively predetermined those decisions by control over the \ndesign of the asset, or it contr ols the operational decisions that remain after the \nrelevant how and for what purpose decisions have already been made. \n[ASU 2016- 02.BC138 –BC140] \n3.3.300 After the Board reached this decision, some entities suggested that the \nsupplier should be deem ed to control the use of the asset if its right to operate \nthe asset more significantly affects the economic benefits to be derived from use of the asset than the customer’s involvement in design. However, the final \nguidance is clear that the customer will be deemed to control the use of the \nasset if it either has the right to operate the asset or designed those aspects of the asset that predetermine how and for what purpose it will be used \nthroughout the period of use (see paragraph 3.3.270). We believe it was the \nBoard’s intent to, in effect, create a bias toward a conclusion that the customer controls the use of the asset in close- call situations to mitigate structuring \nopportunities. \n[842-10-15-20] \n3.3.310 We believe all facts and circumstances sh ould be considered in \ndetermining who controls the use of an identified asset when the substantive decision -making rights about how and for what purpose the asset will be used \nare predetermined. For example, a contract may stipulate that the supplier opera tes the asset but the customer has the right to remove the supplier \nwithout cause at any time during the contract term and to hire someone else to operate the asset. In this situation, we believe the customer controls the use of \nthe asset. \n3.3.320 This is supported by several examples included as illustrations in \nSubtopic 842 -10. For example, in Example 6 Case A, the supplier operates the \nasset and the example adds that the customer is prohibited from hiring another operator or operating the asset it self – i.e. the customer does not have kick -out \nrights and accordingly the supplier controls the use of the asset. We believe the Board intend ed to highlight that if the customer did have the right to replace the \nsupplier as the operator of the asset or ha d the right to operate the asset itself, \nthe contract would be a lease because how and for what purpose the asset will be used is predetermined in the contract. \n[842-10-55-79 – 55-84] \n3.3.330 While it appears that the Board attempted to mitigate str ucturing \nopportunities (e.g. by creating an apparent bias toward a conclusion that the customer controls the use of the asset in close- call situations), the guidance \nabout when rights are predetermined may still provide some structuring opportunities because an entity might be able to avoid meeting the definition of \na lease by carefully specifying what is predetermined versus what is not, and \nwho makes what decisions. The following are examples. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 138}), Document(page\_content='Leases 138 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — When the operation of the asset will be outsourced, the decisi on of which \nparty will operate the asset could be predetermined in the contract. \n— In many situations, the customer may not unilaterally design the asset – \ne.g. an investor might have expertise in renewable energy and play an \nactive role in the design. In ot her cases, the design may involve no \nsignificant decisions because construction of the asset is straightforward \nsuch that the customer does not need to participate in the design of \nthe asset. \n— In other contracts, there may be, or the parties may be able to create, joint decision -making rights that neither party to the contract controls. \n \n Example 3.3.80 \nAll relevant how and for what purpose decisions are \npredetermined – outsourcing arrangement \nAssume the same facts as in Example 3. 3.10, Scenario 2, except that the type, \nquantity and quality of the airbags to be produced are specified in the contract and neither Customer nor Supplier has the right to change any of those \ndecisions absent a modification to the contract. Supplier has the right to make \nall of the operating decisions for the factory during the period of use. Customer \nhas no right to hire another operator or to operate the factory itself. \nSupplier and Customer analyze Customer’s rights as follows to determine if the \narrangement is a lease. \n— The relevant decisions about how and for what purpose the factory will be \nused throughout the period of use (e.g. what and how much it will produce) \nare predetermined by the contract. Customer has no right to make or \nchange the relevant decisions about how and for what purpose the factory \nis used – e.g. Customer has no right to change what, whether, how much \nor when the factory produces. \n— Because how and for what purpose the factory will be used is \npredetermined, Supplier and Customer consider whether Customer has \nother rights of use that extend beyond the receipt of output (i.e. airbags) \nfrom the factory. Customer does not have the right to operate the factory or \nto direct Supplier (or others) to operate it in a manner that Customer \ndetermines. Customer also did not design the factory or cause it to be \ndesigned in a way that predetermines throughout the period of use the \nrelevant decisions about how and for what purpose the factory will be used. \nAs a result of this analysis, Supplier and Customer each conclude that the \ncontract does not contain a lease. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 139}), Document(page\_content='Leases 139 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 3.3.90 \nRight to direct the use of the identified asset is \npredetermined – storage warehouse \nContinuing Example 3.2.2 0, Customer enters into a five- year arrangement with \nSupplier for a climate -controlled storage warehouse to store its coffee beans. \nThe storage warehouse is specified in the contract (storage warehouse 3C), \nCustomer has exclusive use of the warehouse, and Supplier has no right to \nsubstitute it. Therefore, there is an ident ified asset. \nThe contract includes a list of items (coffee) to be stored, agreed on by \nCustomer and Supplier, and a specific quantity of coffee that may be stored in the warehouse. Customer is not permitted to change the types or quantity of \ncoffee stored or use the storage warehouse for any purpose other than storing \ncoffee during the period of use. Customer has no right to operate (or direct \nothers to operate) the storage warehouse and did not design it. \nIn this example, the contract does not contain a lease. Although Customer has the right to obtain substantially all of the economic benefits from use of the \nstorage warehouse (because it has exclusive use of the warehouse), it does not \nhave the right to direct its use. Customer does not have the right to direct how \nand for what purpose the storage warehouse is used; instead, it is \npredetermined in the contract. Customer also does not have the right to operate the warehouse and did not design it. \n \n Example 3.3.95 \nConstruction subcontractor arrangement (2) – \nperimeter fencing \nABC Construction (Customer), the primary contractor on the construction of an \noffice building, enters into a contract with XYZ Security (Supplier) to secure its \ncity-center construction site. This includes Supplier erecting a fence around the \nconstruction site. \nThe fence allows Customer to restrict access to the construction site for safety \nand security reasons . Due to building regulations, the fence must remain \nthroughout the construction period, which is expected to last three years. T he \ndimension and grade of the fence is specified in the contract based on the size \nof the construction site and regulatory requirements. Supplier is responsible for \nthe maintenance and zoning requirements for the fence. Customer controls \nwho may access the construction site (e.g. its own personnel and those of its \ncustomer, and numerous subcontractors). At the end of the construct ion period, \nSupplier will remove the fence and related materials. \nCustomer and Supplier each analyze whether the contract contains a lease of \nthe fence. The parties first conclude that the fence is an identified asset \nbecause it is a physically distinct i tem of property, plant or equipment, and once \ndelivered to Customer’s construction site, Supplier will not benefit economically \nfrom substituting equivalent fencing. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 140}), Document(page\_content='Leases 140 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Customer and Supplier next consider whether Customer controls the use of the \nfence. \n— They first determine that Customer has the right to obtain substantially all \nof the economic benefits from use of the fence . This is because there are \nno other parties that will benefit from its use during the construction of the building. The fence will solely protect Customer’s construction site and the \nability to fulfill that task is the fence’s sole economic benefit from use. \n— They then evaluate whether Customer or Supplier has the right to direct \nand change how and for what purpose the fence is used, or whether such \ndecisions are predetermined. \nRelevant \nhow and for \nwhat \npurpose \ndecisions Considerations Who controls the \nrelevant decision \nor is it \npredetermined? \nWhere Surrounding the city block on which the \nconstruction site resides, as specified in the contract. That area cannot be expanded or \nreduced during the construction period. Predetermined \nWhat The fence will be used in the same manner \nthroughout the construction period – i.e. to \nrestrict access to the construction site for \nsecurity and safety reasons. It cannot be used \nfor any other purpose. Predetermined \nWhen Throughout the construction period, as \ndefined in the contract. The fence will remain erected at all times during the project and \ncannot be removed until a safety clearance is \nreceived at the end of the project. Predetermined \nWhether / \nHow much The fence is required by building regulations \nthroughout the entire construction period. Predetermined \nBased on this analysis, all of the relevant decisions about how and for what \npurpose the fence will be used throughout the period of use are \npredetermined. Therefore, to determine if Cus tomer has the right to direct \nthe use of the fence, Customer and Supplier evaluate whether Customer \neither (1) designed the fence or (2) has the right to operate (or direct others \nto operate) the fence. \n— Design. Customer did not have input into the design of the fence – it is \nstandard, non- specialized fencing. \n— Operations. Once the fence is constructed, decisions about who is \npermitted to enter and exit the construction site during the construction \nperiod, as well as during what hours they may do so, are the relevant \noperational decisions. These decisions are controlled by Customer and \ncannot be overridden by Supplier . \nBecause Customer has the right to operate the fence in the manner it \ndetermines (and Supplier cannot override those operational decisions), \nCustomer has the right to direct the use of the fence. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 141}), Document(page\_content='Leases 141 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Because the fence is an identified asset and Customer controls the use of the \nfence, Customer is leasing the fence. \n \n Question 3.3.160 \nEvaluating the customer design criterion in \nrenewable energy power purchase agreements \nWhat does an entity consider when evaluating whether the \ncustomer designed a renewable energy power plant? \nBackground: As outlined in paragraph 3.3.270, when all of the relevant how \nand for what purpose decisions about use of the asset are predetermined – \nwhether by design of the asset or by the terms of the contract – the customer \nis deemed to direct the asset’s use if it either (1) operates the asset or (2) \ndesig ned the asset (or specific aspects of the asset) in a way that \npredetermine d those decisions (the ‘design criterion’). \nIn the case of renewable energy power purchase agreements (PPAs), all of the \nrelevant how and for what purpose decisions about the plant ’s use – i.e. what \nthe plant will produce (electricity); where it is located and will produce power; \nand when, whether and how much electricity it will produce – are often \npredetermined by the design of the plant. In addition, the plant owner typically operates and maintains the plant throughout the ‘period of use’ (see paragraph \n3.1.130). Consequently, the question of whether the customer directs the use \nof the plant in these scenarios depends on the design criterion. \nInterpretive response: Often in renewable energy PPAs, both the customer \nand the plant owner have some involvement in the plant’s design. Therefore, \nthe judgment to be made in assessing the design criterion is which party \ncontrolled – or most significantly influenced, if both parties were inv olved in a \nparticular design decision – those design aspects that predetermined the \nrelevant how and for what purpose decisions outlined in the background, which \nin effect predetermine the economic benefits to be derived from the plant’s \nuse. \nThe party (plant owner or customer) that controlled (or most significantly \ninfluenced) those design decisions will be the one deemed to have the right to \ndirect the use of the plant when the design criterion is determinative. Design \ndecisions made by a third party (e. g. an engineering firm) should generally be \nattributed to the party (i.e. the plant owner or the customer) who engaged it. \nCommon design aspects of a renewable energy plant that affect the economic benefits that can be derived from its use include (not exhaustive): \n— the specific location of the plant (or farm); \n— the specific generating equipment (e.g. the specific turbines or solar panels) \nthat will be used; \n— the technical design of the plant (or farm); and \n— site layout. \nWhich design aspects most significantly influence the economic benefits that \ncan be derived from the plant’s use will differ for different types of plants. That \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 142}), Document(page\_content='Leases 142 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. is, those design aspects usually are not the same for a solar farm as for a wind \nfarm or a hydr oelectric or geothermal plant. \nJudgment is likely to be involved in evaluating (1) which design aspects are the \nmost significant for a particular plant (or type of plant) and (2) which party \ncontrolled (or most significantly influenced) those design aspec ts. Judgment \nabout which design aspects are the most significant to the economic benefits \nthat can be derived from the plant during the period of use may require the \ninvolvement of engineers, scientists or other experts outside of an accounting \nor finance function. \nWhen making judgments (1) and (2), it may be relevant to consider: \n— whether the customer initiated the plant’s construction – i.e. the plant \nsubject to the PPA was (or is being) constructed to fulfill the customer’s \nspecific requirements; and \n— if so, the extent to which certain design decisions are, in effect, \npredetermined by the customer’s requirements (e.g. as to location, \ngenerating capacity). \nIf the plant is being constructed to meet specific customer requirements, this \nlikely suggests there i s, or will be, more customer involvement in design than if \nthe plant is pre- existing or under construction by the supplier on spec. In \ncontrast, if the plant is pre- existing or under construction by the supplier on \nspec, it is likely most significant desig n decisions were made by the supplier \nbefore PPA negotiations with the customer began. \nIf the customer’s requirements substantively predetermine a key design \ndecision, that decision generally should be attributed to the customer. For \nexample, if the customer’s power generation requirements can only be met by \nspecific generating equipment (a certain type and model), that would typically \nsuggest that the customer’s decisions about those requirements were more \nsignificant to predetermining the economic benefi ts that can be derived from \nuse of the plant than the supplier’s actions of identifying and acquiring that \ngenerating equipment. This would be the case even if the customer did not \nknow that there was only one generating equipment option that would meet it s \nplant requirements. \n \n Comparison to legacy US GAAP \nNew control concept differs from Topic 840 \n3.3.340 The concept of control over the use of the identified asset in Topic 842 \nis based on both a power element (the right to control the use of the identified \nasset) and a benefits element (the right to obtain substantially all of the \neconomic benefits from use of that asset). While a lease could have exist ed \nunder Topic 840 solely on the basis of the customer having the right to obtain \nsubstantially all of the output or other utility from an identified asset, the \ncustomer needs to have decision- making rights ov er the use of the asset for \nthere to be a lease under Topic 842. The Board concluded that without the right \nto control the use of the identified asset, the customer has no more control ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 143}), Document(page\_content='Leases 143 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. over the asset than any customer purchasing goods or services from the \nsupplier. [840- 10-15-6] \n3.3.35 0 Under Topic 840, the right to control the use of an asset was \nconveyed if: [840- 10-15-6] \n1. the purchaser had the ability to operate the asset in a manner it determined \nwhile obtaining or controlling more than a m inor amount of the asset’s \noutput; \n2. the purchaser ha d the ability or right to control physical access to the asset \nwhile obtaining or controlling more than a minor amount of the asset’s \noutput; or \n3. there was only a remote possibility that one or more parties other than the \npurchaser would take more than a minor amount of the output and the \nprice that the purchaser would pay for the output was neither contractually \nfixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output. \n3.3.360 Under either criterion (2) or (3), control over the use of a specified asset \ndid not require that the customer have the right to direct the use of the asset. The \ncontrol concept in Topic 842 also differs from criterion (1) because the right to \noperate the asset is not considered relevant unless the substantive decisions \nabout how and for what purpose the asset will be used are predetermined in the \ncontract (or the operational decisions constitute relevant ‘how and for what \npurpose’ decisions – see Question 3.3.10 0). In addition, not only must the \ncustomer be able to direct the use of the asset, but the customer must also have the right to obtain substantially all (rather than only more than a minor amount) of \nthe economic benefits from use of the asset throughout the period of use. \n3.3.370 These changes to the concept of control mean that there will be some \ndifferences in terms of whether a contract is or contains a lease. S ome \ncontracts that were previous ly considered to be leases will no longer meet the \ndefinition of a lease and vice versa . For example: \n— A lease may have existed under Topic 840, but will not exist under Topic 842, in arrangements where the customer receives substantially all of \nthe output or utility of an identified asset , but does not control what, \nwhether and/or how much output or utility the asset produces. Those \nleases under Topic 840 may also not be leases under Topic 842 if the \noutput or utility of the asset is not the only economic b enefit available from \nuse of the asset (see Question 3.3.4 0). \n— In contrast, a lease may exist under Topic 842 that did not exist under \nTopic 840 where the customer has ‘ dispatch ’ rights – i.e. controls when, \nwhether and/or how much output or utility an identified asset produces – \nbut (1) does not operate or control physical access to the asset and (2) pay s \nthe supplier a variable amount per unit of output produced by the asset that \nis not equal to the market price for the output at the time of its delivery . \n3.3.380 However , in general, we believe most arrangements that met the \ndefinition of a lease under Topic 840 will also meet the definition of a lease in \nTopic 842 and vice versa. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 144}), Document(page\_content='Leases 144 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 3.3.100 \nOutsourcing arrangement that was a lease under \nTopic 840 but is not under Topic 842 \nCustomer enters into a 10- year agreement for Supplier to supply parts to \nCustomer’s manufacturing plant. Customer builds its facility adjacent to \nSupplier’s manufacturing plant. Customer will make an equity investment in the \nentity formed by Supplier to own the facility but does not participate in the \ndesign of the facility. \nThe following additional facts are relevant. \n— Customer and Supplier agree that the part s facility will produce constant -\nvelocity (CV) joints for Customer. \n— The initial capacity of the facility will be used to produce only CV joints and Customer will purchase all of the CV joints produced by the facility. \n— The price paid by Customer will be det ermined based on Supplier’s actual \noperating costs plus a profit margin. \n— Supplier has the right to expand the facility in the future if it wishes to \nproduce other parts (but does not expect to do so) and has the right to \nmake all operating decisions for the facility. \nTopic 840 \nUnder Topic 840 , the arrangement contained a lease because Customer was \nexpected to obtain substantially all of the facility’s output during the term of the \narrangement for a price that was not fixed per unit of output or equal to the \nmarket price per unit of output at the time it was delivered. \nTopic 842 \nUnder Topic 842, the arrangement does not contain a lease. Customer does not have the right to direct the use of the facility throughout the 10- year period of \nuse because it cannot di rect how and for what purpose the facility is used. \nEven though Supplier built the facility for the express purpose of supplying parts \nto Customer, Customer has no right to change how the facility is used or to \nchange what, how much or when it produces. Because how and for what \npurpose the facility will be used is predetermined by the terms of the contract, \nSupplier and Customer also consider whether the arrangement meets either of \nthe criteria for directing the use of the asset when the how and for what purpose decisions are predetermined (see paragraph 3.3.270). \n— Customer does not have the right to operate the facility or direct Supplier to operate it in a manner that Customer determines. \n— Customer also did not design the facility (or specific aspects of the facility) \nin a way that predetermines how and for what purpose the facility will be \nused throughout the period of use. \nConsequently, Customer is not leasing the facility. \nCustomer will need to separately evaluate whether to consolidate the entity \nthat owns the facility . If it is required to consolidate the entity, the inventory ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 145}), Document(page\_content='Leases 145 \n3. Definition of a lease \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. acquisition accounting will be eliminated in Customer’s consolidated financial \nstatements. \nThere are a number of alternative fact patterns related to this example that \nwould result in a conclusion that Customer has the right to direct the use of the \nfacility, and therefore that the arrangement contains a lease. The f ollowing are \nsome examples . \n— If Customer had the right to change the parts produced by the facility \nthroughout the period of use (e.g. to require that the facility produce axles \nrather than, or in addition to, CV joints), then Customer would have the right to direct the use of the facility. This is because it would be able to direct \nhow and for what purpose the facilit y is used by virtue of being able to \nchange what the facility produces. \n— If Customer had the right to determine when and how many CV joints the \nfacility produces throughout the period of use (i.e. Customer control led how \nmuch output the facility produced , even if it could not change the nature of \nthe output produced), then Customer would have the right to direct the use \nof the facility. This is because it would be able to direct how and for what \npurpose the facility is used by virtue of being able to effecti vely control \nwhether, when and how much economic benefit is derived from use of \nthe facility. \nIf Customer had designed the facility, or those specific aspects of the facility \nthat predetermined how and for what purpose it would be used throughout the \nperio d of use, Customer would be deemed to have the right to direct the use of \nthe facility. \n \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 146}), Document(page\_content='Leases 146 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 4. Separating components of \na contract \nDetailed contents \nItem significantly updated in this edition : # \nHow the standard works \n4.1 Step 1: Identify the separate lease components \n4.1.1 Separating lease components \n4.1.2 Additional considerations for land \nObservation \nComplexity of land separation analysis will vary \nQuestions \n4.1.10 Accounting insignificance for land lease elements \n4.1.20 Land and multi -tenant building \nExamples \n4.1.10 Leases of multiple underlying assets – separation criteria \nmet \n4.1.20 Leases of multiple underlying assets – separation cri teria not \nmet \n4.1.30 Leases of multiple underlying assets – land element \naccounted for separately \nComparison to legacy US GAAP \n4.2 Step 2: Identify any non -lease components \n4.2.1 Taxes and insurance \nObservation \nComponents in Topic 842 equivalent to promised goods or services in \nTopic 606 \nQuestions \n4.2.05 Shipping, delivery, installation or similar activities \n4.2.10 Common area maintenance \n4.2.20 Assessing the number of CAM components \n4.2.25 Capital replacements and repairs \n4.2.30 Residual value guarantees \n4.2.40 Property taxes and insurance – lessor or lessee costs ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 147}), Document(page\_content='Leases 147 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 4.2.42 Identi fying the primary beneficiary of lessee- obtained \ninsurance on the underlying asset \n4.2.45 Effect of lease classification on identifying lessor costs \n4.2.50 Accounting for gross and net leases \n4.2.60 Sales and other similar taxes \n4.2.70 Refundable and nonrefundable VAT \nExamples \n4.2.10 Differentiating lessor insurance costs from lessee insurance \ncosts \n4.2.20 Identifying components in gross and net leases \n4.2.30 Property taxes and insurance in a gross lease \n4.2.40 Property taxes and insurance in a net lease – lessee \nreimburses lessor \n4.2.50 Property taxes and insurance in a net lease – lessee pays \nthird party directly (lessor accounting) \nComparison to legacy US GAAP \nComparison to legacy US GAAP \n4.3 Step 3: Measure the consideration in the contract \n4.3.1 Lessee \n4.3.2 Lessor \nObservation \nDifferences between Topic 842 and Topic 606 for lessors \nQuestions \n4.3.10 Measuring consideration in a contract with variable \npayments \n4.3.20 Variable payments for CAM in a net lease \n4.3.30 ‘Free lease’ granted to a supplier \n4.3.40 Timing of measurement \nExamples \n4.3.10 Measuring the cons ideration in the contract – variable \npayments \n4.3.20 ‘Free lease’ granted to a supplier \nComparison to legacy US GAAP \n4.4 Step 4: Separate and allocate consideration between the lease and \nnon-lease components \n4.4.1 Allocate the consideration in the contract \n4.4.2 Allocate variable consideration in the contract – lessor ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 148}), Document(page\_content='Leases 148 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 4.4.3 Variable payments not included in the consideration in the \ncontract \nObservations \nPredominant element \nBurden of proof for observable stand- alone (se lling) prices \nVariable payments of lessor costs made directly to a third party recognized net by lessors\n \nQuestions \n4.4.05 Non- separation practical expedients – meaning of \n‘associated with’ \n4.4.10 Non- separation practical expedients for lessees and lessors \nnot limited to insignificant non- lease components \n4.4.11 Non- separation practical expedients elected by class of \nunderlying asset \n4.4.12 Lessor practical expedient – operating lease classification \ncriterion \n4.4.13 Lessor practical expedient – same pattern of transfer \nrequirement \n4.4.14 Lessor practical expedient – measure of progress toward \nsatisfaction of a combined Topic 606 component \n4.4.15 Lessor practical expedient – evaluating predominance \n4.4.16 Lessor practical expedient – lease and services are not co -\nterminus \n4.4.20 [Not used] \n4.4.30 Allocation on a relative stand- alone price basis \n4.4.40 Different perspectives on observable stand- alone (selling) \nprices \n4.4.50 Different estimation techniques \n4.4.55 Stand -alone selling price estimation methods – residual \napproach (lessors) \n4.4.56 Stand -alone selling price estimation methods – residual \napproach (lessees) \n4.4.60 Allocating consideration when there are multiple lease and multiple non- lease components \n4.4.65 Allocating consideration in related party leases # \n4.4.70 Stand -alone selling price for CAM provided by the lessor at a \nloss\n \n4.4.80 Lessor accounting for a supply agreement that includes a ‘free’ lease of equipment\n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 149}), Document(page\_content="Leases 149 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Examples \n4.4.05 Non- separation practical expedients – applying ‘associated \nwith’ \n4.4.10 Allocating the consi deration in the contract – observable \ninputs \n4.4.20 Allocating the consideration in the contract – observable and \nestimated stand- alone (selling) prices (1) \n4.4.2 5 Embedded supply agreement lease with minimum purchase \nquantities – lessee accounting \n4.4.30 Allocating the consideration in the contract – observable and \nestimated stand- alone (selling) pric es (2) \n4.4.40 Percentage rent in a real estate lease \n4.4.45 Supply agreement with no stated consideration for the lease \n4.4.50 Variable lease payments not included in the consideration in \nthe contract \nComparison to legacy US GAAP \nComparison to legacy US GAAP \n4.5 Subsequent changes to the consideration in the contract \n4.5.1 Lessee \n4.5.2 Lessor \nObservation \nAllocating subsequent changes to the consideration in the contract after a modification or remeasurement\n \nQuestion \n4.5.10 Variable payments that do not depend on an index or rate and the consideration in the contract\n \n4.6 Combining two or more contracts \nObservation \nCombining two or more contracts \nQuestions \n4.6.10 'At or near the same time’ \n4.6.20 Different divisions or business units \nExample \n4.6.10 Combination of contracts \n ", metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 150}), Document(page\_content='Leases 150 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. How the standard works \nIf a contract is, or contains, a lease, the entity follows these steps in accounting \nfor the components of the contr act: \n— Step 1: Identify the separate lease components. In many cases there will \nbe a single lease component, but in some cases, there will be multiple \nlease components. \n— Step 2: Identify any non- lease components – e.g. a maintenance or \noperating service. \n— Step 3: Measure the ‘consideration in the contract’. This calculation is \ndifferent for the lessee versus the lessor. \n— Step 4: Separate and allocate the consideration in the contract between the \nlease and non- lease components. This process and the requirements differ \nto some extent for the less ee and the lessor, but in both cases require the \nentity to maximize the use of observable data. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 151}), Document(page\_content='Leases 151 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 4.1 Step 1: Identify the s eparate l ease c omponents \n4.1.10 Lessees often contract with lessors for the right to use multiple \nunderlying assets – i.e. the contract contains multiple leases. However, the unit \nof account in applying Topic 842 is not each lease in the contract – it is each \n‘separate lease component’. A contract with multiple leases may contain many \nor only one separat e lease component. The following diagram illustrates this \nprinciple. [842- 10-15-28, 15- 30] \nContract 1 Contract 2\nLease of \nasset ALease of \nasset BLease of \nasset CLease of \nasset DLease of \nasset E\nSeparate \nlease \ncomponent Separate \nlease \ncomponent Separate \nlease \ncomponent Separate lease component \n4.1.20 On the basis that the requirements of Topic 842 for lessees and lessors \napply to each separate lease component, an entity: \n— assesses lease classification for the separate lease component – i.e. not \nfor each of the individual leases that comprise that component (s ee \nsection 6.2 for lessees and section 7.2 for lessors ); and \n— applies the recognition and measurement requirements of Topic 842 to each separate lease component (see section 6.3 for lessees , and \nsections 7.3 and 7.4 for lessors ). \n4.1.30 The guidance about what constitutes a separate lease component is the \nsame for lessees and lessors. \n \n4.1.1 Separating lease components \n Excerpt from ASC 842 -10 \n15 Scope and Scope Exceptions \nGeneral \n> Separating Components of a Contract \n15-28 After determining that a contract contains a lease in accordance with \nparagraphs 842- 10-15-2 through 15- 27, an entity shall identify the separate lease \ncomponents within the contract. An entity shall consider the right to use an \nunderlying asset to be a separate lease component (that is, separate from any \nother lease components of the contract) if both of the following criteria are met: ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 152}), Document(page\_content='Leases 152 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. a. The lessee can benefit from the right of use either on its own or together \nwith other resources that are readily available to the lessee. Readily \navailable resources are goods or services that are sold or leased separately \n(by the lessor or other suppliers) or resources that the lessee already has \nobtained (from the lessor or from other transactions or events). \nb. The right of use is neither highly dependent on nor highly interrelated with \nthe other right(s) to use underlying assets in the contract. A lessee’s right \nto use an underlying asset is highly dependent on or highly interrelated \nwith another right to use an underlying a sset if each right of use \nsignificantly affects the other. \n15-29 The guidance in paragraph 842- 10-15-28 notwithstanding, to classify and \naccount for a lease of land and other assets, an entity shall account for the \nright to use land as a separate lease component unless the accounting effect \nof doing so would be insigni ficant (for example, separating the land element \nwould have no effect on lease classification of any lease component or the \namount recognized for the land lease com ponent would be insignificant). \n55 Implementation Guidance and Illustrations \nGeneral \n> Illustrations \n>> Illustrations of Allocating Considerat ion to Components of a \nContract \n>>> Example 11 —Allocation of Consideration to Lease and Nonlease \nComponents of a Contract \n>>>> Case A —Allocation of Consideration in the Contract \n55-132 Lessor leases a bulldozer, a truck, and a crane to Lessee to be used in \nLessee’s construction operations for three years. Lessor also agrees to \nmaintain each piece of equipment throughout the lease term. The total \nconsideration in the contract is $600,000, payable in $200,000 annual \ninstallments. \n55-133 Lessee and Lessor both conclude that the leases of the bulldozer, the \ntruck, and the crane are each separate lease components because both of t he \ncriteria in paragraph 842- 10-15-28 are met. That is: \na. The criterion in paragraph 842- 10-15-28(a) is met because Lessee can \nbenefit from each of the three pieces of equipment on its own or together \nwith other readily available resources (for example, Less ee could readily \nlease or purchase an alternative truck or crane to use with the bulldozer). \nb. The criterion in paragraph 842- 10-15-28(b) is met because, despite the fact \nthat Lessee is leasing all three machines for one purpose (that is, to \nengage in const ruction operations), the machines are not highly dependent \non or highly interrelated with each other. The machines are not, in effect, \ninputs to a combined single item for which Lessee is contracting. Lessor \ncan fulfill each of its obligations to lease one of the underlying assets \nindependently of its fulfillment of the other lease obligations, and Lessee’s \nability to derive benefit from the lease of each piece of equipment is not ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 153}), Document(page\_content='Leases 153 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. significantly affected by its decision to lease or not lease the other \nequipm ent from Lessor. \n[The remainder of Example 11 Case A is not included in this section because it \nis not relevant to section 4.1 – it is included in full in section 4.4] \n>>> Example 13 —Lease of a Turbine Plant \n55-146 Lessor leases a gas- fired turbine plant to Lessee for eight years so that \nLessee can produce electricity for its customers. The plant consists of the \nturbine housed within a building together with the la nd on which the building \nsits. The building was designed specifically to house the turbine, has a similar \neconomic life as the turbine of approximately 15 years, and has no alternative \nuse. The lease does not transfer ownership of any of the underlying ass ets to \nLessee or grant Lessee an option to purchase any of the underlying assets. \nLessor does not obtain a residual value guarantee from Lessee or any other \nunrelated third party. The present value of the lease payments is not \nsubstantially all of the aggr egate fair value of the three underlying assets. \n55-147 While the lease of the plant includes the lease of multiple underlying \nassets, the leases of those underlying assets do not meet the second criterion \nnecessary to be separate lease components, which i s that the right to use the \nunderlying asset is neither dependent on nor highly interrelated with the other \nrights of use in the contract. Therefore, the contract contains only one lease \ncomponent. The rights to use the turbine, the building, and the land are highly \ninterrelated because each is an input to the customized combined item for \nwhich Lessee has contracted (that is, the right to use a gas -fired turbine plant \nthat can produce electricity for distribution to Lessee’s customers). \n55-148 However, beca use the contract contains the lease of land, Lessee and \nLessor also must consider the guidance in paragraph 842- 10-15-29. Lessee and \nLessor each conclude that the effect of accounting for the right to use the land \nas a separate lease component would be ins ignificant because Lessee’s right \nto use the turbine, the building, and the land is coterminous and separating the \nright to use the land from the right to use the turbine and the building would \nnot affect the lease classification of the turbine/building lease component. \nLessee and Lessor each conclude that a single lease component comprising \nthe turbine, the building, and the land would be classified as an operating \nlease, as would two separate lease components comprising the land and the \nturbine/building, respectively. \n55-149 The predominant asset in the single lease component is the turbine. \nLessee entered into the lease primarily to obtain the power -generation \ncapabilities of the turbine. The building and land enable Lessee to obtain the \nbenefits from use of the turbine. The land and building would have little, if any, \nuse or value to Lessee in this contract wi thout the turbine. Therefore, the \nremaining economic life of the turbine is considered in evaluating the \nclassification of the single lease component. \n \n4.1.40 A right to use an underlying asset (i.e. a lease), or a bundle of such rights , \nis a separate l ease component if both of the criteria in paragraph 842- 10-15-28 \nare met . [842- 10-15-28] \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 154}), Document(page\_content='Leases 154 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — on its own ; or\n— together with other \nresources readily \navailable to lessee&\n— highly dependent \non; nor\n— highly interrelated \nwith ...\n… the other ROU (s) in \nthe contract(1) Lessee can benefit \nfrom ROU either :(2) ROU is neither :\n \n4.1.50 In interpreting the first criterion in paragraph 842- 10-15-28, ‘readily \navailable’ resources are goods or services that are sold or leased separately by \nthe lessor or other suppliers (e.g. office furniture), or that the lessee has already \nobtained from the lessor or from other transactions or events. And t he fact that \nthe lessor or other entities regularly lease a n asset separa tely would indicate \nthat a customer can benefit from the lease of that asset on its own or with \nother readily available resources. [842- 10-15-28(a) , 606-10-25-20] \n4.1.60 In interpreting the second criterion in paragraph 842- 10-15-28, a lease is \nhighly dependent on or highly interrelated with another lease if each lease \nsignificantly affects the other. Topic 606 provides an example of when two or \nmore goods or services are ‘significantly affected by each other’ . It states this \nwould be the case when the entity would not be able to fulfill its promises to \nthe customer by transferring each of the goods or services independently – i.e. \nfulfillment of each promise depends on the other . Example 4. 1.20 illustrates \nhow to apply this concept. [842- 10-15-28(b) , 606- 10-25-21(c) , ASU 2016- 10.BC32] \n4.1.70 The identification of separate lease components in a lease contract is \nsimilar to the identification of separate performance obligations in a revenue \ncontract . This means that an entity applying the separate lease components \nguidance is, fundamentally, deciding whether the lessee has contracted for multiple leases (e.g. to use multiple pieces of similar office equipment) that the \nlessor can fulfill independently , or is instead leasing a combined item (e.g. a \nproduction facility or a data center comprising multiple underlying assets). This \nevaluation focuses primarily on the level of i ntegration, interrelation and/or \ninterdependence between the rights of use that are conveyed under the \ncontract – i.e. whether those multiple rights to use underlying assets \nsignificantly affect each other . \n[ASU 2016- 02.BC146] \n \n Example 4.1.10 \nLeases of multiple underlying assets – separation \ncriteria met \nLessor LR leases a bulldozer, a truck and an excavator to Lessee LE to be used in LE’s land development operations. \nThe equipment that LR leases is leased and sold separately by other supplier s \nand LR regularly leases each of these types of equipment separately. For ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 155}), Document(page\_content='Leases 155 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. example, LR regularly leases a bulldozer to a customer without also leasing a \ntruck or an excavator to the customer . \nDespite the fact that LE is leasing all three machines for one purpose (i.e. to \nengage in land development), LR and LE each conclude that the lease of each \nunderlying machine is a separate lease component for accounting purposes (i.e. \nthere are three separate lease components). \nThis conclusion is based on the foll owing: \n— LE can benefit from each lease on its own, or together with other readily available resources; for example, LE could readily lease or purchase an \nalternative truck or excavator to use with the bulldozer; and \n— the leases are not highly dependent on, or highly interrelated with, each \nother. The ability of LR to fulfill each lease obligation (i.e. to make each \nunderlying asset available for LE’s use) is not affected by the other leases in \nthe contract; LR could fulfill its lease obligation for any one of the three \npieces of equipment even if the customer did not enter into a lease for either of the other two pieces of equipment. In addition, LE’s ability to \nderive benefit from each lease is not significantly affected by its decision to lease or not lease the other equipment from LR. \n \n4.1.2 Additional considerations for l and \n4.1.80 For leases that include a land element (e.g. a lease of land and a building, \nor land and integral equipment), the right to use the land is considered a \nseparate lease component unless the accounting effect of separately \naccounting for the land element would be ‘insignificant’. [842- 10-15-29] \n4.1.90 Topic 842 provides the following examples of circumstances in which the \naccounting effect of accounting for the land element separa tely would be \ninsignificant: [842- 10-15-29] \n— separating the land element would have no effect on lease classification; \nfor example, it would not affect whether the land or the related building (or \nintegral equipment) is classified as a finance or an operating lease; or \n— the amount that would be recognized for the land lease component is insignificant. \n4.1.100 Those examples are not exhaustive, and Topic 842 does not define \ninsignificant. Consequently, determining whether the effect of accounting for a \nland lease element as a separate lease component would be insignificant may \nrequire significant judgment in some cases. [ASU 2016- 02.BC147] \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 156}), Document(page\_content='Leases 156 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 4.1.10 \nAccounting insignificance for land lease elements \nHow should entities evaluate the concept of insignificance \nwhen deciding whether to separate a land lease element ? \nInterpretive response: We believe the Board intended that if the lease \nclassification of a combined (e.g. land plus building or land plus integral \nequipment) lease component would not differ from that of the two lease \ncomponents evaluated separately, an entity should not be required to account \nfor the lease components separately. The Board considered separati on of \nbuilding (or integral equipment) and land lease components in situations where \nthere would be no effect on classification as inconsequential from an accounting perspective. \nIf there is a classification difference that would result from separation, it would \naffect the following for lessees: timing of lease cost recognition; amounts \nrecognized on the balance sheet after lease commencement; presentation in \nthe income statement, balance sheet and statement of cash flows; and \ndisclosures. The effects for l essors would be similar. \nThe second example provided in paragraph 842-10-15-29 appears to suggest it \nwas the Board’s intent to ignore such effects if they would be ‘insignificant’. \nFor example, if either component was quantitatively insignificant, the eff ect on \nthe contract of accounting for that component using the ‘wrong’ classification \nmay also be insignificant. \nConsistent with many other aspects of the guidance in Topic 842, we believe \nthe concept of insignificance was considered by the Board similarly to how that \nterm was considered in Topic 606. Consequently, we believe insignificance with respect to the amount that would be recognized is principally a quantitative \nevaluation that occurs in the context of a single contract. That is, if the \naccounting effect of non- separation is insignificant to the contract, an entity \ndoes not further consider whether unrecognized separate land lease components would be significant at a portfolio or financial statement level. \n[606- 10-25-16A, ASU 2016- 10.BC12, ASU 2014- 09.BC234] \n \n Example 4.1.20 \nLeases of multiple underlying assets – separation \ncriteria not met \nLessor LR leases a production facility to Lessee LE for LE to produce its \nwidgets for five years. \nThe production facility includes the building, the land the building is on , and \nseveral pieces of manufacturing equipment that are installed within the building. The building was designed to house manufacturing equipment, and it would be \ndifficult and cost ly to remove the equipment from the facility. The remaining \neconomic lives of the building and the equipment are substantially longer than \nthe lease term. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 157}), Document(page\_content='Leases 157 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Identify the separate lease component(s) \nLE could lease or purchase each of the underlying assets independently; for \nexample, it could acquire a piece of equipment to put into the production line or \nrelocate the equipment to a substantially equivalent vacant building. Therefore, \nLE can benefit from each lease on its own or together with other readily \navailable resources. \nHowever, the leases in this contract are highly interdependent and highly \ninterrelated. The nature of this arrangement is the lease of an in- place \nproduction facility with which LE can produce its widgets. The land, the building and the installed equipment are, in effect, inputs to the combined item that LE \ncontracted to lease. \nThe multiple leases significantly affect each other because, absent significant \ntime and expenditure, LR would not be able to fulfill its obligation to lease the \nland, the building or any of the pieces of installed equipment without also \nconveying a right to use those other assets. For example, to grant a lease of the land only, LR would have to uninstall and relocate the manufacturing equipment \nand demolish the build ing. \nConsequently, there is only a single lease component. \nAdditional consideration of the land element \nThe above conclusion notwithstanding, because the contract contains a lease of \nland, LR and LE also need to consider the guidance specific to leases tha t \ninclude a land element. \nApplying th e guidance in paragraphs 4.1.80 – 4.1.100, LR and LE each conclude \nthat the accounting effect of separately accounting for the land lease would be insignificant, and therefore they do not account for the land lease as a separate \nlease component. This is because, given the five- year lease term (which is the \nsame for all of the elements) and the lease payments , each lease (land, \nbuilding, equipment), if evaluated independently, would be an operating lease. Therefore, the accounting effect of separating the land element from the \notherwise single lease component would be insignificant . \n \n Example 4.1.30 \nLeases of multiple underlying assets – land element \naccounted for separately \nLessor LR leases an entire, non- specialized building to Lessee LE for 25 years \nwith no renewal or termination options; in addition to the explicit lease of the \nbuilding, there is an implied lease of the underlying land for the same period \n(see paragraph 4.1.130) . There are no non -lease components of the contract. \nIn addition, the following facts are relevant (LE and LR). \nAnnual payments (in advance): $850,000 \nResidual value guarantees: None \nPurchase options or title transfer provisions: None \nRemaining economic life of the building at lease commencement: 30 years ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 158}), Document(page\_content='Leases 158 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. \nLand Building Land and \nbuilding \nFair value: $1,200,000 $10,800,000 $12,000,000 \nEstimated future residual value: $1,200,000 $ 2,800,000 $ 4,000,000 \nLE’s incremental borrowing rate (implicit \nrate cannot be readily determined) :1 7.5% 8% 8% \nLR’s implicit rate for the lease: 7.61% 6.21% 6.38% \nNote: \n1. The incremental borrowing rate is the rate of interest that LE would have to pay to borrow \non a collateralized basis over a similar term an amount equal to the lease payments in a \nsimilar economic environment. As the amount of lease payments related to the land and \nbuilding are different, LE’s incremental borrowing rate may also be different. \nTotal consideration for the term of the contract is $21,250,000 ($850,000 × \n25 years). LR and LE each conclude that, based on the stand- alone (selling) \nprices of each lease, 90% of the consideration ($19,125,000) should be \nallocated to the building lease and 10% ($2,125,000) to the land lease. \nLE’s incremental borrowing rate \nLE does not know LR’s estimated residual value of the land, building or land and \nbuilding or LR ’s deferred initial direct costs . Without this information, LE cannot \ndetermine the rate implicit in the lease (see Question 5.6.20) . Therefore, LE \nwill use its incremental borrowing rate as the discount rate for the lease. In \ndetermining the incremental borrowing rate, LE considers the rate of interest it would pay on a secured borrowing in an amount equal to the lease payments \nfor the land ($2,125,000), the building ($19,125,000), and the land and building \n($21,250,000) under similar terms (e.g. over 25 y ears). \nLR’s implicit rate \nThe rate implicit in the lease is the rate of interest that, at a given date, causes \nthe aggregate present value of (a) the lease payments, and (b) the amount that \na lessor expects to derive from the underlying asset following t he end of the \nlease term to equal the sum of (1) the fair value of the underlying asset minus any related investment tax credit retained and expected to be realized by the \nlessor, and (2) any deferred initial direct costs of the lessor. \nFor this example, assume there are no residual value guarantees, deferred initial \ndirect costs or investment tax credit. LR calculates the rate implicit in the lease \nas follows . \nComponent Lease \npayments Estimated \nresidual value Fair value Rate implicit \nin the lease \nLand $ 2,125,000 $1,200,000 $ 1,200,000 7.61% \nBuilding 19,125,000 2,800,000 10,800,000 6.21% \nLand and b uilding 21,250,000 4,000,000 12,000,000 6.38% ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 159}), Document(page\_content='Leases 159 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The lease term (25 years) is for a major part of the building’s remaining \neconomic life (30 years). Therefore, LE and LR would classify the building lease \nas a finance lease and sales- type lease, respectively. \nClassification \nLE and LR each evaluate the pr esent value of the lease payments for purposes of \ndetermining the classification of the land lease. None of the other finance/sales -\ntype lease classification criteria are met for the land lease (see s ection s 6.2 and \n7.2 for lessee and lessor lease classifi cation criteria, respectively). \n— LE. Present value of the lease payments allocable to the land lease (fixed at \n$85,000 per year, paid in advance, for 25 years) discounted at LE’s incremental borrowing rate of 7.5% is $1,018,552, which is 85% of the \nland’s fair value. LE concludes that the land lease does not meet the \npresent value test (see Question 6.2.20) and will be classified as an \noperating lease. \n— LR. Present value of the lease payments allocable to the land lease (fixed at \n$85,000 per year, paid in advance, for 25 years) discounted at the rate \nimplicit in the lease of 7.61% is $1,009,832, which is 84% of the land’s fair \nvalue. LE concludes that the la nd does not meet the present value test (see \nQuestion 6.2.20) and will be classified as an operating lease. \nTherefore, LR and LE each conclude that the accounting effect of not separately \naccounting for the land lease would be more than insignificant beca use, if \nseparate lease components: \n— the building lease and the land lease would be classified differently – as a \nfinance/sales -type lease and an operating lease, respectively; and \n— the amount that would be recognized for the land lease component \nseparately is not insignificant such that the different classifications would \nhave an only insignificant accounting effect. \n \n Observation \nComplexity of land separation analysis will vary \n4.1.110 If a lease of real estate includes a land lease component, Topic 842 \nrequires that component to be accounted for separately unless the accounting \neffect of doing so would be insignificant. Consequently, in a lease of real estate \nit is necessary to determine: \n— whether the lessee obtains a right to use the land; and \n— if so, whether the accounting for that right of use is more- than-\ninsignificantly different on a stand- alone basis from what it would be if \ncombined with the other lease component(s) in the arrangem ent. \n4.1.120 Determining whether a lease of real estate includes a right to use the \nunderlying land includes determining: \n— whether the land represents an identified asset; and \n— if so, whether the lessee has the right to control its use. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 160}), Document(page\_content='Leases 160 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 4.1.130 Topic 842 does not distinguish between types of real estate leases (e.g. \ngross leases versus net leases , or building leases versus leases of integral \nequipment) or the duration of the lease term in establishing whether a land \nlease component should be accounted for separately. However, the evaluation \nwill frequently differ for leases of single- tenant properties versus leases of \nspace in multi -tenant properties. While leases of single -tenant properties will \ngenerally include a lease of the underlying land, frequently leases of space in \nmulti- tenant properties will not include a lease of the underlying land. Specific \nconsiderations relevant to lea ses of space (e.g. office or retail space) in multi -\ntenant properties are discussed in Question 4.1.20. \n4.1.140 If it is determined that there is a land lease component , it may be \nconsiderably less complex to determine whether that land lease component \nshould be accounted for separately from the building (or integral equipment) \nlease component than what is illustrated in Example 4.1.30. This will frequently \nbe the case in shorter -term lease scenarios. \n4.1.150 In shorter -term real estate lease scenarios (e.g. 3, 5 or even 10 years), it \nwill typically be the case that both the given space and the implied land \ncomponent will be determined to be operating leases with relatively little effort. \nFor example, entities may be able to reach this conclusion without having to \nundertake much of the effort illustrated in Example 4.1.30 because it will be \nclear that any rational allocation of the lease payments, even on an \nundiscounted basis, will not equal or exceed substantially all of the fair value of \neither the bui lding or the land. And as described in Question 4.1.10, if there is \nno effect on lease classification, the building component and the land component should not be separately accounted for. \n \n Question 4.1.20 \nLand and multi -tenant building \nDoes a lease of space in a multi -tenant building include a \nlease of the underlying land that must be evaluated for \nseparation? \nInterpretive response: It depends. In many multi -tenant lease arrangements – \ne.g. a lease of retail space in a shopping mall or office s pace in a multi -tenant \nbuilding – we do not believe there is a lease of the underlying land. Therefore, \nneither the lessee nor the lessor needs to evaluate the land separation criteria \nin paragraph 4.1.90. \nIn general, we believe that in a typical multi -tenant lease scenario, the lessee \ndoes not have a right to control the use of any physically distinct portion of the \nland underlying the multi -tenant building. Rather, all of the tenants enjoy a \nshared benefit from all of the underlying land – i.e. the underl ying land supports \nthe entire building; there is no physically distinct portion of the land specifically \nsupporting the lessee’s leased space in the building. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 161}), Document(page\_content='Leases 161 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Further , if it is concluded that the entire underlying land is an identified asset, \nno single les see in the multi -tenant building is likely to have control over its use. \nNo single lessee would be deemed to have either: [ASU 2016- 02.BC133] \n— the right to obtain substantially all of the economic benefits from use of the \nland; or \n— the right to direct the use of the land – i.e. change how and for what \npurpose the land is used, or affect how the land is operated if the relevant \nhow and for what purpose decisions for the land are viewed as \npredetermined. \nIn contrast, a land lease comp onent may exist if the lessee is leasing substantially \nall of the building, or substantially all of the capacity of a piece of integral \nequipment (e.g. a cellular tower). In that case, the entirety of the underlying land \nwould likely be considered a single, identified asset and the lessee may have the \nright to control its use just as it would if it were leasing the entire building (or \npiece of integral equipment). If so, the lessee is required to account for the land lease component separately unless the cr iteria in paragraph 4.1.90 are met. \n \n Comparison to legacy US GAAP \nSeparating land lease components \n4.1.160 Topic 840 require d separate accounting for the land and building \nelements of a lease when the fair value of the land was 25 percent or more of \nthe total fair value of the property at lease inception. [840- 10-25-38(b)(2)] \n4.1.170 The method under Topic 842 by which lease pa yments are allocated \nbetween the land and building represents a change from Topic 840, which \nrequire d lease payments equal to the product of the fair value of the land \nmultiplied by the lessee’s incremental borrowing rate to be allocated to the land \nelement and the residual portion of the lease payments to be allocated to the building element. \n[840- 10-25-38(b)(2)] \n4.1.180 This difference could change the pattern of expense or income for \nleases of land and buildings in some cases. However, this potential outcome is \nmitigated by the relatively high proportion of situations in which the lease \nclassification tests (see sections 6.2 (lessees) and 7.2 (lessors)) likely will result \nin operating lease classification for both the land and the building lease elements if they were accounted for separately. \nSeparating other lease components \n4.1.190 Topic 840 require d the equipment element(s) of a lease of both real \nestate and equipment to be accounted for separately from the real estate \nelement(s). However, lessees and lessors generally account ed for leases of \nmultiple underlying assets of the same nature (i.e. buildings or equipment) : \n— in the aggregate if the separate leased assets were functionally \ninterdependent – e.g. a mainframe computer system, associated terminal s, \nservers, and other peripheral and output devices may be considered \nfunctionally interdependent ; and ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 162}), Document(page\_content='Leases 162 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — separately if the separate leased assets were functionally independent – \ne.g. a manufacturing facility and an office building typically would be \nconsidered functionally independent. \n \n4.2 Step 2: Identify any non-lease c omponents \n Excerpt from ASC 842 -10 \n15 Scope and Scope Exceptions \nGeneral \n> Separating Components of a Contract \n15-30 The consideration in the contract shall be allocated to each \nseparate lease component and nonlease component of the contract (see \nparagraphs 842- 10-15-33 through 15- 37 for lessee allocation guidance and \nparagraphs 842- 10-15-38 through 15- 42C for lessor allocation guidance). \nComponents of a contract include only those items or activities that transfer \na good or service to the lessee. Consequently, the following are not \ncomponents of a contract and do not receive an allocation of the considerat ion \nin the contract: \na. Administrative tasks to set up a contract or initiate the lease that do not \ntransfer a good or service to the lessee \nb. Reimbursement or payment of the lessor’s costs. For example, a lessor \nmay incur various costs in its role as a lessor or as owner of the underlying \nasset. A requirement for the lessee to pay those costs, whether directly \nto a third party or as a reimbursement to the lessor, does not transfer a \ngood or service to the lessee separate from the right to use the \nunderlying asset. \n15-31 An entity shall account for each separate lease component separately \nfrom the nonlease components of the contract (that is, unless a lessee makes \nthe accounting policy election described in paragraph 842- 10-15-37 or unless a \nlessor makes the accounting policy election in accordance with paragraph 842-\n10-15-42A). Nonlease components are not within the scope of this Topic and \nshall be accounted for in accordance with other Topics. \n15-32 See Examples 11 through 14 (paragraphs 842- 10-55-131 through 55- 158) \nfor illustrations of the requirements for allocating consideration to components \nof a cont ract. \n15-39A A lessor may make an accounting policy election to exclude from the \nconsideration in the contract and from variable payments not included in the \nconsideration in the contract all taxes assessed by a governmental authority \nthat are both imposed on and concurrent with a specific lease revenue-\nproducing transaction and collected by the lessor from a lessee (for example, \nsales, use, value added, and some excise taxes). Taxes assessed on a lessor’s \ntotal gross receipts or on the lessor as owner of t he underlying asset shall be \nexcluded from the scope of this election. A lessor that makes this election shall ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 163}), Document(page\_content='Leases 163 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. exclude from the consideration in the contract and from variable payments not \nincluded in the consideration in the contract all taxes within the scope of the \nelection and shall comply with the disclosure requirements in paragraph 842-\n30-50-14. \n15-40A The guidance in paragraph 842- 10-15-40 notwithstanding, a lessor shall \nexclude from variable payments lessor costs paid by a lessee directly to a third \nparty. However, costs excluded from the consideration in the contract that are \npaid by a lessor directly to a third party and are reimbursed by a lessee are \nconsidered lessor costs that shall be accounted for by the lessor as variable \npayments (this requirement does not preclude a lessor from making the \naccounting policy election in paragraph 842 -10-15-39A). \n55 Implementation Guidance and Illustrations \nGeneral \n> Illustrations \n>> Illustrations of Allocating Consideration to Components of a \nCont ract \n>>> Example 11 —Allocation of Consideration to Lease and Nonlease \nComponents of a Contract \n>>>> Case A —Allocation o f Consideration in the Contract \n55-132 Lessor leases a bulldozer, a truck, and a crane to Lessee to be used in \nLessee’s construction operations for three years. Lessor also agrees to \nmaintain each piece of equipment throughout the lease term. The total \nconsideration in the contract is $600,000, payable in $200,000 annual \ninstallments. \n55-133 Lessee and Lessor both conclude that the leases of the bulldozer, the \ntruck, and the crane are each separate lease components because both of the \ncriteria in paragraph 842- 10-15-28 are met. That is: \na. The criterion in paragraph 842- 10-15-28(a) is met because Lessee can \nbenefit from each of the three pieces of equipment on its own or together \nwith other readily available resources (for example, Lessee could readily \nlease or purchase an alternative truck or crane to use with the bulldozer). \nb. The criterion in paragraph 842- 10-15-28(b) is met because, despite the fact \nthat Lessee is leasing all three machines for one purpose (that is, to \nengage in construction operations), the machines are not highly dependent \non or highly interrelated with each other. The machines are not, in effect, \ninputs to a combined single item for which Lessee is contracting. Lessor \ncan fulfill each of its obligations to lease one of the underlying assets \nindependently of its fulfillment of the other lease obligations, and Lessee’s \nability to derive benefit from t he lease of each piece of equipment is not \nsignificantly affected by its decision to lease or not lease the other \nequipment from Lessor. \n55-134 In accordance with paragraph 842- 10-15-31, Lessee and Lessor will \naccount for the nonlease maintenance services components separate from the \nthree separate lease components (unless Lessee elects the practical \nexpedient —see Case B [paragraphs 842 -10-55-138 through 55 -140]). In ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 164}), Document(page\_content='Leases 164 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. accordance with the identifying performance obligations guidance in \nparagraphs 606- 10-25-19 through 25- 22, Lessor further concludes that its \nmaintenance services for each piece of leased equipment are distinct and \ntherefore separate performance obligations, resulting in the conclusion that \nthere are three separate lease components and three separate nonlease \ncomponents (that is, three maintenance service performance obligations). \n[The remainder of Example 11 Case A is not included in this section because it \nis not relevant – it is included in full in section 4.4] \n>>> Example 12—Activities or Costs That Are Not Components of a \nContract \n>>>> Case A —Payments for Taxes and Insurance Are Variable \n55-141 Lessor and Lessee enter into a five- year lease of a building. The \ncontract designates that Lessee is required to pay for the costs relating to the \nasset, including the real estate taxes and the insurance on the building. The \nreal estate taxes would be owed by Lessor regardless of whether it leased the \nbuilding and who the lessee is. Lessor is the named insured on the building \ninsurance policy (that is, the insurance protects Lessor’s investment in the \nbuilding, and Lessor will receive the proceeds from any claim). The annual \nlease payments are fixed at $10,000 per year, while the annual real estate \ntaxes and insurance premium wi ll vary and be billed by Lessor to Lessee each \nyear. \n55-142 The real estate taxes and the building insurance are not components of \nthe contract. The contract includes a single lease component — the right to use \nthe building. Lessee’s payments of those amounts solely represent a \nreimbursement of Lessor’s costs and do not represent payments for goods or \nservices in addition to the right to use the building. However, because the real \nestate taxes and insurance premiums during the lease term are variable, t hose \npayments are variable lease payments that do not depend on an index or a rate \nand are excluded from the measurement of the lease liability and recognized \nby Lessee in profit or loss in accordance with paragraph 842- 20-25-5 or 842- 20-\n25-6. Lessor also recognizes those payments as variable lease payments in \naccordance with paragraph 842- 10-15-40A because the real estate taxes and \ninsurance premiums are paid by Lessor to the taxing jurisdiction and insurance \ncompany and reimbursed by Lessee to Lessor. How ever, if Lessee paid the \ncosts directly to the third parties, those lessor costs would not be recognized \nby Lessor as variable payments because of the requirement in paragraph 842-\n10-15-40A. \n>>>> Case B —Payment for Taxes and Insurance Are Fixed \n55-143 Assume the same facts and circumstances as in Case A \n(paragraphs 842-10-55-141 through 55- 142), except that the fixed annual lease \npayment is $13,000. There are no additional payments for real estate taxes or \nbuilding insurance; however, the fixed payment is itemized in the contract (that \nis, $10,000 for rent, $2,000 for real estate taxes, and $1,000 for building \ninsurance). Consistent with Case A, the taxes and insurance are not \ncomponents of the contract. The contract includes a single lease component, \nthe right to use the building. The $65,000 in payments Lessee will make over ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 165}), Document(page\_content='Leases 165 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the 5 -year lease term are all lease payments for the single component of the \ncontract and, therefore, are included in the measurement of the lease liability. \n>>>> Case C —Common Area Maintenance \n55-144 Assume the same facts and circumstances as in Case B \n(paragraph 842-10-55-143), except that the lease is of space within the \nbuilding, rather than for the entire building, and the fixed annual lease \npayment of $13,000 also covers Lessor’s performance of common area \nmaintenance activities (for example, cleaning of common areas, parking lot \nmaintenance, and providing utilities to the building). Consistent with Case B, \nthe taxes and insurance are not components of the contract. However, the \ncommon area maintenance is a component because Lessor’s activities \ntransfer services to Lessee. That is, Lessee receives a service from Lessor in \nthe form of the common area maintenance activities it would otherwise have \nto undertake itself or pay a nother party to provide (for example, cleaning the \nlobby for its customers, removing snow from the parking lot for its employees \nand customers, and providing utilities). The common area maintenance is a \nsingle component in this contract rather than multipl e components, because \nLessor performs the activities as needed (for example, plows snow or \nundertakes minor repairs when and as necessary) over the same period \nof time. \n55-145 Therefore, the contract in Case C includes two components —a \nlease component (tha t is, the right to use the building) and a nonlease \ncomponent . The consideration in the contract of $65,000 is allocated \nbetween those 2 components (unless Lessee elects the practical expedient \nin paragraph 842-10-15-37 or Lessor elects the practical exped ient in \nparagraph 842-10-15-42A when the conditions in that paragraph are met) . The \namount allocated to the lease component is the lease payments in accounting \nfor the lease. \n \n4.2.10 A contract might contain non -lease components in addition to lease \ncomponents – e.g. an arrangement to lease a machine with the lessor \nresponsible for machine maintenance or for operating the machine, or to lease \noffice space with the lessor responsible for common area maintenance (CAM) . \nIn these examples, the machine maintenance , the operation services and CAM \nare non-lease component s of the contract. The consideration in the contract , \ndetermined in Step 3 (see section 4.3), is allocated between the lease a nd non-\nlease components in Step 4 (see section 4.4). [842- 10-15-31] \n4.2.20 Not every element of a contract that contains a lease is necessarily a \n‘component’. While it may be intuitive to assume that any activity or payment \nthat is not a lease component or an explicit ‘lease payment’ must be a non-\nlease component, this is not how Topic 842 works. Instead, some elements of \na contract may not be components at all because they do not transfer a good or \nservice to the lessee. [842- 10-15-30] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 166}), Document(page\_content='Leases 166 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Contract\nLease components Non-lease components Not a component\nAllocate consideration in the contract (Step 4)Activities (or lessor \ncosts ) that do not \ntransfer a good or \nservice to the lessee \n4.2.30 Examples of activities (or costs of the lessor) that do not transfer a good \nor service to the lessee include a lessee’s reimbursement or payment (to a third \nparty) of the lessor’s property taxes and insurance. A lessee’s payment of such \namounts is discussed in section 4.2.1 , which highlights applying Step 3 \n(measuring the consideration in the contract ) and Step 4 (allocati ng the \nconsideration in the contract ) when certain elements of the contract are not \ncomponents. [842- 10-15-30] \n4.2.40 The guidance in Topic 842 on separating lease from non -lease \ncomponents of a contract applies only once an entity has determined that a \ncontract is or contains one or more leases (see chapter 3). No aspect of the \nseparation or allocation guidance f or lease and non- lease components affects \nthe conclusion already reached that the contract is or contains one or more leases. For example, a determination that the contract involves a very \nsignificant service (i.e. non -lease) component, upon which effectiv e use of the \nunderlying asset depends, does not change the conclusion that there is a lease. \n[842- 10-15-28, ASU 2016- 02.BC142 ] \n \n Observation \nComponents in Topic 842 equivalent to promised \ngoods or services in Topic 606 \n4.2.50 The guidance on activities or costs that do not transfer a good or service \nto the lessee (e.g. payments of the lessor’s property tax and insurance) is \nintended to be consistent with the guidance in Topic 606 relating to set -up or \nother activities that do not transfer a good or service to the customer (see \nchapter 4 of KPMG Handbook, Revenue recognition) . In both cases, no \nconsideration is allocated to such activities; consideration is only allocated to \npromised goods or services. [ASU 2016- 02.BC159] \n4.2.60 The Board concluded that defining components as only those items that \ntransfer a good or service to the lessee provides a clearer way in which to \nidentify the components of a contract that is likely to be operable for both \nlessees and lessors. It also prevent s entities from structuring how payments \nare written into a contract to avoid their classification as lease payments, and \ntherefore their inclusion in the lessee’s lease liability. [ASU 2016- 02.BC160] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 167}), Document(page\_content='Leases 167 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 4.2.05 \nShipping, delivery, installation or similar activities \nAre shipment, delivery, installation or similar activities \nundertaken by the lessor related to the underlying asset that \noccur before lease commencement non- lease component s? \nInterpretive response: No. Shipping, delivery, installation or similar activities \nrelated to the underlying asset that the lessor undertakes before lease \ncommencement (even if performance thereof is a condition of the lease \ncontract) are not service s to the lessee, and therefore are not non- lease \ncomponent s of the contract. For example, if the lease contract stipulates that \nthe lessor will deliver and install the underlying asset at the lessee’s premises \nor other lessee- designated location and that it will occur before lease \ncomm encement, those delivery and installation activities are not non- lease \ncomponents of the contract. \nIn contrast, if such activities are performed after lease commencement, they \ngenerally will be considered non- lease services provided to the lessee. In that \ncase, they will be accounted for consistent with the accounting for any other non-lease component of a contract. \nThis interpretive response generally is not affected by whether the lessor \nperforms the activities itself or engages a third party to do so. \nSection 5.1 provides guidance on determining the commencement date for a \nlease. Question 5.1.10 addresses lessee and lessor accounting for lessee \npayments made, and lessor costs incurred, for the activities discussed in this \nquestion. \n \n Question 4.2.10 \nCommon area maintenance \nIs CAM a non- lease component under Topic 842? \nBackground: CAM generally includes maintaining the common areas (e.g. \nrestrooms, food court, lobby) and the grounds of a multi -tenant building. Typical \nmaintenance activities inc lude landscaping, janitorial services , snow removal \nand repairs. \nInterpretive response: Yes. CAM transfers a good or service to the lessee \nother than the right to use the underlying asset, and therefore it is a non -lease \ncomponent of the contract. As a res ult, a portion of the consideration in the \ncontract is allocated to CAM (non- lease component). [842- 10-55-144 – 55-145] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 168}), Document(page\_content='Leases 168 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 4.2.20 \nAssessing the number of CAM components \nIs CAM a single non- lease component or does CAM \nencompass multiple non- lease components? \nInterpretive r esponse: Whether CAM is a single non -lease component or \nmultiple non- lease components is assessed based on the performance \nobligations guidance in Topic 606 – Step 2 of the Topic 606 revenue model (see \nchapter 4 of KPMG Handbook, Revenue recognition). \nWe believe the nature of CAM is such that it will frequently comprise only a \nsingle performance obligation under Topic 606; therefore, it will be a single non-\nlease component when allocating the consideration in the contract under Topic 842. \nIn many lease arrangements, CAM is substantially similar to the hotel \nmanagement services in Example 12A in Topic 606 and the IT outsourc ing \nservices example discussed by the TRG. In fulfilling its promise to provide \nCAM, the nature of which is to maintain the common areas of the multi -tenant \nproperty, the lessor performs a variety of underlying activities, and those \nactivities vary in term s of timing and quantity. For example, at lease \ncommencement, it is not known how much snow the lessor will have to clear from the parking lot during the winters, the extent of landscaping that will be \nrequired during the spring and summer months, when or how often minor \nrepairs will be needed, or when unexpected janitorial needs will arise; but \nregardless, the lessor commits to undertake those activities as needed to fulfill \nits overall promise to the lessee to provide it space in a building with maintained \ncommon areas. \n[606- 10-55-157B – 55-157E, TRG 07- 15.39] \nThe preceding notwithstanding, the characterization of an activity as part of CAM does not necessarily mean it is not a separate non- lease component – i.e. \nseparate from the other activities that are part of CAM. There is no single or \nstandard definition of CAM; therefore, lessors may characterize items that are \nnot part of fulfilling the promise to the lessee to maintain the common areas of \nthe building as part of CAM. This may include billing for th ose items together \nwith CAM or as part of a single CAM billing. Entities will need to evaluate what \npromised lessor activities are truly part of fulfilling CAM, and separately account \nfor those that provide a different or incremental benefit to the lessee beyond \nmaintaining the common areas of the property. \nAs an example, lessors will frequently provide the utilities needed by the lessee \n(e.g. heat, water, electricity). In some cases, the provision of utilities is \ncharacterized as part of, or billed together with, CAM. Despite its \ncharacterization in the contract or how it is billed, the provision of utilities to the \nlessee is generally a separate non- lease component because the provision of \nutilities to the lessee is not an underlying activity to maintain the common areas \nof the property and is distinct from the CAM . \nAnother example of an item that may not be appropriately characterized as CAM is the provision of non- routine or ‘major’ maintenance. Facts and \ncircumstances will need to be considered, but the performance of non- routine \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 169}), Document(page\_content='Leases 169 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. or major maintenance should not be presumed to be part of a single CAM non-\nlease component. \n \n Question 4.2.25 \nCapital replacements and repairs \nIs a lessor’s replacement or repair of the asset’s essential \nstructure a non- lease component ? \nBackground: A lessor frequently has the contractual right to pass through costs \nof capital replacements or repairs to its tenants. For example, if a lessor installs \na new roof on its property (i.e. part of its essential structure), the tenants may \nbe required to reimburse the lessor for those costs. A common reimbursement structure is for tenants to reimburse the lessor consistent with the useful life of \nthe replacement/repair and consistent with the lessee’s proportionate right to \nuse the property. \nIn determining how to account for those lessee reimbursements, a key first \nquestion is whether the capital replacement/repair is a non- lease component of \nthe contract. \nInterpretive response: It depends on whether the capital replacement/repair is \na promise to the lessee. This would be the case if the particular \nreplacement/repair is either: \n— promised in the lease contract; or \n— an activity necessary to fulfill another lessor performance obligatio n (e.g. \nCAM). \nIf a particular capital replacement or repair is a promise to the lessee, the lessor will need to determine whether that particular replacement/repair is a separate \nperformance obligation under Topic 606, or instead is part of another \nperform ance obligation such as CAM – i.e. one of many fulfillment activities \nnecessary to satisfy that performance obligation. \nUsing CAM as an example, necessary repairs to the roof of the property are \npart of the CAM performance obligation. Maintaining the roof is a fulfillment \nactivity of the CAM; it is not an additional performance obligation that is \nseparate from other CAM fulfillment activities such as cleaning/maintaining the \ncustomer restrooms, food court, parking lot, and/or parking garage. \nIn cont rast, a capital replacement or repair that is not a promise to the lessee \n(as described above) is similar to property tax or insurance costs that a lessor \nincurs as the owner of the property . Typically, this replacement or repair will \nbenefit the lessor ’s asset fo r many years past existing tenants’ lease terms at \nthe time of the replacement or repair . Because this action does not fulfill a \npromise to any particular lessee, a requirement for the lessee to reimburse the lessor for the replacement/repair is substantiv ely the same as a requirement for \nthe lessee to reimburse the lessor for its p roperty tax or insurance costs . \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 170}), Document(page\_content='Leases 170 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Questions 6.6. 50 and 7.4.20 address lessee and lessor accounting, \nrespectively, for lessee reimbursements of capital replacements and repairs \nthat are not promises to the applicable lessee. \n \n Question 4.2.30 \nResidual value guarantees \nAre residual value guarantees a component (lease or non-\nlease) of a contract that includes a lease? \nInterpretive response: No. Residual value guarantees are not components of a \ncontract that is or contains a lease. Section 5.4.6 discusses the accounting for \nresidual value guarantees under Topic 842. \n \n Comparison to legacy US GAAP \nMaintenance, including CAM \n4.2.70 Topic 840 excluded ‘substantial services’ from its scope. In general, \nanything that was considered a substantial service under Topic 840 is a non-\nlease component of a contract under Topic 842. [840- 10-15-8, 15 -19] \n4.2.80 However, substantial services excluded ‘executory costs’, which included \nmaintenance of the underlying asset. Therefore, maintenance of the underlying \nasset, including CAM in real estate leases, was considered part of the lease \nelement under Topic 840. Consequently, lessee payments attributable to \nmaintenance of the underlying asset that were fixed were part of the ‘minimum lease payments’ for the lease (but excluded from that amount for purposes of \nlease classification and measurement) and, potentially, part of the minimum \nrental payments (see Questions 13A.3.10 and 13B.3.10). \n[840- 10-25-1(d), 25 -5(b), \n25-6] \n4.2.90 In contrast, under Topic 842, maintenance (including CAM) is a non-\nlease component, and the portion of the ‘consideration in the contract’ (see \nsection 4.3) allocable to maintenance is excluded from the ‘lease payments’. \n4.2.100 Consequently, the lease payments under Topic 842 will be less than the \n‘minimum lease payments’ and may be less than the ‘minimum rental \npayments’, would have been for the same lease under Topic 840 when there \nare fixed payments for maintenance, including CAM, required by the contract \n(ignoring any other potential differences between these defined terms). \n \n \n4.2.1 Taxes and insurance \n4.2.110 This section explores the accounting f or various tax and insurance \npayments made by a lessee in connection with a lease, including considerations \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 171}), Document(page\_content='Leases 171 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. relevant to determining whether the taxes and insurance are costs of the lessee \n(lessee costs) or of the lessor (lessor costs). This section also explores the \ndifferent outcomes of a gross lease versus a net lease. \n— In a gross lease, lessee payments of taxes and insurance are fixed as part \nof the rental payments specified in the contract. \n— In a net lease, the lessee makes variable payments, either to the lessor or \nto a third party, for items like property taxes and insurance. \nProperty taxes and insurance \n4.2.120 As discussed in paragraphs 4.2.20 – 4.2.30, a lessee’s reimbursement or \npayment of the lessor’s property taxes and insurance is an example of an \nactivit y (or costs of the lessor) that does not transfer a good or service to the \nlessee. [842- 10-15-30] \n4.2.130 In a gross lease (see paragraph 4.2.110 and Example 4.2.20), the \nlessee’s payments are always part of the ‘consideration in the contract’, which \nmeans they are: \n— allocated to the separate lease and non -lease components of the contract in \nStep 4 (see section 4.4) ; and \n— affect the measurement of (1) lease assets and lease liabilities , and (2) \nlease cost (lessee) or lease income (lessor). \n4.2.140 In a net lease (see paragraph 4.2.110 and Example 4.2.20) , the lessee’s \npayments of property taxes are not part of the consideration in the contract for the lessee because they are variable. For lessors, they are not part of the \nconsideration in the contract because they are variable and because they do not \nrelate specifically to a non -lease component (see paragraph 4.3.50). Accounting \nfor the payments depends on whether the property taxes and insurance are \nlessee or lessor costs (see Questions 4.2.40, 4.2.42 and 4.2.45) . \n4.2.150 If the property taxes and insurance are lessee costs, neither the costs \nnor the lessee’s variable payments thereof are part of the entity’s lease \naccounting. \n— The lessee accounts for the costs in the same way as any other period \ncosts. \n— The lessor recognizes neither the cost nor the lessee’s payment thereof. \n4.2.160 If the property taxes and insurance are lessor costs , the following \napplies. \n— The lessee accounts for variable payments of those costs in the same way \nas any other variable payments (see section 4.4.3). \n— The lessor recognizes the costs separately from the lessee’s variable \npayments thereof – i.e. on a gross basis (see ‘Gross vs. net considerations ’ \nin section 7.3.2). \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 172}), Document(page\_content='Leases 172 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 4.2.40 \nProperty taxes and insurance – lessor or lessee \ncosts \nAre property tax or insurance payments required by a lease \ncontract costs of the lessor or executory costs of the lessee? \nInterpretive response: \nLessee accounting \nExample 12 in Subtopic 842- 10 illustrates two important considerations for a \nlessee in determining whether a payment is for the lessor’s costs. Example 12 \nconcludes that: [842- 10-55-141 – 55-145] \n— the property taxes being reimbursed to the lessor are the lessor’s costs \nbecause they would be owed by the lessor regardless of whether it leased \nthe building and who the lessee is; and \n— the building insurance is a lessor cost because the lessor is the ‘named \ninsured’ on the building insurance policy, and therefore the policy principally benefits the lessor by protecting the lessor’s investment in the building. \nTherefore, we believe a lessee should consider any lessee payment that is \nrequired by the contract to be a reimbursement or payment of a lessor cost if \nthe payment is for a cost the lessor would have regardless of the lease (e.g. \nmost property taxes) or if the lessor is the primary beneficiary of the payment, \nsuch as in the case of the building insurance in Example 12. Question 4.2.42 \ndiscusses further when we believe the lessor is the primary beneficiary of a \nlessee- obtained insurance policy that covers the underlying asset. \nConsistent with the guidance in paragraph 842- 10-15-30(b), it does not matter \nwhether the lessee pays those costs directly (e.g. to a taxing authority or insurer) or through a reimbursement to the lessor (see section 7.3.2) . However , \nas noted elsewhere in this section, the accounting may differ significantly \ndepending on whether the payment of those amounts, regardless of the party to whom the payment is made, is fixed or variable. \nPayments related to insurance may benefit both the lessee and the lessor . An \nexample is insurance that pri ncipally protects the lessor’s investment in the \nunderlying asset, but also protects the lessee from having to replace or repair \nthe underlying asset using its own funds. The lessee’s insurance may also \nreimburse the lessee for use of an alternative asset while the underlying asset \nis being repaired. In such cases, we do not believe an entity should split the \npolicy payments between an amount that reflects the benefit to the lessor and \nan amount that reflects the benefit to the lessee . \nHowever, in contrast , an insurance policy might include multiple distinct \ninsurance service s that could be purchased separately , some of which \nprincipally benefit the lessee and others that principally benefit the lessor. In \nthat case, we believe an entity should bifurcate the policy between the distinct \ninsurance services. \nThe bifurcation should be based on stand- alone (selling) prices in those \ninstances. As an example, a lessee may be required to obtain a building \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 173}), Document(page\_content='Leases 173 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. insurance policy that names the lessor as the insured benefi ciary for any loss to \nthe building, but also obtains renters’ insurance from that same insurance \ncompany (protecting its contents). In this example, it would be appropriate to \nbifurcate the premium for the renters’ insurance from the building insurance \nbecause those two policies can, and frequently are, purchased separately. If the \npolicy amounts for each type of insurance do not reasonably reflect the stand-\nalone prices for those policies, the bifurcation should reflect those stand- alone \nprices rather than the stated premiums in the contract. \nLessor accounting \nBefore the issuance of ASU 2018- 20 in December 2018, a lessor appl ied the \nsame considerations as a lessee to determine whether a variable payment was \nfor a lessor cost or lessee cost. Sections 13A.4.3 (effective date transition \nmethod) and 13B.4.3 (comparative transition method) discuss the effective date and transition provisions for ASU 2018 -20. \nAfter the adoption of ASU 2018 -20, for lessors only, property taxes and \ninsurance on the underlying asset are accounted for as : \n— lessee costs if the lessee remits the tax or pays the insurance premium \ndirectly to the relevant third party – e.g. the taxing authority or insurer. \n— lessor costs if the lessor remits the tax or pays the insurance premium to \nthe relevant third party and receives reimbursement from the lessee. \nNo additional analysis is undertaken by a lessor, such as that required of \nlessees , to determine whether the property taxes or insurance are lessee or \nlessor costs. In other words, it does not matter for lessors whether they are the \nprimary obligor for a property tax or the primary beneficiary of insurance on the \nunderlying asset; whether the property tax or ins urance is a lessee or a lessor \ncost is determined solely by which party (lessee or lessor) pays the relevant \ntaxing authority or insurer. \n \n Question 4.2.42 \nIdentifying the primary beneficiary of lessee -\nobtained insurance on the underlying asset \nWhen is the lessor the ‘primary beneficiary’ of insurance on \nthe underlying asset obtained and paid for by the lessee? \nBackground: Lease contracts frequently require the lessee to obtain and \nmaintain insurance on the underlying asset throughout the lease term. \nQuestion 4.2.40 explains that costs of insurance on the underlying asset that \nprimarily benefit the lessor are accounted for as lessor costs, rather than \nexecutory costs of the lessee. \nInterpretive response: Notwithstanding that the lessee also benefits from the \ninsurance in many cases, an insurance policy on the underlying asset may \nprimarily benefit the lessor even when the lessee obtains the required policy in \nits own name and is responsible for the payment of the policy premium. \nTopic 842 does not address when the lessor is the primary beneficiary of the \ninsurance in that scenario. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 174}), Document(page\_content='Leases 174 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. In the absence of specific guidance, we believe either of the following \napproaches is acceptable. Approach 2 will result in a conclusion that the lessor \nis the primary beneficiary of lessee- obtained insurance in more cases than \nApproach 1. \nApproach 1: Proceeds must be used for lessor’s benefit \nThe lessor is the primary beneficiary when: \na. the insurance policy covering the underlying asset is obtained by the lessee \nas a requirement of the lease contract; and \nb. the terms of the policy, the lease contract or another contractual arrangement ensure that the insurance proceeds from a claim must be: \n— remitted to the lessor at the lessor’s election; or \n— used to repair or replace the underlying asset. \nFor example, the lessor would be the primary beneficiary of the insurance if the \ninsurance is a requirement of the lease contract and the lessor is ent itled to \neither: \n— receive the funds paid by the insurer on any claim pertaining to the asset; or \n— approve the release of the funds paid on any claim pertaining to the asset – \ne.g. the lessor may have the right to endorse an insurance claim check for \nthe less ee to receive the funds, which it may only do if it is assured the \nlessee will use the funds to repair or replace the underlying asset. \nWhen criterion (b) is met, the insurance required by the lease contract serves as \na guarantee to the lessor that its i nvestment in the underlying asset is protected \nregardless of the lessee’s actions in the event of damage to, or destruction of, \nthe underlying asset. And in that case, the insurance is of primary benefit to the \nlessor. \nWhen that is not the case, the insur ance does not guarantee that the lessee will \nrepair or replace the lessor’s asset because there is no contractual requirement \nfor the insurance proceeds to be used for that purpose. Consequently, we \nbelieve it is reasonable to conclude that the insurance primarily benefits the \nlessee; providing assurance to the lessee that it will be able to fulfill its \nobligation to return the underlying asset to the lessor without having to pay \nfor replacement of, or significant repairs to, the underlying asset out of its \nown funds. \nApproach 2: Insurance required by lease contract \nThe lessor is the primary beneficiary whenever the insurance policy is on the \nunderlying asset and obtaining the insurance is a requirement of the lease \ncontract. \nThis approach to determining the primary beneficiary is based on the notion that \nif the lessor did not believe that the insurance principally protects its investment \nin the underlying asset it would not have required that the lessee obtain insurance as a condition of granting the lease. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 175}), Document(page\_content='Leases 175 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 4.2.45 \nEffect of lease classification on identifying lessor \ncosts \nIs the determination of whether property tax or insurance \npayments are lessor or lessee costs affected by lease \nclassification? \nInterpretive response: No. We do not believe the framework for identifying \nwhen property taxes and insurance are lessor costs outlined in Question 4.2.40 \ndiffers based on classification of the lease. Based on discussions with the FASB \nstaff, we understand that they share this view. \nThis concl usion is based on the fact that lease classification will frequently only \nbe incidental to whether property taxes or insurance on the underlying asset \nrepresents a lessor cost under the Question 4.2.40 framework. \nFrom the lessee perspective, even if a les sor concludes that the classification of \nthe lease is sales -type or direct financing (and therefore derecognizes the \nunderlying asset), the lessor still legally owns the asset and therefore will \nfrequently still be the primary obligor for any property (or similar) taxes related \nto the underlying asset, and/or the primary beneficiary of any insurance on the \nasset (see Question 4.2.42). \nFrom the lessor perspective, classification of the lease will not affect whether the lessee or the lessor remits the propert y tax or pays the insurance premium \nto the relevant third party. \n \n Example 4.2.10 \nDifferentiating lessor insurance costs from lessee \ninsurance costs \nScenario 1: Lessee is primary beneficiary \nLessee LE and Lessor LR enter into a two -year residential apartment lease that \nrequires LE to maintain renter’s insurance coverage with LR listed as an additional insured on the policy (LE is the named insured). LE obtains this \ncoverage through a third- party insurance company concurrently with obtaining \nthe lease. The insurance premium will vary and will be billed to LE each year. \nEven though obtaining the renter’s insurance is a requirement of the lease \ncontract, the premiums associated with the renter’s insurance policy represent \nan executory cost of LE and not a cost of LR that LE is paying as a condition of \nthe lease. This is because, whether applying Ap proach 1 or Approach 2 to \nQuesti on 4.2.42, the insurance policy is not on the underlying asset; rather , it \nserves to protect LE’s proper ty from certain loss events (e.g. fire or theft) and \nto cover LE’s liability for any visitor injuries in the apartment. \nScenario 2: Lessor is primary beneficiary \nLessee LE and Lessor LR enter into a standard three -year car lease that \nrequires LE to mainta in collision insurance coverage on the car throughout the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 176}), Document(page\_content='Leases 176 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. lease term. LR is entitled to any proceeds if the car is a writeoff and has the \nright to ensure that proceeds paid to LE are used to repair the vehicle if it is not \na writeoff – LR must sign the ins urance reimbursement check for LE to collect \non a claim. \nLE contracts with a third -party insurance company to obtain the required \ncoverage. The insurance premium will vary and will be billed to LE each year. \nThe insurance coverage in this example primaril y benefits LR (regardless of the \napproach taken in Question 4.2.42) ; it protects LR’s investment in the car. \nTherefore, the insurance is not a component (lease or non- lease) of the contract \nand LE’s payments for the insurance premiums represent variable payments of \nLR’s cost. \n \n Question 4.2.50 \nAccounting for gross and net leases \nHow does the accounting differ for gross vs. net leases? \nInterpretive response: Examples 4.2.20 – 4.2.50 illustrate differences in the \naccounting for gr oss leases (i.e. those for which payments of lessor costs are \nfixed as part of the rental payment s) versus net leases – i.e. those for which \nlessees make variable payments to the lessor or a third party. Lessees will generally recognize smaller ROU assets and lease liabil ities for a net lease than \nfor a gross lease because lessees will not include estimates of variable payments in those amounts. \n[842- 10-55-141 – 55-143] \nVariable payments for lessor costs of property taxes and insurance (see \nQuestions 4.2.40 and 4.2.45) , while not part of the ‘ consideration in the \ncontract ’, are not excluded from lease accounting in a net lease scenario. \nDepending on whether the contract also includes non- lease components, either \nall or a portion of the variable payments for the property tax es or insurance will \nbe accounted for as variable lease payments (see sections 5.4, 6.3 and 7.3 – \n7.4). Lessees and lessors will need to track such variable lease payments for \ndisclosure purposes – i.e. disclosures of variable lease cost /income (see \nsections 12.2 – 12.3). [842-10-15-40 – 15-40A, 842-20-50-4(d), 842- 30-50-5(c)] \nWe believe the Board recognized that economically similar contracts will be \naccounted for differently on the balance sheet as a r esult of its decision on \nvariable payments. However, that different accounting result will not be unique to gross versus net lease scenarios. Similarly, a retail lessee required to make \nfixed payments of $10,000 per month will recognize a n ROU asset and le ase \nliability significantly different from a retail lessee that is required to make \npayments expected to approximate $10,000 per month comprising a fixed \npayment of $5,000 per month plus a variable payment of 2% of store sales for \nthe previous month. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 177}), Document(page\_content='Leases 177 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 4.2.20 \nIdentifying components in gross and net leases \nTwo companies enter into similar leases of a building, but with the underlying \ncontracts structured differently. \nScenario 1: Gross lease \nLessee LE1 leases a building from Lessor LR1 for 24 months. \nLE1 pays LR1 $20,000 per month with no separate obligation with respect to \nLR1’s pr operty taxes or building insurance (i.e. the lease is a gross lease). \nThe contract has a single component, which is the lease of the building. The \nconsideration in the contract (see section 4.3) is $480,000 ($20,000 × 24). As \noutlined in Step 4 (see section 4.4), that amount is allocated entirely to the \nsingle component of the contract (the building lease component) . \nScenario 2: Net lease \nLessee LE2 leases a similar building from Lessor LR2. \nLE2 pays LR2 $18,000 per month and must reimburse LR2 for LR2’s ac tual \nproperty tax assessments and building insurance costs during the lease term (i.e. the lease is a net lease). Costs of the property taxes and insurance are \nexpected to approximate $2,000 per month but will vary based on actual tax \nassessments and insur ance premiums . \n— LE2 concludes that the property taxes and insurance are lessor costs \nbecause LR2 is primarily obligated to the taxing authority for the property taxes and primarily benefits from the building insurance (LR2 is the owner \nand named beneficiary of the insurance policy) – see Questions 4.2.40 \nand 4.2.42. \n— LR2 concludes that the property taxes and insurance are lessor costs \nbecause it pays the property taxes and insurance premiums and LE2’s payments reimburse LR2 – see Question 4.2.40. \nAlthough the contract includes the explicit requirement for LE2 to reimburse \nLR2’s property tax and insurance costs, these are not components of the \ncontract. Therefore, as in Scenario 1, the contract has only a single component \n(i.e. the lease of the buil ding). \nThere are two types of payments in the contract: \n— The fixed payments of $18,000 per month are included in the consideration in the contract. \n— The variable payments (approximately $2,000 per month) are not included in \nthe consideration in the contract. Because there are no non- lease \ncomponents of the contract, the additional considerations applicable to lessors for variable payments (see section 4.3.2 ) are not applicable and the \nvariable reimbursement payments are entirely variable lease payments. \nSuch amounts are recognized as incurred (lessee) or earned (lessor). \nLike Scenario 1, the contract has a single component, which is the lease of the building. The consideration in the contract (see section 4.3) is $432,000 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 178}), Document(page\_content='Leases 178 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. ($18,000 × 24). As outlined in Step 4 ( see section 4.4), that amount is allocated \nentirely to the single component of the contract. \nComparing Scenarios 1 and 2 \nThis example illustrates the following key points. \n— Property taxes and insurance obligations of the lessor are not lease or non -\nlease components of a contract. \n— Variable payments not dependent on an index or rate are excluded from the \nconsideration in the contract. \n— The c onsideration in the contract is allocated only to the separate lease and \nnon-lease components of the contract. \n— When there are no non- lease components of the contract, variable \npayments of lessor costs (which include reimbursements of the lessor \nproperty tax and insurance costs) are accounted for as variable lease \npayments. \n \n Example 4.2.30 \nProperty taxes and insurance in a gross lease \nLessee LE and Lessor LR enter into a five- year lease of retail space that \nincludes CAM thr oughout the lease term. LE will pay LR a fixed payment of \n$106,000 per year (in arrears) for Year 1, increasing by $5,000 each year \ntherea fter. \nLE has no separate obligation to pay LR for its property taxes, insurance or \nCAM. Of the annual fixed payment, approximately $15,000 is expected to cover \nLR’s property tax assessments and building insurance costs, and approximately \n$5,200 is expected to cover LR’s actual CAM costs. \nInitial direct costs are $5,000 (broker commissions) for both LE and LR. \nLR provides a moving allowance (i.e. a lease incentive) to LE of $7,500, which it \npays at lease commencement. \nConsideration in the contract \nLessee LE \nThe consideration in the contract is $572,500, equal to: \n— the sum of the payments of $106,000 for Year 1 increasing $5,000 each \nyear thereafte r ($580,000 in total); less \n— the leas e incentive received of $7,500. \nLessor LR \nThe consideration in the contract for LR is the same as it is for LE ($572,500). \nAllocation to components \nIf LR and LE separate the lease and CAM components (see separation and non -\nseparation scenarios presented below), they will allocate the consideration in \nthe contract in proportion to the stand- alone (selling) prices of the components. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 179}), Document(page\_content='Leases 179 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The stand- alone (selling) prices are assumed to be $570,000 (lease) and \n$30,000 (CAM). \n— The estimated stand- alone (selling) price of CAM equals the estimated \nactual CAM cost reimbursements plus an assumed market -based profit \nmargin for those CAM services. \n— The estimat ed stand- alone (selling) price of the lease is an estimate of what \na lessor would charge for the lease without providing CAM ( while still \nrecover ing its property tax and insurance costs through the fixed lease \npayments). \nComponent Stand -alone price Allocation Calculation \nLease $570,000 $543,875 (570,000 / 600,000) × 572,500 \nCAM 30,000 28,625 (30,000 / 600,000) × 572,500 \n $600,000 $572,500 \nThe allocation results in 95% of the consideration in the contract being allocated \nto the lease component and 5% being allocated to the CAM non- lease \ncomponent. \nAssuming the lease is an operating lease, the initial and day 2 accounting for \nthat lease is as follows . \nLessee LE elects to separate lease and non -lease components \nThe rate implicit in the lease is not readily determinable and therefore LE uses its increm ental borrowing rate of 5%. LE determines its lease liability by \ncalculating the present value of the allocated unpaid lease payments of \n$551,000 (equal to $543,875 of allocated lease payments + an allocation of the \nlease incentive of $7,125, which is $7,500 received up- front × 95%), discounted \nat 5%, to arrive at the lease liability initial measurement of $475,104. \n— LE’s initial measurement of its ROU asset is $472,979, calculated as \nfollows: \nLease liability ($475,104) + Initial direct costs ($5,000) + Prepaid lease \npayments (none) – Lease incentives received ($7,125, which is $7,500 \n× 95%) \n— LE’s total lease cost is $548,875 (allocated lease payments of $543,875, \nwhich is net of allocated lease incentives of $7,125, + initial direct costs of \n$5,000), which is recognized straight -line over the lease term – i.e. \n$109,775 each year. \nLessee LE elects not to separate lease and non -lease components \nAssume the rate implicit in the lease is not readily determinable and therefore \nLE uses its incremental borrowing rate of 5%. LE determines its lease liability \nby calculating the present value of the unpaid payments of $580,000, discounted at 5% to arrive at the lease liability initial measurement of $500,109. \n— LE’s initial measurement of its ROU asset is $497,609, calculat ed as follows: \nLease liability ($500,109) + Initial direct costs ($5,000) + Prepaid lease \npayments (none) - Lease incentives received ($7,500) ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 180}), Document(page\_content='Leases 180 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — LE’s total lease cost is $577,500 (payments of $580,000 + initial direct \ncosts of $5,000 – lease incentives recei ved of $7,500), which is recognized \nstraight -line over the lease term – i.e. $115,500 each year. \nLessor LR elects to separate lease and non -lease components \nBecause the lease is an operating lease, LR continues to recognize and depreciate the asset. At lease commencement, LR defers the $5,000 of initial \ndirect costs and amortizes them as an expense over the lease term on the \nsame basis as the lease income (i.e. $1,000 of amortization each year) – in this \ncase, the initial direct costs were allocated enti rely to the lease component. \nJudgment will be involved in determining whether initial direct costs, such as a \nbroker’s commission, relate to a lease component, a non- lease component, or \nboth (see section 5.5). If, instead, a portion of the broker’s commiss ion was \nallocated to the CAM non- lease component, those costs would not be initial \ndirect costs but rather would be accounted for under Subtopic 340 -40 (other \nassets and d eferred costs related to c ontracts with c ustomers ). \nLR recognizes lease income of $543,875 (which is net of an allocated amount of the lease incentive paid) on a straight -line basis over the lease term (i.e. \n$108,775 of lease income each year). \nLR recognizes CAM revenue of $28,625 (which is net of an allocated amount of \nthe lease incent ive paid) over the lease term based on an appropriate measure \nof progress determined in accordance with paragraphs 606- 10-25-31 – 25-37. \nLessor LR elects not to separate lease and non -lease components \nLR has elected the practical expedient not to separate the lease and non- lease \ncomponents for its retail space leases (see paragraphs 4.4.51 – 4.4.5 6), and has \ndetermined that the CAM non- lease component qualifies for non- separation in \nthis lease because: \n— the retail space lease would be classified as an operat ing lease if accounted \nfor separately (see Question 4.4.12) ; and \n— the CAM, like the operating retail space lease, is satisfied over time (i.e. LE \nsimultaneously receives and consumes benefit from the CAM) and it has a \ntime-elapsed (i.e. straight -line) pattern of transfer to LE (see Question 4.4.13) . \nFurther, LR determines that the CAM element is not the predominant element of the combined component – i.e. the retail space is the predominant element . \nTherefore, the c ombined component is accounted for as a single lease \ncomponent classified as an operating lease (see paragraphs 4.4.53 – 4.4.55). \nConsistent with the LR separation scenario, LR continues to recognize and depreciate the underlying asset. At lease commencem ent, LR defers the \n$5,000 of initial direct costs and amortizes them as an expense over the lease \nterm on the same basis as the lease income. \nLR recognizes lease income of $572,500 ($580,000 net of the $7,500 lease \nincentive paid) on a straight -line basis over the lease term – i.e. $114,500 of \nlease income each year. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 181}), Document(page\_content='Leases 181 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 4.2.40 \nProperty taxes and insurance in a net lease – lessee \nreimburses lessor \nLessee LE and Lessor LR enter into a five -year lease of retail space that \nincludes CAM services throughout the lease term. LE will pay LR a fixed \npayment of $90,200 per year (in arrears) for Year 1, increasing by $5,000 per \nyear thereafter. The lease is (or would be, if accounted for separ ately by LR) \nclassified as an operating lease because: \n— there are no title transfer provisions or lessee purchase options; \n— the remaining economic life of the building in which the retail space is \nlocated is 30 years; \n— the fair value of the retail space signi ficantly exceeds even the \nundiscounted lease and non- lease payments due under the contract; and \n— the retail space is not specialized. \nLE reimburses LR for its pro rata portion of LR’s actual property taxes, insurance costs and CAM costs during the lease ter m. LR estimates its \nproperty tax assessments and building insurance costs will be approximately \n$15,000 per year and its CAM costs will be approximately $5,200 per year. \nConsistent with Question 4.2.40: \n— LE concludes that the property taxes and insurance ar e lessor costs \nbecause LR is primarily obligated to the taxing authority for the property \ntaxes and primarily benefits from the building insurance (LR is the owner and named beneficiary of the insurance policy). \n— LR concludes that the property taxes and ins urance are lessor costs \nbecause it pays the property taxes and insurance premiums and LE’s \npayments reimburse LR. \nInitial direct costs are $5,000 (broker commissions) for both LE and LR. \nLR provides a moving allowance (i.e. a lease incentive) to LE of $7,500, which it pays at lease commencement. \nConsideration in the contract \nLessee LE \nThe consideration in the contract is $493,500, equal to the sum of the payments of $90,200 for Y ear 1 and increasing $5,000 each year thereafter ($501,000 in \ntotal), less th e lease incentive received of $7,500. The amounts LE expects to pay \nto LR for property taxes, insurance and CAM are variable payments that are \nexcluded from LE’s measurement of the consideration in the contract because \nthey do not depend on an index or rat e (and are not in- substance fixed). \nLessor LR elects to separate lease and non -lease components \nThe consideration in the contract is $519,500, equal to the sum of the \npayments of $90,200 for Y ear 1 and increasing $5,000 each year thereafter \n($501,000 in total), less the lease incentive received of $7,500 plus $26,000 of \nexpected payments for CAM. LR concludes it is appropriate to include the \n$26,000 in expected CAM payments because those variable payments to which ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 182}), Document(page\_content='Leases 182 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. it expects to be entitled specifically relate to its effort to provide CAM (a non-\nlease component). \nLR arrives at $26,000 using the variab le consideration requirements in Topic 606:1 \n— LR estimates it will be entitled to $26,000 in variable payments for CAM ; \nand \n— LR concludes it is probable that including that amount in the consideration \nin the contract will not result in a significant revenu e reversal of cumulative \nrevenue recognized for the lease and the CAM when the variability around those payments is resolved. \nNote: \n1. Paragraphs 606- 10-32-5 – 32-13 govern this initial estimate of $26,000. Estimates of \nvariable consideration for CAM need to be updated each reporting period under \nparagraph 606-10-32-14. If the entity allocates the estimated CAM variable payments \nentirely to the CAM non- lease component initially, subsequent changes to that estimate \nwill also generally be allocated entirely to the CAM non -lease component. \nThe amounts LR expects LE to reimburse LR for property taxes and insurance \nare variable payments that are excluded from LR’s measurement of the consideration in the contract because they : \n— do not depend on an index or rate; \n— are not in -substance fixed; and \n— do not relate solely to LR’s efforts to provide a non-lease good or service to \nLE. \nHowever , because the property taxes and insurance are LR costs (rather than \nLE costs), LE’s variable payments are recognized separately (i.e. on a gross \nbasis) from LR’s associated property tax and insurance costs (see Gross vs. net \nconsiderations in section 7.3.2) and allocated to the lease and non- lease \ncomponents. \nLessor LR elects not to separate lease and non -lease components \nLR elects the lessor practical expedient discussed in section 4.4. 1 for its retail \nspace leases. T he retail space lease and the CAM in this example qualify for \ncombination as described in paragraph 4.4. 51. \nLR determines that the CAM is not the predominant element of the c ombined \ncomponent. Therefore, the combined component is accounted for as a single, \noperating lease component (see paragraphs 4.4.53 – 4.4.5 5). \nBecause there is only a single lease component in the contract, the variable \npayments LE will make to LR under t he contract for property taxes, insurance \nand CAM are all considered to relate to that lease component (see \nparagraph 4.3.75). Therefore: \n— none of those expected variable payments are included in the consideration \nin the contract (see Question 4.3.10) ; and \n— all of them will be accounted for as variable lease payments (that do not \ndepend on an index or rate and are not in- substance fixed). \nConsequently, the consideration in the contract is $493,500: $501,000 of fixed \nlease payments, less the lea se incentive received of $7,500. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 183}), Document(page\_content='Leases 183 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Allocation of the consideration in the contract to components \nIf LR and LE separate the lease and the CAM components of this contract, they \nallocate the consideration in the contract in proportion to the stand- alone \n(selling) prices of the two components as follows. The stand- alone (selling) \nprices are determined to be $570,000 ( lease ) and $30,000 (CAM) , consistent \nwith Example 4.2.30. The est imated stand- alone selling price of CAM includes \nthe estimated cost reimbursements, plus an assumed market -based profit \nmargin for providing those services. \nIn contrast, if LR and LE elect not to separate the lease and the CAM \ncomponents of this contract ( and the two components qualify for combination \nin the case of LR), there is no allocation of the consideration in the contract or \nthe variable payments between the lease and the CAM. \nLessee LE elects to separate lease and non -lease components \nLE allocates the consideration in the contract of $493,500 in proportion to \nstand -alone prices . \nComponent Stand -alone price Allocation Calculation \nLease $570,000 $468,825 (570,000 / 600,000) × 493,500 \nCAM 30,000 24,675 (30,000 / 600,000) × 493,500 \n $600,000 $493,500 \nThe allocation results in 95% of the consideration in the contract being allocated \nto the lease component and 5% being allocated to the CAM non- lease \ncomponent. \nLessee LE elects not to separate lease and non -lease components \nBecause LE elects not to separate the lease and the CAM components , the \nentire consideration in the contract of $493,500 is allocated to the single lease \ncomponent. \nLessor LR separates lease and non -lease components \nThe following is an example of how the allocation requirements may be applied; \nother methods may be appropriate based on the facts and circumstances. \nThe consideration in the contract for LR is measured a t $519,500. \nLR begins by allocating to the CAM the variable payments specifically related to \nits effo rts to satisfy that non- lease component . Allocation of only the CAM \nvariable payments to the CAM component would be inconsistent with the allocation objective in paragraph 606- 10-32-28. This is because LR is billing only \nits costs with no assumption of profit , and therefore, the variable payments \nalone do not reflect the price at which LR would sell CAM separately to a \ncustomer . Therefore, the remaining consideration in the contract ($493,500, \nwhich does not include variable payments for taxes and insurance) is allocated \non a relative stand -alone selling price basis, after adjusting for the variable \npayments that have been specifically allocated to the non- lease component. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 184}), Document(page\_content='Leases 184 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. LR allocates the consideration in the contra ct to the lease and the CAM \ncomponent as follows . \nComponent Stand -alone price Allocation Calculation \nLease $570,000 $490,061 (570,000 / 574,0001) × 493,500 \nCAM 30,000 29,439 (4,000 / 574,0001) × 493,500 + \n26,000 \n $600,000 $519,500 \nThe allocation results in 94% of the consideration in the contract being allocated \nto the lease component and 6% being allocated to the maintenance non -lease \ncomponent. \nNote: \n1. The total of the stand- alone selling prices used in the calculations ($574,000) has b een \nadjusted to remove the $26,000 that has already been specifically allocated to the non-\nlease maintenance component ($600,000 total stand- alone selling price less the amount \nof variable consideration attributed to the non -lease component of $26,000). \nLessor LR elects not to separate lease and non -lease components \nThe consideration in the contract for LR is measured a t $493,500 . \nBecause (1) LR elects not to separate the lease component and the CAM non -\nlease component, and (2) the CAM is not the predominant element of the \ncombined lease/CAM component , the entire consideration in the contract of \n$493,500 is allocated to the single lease component. \nAccounting for lease and non -lease components \nLessee LE elects to separate lease and non -lease compon ents \nAssume the rate implicit in the lease is not readily determinable and therefore \nLE uses its incremental borrowing rate of 5%. LE determines its lease liability \nby calculating the present value of the allocated unpaid lease payments of \n$475,950 (equal to $468,825 of allocated unpaid lease payments + an allocation \nof the lease incentive of $7,125, which is $7,500 received × 95%), discounted \nat 5%, to arrive at the lease liability initial measurement of $410,118. \n— LE’s initial measurement of its ROU asset is $407,993, calculated as \nfollows : \nLease liability ($410,118) + Initial direct costs ($5,000) + Prepaid lease \npayments (none) – Lease incentives received ($7,125 [$7,500 × 95%]) \n— LE’s total lea se cost is $473,825 (allocated lease payments, net of allocated \nlease incentives, of $468,825 + initial direct costs of $5,000) and is \nrecognized straight -line over the lease term – i.e. $94,765 each year. \n— Amounts allocated to CAM of $24,675 (which is net of allocated lease incentives of $375) are recognized over the service period. \n— Payments for property taxes, building insurance and CAM are variable payments. Thes e variable payments would be allocated in the same \nmanner as fixed payments (i.e. 95% to the l ease component and 5% to \nCAM) and recognized as incurred. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 185}), Document(page\_content='Leases 185 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Lessee LE elects not to separate lease and non -lease components \nThe rate implicit in the lease is not readily determinable and therefore LE uses \nits incremental borrowing rate of 5%. LE determines its lease liability by \ncalculating the present value of the unpaid lease payments of $501,000 \n($493,500 of unpaid lease payments + lease incentive of $7,500), discounted at \n5%, to arrive at the lease liability initial measurement of $4 31,703. \n— LE’s initial measurement of its ROU asset is $4 29,203: \nLease liability ($4 31,703) + Initial direct costs ($5,000) + Prepaid lease \npayments (none) – Lease incentives received ($7,500) \n— LE’s total lease cost is $4 98,500 (lease payments, net of lease incentives, \nof $493,500 + initial direct costs of $5,000 ) and is recognized on a straight -\nline basis over the lease term – i.e. $99 ,700 each year. \n— Payments LE makes for property taxes, building insurance and CAM \nthroughout the lease term are accounted for as variable lease payments \nbecause there is only a single lease component of the contract . \nLessor LR separates lease and non -lease components \nBecause the lease is an operating lease, LR continues to recognize and depreciate the underlying asset. At lease commencement, consistent with \nExample 4.2.30, LR defers the $5,000 of initial direct costs and amortizes \nthem as an expense over the lease term on the same basis as the lease income \n(i.e. $1,000 of amortization each year). If a portion of the broker’s comm ission \nhad been allocated to the CAM (non -lease component), those costs would not \nbe initial direct costs but rather would be accounted for under Subtopic 340- 40. \nLR recognizes lease income of $490,061 (which is net of an allocated amount of \nthe $7,500 lease incentive paid) on a straight -line basis over the lease term – i.e. \n$98,012 of lease income per year. \nLR recognizes the consideration in the contract allocated to the CAM (non -lease \ncomponent) of $29,439 (i.e. CAM revenue) on a straight -line basis (i.e . using a \ntime-elapsed measure of progress, determined to be appropriate under \nparagraphs 606- 10-25-31 – 25-37). Estimates of the variable consideration that \nwill be earned for CAM will need to be updated each reporting period in \naccordance with paragraph 606-10-32-14. Changes in the consideration in the \ncontract are allocated to the lease and/or non- lease components based on the \nguidance for changes in the transaction price in Topic 606. Consequently, \nchanges in the consideration in the contract as a resul t of changes to the \nestimate of CAM reimbursements will be allocated entirely to the CAM non-lease component, consistent with how the consideration in the contract was \noriginally allocated. \nReimbursements of LR property tax and insurance costs are variable payments \nthat are not part of the consideration in the contract either at contract inception \nor subsequently. In this example, LR allocates the variable payments it receives \nfor property taxes and insurance entirely to the lease component – i.e. \naccounting for those payments entirely as variable lease payments – because: \n— charges for property taxes and insurance relate specifically to LR’s \nownership of the property, which permits LR to provide the right to use the \nretail space; and ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 186}), Document(page\_content='Leases 186 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — allocating the property t axes and insurance payments entirely to the lease \ncomponent is consistent with the allocation objective in Topic 606 because \nit would result, given the amounts LR expects LE to pay, in total income \nrecognition for the lease ($565,061) and non- lease ($29,43 9) components \nthat approximates each component’s stand- alone selling price. \nAll facts and circumstances must be considered; lessors should carefully \nconsider whether their overall allocation methodology yields reported results for \nthe lease and non- lease c omponents that are consistent with the allocation \nobject ive in paragraph 606- 10-32-28. \nLR recognizes the variable property tax and insurance payments as variable \nlease income when the changes in facts and circumstances on which the \npayments are based occ ur. \nLessor LR elects not to separate lease and non -lease components \nConsistent with the accounting by LR when it elects to separate the lease and the CAM, because t he lease is an operating lease, LR continues to recognize \nand depreciate the underlying asset , and defer and amortize the initial direct \ncosts over the lease term . \nLR recognizes lease income of $493 ,500 on a straight -line basis over the lease \nterm – i.e. $98, 700 of lease income per year. Because LR accounts for the \nlease and the CAM as a single, combined lease component , the variable \npayments LE will make to LR for property taxes, insurance and CAM are \naccounted for entirely as variable lease payments, which means they: \n— do not change the consideration in the contract when they become owed \nto LR ; and \n— are recognized as variable lease income when the changes in facts and \ncircumstances on which the payments are based occur . \n \n Example 4.2.50 \nProperty taxes and insurance in a net lease – lessee \npays third party directly (lessor accounting) \nOnly Lessor LR’s accounting is illustrated in this example. Because the \nnumbers used in this example are the same as those used in Example 4.2.40, \nLessee LE’s accounting is the same in both examples. \nLessee LE and Lessor LR enter into a five- year lease of a building that includes \nmaintenance of the building by LR throughout the lease term. LE will pay LR a \nfixed payment of $90,200 per year (in arrears) for Year 1, increasing by $5,000 \nper year thereafter. The lease is (or would be, if accounted for separately by LR) \nclassified as an operating lease because: \n— there are no title transfer provisions or lessee purchase options; \n— the remaining economic life of the building is 30 years; \n— the fair value of the building significantly exceeds the undiscounted lease \nand non- lease payments due under the contract; and \n— the building is not specialized. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 187}), Document(page\_content='Leases 187 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Under the contract, LE is required to pay the building’s property taxes directly to \nthe local taxing authority and obtain hazard insurance on the building for which \nLR is to be the named insured. LE will reimburse LR for its actual building \nmaintenance costs during the lease term. LR estimates the property tax \nassessments and building insurance costs will be approximately $15,000 per \nyear and its maintenance costs will be approximately $5,200 per year. LR \nconcludes the property taxes and insurance are lessee costs because LE will pay those costs to the taxing authority and insurer directly (see \nQuestion 4.2.40) . \nInitial direct costs are $5,000 (broker commissions) for both LE and LR. \nLR provides a moving allowance (i.e. a lease incentive) to LE of $7,500, which \nLR pays at lease commencement. \nConsideration in the contract \nLessor LR elects to separate lease and non -lease components \nThe consideration in the contract is $519,500, equal to the sum of the \npayments of $90,200 f or Year 1 increasing by $5,000 each year thereafter \n($501,000 in total), less the lease incentive received of $7,500, plus $26,000 of \nexpected payments for maintenance. \nLR concludes that it is appropriate to include the $26,000 in expected \nmaintenance pay ments in the consideration in the contract because the variable \npayments to which it expects to be entitled specifically relate to its effort to \nprovide maintenance (a non- lease component). \nLR arrives at $26,000 using the variable consideration requirements in Topic \n606:\n1 \n— LR estimates that it will be entitled to $26,000 in variable payments for \nmaintenance; and \n— LR concludes that it is probable that including that amount in the \nconsideration in the contract will not result in a significant revenue reversa l \nof cumulative revenue recognized for the lease and the maintenance when \nthe variability around those payments is resolved. \nNote: \n1. Paragraphs 606- 10-32-5 – 32-13 govern this initial estimate of $26,000. Estimates of \nvariable consideration for maintenance will need to be updated each reporting period in \naccordance with paragraph 606 -10-32-14. If the entity allocates the estimated \nmaintenance variable payments entirely to the maintenance non-lease component \ninitially, subsequent changes to that estimate will also generally be allocated entirely to \nthe maintenance non-lease component. \nBecause the property tax and insurance costs are LE costs (rather than LR \ncosts), neither the costs, nor LE’s payments thereof, are reflected in LR’s accounting for the lease (see paragraph 4.2.1 50). \nLessor LR elects not to separate lease and non -lease components \nLR elects the lessor practical expedient discussed in section 4.4. 1 for its \nbuilding leases. The building lease and the maintenance in this example qualify \nfor combination as described in paragraph 4.4.51. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 188}), Document(page\_content='Leases 188 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. LR determines that the maintenance is not the predominant element of the \ncombined component. Therefore, the combined component is accounted for as \na single, operating lease component (see paragraphs 4.4.53 – 4.4.55). \nBecause there is only a single lease component in the contract, the variable \npayments LE will make to LR under the contract for maintenance are considered to relate to that lease component (see paragraph 4.3.75). Therefore: \n— none of the expected variable pay ments are included in the consideration in \nthe contract (see Question 4.3.10); and \n— they wi ll be accounted for as variable lease payments (that do not depend \non an index or rate and are not in -substance fixed). \nConsequently, the consideration in the contract is $493,500: $501,000 of fixed lease payments less the lease incentive received of $7,500. \nBecause the property tax and insurance costs are LE costs (rather than LR \ncosts), neither the costs, nor LE’s payments thereof, are reflected in LR’s \naccounting for the lease. \nAllocation of the consideration in the contract to components \nIf LR separates the lease and the maintenance components of this contract, it \nallocates the consideration in the contract in proportion to the stand- alone \nselling prices of the two components. \nThe stand- alone selling prices are determined to be $495,000 (lease) and \n$30,000 (maintenance). \n— The estimated stand- alone selling price of maintenance equals the \nestimated actual maintenance cost reimbursements plus an assumed \nmarket-based profit margin for the maintenance. \n— The estimated stand- alone selling price of the lease is an estimate of what \na lessor would charge for the lease without providing maintenance. Unlike Examples 4.2.30 and 4.2.40, LR’s estimated stand- alone sell ing price does \nnot include recovery of property tax and insurance costs ; this is because \nthey are LE costs in this example. \nIn contrast, if LR elects not to separate the lease and the maintenance components of this contract, and the two components qualify for combination, \nthere is no allocation of the consideration in the contract or the variable \npayments between the lease and the maintenance. \nLessor LR separates lease and non -lease components \nThe following is an example of how the allocation requirements may be applied; \nother methods may be appropriate based on the facts and circumstances. \nThe consideration in the contract for LR is measured at $519,500. \nLR begins by allocating to the maintenance the variable payments specifically \nrelated to its efforts to satisfy th at non-lease component. Allocation of only the \nvariable maintenance payments to the maintenance component would be inconsistent with the allocation objective in paragraph 606- 10-32-28. This is \nbecause LR is billing only its costs with no assumption of profit, and therefore \nthe variable payments alone do not reflect the price at which LR would sell \nmaintenance separately to a customer. Therefore, the remaining consideration \nin the contract ($493,500, which does not include variable payments for t axes ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 189}), Document(page\_content='Leases 189 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. and insurance) is allocated on a relative stand- alone selling price basis, after \nadjusting for the variable payments that have been specifically allocated to the \nnon-lease component. \nLR allocates the consideration in the contract to the lease and the maintenance \ncomponent as follows. \nComponent Stand -alone price Allocation Calculation \nLease $495,000 $489,544 (495,000 / 499,0001) × 493,500 \nMaintenance 30,000 29,956 (4,000 / 499,0001) × 493,500 + \n26,000 \n $525,000 $519,500 \nThe allocation results in approximately 94% and 6% of the consideration in the \ncontract being allocated to the lease component and the maintenance, \nrespectively. \nNote: \n1. The total of the stand- alone selling prices used in the calculations ($499,000) has been \nadjusted to remove the $26,000 that has already been specifically allocated to the non-\nlease maintenance component ($525,000 total stand- alone selling price less the amount \nof variable consideration attributed to the non -lease component of $26,000). \nLessor LR elects not to separate lease and non -lease components \nThe consideration in the contract for LR is measured at $493,500 . \nBecause (1) LR elects not to separate the lease component and the \nmaintenance non- lease component, and (2) the maintenance is not the \npredominant element of the combined lease/maintenance component, the \nentire consideration in the contract of $493,500 is allocated to the single lease \ncomponent. \nAccounting for lease and non -lease components \nLessor LR separates lease and non -lease components \nBecause the lease is an operating lease, LR continues to recognize \nand depreciate the underlying asset. At lease commencement, consistent with \nExample 4.2.40, LR defers the $5,000 of initial direct costs and amortizes them \nto expense over the lease term on the sa me basis as the lease income (i.e. \n$1,000 of amortization each year). If a portion of the broker’s commission had \nbeen allocated to the maintenance (non- lease component), those costs \nwould not be initial direct costs but rather would be accounted for under \nSubtopic 340 -40. \nLR recognizes lease income of $489,544 (which is net of an allocated amount of \nthe $7,500 lease incentive paid) on a straight -line basis over the lease term – i.e. \n$97,909 of lease income per year. \nLR recognizes the consideration in the contract allocated to the maintenance \n(non- lease component) of $29,956 (i.e. maintenance revenue) on a straight -line \nbasis (i.e. using a time -elapsed measure of progress, determined to be \nappropriate under paragraphs 606-10-25-31 – 25-37). Estimates of the variable \nconsideration that will be earned for maintenance will need to be updated each \nreporting period under paragraph 606- 10-32-14. Changes in the consideration in ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 190}), Document(page\_content='Leases 190 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the contract are allocated to the lease and/or non -lease components based on \nthe guidance for changes in the transaction price in Topic 606. Consequently, \nchanges in the consideration in the contract as a result of changes to the \nestimate of maintenance reimbursements will be allocated entirely to the \nmaintenance non- lease component, consistent with how the consideration in \nthe contract was originally allocated. \nAs explained earlier in this example, because the property tax and insurance \ncosts are LE costs (rather than LR costs), neither the costs, nor LE’s payments \nthereof, are reflected in LR’s accounting for the lease. \nLessor LR elects not to separate lease and non -lease components \nBecause the lease is an operating lease, LR continues to recognize \nand depreciate the underlying asset, and defer and amortize the initial direct \ncosts over the lease term. \nLR recognizes lease income of $493,500 on a straight -line basis over the lease \nterm – i.e. $98,700 of lease income per year. Because LR accounts for the \nlease and the maintenance as a single, combined lease component, the variable \npayments LE will make to LR for maintenance are accounted for entirely as \nvariable lease payments, which means they: \n— do not change the consideration in the contract when they become owed to LR; and \n— are recognized as variable lease income when the changes in facts and \ncircumstances on which the payments are based occur. \nNeither the property tax and insurance costs, nor LE’s payments thereof, are \nreflected in LR’s accounting for the lease. \n \nSales and other similar taxes \n4.2.170 ‘Sales and other similar taxes ’ refers to taxes assessed by a \ngovernmental authority that are both imposed on and concurrent with a spec ific \nlease revenue- producing transaction. Other similar taxes include use, value \nadded taxes (VAT) and some excise taxes. Such taxes exclude (1) gross \nreceipts taxes and (2) taxes assessed on the lessor as owner of the underlying \nasset. Question 5.2.05 and Example 5.2.05 in KPMG Handbook, Revenue \nRecognition, provide additional guidance on identifying ‘sales and other similar \ntaxes’. [842- 10-15-39A] \n4.2.180 Taxes assessed on the lessor as owner of the underlying asset include \n(not exhaustive): \n— most property taxes; and \n— sales taxes assessed on the owner’s purchase of the underlying asset. \n4.2.190 Sales and other similar taxes are incurred differently in diff erent \njurisdictions. In some jurisdictions, the prevailing tax rate is applied to each lease payment throughout the lease term – e.g. X% of each lease payment. In \nother jurisdictions, tax is incurred before lease commencement and is based on, for example, the purchase price of the underlying asset or the total gross lease payments that will be made over the lease term. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 191}), Document(page\_content='Leases 191 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 4.2.200 After the issuance of ASU 2018- 20 in December 2018, lessors only, as \nan accounting policy election applied to all leases, may choos e to present all \nfunds collected from lessees for sales and other similar taxes net of the related \nsales tax expense. A lessor electing this practical expedient must disclose its \npolicy election and comply with the disclosure requirements in Topic 235. \n[842-10-15-39A, 842- 30-50-14] \n4.2.210 A lessor that does not elect the practical expedient assesses whether all \nsales and other similar taxes are lessee or lessor costs in the same way as it \ndoes for property taxes (see Question 4.2.40) , and then accounts for those \ntaxes and the lessee’s payment thereof as prescribed in paragraph 4.2.150 (if \nthe tax is a lessee cost) or paragraph 4.2.160 (if the tax is a lessor cost) . \n4.2.22 0 Sections 13A.4.3 (effective date transition method) and 13B.4.3 \n(comparative transition method) discuss the effective date and transition \nprovisions applicable to ASU 2018- 20. \n \n Question 4.2. 60 \nSales and other similar taxes \nAre sales and other similar taxes paid by the lessee part of \nthe consideration in the contract? \nInterpretive response: The accounting for sales and other similar taxes is \ndifferent for the lessee versus the lessor. \nLessee accounting \nWe believe the appropriate accounting by a lessee for it s tax payments \ndepends on whether: \n— the lessee or the lessor is the primary obligor for the tax; and \n— the tax is incurred at or before lease commencement or over the lease \nterm. \nLessee is the primary obligor \nThe tax amount paid is not part of the ‘consideration in the contract’, whether \nfixed or variable. The lessor, when it collects and remits the sales tax to the \ntaxing authority, is merely a collection agent for the taxing authority. As \nsummarized in the following table, the appropriate lessee accounti ng is based \non when the tax liability is incurred by the lessee. \nTax is incurred: \nOver the lease term At or before lease commencement \nThe tax is a variable, executory (non -\nlease) cost of the lessee that should be \naccounted for in the same manner as any \nother period cost. It should not be capitalized as part of the cost of the ROU \nasset. Consistent with the lessee’s accounting \npolicy elected in accordance with Question 5.1.10, the tax should be either: \n— capitalized as part of the cost of the \nROU asset by analogy to the \nguidance in Topic 360 (property, \nplant and equipment); or \n— expensed as incurred. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 192}), Document(page\_content='Leases 192 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Tax is incurred: \nOver the lease term At or before lease commencement \nEven if the tax will be paid over time, the \nobligation to make the fixed tax payments \nover time should be recognized at lease \ncommencement. However, the \ncorresponding liability is not a part of the \nlease liability because the tax payments \nare not ‘lease payments’ ( because the tax \nis a lessee cost). Instead, the obligation to make the fixed tax payments over time \nshould be recognized as a separate \nfinancial liability. \nLessor is the primary obligor \nIf the lessee pays the lessor’s tax obligation (i.e. the tax is a lessor cost – see \nQuestion 4.2.40) on a nonrefundable basis, the following table summarizes the \nlessee’s accounting. This accounting applies regar dless of whether payment is \nmade to the lessor or directly to a taxing authority (or other third party). \nTax is incurred: \nOver the lease term At or before lease commencement \nThe lessee’s tax payments are variable \npayments not part of the consideration in \nthe contract that should be accounted for as outlined in section 4.4.3. It is part of the consideration in the \ncontract and accounted for in the same \nmanner as any other amount that is part of the consideration in the contract. \nLessor acc ounting \nA lessor’s accounting first depends on whether the lessor elects the sales and \nother similar taxes practical expedient (see paragraphs 4.2.200 – 4.2.210) . \nLessor elects the practical expedient – in-scope taxes \nThe lessor accounts for all ‘in -scope’ taxes ( see paragraphs 4.2.170 – 4.2.180) \nas lessee costs, rather than evaluating whether each tax in each taxing \njurisdiction is a lessee or a lessor cost; this is regardless of who remits payment \nof the tax to the taxing authority. \nThis means that the tax and the lessee’s payment thereof will be presented net \nof each other (i.e. with zero effect) in the lessor’s income statement. \nLessor elects the practical expedient – out-of-scope taxes \nEven if a lessor has elected the sales and other similar taxes practical \nexpedient, it follows the guidance for a lessor that has not elected the practical \nexpedient (see below) for out-of-scope taxes. Paragraphs 4.2.170- 4.2.180 \naddress in- scope and out -of-scope taxes. \nLessor does not elect the practical expedient \nThe first step for a lessor that does not elect the practical expedient is to \ndetermine whether the applicable tax is a lessee or a lessor cost. This approach \nalso applies to taxes that are outside the scope of the practical expedient \nregardless of the lessor’s election. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 193}), Document(page\_content='Leases 193 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The tax is a lessee cost if the lessee remits the tax directly to the relevant \ntaxing authority. In contrast, the tax is a lessor cost if the lessor remits the tax \nto the taxing authority and receives reimbursement for the tax amount from the \nlessee (see Question 7.3. 60). It does not matter which party (lessee or lessor) is \nprimarily obligated for the tax. [842- 10-15-40A] \nIf the tax is a lessee cost \nThe lessor’s accounting for the tax and the lessee’s payment thereof is the same as for in -scope taxes for a lessor that elects the sales and other similar \ntaxes practical expedient. The tax and the lessee’s payment thereof will be \npresented net of each other (i.e. with zero effect) in the lessor’s income \nstatement. \nIf the tax is a lessor cost \nThe lessor’s accounting for the tax will depend on when the tax is incurred and \nwhether the lessor is a manufacturer or dealer. The following table summarizes \nthe accounting that we believe applies. \nTax is incurred: \nOver the lease \nterm At or before lease \ncommencement \n(manufacturer or dealer \nlessor ) At or before lease \ncommencement (non -\nmanufacturer or dealer \nlessor ) \nThe lessor should \nfollow the guidance \non lessee payments \nof lessor costs in \nparagraph 7.3.190 — Operating lease. The tax \nis capitalized as part of \nthe cost basis of the \nunderlying asset. It \nshould be accounted for \nin the same way as the \nremainder of the asset’s \ncost over its useful life. \n— Sales -type or direct \nfinancing lease. The tax \nshould be expensed at lease commencement because it is part of the \ncost basis of the asset \n(which will be derecognized) , but \ncannot be included as \npart of the lessor’s net \ninvestm ent in the lease. — Operating lease. Same \nas for manufacturer or dealer lessors. \n— Sales -type or direct \nfinancing lease. The tax \ncost is included in the \nfair value of the \nunderlying asset (see \nparagraph 7.3.41 ), and \ntherefore capitalized as \npart of the net investment in the lease. \nAs a result, it will be \nrecognized as a reduction \nto interest income \nearned on the lease over \nthe lease term in the \nsame manner as an initial \ndirect cost. \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 194}), Document(page\_content='Leases 194 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 4.2. 70 \nRefundable and nonrefundable VAT \nWhat is the appropriate lessee and lessor accounting for \nrefundable and nonrefundable VAT? \nBackground: A value -added tax (VAT) is a type of consumption tax that is \nplaced on a product whenever value is added at a stage of production and at the \npoint of retail sale. \nVAT is charged based on the value added at each stage of production. VAT is \nassessed and collected on the value of goods or services that have been \nprovided every time there is a transaction (sale/purchase). The seller charges \nVAT to the buyer, and the seller pays this VAT to the government. If, however, \nthe purchasers are not the end users, but the goods or services purchased are costs to their business, the tax they have paid for such purchases can be \ndeducted from the amounts they charge to t heir customers when the tax is \nremitted to the government. The government receives only the difference – i.e. \nVAT is a tax paid on the gross margin of each transaction, by each participant in \nthe sales chain. \nThe characteristics of VAT vary by jurisdiction . However, assume the following \ngeneral characteristics for purposes of this discussion. \n— The tax applies to goods and services consumed in the applicable jurisdiction. \n— Either the lessor or the lessee may be the primary obligor to the taxing authority for the VAT. For example, in many cases the lessor is responsible \nfor ensuring that the VAT is remitted – i.e. it is the lessor that the taxing \nauthority will take action against if the VAT is not paid. In other cases the taxing authority will hold the lessee responsible for ensuring that the VAT \nis remitted. \n— For purchases of goods and services to which VAT applies, the customer is \nobligated to pay VAT to the supplier, and the supplier is obligated to collect the VAT and remit it to the taxing authority. \n— Busin esses will charge tax on their sales and usually will be able to recover \nthe tax paid on goods and services used in the course of doing business \n(input tax credits) – i.e. the amounts are refundable. However, in some \ncases the customer cannot recover the V AT paid – i.e. the VAT is \nnonrefundable. This can occur, for example, because the customer’s \nrevenue- generating activities are not subject to VAT. \n— In leasing transactions, VAT is typically incurred over the lease term, \nconsistent with how VAT is incurred on service transactions. However, if \nthe lease is akin to a sale of the underlying asset, the VAT generally is \nincurred at lease commencement. \nInterpretive response: We believe the accounting for VAT is substantially the \nsame as that for sales taxes. Theref ore, entities that incur VAT and make or \nreceive VAT payments in connection with a lease on a nonrefundable basis \nshould follow the guidance in Question 4.2.60. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 195}), Document(page\_content='Leases 195 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. VAT is refundable \nIf the VAT is refundable, the lessee’s payment of the VAT will neither trigger \nincome statement recognition by the lessee, nor be capitalized as part of the \ncost of the ROU asset. This is because the VAT is not truly a cost of the lessee \nif it will be refunded. The VAT should be accounted for as it would any other \nrefundable payment. \nFor the lessor, lessee VAT payments to the lessor that will be refunded to the \nlessee should be presented net in the lessor’s income statement – i.e. no lease \nrevenue or tax expense. This is regardless of whether the lessor elects the sales and other si milar taxes practical expedient. \n \n Comparison to legacy US GAAP \nAccounting for property taxes and insurance \nFinance (sales -type/direct financing leases) \n4.2.230 Under Topic 840, executory costs for property taxes or insurance \n(whether fixed or variable) were excluded from the measurement of the capital \nlease asset and capital lease obligation (lessees) and the net investment in the \nlease (lessors ). [840- 10-25-1(d), 840- 30-30-1 – 30-2] \n4.2.240 In contrast, under Topic 842, lessee payments of lessor property taxes \nor insurance, if fixed, are part of the ‘consideration in the contract’. \nConsequently, all or a portion (if the contract includes one or more non- lease \ncompone nts) of such payments are allocated to the lease component(s) of the \ncontract, considered ‘lease payments’, and included in the measurement of (1) \nthe lessee’s ROU asset and finance lease liability and (2) the lessor’s net \ninvestment in the lease. \n4.2.250 As a result, the lease assets and lease liabilities for lessees and lessors may \nbe larger in gross finance (sales -type/direct financing) lease scenarios under \nTopic 842 than they were under Topic 840; barring other measurement differences \nsuch as with re spect to residual value guarantees, which will generally result in \nlarger lease assets and liabilities under Topic 840 (see section 5.4.6). \nOperating leases \n4.2.260 Under Topic 840, ‘minimum rental payments’ was not a defined term. As \ndiscussed in Questions 13A.3.10 and 13B.3.10, some entities interpreted the \nminimum rental payments to include fixed payments required by the lease contract for executory costs such as proper ty taxes and insurance, while others interpreted \nminimum rental payments to exclude those amounts. \n[840- 10-25-5(b), 25- 6] \n4.2.270 Topic 842 treats lessee payments of lessor property taxes or \ninsurance in the same manner regardless of the classification of the lease ( see \nparagraph 4.2.140 for finance ( and sales- type/direct financing) leases ). \nConsequently, ignoring other potential effects (e.g. resulting from differences in the accounting for residual value guarantees – see section 5.4.6), the lease \npayment s under Topic 842 will differ from the minimum rental payments. \nThat is, ignoring other potential differences: ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 196}), Document(page\_content='Leases 196 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — If the lessee excluded fixed executory costs from minimum rental \npayments (see Questions 13A.3.10 and 13B.3.10) , the lease payments \nunder Topic 842 will be greater than the minimum rental payments. \n— If the lessee included fixed executory costs in minimum rental payments, \nthe lease payments under Topic 842 will be less than the minimum rental payments when there are non- lease components of the contra ct. \nLease classification \n4.2.280 Under Topic 840, l essee payments of executory costs for property taxes \nor insurance, if fixed (e.g. in a gross lease), were excluded from the ‘minimum \nlease payments’ for purposes of determining lease classification – i.e. in \nperforming the 90 percent test. [840- 10-25-1(d)] \n4.2.290 In contrast, under Topic 842, the portion of those payments that are \nconsidered ‘lease payments’ are not excluded from the lease classifica tion test \n– they are included when determining whether the present value of the sum of \nthe lease payments and any residual value guaranteed by the lessee (or a third \nparty) that is not already reflected in the lease payments in accordance with \nparagraph 842 -10-30-5(f) equals or exceeds substantially all of the fair value of \nthe underlying asset. Consequently, a lease with fixed payments for property taxes or insurance may meet the lease payments criterion in paragraph 842- 10-\n25-2(d) or paragraph 842- 10-25-3(b)(1) even though it would not have met the \n90 percent test in paragraph 840- 10-25-1(d). \n \n4.3 Step 3: Measure the c onsideration in the c ontract \n Excerpt from ASC 842 -10 \n30 Initial Measurement \nGeneral \n> Initial Measurement of the Lease Payments \n30-5 At the commencement date , the lease payments shall consist of the \nfollowing payments relating to the use of the underlying asset during the \nlease term : \na. Fixed payments, including in substance fixed payments, less any lease \nincentives paid or payable to the lessee (see paragraphs 842- 10-55-30 \nthrough 55- 31). \nb. Variable lease payments that depend on an index or a rate (such as the \nConsumer Price Index or a ma rket interest rate), initially measured using \nthe index or rate at the commencement date. \nc. The exercise price of an option to purchase the underlying asset if the \nlessee is reasonably certain to exercise that option (assessed considering \nthe factors in par agraph 842- 10-55-26). \nd. Payments for penalties for terminating the lease if the lease term (as \ndetermined in accordance with paragraph 842- 10-30-1) reflects the lessee \nexercising an option to terminate the lease. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 197}), Document(page\_content='Leases 197 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. e. Fees paid by the lessee to the owners of a special -purpose entity for \nstructuring the transaction. However, such fees shall not be included in the \nfair value of the underlying asset for purposes of applying paragraph 842-\n10-25-2(d). \nf. For a lessee only, amounts probable of being owed by the lessee under \nresidual value guarantees (see paragraphs 842 -10-55-34 through 55 -36). \n15 Scope and Scope Exceptions \nGeneral \n> Separating Components of a Contract \n>> Lessee \n15-35 The consideration in the contract for a lessee includes all of the \npayments described in paragraph 842- 10-30-5, as well as all of the following \npayments that will be made during the lease term : \na. Any fixed payments (for example, monthly service charges) or i n substance \nfixed payments, less any incentives paid or payable to the lessee, other \nthan those inc luded in paragraph 842- 10-30-5 \nb. Any other variable payments that depend on an index or a rate, initially \nmeasured using the index or rate at the commencement date . \n15 Scope and Scope Exceptions \nGeneral \n> Separating Components of a Contract \n>> Lessor \n15-39 The consideration in the contract for a lessor includes all of the amounts \ndescribed in paragraph 842 -10-15-35 and any other variable payment amounts \nthat would be included in the transaction price in accordance with the guidance \non variable consideration in Topic 606 on revenue from contracts with \ncustomers that specifically relates to either of the following: \na. The lessor’s efforts to transfer one or more goods or services that are not \nleases \nb. An outcome from transferring one or more goods or services that are not \nleases. \nAny variable payment amounts accounted for as consideration in the contract \nshall be allocated entirely to the nonlease component(s) to which the variable \npayment specifically relates if doing so would be consistent with the \ntransaction price allocation objec tive in paragraph 606- 10-32-28. \n15-39A A lessor may make an accounting policy election to exclude from the \nconsideration in the contract and from variable payments not included in the \nconsideration in the contract all taxes assessed by a governmental authority \nthat are both imposed on and concurrent with a specific lease revenue-\nproducing transaction and collected by the lessor from a lessee (for example, \nsales, use, value added, and some excise taxes). Taxes assessed on a lessor’s \ntotal gross receipts or on the lessor as owner of the underlying as set shall be \nexcluded from the scope of this election. A lessor that makes this election shall \nexclude from the consideration in the contract and from variable payments not \nincluded in the consideration in the contract all taxes within the scope of the ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 198}), Document(page\_content='Leases 198 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. election and shall comply with the disclosure requirements in paragraph 842 -\n30-50-14. \n15-40 If the terms of a variable payment amount other than those in \nparagraph 842-10-15-35 relate to a lease component, even partially, the lessor \nshall not recognize those payments before the changes in facts and \ncircumstances on which the variable payment is based occur (for example, \nwhen the lessee’s sales on which the amount of the variable payment \ndepends occur). When the changes in facts and circumstances on which the \nvariable payment is based occur, the lessor shall allocate those payments to \nthe lease and nonlease components of the contract. The allocation shall be on \nthe sam e basis as the initial allocation of the consideration in the contract or \nthe most recent modification not accounted for as a separate contract unless \nthe variable payment meets the criteria in paragraph 606- 10-32-40 to be \nallocated only to the lease component(s). Variable payment amounts allocated \nto the lease component(s) shall be recognized as income in profit or loss in \naccordance with this Topic, while variable payment amounts allocated to \nnonlease component(s) shall be recognized in accordance with ot her Topics \n(for example, Topic 606 on revenue from contracts with customers). \n15-40A The guidance in paragraph 842- 10-15-40 notwithstanding, a lessor shall \nexclude from variable payments lessor costs paid by a lessee directly to a third \nparty. However, cos ts excluded from the consideration in the contract that are \npaid by a lessor directly to a third party and are reimbursed by a lessee are \nconsidered lessor costs that shall be accounted for by the lessor as variable \npayments (this requirement does not prec lude a lessor from making the \naccounting policy election in paragraph 842 -10-15-39A). \n55 Implementation Guidance and Illustrations \nGeneral \n> Illustrations \n>> Illustrations of Allocating Consideration to Components of a \nContract \n>>> Example 14 —Determining the Consideration in the Contract —\nVariable Payments \n>>>> Case A—Variable Payments That Relate to the Lease Component \nand the Nonl ease Component \n55-150 Lessee and Lessor enter into a three- year lease of equipment that \nincludes maintenance services on the equipment throughout the three- year \nlease term. Lessee will pay Lessor $100,000 per year plus an additional $7,000 \neach year that the equipment is operating a minimum number of hour s at a \nspecified level of productivity (that is, the equipment is not malfunctioning or \ninoperable). The potential $7,000 payment each year is variable because the \npayment depends on the equipment operating a minimum number of hours at \na specified level of productivity. The lease is an operating lease. \n55-151 In accordance with paragraph 842- 10-15-35, variable payments other \nthan those that depend on an index or a rate are not accounted for as \nconsideration in the contract by Lessee. Therefore, the consideration in the \ncontract to be allocated by Lessee to the equipment lease and the ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 199}), Document(page\_content='Leases 199 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. maintenance services at lease commencement includes only the fixed \npayments of $100,000 each year (or $300,000 in total). Lessee allocates the \nconsideration in the contract to the equipment lease and the maintenance \nservices on the basis of the standalone prices of each, which, for purposes of \nthis example, are $285,000 and $45,000, respectively. \n Standalone \nPrice Relative \nStandalone \nPrice \nLease $ 285,000 $ 259,091 \nMaintenance 45,000 40,909 \n $ 330,000 $ 300,000 \nEach $100,000 annual fixed payment and each variable payment are allocated \nto the equipment lease and the maintenance services on the same basis as the \ninitial allocation of the consideration in the contract (that is, 86.4 percent to the \nequipment lease and 13.6 percent to the maintenance services). Therefore, \nannual lease expense, excluding variable expense, is $86,364. Lessee \nrecognizes the expense related to the variable payments in accordance with \nparagraphs 842- 20-25-6 and 842- 20-55-1 through 55- 2. \n55-152 In accordance with paragraphs 842- 10-15-39 through 15- 40, Lessor also \nconcludes that the potential var iable payments should not be accounted for as \nconsideration in the contract. That is because the potential variable payment \neach year is not solely related to performance of the nonlease maintenance \nservices; the quality and condition of the underlying ass et also substantively \naffect whether Lessor will earn those amounts. Therefore, Lessor’s allocation \nof the consideration in the contract ($300,000) in this Example is the same as \nLessee. Lessor will allocate, in accordance with paragraph 842- 10-15-40, the \nvariable payments between the lease and nonlease maintenance services (on \nthe same basis as the initial allocation of the consideration in the contract), \nwhen and if the productivity targets are met. Lessor will recognize the portion \nallocated to the lease at that time and will recognize the portion allocated to \nthe nonlease maintenance services in accordance with the guidance on \nsatisfaction of performance obligations in Topic 606 on revenue from contracts \nwith customers . \n>>>> Case B —Variable Payments That Relate Specifically to a Nonlease \nComponent \n55-153 Assume the same facts and circumstances as in Case A \n(paragraphs 842-10-55-150 through 55- 152), except in this scenario the \nmaintenance services are highly specialized and no entity would expect the \nequipment to meet the performance metrics without the specialized \nmaintenance services. \n55-154 Lessee would account for the potential variable payments consistent \nwith Case A. The rationale for this accounting also is consistent with that in \nCase A. \n55-155 In contrast to Case A, Lessor concludes that the variable payments \nrelate specifically to an outcome from Lessor’s performance of its maintenance \nservices. Therefore, Lessor evaluates the variable payments in accordance \nwith the variable consideration gui dance in paragraphs 606 -10-32-5 through 32 -', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 200}), Document(page\_content='Leases 200 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13. If Lessor estimates, using the most likely amount method, that it will be \nentitled to receive the $21,000 in variable payments and that it is probable that \nincluding that amount in the transaction price for the maintenance services \nwould not result in a significant revenue reversal when the uncertainty of the \nperformance bonus is resolved, the $21,000 would be included in the \nconsideration in the contract. Because allocating the $21,000 entirely to the \nmaintena nce services would not result in an allocation that is consistent with \nthe allocation objective in paragraph 606- 10-32-28 (that is, it would result in \nallocating $61,909 to the maintenance services and the remainder to the \nequipment lease, which would not reasonably depict the consideration to \nwhich Lessor expects to be entitled for each component), the entire \nconsideration in the contract of $321,000 is allocated on a relative standalone \nprice basis as fol lows. \n Standalone \nPrice Relative \nStandalone \nPrice \nLease $ 285,000 $ 277,227 \nMaintenance 45,000 43,773 \n $ 330,000 $ 321,000 \n 55-156 The $277,227 allocated to the equipment lease is the lease payment in \naccounting for the lease in accordance with Subtopic 842- 30. Lessor will \nrecognize the consideration in the contract allocated to the maintenance \nservices in accordance with the guidance on the satisfaction of performance \nobligations in paragraphs 606- 10-25-23 through 25 -37. If the consideration in \nthe contract changes (for example, because Lessor no longer estimates that it \nwill receive the full $21,000 in potential variable payments), Lessor will allocate \nthe change in the transaction price on the same basis as was initially done. \n>>>> Case C —Allocating Variable Payments Entirely to a Nonlease \nComponent \n55-157 Assume the same facts and circumstances as in Case B \n(paragraphs 842-10-55-153 through 55- 156), except that in this scenario all \nof the following apply: \na. The potential variable payments are $14,000 per year ($42,000 in total), and \nthe annual fixed payments are $93,000 per year ($279,000 in total). \nb. While Lessor’s estimate of the variable payments to which it will be \nentitled is $42,000, Lessor concludes that it is not probable that including \nthe full $42,000 in potential variable payments in the consideration in the \ncontract will not result in a significant revenue reversal (tha t is, the entity \napplies the constraint on variable consideration in paragraph 606- 10-32-11). \nLessor concludes that only $28,000 is probable of not resulting in a \nsignificant revenue reversal. Therefore, the consideration in the contract is \ninitially $307, 000 ($279,000 + $28,000). \n55-158 In contrast to Case B, Lessor concludes that allocating the variable \npayments entirely to the maintenance services and the fixed payments entirely to \nthe equipment lease is consistent with the allocation objective in paragraph 606 -\n10-32-28. This is because $42,000 (Lessor considers its estimate of the variable \npayments to which it expects to be entitled exclusive of the constraint on variable ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 201}), Document(page\_content='Leases 201 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. conside ration in Topic 606 on revenue recognition) and $279,000 approximate the \nstandalone price of the maintenance services ($45,000) and the equipment lease \n($285,000), respectively. Because the variable payments are allocated entirely to \nthe maintenance servic es, if the consideration in the contract changes (for \nexample, because Lessor concludes it is now probable that it will earn the full \n$42,000 in variable payments), that change is allocated entirely to the maintenance \nservices component in the contract. \n \n4.3.1 Lessee \n4.3.10 The starting point for a lessee measuring the consideration in the contract \nis the defined payments in paragraph 842- 10-30-5 relating to the use of the \nunderlying asset (see section 5.4), which are then adjusted as follows . \n[842- 10-15-35] \n \nPayments related to the use of the underlying asset\nOther fixed or in -substance fixed payments \nOther variable payments that depend on an index or rate1\nIncentives paid or payable to the lessee2\nConsideration in the contract (lessee ) \nNotes: \n1. The payments are calculated using the commencement date index or rate. \n2. Other th an those included in paragraph 842 -10-30-5. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 202}), Document(page\_content='Leases 202 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 4.3.20 As this calculation illustrates, not all payments contemplated in the \ncontract are included. For example, a fixed monthly service charge is included, \nbut a variable monthly service charge that does not depend on an index or rate \nis not included. The following concepts that apply to determining the lease \npayments also apply in determining whether other payments should be \nincluded in the consideration in the contract . \n— Determining whether a payment is in- substance fixed. \n— Determining whether a payment is based on an i ndex or a rate and \ncalculating the amount to include in the calculation. \n— The approach to, and logic for, adjusting for incentives. \nSee section 5.4 for further guidance on determining lease payments. \n4.3.30 A payment made by a lessor to a lessee is an ince ntive, reducing the \nconsideration in the contract, unless the payment is for a distinct good or \nservice provided by the lessee to the lessor – e.g. for construction of, or \nmanaging the construction of, the lessor’s asset. In addition, even if the lessee \nprovides a distinct good or service to the lessor, any amount of the lessor’s \npayment in excess of the fair value of the distinct good( s) or service (s) provided \nis an incentive. [842- 10-15-35(a) , 606-10-32-25 – 32-26] \n4.3.40 Once the amount of consideration in the contract has been measured, it \nis allocated to the lease and non- lease components of the contract in Step 4 \n(see section 4.4). The accounting for amounts payable under the contract that are not included in the considerat ion in the contract is discussed in \nsection 4.4.3. \n[842- 10-15-30] \n \n4.3.2 Lessor \n4.3.50 As a starting point, a lessor measures the consideration in the contract in \nthe same way as a lessee. However, further adjustments are made as follows. \n[842- 10-15-38 – 15-39, 606- 10-32-8 – 32-14] \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 203}), Document(page\_content='Leases 203 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Consideration in the contract (same as lessee )\nAre there any other variable payments that specifically relate \nto either :\nThe lessor ’s efforts to \ntransfer one or more goods \nor services that are not \nleases ?An outcome from transferring \none or more goods or \nservices that are not leases ?\nApply variable consideration requirements in Topic 606 to \nmeasure the amount to be included in the consideration in the \ncontract :\nStep 2: \nDetermine the portion (if any ) \nof the Step 1 amount for \nwhich it is probable that a \nsignificant revenue reversal \nwill not subsequently occurStep 1: \nEstimate the amount using \nthe expected value or most \nlikely amountPart 1\nConsideration in the \ncontract (lessor )Part 2No adjustment \nnecessaryOR\nYes YesNo\n \n4.3.60 In considering whether any variable payments should be included in the \nconsideration in the contract, the objective in Part 1 of the above flowchart is to \nestablish whether such payments vary solely on the performance of the non-\nlease component(s); for example, do the payments depend solely on the \nlessor’s performance of non- lease services or the delivery or quality of \nconsumables to be used with the leased asset? This is explored in \nExample 4.3.10. [842- 10-55-153 – 55-156] \n4.3.70 The following flowchart sum marizes the lessor’s process for evaluating \nvariable payments in the contract when either: \n— the lessor has elected to separate lease and non- lease components – i.e. \nhas not elected the practical expedient outlined in paragraphs 4.4.51 – \n4.4.5 6; or \n— the contr act contains at least one lease component (including a combined \nlease component) and one or more non- lease components that do not \nqualify to be combined with the lease component based on the criteria in \nparagraph 4.4.51. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 204}), Document(page\_content='Leases 204 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Does the variable \npayment depend \non an index or \nrate?\nDoes the variable \npayment relate to a \nlease component \neven partially ?\nThe variable \nconsideration \nrelates specifically \nto a non -lease \ncomponent The variable payment is part of the \nconsideration in the contract , measured \nusing the index or rate at lease \ncommencement\nExclude the variable \npayment from the \nmeasurement of the \nconsideration in the \ncontract\n When changes in facts /circumstances \nupon which variable payment \nis based occur , allocate variable consideration\nto the lease and non -lease components based \non the initial relative stand -alone price \nallocation (or most recent allocation if the \ncontract has been modified )\nIs allocation of the \nvariable consideration \nentirely to the non -\nlease component \nconsistent with \nparagraph \n606-10-32-40(b)?Allocate the variable consideration \nentirely to the non -lease component . \nIf the non -lease component is a series \n(see paragraph 606-10-25-14(b)),\n it may not be necessary to estimate \nthe variable consideration\nEstimate the variable consideration \nin accordance with 606-10-32-5 – 32-14 \nand allocate to the lease component and \nthe non -lease component on same\nbasis as the remainder of the\n consideration in the contractYes\nNo\nNoYes\nNoYes\n \n4.3.75 If a lessor has elected to not separate lease and non- lease \ncomponents that qualify for the non- separation practical expedient outlined in \nparagraphs 4.4.51 – 4.4.56 , and, as a result, the contract contains only (1) lease \ncomponents or (2) non -lease performance obligations accounted for under \nTopic 606, the model flowcharted in the preceding paragraph does not apply. \nRather , if application of the practical expedient results in only : [842-10-15-42B, \nASU 2018- 11.BC33, 842-10-15-40] \n— Lease components , all variable payments that do not depend on an index \nor rate (and are not in- substance fixed payments) are excluded from the \nmeasurement of the consideration in the contract, r egardless of whether \nthere are variable payments that relate specifically to a non- lease element ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 205}), Document(page\_content='Leases 205 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. of the combined component (or an outcome from transferring a non -lease \nelement that is part of the combined component) . \n— Topic 606 performance obligations , then all variable payments are \naccounted for in accordance with t he variable consideration transaction \nprice guidance in Topic 606 (see chapter 5 of KPMG Handbook, Revenue \nrecognition) , even if t hose variable payments relate (wholly or partially) to \nthe lease element of the combined performance obligation (component). \n[606- 10-32-5 – 32-14] \n \n Question 4.3.10 \nMeasuring consideration in a contract with variable \npayments \nWhat types of variable payments are excluded from the \nconsideration in the contract? \nInterpretive response: The following types of variable payments are excluded \nfrom the consideration in the contract. \nLessee \n— Variable payments that do not depend on an index or rate – e.g. property \ntax and insurance reimbursem ents and rental payments based on the use \nof the underlying asset. [842- 10-15-35] \nLessor \n— Variable payments specifically or partially related to a lease component(s) \nthat do not depend on an index or rate – e.g. property tax and insurance \nreimbursements and rental payments based on use of the underlying asset. \nThis includes all variable payments that relate to a combined operating \nlease component (see paragraph 4.3.75) . [842- 10-15-40] \n— Variable payments that, while specifically related to one or more non-lease \ncomponents , if included in the consideration in the contract, give rise to a \nmore- than- remote possibility that the lessor will have a significant revenue \nreversal (see Question 4.5.10) . \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 206}), Document(page\_content='Leases 206 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 4.3.20 \nVariable payments for CAM in a net lease \nAre variable payments for CAM included in the consideration \nin the contract when amounts that will be billed are unknown \nat lease commencement? If so, how are those amounts \nmeasured? \nInterpretive response: \nLessee \nNo. Expected variable payments for CAM during t he lease term, even if virtually \ncertain to be incurred, are not included in the consideration in the contract. \n[842- 10-15-35] \nLessor \nYes. The lessor’s estimate of variable CAM charges is included in the \nconsideration in the contract , unless the CAM is par t of a combined operating \nlease component (see paragraphs 4.4.53 – 4.4.5 5). This is because variable \nCAM charges specifically relate to the CAM non-lease component . The lessor’s \nestimate of CAM charges to which it will be entitled during the lease term is \ndetermined based on the guidance in paragraphs 606- 10-32-5 – 32-14 – i.e. \nbased on a most likely amount or expected value method estimate, subject to the constraint on variable consideration. \n[842- 10-15-39] \nUnder some lease contracts the lessor may bill for other non- lease items \ntogether with, or characterized as, CAM that are not part of CAM (see \ndiscussion in Question 4.2.20) . For example, utilities for a retail or office space \nmay be provided to the lessee by the lessor and billed together with, or as pa rt \nof, CAM. In the case of non- lease goods or services other than CAM such as \nutilities, variable payments that specifically relate to those items will follow the same requirements as for variable payments that are for CAM. \nHowever, lessors should ensure they do not include in their estimate of variable \nCAM charges variable payments for items bundled together with CAM that relate to either lease components or costs that are not components at all (e.g. \nproperty taxes or building insurance), which sometimes may be billed to the \nlessee as part of total charges described as CAM but represent discrete, \nseparately identifiable, components of those total charges . Such amounts are \nnot variable payments for the transfer of a non- lease good or service and \ntherefore are not estimated or included in the consideration in the contract (see Question 4.3.10). \n4.3.80 Once the consideration in the contract has been measured, it is \nallocated to the lease and non- lease components of the contract in Step 4 , \nunless the lessee or lessor non- separation practical expedient is being applied \n(see section 4.4). The accounting for amounts payable under the contract that \nare not included in consideration is discussed in section 4.4.3. [842- 10-15-30] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 207}), Document(page\_content='Leases 207 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 4.3.10 \nMeasuring the consideration in the contract – \nvariable payments \nScenario 1: Variable payments do not specifically relate to non-lease \ncomponent \nLessee LE and Lessor LR enter into a three -year lease of equipment that \nincludes maintenance services on the equipment throughout the lease term. LE \nwill pay LR: \n— a fixed payment of $110,000 per year; and \n— a variable payment of $7,700 each year that the equipment is operational \nfor a minimum number of hours at a specified level of productivity – i.e. the \nequipment is not malfunctioning or inoperable. \nLessee \nLE does not include the variable payments in the consideration in the contract. \nThis is because the variable payments do not depend on an index or rate (and \nare not in -substance fixed). \nTherefore, the consideration in the contract is $330,000 ($110,000 × 3). \nLessor \nLR starts with the amount of consideration determined in the same way as LE \n(i.e. $330,000). \nNext, LR considers the link between the variable payments of $23,100 \n($7,700 × 3) and the performance of the maintenance services. LR concludes \nthat the variable payments do not specifically relate to performance of the \nmaintenance services. The quality and condition of the leased equipment also \nsubstantively affects whether LR will earn the variable amounts. \nTherefore, the variable payments are excluded, and the consideration in the \ncontract is $330,000. The potential $23,100 in variable payments will be \nrecognized when earned. \nThis scena rio is continued in Example 4. 4.30, Scenario 1, which illustrates how \nLR allocates the consideration in the contract ( Step 4 – see section 4.4.2). \nScenario 2: Variable payments specifically relate to non -lease component \n– no amounts constrained \nChanging the facts of Scenario 1, the maintenance services are highly \nspecialized, and no entity would expect the leased equipment to meet the \nspecified performance metrics without the related maintenance services. \nLessee \nThis change in fact pattern makes no difference for LE. The consideration in the \ncontract remains at $330,000. \nLessor (does not elect the practical expedient to not separate the lease \nand maintenance components) \nLR starts with the amount of consideration determined in the same way as LE \n(i.e. $330,000). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 208}), Document(page\_content='Leases 208 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Next, LR considers the link between the variable payments of $23,100 and the \nperformance of the maintenance services. LR concludes that the variable \npayments relate specifically to an outcome dependent on LR’s satisfactory \nperformance of its maintenance services. This is because the maintenance \nservices are highly specialized and critical to the operation of the equipment. \nNext, LR applies the variable consideration requirements in Topic 606 to \ncalculate the amount that should be included in the consideration in the contract: \na. LR estimates that the amount to which it expects to be entitled is $23,100. \nb. LR concludes that it is probable that including that amount in the \ntransaction price for the maintenance services will not result in a significant \nrevenue reversal when the uncertainty is resolved. \nTherefore, the consideration in the contract is $353,100 ($330,000 + $23,100). \nThis scenario is continued in Example 4. 4.30, Scenario 2, which illustrates how \nLR allocates the consideration in the contra ct (Step 4 – see section 4.4.2). \nLessor (elects and qualifies for the practical expedient to not separate the \nlease and maintenance components) \nBecause the maintenance services are not the predominant element of the \ncombined lease/maintenance services component (i.e. LE would ascribe more \nvalue to the lease element) , the combined co. mponent is accounted for as an \noperating lease. Therefore, the consideration in the contract is the same as for \nLE (see paragraph 4.3.75). \nScenari o 3: Variable payments specifically relate to non -lease component \n– amounts partially constrained \nChanging the facts of Scenario 2, LE will pay LR: \n— a fixed pay ment of $102,700 per year; and \n— a variable p ayment of $15,000 each year that the equipment is oper ational \nfor a minimum number of hours at a specified level of productivity – i.e. the \nequipment is not malfunctioning or inoperable. \nLessee \nLE does not include the variable payments in the consideration in the contract. \nThis is because the payments do not depend on an index or rate. \nTherefore, the consideration in the contract is $308,100 ($102,700 × 3). \nLessor (does not elect the practical expedient to not separate the lease \nand maintenance components) \nLR starts with the amount of consideration determined in the same way as LE \n($308,100). \nNext, LR considers the link between the variable payments of $45,000 ($15,000 \n× 3) and the performance of the maintenance services. As in Scenario 2, LR \nconcludes that the variable payments relate specifically to an outcome \ndependent on LR’s satisfactory performance of its maintenance services. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 209}), Document(page\_content='Leases 209 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Next, LR applies the variable considera tion requirements in Topic 606 to \ncalculate the amount that should be included in the consideration in the \ncontract. \na. LR estimates that the amount to which it expects to be entitled is $45,000. \nb. LR concludes that only $30,000 of that amount is probable of not resulting in a significant revenue reversal when the uncertainty is resolved. \nTherefore, the consideration in the contract is $338,100 ($308,100 + $30,000). \nThis scenario is continued in Example 4. 4.30, Scenario 3, which illustrates how \nLR allocates the consideration in the contract ( Step 4 – see section 4.4.2). \nLessor (elects and qualifies for the practical expedient to not separate the \nlease and maintenance components) \nThe analysis and the conclusion are the same as for Scenario 2. \n \n Question 4.3.30 \n‘Free lease’ granted to a supplier \nIs a ‘free’ lease granted to a supplier or a service provider by \nthe customer noncash consideration for the vendor’s goods \nor services? \nBackground: Consider a scenario in which a supplier is a service provider and \nprovides a service to a customer (owner and operator of a building) that involves \nthe placement of equipment in a physically distinct portion of the customer’s \nbuilding. The equipment will a lso benefit parties other than the customer, such \nthat the customer does not have the right to obtain substantially all of the economic benefits from use of the equipment. Therefore, the equipment is not \nbeing leased to the customer. \nFurther, neither the customer nor any other party can use the identified space in \nwhich the equipment is installed. Assume that on the basis of this and other \nfacts, the supplier’s use of the physically distinct portion of the customer ’s \nbuilding meets the definition of a leas e of the identified space from the \ncustomer to the supplier. \nTherefore, there are two elements to the arrangement. \nExplicit :\nImplicit :Services to customer\nLease to supplier \nThe customer will pay the supplier a contractually stipulated monthly service \ncharge (which may be fixed, or va riable based on usage of the service). There is \nno stated consideration for the lease between the customer and the supplier. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 210}), Document(page\_content='Leases 210 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The service period is three years. The question, in this scenario, is whether, as \na result of the property lease: \n— the supplier shou ld account for the property lease as additional \nconsideration for the service, and recognize an ROU asset and a lease liability; and \n— the customer should recognize lease income, along with corresponding \nadditional service expense. \nInterpretive response: Yes. If, as in the background, a supplier is obtaining a \nlease from a customer for no stated consideration, we believe the fair value of \nthe lease should be considered additional, noncash, consideration for the \nvendor’s goods or services. The transaction pric e for the goods or services will \nbe the sum of the cash consideration plus the fair value of the noncash \nconsideration (i.e. the fair value of the lease). The fair value of the lease will \ndrive the initial measurement for the supplier (lessee) of the ROU a sset and \nlease liability. \nCorrespondingly, the customer (lessor) will recognize lease income based on \nthe fair value of the lease at contract inception, with an offsetting increase to \nthe cost of the goods or services from the supplier (lessee). The cost of the \ngoods or services to the customer will, therefore, exceed the customer’s cash \npayments for those goods or services, just as the supplier’s revenue will \nexceed the customer’s cash payments for the goods or services. This would be \nthe case even if the stated consideration in the service contract (i.e. which \nexcludes the embedded lease) is consistent with the observable stand- alone \nselling price for the goods and/or services the supplier is providing. \n \n Example 4.3.20 \n‘Free lease’ granted to a supplier \nConsider the fact pattern included in the background to Question 4.3.30 . In \naddition , the following facts are relevant. \nService charge in the contract: $10,000 per month \n($360,000 for the three- year contract) \nFair value of the lease: $1,000 per month \n($36,000 for the three -year contract) \nSupplier’s (lessee’s) incremental borrowing rate: 5% \nLease classification : Operating \nBased on the guidance in Topic 606, the services are a performance obligation \nsatisfied over time and a time- elapsed measure of progress for the services is \nappropriate (see c hapter 7 of KPMG Handbook, Revenue recognition). \nSupplier (lessee) \nBased on these facts and the interpretive response above, Supplier’s \naccounting is as follows. Assume that despite the fact that the right of use (i.e. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 211}), Document(page\_content='Leases 211 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the noncash consideration) is provided up-front, while the services will be \nprovided over three years, there is not a significant financing component in the \ncontract that Supplier must address in its revenue recognition under Topic 606. \n— At lease commencement (i.e. the start of the three -year service period), \nSupplier recognizes a lease liability of $32,679 representing the total \nconsideration for the lease ($1,000 × 36 months), discounted at Supplier’s \nincremental borrowing rate. \n— At lease commencement , Supplier recognizes an ROU asset equal to the \nlease liability because there are no initial direct costs, lease prepayments or \nlease incentives. \n— Supplier recognizes annual lease expense of $12,000 in each of the three years. \n— Supplier recognizes the $396,000 transaction price ($360,000 in cash + \n$36,000 fair value of the noncash lease consideration) on a straight -line \nbasis (i.e. using a time -based measure of progress) over the three -year \nservices period. \nCustomer (lessor) \nCustomer (property owner) recognizes annual lease income of $12,000 (the \nopposite of Supplier’s $12,000 of lease expense) and annual service expense of $132,000 as the services are provided by Supplier. Because the lease is an \noperating lease, Customer does not derecognize any portion of the building that \nit is leasing to Supplier. \n \n Question 4.3.40 \nTiming of measurement \nHow should an e ntity measure the consideration in the \ncontract if the lessor provides (1) a non- lease component \nbefore lease commencement and/or (2) two or more lease \ncomponents with different commencement dates? \nInterpretive response: The consideration in the contract f or both lessees and \nlessors starts with the payments relating to the use of the underlying asset. \nThose payments are measured at the lease commencement date (see \nchapter 5). \nTopic 842 does not provide guidance about how an entity measures the \nconsideratio n in the contract if the lessor provides a non- lease component – i.e. \nother goods or services – before commencement of the lease. \nFor example, a lessor agrees to lease a lessee a new piece of IT equipment, the \nterm of which commences in two months when the requested piece of \nequipment can be delivered and made available to the lessee. The lease \nincludes a lessee renewal option, a les see purchase option, and a lessee \nprovided residual value guarantee. In addition to the lease, the lessor also \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 212}), Document(page\_content='Leases 212 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. agrees to immediately begin maintaining the lessee’s existing IT equipment that \nwill remain in service together with the new leased equipment. \nThe lessee should begin recognizing expense, and the lessor income, for the \nmaintenance services being provided; however, it is unclear what amount the \nparties should recognize because the payments relating to the use of the \nunderlying asset are measured at lease commencement. The assessments of \nwhether the lessee is reasonably certain to exercise the renewal and purchase \noptions, or if it is probable that the lessee will owe an amount under the \nresidual value guarantee, are based on facts and circumstances at lease \ncommencement. [842- 10-15-35, 30- 5] \nThis timing issue could also arise for a contract that includes onl y lease \ncomponents, but for which the commencement date of those leases differs. For example, a lessee leases two pieces of equipment and each lease is a \nseparate lease component. The lessee and the lessor are required to allocate \nthe consideration in the contract to those two separate lease components, and \nwill begin recognizing lease cost or lease income upon commencement of the \nfirst lease. However, consistent with the previous lease and non- lease \ncomponent example, the parties cannot measure the total c onsideration in the \ncontract before commencement of the second lease. \nIn the absence of guidance in Topic 842 to resolve this issue, we believe an \nentity should make a preliminary estimate of the consideration in the contract. \nThis includes doing all of th e following at the point in time that the parties need \nto commence their accounting: \n— measuring any variable lease payments that depend on an index or rate \nbased on the index or rate at that point in time; \n— assessing the likelihood of lessee option exercises (renewal, termination \nand/or purchase options) based on the then -current facts and \ncircumstances; and \n— assessing amounts probable of being owed under a residual value guarantee based on the then- current facts and circumstances. \nHowever, because Topic 842 r equires measurement as of the commencement \ndate, we believe an entity should true up this initial accounting at the commencement date (or the final commencement date in the multiple separate lease components example). \n \n Observation \nDifferences between Topic 842 and Topic 606 \nfor lessors \n4.3.90 The accounting for variable payments by lessors under Topic 842 is \ndifferent from how variable consideration is accounted for under Topic 606 by \nvendors/suppliers. \n4.3.100 Therefore, the Board decided that guidance was necessary for lessors to \nnavigate the d ifferences. The guidance is intended to help clarify whether and, \nif so, when the consideration in the contract for a lessor includes variable \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 213}), Document(page\_content='Leases 213 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. consideration (subject to the constraint in Topic 606) – Step 2 of Part 2 in the \nflowchart in paragraph 4.3.50. [ASU 2016- 02.BC161 –BC163] \n4.3.110 Paragraph 606-10-15-4 states that if other Topics (e.g. Topic 842) provide \nseparation and measurement guidance, an entity applies that guidance first. The \nentity then excludes amounts allocated to items covered by the other Topics \nfrom the Topic 606 transaction pri ce that applies to the performance obligations \nwithin the scope of Topic 606. In the context of Topic 842, this means that a lessor separates lease from non- lease components (as required by Topic 842), \nmeasures the consideration in the contract in accordance with Topic 842, and allocates consideration to the lease and non- lease components in accordance \nwith Topic 842. \n4.3.120 As a result, the consideration in the contract allocated to a non -lease \n(e.g. service) component in the scope of Topic 606 may diff er from the \ntransaction price that would be determined for that component if it were not \nassociated with a lease. Consequently, applying the separation and \nmeasurement guidance in Topic 842 to a non- lease component in the scope of \nTopic 606 may result in a n entity accounting for the same good or service \nobligation to a customer differently depending solely on whether it is (or is not) \nprovided in conjunction with a lease. [842- 10-55-150 – 55-156, 606- 10-15-4, \nASU 2016- 02.BC163] \n4.3.130 Example 4.4.30 (Scenarios 1 and 2) illustrates this effect. Lessors will \nnot recognize variable amounts that are partially, but not solely, attributable to a \nnon-lease (e.g. service) component as income before the changes in facts and \ncircumstances upon which the amount of the payments is based has occurred. \nIn contrast, the entity’s revenue recognition might differ for that service \ncomponent if it were being provided separately or in conjunction with a sold \n(rather than leased) piece of equipment because revenue attributable to the \nservice may be recognized under Topic 606 before the change in facts and \ncircumstances upon which the amount of the payments is based has occurred. \n \n Comparison to legacy US GAAP \nLessor accounting for variable payments affected by definition of \nconsideration in the contract \n4.3.14 0 Under Topic 840, lessors recognized all contingent payments in the \nsame manner as lessors will recognize variable payments that relate at least \npartially to a lease component under Topic 842 (see paragraph 4.3.130). \nTherefore, while most variable payments in lease contract s will continue to be \nrecognized in a manner consistent with how they were recognized under \nTopic 840, the requirement for lessors to estimate variable payments and \ninclude them in the cons ideration in the contract in some cases – i.e. when they \nrelate solely to a non- lease component – could affect the timing and/or pattern \nof income recognition for lessors. [SAB Topic 13.A] \n4.3.15 0 For example, if a lessor applying Topic 842 includes a per formance \nbonus that it expects to earn from providing a service to the lessee in the consideration in the contract, it will generally recognize at least a portion of that ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 214}), Document(page\_content='Leases 214 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. amount as income over the period the service is provided even if the \nperformance bonus is not yet earned. In contrast, under Topic 840, that same \nlessor generally would not recognize the performance bonus until the \nperformance metric triggering the bonus was met . [840-10-25-4, 840- 20-25-2, \n840-30-25-3] \n \n4.4 Step 4: Separate and a llocate c onsideration \nbetween the lease and non-lease c omponents \n4.4.1 Allocate the c onsideration in the c ontract \n Excerpt from ASC 842 -10 \n15 Scope and Scope Exceptions \n> Separating Components of a Contract \n>> Lessee \n15-33 A lessee shall allocate (that is, unless the lessee makes the accounting \npolicy election described in paragraph 842- 10-15-37) the consideration in the \ncontract to the separate lease components determined in accordance with \nparagraphs 842- 10-15-28 through 15 -31 and the nonlease components as \nfollows: \na. The lessee shall determine the relative standalone price of the separate \nlease components and the nonlease components on the basis of their \nobservable standalone prices. If observable standalone prices are not \nreadily available, the lessee shall estimate the standalone prices, \nmaximizing the use of observable information. A residual estimation \napproach may be appropriate if the standalone price for a component is \nhighly variable or uncertain. \nb. The lessee shall al locate the consideration in the contract on a relative \nstandalone price basis to the separate lease components and the nonlease \ncomponents of the contract . \nInitial direct costs should be allocated to the separate lease components on \nthe same basis as the lease payments . \n15-34 A price is observable if it is the price that either the lessor or similar \nsuppliers sell similar lease or nonlease components on a standalone basis. \n15-37 As a practical expedient, a lessee may, as an accounting policy election \nby class of underlying asset, choose not to separate nonlease components \nfrom lease components and instead to account for each separate lease \ncomponent and the nonlease components ass ociated with that lease \ncomponent as a single lease component. \n>> Lessor \n15-38 A lessor shall allocate (unless the lessor makes the accounting policy \nelection in accordance with paragraph 842- 10-15-42A) the consideration in ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 215}), Document(page\_content='Leases 215 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the contract to the separate lease components and the nonlease components \nusing the requirements in paragraphs 606- 10-32-28 through 32- 41. A lessor \nalso shall allocate (unless the lessor makes the accounting policy election in \naccordance with paragraph 842- 10-15-42A) any capitalized costs (for example, \ninitial direct costs or contract costs capitalized in accordance with \nSubtopic 340-40 on other assets and deferred costs —contracts with \ncustomers) to the separate lease components or nonlease components to \nwhich those costs relate. \n15-42A As a practical expedient, a lessor may, as an accounting policy election, \nby class of underlying asset, choose to not separate nonlease components \nfrom lease components and, instead, to account for each separate lease \ncomponent and the nonlease components associated with that lease \ncomponent as a single component if the nonlease components otherwise \nwould be accounted for under Topic 606 on revenue from contracts with \ncustomers and both of the following are met: \na. The timing and patter n of transfer for the lease component and nonlease \ncomponents associated with that lease component are the same. \nb. The lease component, if accounted for separately, would be classified as \nan operating lease in accordance with paragraphs 842 -10-25-2 through \n25-3A. \n15-42B A lessor that elects the practical expedient in paragraph 842- 10-15-42A \nshall account for the combined component : \na. As a single performance obligation entirely in accordance with Topic 606 if \nthe nonlease component or components are the predominant \ncomponent(s) of the combined component. In applying Topic 606, the \nentity shall do both of the following: \n1. Use the same measure of progress as used for applying paragraph 842-\n10-15-42A(a) \n2. Account for all variable payments related to any good or service, \nincluding the lease, that is part of the combined component in \naccordance with the guidance on variable consideration in Topic 606. \nb. Otherwise, as an operating lease entirely in accordance with this Topic. In \napplying this Topic, the entity shall account for all variable payments related \nto any good or service that is part of the combined component as variable \nlease payments. \nIn determining whether a nonlease component or components are the \npredominant component (s) of a combined component, a lessor shall consider \nwhether the lessee would be reasonably expected to ascribe more value to the \nnonlease component(s) than to the lease component. \n15-42C A lessor that elects the practical expedient in paragraph 842- 10-15-42A \nshall combine all nonlease components that qualify for the practical expedient \nwith the associated lease component and shall account for the combined \ncomponent in accordance with paragraph 842- 10-15-42B. A lessor shall \nseparately account for nonlease c omponents that do not qualify for the \npractical expedient. Accordingly, a lessor shall apply paragraphs 842- 10-15-38 \nthrough 15- 42 to account for nonlease components that do not qualify for the \npractical expedient. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 216}), Document(page\_content='Leases 216 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 55 Implementation Guidance and Illustrati ons \nGeneral \n> Illustrations \n>> Illustrations of Allocating Considerati on to Components of a \nContract \n>>> Example 11 —Allocation of Consideration to Lease and Nonlease \nComponents of a Contract \n>>>> Case A —Allocation of Consideration in the Contract \n55-132 Lessor leases a bulldozer, a truck, and a crane to Lessee to be used in \nLessee’s construction operations for three years. Lessor also agrees to \nmaintain each piece of equipment throughout the lease term. The total \nconsideration in the contract is $600,000, payable in $200,000 annual \ninstallments. \n55-133 Lessee and Lessor both conclude that the leases of the bulldozer, the \ntruck, and the crane are each separate lease components because both of t he \ncriteria in paragraph 842- 10-15-28 are met. That is: \na. The criterion in paragraph 842- 10-15-28(a) is met because Lessee can \nbenefit from each of the three pieces of equipment on its own or together \nwith other readily available resources (for example, Less ee could readily \nlease or purchase an alternative truck or crane to use with the bulldozer). \nb. The criterion in paragraph 842- 10-15-28(b) is met because, despite the fact \nthat Lessee is leasing all three machines for one purpose (that is, to \nengage in const ruction operations), the machines are not highly dependent \non or highly interrelated with each other. The machines are not, in effect, \ninputs to a combined single item for which Lessee is contracting. Lessor \ncan fulfill each of its obligations to lease one of the underlying assets \nindependently of its fulfillment of the other lease obligations, and Lessee’s \nability to derive benefit from the lease of each piece of equipment is not \nsignificantly affected by its decision to lease or not lease the other \nequipm ent from Lessor. \n55-134 In accordance with paragraph 842- 10-15-31, Lessee and Lessor will \naccount for the nonlease maintenance services components separate from the \nthree separate lease components (unless Lessee elects the practical expedient \nin paragraph 842-10-15-37 or Lessor elects the practical expedient in \nparagraph 842-10-15-42A when the conditions in that paragraph are met —see \nCase B [paragraphs 842- 10-55-138 through 55- 140] for an example in which \nLessee elects the practical expedient ). In accordan ce with the identifying \nperformance obligations guidance in paragraphs 606- 10-25-19 through 25- 22, \nLessor f urther concludes that its maintenance services for each piece of leased \nequipment are distinct and therefore separate performance obligations, \nresult ing in the conclusion that there are three separate lease components and \nthree separate nonlease components (that is, three maintenance service \nperformance obligations). \n55-135 Lessor allocates the consideration in the contract to the separate \nlease compo nents and nonlease components by applying the guidance in \nparagraphs 606-10-32-28 through 32 -41. The consideration allocated to each ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 217}), Document(page\_content='Leases 217 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. separate lease component constitutes the lease payments for purposes of \nLessor’s accounting for those components. \n55-136 Lessee allocates the consideration in the contract to the separate lease \nand nonlease components. Several suppliers provide maintenance services \nthat relate to similar equi pment such that there are observable standalone \nprices for the maintenance services for each piece of leased equipment. In \naddition, even though Lessor, who is the manufacturer of the equipment, \nrequires that all leases of its equipment include maintenance services, Lessee \nis able to establish observable standalone prices for the t hree lease \ncomponents on the basis of the price other lessors lease similar equipment on \na standalone basis. The standalone prices for the separate lease and nonl ease \ncomponents are as follows. \n Lease Maintenance \nBulldozer $ 200,000 $ 50,000 \nTruck 120,000 20,000 \nCrane 240,000 70,000 \n $ 560,000 $ 140,000 \n55-137 Lessee first allocates the consideration in the contract ($600,000) to \nthe lease and nonlease components on a relative basis, utilizing the observable \nstandalone prices determined in paragraph 842- 10-55-136. Lessee then \naccounts for each separate lease component in accordance with Subtopic 842-\n20, treating the allocated consideration as the lease payments for each lease \ncomponent. The nonlease components are accounted for by Lessee in \naccordance with other Topics. The allocation of the consideration to the lease \nand nonlease components is as follows. \n Lease Maintenance \nBulldozer $ 171,249 $ 42,857 \nTruck 102,857 17,143 \nCrane 205,714 60,000 \n $ 480,000 $ 120,000 \n>>>> Case B —Lessee Elects Practical Expedient to Not Separate Lease \nfrom Nonlease Components \n55-138 Assume the same facts and circumstances as in Case A \n(paragraphs 842-10-55-132 through 55- 137), except that Lessee has made an \naccounting policy election to use the practical expedient to not separate \nnonlease from lease components for its leased construction equipment. \nConsequently, Lessee does not separate the maintenance services from the \nrelated lease components but, instead, accounts for the contract as containing \nonly three lease components. \n55-139 Because Lessor regularly leases each piece of equipment bundled \ntogether with maintenance services on a s tandalone basis, there are \nobservable standalone prices for each of the three combined components, \neach of which includes the lease and the maintenance services. Because each \nof the three separate lease components includes the lease of the equipment ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 218}), Document(page\_content='Leases 218 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. and th e related maintenance services, the observable standalone price for each \ncomponent in this scenario is greater than the observable standalone price for \neach separate lease component that does not include the maintenance \nservices in Case A. \n55-140 Lessee al locates the consideration in the contract ($600,000) to the \nthree separate lease components on a relative basis utilizing the observable \nstandalone selling price of each separate lease component (inclusive of \nmaintenance services) and then accounts for eac h separate lease component \nin accordance with the guidance in Subtopic 842- 20, treating the allocated \nconsideration as the lease payments for each separate lease component. \nThe standalone prices for each of the three combined l ease components is \nas follows . \n Standalone \nPrice Relative \nStandalone \nPrice \nBulldozer $ 230,000 $ 215,625 \nTruck 130,000 121,875 \nCrane 280,000 262,500 \n $ 640,000 $ 600,000 \n \n4.4.10 Non- lease components are separated from related lease components , \nunless the applicable lessee or lessor non- separatio n practical expedient \napplies . Lease components are accounted for under Topic 842; non -lease \ncomponents are accounted for under other applicable US GAAP. [842- 10-15-31] \n4.4.20 When t he consideration in the contract is alloc ated between the lease \nand non- lease components of a contract , different methodologies apply to the \nlessee and the lessor. [842- 10-15-33, 15- 38] \n Lessee Lessor \nWhen there is an \nobservable stand- alone \n(selling) price for each \ncomponent: Separate and allocate based \non the relative stand- alone \nprice of components. Allocate following the \nTopic 606 transaction price \nallocation guidance – i.e. \ngenerally on a relative stand-\nalone selling price basis. When there is not an observable stand- alone \n(selling) price for some \nor all components: Estimate the stand -alone \nprice, maximizing using \nobservable information. \n Remember: \nActivities (or costs of the lessor) that do not transfer a good \nor service to the lessee are not components of the contract \n(see section 4.2). Therefore, no consideration is allocated to \nsuch items. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 219}), Document(page\_content='Leases 219 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Practical expedient s to not separate lease and related non-\nlease components \nLessee \n4.4.30 As a practical expedient, a lessee may elect not to separate the non- lease \ncomponents of a contract from the lease component to which they relate. This \nmeans that the components will be treated as a single lease component. For \nexample, in a lease of a machine with the lessor responsible for machine \nmaintenance, the lessee may account for a single lease component – i.e. the \npayments that would otherwise be attributed to the maintenance will be accounted for as lease payments and included in the measurement of the \nlessee’s ROU asset and lease liability. Including the payments for non- lease \ngoods or services in the lease payments may affect lease classification – e.g. \nthe inclusion of those payments in the lease payments may result in ‘ failing ’ the \npresent value lease classification test (see section 6.2). \n[842- 10-15-37] \n4.4.40 Combining a non- lease component with a lease component will generally \nresult in straight -line recognition of the cost for the non- lease component. This \npattern of expense recognition might differ in some cases from the pattern of \nexpense recognition that would apply if the non -lease component were \naccounted for separately from the lease. \n4.4.50 A lessee elects this practical expedient by class of underlying asset – e.g. \noffice equipment, a utomobiles, office space. [842- 10-15-37] \nLessor \n4.4.51 As a practical expedient , a lessor may elect not to separate non- lease \ncomponents that would be within the scope of Topic 606 if accounted for \nseparately from associated lease components when two specific criteria are \nmet. Those criteria are: [842-10-15-42A] \na. The timing and pattern of transfer to the lessee of the lease component and the non- lease component(s) associated with that lease component are the \nsame; and \nb. The lease component, if accounted for separately, would be classified as an \noperating lease in accordance with paragraphs 842- 10-25-2 through 25 -3A. \n4.4.52 If the practical ex pedient has been elected and a contract includes \nmultiple non- lease components —one or more that meet (s) the timing and \npattern of transfer criterion and one or more that does(do) not—the lessor \ncombines the non- lease component (s) that meet the criterion with the lease \ncomponent and separates any non-lease components that do not. [842- 10-15-42C] \n4.4.53 If the non- lease component(s) is (are) the predominant component(s) of \nthe combined component, the lessor should account for the c ombined \ncomponent under Topic 606 as a single Topic 606 performance obligation, \nrather than the leases guidance in Topic 842. In those cases, the lessor: [842- 10-\n15-42B] \n— uses the same measure of progress for the combined Topic 606 \ncomponent as it used when determining eligibility for combination of the \nlease and non- lease component(s) in accordance with paragraph 842- 10-15-\n42A(a) (generally, time- elapsed – see Question 4.4.13); and ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 220}), Document(page\_content='Leases 220 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — accounts for all variable payments related to any good or service, incl uding \nthe lease, that is part of the combined Topic 606 performance obligation in \naccordance with the guidance on variable consideration in Topic 606 (see paragraph 4.3.75). \n4.4.54 In determining whether the non- lease component(s) is (are) predominant, \nthe lessor should consider whether the lessee would be reasonably expected to \nascribe more value to the non- lease component(s) than to the lease component \n(see paragraphs 4.4.62 – 4.4.63 and Question 4.4.15). [842- 10-15-42B] \n4.4.55 All other combined components are accounted for under Topic 842 as a \nsingle lease component. This includes when the lease component and non-lease component(s) are equally significant to the contract. If the combined \ncomponent is accounted for under Topic 842 as a single lease com ponent, the \nlease is classified as an operating lease by default. A lessor does not assess classification of the single lease component using the guidance in section 7.2. \n[842- 10-15-42B] \n4.4.56 A lessor elects this practical expedient by class of underlying asset (see \nexamples in paragraph 4.4.50). [842- 10-15-42A] \n4.4.57 Effects of electing this practical expedient on transition are discussed in \nsection 13A.5.2 (for the effective date method) an d section 13B.5.2 (for the \ncomparative method). \n4.4.60 [Not used] \n4.4.61 [Not used] \n \n Observation \nPredominan t element \n4.4.62 In many cases, determining whether to account for the combined \ncomponent as a single lease component or as a single non- lease component in \nthe scope of Topic 606 will be simple. For example, in most real estate lease \nscenarios it will be clear that the lease is the predominant element of the \ncombined component when it is combined with CAM; this is because, \nconsistent with paragraph 4.4.5 4, the lessee would clearly be expected to \nascribe more value to its right to use the real estate (e.g. the office or retail \nspace) than to the CAM services. Similarly, in many other arrangements, such \nas those for consumer high -speed internet or cable/satellite television services \nthat include the lease of customer -premise equipment, it will be clear that the \nservices are predominant within the combined component; this is because the \nconsumer would clearly be expected to ascribe more value to its ability to \naccess video content and the internet than to the particular device it uses to \nobtain that access. \n4.4.63 There may be ot her cases that require more judgment to make this \ndetermination because it may not be clear whether the customer would ascribe \nmore value to the lease component or to the non- lease component(s). \nHowever, in ‘close call’ situations, given the similarities between the revenue and lessor accounting guidance and the robust disclosure requirements of each, \nwe believe companies and practitioners should be able to reach reasoned \nconclusions. This is consistent with (1) the public comments of the FASB vice \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 221}), Document(page\_content='Leases 221 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. chairman at the Board’s March 28, 2018 meeting, and (2) the Board’s statement \nin the basis for conclusions to ASU 2018- 11 that it was “comfortable with \nallowing stakeholders discretion for determining whether the nonlease \ncomponent is the predominant component.” I n these close call situations, we \nbelieve it may be relevant to give consideration to which Topic’s guidance and \ndisclosures will provide more useful information to the entity’s financial \nstatement users. [ASU 2018- 11.BC35] \n \n Question 4.4.05 \nNon-separatio n practical expedients – meaning of \n‘associated with’ \nHow should entities interpret ‘associated with’ when \napplying the lessee and lessor non- separation practical \nexpedients ? \nBackground: Paragraphs 4.4.30 and 4.4.51 – 4.4.56 describe practical \nexpedients available to lessees and lessors, respectively, that permit them to \nnot separate non- lease components from lease components to which they \nrelate. \n— A lessee may elect (by class of underlying asset ) to account for each \nseparate lease component and the non- lease components associated with \nthat lease component as a single lease component. [842- 10-15-37] \n— A lessor may elect (by class of underlying asset ) to account for each \nseparate lease component and the non- lease components associated with \nthat lease component as a single component if : [842- 10-15-42A] \n— the non- lease components otherwise would be accounted for under \nTopic 606 on revenue from contracts wi th customers; and \n— two additiona l criteria are met (see paragraph 4.4.51). \nIn practice, questions have arisen about whether and how ‘associated with’ \naffects an entity’s ability to combine a non- lease component with a lease \ncomponent, including how it applies to contracts that contain: \n— multiple separate lease components ; and \n— non-lease components that specifically relate to the lessee’s owned assets \n(or assets leased from an unrelated third- party lessor). \nInterpretive response: We believe the ‘associated with’ language was \nincluded principally to ensure that non- lease components are combined with the \nlease component(s) to which they relate when the contract contains multiple \nseparate lease components. \nFor example, if a lease contains two leases of equip ment, each of which is a \nseparate lease component, and maintenance on both pieces of equipment, the \n‘associated with’ language in the practical expedients means that: \n— the mai ntenance associated with the equipment in lease #1 should be \ncombined with equipm ent lease component #1; and \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 222}), Document(page\_content='Leases 222 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — the maintenance associated with the equipment in lease #2 should be \ncombined with equipment lease component #2. \nAssigning non -lease components to separate lease components could affect \nthe accounting for the contract. For exam ple, combining the fixed payments for \na non- lease component with the wrong lease component could result in \nincorrect lease classification for either the combined component or another \nseparate lease component. The fixed non- lease payments might incorrectly \nresult in finance lease classification for the combined component, or operating \nlease classification of the separate lease component with which the non- lease \ncomponent should have been combined. \nNon-lease components related to an asset owned by the lessee or leased \nfrom a lessor that is not a party to the contract \nA lease contract might include non- lease services (e.g. maintenance or \noperations) for equipment the lessee owns or leases from a lessor that is not a \nparty to the contract. For example, a lessor might lease equipment to a lessee \nand in addition to maintaining that equipment, contract to maintain the lessee’s owned equipment. \nWhen a non -lease component specifically relates to one or more assets the \nlessee owns or leases from a lessor that is not a party to the contract, it should not be combined with a separate lease component of the contract. The same \nconcerns with respect to multiple separate lease components arise in this \nsituation. Combining the non- lease component with (one of) the separate lea se \ncomponent(s) could change the accounting for both – e.g. if it changes the \nclassification of the lease. \nThe contract might not discuss multiple non -lease components. That is, it might \nnot outline multiple maintenance or operations services, even though the \nservices pertain to both assets leased from the lessor and other owned or \nleased assets. In that case, the contract’s description of the services singularly, \nrather than as multiple services, should not change the entity’s accounting; the \nentity shoul d allocate the consideration for the single enumerated service \nbetween the combined lease component (the lease and the services associated with that leased asset) and a non- lease service component (the service \nassociated with the lessee’s owned asset). \nOther situations \nSo far this response illustrates circumstances in which it is clear that a non -\nlease component is associated with a particular asset (leased or owned). Those circumstances may frequently exist; for example, it may be clear to which \nasset(s) m aintenance or operations services relate. However, the association \nmay not always be clear. Topic 842 does not provide guidance about whether or \nhow an entity should assess whether a non- lease component is associated with \na lease component in those cases. Therefore, judgment will be required. \nOne approach we believe may be acceptable in making this evaluation (there \nmay be others) is to consider the nature of the relationship between the lease \nand the non- lease component; this includes how dependent the les see’s ability \nto use or derive benefit from the non- lease good(s) or service(s) is on the lease. \nThe following are example considerations that may be relevant in this \nassessment (not exhaustive). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 223}), Document(page\_content='Leases 223 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — A ‘yes’ to the following questions may suggest that the non- lease \ncomponent is associated with the lease. \n— Must non- lease goods purchased in a lease contract be used with or \nconsumed by the underlying asset? \n— Must services purchased in a lease contract be performed on or using \nthe leased asset? \n— In contrast, a ‘yes’ to the following questions may suggest that the non-\nlease component is not associated with the lease. \n— Could the lessee use the non- lease goods with a different asset – e.g. \nuse purchased supplies with an owned asset rather than the asset \nleased from the lessor? \n— Could the lessee direct the lessor to perform the contracted services \non an asset other than the asset leased from the lessor – e.g. direct \nthe lessor to perform maintenance on one of the lessee’s owned \nassets instead of the asset leased from the lessor? \n \n Example 4.4.05 \nNon-separation practical expedients – applying \n‘associated with’ \nScenario 1: Airplane lease and maintenance services \nLessee LE enters into a five- year airplane lease with Lessor LR. LR is \nresponsible for providing maintenance on the airplane over the lease term. \n— The air plane lease would be classified as an operating lease if accounted for \nseparately. \n— The mai ntenance is a stand -ready performance obligation satisfied over \ntime for which a time- elapsed measure of progress toward its complete \nsatisfaction is appropriate – i.e. the maintenance has a straight -line pattern \nof transfer to the customer. \nBoth LE and LR have elec ted their respective non- separation practical expedient \nfor leases of airplanes. \nLE and LR both conclude that the maintenance is associated with the airplane \nlease. Their respective conclusions principally consider that the airplane \nmaintenance provided by LR specifically relates to the airplane being leased \nfrom LR and is not transferrable to other airplanes it owns or leases from a \ndifferent lessor – i.e. LE cannot instruct LR to perform maintenance on its other \nowned airp lanes or airplanes leased from another lessor. \nConsequently, the maintenance in this contract is highly dependent on the \nairplane lease, and LE and LR conclude the maintenance is ‘associated with’ the \nairplane lease. As a result, LE and LR both acc ount for the airplane lease and \nthe maintenance as a single lease component. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 224}), Document(page\_content='Leases 224 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Scenario 2: Airplane lease and jet fuel \nIn addition to the airplane lease and the maintenance in Scenario 1, LE commits \nas part of the contract to purchase a minimum quantity of jet fuel from LR at a \nfixed price p er gal lon during the lease term. \nThere are no restrictions preventing LE from using the jet fuel in LE’s other \nowned and leased (from other lessors) airplanes, or reselling the jet fuel, and LE \ncould obtain equivalent jet fuel from other suppliers. \nLessee LE \nLE concludes that the jet fuel is not associated with the airplane lease. This is \nbecause the jet fuel it acquires from LR is available for any LE use – e.g. in its \nother owned or leased aircraft, or for resale to an unrelated third party – and \nfrom numerous other suppliers. Therefore, the jet fuel component of this \ncontract is not dependent on the airplane lease. Consequently , LE concludes \nthat the lessee non- separation practical expedient cannot be applied to combine \nthe jet fuel component with the airplane lease and maintenance. \nLessor LR \nLR cannot combine the jet fuel with the airplane lease and maintenance using \nthe lessor non- separation practical expedient. This is because the jet fuel \ncomponent is not a performance obligation satisfied over time under Topic 606; therefore, it does not have the same timing and pattern of transfer to LE as the \nairplane lease (see Question 4.4.13). \nConsequently, LR may not consider whether the jet fuel component is \n‘associated with’ the airplane lease in this scenario. However, if LR did, its evaluation would be consistent with LE’s. \n \n Question 4.4.10 \nNon-separation practical expedient s for lessees and \nlessors not limited to insignificant non- lease \ncomponents \nDo the practi cal expedient s not to separate non- lease \ncomponents from the lease components to which they relate \napply to non- lease components that are significant ? \nInterpretive response: Yes. Lessees and lessors are permitted to elect their \nrespective practical expedient s without regard to whether they expect the non -\nlease components to which the expedient will apply to be significant to the leases to which they will relate or to the ir financial statements. \n[ASU 2016-\n02.BC150 , ASU 2018- 11.BC30 ] \nFor lessors applying the practical expedient , the accounting for the combined \ncomponent is determined by the significance of the non- lease component (see \nparagraphs 4.4.53 – 4.4.55 ). Lessees do not have a similar requirement and \nalways account for the combined component as a single lease component . \n[ASU 2018- 11.BC33 ] \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 225}), Document(page\_content='Leases 225 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Once elected for a class of underlying asset, the applicable practical expedient \napplies to all non- lease components (for lessors, the non- lease components that \nqualify – see paragraph 4.4.52) that relate to leases within that class of \nunderlying asset regardless of how significant that component is. \n \n \nQuestion 4.4.11 \nNon-separation practical expedient s elected by \nclass of underlying asset \nCan a n entity elect the practical expedient not to separate \nnon- lease components from the lease components to which \nthey relate based on the nature of the lease? \nBackground: Lessees and lessors may enter into leases of similar assets under \ndifferent terms. For example, lessees /lessors with a significant number of retail \nor office space leases may enter into gross leases in some cases and net \nleases in others (paragraph 4.2.120 and Question 4.2.50 explain the distinction \nbetween gross leases and net leases ). Similarly, l eases of similar equipment \nmay be structured with mostly fixed lease payments or mostly variable \nlease payments. \nInterpretive response: No. The accounting policy election not to separate non-\nlease components from the lease components to which they relate is made by \nclass of underlying asset (see paragraphs 4.4.50 and 4.4.5 6). The election \ncannot be made based on different lease terms and c onditions – e.g. whether \nthe lease is a gross lease or a net lease. Different lease terms and conditions do \nnot define a class of underlying asset for the purpose of electing either the \nlessee or the lessor non- separation practical expedient. \n \n Question 4 .4.12 \nLessor practical expedient – operating lease \nclassification criterion \nIs a lessor required to undertake a quantitative analysis to \nprove that the lease element of a combined component \nwould be classified as an operating lease if accounted for separately? \nBackground: To combine a lease component with a n eligible non-lease \ncomponent , the lease component must be classified as an operating lease if \naccounted for separately (see paragraph 4.4.51) . \nDuring development of the practical expedient, s ome stakeholders expressed \nconcern about applying the Part A and Part B ‘present value’ classification test s \n(see section 7.2). The tests appear to require the lessor to allocate the \nconsideration for the combined component to the lease and non- lease \ncomponent(s) only to then be able to apply the practical expedient not to \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 226}), Document(page\_content='Leases 226 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. separate and allocate consideration to those same components . This would \nnegate the benefits of the expedient. \nInterpretive response: No. In response to stakeholder concerns, the Board \nexplained in the basis for conclusions to ASU 2018- 11 that it does not intend to \nrequire lessors to quantitatively prove the lease passes the present value \nclassification tests by allocating the combined payments to the lease and non-\nlease compo nents. Rather, similar to the level of evidence needed to apply a \nportfolio approach (see section 5.8), lessors would meet the practical \nexpedient’s operating lease classification criterion if it is reasonably expected, \nbased on an appropriate qualitative evaluation, that the lease component would \nbe classified as an operating lease if accounted for separately. [ASU 2016- 02.BC120, \nASU 2018- 11.BC30] \nJudgment may be required to determine what constitutes an ‘appropriate \nqualitative evaluation’. The following paragraphs address two acceptable \napproaches we believe lessors could use to address the practical expedient’s \noperating lease clas sification crit erion. There may be other acceptable \napproaches. \nIn many cases, and assuming the lease does not meet any of the other criteria \nto be classified as a sales- type or direct financing lease, we believe lessors will \nbe able to conclude that the lease would be c lassified as an operating lease by \nperforming the present value tests using the combined lease and non- lease \npayments . If the combined payments do not result in sales -type or direct \nfinancing classification of the lease under the present value tests, then neither \nwould any other possible allocation of the payments to the lease. For example, \nthis may be the case for some real estate leases where the non- lease CAM \ncomponent is relatively insignificant in comparison to the lease. \nAlternatively, in some cases, a lessor may be able to consider an allocation \napproach that would not be permissible if allocation to the components was \nrequired. For example, even if the lessor is not permitted to use a residual \napproach to estimate the st and-alone selling price of the lease or non -lease \ncomponent (see Question 4.4.55), in some cases the results of a residual \napproach may provide a relevant data point when assessing the practical \nexpedient’s operating lease classification criterion. This ma y be the case if, for \nexample, the residual allocation is to the non- lease component, resulting in a \ngreater allocation to the lease component than would result from using a non-\nresidual allocation technique. \n \n Question 4.4.13 \nLessor practical expedient – same pattern of \ntransfer requirement \nWhen does a non- lease component meet the same pattern of \ntransfer criterion to qualify for combination with a lease \ncomponent ? \nBackground: Criterion (b) to qualify for the lessor practical expedient (see \nparagraph 4.4.51) requires that the lease component would be classified as an \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 227}), Document(page\_content='Leases 227 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. operating lease if accounted for separately, which means the pattern of transfer \nto the lessee of that lease component will generally be straight -line (see \nsection 7.4.2) . \nInterpretive response: In general, to meet the same pattern of transfer \nrequirement , a non- lease component must: [606-10-25-15, 25-27, 25-31 – 25-37, 55-17, \n55-20] \n— meet one of the Topic 606 criteria to be satisfied over time; and \n— have a straight -line pattern of transfer to the lessee – i.e. the Topic 606 \nmeasure of progress toward satisfaction of the component must be a time-\nelapsed input or output measure. \nIf a lessor concludes that the non- lease component qualifies for recognition \nover time under Topic 606 but the pattern of transfer to the lessee is something \nother than time- elapsed, the non- lease component would not qualify for the \npractical expedient unless the pattern of transfer to the lessee of the operating \nlease component was also something other than straight -line (which is \nexpected to be extrem ely rare). \nSimilarly, if the non -lease component does not meet one of the Topic 606 \ncriteria to be satisfied over time, the practical expedient cannot be applied. At a June 2018 preparer leasing forum, the FASB staff stated that this means \narrangements for the sale of goods expected to be used with leased equipment \nwould not qualify for the practical expedient if those goods are determined to \nbe transferred at a point in time, rather than over time, under Topic 606. This is \nthe case even if it is expected t hat goods will be sold for use with the leased \nequipment throughout the lease term. \n \n Question 4.4.1 4 \nLessor practical expedient – measure of progress \ntoward satisfaction of a combined Topic 606 \ncomponent \nIs a lessor permitted to use a measure of progress in \nrecognizing revenue for a combined component accounted \nfor under Topic 606 different from that applied to the lease \nand non- lease elements of the combined component when \nevaluating the criterion in para graph 842 -10-15-42A(a) ? \nBackground: To apply the lessor non- separation practical expedient to a lease \nand a non -lease component, those two components must have the same \ntiming and pattern of transfer to the lessee (see paragraph 4.4.51) . As outlined \nin Qu estion 4.4.13, th e pattern of transfer of both components will generally be \nstraight -line. \nConsider an example of a lessor providing a n operating lease and operations \nand maintenance services. The lessor concludes that the lease component and \nthe non- lease operations and maintenance services can be combined because \neach component would have a straight -line pattern of transfer to the lessee – \ni.e. each component is satisfied over time and the lessor would use a time-\nelapsed measure of progress toward complete satisfaction of each component. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 228}), Document(page\_content='Leases 228 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. If the combined component is accounted for under Topic 606 – i.e. because the \nnon-lease element(s) of the combined component is (are) predominant , a \nquestion arises about whether it is acceptable to measure progress towa rd \ncomplete satisfaction of the combined component on a basis other than time \nelapsed (e.g. on a cost -to-cost input basis). \nInterpretive response: No. Paragraph 842- 10-15-42B(a)(1) explicitly states \nthat a lessor must use the same measure of progress for the combined \nTopic 606 performance obligation as it used when evaluating the criterion in \nparagraph 842-10-15-42A(a). \nThis means that the measure of progress for a combined Topic 606 \nperformance obligation will generally be (and in the background example must \nbe) time-elapsed (see Question 4.4.13). \n \n Question 4.4.15 \nLessor practical expedient – evaluating \npredominance \nIs a lessor required to evaluate predominance of the lease \ncomponent or non- lease component(s) quantitatively ? \nInterpretive response: No. The basis for conclusions to ASU 2018 -11 states \nexplicitly that, “The Board concluded that an entity should be able to reasonably \ndetermine which Topic to apply (based on predominance) without having to \nperform a detailed quantit ative analysis or theoretical allocation to each \ncomponent.” Therefore, we believe it would be inconsistent with the Board’s \nview to require a quantitative predominance evaluation. [ASU 2018- 11.BC35] \nFurther, when considering predominance, the lessor consi ders whether the \nlessee would be reasonably expected to ascribe more value to the non- lease \ncomponent(s) than to the lease component (see paragraph 4.4.53). [842- 10-15-42B] \nWe believe this assessment is inherently a qualitative, rather than quantitative, \nevaluation that would necessarily consider generally qualitative information \nabout how the lessor markets and promotes itself to customers. Particularly \nrelevant , given that each combined component is subject to its own \npredominance evaluation, will likely be how the lessor promoted itself and the \nrelevant lease and non- lease components in the context of the present contract \n– e.g. its response to the relevant customer request for proposal. \nNotwithstanding the above, there may be available and relev ant quantitative \ninformation other than a theoretical allocation to the components that should be \nconsidered as part of the analysis. O ne example could be quantitative \ninformation about the lessor’s costs to fulfill the components . Assuming the \nlessor expects that the customer has at least some understanding of the \nlessor’s relative efforts and costs to fulfill the components, that cost \ninformation may be relevant when evaluating the relative value a customer \nwould be expected to ascribe to the lease and non -lease component(s). \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 229}), Document(page\_content='Leases 229 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 4.4.16 \nLessor practical expedient – lease and services are \nnot co -terminus \nCan the lessor apply the non- separation practical expedient \nwhen the lease and non- lease components are not co-\nterminus? \nBackground: Consider a scenario in which Lessor LR and Lessee LE enter into \na three- year lease of equipment that includes one year of bundled maintenance. \nLE has the option to renew the maintenance for each of the two remaining \nyears of the equipment lease. If LE does renew the maint enance services for \nYear 2 or Year 3 , its total payment to LR for that year will be the same as in \nYear 1. The equipment lease is an operating lease, and the maintenance is a \nstand -ready performance obligation for which a time -elapsed measure of \nprogress is appropriate under Topic 606. \nIn this scenario, the question arises as to whether LR is permitted to apply the lessor non -separation practical expedient when the promised maintenance \nservices are only for part of the equipment lease term. \nInterpretive response: No. For the lessor non- separation practical expedient to \napply, we believe the lease and the non- lease component must be satisfied \nover the same period of time – i.e. the lease term and the term of the non- lease \ncomponent must be co- terminus. \nOur view is based on the following. \n— The basis for conclusions to ASU 2018- 11 indicates the FASB intended that \nthe lease and the non -lease component must be co- terminus for the lessor \nnon-separation practical expedient to apply. Paragraph BC27(b), in \nexplaining the criterion in paragraph 4.4.51(a), states that having the same \ntiming and pattern of transfer means that the lease and the non- lease \ncomponent each have a straight -line p attern of transfer to the customer \n‘over the same time period’. \n[ASU 2018- 11.BC27(b)] \n— The practical expedient was developed with the intent that it be applied in the same manner as the similar practical expedient in Topic 606. Under \nTopic 606, entities ar e permitted to account for two or more distinct goods \nor services that are concurrently delivered and have the same pattern of transfer to the customer as a single performance obligation. Two services, \ntransferred over three years and one year, respectivel y, would not be \neligible to be accounted for as a single performance obligation because they are not ‘concurrently delivered’. To be consistent, t he lessor non- separation \npractical expedient would similarly not apply to an operating lease and a \nservice provided over different periods of time. \n[ASU 2014- 09.BC116, ASU 2018-\n11.BC21] \n— The basis for conclusions to ASU 2018- 11 and the public Board discussions \nof the practical expedient both indicate that the principal application issue influencing creation of the practical expedient was the difficulty cited by \nmany lessors in determining stand- alone selling prices for lease and non -\nlease components that are rarely, if ever, sold separately (e.g. lease and \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 230}), Document(page\_content='Leases 230 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. maintenance and/or operations s ervices always sold together \nco-terminusly). \nConsequently, we do not believe the FASB intended for the practical \nexpedient to apply to contracts where this application issue generally \nshould not exist. Determining stand- alone selling prices, and allocating the \nconsideration in the co ntract accordingly, should be less difficult and require \nless estimation in contracts like the background example, because the \nlessor’s stand -alone sales of the services (through renewals, separate from \nthe longer term lease component), will generally prov ide observable stand-\nalone pricing information about the services that does not exist if the lease \nand services are always sold together as a bundle. [ASU 2018- 11.BC19, BC22] \nWe believe an exception arises if the lessee has the option to renew a shorter term non- lease component for the full duration of the ‘lease term’ or longer, \nand: \n[606- 10-55-42 – 55-43, 55 -45] \n\uf8e7 the option provides the lessee with a material right; \n\uf8e7 the lessor has elected and is permitted to apply the practical expedient in \nparagraph 606- 10-55-45 to account for the material right; and \n\uf8e7 the lessor expects, in accordance with paragraph 606- 10-55-45, to provide \nthe non- lease service for a period equal to (neither shorter than, nor \nexceeding) the lease term. \n \nLessee allocation of the consideration in the contract \n4.4.70 The consideration in the contract is allocated to the separate lease and \nnon-lease components on a relative stand- alone price basis. The stand- alone \nprice of a component is the price at which a customer would purchase that \ncomponent separately. Lessees are required to use observable stand- alone \nprices when they are available and to estimate stand- alone prices if observable \nprices are not available. [842-10-15-33, 842 Glossary] \n4.4.80 Initial direct costs are allocated to the separate lease components on the \nsame basis as the lease payments. The definition of and accounting for initial \ndirect costs are discussed in section 5.5. \n4.4.90 An observable stand- alone price is the price charged by the lessor or \nsimilar suppliers for a similar lease or non -lease component – i.e. a lease of a \nsubstantially similar asset or non -lease component under similar terms and \nconditions; for example, with respect to duration and payment terms – on a \nstand -alone basis. When estimating stand- alone prices, lessees are required to \nmaximize the use of observable information. In some circumstances, using a \nresidual approach for estimating the stand- alone price of a separate lease or \nnon-lease component may be appropriate (see Question 4.4.56 and \nExample 4.4.20). For example, a residual estimation approach may be \nappropriate if the stand- alone price for a component is highly variable or \nuncertain. [842- 10-15-33 – 15-34] \nLessor allocation of the consideration in the contract \n4.4.100 In following the guidance in Topic 606, a lessor allocates the \nconsideration in the contract to each separate lease and non- lease component \nto depict the amount of consideration to which t he lessor expects to be entitled ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 231}), Document(page\_content='Leases 231 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. (i.e. consistent with the ‘allocation objective in Topic 606 – see chapter 6 of \nKPMG Handbook, Revenue recognition ). [842- 10-15-38, 606 -10-32-28] \n4.4.110 The lessor will generally allocate the consideration in the contract to \neach separate lease component and each non- lease component on a relative \nbasis in proportion to its stand- alone selling price, which is determined as \nfollows. [606- 10-32-29 – 32-35] \nDetermine stand -alone selling prices\nIs an observable price available ?\nUse the observable \nprice1 Estimate price2\nAdjusted market \nassessment \napproachExpected cost \nplus a margin \napproachResidual \napproach \n(only in limited \ncircumstances )3Yes No\nNotes: \n1. An observable price is the price at which the lessor sells that component separately in \nsimilar circumstances and to similar customers. \n2. A lessor considers all information that is reasonably available when estimating a stand-\nalone selling price – e.g. market conditions, entity -specific factors, and information about \nthe lessee. A lessor also maximizes the use of observabl e inputs and applies consistent \nmethods to estimate the stand- alone selling price of components with similar \ncharacteristics. \n3. See Questi on 4.4.55 . \n4.4.120 Consistent with other components of ‘lease payments’, lease incentives \nmay be an allocated number. That is, a lessor may grant incentives to a lessee \nin a contract that includes lease and non- lease components. All incentives, \nhowever charac terized (i.e. as a lease incentive or otherwise) , reduce the \nconsideration in the contract (see section 4.3), which is allocated to the \ncomponents of the contract either on a relative stand- alone price basis (lessees) \nor in accordance with the transaction price allocation guidance in Topic 606 \n(lessors). Consequently, a portion of amounts characterized as lease incentives \nmay not be accounted for as such (i.e. may be allocated to a non- lease \ncomponent) and vice versa. \n4.4.13 0 In some circumstances, the tra nsaction price allocation guidance in \nTopic 606 requires the lessor to allocate a bundled discount or vari able \nconsideration on an other -than- relative basis to the components of the contract \n– i.e. a bundled discount or variable consideration may be alloca ted entirely to \nonly one or some, but not all, of the components (see chapter 6 of KPMG \nHandbook, Revenue recognition) . [606- 10-32-36 – 32-41] \n4.4.14 0 Topic 606 does not preclude or prescribe any particular method for \nestimating the stand- alone selling price of a good or service when observable ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 232}), Document(page\_content='Leases 232 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. stand -alone selling prices are not available but describes the following \nestimation methods as suitable approaches. [606- 10-32-34] \nEvaluate the market in which the performance \nobligation is sold and estimate the price that \ncustomers in the market would be willing to pay\nForecast the expected costs of satisfying a \nperformance obligation and then add an \nappropriate margin for that good or service\nSubtract the sum of the observable stand -alone \nselling prices of other performance obligations in \nthe contract from the total transaction priceAdjusted market \nassessment \napproach\nExpected cost plus a \nmargin approach\nResidual approach \n(limited \ncircumstances ) \n \n Question 4.4.30 \nAllocat ion on a relative stand -alone price basis \nHow is the guidance for allocating consideration different for \nlessees and lessors? \nInterpretive response: Lessees always allocate the consideration in the \ncontract on a relative stand -alone price basis. In contrast, because lessors apply \nthe transaction price allocation guidance in Topic 606, in some cases they will \nallocate a discount or variable consideration that is accounted for as \nconsideration in the contract to only one or some of the separate lease or non-\nlease components of the contract. [842- 10-15-33, 15- 38] \n \n Question 4.4.40 \nDifferent perspectives on observable stand -alone \n(selling) prices \nHow is an observable stand- alone price for a lessee different \nfrom an observable stand- alone selling price for a lessor? \nInterpretive response: For the lessee , observable stand- alone prices include \nthose charged not only by the lessor but also by other suppliers for the same or \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 233}), Document(page\_content='Leases 233 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. a similar component – e.g. the price charged for the lease of a similar piece of \nequipment or for similar services. [842- 10-15-34] \nFor the lessor , the definition of observable stand- alone selling price is more \nrestrictive, both in terms of using similar goods or services and considering \nsuppliers other than the lessor. Taken from Topic 606, an observable stand-\nalone selling price is the price for which the entity sells that good or service \nseparately in similar circumstances and to similar customers. [606- 10-32-32] \nHowever, applying a market assessment approach under Topic 606 might \ninclude referring to prices from the lessor’s competitors for similar goods or \nservices (and adjusting those prices as necessary to reflect the lessor’s costs \nand margins) as an acceptable technique for estimating the stand- alone selling \nprice. Therefore, while the lessor might use similar information to the lessee, its \nstand -alone selling price of a component may be considered ‘estimated’ , while \nthe lessee’s stand- alone price m ay be considered ‘observable’. [606- 10-32-34] \n \n Observation \nBurden of proof for observable stand -alone (selling) \nprices \n4.4.150 Both lessees and lessors are required to maximize the use of observable \ninformation in determining the stand- alone (selling) price of contract \ncomponents. However, we believe the Board generally intended to permit \nlessees to estimate stand -alone prices more fr equently than lessors. This is \nevidenced by the fact that Topic 842 requires a lessee to estimate stand- alone \nprices when observable stand- alone prices are not ‘readily available’. We \nbelieve it was the Board’s intent that lessees should not have to exhaus tively \nsearch for observable stand- alone prices, particularly when such a requirement \nmight put significant pressure on lessors to provide proprietary information to lessees. \n \n Example 4.4.10 \nAllocating the consideration in the contract – \nobservable input s \nThis example assumes that Lessee LE and Lessor LR have not elected the non-separation practical expedients in paragraphs 4.4.30 – 4.4.50 and \nparagraphs 4.4.51 – 4.4.56 , respectively. \nLessor LR leases a bulldozer to Lessee LE to be used in LE’s mining operations. \nLR also provides maintenance services for the bulldozer for the entire lease \nterm. Total consideration for the use of the bulldozer and the maintenance \nservices over the term of the contract is $125,000. There is no variable \nconsideratio n. \nLR and LE each consider stand- alone (selling) prices. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 234}), Document(page\_content='Leases 234 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — LR regularly leases bulldozers separately for comparable lease terms under \nsimilar terms and conditions. Therefore, both LE and LR have access to \nobservable stand- alone (selling) prices for the lease component ($100,000). \n— Although LR does not provide maintenance services separately from its equipment leases, there are many other service providers that do under \nsimilar terms and conditions (e.g. for similar periods and with similar \npayment terms). Both LR and LE arrive at a stand -alone (selling) price of \n$40,000, but their approaches differ. \n— LE is able to obtain an observable stand- alone price for the maintenance \nservices. The price of service providers other than LR for similar \nservices constitutes an observable stand- alone price for LE. \n— The price charged by other service providers does not constitute an \nobservable stand- alone selling price for LR; instead, LR uses the \nrates charged by other service providers to estimate a stand- alone \nselling price for the maintenance services (i.e. using a market assessment approach). \nIn this example, the allocation of consideration is the same for both LR and LE. \nComponent Stand -alone price Allocation Calculation \nBulldozer lease $100,000 $ 89,286 (100,000 / 140,000) × 125,000 \nMaintenance 40,000 35,714 (40,000 / 140,000) × 125,000 \n $140,000 $125,000 \n \n \n Question 4.4.50 \nDifferent estimation techniques \nHow might the techniques used to estimate stand- alone \n(selling) prices differ for lessees and lessors? \nInterpretive response: Lessees may rely on estimation techniques different \nfrom those used by lessors because lessors will frequently have greater access \nto observable information – e.g. their own incurred cost data or nonpublic \nindustry informati on on the pricing of lease or related non- lease components. \nEven so, it will generally not be appropriate for a lessee to default to the \nresidual approach when another approach would give a more representative \nresult. Estimation techniques used should be r easonable, applied consistently \nto similar circumstances, and not developed with a bias to reducing amounts \nallocated to lease components. [ASU 2016- 02.BC156] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 235}), Document(page\_content='Leases 235 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 4.4.55 \nStand -alone selling price estimation methods – \nresidual approach (lessors) \nWhen can a lessor use the residual ap proach to estimate \nstand- alone selling price? \nInterpretive response: The residual approach is appropriate only if the stand-\nalone selling price of one or more goods or services is highly variable or \nuncertain, and observable stand- alone selling prices exist for the other goods or \nservices promised in the contract. [606- 10-32-34(c)] \nSelling price is … If … \nHighly variable The entity sells the same good or service \nto different customers at or near the same time for a broad range of prices. \nUncertain The entity has not yet established the price \nfor a good or service and the good or \nservice has not previously been sold on a \nstand -alone basis. \nIf two or more goods or services in a lease have highly variable or uncertain \nstand -alone selling prices, a lessor may need to use a combination of methods \nto estimate the stand- alone selling prices of the lease and non- lease \ncomponent s in the contract. For example, a lessor may use: \n— the residual approach to estimate the aggregate stand- alone selling prices \nfor all of the promised goods or services with highly variable or uncertain \nstand -alone selling prices; and then \n— another techniqu e to estimate the stand- alone selling prices of the \nindividual goods or services in the bundle that was determined by the \nresidual approach. [606- 10-32-35] \nAdditionally, the residual approach is not appropriate if it results in zero or very \nlittle consider ation being allocated to a component, or to a bundle of \ncomponents. [606- 10-55-269, ASU 2014- 09.BC273] \nAnother approach may be more appropriate to estimate the stand- alone selling \nprice of a lease or non- lease component even if the criteria to use the resi dual \napproach are met. Topic 842 us es the transaction price allocation guidance in \nTopic 606 to allocate the consideration in the contract to lease and non- lease \ncomponents of the contract. Topic 606 requires that the method used to \nestimate a stand -alone selling price maximize the use of observable inputs. \nWhen there are observable inputs such as third- party pricing, or cost and/or \nmargin data from selling the same or similar goods or services another approach may be more appropriate. \n[606- 10-32-33] \nAdditional guidance is provided on estimating stand- alone selling prices in \nchapter 6 of KPMG Handbook, Revenue recognition . \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 236}), Document(page\_content='Leases 236 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 4.4.56 \nStand -alone selling price estimation methods – \nresidual approach (lessees) \nWhen can a lessee use the residual approach to estimate \nstand- alone selling price? \nInterpretive response: We believe four criteria need to be met for a lessee to \nuse the residual approach to estimate the stand- alone price of a component of a \ncontract. These criteria are broadly consistent with those for lessors (see \nQuestion 4.4.55), which is because the allocation guidance for lessees was \nintended to be similar to, and was largely drawn from, the Topic 606 transaction \nprice allocation guidance lessors are required to apply. [ASU 2016 -02.BC156] \nCriteria 1 and 2 are included in Topic 842, while Criteria 3 and 4 are drawn from \nthe Board’s statement that the lessee allocation guidance is intended to be \nsimilar to that for lessors (without directing lessees to the revenue recognition guidance). \nCriterion 1: Highly variable or uncertain stand -alone price \nUsing the residual approach to estimate the stand- alone price of a component is \nappropriate only if the stand -alone price of the component to which the \napproach would be applied is highly variable or uncertain. \n[842- 10-15-33(a), ASU 2016-\n02.BC155(a) ] \nStand -alone price is … If … \nHighly variable The price at which the lessee could \npurchase the same or a substantially \nsimilar good or service in the same \ntimeframe is widely varied. \nUncertain The same or a substantially similar good or \nservice is not, and has not previously been, \nsold on a stand- alone basis such that its \nstand -alone price has not been established. \nCriterion 2: Other observable data is considered first \nTopic 842 requires that the method used to estimate a stand- alone price \nmaximize the use of observable inputs (or information). Therefore, before using \na residual estimation approach, the lessee must consider whether another \nestimation approach that maximize s the use of observable information/inputs, \nsuch as observable cost and/or margin information, is more appropriate. [842- 10-\n15-33(a), ASU 2016- 02.BC155(a)] \nCriterion 3: Resid ual approach does not produce zero or de minim is stand -\nalone price \nConsistent with the requirements for lessors, we believe a residual estimation \napproach is not appropriate if it results in zero or very little consideration being \nallocated to a component, or to a bundle of components. It is inconsistent with \nthe view that the component transfers a good or service – i.e. provides benefit \nto the lessee – to conclude that it has no stand- alone value. [606- 10-55-269, \nASU 2014- 09.BC273] \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 237}), Document(page\_content='Leases 237 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Criterion 4: Observable stand -alone prices for other components \nTo apply the resi dual approach, the lessee needs to have observable stand-\nalone prices (see paragraph 4.4.90) for the components of the contract for \nwhich the residual approach will not be used to estimate their stand- alone \nprices. This is consistent with the requirement for lessors that observable \nstand -alone selling prices exist for the other components of the contract; \nhowever, as outlined in Question 4.4.40, what consti tutes an ‘observable stand-\nalone price’ for a lessee is not the same as what constitutes an ‘observable \nstand -alone selling price’ for a lessor. \nResidual bundles \nConsist ent with the allocation guidance for lessors (see Question 4.4.55), i f two \nor more goods or services in a lease have highly variable or uncertain stand -\nalone selling prices , a lessee may need to use a combination of methods to \nestimate the stand- alone prices of the lease and non -lease components in the \ncontract. For example, the lessee may u se: \n— the residual approach to estimate the aggregate stand- alone prices for all of \nthe components with highly variable o r uncertain stand- alone prices; and \nthen \n— another technique to estimate the stand- alone prices of the components in \nthe residual bundl e. \n \n Example 4.4.20 \nAllocating the consideration in the contract – \nobservable and estimated stand -alone (selling) \nprices (1) \nThis example assumes that Lessee LE and Lessor LR have not elected the non-separation practical expedients in paragraphs 4.4.30 – 4.4.50 and \nparagraphs 4.4.51 – 4.4.56 , respectively. \nLessor LR leases a specialized machine for two years to Lessee LE, and \nprovides consulting services to help LE effectively use the machine in its \nproduction processes. The machine is not sold or leased separately by LR and \nthere are no similar machines for sale or lease from other suppliers. \nThe contract consideration is $100,000 for the first year and $80,000 for the \nsecond year. LR priced the contract in this way assuming that it will provide \nmore consult ing services in the first year. \nLessee \nBecause LR does not sell or lease the specialized machine, or provide substantially equivalent consulting services separately, LE allocates the consideration in the contract based on observable and estimated relative stand- alone prices. \nLE determines the stand- alone prices for the lease and the consulting services \nas follows. \n— LE obtains an observable stand- alone price for the consulting services \nbased on similar services offered in the marketplace ($40,000). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 238}), Document(page\_content='Leases 238 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — There are no similar machines for sale or lease from suppliers other than \nLR, and therefore LE cannot obtain an observable stand- alone price or use a \nmarket -base d assessment estimation approach. In addition, LE also does \nnot have the information needed to apply an expected cost -plus-margin \napproach. Consequently, because LE has an observable stand- alone price \nfor the consulting services and using a residual approach would not result in \nan estimated stand- alone price that is $0 or de minim is, LE concludes t hat a \nresidual approach is reasonable and appropriate in the circumstances. \nOn this basis, LE allocates the consideration as follows. \nComponent Stand -alone price Allocation Calculation1 \nMachine lease $140,000 $140,000 Residual (180,000 – 40,000) \nConsulting 40,000 40,000 Observable price \n $180,000 $180,000 \nNote: \n1. This calculation relates to determining the stand -alone prices, which are then allocated to \nthe components of the contract. \nLessor \nBecause LR does not sell or lease the specialized machine, or provide substantially \nequivalent consulting services separately, LR allocates the consideration in the \ncontract on a relative basis using estimated stand- alone selling prices. \nLR estimates the stand- alone selling prices as follows. \n— The specialized nature of the machine precludes using a market \nassessment approach – i.e. there are no similar machines for lease by other \nsuppliers to assess. Consequently, LR uses another estimation technique to arri ve at a stand -alone selling price of $160,000 for the machine lease. \n— LR uses a market -based assessment approach to arrive at a stand -alone \nselling price of $40,000 for the consulting services based on similar services offered in the consulting marketplace. \nOn this basis, LR allocates the consideration as follows. \nComponent Stand -alone price Allocation Calculation \nMachine lease $160,000 $144,000 (160,000 / 200,000) × 180,000 \nConsulting 40,000 36,000 (40,000 / 200,000) × 180,000 \n $200,000 $180,000 \n \n \n Example 4.4.25 \nEmbedded supply agreement lease with minimum \npurchase quantities – lessee accounting \nThis example assumes that Lessee LE has not elected the non- separation \npractical expedient in paragraphs 4.4.30 – 4.4.50. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 239}), Document(page\_content='Leases 239 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Scenario 1: Annual purchase minimum \nLessee LE enters into a five- year supply contract for widgets from \nManufacturer LR. On the basis that LE will have exclusive rights to the output \nfrom LR’s facility that produces the widgets over the five- year contract term, \nand LR’s production from the facility will be dictated by LE’s purchase orders, LE concludes it is leasing LR’s facility. The lease is classified as an operating \nlease because none of the criteria in paragraph 842- 10-25-2 are met. \nLR will operate the production facility throughout the contract term – i.e. \noperating and maintaining the facility and its component equipment. Its servi ce \n(O&M) to do so is a non- lease component of the contract. \nThe following additional facts are relevant. \nContract payments : $1.50 per widget, subject to an \nannual minimum of 1,000 widgets \nNon-cancellable contract term: 5 years \nRenewal or termination options: None \nLE’s incremental borrowing rate (implicit rate \nis not readily determinable) : 6% \nIDCs, lease incentives or lease prepayments: None \nBased on its forecasts and experience, LE ex .pects to purchase between 1,800 \nand 2,400 widgets per year over the five- year term of the supply contract. This \nequates to LE payments to LR of between $13,500 and $18,000 over that \nperiod. \nHowever, because LE is only required to purchase 1,000 widgets per yea r, the \nconsideration in the contract at lease commencement is only $7,500 (1,000 \nwidgets x $1.50 × 5 years). Any payments for widgets above the minimum are \nvariable payments not part of the consideration in the contract. \nLE considers the stand- alone prices of the facility lease and the O&M services. \nLR does not lease production facilities or provide operations services for other \nentities’ facilities. In addition, there are not observable stand- alone prices from \nother suppliers for either similar leases or similar O&M services. \nTherefore, LE estimates the stand- alone prices of each, and allocates the \nconsideration in the contract as follows. \nComponent Stand -\nalone \nprice Allocation Calculation Allocation \nper widget Calculation \nFacility lease $ 6,000 $ 4,500 (6,000 / 10,000) × \n7,500 $ 0.90 (6,000 / 10,000) \n× $1.50 \nO&M services 4,000 3,000 (4,000 / 10,000) × \n7,500 0.60 (4,000 / 10,000) \n× $1.50 \n $10,000 $7,500 \nConsistent with paragraphs 4.4.220 and 4.4.221, LE recognizes the variable \npayments for widgets above the contract minimums when incurred as a result \nof LR production. It allocates those payments to the facility lease and ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 240}), Document(page\_content='Leases 240 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. operations services consistent wit h the allocation in the table – i.e. $0.90 per \nwidget to the facility lease and $0.60 per widget to the O&M services. \nAssuming the actual widget purchases in the following table and no lease \nremeasurements, contract modifications or ROU asset impairments, LE \naccounts for the lease liability, ROU asset and lease cost as follows over the \nfive-year lease term. For ease of illustration, it is assumed that payments for the \npurchased widgets are made at the end of each year in arrears. \nYr. Widgets \npurch.1 Lease \nliab. / \nROU \nasset2 Lease \nliab. \naccret.3 ROU \nasset \namort.4 Single \nlease \ncost5 Variable \nlease \ncost6 Total \nlease \ncost7 Ops \ncost8 \n $ 3,791 $ 0 $ 0 $ 0 $ 0 $ 0 $ 0 \n1 1,900 3,119 227 673 900 810 1,710 1,140 \n2 2,000 2,406 187 713 900 900 1,800 1,200 \n3 2,100 1,650 144 756 900 990 1,890 1,260 \n4 2,200 849 99 801 900 1,080 1,980 1,320 \n5 2,400 0 51 849 900 1,260 2,160 1,440 \nNotes: \n1. Actual widgets purchased by LE. \n2. The lease liability and the ROU asset are equal at the end of each year of the lease term \nbecause there are no lease prepayments, IDCs or lease incentives. \n3. Lease liability accretion = prior year lease liability balance × 6%. \n4. ROU asset amortization = single lease cost – lease liability accretion. \n5. The single lease cost equals $4,500, which is the ‘lease payments’ allocated to the lease \ncomponent (5,000 widgets × $0.90). Amount calculated as ($4,500 / 5 years = $900 per \nyear). \n6. Variable lease cost = (total widg ets purchased for the year × $0.90) – single lease cost for \nthe year. \n7. Total lease cost = single lease cost + variable lease cost. LE capitalizes lease cost as part \nof the carrying amount of its widget inventory; see paragraph 6.4.70. \n8. O&M service (i.e. non -lease component) cost = total widgets purchased for the year × \n$0.60 per widget. \nScenario 2: Cumulative purchase minimum (1) \nAssume the same facts as Scenario 1, except that instead of an annual \npurchase minimum of 1,000 widgets per year, the contract stipulates a \ncumulative minimum for the five- year contract term of 6,000 widgets. \nLE recognizes the single lease cost of $5,400 (6,000 widgets × $0.90 per \nwidget for the lease component) on a straight -line basis over the five- year lease \nterm; the ROU asset is also amortized over that same period. \nIn contrast, the lease liability is reduced as widgets are produced and paid for by \nLE such that the lease liability is reduced to $0 once the cumulative m inimum \npurchase requirement has been met. Based on actual purchases in the table \nbelow, the lease liability is $0 at the end of Year 3. \nConsistent with paragraph 4.3.20, LE does not include the variable payments \nfrom widget purchases above the cumulative minimum volume in the ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 241}), Document(page\_content='Leases 241 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. consideration in the contract. Those variable payments do not depend on an \nindex or rate and are not in- substance fixed. \nAssuming the actual widget purchases in the following table and no lease \nremeasurements, contract modifications or ROU asset impairments, LE \naccounts for the lease liability, ROU asset and lease cost as follows over the \nfive-year lease term. For ease of illustration, it is assumed that payments for the \npurchased widgets are made at the end of each year in arrears. \n Lease liability ROU asset \nYr. Beg. balance Liability \naccret.1 Lease \npmts.2 End. \nbalance Beg. \nbalance Amort.3 End. \nbalance \n1 $ 4,802 $ 288 $ (1,710) $ 3,380 $ 4,802 $ (792) $ 4,010 \n2 3,380 203 (1,800) 1,783 4,010 (877) 3,133 \n3 1,783 107 (1,890) 0 3,133 (973) 2,160 \n4 0 0 (1,980) 0 2,160 (1,080) 1,080 \n5 0 0 (2,160) 0 1,080 (1,080) 0 \nNotes: \n1. Lease liability accretion = beginning lease liability balance × 6%. \n2. Lease payments = widgets purchased × $0.90 per widget. \n3. ROU asset amortization = single lease cost below – lease liability accretion. \n \nYr. Widgets \npurchased4 Single lease \ncost5 Variable lease \ncost6 Total lease \ncost7 O&M svc. \ncost8 \n1 1,900 $ 1,080 $ 630 $ 1,710 $ 1,140 \n2 2,000 1,080 720 1,800 1,200 \n3 2,100 1,080 810 1,890 1,260 \n4 2,200 1,080 900 1,980 1,320 \n5 2,400 1,080 1,080 2,160 1,440 \nNotes: \n4. Actual widgets purchased by LE. \n5. The single lease cost equals $ 5,400, which is the ‘lease payments’ allocated to the \nlease component (6,000 widgets × $0.90) . Annual amount calculated as ($5,4 00 / 5 \nyears = $ 1,080 per year). \n6. Variable lease cost = (total widgets purchased for the year × $0.90) – single lease cost \nfor the year . \n7. Total lease cost = single lease cost + variable lease cost . LE capitalizes lease cost as \npart of the carrying amount of its widget inventory; s ee paragraph 6.4.70. \n8. O&M service (i.e. non -lease component) cost = total widgets purchased for the year \n× $0.60 per widget. \nScenario 3: Cumulative purchase minimum (2) \nAssume the same facts as Scenario 2. \nIn contrast to Scenario 2, LE recognizes the single lease cost of $5,400 (6,000 \nwidgets × $0.90 per widget for lease component) on a straight -line basis over ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 242}), Document(page\_content='Leases 242 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the anticipated period it will take LE to reach the cumulative purchase minimum \nof 6,000 widgets. In this scenario, that is three years. \nThe ROU asset is amortized over that same three- year period. \nThe following are consistent with Scenario 2. \n— The lease liability is reduced as widgets are produced and paid for by LE \nsuch that the lease liability is re duced to $0 once the cumulative minimum \npurchase requirement has been met. Based on actual purchases in the \ntable below, the lease liability is $0 at the end of Year 3. \n— LE does not include the variable payments from widget purchases above \nthe cumulative m inimum volume in the consideration in the contract. Those \nvariable payments do not depend on an index or rate and are not in-\nsubstance fixed. \nAssuming the actual widget purchases in the following table and no lease \nremeasurements, contract modifications or ROU asset impairments, LE \naccounts for the lease liability, ROU asset and lease cost as follows over the \nfive-year lease term. For ease of illustration, it is assumed that payments for the \npurchased widgets are made at the end of each year in arrears. \n Lease liability ROU asset \nYr. Beg. balance Liability \naccret.1 Lease \npmts.2 End. \nbalance Beg. \nbalance Amort.3 End. \nbalance \n1 $4,802 $288 $(1,710) $3,380 $4,802 $(1,512) $3,290 \n2 3,380 203 (1,800) 1,783 3,290 (1,597) 1,693 \n3 1,783 107 (1,890) 0 1,693 (1,693) 0 \n4 0 0 (1,980) 0 0 (0) 0 \n5 0 0 (2,160) 0 0 (0) 0 \nNotes: \n1. Lease liability accretion = beginning lease liability balance × 6%. \n2. Lease payments = widgets purchased × $0.90 per widget. \n3. ROU asset amortization = single lease cost below – lease liability accretion. \n \nYr. Widgets \npurchased4 Single lease \ncost5 Variable lease \ncost6 Total lease \ncost8 O&M svc. \nCost9 \n1 1,900 $ 1,8 00 $ 06 $ 1,800 $ 1,800 \n2 2,000 1,800 06 1,800 1,800 \n3 2,100 1,800 07 1,800 1,800 \n4 2,200 0 1,9806 1,980 1,980 \n5 2,400 0 2,1606 2,160 2,160 \nNotes: \n4. Actual widgets purchased by LE. \n5. The single lease cost equals $ 5,400, which is the ‘lease payments’ allocated to the \nlease component (6,000 widgets × $0.90) . Annual amount calculated as ($5,4 00 / 3 \nyears = $ 1,800 per year). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 243}), Document(page\_content='Leases 243 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Yr. Widgets \npurchased4 Single lease \ncost5 Variable lease \ncost6 Total lease \ncost8 O&M svc. \nCost9 \n6. Variable lease cost = (total widgets purchased for the year × $0.90) – single lease cost \nfor the year. \n7. Year 3 single lease cost reflects the reversal of the $90 in deferred rent created in \nyear 1, when LE’s purchase of only 1,900 widgets incurred payments to LR of only \n$1,710. It is for this reason that there is no variable lease cost in year 3 despite that \nLE’s purchases of 2,100 widgets incurred payments to LR of $1,890. \n8. Total lease cost = single lease cost + variable leas e cost . LE capitalizes lease cost as \npart of the carrying amount of its widget inventory – see paragraph 6.4.70. \n9. O&M service (i.e. non -lease component) cost = total widgets purchased for the year × \n$0.60 per widget. \n \n \n Question 4.4.60 \nAllocating consider ation when there are multiple \nlease and multiple non -lease components \nHow does the method for allocating consideration when \nthere are multiple lease and multiple non- lease components \ndiffer for lessors and lessees? \nInterpretive response: For lessors, we believe each separate lease and non-\nlease component needs to be identified before allocating the consideration in \nthe contract, which is the methodology followed in the examples in Topic 842. \nNon- lease components are assessed for separation from each other using the \nguidance on identifying performance obligations in Topic 606. \nThis means that each separate component – whether lease or non -lease – is a \nseparate unit of account for the purpose of determining stand- alone selling \nprices and allocating consideration. This is relevant because a bundle of two or \nmore components may have a different stand- alone selling price (e.g. a bundled \ndiscount) that would affect allocation if components were grouped. [842- 10-55-132 \n– 55-137, ASU 2016- 02.BC145] \nWe believe the Board intended for lessees to identify the separate lease \ncomponents of the contract and then account for non- lease components that \nrelate to different separate lease components as separate units of account. \nIt is not clear whether a lessee would be required to separately account for \nmultiple non- lease components that relate to a single lease component. In such \ncases, it may be acceptable for a lessee to determine the stand- alone price for \nmultiple non- lease components that relate to a single lease component as a \nbundle. However, because Topi c 842 requires that stand- alone prices be \nobservable (when readily available) and the use of observable data maximize d \nwhen stand- alone prices are estimated, that might limit lessees’ choices in this \nregard. For example, the requirement to maximize the use of observable data \ngenerally means that it is not appropriate to estimate the stand- alone price of a \nbundle that is not regularly sold separately if there are readily available observable prices for the non- lease components individually. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 244}), Document(page\_content='Leases 244 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 4.4.65 # \nAllocating consideration in related party leases \nShould an entity allocate consideration in the contract for a \nrelated party lease based on stand -alone (selling) prices ? \nBackground: An entity classifies a lease on the basis of its legally enforceable \nterms and conditions if the lease is between: [842- 10-55-12] \n— related parties not under common control; or \n— parties under common control to which the practical expedient described \nbelow is not applied. \nSee paragraph 6.2.210 regarding related party leases . \nThese leases are also recognized and measured based on the legally \nenforceable terms and conditions of the arrangement . As stated in the basis for \nconclusions to ASU 2016- 02, the accounting that results therefrom is not \nadjusted to reflect the economic substance of the arrangement . [ASU 2016 -\n02.BC374] \nFor common control leases, an entity can elect, on an arrangement -by-\narrangement basis, a practical expedient to classify and account for the lease \nbased solely on the written terms and conditions, regardless of whether those terms and conditions are legally enforceable (see section 3.1.2). \n[842- 10-15-3A] \nInterpretive response: It depends on whether the related part y lease is \nbetween entities under common control and, if so, whether the entity elected the written terms and conditions practical expedient . \nLease is between related parties not under common control (or under \ncommon control but practical expedient not el ected) \nAs noted above, Topic 842 specifies these leases should be accounted for \nbased on their enforceable terms and conditions. Therefore, we do not believe \namounts should be allocated to separate lease and non- lease components that \nexceed the amounts to which the lessee is legally obligated (the lessor is legally entitled) for those components. This applies even if the resulting allocations are \nuneconomical or clearly designed to achieve a particular accounting outcome \n(e.g. a smaller lease liability). \n \nIn contrast, if the enforceable amounts for each component cannot be \ndetermined (e.g. the contract is enforceable only as a whole), then we believe \nthe entity should allocate the consideration in the contract on a relative stand-\nalone (selling) price basis. \nLease is between related parties under common control and the terms \nand conditions practical expedient is elected \nTopic 842 specifies that these leases are classified and accounted for based on \ntheir written (instead of enforceable) terms and conditions. Therefore, because \nallocation of the consideration in the contract is an integral aspect of lease \naccounting under Topic 842, we believe amounts should be allocated to \nseparate lease and non- lease components on the basis of the amount s to which \nthe lessee is obligated (the lessor is entitled) for those components in \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 245}), Document(page\_content='Leases 245 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. accordance with the written terms and conditions between the parties. This \napplies even if the resulting allocations are uneconomical or clearly designed to \nachieve a parti cular accounting outcome (e.g. a smaller lease liability). \nIn contrast, if the written terms and conditions do not specify the amounts \nowed (entitled) for each component, then we believe the entity should allocate \nthe consideration in the contract on a relative stand -alone (selling) price basis. \n \n Question 4.4.70 \nStand -alone selling price for CAM provided by the \nlessor at a loss \nShould a lessor providing CAM at a loss include a profit \nmargin when determining the stand- alone selling price for \nCAM? \nInterpretive response: Yes. While CAM may be provided at a loss by real \nestate lessors, the stand- alone selling price (i.e. ‘the price at which an entity \nwould sell a promised good or service separately to a customer’) of CAM would \ngenerally not be such that it would result in a loss. \nAn entity providing CAM (or the services underlying CAM) would not sell such \nservices separately at a loss. Therefore, even if the loss -based CAM pricing is \nstipulated in the contract, and even if other lessors similarly price their CAM in \nbundled lease arrangements, the stand- alone selling price for CAM based on \nthe guidance in Topic 606 would differ from that contractually stated amount. In \ngeneral, where CAM is provided at a loss, the economics of the lease \narrangement are that the rental payment subsidizes CAM (in the form of a higher rental payment). \nBy applying the guidance in Topic 606 on determining stand- alone selling prices \nand allocating the transaction price to these lease arrangements, lessors may allocate more revenue to CAM and less revenue to the lease component than \nthey did under Topic 840. \n \n Comparison to legacy US GAAP \nSeparating lease from non -lease components \n4.4.160 Topic 842 and Topic 840 are generally consistent with respect to \naccounting for non- lease components (or elements) separately from lease \ncomponents. For example, Topic 840 , like Topic 842, required ‘substantial \nservices’ (i.e. in general, most services other than routine maintenance) or \ngoods, such as consum ables, provided by the lessor to be accounted for \nseparately from the lease elements of a contract. However, unlike Topic 842, \nTopic 840 did not permit entities to not separate substantial service elements \nfrom the lease element to which they related . [840- 10-15-19] \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 246}), Document(page\_content='Leases 246 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 4.4.170 The guidance in Topic 842 with respect to separating lease from non-\nlease components of a contract is significantly more consequential to a lessee’s \naccounting than the similar guidance in Topic 840. This is because while \noperating leas e elements and service elements are accounted for similarly \nunder Topic 840, lease components are subject to substantially different \naccounting requirements (i.e. the recognition of lease assets and lease \nliabilities) under Topic 842 than non- lease components. \nDetermining the stand -alone (selling) price of components and allocating \nconsideration \n4.4.180 The requirements of Topic 842 differ from those in Topic 840 in the \nfollowing key respects . \n— Under Topic 842, executory costs that do not transfer a good or service to \nthe customer (e.g. payment of the lessor’s property taxes or insurance) are \nallocated to both the lease and the non- lease components of the contract \non the same basis as the other consideration in the contract . Under \nTopic 840, all executory costs are considered related to the lease element. \n— While the relative fair value allocation method under Topic 840 was \nsubstantially the same as the relative stand -alone price allocation method \napplicable to lessees under Topic 842, additional ri gor is prescribed for \ndetermining the stand- alone price of the components of the contract. \nFor example, in no case does Topic 842 permit an entity to default to \namounts specified in the contract when determining the stand- alone price \nfor a component. An entity determines the stand- alone (selling) price of a \nlease or a non- lease component based on its observable stand- alone \n(selling) price (if readily available), and estimated stand -alone (selling) prices \nif observable prices are not readily available. Cont ractually stated amounts \nfor lease or non- lease payments should not be presumed to represent the \nstand -alone (selling) price for a component. \n Consistent with the discussion in Question 4.4.70, the allocation \nrequirements in Topic 842 may result in differ ent allocations between \ncomponents than occurred under Topic 840. [840- 10-15-19] \n \n4.4.2 Allocate variable consideration in the contract – \nlessor \n4.4.190 If variable payment s are included in the consideration in the contract \n(see section 4.3) for a lessor, they are allocated entirely to the non- lease \ncomponent(s) to which they relate if that would be consistent with the transaction price allocation objective in Topic 606. \n[842- 10-15-39] \nTransaction price allocation objective \nThe objective when allocating the transaction price is for an entity to allocate the \ntransaction price to each performance obligation (or distinct good or service) in an \namount that depicts the amount of consideration to which the entity expects to be \nentitled in exchange for transferring the promised goods or services to the customer. \n[606- 10-32-28] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 247}), Document(page\_content='Leases 247 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 4.4.200 If the lessor does not allocate those variable payments entirely to the \nnon-lease component(s) to which they relate, it allocates them on the same \nbasis as the remainder of the consideration in the contract. [606- 10-32-39] \n \n Example 4.4.30 \nAllocating the consideration in the contract – \nobservable and estimated stand -alone (selling) \nprices (2) \nThis example is a continuation of Example 4. 3.10, which illustrated how to \nmeasure the consideration in the contract in three scenarios. This example \ntakes the consideration that was calculated for the lessor , and allocates it to \ncomponents following the guidance in Topic 606. \nIn all three scenarios, it is assumed the stand- alone selling prices are $315,000 \n(equipment) and $40,000 (maintenance) , and Less or LR has not elect ed the \nnon-separation practical expedient in paragraphs 4.4.51 – 4.4.56 . \nScenario 1: Variable payments not based solely on non -lease component \nLessee LE and Lessor LR enter into a three- year lease of equipment that \nincludes maintenance services on the equipm ent throughout the lease term. LE \nwill pay LR: \n— a fixed payment of $110,000 per year; and \n— a variable payment of $7,700 each year that the equipment is operating a minimum number of hours at a specified level of productivity (i.e. the \nequipment is not malfunctioning or inoperable). \nIn Example 4. 3.10, Scenario 1, the consideration in the contract was measured \nat $330,000, which excluded any variable payments. LR allocates the \nconsideration in proportion to stand- alone selling prices as follows. \nComponent Stand -alone \nselling price Allocation Calculation \nEquipment lease $315,000 $292,817 (315,000 / 355,000) × 330,000 \nMaintenance 40,000 37,183 (40,000 / 355,000) × 330,000 \n $355,000 $330,000 \nScenario 2: Variable payments that specifically relate to a non -lease \ncomponent – allocation to lease and non -lease components \nChanging the facts of Scenario 1, the maintenance services are highly \nspecializ ed and no entity would expect the equipment to meet the specified \nperformance metrics without the related maintenance services. \nIn Example 4.3.10, Scenario 2, the consideration in the contract was measured \nat $353,100, which included $23,100 of variable payments related to the \nmaintenance (non -lease) comp onent. \nNext, following the allocation objective in Topic 606 (see paragraph 4.4.190), LR \nconsiders whether allocating the entire variable amount of $23,100 to the ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 248}), Document(page\_content='Leases 248 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. maintenance component would depict the amount of consideration to which LR \nexpects to be enti tled in exchange for providing the lease and maintenance \nservices to LE. If it does, total consideration would be allocated in one of the \ntwo following ways. \nApproach 1 \nComponent Stand -alone \nselling price Allocation Calculation \nEquipment lease $315,000 $292,817 (315,000 / 355,000) × 330,000 \nMaintenance 40,000 60,283 ((40,000 / 355,000) × 330,000) \n+ 23,100 \n $355,000 $353,100 \nApproach 2 \nComponent Stand -alone \nselling price Allocation Calculation \nEquipment lease $315,000 $330,000 All fixed consideration \nMaintenance 40,000 23,100 Only variable consideration \n $355,000 $353,100 \nHowever, in this Scenario, LR concludes that allocating $60,283 (or $23,100) to \nthe maintenance services would not depict the consideration to which LR \nexpects to be entitled for each component. This is because these two amounts \nare significantly higher (lower) than the amount to which LR expects to be \nentitled for the maintenance services. \nLR allocates the total consideration in proportion to the components’ stand-\nalone selling prices as follows. \nComponent Stand -alone \nselling price Allocation Calculation \nEquipment lease $315,000 $313,314 (315,000 / 355,000) × 353,100 \nMaintenance 40,000 39,786 (40,000 / 355,000) × 353,100 \n $355,000 $353,100 \nAlternatively, consistent with Lessor LR’s allocation of the consideration in the contract between the lease component and the CAM in Example 4.2.40, we \nbelieve the following allocation would also be acceptable in this scenario: \nComponent Stand -alone \nselling price Allocation Calculation \nEquipment lease $315,000 $313,197 (315,000 / 331,9001) × 330,000 \nMaintenance 40,000 39,903 ((16,900 / 331,9001) × \n330,000) + 23,100 \n $355,000 $353,100 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 249}), Document(page\_content='Leases 249 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Note : \n1. The total of the stand- alone selling prices used in the calculations ($331,900) has been \nadjusted to remove the $23,100 that has already been specifically allocated to t he non -\nlease maintenance component ($355,000 – $23,100 ). \nEither allocation method illustrated results in approximately 89% of the \nconsideration in the contract being alloca ted to the lease component and \napproximately 11 % being allocated to the maintenance non- lease component. \nScenario 3: Variable payments that specifically relate to a non -lease \ncomponent – allocation only to non -lease component \nChanging the facts of Scenario 2, LE will pay LR: \n— a fixe d payment of $102,700 per year; and \n— a variable payment of $15,000 each year that the equipment is operating a \nminimum number of hours at a specified level of productivity. \nIn Example 4. 3.10, Scenario 3, the consideration in the contract was measured \nat $338,100, which included $30,000 of variable payments related to the maintenance (non -lease) component. \nNext, LR concludes that allocating the entire variable amount of $45,000 to the maintenance component (full value of the estimated variable payments, without \nconsi deration of the constraint on variable consideration) and the entire fixed \namount of $308,100 to the lease would reasonably depict the amount of consideration to which LR expects to be entitled in exchange for providing the \nlease and maintenance services t o LE. The $308,100 and the $45,000 \napproximate the stand- alone selling prices of the lease ($315,000) and the \nmaintenance services ($40,000), respectively. \nBecause the variable payments are allocated entirely to the maintenance \nservices, if the considerati on in the contract changes because LR concludes it is \nnow probable that it will earn the full $45,000 in variable payments, that change \nis allocated entirely to the maintenance services component. \n \n Example 4.4.40 \nPercentage rent in a real estate lease \nThis example assumes that Lessee LE and Lessor LR have not elected the \nnon-separation practical expedients in paragraphs 4.4.30 – 4.4.50 and \nparagraphs 4.4.51 – 4.4.56 , respectively. \nLessee LE and Lessor LR enter into a five- year lease for LE to be an anchor \ntenant at a regional mall. \nThe lease does not require LE to pay LR any fixed payments. Rather, LE will pay \npercentage rent to LR equal to 5% of the first $2,000,000 in gross annual sales, and 7% on any sales in excess of $2,000,000 during the period. \nLE will also reimburse LR for its portion of LR’s actual property tax \nassessments and building insurance costs during the lease term and its share \nof LR’s CAM costs. LR estimates LE’s portion of LR’s costs of property taxes ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 250}), Document(page\_content='Leases 250 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. and building insurance to be approximately $20,000 per year. LR estimates LE’s \nportion of LR’s CAM costs to be $10,000 per year. \nLessee \nLE does not include the variable payments in the consideration in the contract. \nThis is because the payments do not depend on an index or rate, and are not in -\nsubstance fixed because the variable terms have economic substance – i.e. \nthey exist as a substantive way for LE and LR to share in the risks and benefits \nfrom use of the retail space – and create genuine variability in the lease \npayments to be made. This is true even if LE and LR can reliably forecast \nLE’s annual sales for purposes of estimating the percentage rent (see \nExample 5.4.80). \nTherefore, the consideration in the contract is $0. LE will not recognize an ROU \nasset or lease liability at lease commencement. \nLessor \nLR starts with the amount of consideration determined in the same way as LE ($0). \nNext, LR considers the link between the variable payments of $50,000 ($10,000 × 5) and the performance of CAM. LR concludes that the variable \npayments relate specifically to an outcome dependent on LR’s satisfactory \nperformance of CAM (non- lease component). \nNext, LR applies the variable consideration requirements in Topic 606 to \ncalculate the amount that should be included in the consideration in the \ncontract. \na. LR estimates that the amount to which it expects to be entitled from \nvariable payments for CAM is $50,000. \nb. LR concludes that it is probable that including that amount in the \nconsideration in the contract will not result in a significant revenue reversal \nto the cumulative revenue recognized under the contract when the \nuncertainty is resolved. \nTherefore, the consideration in the contract is $50,000. \nLR does not include estimated payments related to percentage rent or property \ntaxes and building insurance reimbursements in the consideration in the \ncontract. This is because these payments represent variable payments \nspecifically or partially related to the lease component that do not depend on an \nindex or rate. \nLR will recognize these variable payments related to percentage rent and \nproperty tax and building insurance reimbursements as earned – e.g. recognize \npercentage rent once LE’s actual sales occur. \nNext, applying the allocation objective in Topic 606 (see paragraph 4.4.190) , LR \nconsiders whether allocating the entire variable amount of $50,000 to CAM \nwould be appropriate. The evaluation of whether the allocation objective is met \nshould consider the resulting allocation to both the lease and CAM. \nIn this example, the allocat ion objective would not be met for the lease because \nthe lease would receive no allocation of the consideration in the contract unless ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 251}), Document(page\_content='Leases 251 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. a portion of the $50,000 is allocated to it. This is true even if the $50,000 is \nconsistent with the stand- alone selling price for CAM. \nTherefore, LR allocates the consideration in the contract of $50,000 to the lease \ncomponent and non- lease component based on their relative stand- alone \nselling prices. When LR’s estimate of the amount to which it expects to be \nentitled for CAM changes from $50,000, those changes are changes to the \nconsideration in the contract and will be allocated on the same basis as the $50,000 was allocated to the lease and CAM initially (see Example 14 Case B in \nSubtopic 842-10). \n[842- 10-55-153 – 55-156] \n \n Question 4.4.80 \nLessor accounting for a supply agreement that \nincludes a ‘free’ lease of equipment \nHow does a lessor allocate the consideration in the contract \nand variable payments between goods and a ‘free’ lease of \nequipment with which the goods will be used? \nBackground : A supplier of goods will frequently provide customers with related \nequipment for use with its goods for no stated consideration – i.e. the contract \ndoes not stipulate a fixed or variable payment expressly for the right to use the \nequipment. Rather, the customer pays only a per unit price for the applicable goods. \nThe following are exa mples. \n— A supplier of chemicals or gases may provide its customers with the right to use storage tanks (or other containers) to store the chemicals or gases \nuntil their use by the customer for no stated consideration. The only \nconsideration that will be pai d by the customer is a per unit purchase price \nfor the chemicals or gases. \n— A supplier of medical devices and related consumables may provide its \ncustomers with the right to use a medical device, with which the customer \nmay use only the supplier’s consumabl es, for no stated consideration. The \nonly consideration that will be paid by the customer is a per unit purchase \nprice for the consumables. \nTerms and conditions of the arrangement, and other facts and circumstances, \ncan vary. The following are examples (not exhaustive). \n— Some contracts include a minimum purchase volume, while others do not. \nAdditionally, the minimum may be significant or minor compared to the \ntotal expected purchases by the customer under the contract. \n— The supplier may sell the goods and/or the equipment separately – e.g. the \ngoods may be sold separately to customers that previously purchased the equipment, and/or the equipment may be sold separately by the supplier to \nauthorized dealers or resellers (and by them, separately to end customers) . \n— The price per unit of the goods sold may or may not be the stand- alone \nselling price of those goods when sold separately – e.g. to customers that \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 252}), Document(page\_content='Leases 252 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. previously purchased the supplier’s equipment or other equipment with \nwhich the goods can be used. \nAddition ally, in these arrangements, the equipment can be either relatively \ninexpensive or more valuable. \nInterpretive response: This question should not be analogized to by customers \n(lessees). Customers’ (lessees’) accounting will depend on factors beyond \nthose in this Question, such as whether an enforceable minimum is cumulative \n(i.e. applies to the entire contract period) or periodic (e.g. the customer must \npurchase a specified number of goods each month, quarter or year during the \ncontract period). It will generally never be appropriate for a customer (lessee) to \nallocate none of the consideration in the contract or variable payments to the \nequipment lease. \nWe believe the answer to this question depends on the facts and \ncircumstances. \nContracts with mandatory minimum purchase volumes \nIf a contract as described in the background includes an enforceable minimum \npurchase volume of the goods, there is ‘consideration in the contract’ equal to \nthe minimum amount of consideration the customer will pay the supplier to \nfulfill the minimum. Purchases above the minimum are ‘optional purchases’; \nsee Question 5.3.10 and related examples in KPMG Handbook, Revenue \nrecognition. \nThe supplier must consider whether there is a material right related to the \ncustomer option to make purchases above the enforceable minimum; if so, the \nmaterial right is a non -lease component of the contract. However, there would \ngenerally not be a material right if the per unit price for the optional purchases is \nthe same as or more than the per unit price for the units that comprise the \nminimum. \nChapter 8 of KPMG Handbook, Revenue recognition, discusses identifying and accounting for material rights. The remainder of this interpretive response \nassumes there is not a material right in the contract. \nDepending on the facts and circumstances, we believe the supplier (lessor) \nshould apply one of two methods to account for the contract. The example that \nfollows this question (Example 4.4.45) illustrates both methods. \nMinimum purchase method \n— Step 1. The supplier allocates the consideration in the contract (e.g. \n$100,000, based on a 10,000- unit purchase minimum at $10/unit) to the \nlease and the minimum purchase quantity based on the stand- alone selling \nprices of each. The ‘lease payments’ equal the portion of the consideration in the contract allocated to the lease. \n— Step 2. The supplier accounts for the lease, including recognition of lease \nrevenue, in accordance with Subtopic 842- 30 (see chapter 7), and \nrecognizes revenue related to the promised goods in accordance with \nTopic 606. \n— Step 3. Customer orders for optional goods above the purchase minimum \nare accounted for separately from the initial contract including the lease and \nthe purchase minimum. Consequently, the consideration for those orders is ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 253}), Document(page\_content='Leases 253 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. allocated entirely to the optional goods ordered – i.e. none of the \nconsideration from those orders is allocated to the ongoing lease. \nUnder this method (unlike the total estimated purchases method), the supplier \ndoes not need to estimate total expected cust omer purchases under the \ncontract, and there is no variable lease revenue earned by the supplier. \nWe do not believe this method is appropriate if the amount that would be \nallocated to the lease is inconsistent with the Topic 606 allocation objective (see \nparagraph 4.4.190) – e.g. it is an uneconomical amount. In that case, the lessor \nshould use the total estimated purchases method. See discussion below about using the minimum purchase method when the contract does not include a \nmandatory minimum purchase volume. \nWe believe the minimum purchase method is more likely to yield an acceptable result if the minimum purchase amount is a substantial (not minor) portion of the total expected purchases of goods by the customer under the contract. \nTotal estimated purch ases method \n— Step 1. The supplier allocates the consideration in the contract (calculated \nin the same way as under the minimum purchase method) to the lease and \nthe total expected purchase quantity (rather than the minimum purchase \nquantity) based on the st and-alone selling prices of each. The ‘lease \npayments’ equal the portion of the consideration in the contract allocated to \nthe lease, which will be less than what is allocated to the lease under the \nminimum purchase method, because the total expected purchase quantity \ngenerally will exceed the minimum purchase quantity (see Example 4.4. 45). \n— Step 2. The supplier accounts for the lease, including recognition of lease \nrevenue, in accordance with Subtopic 842- 30 (see chapter 7), and \nrecognizes revenue related t o the promised goods (i.e. the committed \nminimum) in accordance with Topic 606. \n— Step 3. Customer orders for optional goods above the purchase minimum \nare not accounted for separately. Because the original allocation of the consideration in the contract contemplated customer orders above the \npurchase minimum, and therefore allocated less consideration to the lease, \nthe consideration from each order is allocated to the lease and the goods \nordered on the same basis as the consideration in the contract was allocated originally. \n— Step 4. Amounts allocated to the lease under the optional goods orders are \naccounted for as variable lease payments. The amount allocated to the \ngoods in each order is the Topic 606 ‘transaction price’ for those goods and \nis recognized in accordance with Topic 606. \nWe believe the total estimated purchases method is acceptable under any \ncircumstance – i.e. regardless of whether the minimum purchase volume is a \nsubstantial or minor portion of the customer’s total expected purchase volume. In circumstances where use of the minimum purchase method would yield a \nresult that is inconsistent with the Topic 606 allocation objective, we believe the total estimated purchases method must be used. See discussion below about \nusing the minimum purchase m ethod when the contract does not include a \nmandatory minimum purchase volume. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 254}), Document(page\_content='Leases 254 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Contracts without mandatory minimum purchase volumes \nBased on discussions with the FASB and SEC staffs about contracts of this \nnature, in general we believe that when the contrac t does not include a \nminimum purchase volume requirement, the supplier should use the total estimated purchases method. \nApplying the total estimated purchases method to these contracts will differ \nfrom its application to contracts that include a minimum purchase volume. This \nis because the contract will include no ‘consideration in the contract’. Therefore, \nin effect, only Steps 3 and 4 of the total estimated purchases method will apply. \nIn limited circumstances, the minimum purchase method may be acceptabl e. \nBased on our discussions with the FASB and SEC staffs, this method, which \nwould result in no allocation of payments stemming from the customer’s orders \nfor the supplier’s goods to the lease, would be appropriate only when both: \na. the lease is insignifican t in value, such that the customer would effectively \nview the lease as a ‘convenience’, rather than a valuable aspect of the contract; and \nb. there is objective evidence that the price for the goods available for \npurchase under the contract is the stand- alone selling price for those goods. \nIn other words, the price offered for the goods is the observable stand-alone selling price of the goods when sold separately to customers that are \nnot leasing the supplier’s equipment, such as customers that previously \npurchased the supplier’s equipment or another vendor’s equipment with \nwhich the supplier’s goods can be used. \nWhile not expressly stated by the staffs, it appears to be their view that when \nthese criteria are met, allocating no consideration from the customer’ s goods \norders to the lease would not be inconsistent with the Topic 606 allocation \nobjective – i.e. it would not be an uneconomical reflection of the transaction. \nRelated to criterion (a), based on our discussions with the FASB and SEC staffs, \nwe believe: \n— This requirement would be met only if the underlying asset is inexpensive – \ni.e. has an insignificant fair value – such that the stand- alone selling price of \nthe lease is insignificant. In other cases (e.g. if the asset is an expensive \npiece of medical equipment, for which the stand- alone selling price of a \nlease thereof would be more than insignificant), it would not be reasonable \nto ascribe no economic value to the lease, regardless of the price for the goods offered under the contract. \n— Significance in the context of this criterion is not determined on a relative \nbasis – i.e. the stand- alone selling price of the lease relative to the stand-\nalone selling price of the total expected consumable purchases. In other \nwords, it is not relevant t o the evaluation of this criterion whether the \nportion of the total expected payments that would be allocated to the lease is insignificant in relation to the customer’s total expected payments under \nthe contract. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 255}), Document(page\_content='Leases 255 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 4.4.45 \nSupply agreement with no stated consideration for \nthe lease \nSupplier, a chemical manufacturer, enters into a supply agreement with \nCustomer to sell chemicals (Chemical) over a five -year period. \nAs part of the agreement, Supplier provides a storage tank to Customer for storing and using Chemical during the same period. The contract stipulates that \nthe storage tank is provided at no additional charge. Supplier retains title to the \nstorage tank. At the end of the five years, the storage tank will be returned to \nSupplier. \nUnder the c ontract, Customer is required to make minimum purchases each \nyear and must pay a penalty if its actual purchases do not meet the required \nminimum. There is not a material right in the contract because the unit pricing \nfor Chemical is the same throughout the contract period. \nThe following additional facts are relevant. \nMinimum purchase requirement: 22,500 units per year (112,500 total) \nExpected purchases: 30,000 units per year (150,000 total) \nContract price of Chemical: $2.50/unit \nPenalty for failing to reach the minimum \npurchase requirement: $0.20/unit of shortfall \nStand -alone selling price of the storage tank lease: $18,000 \nRenewal options: None \nStorage tank purchase option: None \nRemaining economic life of the storage tank: 10 years \nFair value of the storage tank: $22,500 \nLessee or third- party residual value guarantees: None \nSupplier determines that the penalty is substantive, and therefore the minimum \npurchase requirement is deemed to be enforceable. In addition, Supplier \nconcludes that $2.50/unit is the stand- alone selling price of Chemical in other \ncontracts. \nTo account for the arrangement, Supplier must determine how to allocate the \nconsideration in the contract and variable payments between the lease \ncomponent (i.e. th e right to use the storage tank) and the non- lease component \n(i.e. purchases of Chemical). \nApproach 1: Minimum purchase method \nSupplier determines that the minimum purchase method is acceptable because \nthe total allocation to the lease is reasonable when c onsidered against the \nTopic 606 allocation objective. That is, as illustrated below, the total lease \nrevenue that will be recognized is in line with the stand- alone selling price for \nthe lease. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 256}), Document(page\_content='Leases 256 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Step 1 \nThe consideration in the contract is based on the minim um purchase volume. \nThis results in total consideration in the contract of $281,250 (112,500 units × \n$2.50/unit). This amount is allocated to the storage tank and the minimum \npurchase quantity of Chemical based on their stand- alone selling prices. \nComponent Units Stand -alone \nselling price Total stand -\nalone \nselling price Allocation Calculation \nStorage tank 1 $18,000 $ 18,000 $ 16,917 (18,000 / 299,250) \n× 281,250 \nUnits of \nChemical 112,500 $2.50 281,250 264,333 (281,250 / 299,250) \n× 281,250 \n $299,250 $281,250 \nStep 2 \nSupplier recognizes total lease revenue of $16,917 on a straight -line basis over \nthe five- year lease term ($3,383 per year) because the lease is classified as an \noperating lease. Supplier recognizes product revenue by allocating a transaction \nprice of $2.35 ($264,333 / 112,500 units) to each unit of Chemical as it is sold \nuntil the minimum purchase requirement is met. \nStep 3 \nOnce the minimum purchase requirement of 112,500 units is met, the \nconsideration for additional orders is allocated entirely to the optional purchases \nof Chemical. Therefore, the transaction price for these optional purchases is \n$2.50 per unit. No variable lease revenue is recognized by Supplier. \nDescription Allocatio n Calculation \nStraight- line operating lease \nrevenue recognized over five years $ 16,917 112,500 units x [(18,000 / 299,250) × \n$2.50] \nTopic 606 revenue recognized for \nunits of Chemical sold against the \nminimum purchase requirement 264,333 112,500 units x [(281,250 / 299,250) × \n$2.50] \nTopic 606 revenue recognized on \noptional Chemical purchases above \nthe minimum 93,750 37,500 units × $2.50 \n $375,000 \nApproach 2: Total estimated purchases method \nStep 1 \nThe consideration in the contract is still based on the minimum purchase \nrequirement because those purchases represent the fixed payments in the \ncontract. Therefore, the consideration in the contract is $281,250 (112,500 units \n× $2.50/unit). \nHowever, this consideration is allocated to the storage tank and the total expected purchase quantity (rather than the minimum purchase quantity) based on their stand- alone selling prices. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 257}), Document(page\_content='Leases 257 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Component Units Stand -alone \nselling price Total stand -\nalone \nselling price Allocation Calculation \nStorage tank 1 $18,000 $ 18,000 $ 12,882 (18,000 / 393,000) \n× 281,250 \nUnits of \nChemical 150,000 $ 2.50 375,000 268,368 (375,000 / 393,000) \n× 281,250 \n $299,250 $281,250 \nStep 2 \nSupplier recognizes operating lease revenue of $12,882 on a straight -line basis \nover the five- year lease term ($2,576 per year) because the lease is classified as \nan operating lease. Supplier recognizes product revenue by allocating a \ntransaction price of $2.39 ($268,368 / 112,500 units) to each unit of Chemical as it is sold. \nStep 3 \nThe original allocation of the consideration in the contract contemplated \nadditional orders above the purchase minimum, and therefore allocated less \nconsideration to the lease. As a result, the consideration from each order is \nallocated to the stora ge tank and purchases of Chemical on the same basis as \nthe consideration in the contract was allocated originally – i.e. $2.39 to each unit \nof Chemical purchased and the remaining $0.11 to the storage tank. \nStep 4 \nAmounts allocated to the lease from optional purchases of Chemical above the purchase minimum in Step 3 are accounted for as variable lease payments. The \namount allocated to the units of Chemical in each such order is the Topic 606 \n‘transaction price’ for each unit of Chemical. Total amounts recognized for each \ncomponent are as follows. \nDescription Allocation Calculation \nStraight- line operating lease \nrevenue recognized over five years $ 12,882 112,500 units x [(18,000 / 393,000) × \n$2.50] \nTopic 606 revenue recognized for \nunits of Chemical sold against the \nminimum purchase requirement 268,368 112,500 units x [(375,000 / 393,000) × \n$2.50] \nTopic 606 revenue recognized on \noptional Chemical purchases above \nthe minimum 89,456 37,500 units x [(375,000 / 393,000) × \n$2.50] \nVariable lease revenue arising from \noptional Chemical purchases above \nthe minimum 4,294 37,500 units x [(18,000 / 393,000) × \n$2.50] \n $375,000 \n. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 258}), Document(page\_content='Leases 258 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Comparison to legacy US GAAP \nAllocation differences \n4.4.210 The transaction price allocation guidance in Topic 606 that must be \napplied by lessors will not always result in an allocation of the consideration \nin the contract consistent with the relative fair value allocation method in \nTopic 840. In some cases, the less or allocation guidance in Topic 842 will \nallocate a discount or variable consideration entirely to only one or some of the \ncomponents of the contract, rather than on a relative basis. [840- 10-15-19, \n606-10-32-37, 32- 40] \n \n4.4.3 Variable payments not included in the consideration \nin the contract \n4.4.220 Following from the discussion of Step 3 (see section 4.3), variable \npayments not included in the consideration in the contract are generally allocated to the lease and/or non- lease components consistent with the \nallocation decisions made in Step 4 . \n4.4.221 A lessee recognizes these variable payments in the income statement \nwhen (or as) incurred. \n4.4.222 A lessor recognizes the portion of such variable payments allocated to: \n[842- 10-15-40, 842-10-55-152] \n— the separate lease component as revenue in the period in which the \nchanges in facts and circumstances on which those payments are based occur; and \n \n— the non- lease component(s) as revenue when the requirements of the \napplicable Topic (e.g. Topic 606) are met. \n4.4.223 Recognition of variable lease payments not included in the consideration \nin the contract is addressed in sections 5.4, 6.4 (lessees) and 7.3 – 7.4 (lessors). \n[842- 10-15-35, 15- 40, 55-150 – 55-152, 842-20-25-5 – 25-6, 55- 1 – 55-2, 842 -30-25-2, 25 -9, 25- 11] \n \n Observation \nVariable payments of lessor costs made directly to a \nthird party recognized net by lessors \n4.4.224 As outlined in section 4.2.1, lessor costs (i.e. costs incurred by the lessor \nin its role as lessor or as owner of the underlying asset, such as property taxes \nand insurance costs) and variable payments thereof made by a lessee directly to \nthe relevant third party (e.g. taxing authority or insur er) are recognized on a net \nbasis by the lessor . [ASU 2018- 20.BC14] \n4.4.225 Neither the costs nor the lessee ’s payments are reflected in the lessor’s \nincome statement, regardless of whether the lessor knows, can readily determine or can reliably estimate the cost paid by the lessee. Therefore, the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 259}), Document(page\_content='Leases 259 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. guidance in paragraph 4.4.222 applies only when a lessee’s variable payments \nof lessor costs are made to the lessor. [842- 10-15-40A] \n \n Example 4.4.50 \nVariable lease payments not included in the \nconsideration in the contract \nThis example assumes that Lessee LE and Lessor LR have not elected the \nnon-separation practical expedients in paragraphs 4.4.30 – 4.4.50 and \nparagraphs 4.4.51 – 4.4.56 , respectively. \nLessee LE leases a specifically identified space in a building and a printing press \nfrom Lessor LR for three years. \nThe following additional facts are relevant . \n— LE and LR each conclude that the building space and the printing press are \nseparate lease components. \n— The contractual lease payments for the building space are fixed at $300,000 \nper year, which is considered to be a market rate. \n— The contractual lease pay ments for the printing press are based entirely on \nthe level of usage, at $50 for each hour operated, which is considered to be \na market rate. \n— LE and LR each predict that the printing press will be operated for 2,000 hours per year over the three -year lease term, resulting in total \nexpected variable payments of $300,000 over the three- year lease term. \n— There are no non- lease components of the contract, and the variable \npayments are not based on an index or rate. Therefore, the consideration in \nthe contract is $900,000 ($300,000 × 3) for LE and LR, and all of the fixed payments are ‘lease payments’ (see section 5.4). \nLessee \nLE allocates the lease payments of $900,000 ($300,000 × 3) to the two lease \ncomponents as follows. \nComponent Stand -alone \nprice Allocation Calculation \nBuilding space $ 900,000 $675,000 (900,000 / 1,200,000) × 900,000 \nPress 300,000 225,000 (300,000 / 1,200,000) × 900,000 \n $1,200,000 $900,000 \nLE recognizes the variable lease cost as incurred, and each variable amount that \nwill be paid is allocated between the building space lease and the printing press \nlease in the same proportion as the lease payments were originally allocated – \n75% to the building space lease and 25% to the printing press lease. This \nmeans that if th e total variable lease payments ultimately owed by LE are \n$300,000, they will have been allocated as follows over the term of the lease. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 260}), Document(page\_content='Leases 260 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Component Stand -alone \nprice Allocation Calculation \nBuilding space $ 900,000 $225,000 (900,000 / 1,200,000) × 300,000 \nPress 300,000 75,000 (300,000 / 1,200,000) × 300,000 \n $1,200,000 $300,000 \nLessor \nLR allocates the $900,000 in fixed lease payments entirely to the building space \nlease and the $300,000 in expected variable lease payments entirely to the printing press lease. \nLR concludes this is appropriate because: \n— the variable amounts relate specifically to LE’s use of the printing press; and \n— this allocation of the fixed and variable lease payments to the building space lease and the pri nting press lease reasonably depicts the amounts to \nwhich LR expects to be entitled for each lease component – i.e. this \nallocation meets the transaction price allocation objective in Topic 606 ( see \nparagraph 4.4.190). \nThe lease payments used by LR in its evaluation of the lease classification and \nin accounting for the printing press lease are nil because only variable lease \npayments are allocated to that lease component. \nLR recognizes the variable payments when they are earned, which is when/as \nLE’s usage of the printing press occurs, and each variable amount earned is \nallocated entirely to the printing press lease. \n \n4.5 Subsequent c hanges to the c onsideration in the \ncontract \n Excerpt from ASC 842 -10 \n>> Lessee \n15-36 A lessee shall remeasure and reallocate the consideration in the contract \nupon either of the following: \na. A remeasurement of the lease liability (for example, a remeasurement \nresulting from a chang e in the lease term or a change in the assessment of \nwhether a lessee is or is not reasonably certain to exercise an option to \npurchase the underlying asset ) (see paragraph 842- 20-35-4) \nb. The effective date of a contract modification that is not accounted for as a \nseparate contract (see paragraph 842- 10-25-8). \n>> Lessor \n15-41 A lessor shall remeasure and reallocate the remaining consideration in ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 261}), Document(page\_content='Leases 261 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the contract when there is a contract modification that is not accounted for as \na separate contract in accordance with paragraph 842- 10-25-8. \n15-42 If the consideration in the contract changes, a lessor shall allocate those \nchanges in accordance with the requirements in paragraphs 606- 10-32-42 \nthrough 32 -45. \n \n4.5.1 Lessee \n4.5.10 Lessees remeasure and reallocate the consideration in the contract \nwhen: [842- 10-15-36] \n— there is a remeasurement of the lease liability – e.g. a change in the lease \npayments resulting from a change in the lease term or a change in the \namount probable of being owed under a residual value guarantee; or \n— there is a contract modification that is not accounted for as a separate \ncontract. \n4.5.20 The accounting for changes in consideration in the contract from the \nlessee’s perspective is discussed in sections 6.6 and 6.7. \n \n4.5.2 Lessor \n4.5.30 Lessors remeasure and reallocate the consideration in the contract only \nwhen a contract modification occurs that is not accounted for as a separate \ncontract (see section 7.6) . [842- 10-15-41] \n4.5.40 Changes in the consideration in the contract not resulting from a \nmodification are accounted for in accordance with the changes in the \ntransaction price guidance in Topic 606. An example is changes in the lessor’s \nestimate of variable payments to which it will be entitled specifically for a non-\nlease component or changes in the estimated amount that are unconstrained. \n[842- 10-15-42, 606- 10-32-42 – 32-45] \n4.5.50 In most cases, changes in the consideration in the contract will be \nallocated to the separate lease and non-lease components of the contract on \nthe same basis as was done initially. For example, if a variable payment was \nallocated entirely to a non -lease component initially, a change to the \nconsideration in the contract resulting from a change in the estima te of that \nvariable payment will generally be allocated entirely to the non- lease \ncomponent . Similarly, if the consideration in the contract was allocated \nproportionally on a relative stand- alone selling price basis, changes will generally \nalso be allocate d in that manner. However, in some cases, changes may \nbe allocated to only one (or some) of the components of the contract. \nExample 4.4.30, Scenario 3 describes how the lessor will account for a change \nin the consideration in the contract – i.e. a change r esulting from estimated \namounts becoming unconstrained. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 262}), Document(page\_content='Leases 262 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 4.5.10 \nVariable payments that do not depend on an index \nor rate and the consideration in the contract \nDo variable payments that do not depend on an index or rate \nchange the consideration in the contract when they become \nfixed? \nInterpretive response: For lessees, no. Variable payments that do not depend \non an index or a rate, even when they are incurred, do not change (i.e. become \npart of) the consideration in the contract. \nFor lessors, variable payments that do not depend on an index or rate change \n(i.e. become part of) the consideration in the contract when the variable \npayment specifically relates to a non -lease component (or to an outcome \nresulting from transferring or prov iding a non -lease component) ( see \nparagraph 4.3.50). That is, when the changes in facts and circumstances \non which the variable payment is based occur, the consideration in the \ncontract changes. \nIn contrast, v ariable payments that do not specifically relate to a non- lease \ncomponent (or to an outcome resulting from transferring or providing a non-lease component) never change the consideration in the contract (absent a \ncontract modification not accounted for as a separate contract) – even when \nthey become fixed (i.e. when the changes in facts and circumstances on which \nthe variable payment is based occur). \nThis distinction between what does and does not change the consideration in \nthe contract matters for lessors because there is specific guidance in Topic 606 \napplicable to changes in the ‘transaction price’ that lessors are required to \nconsider when there are changes to the consideration in the contract. That \nspecific guidance does not apply to variable payments that are not part of the \ncons ideration in the contract. [842- 10-15-42] \n \n Observation \nAllocating subsequent changes to the consideration \nin the contract after a modification or \nremeasurement \n4.5.60 While not explicitly stated, we believe the Board intended that if the \nconsideration in the contract has been reallocated as a result of a contract \nmodification or remeasurement of the lease liability, changes to the \nconsideration in the contract subsequent to the reallocation resulting from the \nmodification or remeasurement should be allocated on the same basis a s the \nmost recent reallocation. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 263}), Document(page\_content='Leases 263 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 4.6 Combining t wo or m ore c ontracts \n Excerpt from ASC 842 -10 \n25 Recognition \nGeneral \n> Cont ract Combinations \n25-19 An entity shall combine two or more contracts , at least one of which is \nor contains a lease , entered into at or near the same time with the same \ncounterparty (or related parties) and consider the contracts as a single \ntransaction if any of the following criteria are met: \na. The contracts are negotiated as a package with the same commercial \nobjective(s). \nb. The amount of consideration to be paid in one contract depends on the \nprice or performance of the other contract. \nc. The rights to use underlying assets conveyed in the contracts (or some of \nthe rights of use conveyed in the contracts) are a single lease component \nin accordance with paragraph 842 -10-15-28. \n \n4.6.10 Two or more contracts (at least one of which is or contains a lease) \nentered into at or near the same time with the same counterparty (or related \nparty) are combined as a single transaction if: [842- 10-25-19] \n— the contracts are negotiated as a package with a single commercial objective; \n— the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or \n— the leases in the contracts (or some of the leases) are a single lease \ncomponent. \n \n Question 4.6.10 \n‘At or near the same time’ \nWhat constitutes ’at or near the same time’ when evaluating \nwhether two or more contracts should be combined? \nInterpretive response: Topic 842 does not provide a bright line for evaluating \nwhat constitutes at or near the same time to determine whether two or more \ncontracts should be combined. We believe an entity should consider its \ncustomary business practices and other reasonable expectations, such as recent changes to contracting practi ces, in evaluating whether two or more \ncontracts have been entered into at or near the same time. \nFor example, a lessor may perform services for a significant portion of its lessee \ncustomers and generally enter into separately papered contracts for those \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 264}), Document(page\_content='Leases 264 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. services. In that case, the entity might consider the period of time that generally \nelapses between the initiation of the lease contract and the initiation of the \nservices contract in determining what represents a minimum period of time \nwithin which the entity would conclude two or more contracts were entered \ninto at or near the same time. \nAn entity should also have processes in place that consider specific facts and \ncircumstances in cases that may not be ‘customary’ or usual. For example, an \nentity should not ignore the fact that two non- standard agreements – i.e. that \nare different from or larger than its typical arrangements – were being \ndiscussed or negotiated over the same period of time and would appear to be \nsignificantly interrelated solely because t hey were not executed within its \nestablished ‘minimum period’ used to determine generally whether two or more contracts were entered into at or near the same time. \nAn entity should establish procedures to ensure multiple contracts initiated with the same customer at or near the same time are identified on a timely basis, \nand therefore appropriately considered as to whether they should be accounted \nfor as a single contract. \n \n Question 4.6.20 \nDifferent divisions or business units \nIf the entity (lessee or lessor) and/or the counterparty have \nmultiple divisions (or business units), should contracts entered into between different divisions be evaluated for possible combination? \nInterpretive response: Yes. There is no exception for considering whether \ntwo or more contracts should be combined because they were executed by \ndifferent divisions of the entity and/or the counterparty. However, whether the \ncontracts were negotiated by the same parties, or instead were negotiated with \ndifferent divisions of the entity or the counterparty may significantly influence \nwhether any of the three specified criteria in paragraph 4.6.10 are met. For example, two contracts entered into by different divisions of one or both \nparties may be less likely to ha ve been ‘negotiated as a package with a \nsingle commercial objective’ or to have multiple leases that are a single \nlease component. \n \n Example 4.6.10 \nCombination of contracts \nLessee LE leases a specifically identified space in a building and a printing press from Lessor LR for three years. The following additional facts are relevant. \n— LR leases the building space and printing press to LE in two separate \ncontracts, executed within a few calendar days of each other. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 265}), Document(page\_content='Leases 265 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — The contractual lease payments f or the building space are fixed at $250,000 \nper year, compared to an estimated market rate of $300,000 per year . \n— There are no non- lease components of the building contract and the \nvariable payments are not based on an index or a rate. Therefore, the \nconsideration in the contract is $750, 000 ($250,000 × 3) for LE and LR, and \nall of the fixed payments are lease payments (see section 5.4). \n— The contractual lease payments for the printing press are entirely based on \nthe level of use ($75 for each hour operated), compared to an estimated \nmarket rate of $50 for each hour operated. \n— LE and LR each predict that the printing press will be operated for \n2,000 hours per year over the three -year lease term, giving total expected \nvariable payments of $450,000 over the three- year lease term. \n— Total expected fixed and variable consideration is $1,200,000 over the three- year lease term. However, the stated $250,000 per year for the \nbuilding space lease is a below market rate, and the $75 per hour variable payment for using the printing press is considered to be an above market \nrate. LR agrees to a lower fixed payment to incentivize LE, with the expectation of making up the difference with the above market \nvariable payments. \nIn this example, the contracts should be combined and considered a single contract for the purpose of applying Topic 842. This is because the two \ncontracts are executed near the same time, and together they fulfill a single \ncommercial objective. As noted, LR agrees to a lower fixed payment in the first \ncontract to incentivize LE, with the expectation of making up the difference \nwith the above market variable payments in the second contract. \n \n Observation \nCombining two or more contracts \nAllocation of consideration in a combined contract \n4.6.20 A combined contract (i.e. one comprising two or more separately papered \ncontracts) may have multiple lease (and potentially non -lease) components. In \nthis scenario, it is likely that the allocation of the consideration in the combined contract will be different from the stated consideration in the original, separately \npapered contracts. \nAligning contract combinations guidance in Topic 842 and Topic 606 \n4.6.30 Consistent with its rationale for a number of other decisions in developing \nTopic 842, the Board concluded that, particularly for lessors, there would be a \nsignificant benefit to substantially aligning the guidance on combining contracts \nin Topic 842 to that in Topic 606. Because many contracts contain components \nthat will be in the scope of both Topics, coming to generally consistent conclusions as to when two or more contracts should be combined will reduce \ncomplexity for les sors. \n[ASU 2016- 02.BC165– BC167] \n4.6.40 While the contract combinations guidance will be familiar to most entities \nbecause of its similarity to the contract combinations guidance in Topic 606, \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 266}), Document(page\_content='Leases 266 \n4. Separating components of a contract \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. there will be some judgment involved in determining when two contracts must \nbe combined. This judgment includes, but is not limited to, determining: \n— what ‘at or near the same time’ means – some entities have interpreted \nthat to mean within 90 days or within the same fiscal quarter or reporting \nperiod when applying that notion to other situations; \n— when two or more contracts have the same commercial objective; and \n— when consideration to be paid in one contract is dependent on the \nconsideration to be paid in another. \n4.6.50 These judgments are not unique to the contract combinations guidance \nin Topic 842 and Topic 606. Similar judgments were required in the legacy \nUS GAAP revenue recognition guidance – e.g. within Subtopic 605 -25 (multiple -\nelement arrangements ) and Subtopic 985- 605 (software revenue recognition) – \nsuch that judgments made historically may continue to be acceptable in \napplying the new guidance. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 267}), Document(page\_content='Leases 267 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 5. Concepts and d efinitions \nfor lessees and l essors \nDetailed contents \nNew item added to this chapter: \*\* \nHow the standard works \n5.1 Commencement date \nObservation \nProperly identifying the commencement date is key \nQuestion \n5.1.10 Payments and costs associated with shipping, delivery, \ninstallation or similar activities that occur pre -\ncommencement \nExamples \n5.1.10 Lease commencement date – constructing leasehold \nimprovements \n5.1.15 Lease commencement date – new construction \n5.1.20 Lease commencement date – mobilization of equipment \nComparison to legacy US GAAP \n5.2 Reasonably certain \nObservation \n‘Reasonably certain’ synonymous with ‘reasonably assured’ \nQuestions \n5.2.10 Facts and circumstances and additional factors to consider \n5.2.20 Lessees and lessors may reach different conclusions \nExamples \n5.2.10 Assessment of a lessee renewal option \n5.2.20 Assessment of a lessee purchase option with strike price below expected fair value\n \n5.3 Lease term \nObservation \nDetermining the lease term for cancellable (‘evergreen’) leases may be \ndifficult \nQuestions \n5.3.10 Legal evaluation of the non-cancellable period ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 268}), Document(page\_content='Leases 268 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 5.3.20 Effect of termination notice clauses on the non- cancellable \nperiod \n5.3.25 Contingent termination provisions \n5.3.30 Extension or renewal options controlled by an unrelated \nthird party \n5.3.40 Lease term when lessee and lessor both have termination rights – lessor only incurs penalty\n \n5.3.50 Lease term when lessee and lessor both have termination rights – lessee only incurs penalty\n \n5.3.6 0 Lessee and lessor extend the lease even though both have the right to terminate without penalty\n \n5.3.70 Terminal rental adjustment clauses (TRAC leases) \n5.3.80 Lease term when the non- cancellable lease period is not \nfixed \n5.3.90 Lease term when the period of use includes non-consecutive periods of time \n5.3.100 Mandatory and optional underlying asset replacement \nExamples \n5.3.10 Initial lease term (lessee renewal options)\n \n5.3.20 Termination rights \n5.3.25 Lessee partial termination right (downsizing clause) \n5.3.30 No stated term \n5.3.40 Lease term when the period of use includes non-consecutive periods of time \n5.3.50 Mandatory and optional underlying asset replacement \n5.4\n Lease payments \n5.4.1 Variable lease payments \n5.4.2 In-substance fixed lease payments \n5.4.3 Lease incentives \n5.4.4 Purchase options \n5.4.5 Termination penalties \n5.4.6 Residual value guarantees \nObservations \nImpact of excluding variable lease payments from lease payments \nConcept of in- substance fixed lease payments consistent with previous \nUS GAAP \nIncluding only amounts probable of being owed under a residual value \nguarantee increases judgment ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 269}), Document(page\_content='Leases 269 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Questions \n5.4.05 Costs to dismantle and remove the underlying asset \nimposed by the lease agreement \n5.4.10 Payments made by the lessee to the lessor to extend the lease term\n \n5.4.20 Effect of lease payments made before commencement date \non lease classification \n5.4.30 Payment as consideration for a minimum resale guarantee in a sale contract\n \n5.4.40 Deposits \n5.4.50 Changes in a reference index or rate as resolution of a contingency\n \n5.4.60 Variable lease payments based on fair market rent \n5.4.65 Variable lease payments that depend on the fair value of the underlying asset \n5.4.70 Highly certain payments based on performance or usa ge\n \n5.4.80 Determining the accounting owner of leasehold improvements \n5.4.81 Accounting owner of structural leasehold improvements \n5.4.85 Lessee payments for leasehold improvements owned by the lessor\n \n5.4.90 Determining probable amounts owed \n5.4.100 Guarantees of lessor debt \n5.4.110 Interaction of Topic 842 with Topic 810 \nExamples \n5.4.10 Allocated lease payments \n5.4.20 Variable lease payments that depend on an index or rate \n5.4.30 Payments periodically adjusted to fair market rent \n5.4.40 Two possible sets of lease payments \n5.4.50 Variable lease payments without economic substance \n5.4.60 Variable lease payments vs. in -substance fixed lease \npayments – payments based on performance or usage \n5.4.70 Protective provisions in lease payments \n5.4.80 Substantive variability in lease payments \n5.4.85 Determining the accounting owner of structural leasehold improvements \n \n5.4.90 Impact of lease incentives on lease payments \n5.4.100 Purchase option price included in lease payments \n5.4.110 Termination penalty included in lease payments ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 270}), Document(page\_content='Leases 270 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 5.4.120 Residual value guarantee as a component of the lessee’s \nlease payments \n5.4.130 Lessee accounting for right to receive excess over guaranteed residual value\n \nComparison to legacy US GAAP \n5.5 Initial direct costs \nObservation \nNarrowed definition of ‘initial direct costs’ based on contract acquisition costs guidance in Topic 606\n \nQuestions \n5.5.10 Payments to existing lessee to induce early termination \n5.5.20 ‘Key money’ payments \n5.5.30 Sales taxes as initial direct costs \n5.5.40 Third- party payments to a lessee for executing a lease \nExamples \n5.5.10 Costs that are initial direct costs \n5.5.20 Allocation of initial direct costs (1) \n5.5.30 Allocation of initial direct costs (2) \nComparison to legacy US GAAP \n5.6 Discount rate for the lease \n5.6.1 Rate implicit in the le ase \n5.6.2 Lessee’s incremental borrowing rate \nQuestions \n5.6.05 Use of a risk- free discount rate by certain public business \nentities \n5.6.06 Use of risk -free discount rate during an IPO \*\* \n5.6.10 Significant variable lease payments that result in negative implicit rate \n \n5.6.20 Lessee use of the rate implicit in the lease – readily \ndeterminable \n5.6.25 Lessee use of the rate implicit in the lease when it is zero for the lessor\n \n5.6.30 Lessor vs. lessee discount rates \n5.6.35 Lessee credit rating \n5.6.40 Determining the discount rate for a portfolio of leases \n5.6.50 Subsidiary’s use of parent (or group) incremental borrowing rate \n5.6.51 Adjustments to parent (or group) incremental borrowing rate ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 271}), Document(page\_content='Leases 271 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 5.6.55 Incremental borrowing rate for a lease denominated in a \nforeign currency \n5.6.60 ‘Cost of money’ as a potential discount rate \n5.6.65 Secured and unsecured funding sources to determine the incremental borr owing rate\n \n5.6.65A Collateral to use in estimating incremental borrowing rate \n5.6.66 Lessee borrows only on an unsecured basis \n5.6.67 Adjustments to reach an appropriate incremental borrowing rate\n \n5.6.67A Over -collateralization \n5.6.67B Anomalous incremental borrowing rate \n5.6.68 Existing borrowing as a starting point for estimating the \nincremental borrowing rate \n5.6.69 Negative incremental borrowing rates \n5.6.69A Negative risk -free discount rates using practical \nexpedient \*\* \n5.6.70 Grant received by lessor from a government agency \n5.6.80 Considering loan origination fees in determining the \nincremental borrowing rate \n5.6.90 Effect on incremental borrowing rate of inability to obtain financing\n \nExamples \n5.6.10 Lessor determination of the rate implicit in the lease \n5.6.20 Lessee determination of incremental borrowing rate (1) \n5.6.30 Lessee determination of i ncremental borrowing rate (2) \n5.6.40 Lessee elects risk -free discount rate practical expedient \nComparison to legacy US GAAP \n5.7 Economic life of the underlying asset \nExample \n5.7.10 Economic life vs. remaining useful life of an asset \nComparison to legacy US GAAP \n5.8 Portfolio approach \nObservation s \nPortfolio approach guidance aligns with Topic 606 \nCost vs. benefits of applying a portfolio approach \nAssessing impairment for ROU assets in a lease portfolio ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 272}), Document(page\_content='Leases 272 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question \n5.8.10 Applying the portfolio approach to multiple separate lease \ncomponents \nExample \n5.8.10 Applying the portfolio approach to leases of vehicles \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 273}), Document(page\_content='Leases 273 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. How the standard works \nThere are a number of key concepts and definitions that apply to both lessees \nand lessors that are integral to the guidance in Topic 842. The following are \ndiscussed in this chapter, as an introduction to the accounting in chapters 6 \n(lessees) and 7 (lessors). \nKey concept or definition Application in Topic 842 \nCommencement date The date of initial recognition and measurement of a \nlease for lessees and lessors. In addition, lease \nclassification is determined at lease commencement. \nReasonably certain Determining whether a lessee is reasonably certain to \nexercise an option to either extend (or renew) a lease or \npurchase the underlying asset (or is reasonably certain \nnot to exercise an option to terminate a lease) is integral \nto determining the ‘lease term’ and the ‘lease \npayments’. \nLease term The lease term is integral to determining: \n— lease payments; \n— lease classification; \n— the measurement of lease assets and lease liabilities; and \n— whether the lease is a ‘short -term’ lease (for \nlessees). \nLease payments The lease payments are integral to determining: \n— lease classification; and \n— the measurement of lease assets and lease liabilities. \nInitial direct costs Initial direct costs affect: \n— the discount rate for the lease, if the rate implicit in \nthe lease is used; and \n— the measurement of lease assets and lease liabilities. \nDiscount rate for the lease The discount rate for the lease affects: \n— lease classification; and \n— the measurement of lease assets and lease \nliabilities. \nEconomic life The total and remaining economic life of the underlying asset affects lease classification. \nPortfolio approach Topic 842 may be applied on a portfolio basis to similar \nleases if the entity reasonably expects that the outcome \nwill not differ from applying the standard to the \nindividual leases. \nUseful life The period over which an asset is expected to \ncontribute directly or indirectly to future cash flows. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 274}), Document(page\_content='Leases 274 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Key concept or definition Application in Topic 842 \nProbable (second \ndefinition) The second definition (US GAAP includes two) is \nincluded in the glossary sections of Topic 842. \nThe second definition of probable is that ‘the future \nevent or events are likely to occur’. \nRemote The chance of the future event or events occurring is \nslight. \nThis chapter addresses those concepts and definitions that are key to applying \nboth the lessee and lessor accounting models. There are additional definitions \nand concepts that apply solely to lessees (see chapter 6) or solely to lessors \n(see chapt er 7), as well as definitions and concepts that are key to identifying a \nlease (see chapter 3) and identifying lease/non -lease components (see \nchapter 4) that are discussed in the respective chapters. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 275}), Document(page\_content='Leases 275 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 5.1 Commencement date \n Excerpt from ASC 842 -10 \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance \n>> Commencement Date \n55-19 In some lease arrangements, the lessor may make the underlying \nasset available for use by the lessee (for example, the lessee may take \npossession of or be given control over the use of the underlying asset) before \nit begins operations or makes lease payments under the terms of the lease. \nDuring this period, the lessee has the right to use the underlying asset and \ndoes so for the purpose of construc ting a lessee asset (for example, \nleasehold improvements). \n55-20 The contract may require the lessee to make lease payments only after \nconstruction is completed and the lessee begins operations. Alternatively, \nsome contracts require the lessee to make lease payments when it takes \npossession of or is given control over the use of the underlying asset. The \ntiming of when lease payments begin under the contract does not affect the \ncommencement date of the lease. \n55-21 Lease costs (or income) associated with building and ground leases \nincurred (earned) during and after a construction period are for the right to use \nthe underlying asset during and after construction of a lessee asset. There is \nno distinction between the right to use an underlying asset during a \nconstruction period and the right to use that asset after the construction \nperiod. Therefore, lease costs (or income) associated with ground or building \nleases that are incurred (earned) during a construction period should be \nrecognized by the lessee (or lessor) in accordance with the guidance in \nSubtopics 842-20 and 842- 30, respect ively. That guidance does not address \nwhether a lessee that accounts for the sale or rental of real estate projects \nunder Topic 970 should capitalize rental costs associated with ground and \nbuilding leases. \n>>> Master Lease Agreements \n55-22 There may be multiple commencement dates resulting from a master \nlease agreement. That is because a master lease agreement may cover a \nsignificant number of underlying assets , each of which are made available for \nuse by the lessee on different dates. Although a mast er lease agreement may \nspecify that the lessee must take a minimum number of units or dollar value of \nequipment, there will be multiple commencement dates unless all of the \nunderlying assets subject to that minimum are made available for use by the \nlessee on the same date. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 276}), Document(page\_content='Leases 276 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 5.1.10 A lessee may take possession of or be given control over the use of an \nunderlying asset – i.e. the underlying asset may be made available for use by \nthe lessee – befor e: [842- 10-55-19] \n— the lessee begins operations – e.g. before the lessee begins selling from a \nleased retail space; \n— lease payments are required to be made under the contract; or \n— a stated commencement date in the contract. \n5.1.15 The underlying asset has been made available for the lessee’s use when \nit is available for constructing or installing a lessee asset (e.g. a lessee- owned \nleasehold improvement). Examples 5.1.10 and 5.1.15 illustrate the effect of \nlessee- versus lessor -owned leasehold improvements on the commencement \ndate, while Questions 5.4.80 and 5.4.81 discuss determining the accounting \nowner of leasehold improvements. [842-10-55-19] \n \n Observation \nProperly identifying the commencement date is key \n5.1.20 An improperly determined commencement date could result in one or \nmore of the following. [ASU 2016- 02.BC182– BC18 3] \n— Misstated lease assets and lease liabilities – i.e. the recognition of lease \nassets and lease liabilities that do not yet exist or not recognizing lease assets and lease liabilities that do exist. \n— Improper measurement of lease assets and lease liabilities – key inputs that \nare used in the initial and subsequent measurement of lease assets and \nlease liabilities (e.g. the lessee’s incremental borrowing rate or the fair value \nof the underlying asset) change over time such that determining those \ninputs as of an incorrect date could result in the inaccurate measurement of \nlease assets and lease liabilities throughout the lease term. \n— Lease cost or lease income (operating lease income or interest income on a sales- type or direct financing lease) that is recognized over the wrong lease \nperiod – i.e. begins to be recognized too early or too late. \n— In the case of sales -type lessors (see section 7.3), selling profit or selling \nloss that is recognized in the wrong period. \n \n Example 5.1.10 \nLease commencement date – constructing leasehold \nimprovements \nLessee LE signs a lease with Lessor LR for an identified space in a shopping mall on June 1, 20X1 – i.e. contract inception is June 1, 20X1. \nScenario 1: Lessee owns leasehold improvements – Lessee constructs \nOn August 1, 20X1, LR provides LE with access to the location so that LE can \nbegin constructing leasehold improvements it will own (see Question 5.4.80) in \nanticipation of opening the store on September 1, 20X1. On September 1, \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 277}), Document(page\_content='Leases 277 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 20X1, LE opens the store for business and pays LR the first month’s \nlease payment. \nIn this example, the lease commencement date is Au gust 1, 20X1. This is the \ndate on which LR makes the underlying asset (i.e. retail space) available for use \nby LE. LE commenc ing operations and making lease payments beginning on \nSeptember 1, 20X1 does not affect determination of the commencement date. \nScenario 2: Lessee owns leasehold improvements – Lessor constructs \nAssume the same facts as in Scenario 1, except that LR will construct the LE -\nowned leasehold improvements. LE personnel will not be able to freely access \nthe store until the leasehold improvem ents are complete and a certificate of \noccupancy is obtained. \nConsistent with Scenario 1, the lease commencement date is August 1, 20X1. \nIt is not relevant to this conclusion that LR, rather than LE or a third party hired \nby LE, will construct the leasehol d improvements, or that LE’s personnel cannot \nfreely access the building as of that date. \nThe lease commences on August 1, 20X1 because LE controls its use from that \ndate. LE is both: \n— obtaining substantially all of the economic benefits from use of the location \n– i.e. the space is being used exclusively for construction of LE’s leasehold \nimprovements; and \n— directing the use of the location by deciding the leasehold improvements to \nbe constructed therein. \nScenario 3: Lessor owns leasehold improvements \nOn A ugust 1, 20X1, LR provides LE with access to the location. LR has \nengaged LE as its construction agent to construct specific improvements that \nwill permit the space to be used as a fast food restaurant (e.g. specific \nplumbing, electrical and other safety f eatures), including beyond the end of LE’s \nlease. \nIf LR and LE do not agree to extend the lease, LR will be able to re- lease the \nspace to any number of other fast food restaurateurs. LR is considered the accounting owner of the improvements on the basis that, subject to the terms \nof the lease, LE cannot rem ove or alter those improvements without LR’s \nconsent and LR retains those improvements, which can serve future lessees, at \nthe end of the lease. \nThe improvements are completed on September 30, 20X1, and consequently \nLE is permitted to occupy and commence o perations on October 1, 20X1. \nBecause LR is the accounting owner of the leasehold improvements, a lease of \nthose improvements exists (as part of the single restaurant space lease \ncomponent – see section 4.1) under Topic 842, even if the improvements are \nnot explicitly identified in the contract as part of the underlying asset. LE has the right to use the improvements (along with the remainder of the inseparable \nrestaurant space) throughout the lease term. \nBecause the specified improvements are part of the underlying asset owned by \nLR, the lease does not commence until the completed asset is made available \nfor LE’s use, which as per the preceding paragraph is October 1, 20X1. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 278}), Document(page\_content='Leases 278 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Therefore, the lease commencement date for the single lease component (i.e. \nthe res taurant space inclusive of the improvements) is October 1, 20X1. \n \n Example 5.1.1 5 \nLease commencement date – new construction \nOn June 1, 20X1, Lessee LE signs a lease with Lessor LR for a new building to be constructed that will serve as LE’s new headquar ters. LR will construct the \nbuilding, and is the legal and accounting owner of the building both during and \nafter construction. LR’s construction of the building is expected to be \ncompleted on June 1, 20X3. \nAs of April 1, 20X3, construction is mostly completed. LR grants LE access to \nthe building for LE to begin installing leasehold improvements LE will own (see \nQuestion 5.4.80). LE’s access to the building is restricted by LR’s certificate of \noccupancy to co nstruction personnel working on behalf of LE to install LE’s \nleasehold improvements. As of April 1, 20X3, LE cannot begin using the \nbuilding for its intended purpose (i.e. as its corporate headquarters). \nOn June 1, 20X3, building construction is completed. On July 1, 20X3, LE’s \nleasehold improvements are completed and LE begins using the building as its \nheadquarters. \nThe lease commencement date is April 1, 20X3. Once LE is given permission to \naccess the building to begin installing its own leasehold improv ements, LR has \nmade the building available for LE’s use and the lease has commenced. \nIt is not relevant that LE cannot begin to use the building for its intended \npurpose due to the ongoing LR construction and LE’s restricted access rights. \nLease commencem ent occurs, despite the restrictions, because LE’s access \npermits it to install the leasehold improvements it needs for the building to be able to fulfill its role of a corporate headquarters. Without such access, LE \nwould not be able to commence headquart ers operations in the building by \nJuly 1, 20X3. \n \n Question 5.1.10 \nPayments and costs associated with shipping, \ndelivery, installation or similar activities that occur \npre-commencement \nHow should a lessee and a lessor account for payments and \ncosts associated with shipping, delivery, installation or other \nsimilar activities that occur before lease commencement ? \nBackground : Question 4.2.05 discusses that lessor activities to ship, deliver, \ninstall or undertake similar activities related to the underly ing asset before lease \ncommencement do not provide a service to the lessee; therefore, they are not \na non- lease component of a contract that is or contains a lease. This is the case \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 279}), Document(page\_content='Leases 279 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. regardless of whether the lessor performs the activities itself or engages a third \nparty to undertake those activities. \nInterpretive response: For lessees and lessors, contractual payments to the \nlessor for activities of the nature described in the background are either prepaid \nlease payments (if there are no non -lease component s in the contract) or are \nprepayments of the ‘consideration in the contract’ (if there are lease and non-\nlease components of the contract). \nLessee payments to a third party unrelated to the lessor \nThe lessee may pay a third party that is unrelated to the lessor to undertake \nthese activities before lease commencement. These amounts are not lease \nprepayments (or prepayments of the ‘consideration in the contract’) because \nthey are not payments to the lessor. Based on discussions with the FASB and \nSEC staffs, we believe: \n— the costs incurred to the third party (or third parties) do not meet the \ndefinition of ‘initial direct costs’ as they are not incurred ‘because the lease \ncontract was obtained’. Instead, the costs are incurred for the third par ty to \nprovide a requested service – e.g. delivery or i nstallation; and \n— because the costs are not initial direct costs, there are two acceptable \napproaches to accounting for these costs by the lessee: \n— capitalize the costs by analogy to the guidance in Topic 360 (property, \nplant and equipment) because they are incurred to prepare the ROU \nasset for its intended use; or \n— expense the costs as incurred. \nLessor costs to undertake activities \nIn addition to receiving payments from the lessee for undertaking activiti es of \nthe nature described in the background, the lessor will typically incur costs to \nfulfill those activities (which may include payments to third parties to undertake \nthe activities on the lessor’s behalf – e.g. to deliver the underlying asset to a \nlessee-designated location). \nA lessor’s accounting for those costs depends on whether the lessor is a \nmanufacturer or a dealer. \nLessor is a manufacturer or dealer \nBased on discussions with the FASB and SEC staffs, these costs do not meet \nthe definition of ‘i nitial direct costs’ because they are not incurred ‘because the \nlease contract was obtained’. Instead, these costs are incurred because the \nlessor undertakes the shipping, delivery, installation or other activities. \nBecause the costs are not initial direc t costs, and based on discussions with the \nFASB and SEC staffs, we believe there are two acceptable approaches to \naccounting for these costs by the manufacturer or dealer lessor, provided the \naccounting for such costs is not addressed by another US GAAP Topic (e.g. \nTopic 360). \n— Capitalize or expense the fulfillment costs in accordance with \nSubtopic 340-40. Apply the contract fulfillment costs guidance in \nSubtopic 340-40 by analogy. This means capitalize or expense the \nfulfillment costs as incurred based on whether such costs are eligible for ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 280}), Document(page\_content='Leases 280 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. capitalization under that Subtopic. I f capitalized, follow the amortization \nguidance for capitalized contract costs under that Subtopic, which requires \nthe entity to amortize the costs consistent with the transfer to the \ncustomer of the goods or services to which the costs relate. Lessors following this accounting policy must apply all of Subtopic 340- 40’s \nrequirements, including its impairment provisions. See chapter 12 of KPMG Handbook, Revenue recognition, for further guidance on applying Subtopic \n340-40. \n— Expense the fulfillment costs as incurred. Expense the costs as incurred \nbecause Topic 842 does not include fulfillment costs guidance such as that in Subtopic 340 -40. \nLessor is not a manufacturer or dealer \nThe fair value of the underlying asset equals its cost, which reflects volume or \ntrade disc ounts and includes the costs addressed by this question. An \nexception arises if there is a significant lapse in time between asset acquisition \nand lease commencement (see paragraph 7.3.41). \n[842- 30-55-17A] \nSales -type and direct financing leases \nWhen there is not a significant time lapse between asset acquisition and lease \ncommencement, the costs become part of the measurement of the lessor’s \nnet investment in the lease – which is initially measured at the fair value of the \nunderlying asset plus any deferred initial direct costs , and net of any selling \nprofit on the lease if a direct financing lease (see section 7.3.1). \nThe costs get included in the net investment in the lease and affect lease income in the same way as initial direct costs (see paragraph 7.3.35) even \nthough they do not meet the definition of initial direct costs. They affect lease \nincome by reducing the interest income earned by the lessor over the lease \nterm – as compared to what the lessor would earn if the costs were not \nincluded in the measurement of the net investment in the lease. \nIf there is a significant time lapse between asset acquisition and lease \ncommencement, the accounting described in paragraphs 7.3.43 – 7.3.45 will \ngenerally apply. \nOperating leases \nRegardless of whether there i s a significant time lapse between asset \nacquisition and lease commencement, i f the lease is an operating lease (see \nQuestion 7.3.01), the costs form part of the cost basis of the underlying asset . \nFor lessors tha t are not manufacturers or deal ers, the underlying asset is \ngenerally depreciated so that its carrying amount equals its estimated residual \nvalue at the end of the lease term. [ASU 2019- 01.BC10] \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 281}), Document(page\_content='Leases 281 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 5.1.20 \nLease commencement date – mobilization of \nequipment \nScenario 1: Initial location predetermined in the lease \nLessee LE signs a lease with Lessor LR for use of an offshore drilling rig on \nJune 1, 20X1 – i.e. contract inception is June 1, 20X1. The lease requires LR to \nmove the drilling rig to a predetermined location before LE is required to make \nany day- rate payments to LR. LE will, however, make a nonrefundable up -front \n‘mobilization’ payment to LR before LR moves the rig to the predetermined \nlocation. \nLR undertakes the mobilization on July 1, 20X1 and the drilling rig arrives at the \ndesignated location on August 1, 20X1 with the assigned LR crew. LE can begin \nto drill from August 1, 20X1 and is responsible for paying LR the applicable day-rate. \nIn this scenario, the lease commencement date is August 1, 20X1. This is \nthe date on which LR makes the underlying asset (i.e. the rig) available for use \nby LE; from that date, LE can exercise its rights under the contract to direct \nthe use of the drilling rig. Whether LE has plans to, or does, commence \ndrilling operations on that date does not affect determination of the \ncommencement date. \nLE and LR account for the nonrefundable mobilization payment as a prepaid \nlease payment. Regarding its mobilization costs, LR can elect to either: \n— apply the guidance in Subtopic 340- 40 to the costs by analogy, capitalizing \n(and amortizing) or expensing them as appropriate under that guidance ; or \n— expense the mobilization costs as incurred. \nScenario 2: Initial location designated by lessee \nAssume the same facts as Scenario 1, excep t that the lease does not require \nLR to move the drilling rig to a predetermined location and LE does not make an up-front mobilization payment. Instead, the contract provides that beginning on \nJune 1, 20X1, LE has the right to instruct LR where and when t o move the rig, \nand if it does so, it pays LR a specific rate for each day LR is moving the rig. LR \nundertakes mobilization of the rig after it receives instruction from LE and it \narrives at the designated location on August 1, 20X1, at which point LE can begin drilling. \nIn this scenario, the lease commencement date is June 1, 20X1 because this is \nthe date on which LR makes the underlying asset available for use by LE – i.e. \nLE controls how and for what purpose the asset is used by virtue of the fact that it can instruct LR where and when to move the rig from June 1, 20X1. This \nwould be the case even if LE is not responsible for paying LR the applicable \nday-rate under the lease terms until LE actually begins drilling activities on \nAugust 1, 20X1. \nBecau se lease commencement occurs before LR’s actions to move the rig to \nLE’s initial drilling location, in doing so LR’s actions fulfill its non- lease operation \nservices. LE’s payment of the moving ‘day rate’ is accounted for by LE and LR \nin the same manner as LE’s other day -rate payments. LR expenses its non-', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 282}), Document(page\_content='Leases 282 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. lease fulfillment costs to move the rig as incurred because they do not meet \nthe criteria for fulfillment cost capitalization in Subtopic 340- 40 – i.e. the costs \ndo not generate or enhance resources of LR that will be used to satisfy a \nperformance obligation in the future; the costs relate to LR’s present \nperformance of moving the rig to LE’s designated location, satisfying LR’s operation services performance obligation. See section 12.5 of KPMG \nHandbook, Revenue recognition\n. [340- 40-25-5(b), 25- 8(c)] \n \n Comparison to legacy US GAAP \nInception vs. commencement date \n5.1.30 Under Topic 840, the initial measurement of a lease (e.g. determination \nof the discount rate for a capital lease) and the assessment of lease \nclassification occur red at contract inception, rather than at the commencement \ndate. \n5.1.40 The recognition date for leases is consistent bet ween Topic 840 and \nTopic 842 (commencement date) . However , because inputs such as the fair \nvalue of the underlying asset and the lessee’s incremental borrowing rate might \nbe different between those two dates, entities might reach different \nconclusions about initial measurement and lease classification for some leases \nusing the commencement date versus the inception date. [840- 10-25-1] \n \n5.2 Reasonably c ertain \n Excerpt from ASC 842 -10 \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance \n>> Lease Term and Purchase Options \n>>> Reasonably Certain \n55-26 At the commencement date, an entity assesses whether the lessee is \nreasonably certain to exercise or not to exercise an option by considering all \neconomic fact ors relevant to that assessment —contract -based, asset -based, \nmarket -based, and entity -based factors. An entity’s assessment often will \nrequire the consideration of a combination of those factors because they are \ninterrelated. Examples of economic factors t o consider include, but are not \nlimited to, any of the following: \na. Contractual terms and conditions for the optional periods compared with \ncurrent market rates, such as: \n1. The amount of lease payments in any optional period ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 283}), Document(page\_content='Leases 283 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 2. The amount of any variable lease payments or other contingent \npayments, such as payments under term ination penalties and residual \nvalue guarantees \n3. The terms and conditions of any options that are exercisable after initial \noptional periods (for example, the terms and conditions of a purchase \noption that is exercisable at the end of an extension period a t a rate \nthat is currently below market rates). \nb. Significant leasehold improvements that are expected to have significant \neconomic value for the lessee when the option to extend or terminate the \nlease or to purchase the underlying asset becomes exercisable. \nc. Costs relating to the termination of the lease and the signing of a new \nlease, such as negotiation costs, relocation costs, costs of identifying \nanother underlying asset suitable for the lessee’s operations, or costs \nassociated with returning the underl ying asset in a contractually specified \ncondition or to a contractually specified location. \nd. The importance of that underlying asset to the lessee’s operations, \nconsidering, for example, whether the underlying asset is a specialized \nasset and the location of the underlying asset. \n> Illustrations \n>> Illustration of Lessee Accounting for Purchase Options \n55-210 Examples 23 through 24 illustrate the evaluation of whether a lessee is \nreasonably certain to exercise an option to purchase the underlying asset. \n>>> Example 23 —Lessee Purchase Option \n55-211 Lessee enters into a 5- year lease of equipment with annual lease \npayments of $59,000, payable at the end of each year. There are no initial \ndirect costs incurred by Lessee or lease incentives. At the end of Year 5, \nLessee has an option to purchase the equipment for $5,000. The expected \nresidual value of the equipment at the end of the lease is $75,000. Because \nthe exercise price of the purchase option is significantly discounted from the \nexpected fair value of the equipment at the time the purchase option becomes \nexercisable, Lessee concludes that it is reasonably certain to exercise the \npurchase option. The fair value of the equipment at the commencement date is \n$250,000, and its economic life is 7 years. The discount rate for the lease, \nwhich is Lessee’s incremental borrowing rate because the rate implicit in the \nlease is not available, is 6.5 percent. \n55-212 Because the lease grants Lessee an option to purchase the underlying \nasset that it is reasonably certain to exercise, Lessee classifies the lease as a \nfinance lease. \n55-213 Lessee recognizes the lease liability at the commencement date at \n$248,834 (the pr esent value of 5 payments of $59,000 + the present value of \nthe $5,000 payment for the purchase option, discounted at 6.5%). Because \nthere are no initial direct costs, lease incentives, or other payments made to \nLessor at or before the commencement date, L essee recognizes the right -of-\nuse asset at the same amount as the lease liability. \n55-214 Lessee amortizes the right -of-use asset over the seven- year expected \nuseful life of the equipment, rather than over the lease term of five years, \nbecause Lessee is reasonably certain to exercise the option to purchase the ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 284}), Document(page\_content='Leases 284 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. equipment. Lessee depreciates its owned assets on a straight -line basis. \nTherefore, the right -of-use asset is amortized on a straight -line basis. \n55-215 During the first year of the lease, Lessee recognizes interest expense \non the lease liability of $16,174 (6.5% × $248,834) and amortizati on of the \nright-of-use asset of $35,548 ($248,834 ÷ 7). \n55-216 At the end of Year 1, the right -of-use asset is $213,286 ($248,834 – \n$35,548), and the lease liability is $206,008 ($248,834 + $16,174 – $59,000). \n55-217 At the end of Year 5, the carrying amount of the right -of-use asset is \n$71,094 ($248,834 – [$35,548 × 5]), and the remaining lease liability is $5,000, \nwhich is the exercise price of the purchase option. Lessee exercises the \npurchase option and settles the remaining lease liability. If the right -of-use \nasset was not previously presented together with property, plant, and \nequipment, Lessee reclassifies the right -of-use asset to property, plant, and \nequipment and applies Topic 360 to the asset beginning on the date the \npurchase option is exercised. \n>>> Example 24 —Lessee Purchase Option \n55-218 Lessee enters into a 5- year lease of specialized equipment with annual \nlease payments of $65,000, payable in arrears. There are no initial direct costs \nor lease incentives. At the end of Year 5, Lessee has an option to purchase the \nequipment for $90,000, which is the expected fair value of the equipment at \nthat date. Lessor constructed the equipment specifically for the needs of \nLessee. Furthermore, the specialized equipment is vital to Lessee’s business; \nwithout this asset, Lessee would be required to halt operations while a new \nasset was built or customized. As such, Lessee concludes that it is reasonably \ncertain to exercise the purchase option because the specialized nature, \nspecifications of th e asset, and its role in Lessee’s operations create a \nsignificant economic incentive for Lessee to do so. The fair value of the \nequipment at the commencement date is $440,000, and its economic life is \n10 years. Lessee’s incremental borrowing rate is 6.5 percent, which reflects \nthe fixed rate at which Lessee could borrow an amount similar to that of the \nlease payments ([$65,000 × 5 lease payments] + the $90,000 purchase option \nexercise price = $415,000) in the same currency, for the same term, and with \nsimilar collateral as in the lease at the commencement date. \n55-219 The lease grants Lessee an option to purchase the underlying asset \nthat it is reasonably certain to exercise. In addition, the underlying asset is of \nsuch a specialized nature that it is expect ed to have no alternative use to \nLessor at the end of the lease term. As such, Lessee classifies the lease as a \nfinance lease. \n55-220 Lessee recognizes the lease liability at the commencement date at \n$335,808 (the present value of 5 payments of $65,000 + t he present value of \nthe $90,000 payment for the purchase option to be made at the end of Year 5, \ndiscounted at 6.5%). Because there are no initial direct costs, lease incentives, \nor other payments made to Lessor at or before the commencement date, \nLessee r ecognizes the right -of-use asset at the same amount as the lease \nliability. \n55-221 Lessee amortizes the right -of-use asset over the 10- year expected \nuseful life of the equipment rather than over the lease term of 5 years, ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 285}), Document(page\_content='Leases 285 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. because Lessee is reasonably cert ain to exercise the option to purchase the \nequipment. Lessee depreciates its owned assets on a straight -line basis. \nTherefore, the right -of-use asset is amortized on a straight -line basis. \n55-222 During the first year of the lease, Lessee recognizes interest expense \non the lease liability of $21,828 (6.5% × $335,808) and amortization of the \nright-of-use asset of $33,581 ($335,808 ÷ 10). \n55-223 At the end of Year 1, the right -of-use asset is $302,227 ($335,808 – \n$33,581), and the lease liability is $292,636 ($335,808 + $21,828 – $65,000). \n55-224 At the end of Year 5, the carrying amount of the right -of-use asset is \n$167,903 ($335,808 – $33,581 × 5), and the remaining lease liability is $90,000, \nwhich is the amount of the purchase option. Lessee exercises the option to \npurchase the equipment and settles the remaining lease liability. If the right -of-\nuse asset was not previously presented together with property, plant, and \nequipment, Lessee reclassifies the right -of-use asset to property, plant, and \nequipment and will apply Topic 360 to the equipment beginning on the date \nthe purchase option is exercised. \n \n5.2.10 The concept of ‘reasonably certain’ is integral to determining the ‘lease \nterm’ (see section 5.3) and the ‘lease payments’ (see section 5.4). \n5.2.20 Leases often include options that permit the lessee to extend or renew \nthe lease (including by not exercising a termination option) or to purchase the \nunderlying asset. Such options are accounted for (i.e. included in the \nmeasurement of lease assets and lease liabilities) only when it is ‘reasonably \ncertain’ that the lessee will exercise the option. It is assumed that a lessee \ntermination option will be exercised unless the lessee is reasonably certain not \nto do so. [842- 10-30-1] \n5.2.30 ‘Reasonably certain’ is a high threshold of probability that must be met to \ninclude optional lessee payments in the measurement of lease assets and lease \nliabilities. When combined with the economic nature of the evaluation, the \nBoard intended the parties to account for lessee options only when the lessee \nhas a compelling economic reason to exercise the renewal or purchas e option \n(or not to exercise a termination option) . [ASU 2016- 02.BC194, BC197, BC218] \n \n Observation \n‘Reasonably certain’ synonymous with ‘reasonably \nassured’ \n5.2.40 While Topic 842 uses the term ‘reasonably certain’, Topic 840 used the \nterm ‘reasonably assured’ to describe the probability threshold that must be \nmet for including lessee options in the measurement of lease assets and lease \nliabilities and in considering lease classification. \n5.2.41 The Board views these terms as synonyms that should be applied in the \nsame way. Therefore, the probability threshold for including lessee options in the measurement of lease assets and lease liabilities, and in considering l ease \nclassification, is the same as in Topic 840. The Board selected the term \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 286}), Document(page\_content='Leases 286 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. ‘reasonably certain’, rather than retaining the term ‘reasonably assured’, to \nconverge with IFRS 16 terminology in this respect. [ASU 2016- 02.BC195] \n5.2.50 An entity assesses wh ether a lessee is reasonably certain to exercise or \nnot to exercise an option by considering all economic factors relevant to that \nassessment: contract -based, asset -based, entity -based and market -based \nfactors. An entity’s assessment will often require the consideration of a \ncombination of factors because they are interrelated. Therefore, an expectation \nof exercise alone (e.g. based on relevant history in similar arrangements or \nmanagement’s intent) does not result in a conclusion that the lessee is \nreasona bly certain to exercise an option if there is not a compelling economic \nreason to do so. [842- 10-55-26, ASU 2016- 02.BC193] \n5.2.60 All factors are considered together and the existence of any one factor \ndoes not necessarily indicate that a lessee is reasonably certain to exercise the option. Although not exhaustive, Topic 842 includes the following examples of \nfactors to consider. \n[842-10-55-26] \nType of factor Examples \nContract-based — Amount of the lease payments (including variable lease \npayments) in any optional period as compared to market rates \n— Existence and amount of any variable lease payments or other contingent payments \n— Existence and terms of options (renewal or purchase) \n— Costs associated with an obligation to return the leased \nasset in a specified condition or to a specified location \nAsset -based — Location of the asset \n— Existence of significant leasehold improvements that \nwould be lost if the lease were terminated or not \nextended \n— Noncontractual relocation costs \n— Costs associated with lost production \n— Costs associated with sourcing an alternative item \nEntity -based — Financial consequences of a decision to extend or terminate a lease \n— Nature of the leased asset (specialized versus non-specialized; the extent to which the asset is crucial to the \nlessee’s operations, etc.) \n— Tax consequences of terminating or not extending the \nlease \nMarket -based — Statutory law and local re gulations \n— Market rentals for a comparable asset \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 287}), Document(page\_content='Leases 287 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 5.2.10 \nFacts and circumstances and additional factors to \nconsider \nCan an entity reach different conclusions about whether \nexercise is reasonably certain for two options with very \nsimilar terms that relate to different leases? \nInterpretive response: Yes. T he particular facts and circumstances of a lease \ncan significantly affect an entity’s assessment of a lessee option such that an \nentity might reach different conclusions about whether exer cise is reasonably \ncertain for two options with seemingly very similar terms (e.g. the same strike \nprice and the same expected fair value of the underlying asset) based on \ndifferent underlying facts and circumstances. \nThe following are examples. \n— The further out into the future the option exercise date, the more \ncompelling the evidence must be, on an economic basis, that the lessee \nwill exercise the option. This is because an entity’s estimates about \nconditions that will exist at the option date will be less precise the further \nout the option date is; these estimates include, but are not limited to, the fair value of the underlying asset, the availability of suitable alternatives to the underlying asset and the tax environment in a particular jurisdiction. \n— The nature of the underlying asset may significantly affect an entity’s \nassessment of a lessee option. Depending on the nature of the underlying \nasset, it may be more difficult for an entity to predict its fair value or the \navailability of suitable alternati ve resources. This is illustrated in \nExample 5.2.10. \n— The location of the underlying asset could significantly affect relocation \ncosts or the availability of alternative resources. For example, even for two \nidentical underlying assets, considerations about relocation costs or \navailable alternative resources could vary widely if one is deployed in a remote area and the other in a readily accessible area. \n— The jurisdiction governing the lease could significantly affect the \nassumptions about laws and regulations (including tax consequences) \naffecting the assessment of the option; for example, laws and regulations in some countries may be more stable and predictable than in other \ncountries. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 288}), Document(page\_content='Leases 288 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 5.2.20 \nLessees and lessors may reach different conclusions \nCan lessors and lessees reach different conclusions about \nwhether it is reasonably certain that an option will be \nexercised? \nInterpretive response: Yes. The nature of the assessment of ‘reasonably \ncertain’ , which is based on judgments (e.g. about the importance of an \nidentified asset to the lessee) and estimates (e.g. of the fair value of the asset \nin the future) means that lessees and lessors may reach different conclusions \nabout whether it is reasonably certain that a lessee will exer cise a renewal or \npurchase option, or not exercise a termination option. \n \n Example 5.2.10 \nAssessment of a lessee renewal option \nScenario 1: Not reasonably certain to exercise either of the renewal \noptions \nLessee LE enters into a five- year warehouse lease with Lessor LR. \nAs part of the contract, LE has the option to renew the five- year lease for two \nadditional five -year terms (i.e. for 15 years in total) at the market price at the \ndate of exercising each renewal option. If LE does not renew the lease, it is \nresponsible for its costs to vacate the facility, relocate to a new facility and \nreturn the warehouse to its pre- lease condition. \nLE has a track record of remaining in leased warehouse facilities for at least 10 years. It was in each of it s previous three facilities for 15, 10 and 15 years, \nrespectively. \nIn this scenario, both LE and LR conclude that LE is not reasonably certain to exercise either of the five- year renewal options for the warehouse facility. \nLE’s history of renewing its ware house leases may suggest that there is an intent \non the part of LE to exercise at least the first of the two five- year renewal options. \nHowever, the fact pattern does not suggest that LE is reasonably certain to do so. \nThe fact that LE will have to incur c osts (e.g. relocation, restoration, etc.) if it \ndoes not renew the lease also does not make it reasonably certain that LE will \nrenew the lease to avoid those costs. This is because LE will likely incur those \ncosts at some point given the terms of the lease and it is also not reasonably \ncertain that LE will not, five years into the future, offset those costs through \nfavorable lease terms for a replacement facility or other economic factors \nrelevant to the new lease. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 289}), Document(page\_content='Leases 289 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Scenario 2: Significant leasehold improvem ents \nChanging the facts of Scenario 1, before moving into the leased facility, \nLE constructs expensive leasehold improvements with an economic life of \n15 years. \nThese leasehold improvements will have significant economic value to LE at the \nend of both five and 10 years that it will not be able to recover if it vacates the \nfacility. LE will have to remove the improvements and they are not portable to \nanother location. \nThe construction of the significant leasehold improvements and the economic factors surroun ding those improvements (e.g. that a significant portion of \ntheir substantial economic value will be lost if LE relocates before the end of \n15 years) provides a compelling economic reason for LE to remain in the facility \nfor the full 15 years permitted. \nTherefore, in this scenario, both LE and LR conclude that it is reasonably certain \nthat LE will exercise both of its five- year renewal options. \nScenario 3: Specialized facility \nAgain changing the facts of Scenario 1, the warehouse is a highly specialized facility. There are only a limited number of facilities of this nature, no two of \nwhich (presently or historically) are in the same geographic area. Constructing a facility of this nature is expensive and requires significant time. Having access \nto a speciali zed facility of this nature and in this geographic area is vital to LE’s \ncore operations. \nBetween now and the end of the non- cancellable period of the lease (i.e. \nfive years), it is highly unlikely that LR or another entity will construct a suitable \naltern ative facility in the same geographic area as the warehouse being leased. \nThe investment of time and resources that would be required, together with the fact that doing so would invite one of LE’s competitors to operate in the area \n(i.e. by leasing the specialized warehouse from LR), creates a significant \neconomic disincentive for LE to construct its own specialized facility. Therefore, \nin this scenario, both LE and LR conclude that it is reasonably certain, based on \nan evaluation of the relevant economic f actors, that LE will exercise the first \nfive-year renewal option. \nHowever, both LE and LR conclude that it is not reasonably certain, at lease \ncommencement, that LE will exercise the second five- year renewal option. \nWhile the same economic circumstances considered in determining that LE is \nreasonably certain to exercise the first five- year renewal option might exist \n10 years from now, reasonably certain is a high threshold of probability. The \nextended period of time between lease commencement and the exercise date \nfor that option (i.e. approximately 10 years) means that it is not reasonably \ncertain that those same economic circumstances will exist. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 290}), Document(page\_content='Leases 290 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 5.2.20 \nAssessment of a lessee purchase option with strike \nprice below expected fair value \nScenario 1: Fair values volatile \nLessee LE enters into a five -year lease with Lessor LR to use a piece of equipment \nin an evolving area of the technology sector; there are no renewal or termination \noptions. LE has the option under the contract to purchase the underlying asset at \nthe end of the non -cancellable lease term for $500,000. The expected fair value of \nthe asset at the end of the non -cancellable lease term is $650,000. \nBoth LE and LR conclude that it is not reasonably certain that LE will exercise \nthe option. The underlying asset is in an evolving area of the technology sector, and the duration of the non -cancellable period of five years (between the \nassessment of the option at lease commencement and the option exercise date) is significant in that context. Therefore, each party concludes that there is \ntoo much uncertainty about what the fair value of the underlying asset will be at \nthe option exercise date to conclude at lease commencement that LE is \nreasonably certain to exercise the option; for example, newer, better alternative assets may be introduced during the five- year lease term. \nIn this scenario, the lease term (five years) and specific environment \n(technology sector) are important factors in reaching the conclusion. A shorter \nlease term (e.g. one or two years) or a different environment might lead to a \ndifferent conclusion. \nScenario 2: Fair values historically stable \nChanging the facts of Scenario 1, the underlying asset is conventional real estate (e.g. a building that could be used for a variety of purposes) in a market \nthat historically has been highly predictable to within a narrow range – price s \nhave been predictable to within +/ - 10 percent over a long period of time. \nIn this scenario, given the extent of the discount between the strike price ($500,000) and the reasonably predictable expected fair value of the underlying \nasset ($650,000), each of the parties concludes that it is reasonably certain that \nLE will exercise the purchase option. \nAs with Scenario 1, changes to this fact pattern could influence the conclusion \nreached. For example, if the strike price of the option were $600,000 instead of $500,000, it might not be reasonably certain that LE would exercise the option. \nAt that strike price, either (1) the $50,000 forecasted discount may not be \nsignificant enough to conclude that LE is reasonably certain to exercise the \noption, or ( 2) there may be uncertainty, even within the historically predictable \nreal estate market in the example, about whether the strike price will in fact represent a discount from the actual fair value of the building at the option exercise date. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 291}), Document(page\_content='Leases 291 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 5.3 Lease t erm \n Excerpt from ASC 842 -10 \n30 Initial Measurement \nGeneral \n> Lease Term and Purchase Options \nThe date on which a lessor makes an underlying asset available for use by a \nlessee. See paragraphs 842- 10-55-19 through 55- 21 for implementation \nguidance on the commencement date. \n30-1 An entity shall determine the lease term as the noncancellable period of \nthe lease , together with all of the following: \na. Perio ds covered by an option to extend the lease if the lessee is \nreasonably certain to exercise that option \nb. Periods covered by an option to terminate the lease if the lessee is \nreasonably certain not to exercise that option \nc. Periods covered by an option to ex tend (or not to terminate) the lease in \nwhich exercise of the option is controlled by the lessor . \n30-2 At the commencement date , an entity shall include the periods \ndescribed in paragraph 842 -10-30-1 in the lease term having considered all \nrelevant factor s that create an economic incentive for the lessee (that is, \ncontract- based, asset -based, entity -based, and market -based factors). Those \nfactors shall be considered together, and the existence of any one factor does \nnot necessarily signify that a lessee is reasonably certain to exercise or not to \nexercise an option. \n30-3 At the commencement date, an entity shall assess an option to purchase \nthe underlying asset on the same basis as an option to extend or not to \nterminate a lease, as described in paragraph 842- 10-30-2. \n30-4 See paragraphs 842- 10-55-19 through 55- 21 for implementation guidance \non commencement date and paragraphs 842- 10-55-23 through 55- 27 for \nimplementation guidance on lease term and purchase options. See \nExamples 23 through 24 (paragraphs 842- 10-55-210 through 55- 224) for \nillustrations of the requirements on purchase options. \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance \n>> Lease Term and Purchase Options \n55-23 An entity should determine the noncancella ble period of a lease when \ndetermining the lease term . When assessing the length of the noncancellable \nperiod of a lease, an entity should apply the definition of a contract and \ndetermine the period for which the contract is enforceable. A lease is no long er \nenforceable when both the lessee and the lessor each have the right to \nterminate the lease without permission from the other party with no more than ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 292}), Document(page\_content='Leases 292 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. an insignificant penalty . \n55-24 If only a lessee has the right to terminate a lease, that right is considered \nto be an option to terminate the lease available to the lessee that an entity \nconsiders when determining the lease term, as described in paragraph 842- 10-\n30-1(b). If only a less or has the right to terminate a lease, the lease term \nincludes the period covered by the option to terminate the lease , as described \nin paragraph 842- 10-30-1(c). \n55-25 The lease term begins at the commencement date and includes any \nrent-free periods provi ded to the lessee by the lessor. \n>>> Fiscal Funding Clauses \n55-27 The existence of a fiscal funding clause in a lease agreement requires \nan assessment of the likelihood of lease cancellation through exercise of the \nfiscal funding clause. If it is more than remote that the fiscal funding clause \nwill be exercised, the lease term should include only those periods for which \nfunding is reasonably certain. \n \n5.3.10 Beginning at the commencement date, the lease term always includes \nthe non-cancellable period and may include one or more optional periods. \n[842- 10-30-1, 55- 25] \nLease term comprises ...\nNon-cancellable \nperiodPeriods for which \nlessee has option to \nextend (not \nterminate)Periods for which \nlessor has option to \nextend (not \nterminate)\nIncludes any rent -\nfree periodsInclude if lessee is \n‘reasonably certain ’ \nto extend /not \nterminateInclude \n5.3.20 After the commencement date, a lessee may reassess the lease term \nupon the occurrence of certain events or changes in circumstanc es (see \nsection 6.6) or in the case of a lease modification that is not accounted for as a \nseparate contract (see section 6.7). Conversely, a lessor only reassesses the \nlease term in the event of a lease modification that is not accounted for as a \nseparate contract ( see section 7. 6). \n5.3.30 The lease term may be affected by the term of a sublease entered into \nby the lessee. Section 8.1 outlines the effects of entering into the sublease on \nthe assessment of the lease term for the head lease by both the les see and the \nlessor, specifically highlighting that entering into the sublease triggers a \nreassessment of the head lease term for the lessee, but not the lessor. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 293}), Document(page\_content='Leases 293 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 5.3.10 \nInitial l ease term (lessee renewal options) \nAssume the same facts as in Scenarios 1, 2 and 3 in Example 5. 2.10. That \nexample illustrates whether Lessee LE is, or is not, reasonably certain to \nexercise one or both renewal options provided. This example concludes on \nthe ‘lease term’ for each of those scenarios based on the concl usions in \nExample 5.2.10. \nFor each of the scenarios in Example 5.2.10 , the lease term equals the non-\ncancellable period of five years plus the periods covered by renewal options that \nLE is reasonably certain to exercise. That results in lease terms for each \nscenario as follows. \nExample 5.2.10 Scenario Lease term \nScenario 1 5 years \nScenario 2 15 years \nScenario 3 10 years \n \n5.3.40 A contract is an agreement between two or more parties that creates \nenforceable rights and obligations. When assessing the non- cancellable period \nof a lease, an entity applies that definition to determine the period for which a \ncontract exists. A lease is no longer enforceable, and therefore the lease term \ndoes not extend, beyond the point that both the lessee and the lessor have the \nunilateral right to terminate the lease, without permission from the other party \nand with no more than an insignificant ‘penalty’ (see paragraphs 5.3. 80 – \n5.3.90). [842 Glossary, 842- 10-55-23] \n5.3.50 If only a lessee has the right to terminate a lease, that right is considered \nto be an option to terminate the lease available to the lessee that an entity \nconsiders in determining the lease term. [842- 10-55-24] \n5.3.60 If only a lessor has the right to terminate a lease or controls the lessee’s \nability to exercise an option to terminate the lease, the lease term should assume that the lease will not be terminated. \n[842- 10-55-24] \n5.3.70 The lease term excludes periods after which both parties’ unilateral \ntermination rights (with no more than an insignificant penalty) are exercisable \nbecause neither party has enforceable rights or obligations. \n— The lessee neither has the right to continue to use the underlying asset \n(after the lessor’s termination rights become exercisable), nor an obligation \nto make lease payments (after its termination rights become exercisable). \n— The lessor neither has a right to receive lease payments (after the lessee’s \ntermination rights become exercisable), nor an obligation to extend the \nlessee’s right to use the underlying asset (after its termination rights \nbecome exercisable). This principle is illustrated in Example 5.3.20. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 294}), Document(page\_content='Leases 294 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 5.3.10 \nLegal evaluation of the n on-cancellable period \nWhat determines the ‘non- cancellable period’ of a lease? \nInterpretive response: Whether and for what period a contract creates \nenforceable rights and obligations on the parties depends on the relevant law s \nand enforcement practices in the governing jurisdiction to which the contract \nis subject . \nHowever, as a pra ctical matter, in most cases a contract is no longer \nenforceable after it can be cancelled by either party, assuming that the \ncancellation/termination option is substantive because the entity can exercise \nthat option without incurring a more- than- insignifi cant penalty . \n— Once the lessee has the right to cancel the lease, the lessee no longer h as \nan enforceable obligation to make the lease payments and the lessor no \nlonger has an enforceable right to receive lease payments. \n— Similarly, once the lessor has the r ight to cancel the lease, the lessee no \nlonger has an enforceable right to use the underlying asset and the lessor no longer has an enforceable obligation to permit the lessee use of the underlying asset. \n5.3.80 While ‘penalty’ is a defined term in Topic 842, it has a broad meaning. It \nencompasses economic penalties beyond any requirement for the terminating \nparty to make a cash payment to the other party. Lessees and lessors need to \nconsider the broad definition of a penalty when assessing whether both the \nlessee and the lessor have the right to terminate the lease with no more than \nan insignificant penalty . Incorrect conclusions on this point can result in: \n[842 Glossary ] \n— inaccurate measurement of lease assets and liabilities; \n— incorrect lease classificat ion; and/or \n— for lessees, incorrect conclusions about eligibility for the short -term lease \nexemption. \n5.3.90 A penalty may expire or, over a period of time, the effect of a penalty that \nis initially more than insignificant may become insignificant. For ex ample, a \ntermination penalty that is more than insignificant if exercised after only one \nyear of a lease may be insignificant after two or three years when considered in \nthe context of the entire arrangement. \n5.3.100 Under a fiscal funding clause, a lease is cancellable if the legislature or \nother funding authority does not appropriate the funds necessary for the \ngovernmental unit (as lessee) to fulfill its obligations under the lease agreement. \nThe existence of such a clause requires an assessment of the likelihood of \nlease cancellation through exercise of the fiscal funding clause. If it is more than \nremote that the fiscal funding clause will be exercised, the lease term should \ninclude only those periods for which funding is reasonably certain. [842 Glossary, \n842-10-55-27] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 295}), Document(page\_content='Leases 295 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 5.3.20 \nEffect of termination notice clauses on the \nnon-cancellable period \nDoes a clause in a lease that requires a termination notice \nbefore a lessee or lessor can formally terminate a lease \ncontract affect the non -cancellable period of a lease? \nInterpretive response: Yes. When either the lessee or lessor has the right to \nterminate a lease at any time on giving notice to the other party, the non-\ncancellable period of the leas e includes the ‘notice’ period. \nFor example, a lease agreement may grant each party the unilateral right to terminate the lease, for any reason and without penalty (see paragraphs 5.3.80 \n– 90), on giving 90 days’ notice to the other party. This means that at any point \nin time before such notice is given by either party, enforceable rights and obligations for both parties exist for 90 days. Therefore, at lease \ncommencement, and until either party gives notice of its intent to terminate the lease, the non -cancellable period of the lease is 90 days. \n \n Question 5.3.25 \nContingent termination provisions \nDoes a contingent termination provision in a lease affect the \nnon- cancellable period of a lease? \nBackground: A lessee may have the right to terminate the lease before the end \nof the stated non- cancellable period in the contract only if a future event occurs \nor circumstance arises. For example, despite a stated non- cancellable lease \nperiod of 10 years, the lessee may have the contingent right to terminate the \nlease on or after an earlier date if a designated event occurs (or does not occur) \nor condition exists. \nFor example, a lessee has the right to terminate a retail space lease with a \n10-year stated non- cancella ble term after 5 years of that term if its average \nannual sales from the retail space over that 5- year period are less than a \nspecified amount. This provision gives the lessee the ability to early terminate a lease that is not providing its desired return. \nInterpretive response: Yes. Considering the retail space example in the \nbackground, even though the lease contract has a stated non-cancellable lease \nperiod of 10 years, we believe the non- cancellable period of the lease is only \n5 years because of the con tingent termination provision. \nWe believe an entity (lessee or lessor) assesses a contingent termination \nprovision the same way it assesses a non -contingent termination provision. \nThat is, the entity includes the period(s) after the contingent termination option in the ‘lease term’ only if the lessee is reasonably certain not to exercise \nthe option. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 296}), Document(page\_content='Leases 296 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. When assessing whether the lessee is reasonably certain not to exercise the \ncontingent termination option, we believe an entity considers both of the \nfollowing. \n— The probability of the contingency occurring or arising. If it is remote \nthat the contingent event will occur or circumstance arise, the lessee is reasonably certain not to terminate the lease because the contingent \ntermination option will not be exercis able. \n— The likelihood the lessee will choose not to terminate the lease even if the contingency is triggered. If the contingency is at least more than \nremote (i.e. reasonably possible) of being triggered, an entity further \nconsiders other relevant economic factors (see paragraph 5.2.60) that could \nsuggest the lessee would not exercise the option. \nThere may be other economic factors that would induce the lessee not to \nterminate the lease even if the contingency is triggered. For example, the \nretailer descri bed in the background may incur significant costs to relocate \nits store or forfeit valuable leasehold improvements, or there may be limited \nother viable store location options. As a result, the retailer’s average annual \nsales would have to be significantly below the triggering amount before it \nwould vacate the leased property, and it may be remote that the retailer \nwould fail to hit this even lower performance target. \nThe following table summarizes our view on analyzing a contingent termination \nprovision. \nLikelihood of \ncontingency occurring \nor arising Other economic factors \nconsidered? Reasonably certain \nconclusion \nRemote1 N/A. It is reasonably certain \nthe termination option will not \nbecome exercisable, so no \nother economic factors need \nbe considered. Lessee is reasonably certain \nto not terminate . \nMore than remote Yes. Consider likelihood of \ntermination option exercise \nbased on the same factors \nthat would be considered if \nthe termination option were \nnot contingent (see \nparagraph 5.2.60) . It depends. Consider \nlikelihood of triggering the option together with other \nrelevant economic factors. \nNote : \n1. Remote is ‘the chance of the future event or events occurring is slight’. [842 Glossary] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 297}), Document(page\_content='Leases 297 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 5.3.30 \nExtension or renewal options controlled by an \nunrelated third party \nDoes the lease term automatically include extension or \nrenewal options controlled by a third party unrelated to either \nthe lessee or the lessor? \nInterpretive response: No. Only extension or renewal options controlled by the \nlessor are automatically included in the lease term. [842-10-30-1(c)] \nBase d on discussions with the FASB staff, we believe options controlled by \nanother unrelated third party (e.g. a sublessee) are subject to the same \nreasonably certain assessment as lessee -controlled options. U nless the third \nparty is reasonably certain to exer cise, or force the exercise of, the extension or \nrenewal option (or not to terminate the lease at an available termination date), it \nis not included in the lease term. \nWe understand that the FASB staff believes that paragraph 842- 10-30-1(c) \nestablishes a r ule; it does not provide a principle that should be extrapolated \nto other situations in which exercise of an option is outside of the control of \nthe lessee. \n \n Question 5.3.40 \nLease term when lessee and lessor both have \ntermination rights – lessor only inc urs penalty \nWhat is the lease term when both the lessee and lessor have \ntermination rights – the lessor’s right gives rise to a more -\nthan- insignificant penalty while the lessee’s does not? \nInterpretive response : When the lessor’s termination right becomes \nexercisable at the same time as or after the lessee’s termination option, the \nlease term is the shorter of the period from lease commencement until: \na. the lessor’s exercise of its termination option no longer gives rise to a \nmore- than- insignificant penalty; or \nb. the lessee’s termination option becomes exercisable plus any periods after that for which the lessee is reasonably certain not to exercise the option. \nIn contrast, if the lessor’s termination right will no longer result in a more -than-\ninsignificant penalty before the lessee’s termination option becomes \nexercisable, the lessor -only termination option is disregarded for accounting \npurposes until the lessee’s termination option becomes exercisable. When the lessee’s termination option becomes exercisable, both the lessee and the \nlessor have the unilateral right to terminate the lease with no more than an \ninsignificant penalty, and the lease term does not extend beyond that point (see \nparagraph 5.3.40) . \n[842- 10-30-1(c)] \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 298}), Document(page\_content='Leases 298 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Given the similarity between (1) what constitutes a penalty and (2) the factors in \nTopic 842 that could create a compelling economic reason for a lessee to \nrenew (or not terminate) a lease, we generally would not expect (b) above to include per iods after the lessee’s termination option becomes exercisable. That \nis, we believe the absence of a more- than- insignificant penalty would generally \nmean the lessee is not reasonably certain to extend the lease beyond the date \nits termination option (that does not result in a more- than- insignifica nt penalty) \nbecomes exercisable. \n[842 Glossary, 842 -10-55-26] \n \n Question 5.3.50 \nLease term when lessee and lessor both have \ntermination rights – lessee only incurs penalty \nWhat is the lease term when both the le ssee and lessor have \ntermination rights – the lessee’s termination right gives rise \nto a more -than- insignificant penalty while the lessor’s does \nnot? \nInterpretive response : When the lessee’s termination right results in a more-\nthan- insignificant penalty, r egardless of when the lessor’s termination right \nbecomes exercisable, the lease term is the shorter of the period from lease commencement until: \na. the lessee’s exercise of its termination option no longer gives rise to a more- than- insignificant penalty; or \nb. the lessee’s termination option becomes exercisable (without regard to the \npenalty) plus any periods after that for which the lessee is reasonabl y \ncertain not to exercise its termination option. \n‘Reasonably certain’ is a high threshold of probability. It is intended to capture \nsituations in which the lessee is effectively compelled economically (has little or no choice but) to exercise an option. \n[ASU 2016- 02.BC197] \nBecause of this and the similarity between (1) what constitutes a ‘penalty’ and \n(2) the factors in Topic 842 that could create a compelling economic reason for \na lessee to renew (or not terminate) a lease, we would generally not expect an \nentity to conclude both that: [842 Glossary, 842- 10-55-26] \n— the lessee is r easonably certain to extend (i.e. not terminate) the lease; and \n— terminating the lease will result in no or only an insignificant penalty. \nIn other words, we believe it will generally be the case that (b) is equal to or \nshorter than (a), and therefore it will generally not be necessary for an entity to \ncalculate both (a) and (b). \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 299}), Document(page\_content='Leases 299 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 5.3.20 \nTermination rights \nScenario 1: Lessee and lessor both have right to terminate – lessee’s \ntermination right gives rise to a more -than -insignificant penalty; lessor’s \ndoes not \nLessee LE and Lessor LR enter into a lease, granting LE the right to use LR’s \nequipment for a non -cancellable period of one year. After one year, the lease \nwill continue for up to four additional years (five years in total) unless cancelled by either party. The lease payments are fixed, and those payments are \nconsidered to be at -market at lease commencement. \nEach party has the unilateral right to termi nate the contract at the end of \nYears 1–4 by providing notice to the other party at least 30 days before the end \nof the then- current year. If LE terminates the contract, LE must pay to transport \nthe equipment back to LR’s location. \nIn addition, the follow ing facts are relevant. \n— Equiv alent pieces of equipment are readily available for lease from other \nsuppliers at a similar rental price and subject to similar contractual terms and conditions. \n— The equipment must be installed before use. Installation costs are incurred each time a new piece of equipment is installed and the installation is a \nsignificant undertaking. \n— The transportation costs that LE will incur to return the equipment to LR are \nsubstantial due to the location of LE’s operations and the nature of the \nequipment. \n— LE’s operations depend on using this type of equipment. \n— LE’s operations will necessarily halt for a period of at least a few days if it needs or chooses to switch equipment units. The shut -down will result in \nlost production revenue an d idle time costs related to LE’s operating crew. \nThe lost production revenue and idle costs that would result from a shut -\ndown (collectively, ‘shut -down costs’) are substantial. \n— The total of the expected additional installation, transportation and shut -\ndown costs would be significant when compared to the annual lease \npayment. \nThough LE and LR each have the unilateral right to terminate the lease at the end of Year 1, LE cannot do so without incurring a penalty. Based on the \ndefinition of ‘penalty’, if it chooses to terminate the lease, LE will incur a penalty \ncomprising: \n— additional in stallation costs LE will incur to install replacement equipment – \ni.e. LE needs equipment of this nature for its operations; therefore, additional installation costs constit ute an ‘economic detriment’ to LE that \nwould not be incurred if LE simply continued its lease with LR; \n— transportation costs LE will incur to ship LR’s equipment back to LR’s \nlocation; and ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 300}), Document(page\_content='Leases 300 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — shut-down costs incurred while the equipment is being uninstalled and \nreplaced – i.e. LE could avoid the shut -down costs by continuing its lease \nwith LR. \nBased on the expected significance of the penalty that would result, LE does \nnot have the right to terminate the lease without a more- than- insignificant \npenalty at the end of Year 1. Therefore, only LR has an option to terminate the \nlease at the end of Year 1 without a more- than- insignificant penalty, while LE \nhas no similar option until at least the end of Year 2. \nConsequently, the lease term is the shorter of the period from lease commencement until: \na. LE’s exercise of its termination option no longer gives rise to a more- than-\ninsignificant penalty; or \nb. LE’s termination option becomes exercisable (without regard to the penalty) \nplus any periods after that for which LE is reasonably certain not to exercise \nits termination option. \nWith respect to (a), we know that period is at least two years. Similarly, the \nsignificance of the penalty and the short one- year period until the termination \noption becomes exercisable (without regard to penalty) mean LE is reasonably \ncertain not to terminate the lease until at least the end of Year 2. \nAdditional facts that are not provided would be needed to determine the actual \nlease term (i.e. whether the lease term is two years or a longer period). These \ninclude the expected amount of the installation, transportation and shut -down \ncosts; the annual lease payment amount; and expectations about the \nproductivity of the equipment in the future – e.g. expectations about whether \nthe equipment will decline in productivity and/or incur significant operational down -time as it ages, or that technological developments will reduce the \ndesirability of the equipment to LE. \nScenario 2: Lessee and lessor both have right to terminate with no more \nthan an insignificant penalty \nAssume the same facts as Scenario 1, except that: \n— the eq uipment does not require significant installation efforts; \n— transportation costs to return the equipment to LR are minor; and \n— becaus e there is no significant installation process, idle time incurred in \nswitching the units is short. \nTherefore, unlike in Scenario 1, LE’s termination option at the end of Year 1 \ndoes not give rise to a more- than- insignificant penalty, and the non- cancellable \nperiod of the lease and the lease term are both one year. \nLE has no: \n— right to extend the lease beyond the end of Year 1 because LR has the right \nto ter minate the lease at the end of Year 1 without a more- than- insignificant \npenalty; or \n— obligati on to make lease payments beyond the end of Year 1 because it can \nterminate the lease without incurring a more- than-insignificant penalty. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 301}), Document(page\_content='Leases 301 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. LR has no: \n— right to receive lease payments (i.e. by requiring LE to extend the lease) \nbeyond the end of Year 1 beca use LE has the right to terminate the lease at \nthe end of Year 1 without a more- than- insignificant penalty; or \n— obligation to extend LE’s right to use the underlying asset beyond the end \nof Year 1 because it can terminate the lease without incurring a more- than-\ninsignificant penalty. \nScenario 3: Only lessor has right to terminate \nUnlike in Scenarios 1 and 2, only LR has the right to terminate the lease at the end of Years 1– 4. Because only LR can elect to terminate the lease and the \nlease term always includes optional periods controlled by the lessor, the lease term is five years. Whether LR’s option can be exercised without LR incurring a \nmore- than- insignificant penalty is not relevant in this sc enario. \n \n Example 5.3.25 \nLessee partial termination right (downsizing clause) \nLessee LE enters into a contract with Lessor LR to lease 1,000 mobile devices. \nEach device can be used and operated independently of the others. The stated \nlease term for each device is three years. There are no options to renew the \nlease after the three- year stated term. \nScenario 1: All 1,000 leases can be terminated after 9 months \nLE can r eturn all of the devices, at no cost, any time after 9 months. \nIn this s cenario, a ll 1,000 leases have a 9 -month non-cancel lable period . If LE is \nnot reasonably certain to continue the leases beyond the non- cancellable \nperiod, all 1,000 leases have a lease term of 9 months and for LE are ‘short -\nterm leases’, eligible for the short -term lease exemption if LE has elected it \n(see section 6.3.1). \nScenario 2: Only 400 leases can be terminated after 9 months \nLE can return a maximum of 400 devices, at no cost, any time after 9 months. \n(i.e. a ‘downsizing clause’). LE must continue to lease the other 600 devices for \nthe full, stated three- year term. \nLE and LR account for the 1,000 leases as two separate populations . \n— For 400 of the leases, LE and LR will assess whether LE is reasonably \ncertain to continue the lease beyond the non- cancellable 9 -month period. If \nLE is not reasonably certain to continue the leases beyond the no n-\ncancellable period, all 400 leases have a lease term of 9 months and for LE \nare ‘short -term leases’ , eligible for the short -term lease exemption if LE has \nelected it (see section 6.3.1) . \n— For 600 of the leases, the non- cancellable period of the lease is 3 years. \nBecause there are no renewal or extension options beyond the 3 years, the \nlease term is also 3 years. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 302}), Document(page\_content='Leases 302 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. If LE has elected the short -term lease exemption and the 400 leases meet the \ndefinition of short -term leases, at lease commencement LE will only recognize \nlease liabilities and ROU assets for the 600 leases that have a lease term of \nthree years. \nNote: It would not be appropriate for LE to account for all 1,000 l eases as \nshort -term leases in this scenario even though the contract may permit LE to \nunilaterally select which 400 (of the 1,000) devices it will return after only nine \nmonths. This is because LE is obligated to lease at least 600 of the devices for \nthree years. \nAlternative approach (LR only) \nLR considers that LE can return any 400 of the 1,000 devices. Therefore, at \nlease commencement, LE is not reasonably certain to continue the lease of any \nsingle device beyond 9 months. Consequently, LR accounts for al l 1,000 leases \nas having a lease term of 9 months. \nUnlike LR, LE controls which, if any, devices it returns under the downsizing \nclause. At any point it can select which devices it will and will not return. \nTherefore, it is not appropriate for LE to account for the arrangement as if it can \nreturn all 1,000 devices. \n \n Question 5.3.60 \nLessee and lessor extend the lease even though \nboth have the right to terminate without penalty \nHow should an entity account for a lease extension triggered \nby both parties not exercising their unilateral termination \nrights? \nBackground: Consider Scenario 2 in Example 5.3.20. Both Lessee LE and \nLessor LR have the right to terminate the lease at the end of Year 1. For both \nparties, the lease term is one year and a contract does not exist because \nneither party has enforceable rights or oblig ations beyond Year 1. \nThe question arises as to how LE and LR should account for the lease when neither party exercises their termination right at the end of Year 1, and therefore the lease continues into Year 2. \nInterpretive response: We believe a modific ation occurs if neither party \nexercises its termination right, creating new enforceable rights and obligations \nthat now exist until the next date at which both parties can terminate the lease \nwithout incurring a more- than-insignificant penalty – e.g. the end of Year 2 in \nExample 5.3.20, Scenario 2. \nThe contract modification in this scenario is a lease term extension, no different \nfrom the two parties having a non- cancellable one- year lease and executing an \namendment to that lease extending the non -cancellab le period by an additional \nyear. The fact that the new enforceable rights and obligations that exist in \nYear 2 are created by both parties’ in action – i.e. not exercising their respective \ntermination options – rather than by the parties executing a contrac t \namendment is not relevant. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 303}), Document(page\_content='Leases 303 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Both the lessee and the lessor will account for the lease term extension \nmodification in the same manner as they would any other lease term extension \nmodification. The accounting for lease modifications is discussed in \nsections 6.7 (lessees) and 7.6 (lessors). Examples 6.7.20 (lessee) and 7.6.10 \n(lessor) illustrate the accounting for a lease term extension modification. \n \n Example 5.3.30 \nNo stated term \nLessor LR agrees to lease equipment to Lessee LE. There is no stated durati on \nfor the lease in the contract; however, the contract stipulates that LE is required \nto return the underlying asset to LR’s location when it no longer wishes to use \nthe equipment. For each day that the asset remains in LE’s possession, LE will \npay a fixe d fee to LR for the right to use that asset. \nThe non- cancellable period of the lease is one day, because LE could elect to \nreturn the asset to LR’s location before the start of Day 2. \nNext, LE and LR each consider whether LE is reasonably certain to continue to use the asset beyond the non- cancellable period. Unless LE is reasonably \ncertain to continue the lease beyond the first day, the lease term is only \none day. \nWe believe the extremely short non -cancellable period of the lease (one day) \nwill likely influence the determination of whether LE is reasonably certain to \nrenew the lease beyond the non- cancellable period. The costs to LE of \nterminating the lease (e.g. returning the underlying asset to LR’s location) and \nentering into a new lease (e.g. identifying another asset, entering into a \ndifferent contract and training employees to use a different asset) may provide \na compelling economic reason for LE to continue to use the same asset for a \nperiod that is longer than the non- cancellable period. \n \n Observation \nDetermining the lease term for cancellable \n(‘evergreen’) leases may be difficult \n5.3.110 In defining a ‘short -term lease’, the Board considered that many \nevergreen leases (i.e. those on a day -to-day, week -to-week or month- to-month \nbasis) would meet that definition. However, to qualify for the short -term lease \nexemption (see section 6.3.1) and to determine whether the disclosure \nrequirement for short -term lease costs is applicable (the disclosure requirement \napplies only to short -term leases with a term greater than one month – see \nsection 12.2), lessees must nonetheless assess the lease term for such leases. \n[ASU 2016- 02.BC379] \n5.3.120 The lease term for evergreen leases is established in the same manner \nas for all other leases, which means considering whether the lessee is \nreasonably certain to exercise one or more available renewal options. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 304}), Document(page\_content='Leases 304 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 5.3.130 As highlighted by Example 5.3.30, determining whether a lessee is \nreasonably certain to exercise a renewal option in an evergreen lease may \ninvolve significant judgment. We believe that, in general, the shorter the non-\ncancellable period of a lease, the greater the likelihood that the lessee is \nreasonably certain to exercise one or more lease term renewal options. This is \nbecause, in many cases, it may be cost prohibitive to continually substitute \nleased assets. For example, if a lessee is leasing a piece of construction \nequipment on a weekly basis and expects to need a substantially similar piece \nof equipment for the duration of a four -month pr oject, there may be a \ncompelling economic reason not to continually substitute that asset throughout \nthe period. \n \n Question 5.3. 70 \nTerminal rental adjustment clauses (TRAC leases) \nDoes the presence of a terminal rental adjustment clause \nmake it reasonably certain that a lessee will exercise an option to renew (or not terminate) the lease? \nBackground: A terminal rental adjustment clause (or TRAC) is a clause in a \nmotor vehicle lease contract that provides for a final rental payment adjustment \nat the end of the lease, typically based on the amount realized by the lessor \nfrom sale of the vehicle. In a common example, at the end of the lease, the \nlessor sells the vehicle and any difference between the sales price and the \ndepreciated book value of the vehicle is either: \n— owed by the lessor to the lessee – i.e. if the sales price is more than the \ndepreciated book value; or \n— owed by the lessee to the lessor – i.e. if the sales price is less t han the \ndepreciated book value. \nThe specifics of a TRAC can vary by contract. For example, whether the lessee or the lessor has to pay 100% of the difference between sales price and \ndepreciated book value, and the depreciation method used to calculate the \ndepreciated book value, is often a matter of negotiation between the lessee and \nthe lessor. \nIn a TRAC lease, the lessee typically has a number of renewal options and the \nTRAC adjustment will usually vary depending on when the lessee ultimately \nterminates the lease. \nInterpretive response: It depends on the facts and circumstances. It is \nparticularly important to understand how the TRAC is structured. \nAt the renewal/extension date being evaluated (i.e. when evaluating whether \nthe lessee is reasonably certai n to exercise a particular renewal option), there \nmay be a reasonable possibility that the final rental payment adjustment could be either a payment to the lessee or a payment to the lessor. In that case, we \ndo not believe the TRAC would in isolation drive a conclusion that the lessee is \nreasonably certain to exercise a renewal option to avoid a possible TRAC \npayment. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 305}), Document(page\_content='Leases 305 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Similarly, a TRAC payment by the lessee may be expected (i.e. it is remote that \nthe TRAC adjustment will be a payment to the lessee or that no payment will \nbe made to either party), but it is reasonably possible that the amount of the adjustment will not be significant in the context of the lease (see next \nparagraph). Under these circumstances, again, we do not believe the TRAC \nwould in isolat ion result in a conclusion that the lessee is reasonably certain to \nexercise a renewal option. This is because ‘reasonably certain’ is a high \nthreshold of probability that must be met (see section 5.2). \nIn assessing the significance of the TRAC adjustment , it should be considered \nin the context of the lease to which it applies. It should not be evaluated, for \nexample, based on whether it would be material to the lessee. \nTherefore, if there is a reasonable possibility that the TRAC payment adjustment will be either (1) in the lessee’s favor or (2) insignificant, then \ngenerally it will not be reasonably certain that the lessee will exercise a renewal \noption solely to avoid that adjustment. \nIn contrast, a TRAC may be structured so as to be vir tually certain of resulting in \na lessee payment to the lessor if a particular renewal or extension option is not \nexercised and the amount of the payment may be expected to be significant in \nthe context of the lease. In that case, the TRAC is in effect a termination penalty that must be considered when evaluating whether the lessee is \nreasonably certain to exercise the relevant renewal or extension option. \nHowever, even in this case, the lessee is not necessarily reasonably certain to \nexercise the renewal or extension option. Again, this is because reasonably \ncertain is a high threshold of probability, intended to capture situations in which the lessee is effectively compelled to exercise an option. \nIgnoring other potential drivers of economic compulsion (see paragraphs 5.2.50 \n– 5.2.60), the following factors may suggest that even in the face of a virtually \ncertain, significant TRAC payment, the lessee is not reasonably certain to \nexercise the renewal option (not exhaustive). \n— The lessee has the ability to substantially mitigate the economic effect of the TRAC adjustment by reducing its lease costs and other costs related to \noperating the asset. For example, the economic effect of the TRAC \nadjustment may be mitigated because the lessee will not make lease \npayme nts to the lessor (as it would if it renewed the lease) and, if the asset \nwill not simply be replaced in its operations by a similar asset, will realize operational cost savings such as maintenance, fuel and/or operator \nlabor costs. \n— The lessee has a demons trated history of terminating comparable leases \neven when such terminations result in significant TRAC payments. \n— There are viable alternatives to the lessee that would mitigate the effect of the TRAC adjustment. For example, an alternative vehicle lease pr ovider \nmay offer favorable terms to switch providers that will completely or partially offset the TRAC adjustment, or terminating the lease may permit the lessee to lease a better or more efficient vehicle. \nWhen considering such mitigating factors, an ent ity should only consider \nalternatives that presently exist or are likely to arise – i.e. an entity should not \nconsider hypothetical or other scenarios that are not likely to arise. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 306}), Document(page\_content='Leases 306 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. In the absence of mitigating factors, we believe it generally will be reas onably \ncertain that a lessee will exercise an option to renew (or not terminate) a lease \nsubject to a TRAC if: \n— the TRAC is structured so as to be virtually certain of resulting in a payment \nfrom the lessee to the lessor if the renewal option is not exerci sed; and \n— the payment under the TRAC is expected to be significant in the context of \nthe lease. \n \n Question 5.3. 80 \nLease term when the non -cancellable lease period \nis not fixed \nShould an entity reassess the lease term when the non-\ncancellable period of the lease is not fixed or determinable at lease commencement? \nInterpretive response: Yes, both the lessee and the lessor should reassess the \nlease term when the non- cancellable period of the lease becomes fixed or \ndeterminable. \nWe are aware of certain lease arrangements for which the non- cancellable \nperiod of the lease is not fixed or determinable at lease commencement. \nFor example: \n— two parties may enter into an agreement whereby the lessor will lease \nmultiple underlying assets to the lessee, but the non -cancellable period for \nall of the underlying assets does not become fixed until the last one is \ndeployed and that final date of deployment is unknown when earlier underlying assets are made available for the lessee’s use; or \n— the non- cancellable period of the lease may be for the duration of a project \nwhose timeline is uncertain at the commencement date. \nSection 4.3 discusses potential measurement issues that might arise when \nthere are multiple commencement dates for leases in a singl e contract (or \nmultiple contracts that are combined for accounting purposes – see \nsection 4.6). However, Topic 842 does not address situations such as those \nin the preceding paragraph. \nFor lessees , the event that fixes, or makes determinable, the non- cance llable \nperiod of the lease may not be something within the control of the lessee (e.g. the lessor’s deployment of the final leased asset may be solely within the \ncontrol of the lessor), and therefore would not trigger a reassessment of the \nlease term (see section 6.6). For lessors , as noted in paragraph 5.3. 20, they do \nnot reassess the lease term after lease commencement unless the lease is \nmodified (and that modification is not a separate contract). \nPublic Board discussions and FASB staff papers concernin g reassessments all \ncentered on when, if ever, a lessor should reassess lessee options to extend or \nterminate a lease. Those discussions and staff papers did not discuss \ncircumstances in which the non- cancellable period of the lease was not known \nat lease commencement. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 307}), Document(page\_content='Leases 307 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. We believe the Board intended for an entity (lessee or lessor) to update an \ninitial assessment of the lease term that was made at lease commencement \nwhen the non- cancellable period of the lease was not known at that time. To \nnot update the lease term for this finalization of a key fact (i.e. the non -\ncancellable period of the lease), including undertaking an assessment of lessee \nextension or termination options based on the determination of that key fact, \ncould result in counter -intuitive accou nting results. For example, the lessor \nmight recognize lease income (or the lessee lease expense) over a period unrelated to even the non- cancellable period of the lease. \nConsequently, we believe an entity (lessee or lessor) should update its assessment o f the lease term when the non- cancellable period of the lease \nbecomes fixed or determinable if that occurs after lease commencement. This \nis regardless of (1) the reason why the non- cancellable period of the lease was \nnot known at commencement, or (2) what the change in facts or circumstances \nis that fixes, or makes otherwise determinable, the non- cancellable period of \nthe lease. \n \n Question 5.3. 90 \nLease term when the period of use includes non -\nconsecutive periods of time \nWhat is the ‘lease term’ when the period of use comprises \nnon- consecutive periods of time? \nBackground: The ‘period of use’ is the total period of time that an asset is used \nto fulfill a contract with a customer, including the sum of any non- consecutive \nperiods of time. For further disc ussion of the period of use, see section 3.1. \n[842 Glossary] \nAs described in Question 3.1.40, a customer does not have to control the use of an identified asset throughout the term of the contract that contains the \nlease for a lease to exist. \nInterpretive response: The ‘lease term’ is the sum of the non- cancellable, non-\nconsecutive periods of time plus any additional non -consecutive periods of time \ncovered by renewal options (1) that the lessee is reasonably certain to exercise \nor (2) that are controlled by the lessor. Example 5.3.40 illustrates this. \nIf the sum of those non- consecutive periods of time is 12 months or less, the \nlease is a ‘short -term lease’ eligible for the lessee short -term lease recognition \nexemption if the lessee has elected it (see secti on 6.3.1). In some \ncircumstances involving a period of use that includes non- consecutive periods \nof time that qualify for the short -term lease exemption, the lease term will \nextend over a long period of time (see Example 5.3.40, Scenario 2). As a result, \nthe short -term lease cost incurred during a given period may not reflect the \nlessee’s obligation for the lease. In that case, the lessee discloses that fact and the amount of its remaining short -term lease obligation (see Example 12.2.30). \n[842- 20-50-8] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 308}), Document(page\_content='Leases 308 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 5.3.40 \nLease term when the period of use includes non -\nconsecutive periods of time \nScenario 1: Seasonal retail lease \nLessee LE signs a lease with Lessor LR whereby LE will lease a store space in \na shopping mall during the holiday season (October 15 through January 15) \neach year for three years. The lease includes two one- year renewal options \nunder which LE could elect to lease the same store space for the same three- month period for two additional years. LE is not reasonably certain to \nexercise either one- year renewal option. \nIn this scenario, both the ‘period of use’ and the ‘lease term’ are 9 months – i.e. \nthree months for each year of the three- year contract. \nAdditionally, for LE, this lease qualifies for the short -term lease recognition \nexemption because the total lease term is 12 months or less. Changing the facts slightly, if LE were reasonably certain to exercise both renewal options so \nthat the lease term were for 15 months over five years, the lease would not qualify for the short -term lease exemption. \nRegardless of whether the lease is eligible for the short -term lease exemption \nor whether LE elects the exemption, lease cost will be recognized only during \nthe periods of time LE has the right to use the store space. Using the nine-\nmonth lease term, the total lease cost will be recognized on a straight -line basis \nover those nine months with no lease cost recognized between January 16 and \nOctober 14 each year of the contract term. \nAssume the lease is an operating lease and is recogniz ed on the balance sheet \n– i.e. the lease is not eligible for, or LE does not elect, the short -term lease \nexemption. This means that during the months of the contract that no lease cost is recognized, the ROU asset will be increased by the amount of the \naccretion of the lease liability. \nNote: If the lease was a finance lease, interest on the lease liability would be \nrecognized in the usual way (see section 6.4.1) – i.e. it would not be added to \nthe carrying amount of the ROU asset. The ROU asset would not be amortized \nduring the periods of time that LE does not have the right to use the store \nspace. \nScenario 2: Stadium lease \nLessee LE signs a lease with Lessor LR whereby LE will have the right to use \nLR’s stadium for 12 home games per year for 30 years. LE has exclusive rights \nto the stadium on each game day. The 12 home games each year are not \nplayed on consecutive days. There are no renewal options for either party in the \ncontract. \nIn this scenario, both the ‘period of use’ and the ‘lease term’ are 360 days – i.e. \n12 days for each year of the 30- year agreement. \nConsistent with Scenario 1, lease cost will be recognized only during the periods of time LE has the right to use the stadium. Using the 360- day lease \nterm, the total lease cost will be recognized on a straight -line basis over those ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 309}), Document(page\_content='Leases 309 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 360 days with no lease cost recognized on the other days of the 30- year \ncontract term. \nAlso consistent with Scenario 1, this lease would qualify for the lessee short -\nterm lease recognition exemption because the lease term i s 12 months or less. \nGiven the insignificant portion of the lease term that will occur each year, LE \nconcludes at the end of each year (i.e. until near the end of the contract) that its \ndisclosed short -term lease cost does not reasonably reflect its short -term lease \ncommitment. Therefore, LE discloses that fact and discloses the undiscounted \namount of its unpaid stadium lease payments at each annual reporting date. \n \n Question 5.3.100 \nMandatory and optional underlying asset \nreplacement \nHow does a lessor obligation or right to replace the \nunderlying asset affect the lease term ? \nBackground: In some lease agreements, a lessor may be required or permitted \nto replace the underlying asset during the lease term to ensure that it continues \nto meet agreed- upon performance standards. For example, in a 10- year IT \nservice arrangement, the provider may have a replacement right or obligation \nwith respect to one or more of the network infrastructure assets because the economic life is less than 10 years. \nInterpretive response: The nature of the replacement provision will dictate its \neffect on the lease term. Three types of replacement provisions are discussed below. \nMandatory replacements – replacement date specified \nWe believe t he entity (lessee or lessor) should account for each underlying \nasset (i.e. the original asset and each replacement asset) as a separate lease \ncomponent with its own lease commencement date and lease term. This is \nbecause the definition of a lease depends on an identified asset (see section \n3.2); if the identified asset is changed, the right to control its use is a different \nlease. \nTherefore, if the lessor is obligated to replace the identified asset on a particula r \ndate, the term of the initial lease does not extend beyond the specified \nreplacement date. On the date that the replacement asset is made available for \nthe lessee’s use, a separate lease commences with its own lease term. \nIn these scenarios, the lessee s hould consider disclosing the ‘forward- starting’ \nlease. This is because Topic 842 requires a lessee to disclose information about \nleases that have not yet commenced but that create significant rights and \nobligations for the lessee. \n[842- 20-50-3(b)] \nMan datory replacements – replacement date not specified \nIn rarer cases, a lessor may commit to replace an underlying asset during the \nlease term, but not commit to a specific replacement date. In that case, we \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 310}), Document(page\_content='Leases 310 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. believe the term of the initial lease for the or iginal underlying asset should be \nthe shorter of: \n— the period of use – i.e. the total period of time over which the lessee will \nhave the right to control the use of the original and any replacement assets; \nand \n— the remaining economic life of the original und erlying asset at lease \ncommencement . \nWhen the original underlying asset is replaced, the entity should account for the \nreplacement of the identified asset as a lease modification; see section 6.7 \n(lessees) and section 7.6 (lessors). \nOption al replacement s \nIn other cases, a lessor may only have the option to replace the underlying \nasset, rather than an obligation to do so. Despite this difference from the \n‘Mandatory replacements – replacement date not specified’ scenario, we \nbelieve the initial lease term should be the same, as should the accounting \nconsequence when and if the lessor replaces the underlying asset. \n \n Example 5.3.50 \nMandatory and optional underlying asset \nreplacement \nScenario 1: Replacement date specified \nLessee LE enters into a waste disposal services contract with Lessor LR for 6 \nyears. As part of the arrangement, LE obtains the right to use a dumpster for \nrestaurant waste disposal that meets the definition of a lease (see chapter 3). \nThe contract period is 6 years and the dumpster lease commences \nimmediately. Under the contract, for sanitary reasons, LR must replace the \ndumpster at the end of Year 3. \nAt lease commencement, the lease term for the provided dumpster is 3 years. This is the period over which LE controls the use of the identified, original \ndumpster. The lease term does not extend beyond the specified replacement date of the original dumpster. \nBecause of the specified replacement date, there are two identified assets – \nthe original dumpster and the replacement dumpster – the leases of which will \ncommence at the beginning of the 6- year contract period and at the end of Year \n3, respectively, and each with a 3- year lease term. \nScenario 2: Replacement date not specified \nLessee LE signs a lease with Lessor LR whereby LE obtains the right to use \nLR’s IT server. The stated duration of the lease is 8 years; however, the lease \nrequires that LR replace the original server after Year 4, with timing at LR’s \ndiscretion. \nThe replacement provision is intended to ensure that the l eased server does not \nbecome obsolete during the 8- year contract period. The added requirement that \nthe replacement cannot occur before the beginning of Year 5 is intended to ensure that the replacement server is viable throughout the remainder of the ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 311}), Document(page\_content='Leases 311 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. contract period. The remaining economic life of the server provided at lease \ncommencement is 5 years. \nIn this scenario, the lease term is 5 years – i.e. the shorter of the stated \ncontract period (8 years) and the remaining economic life of the server at lease \ncommencement (5 years). \n \n5.4 Lease payments \n Excerpt from ASC 842 -10 \n30 Initial Measurement \nGeneral \n> Initial Measurement of the Lease Payments \n30-5 At the commencement date , the lease payments shall consist of the \nfollowing payments relating to the use of the underlying asset during the \nlease term : \na. Fixed payments, including in substance fixed payments, less any lease \nincentives paid or payable to the lessee (see paragraphs 842- 10-55-30 \nthrough 55- 31). \nb. Variable lease payments that depend on an index or a rate (such as the \nConsumer Price Index or a ma rket interest rate), initially measured using \nthe index or rate at the commencement date. \nc. The exercise price of an option to purchase the underlying asset if the \nlessee is reasonably certain to exercise that option (assessed considering \nthe factors in par agraph 842- 10-55-26). \nd. Payments for penalties for terminating the lease if the lease term (as \ndetermined in accordance with paragraph 842- 10-30-1) reflects the lessee \nexercising an option to terminate the lease. \ne. Fees paid by the lessee to the owners of a special -purpose entity for \nstructuring the transaction. However, such fees shall not be included in the \nfair value of the underlying asset for purposes of applying paragraph 842-\n10-25-2(d). \nf. For a lessee only, amounts probable of being owed by the lessee under \nresidual value guarantees (see paragraphs 842- 10-55-34 through 55- 36). \n30-6 Lease payments do not include any of the following: \na. Variable lease payments other than those in paragraph 842- 10-30-5(b) \nb. Any guarantee by the lessee of the lessor’s debt \nc. Amo unts allocated to nonlease components in accordance with \nparagraphs 842-10-15-33 through 15- 42. \nd. Leasehold improvements recognized by a lessee and accounted for in \naccordance with paragraph 842- 20-35-12A. \n30-7 Paragraph 410- 20-15-3(e) addresses the scope application of \nSubtopic 410-20 on asset retirement obligations to obligations of a lessee in \nconnection with a lease (see paragraph 842- 10-55-37). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 312}), Document(page\_content='Leases 312 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 30-8 See Example 25 (paragraphs 842 -10-55-225 through 55 -234) for an \nillustration of the requirements on lessee accounting for variable lease \npayments and Example 26 (paragraphs 842- 10-55-235 through 55- 238) for an \nillustration of the requirements on termination penalties. \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementati on Guidance \n>> Lease Payments \n>>> Guarantees and Indemnifications \n55-32 Paragraph 460- 10-15-4(c) states that, except as provided in \nparagraph 460-10-15-7, the provisions of Subtopic 460 -10 on guarantees apply \nto indemnification agreements ( contracts ) that contingently require an \nindemnifying party (guarantor) to make payments to an indemnified party \n(guaranteed party) based on changes in an underlying that is related to an \nasset, a liability, or an equity security of the indemnified party. Paragraph 460-\n10-55-23A provides related implementation guidance for a tax indemnification \nprovided to a lessor . \n55-33 A lessor should evaluate a commitment to guarantee performance of \nthe underlying asset or to effectively protect the lessee from obsolescence \nof the underlying asset in accordance with paragraphs 606- 10-55-30 through \n55-35 on warranties . If the lessor’s commitment is more extensive than a \ntypical product warranty, it might indicate that the commitment is providing a \nservice to the lessee that should be accounted for as a nonlease component of \nthe contract. \n>>>> Obligations to Return an Underlying Asset to its Original \nCondition \n55-37 Obligations imposed by a lease agreement to return an underlying asset \nto its original condition if it has been modified by the lessee (for example, a \nrequirement to remove a lessee- installed leasehold improvement) generally \nwould not meet the definition of lease payments or variable lease payments \nand would be accounted for in accordance with Subtopic 410- 20 on asset \nretirement and environmental obligations. In contrast, costs to dismantle and \nremove an underlying asset at the end of the lease term that are imposed by \nthe lease agreement generally would be considered lease payments or variable \nlease payments. \n \n5.4.10 At lease commencement, the lease payments consist of all of the \nfollowing payments relating to the use of the underlying asset during the ‘lease \nterm’ (see section 5.3). [842- 10-30-5] \nType of payment during the lease term Subsections \nFixed payments -- \nVariable lease payments that depend on an index or rate 5.4.1 \nAdjustments to fixed payments: \n— in-substance fixed payments (added); and 5.4.2 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 313}), Document(page\_content='Leases 313 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Type of payment during the lease term Subsections \n— lease incentives paid or payable by the lessor to the lessee \n(subtracted) 5.4.3 \nThe exercise price of a lessee option to purchase the underlying \nasset that the lessee is reasonably certain to exercise 5.4.4 \nPenalties for terminating the lease if the lease term reflects the \nlessee exercising a termination option 5.4.5 \nFor lessees only, a mounts probable of being owed by the lessee \nunder residual value guarantees 5.4.6 \nPayments by the lessee to the owners of a special purpose entity for \nstructuring the transaction -- \n5.4.20 Lease payments do not include: [842- 10-30-6] \n— variable lease payments other than those that depend on an index or rate; \n— any guarantee by the lessee of the lessor’s debt; \n— amounts allocated to non- lease components (see chapter 4) ; or \n— leasehold improvements recognized by a lessee and accounted for in \naccordance with p aragraph 842- 20-35-12A on common control leases. \n5.4.30 Unless specifically excluded from lease payments under Topic 842 (e.g. a \nguarantee by the lessee of the lessor’s debt – see paragraph 5.4.20) , noncash \npayments relating to the use of the underly ing a sset during the lease term are \nincluded in the lease payments at fair value . \n5.4.40 The ‘lease payments’ for a separate lease component might be an \nallocated amount when there are multiple separate lease components, or when \nthere is at least one non- lease component. Chapter 4 addresses components of \na contract, and outlines the following steps for identifying and allocating \ncontract consideration to the components of a contract that includes one or \nmore leases : \nStep 1: Identify the separate lease components. \nStep 2: Identify any non -lease components – e.g. a \nmaintenance or operating service. \nStep 3: Measure the ‘consideration in the contract’. \nStep 4: Separate and allocate the consideration in the contract \nbetween the lease and non -lease components (see \nExample 5.4.10) . \n5.4.50 An obligation to return an underlying asset to its original condition if it \nhas been modified by the lessee (e.g. a requirement to remove lessee- installed \nleasehold improvements) does not generally meet the definition of lease \npayments or variable lease payments. Such obligations are accounted for in \naccordance with Subtopic 410- 20 (asset retirement and environmental \nobligations ). [842- 10-55-37] \n5.4.60 In contrast, c osts to dismantle and remove an underlying asset at the \nend of the lease term that are imposed by the lease agreement are generally \nconsidered lease payments or variable lease payments. Lease payments are ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 314}), Document(page\_content="Leases 314 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. included in the measurement of lease assets and liabilities ( see chapter 6 for \nlessees and chapter 7 for lessors). [842- 10-55-37] \n \n\\ Question 5.4.05 \nCosts to dismantle and remove the underlying \nasset imposed by the lease agreement \nShould costs to dismantle and remove the underlying asset \nrequired by the lease agreement be estimated and included in the lease payments? \nInterpretive response: Except as described below, we believe such costs \nshould be estimated by the entity (lessee or lessor) at lease commencement as \npart of the ‘lease payments’. As a result, the costs will be: \n— factored into lease classification – ‘present value test’ (see paragraph \n6.2.50); and \n— included in the measurement of the lease liability and ROU asset (for the \nlessee) or lease receivable (for the lessor if a sales- type or direct financing \nlease). \nRandolph P. Green, Professional Accounting Fellow, Office of the Chief \nAccountant, discussed this topic in a speech given during the 2003 AICPA \nNational Conference on Current SEC Developments. [2003 AICPA Conf ] \nWhere companies have concluded that such an obligation is within the \nscope of Statement 13, we do not believe that settlement of that obligation \nis attributable to a contingent event, such as “damage, extraordinary wear \nand tea r, or excessive usage.” Nor do we believe that the obligation meets \nthe broader definition of a contingent rental as it results solely from the passage of time and settlement is not based upon “factors on which lease \npayments are based.” In other words, we don't believe the retirement \nobligation should be treated as contingent rent. The lessee should accrue \nthe expected settlement costs over the lease term if it is an operating lease \nor include the present value of the estimated cost as part of the asset if it is \na capital lease. \nWhile the speech was not given in the context of Topic 842, the guidance about \nwhat constitutes a variable lease payment in Topic 842 is essentially unchanged \nfrom the guidance about what constituted contingent rent under Topic 840 \n(formerly FASB Statement No. 13). Therefore, we believe the SEC staff’s position remains relevant. \nIn addition, while the speech specifically referred to lessees only, the relevant \nguidance about lease payments and variable lease payments in Topic 842 \napplies to both lessees and lessors. Therefore, we do not believe an entity’s \naccounting for these costs as lease payments or variable lease payments \nshould differ based on whether it is the lessee or the lessor. \nException to requirement to estimate and inclu de in lease payments \nWe believe that an exception to the above interpretive response arises if the costs will vary on the basis of how, including where and how much, the lessee \n", metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 315}), Document(page\_content='Leases 315 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. uses the asset during the lease term. In that case, the costs are ‘variable lea se \npayments’, and not estimated at lease commencement. \nHowever, if the lessee’s use of the asset cannot result in those costs being $0, \nthe portion of the costs that is unaffected by that use should be estimated and \nincluded in the lease payments. \n \n5.4.70 Section 6.6 outlines when and how a lessee remeasures the lease \npayments. \n5.4.80 A lessor remeasures the lease payments only if the lease is \nmodified and that modification is not accounted for as a separate contract (see \nsection 7.6). A lease modificatio n includes a change to the terms and \nconditions of the contract that contains the lease if that contract modification \nchanges the consideration in the contract, and therefore the lease payments. \n[842- 10-35-6] \n5.4.90 In addition to remeasurements in accordance with paragraph 5.4.80, the \nlease payments for a lessor may also change if there is a change in the \nconsideration in the contract not resulting from a contract modification that is \nnot allocated entirely to the non -lease component(s) of the contract. A change \nin the contract consideration can result if an estimate of variable consideration was included in that consideration initially (see section 4.3) and either (1) that \nestimate changes or (2) there is a change in the lessor’s consideration of the \nconstraint on variable consideration. In many of the cases where an estimate of variable consideration will be included in the contract consideration, a portion of \nthat estimated variable consideration is included in the lease payments, and \ntherefore a change in that estimate, or a change in the amount of that estimate \nthat is constrained, will change the lease payments (see section 4.4.2) . \n \n Example 5.4.10 \nAllocated lease payments \nLessee LE and Lessor LR enter into a three -year lease for a piece of equipment. \nThe following additional facts are relevant. \n— LR will maintain the equipment over the three- year term. \n— In return for the right to use the equipment and LR’s maintenance services, \nLE will make fixed payments of $100 in Year 1, $110 in Year 2 and $120 in \nYear 3 ($330 in total). \n— The stand- alone price for the lease component is $280, and for the \nmaintenance services is $70. \nOn the basis of these stand- alone prices, the payments of $330 are allocated \nbetween the lease an d non -lease components as follows. \nComponent Stand -alone price Allocation Calculation \nLease (equipment) $280 $264 (280 / 350) × 330 \nNon-lease (maintenance) 70 66 (70 / 350) × 330 \n $350 $330 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 316}), Document(page\_content='Leases 316 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. On the basis of this calculation, the total lease payments are $264, or 80% of \nthe total. The breakdown of this amount into the different years is calculated \nusing the same proportion as for the total lease payments. \nYear Lease payment Calculation \n1 $ 80 100 × 80% \n2 88 110 × 80% \n3 96 120 × 80% \n $264 \n \n \n Question 5.4.10 \nPayments made by the lessee to the lessor to \nextend the lease term \nDo payments made by the lessee to the lessor to induce the \nlessor to extend the term of a lease affect the lease payments? \nInterpretive response: Yes. All fixed payments to the lessor are included in the \nconsideration in the contract. Therefore, all (if there are no non- lease \ncomponents of the contract) or a portion (if there are non- lease components of \nthe contract) of the fixed payment will be pa rt of the lease payments for the \nmodified lease. \nIf the lease is not modified – i.e. the option for the lessee to make the fixed \npayment in return for the lessor agreeing to extend the lease exists in the \noriginal contract – the fixed payment amount is included in the lease payments, \nand the lease term includes the option period (see paragraph 5.3.10), at the original lease commencement date provided that it is reasonably certain the \nlessee will exercise its option. \n \n Question 5.4.20 \nEffect of l ease pay ments made before \ncommencement date on lease classification \nHow are payments made by a lessee to a lessor before the \ncommencement date for the right to use the underlying asset \nconsidered when determining lease classification? \nBackground : Payments (or potentially only a portion of such payments if the \ncontract includes non- lease components) made by a lessee to a lessor before \nthe commencement date are ‘ lease payments ’ when they relate to the right to \nuse the underlying asset. \nIn some cases, the prepayments may be made significantly before the lease \ncommencement date. For example, the lessee may be required to make \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 317}), Document(page\_content="Leases 317 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. payments to the lessor while the underlying asset is being constr ucted. If the \nlessee is not the accounting owner of the asset (see section 9.4), those \npayments – or, if the contract includes non -lease components, a portion of \nthose payments – are lease payments. \nUnder Topic 840, payments made before lease commencement were accreted \nto their future value at the commencement date when performing the ‘present value’ lease classification test. \n[840- 10-25-6(d)] \nInterpretive response: Topic 842 does not include explicit guidance like that in \nparagraph 840- 10-15-6(d). However, consistent with that Topic 840 \nrequirement, we believe such amounts should be included in the lease \npayments used to perform the present value lease classification test (see \nsection 6.2 for lessees and section 7.2 for lessors) at their future value as of the \ncommencement date of the lease, using the same interest rate used to \ndiscount the payments to be made after lease commencement (i.e. the \n‘discount rate for the lease’ – see section 5.6), to give effect to the time value \nof money . \nAccreting lease prepa yments to their future value for purposes of lease \nclassification does not extend to the following: \n— recognizing either interest expense (lessee) or interest income (lessor) \nduring the period before lease commencement; or \n— calculating the rate implicit in the lease; the calculation (see paragraph 5.6.40) includes the amount of the lease prepayment – not its accreted \nfuture value used in the present value lease classification test . \n \n Question 5.4.30 \nPayment as consideration for a minimum resale \nguarantee in a sale contract \nIs a payment from a customer to a manufacturer as \nconsideration for a minimum resale guarantee in a sale contract included in the ‘lease payments’? \nBackground: A manufacturer sells equipment to a buyer and guarantees th e \nbuyer a minimum resale amount on the equipment's disposal. A minimum \nresale guarantee does not automatically result in a conclusion that the \narrangement is a lease (see Q uestion 7.2.10); however, assume that in this \ncase, the guaranteed resale amount creates a significant economic incentive \nfor the buyer to sell the asset such that it is accounted for as a lease . At \ncontract inception, the customer pays the lessor (the manufacturer) a fee or \npremium to include the guarantee clause in the sales contract. \nInterpretive response: Yes. Whether a separately stated payment or an \noverpayment for the asset, that amount is a fixed payment that is part of the \nconsideration in the contract that is allocated to the components of the contract \n(see chapter 4). \nIf there are no non- lease components of the contract, the amount will be \naccounted for as a lease payment in its entirety . \n", metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 318}), Document(page\_content='Leases 318 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 5.4.40 \nDeposits \nAre deposits paid by a lessee to a lessor at or before the \ncommencement date part of the ‘consideration in the \ncontract’? \nBackground: Lease agreements frequently include requirements for the lessee \nto remit a deposit to the lessor at or before the lease commencement date. \nDeposits are usually refundable and represent additional collateral for the lessor. \nHowever, they can also be nonrefundable, such as where the deposit \nrepresent s the lessee’s intent to lease the asset. \nInterpretive response: It depends. If a deposit is nonrefundable, it is a \nfixed payment no different from any other fixed payments made before the \ncommencement date (see Question 5.4.20). That is, it is part of the \nconsideration in the contract and allocated to the lease and non- lease \ncomponents in the same manner as the rest of the consideration in the contract. \nA deposit is not part of the consideration in the contract when it is refundable. As indicated in the question background, a refundable deposit represents \nadditional collateral for the lessor – e.g. to protect the lessor’s interest in the \nunderlying asset. The refundable deposit is held by the lessor to satisfy potential contractual obligations of the lessee, if necessary – such as damages \nto the underlying asset. Any amount of the refundable deposit not needed to satisfy those potential contractual obligations is refunded to the lessee at the \nend of the lease term. Because of this, refundable deposits, in addition to any \ninterest earned by the lessor on the refundable deposit, are v ariable payments \nthat do not depend on an index or rate (see paragraph 4.3.20 and the discussion \nin paragraphs 5.4.100 – 5.4.140). \n \n5.4.1 Variable lease payments \n Excerpt from ASC 842 -10 \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance \n>> Lease Payments \n>>> Guarantees and Indemnifications \n>>>> Indemnification Clauses for Certain Tax Benefits \n55-38 Some leases contain indemnification clauses that indemnify lessors on \nan after -tax basis for certain tax b enefits that the lessor may lose if a change in \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 319}), Document(page\_content='Leases 319 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the tax law precludes realization of those tax benefits. Although the \nindemnification payments may appear to meet the definition of variable lease \npayments, those payments are not of the nature normally expec ted to arise \nunder variable lease payment provisions. \n55-39 Because of the close association of the indemnification payments to \nspecific aspects of the tax law, any payments should be accounted for in a \nmanner that recognizes the tax law association. The l ease classification should \nnot be changed. \n55-40 Paragraph 842- 30-55-16 discusses a lessor’s accounting for guarantee \npayments received. \n> Illustrations \n>> Illustrations of Lessee Accounting for Variable Lease Payments \n55-225 Example 25 illustrates how a lessee accounts for variable lease \npayments that depend on an index or a rate and variable lease payments that \nare linked to performance. \n>>> Exam ple 25 —Variable Lease Payments That Depend on an Index or \na Rate and Variable Lease Payments Linked to Performance \n>>>> Case A —Variable Lease Payments That Depend on an Index or a \nRate \n55-226 Lessee enters into a 10- year lease of a building with annual lease \npayments of $100,000, payable at the beginning of each year. The contract \nspecifies that lease payments for eac h year will increase on the basis of the \nincrease in the Consumer Price Index for the preceding 12 months. The \nConsumer Price Index at the commencement date is 125. This Example \nignores any initial direct costs. The lease is classified as an operating lease. \n55-227 The rate implicit in the lease is not readily determinable. Lessee’s \nincremental borrowing rate is 8 percent, which reflects the rate at which \nLessee could borrow an amount equal to the lease payment in the same \ncurrency, over a similar term, an d with similar collateral as in the lease. \n55-228 At the commencement date, Lessee makes the lease payment for \nthe first year and measures the lease liability at $624,689 (the present value of \n9 payments of $100,000 discounted at the rate of 8 percent). Th e right -of-use \nasset is equal to the lease liability plus the prepaid rent ($724,689). \n55-229 Lessee prepares financial statements on an annual basis. Lessee \ndetermines the cost of the lease to be $1 million (the total lease payments \nfor the lease term). The annual lease expense to be recognized is $100,000 \n($1 million ÷ 10 years). \n55-230 At the end of the first year of the lease, the Consumer Price Index is \n128. Lessee calculates the payment for the second year, adjusted to the \nConsumer Price Index, to be $102,400 ($100,000 × 128 ÷ 125). \n55-231 Because Lessee has not remeasured the lease liability for another \nreason, Lessee does not make an adjustment to the lease liability to reflect the \nConsumer Price Index at the end of the reporting period; that is, the lease \nliability continues to reflect annual lease payments of $100,000 (8 remaining ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 320}), Document(page\_content='Leases 320 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. annual payments of $100,000, discounted at the rate of 8 percent is $574,664). \nHowever, the Year 2 payment amount of $102,400 (the $100,000 annual fixed \npayment + $2,400 variable lease payment) will be recognized in profit or loss \nfor Year 2 of the lease and classified as cash flow from operations in Lessee’s \nstatement of cash flows. In its quantitative disclosures, Lessee will include \n$100,000 of the $102,400 in its discl osure of operating lease cost and $2,400 \nin its disclosure of variable lease cost. \n>>>> Case B —Variable Lease Payments Linked to Performance \n55-232 Lessee enters into a 10- year lease of a building with annual lease \npayments of $100,000, payable at the beginning of each year. The contract \nspecifies that Lessee also is required to make variable lease payments each \nyear of the lease, which are determined as 2 percent of Lessee’s sales \ngenerated from the building. \n55-233 At the commencement date, Lessee measures the lease liability and \nright-of-use asset at the same amounts as in Case A (paragraphs 842- 10-55-\n226 through 55- 231) because the 2 percent royalty that will be paid each year \nto Lessor under the lease is a variable lease payment, which mea ns that \npayment is not included in the measurement of the lease liability (or the right -\nof-use asset) at any point during the lease. \n55-234 During the first year of the lease, Lessee generates sales of \n$1.2 million from the building and, therefore, recogn izes total lease cost of \n$124,000 ($100,000 + [2% × $1.2 million]). In its quantitative disclosures, \nLessee will include $100,000 of the $124,000 in its disclosure of operating \nlease cost and $24,000 in its disclosure of variable lease cost. \n \n5.4.100 There are two types of variable lease payments in Topic 842. \n— Variable lease payments that depend on an index or rate (such as the CPI , a \nmarket interest rate or fair market rent) are included in the lease payments. \n[842- 10-30-5(b)] \n— Other variable lease paym ents are excluded from the lease payments. \n[842- 10-30-6(a)] \n5.4.110 The amount of variable lease payments that depend on an index or a \nrate that is included in the lease payments is derived using the index or rate at \nlease commencement. This is because such payments are considered \nunavoidable. However, the entity should not attempt to forecast future changes \nin the index or rate. Consequently, the amount included in the lease payments is assumed to remain unchanged from the initial payment over the lease term. \nThis principle is illustrated in Example 5.4.20. \n[842- 10-30-5(b)] \n5.4.115 Tax rates are not considered an index or a rate for purposes of \nidentifying variable lease payments that depend on an index or rate. Therefore, payments based on, for example, a property tax mill rate or prevailing sales tax \nor VAT rates in a net lease (see section 4.2.1) are not variable lease payments \nthat depend on an index or rate. Variable payments of property taxes are \ndiscussed further in section 4.2.1. In addition to Example 5.4.80 below, the \nprinciple in this paragraph is illustrated in Example 12 (Case A) of Topic 842. \n[842- 10-55-141 – 55-142] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 321}), Document(page\_content='Leases 321 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 5.4.120 A lessee remeasures variable lease payments that depend on an index \nor a rate only when the lease payments are remeasured for another reason – \ne.g. a change in the lease term (see section 5.3) or a change in the estimate of \namounts probable of being owed under a residual value guarantee (see \nsection 5.4.6). They are not remeasured as a result of a change in a reference \nindex or rate, even if the payments cannot decrease once they have increased \n(e.g. if the reference index or rate decreases) . [842- 10-35-5] \n5.4.130 A lessor remeasures variable lease payments that depend on an index \nor a rate only if the lease is modified and that modification is not accounted for \nas a separate contract. [842-10-35-6] \n5.4.140 The remeasurement of the variable lease payments that depend on an \nindex or a rate is based on the index or rate at the date of remeasurement. \n[842- 10-35-5] \n5.4.150 Some leases contain indemnification clauses that indemnify lessors on \nan after -tax basis for certain tax ben efits that the lessor may lose if a change in \nthe tax law precludes realization of those tax benefits. Although the \nindemnification payments may appear to meet the definition of variable lease \npayments, they are not of the nature normally expected to arise under variable \nlease payment provisions. Because of the close association of the \nindemnification payments to specific aspects of the tax law, any payments are \naccounted for in a manner that recognizes the tax law association. The lease \nclassification shou ld not be changed. [842- 10-55-38 – 55-39] \n \n Question 5.4.50 \nChanges in a reference index or rate as resolution of \na contingency \nDoes a change in the reference index or rate upon which \nvariable lease payments depend constitute the resolution of a contingency and trigger a remeasurement of the lease payments? \nInterpretive response: No. A change in a reference index or rate does not \nconstitute the resolution of a contingency that trigger s a remeasurement of the \nlease payments (see section 6.6), inclu ding variable lease payments that \ndepend on an index or rate. This is the case even if those variable lease \npayments can never decrease once they have increased – e.g. in the case of a \nsubsequent decrease in the reference index or rate. Further, we do not believe \na defined limit to the increases over the lease term alters this conclusion – e.g. \na provision stating the lessee’s total annual payment during the lease t erm \nwill never be more than 109% of the total payment during the first year of \nthe lease. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 322}), Document(page\_content='Leases 322 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Observation \nImpact of excluding variable lease payments from \nlease payments \nBalance sheet impact \n5.4.160 The Board’s decision to exclude most variable lease payments from the \ndefinition of lease payments has the following implications for the balance sheet. \n— Two leases with very similar economics, but one structured with variable \nlease payments instead of fixed lease payments (e.g. payments based on \nthe performance or usage of the underlying asset), results in substantially \ndifferent lease liabilities and ROU assets. The lessee with the fixed \npayment only lease generally recognizes a larger lease liability and ROU \nasset throughout the lease term. \n— Leases wi th only variable lease payments do not give rise to any lease \nliability or ROU asset for the lessee upon lease commencement. \n5.4.170 By excluding variable lease payments from the definition of lease \npayments, the ROU asset and lease liability are less than they would be had an \nestimate of the variable lease payments been included. As a result, lessees \nmay wish to include a greater proportion of variable lease payments in their \nlease agreements to minimize the balance sheet effect of Topic 842. In \naddition, as a result of variable lease payments being excluded, some investors \nand analysts may unwind the actual lease assets and lease liabilities recorded \nand estimate their own asset and liability to include variable lease payments, \nwhich may require significa nt effort to make relevant predictio ns and \ncomparisons. \nIncome statement and cash flow impact \n5.4.180 In addition to the balance sheet effect, leases with variable lease \npayments are more likely to be classified as operating leases (by lessees and \nlessors ) because variable lease payments do not factor into the lease \nclassification test ( see sections 6.2 for lessees and 7.2 for lessors). Therefore, \nvariable lease payments increase the likelihood that lessees and lessors \nrecognize lease cost or lease income on a straight -line basis (excluding the \neffect of the variable lease payments) and that lessees recognize their cash \npayments for leases as operating cash outflows, rather than as a mixture of \noperati ng and financing cash outflows. \nIdentifying varia ble lease payments is important for disclosures \n5.4.190 Topic 842 includes guidance about items that do not result in variable \nlease payments (e.g. obligations to return an asset to its original condition, and tax indemnification clauses) because differentiating variable lease payments \nfrom other payments affects lessee and lessor disclosures. Lessees and \nlessors are required to disclose variable lease cost and variable lease income, \nrespectively, such that those disclosures will be inaccurate if an entity \nmisidentifies variable lease payments (see sec tions 12.2 – 12.3). \n[842- 10-55-37 – \n55-38] \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 323}), Document(page\_content='Leases 323 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Remeasurement of variable lease payments that depend on an index \nor rate \n5.4.200 The Board’s decision not to require the remeasurement of the lease \npayments for vari able lease payments that depend on an index or rate \nwhenever that index or rate changes, or when the contractual cash flows \nchange, was principally a cost -benefit decision. The decision was made as part \nof the Board’s broader effort in the final stages of the project to limit the \ncircumstances in which a lessee would be required to remeasure the lease liability for a lease. \n[ASU 2016 -02.BC236– BC237] \n5.4.210 While the Board’s decision may reduce the effort necessary to apply \nTopic 842, it is clear that in m any cases the result of this decision is that the \nlease liability does not reflect the remaining fixed payments required under the \nlease , increas ing the likelihood that investors and analysts will continue to make \ntheir own adjustments to reported lease as sets and lease liabilities. \n5.4.220 Using Example 5. 4.20 as an illustration, at the end of December 20X5, if \nCPI-U increases as expected, the remaining lease payments that will be \nreflected in the lessee’s lease liability in accordance with Topic 842 are \n$168,000 ($24,000 × 7 remaining payments) even though the lessee is \nrequired to make remaining payments of at least $189,000 ($ 27,000 × 7 \nremaining payments). \n \n Example 5.4.20 \nVariable lease payments that depend on an index or \nrate \nLessee LE enters into a 10- year lease of space in a shopping center from \nLessor LR that commences on January 1, 20X3. \nThe following facts are relevant. \n— Annual payments are calculated as $100 times December CPI-U, with \nadjustments set once a year based on the latest December CPI-U. Once \npayments increase, they do not decrease, even if CPI-U were to decrease. \nThere are no fixed lease payments. \n— CPI-U was 230 in December 20X1, and 240 in December 20X2, and is \nexpected to increase to 250 in December 20X3, 260 in December 20X4 and \n270 in December 20X5. \nThe annual payment is measured at $24,000 ($100 × 240) – i.e. based on CPI -U \nat the commencement date. The lease payments over the 10- year lease term \nare therefore $240,000 ($24,000 × 10). The lease payments at commencement \ndo not include any expected increase due to changes in CPI -U during the lease \nterm. \nThe lease payments are not remeasured for changes in CPI -U unless they are \nrequired to be remeasured f or another reason – e.g. a change in the lease term \nor a contract modification that is not accounted for as a separate contract .1 \nTherefore, unless the lease payments are remeasured for another reason, the \nremaining lease payments for the following three y ears will be: ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 324}), Document(page\_content='Leases 324 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — at December 31, 20X3: $216,000 ($24,000 × 9 remaining payments); \n— at December 31, 20X4: $192,000 ($24,000 × 8 remaining payments); and \n— at December 31, 20X5: $168,000 ($24,000 × 7 remaining payments). \nNote: \n1. A change in a reference index or rate (CPI -U in this example), even in the case where the \npayments cannot decrease once they have increased (even if the reference index or rate \ndecreases), does not constitute the resolution of a contingency that would trigger a \nremeasurement of the lease payments (see section 6.6), including variable lease payments that depend on an index or rate. \n \n Question 5.4.60 \nVariable lease payments based on fair market rent \nAre lease payments that adjust to fair market rent during the \nlease term considered to be based on an index or rate? \nBackground: Some leases stipulate that the lease payments will be adjusted to \nfair market rent periodically after lease commencement. For example, a lease \nmay include fixed payments for Years 1– 5 of a 10- year term, but specify that \nthe lease payments for Years 6– 10 will be adjusted to fair market rent as of the \nbeginning of Year 6. \nInterpretive response: Yes. While Topic 842 does not specifi cally identify fair \nmarket rent as an index, we believe it meets the definition of an index. We \nfurther note that the Board and the IASB reached converged decisions on the \nmeasurement of the lease payments at lease commencement and IFRS 16 \nexplicitly state s that ‘payments that vary to reflect changes in market rental rates’ \nare variable lease payments that depend on an index or a rate. Payments equal to \nfair market rent at lease commencement are included in the lease payments and \nare remeasured under the sa me circumstances and in the same manner as other \nvariable lease payments that depend on an index or rate. [IFRS 16.28] \n \n Example 5.4.30 \nPayments periodically adjusted to fair market rent \nLessee LE enters into a five -year lease of a 10,000 square foot space in a \nshopping center from Lessor LR that commences on January 1, 20X1. \nThe following facts are relevant. \n— Annual lease payments for the five- year lease term are fixed at $2.50 per \nsquare foot, which is consistent wit h market rental rates at the \ncommencement date. \n— The lease includes a lessee renewal option for an additional five- year term. \nAnnual lease payments for the renewal period will be set at the beginning \nof the renewal period based on prevailing fair market rental rates at that \ndate. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 325}), Document(page\_content='Leases 325 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — At commencement, LE and LR each determine that it is reasonably certain \nthat LE will exercise the renewal option. Therefore, LE and LR each \nconclude the lease term is 10 years : the five- year non- cancellable period \nplus the five -year renewal period. \nThe lease payments are calculated as follows. \nPeriod Amount Calculation \nNon-cancellable period $125,000 10,000 sq. ft. × $2.50 × 5 years \nRenewal period 125,000 10,000 sq. ft. × $2.50 × 5 years \nTotal $250,000 \nBecause the lease payments during the renewal period are variable payments \nthat depend on an index or a rate, those payments are included in the lease \npayments at the commencement date based on market rental rates at lease \ncommencement. \nThe payments for the five- year renewa l period will not be remeasured, even if \n(as is likely) fair market rent at the adjustment date (beginning of 20X6) is \ndifferent from that at lease commencement, unless the lease payments are \nrequired to be remeasured for another reason. If no such ‘other’ \nremeasurement event occurs, the difference between the $25,000 amount for \neach of Years 6– 10 included in the lease payments and the amount actually paid \nwill be recognized and disclosed as variable lease cost for that year. \n \n Question 5.4.65 \nVariable lease payments that depend on the fair \nvalue of the underlying asset \nAre lease payments that adjust based on the fair value of the \nunderlying asset(s) during the lease term considered variable lease payments that depend on an index or rate? \nBackground: Some leases stipulate that the lease payments will be adjusted \nbased on the fair value of the underlying asset(s) after lease commencement. \nFor example, a lease may include fixed payments for Years 1– 5 of a 10- year \nterm, but specify that the lease payments for Years 6– 10 will equal a \npercentage of the fair value of the underlying asset. \nInterpretive response: In scenarios similar to the background example, we \nbelieve lease payments that adjust based on the fair value of the underlying \nasset(s) shou ld generally be accounted for as variable lease payments that \ndepend on an index. This is for reasons substantially consistent with those in \nQuestion 5.4.60 on lease payments that adjust based on fair market rent. \n— In that case, the payments that are based on the fair value of the underlying \nasset are included in the lease payments at lease commencement based \non the commencement date fair value of the underlying asset(s); and \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 326}), Document(page\_content='Leases 326 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — remeasured under the same circumstances and in the same manner as \nother variable l ease payments that depend on an index or rate (see \nparagraphs 5.4.130 – 5.4.140). \nConsidering the background example, both the lessee and the lessor will \nmeasure the lease payments for Years 6– 10 at lease commencement based on \nthe commencement date fair v alue of the underlying asset. Absent a \nremeasurement event for either party, the difference between the actual \npayments for Years 6– 10 and the amounts included in the ‘lease payments’ \n(based on the fair value of the underlying asset at lease commencement) will be \naccounted for as variable lease payments. If a remeasurement event occurs, \nthe payments that depend on the fair value of the underlying asset will be \nremeasured based on the fair value of the underlying asset on the \nremeasurement date. \n \n5.4.2 In-substance fixed lease payments \n Excerpt from ASC 842 -10 \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance \n>> Lease Payments \n>>> In Substance Fixed Payments \n55-31 Lease payments include in substance fixed lease payments. In \nsubstance fixed payments are payments that may, in form, appear to contain \nvariability but are, in effect, unavoidable. In substance fixed payments for a \nlessee or a lessor may include, for example, any of the following: \na. Payments that do not create genuine variability (such as those that result \nfrom clauses that do not have economic substance) \nb. The lower of the payments to be made when a lessee has a choice about \nwhich set of payments it makes, although it must make at least one set of \npayments. \n \n5.4.230 In-substance fixed payments include payments that do not create \ngenuine variability and the minimum payments the lessee is required to make \nwhen it has alternative payments that it can select under the lease (e.g. due to \noptional features within the lease). In- substance fixed payments for a lessee or \na lessor might include the following, for example: [842- 10-55-31] \n— payments that result from clauses that do not have economic substance; or \n— the lower of the payments to be made when a lessee has a choice about \nwhich set of payments it makes, although it must make at least one set of payments. \n5.4.240 In-substance fixed lease payments are included in the measurement of \nlease payments because they are unavoidable, and therefore economically ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 327}), Document(page\_content='Leases 327 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. indistinguishable from fixed lease payments. Although such payments may \nappear to contain variability, in fact they do not. [ASU 2016- 02.BC203] \n5.4.250 Topic 842 does not include any explicit statements about reevaluating \nwhether variable lease payments represent in-substance fixed payments. \nHowever, we believe that when lease payments are required to be remeasured \n(e.g. because of a change in the lease term – see section 5.3), this would \ninclude reevaluating whether any remaining variable lease payments are in-\nsubstance fixed lease payments. \n5.4.260 Example 5.4.40 illustrates in -substance fixed lease payments in the \ncontext of the lessee having to make one of two possible sets of payments. \nExamples 5. 4.50 and 5. 4.60 illustrate in -substance fixed lease payments in the \ncontext of variable lease payments. \n \n Question 5.4.70 \nHighly certain payments based on performance or \nusage \nShould variable lease payments that are highly certain to \noccur be treated as in -substance fixed lease payments? \nInterpretive response: No. As illustrated in Example 5. 4.80, we believe that \neven variable lease payments that are highly (or even virtually) certain to occur \nare not in -substance fixed lease payments if the payments are based on \nperformance or usage of th e underlying asset. This is consistent with practice \nunder Topic 840, and therefore with the Board’s statement that the concept of \nin-substance fixed lease payments under Topic 842 is intended to be consistent \nwith previous practice under Topic 840. \nIn addition, while not included in Topic 842 and therefore not authoritative, the publicly available FASB staff paper that guided the Board’s discussion in April \n2014 of in- substance fixed lease payments included an example substantially \nsimilar to Example 5. 4.80; the Board discussion generally indicated support for \nthe conclusion reached in that example. \n \n Example 5.4.40 \nTwo possible sets of lease payments \nLessee LE enters into a seven- year lease of land and a building. \nThe following facts are relevant. \n— The lease requires monthly fixed lease payments of $14,000 and variable lease payments that are determined as 10% of LE’s annual sales in excess of $1,000,000. \n— At the end of the seven -year period, if sales are at least $1,500,000 in each \nof the last five years of the lease term, LE has the option to purchase the property for $400,000. At the lease commencement date, LE is not \nreasonably certain to exercise this purchase option. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 328}), Document(page\_content='Leases 328 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — If sales are less than $1,500,000 in any of the last five years of th e lease , \nLE is required to purchas e the propert y for $400,000 at the end of the \nseven- year period. \nThe lease payments under each scenario are calculated as follows. \nPayment Sales > $1.5m Sales < $1.5m Calculation \nFixed $1,176, 000 $1,176,000 $14,000 × 12 months × 7 years \nMinimum variable 250,000 - ($1,500,000 – 1,000,000) × \n10% × 5 years \nPurchase price - 400,000 \nTotal $1,426,000 $1,576,000 \nThe $1, 426,000 (which assumes sales are at least $1.5 million per year in the \nlast five years) is lower than $1, 576,000 (which assumes sales are less than \n$1.5 million in any of the last five years, and therefore that LE must purchase \nthe property for $400,000). LE must pay either $1, 426,000 or $1, 576,000. \nTherefore, the lease payments are $1, 426,000 (see paragraph 5.4.230). \n \n Example 5.4.50 \nVariable lease payments without economic \nsubstance \nLessee LE enters into a 10- year lease of a warehouse from Lessor LR. \nThe following facts are relevant. \n— Lease payments are initially $200,000 per month in arrears. \n— The lease payments increase by 1% annually for every 0.1% increase in \nCPI from the prior year (resulting in a leverage factor of 10 times the \nchange in CPI), limited to a maximum increase of 2% per year. \n— Once variable lease payments increase, they cannot decrease under the \nterms of the lease. \n— The CPI increase has exceeded 1% in each of the previous 20 years and there is only a remote likelihood that annual CPI increases will be less than \n0.2% during the term of the lease. \nIf payments under the CPI escalation provision are considered variable lease \npayments, no increase in rents over the lease term will be included in the lease \npayments. This is because, absent a remeasurement event (e.g. a change in the \nlease term), the measurement of the lease payments for the entire lease term \nwould be performed using the CPI index at lease commencement – i.e. \n$200,000 per month. \nHowever, in this example, the payments under the CPI escalation provision are \nin-substance fixed pa yments, rather than variable lease payments, because of \nthe remote likelihood that the change in CPI will be less than 0.2%. Therefore, \nboth LE and LR include a 2% annual increase in the measurement of lease \npayments at the lease commencement date. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 329}), Document(page\_content='Leases 329 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Examp le 5.4.60 \nVariable lease payments vs. in -substance fixed lease \npayments – payments based on performance or \nusage \nLessee LE and Lessor LR enter into a seven- year lease of retail space. \nThe following facts are relevant. \n— The lease requires monthly variable lease payments equal to 5% of sales \nfrom the retail space. There are no fixed lease payments. \n— LE has an established, successful brand and similar retail stores in similar \nshopping centers in many locations. \n— Based on LE’s extensive, relevant histor y of operating similar stores, LE \nand LR can reliably forecast that LE will generate at least $500,000 in sales \nfrom this store each year of the seven- year lease; therefore, it is highly \ncertain that LE will make at least $25,000 in variable lease payments each \nyear ($500,000 × 5%). In fact, LE and LR each have forecasts for a much \ngreater amount of sales each year. \nThe lease payments are nil for this lease. This means that LE will have no ROU \nasset or lease liability for this lease at the commencement date; and if this were \na sales- type or direct financing lease, LR would have no lease receivable. This \nlease would be classified as an operating lease unless the carrying amount of \nthe space at the commencement date is $0. \nDespite the fact that LE is highly certain to make at least $175,000 ($25,000 × \n7) in variable lease payments over the lease term, those variable payments are not in -substance fixed payments. The variable terms have economic substance \n– i.e. they exist as a substantive way for LE and LR to sh are in the risks and \nbenefits from use of the retail space – and create genuine variability in the lease \npayments to be made. \n \n Example 5.4.70 \nProtective provisions in lease payments \nLessee LE enters into a contract with Lessor LR whereby LR will operate and \nmaintain a specified machine it owns on behalf of LE. LE and LR determine the \ncontract is a lease under Topic 842. The term of the lease is three years. \nThe following facts are relevant . \n— Payments from LE to LR are based on the daily operating status of the \nmachine throughout the term of the lease. \n— For each day that LR operates the machine, LE is required to pay $2,000 for its use and LR’s operations and maintenance services. \n— If the machine is operational and LR is available to operate t he machine, but \nno operations occur (e.g. because LE did not instruct LR to operate the machine on a given day), a standby rate of $1,700 applies. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 330}), Document(page\_content='Leases 330 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — If the machine is not operational, which occurs for a variety of reasons for \nshort periods of time, a daily m aintenance rate of $1,500 applies up to a \nspecified number of contract days. However, if nonoperational days exceed that number, the daily rate for those days is $0. Zero-rate days occur in \nmost contracts. \nTo calculate the lease payments for both LE and LR , it is necessary to analyze \nthe different payments. \n— Maintenance days . The maintenance rate of $1,500 represents the daily \nfixed payment. Nonoperational days that will be subject to the maintenance rate are expected for contracts of this nature such that t here is genuine \nvariability between the maintenance rate and the full operating rate. \n— Operat ing and stand by days. Amounts paid above $1,500 per day on \noperating and standby days ($500 and $200, respectively) are variable \npayments that do not depend on an index or rate. \n— Nonoperational days in excess of the contractually stipulated limit. \nEven though there are circumstances under the terms of the contract \nwhere LE may not be obligated to pay a daily rate to LR, the $0 rate for \nnonoperational days in excess of the contractually stipulated limit is \nconsidered a protective provision for LE – i.e. it is intended to hold LE \nharmless when the machine is not available and operational for an \nexcessive period of time for reasons outside LE’s control . In contrast to the \n$0 rate, the difference between the maintenance rate of $1,500 and the full \noperating rate of $2,000 reflects genuine economic variability in the \ncontract given that maintenance events occur regularly for this type of \nmachine, operating under similar conditions . \nThe maintenance rate is the lowest economic rate in the contract that does \nnot reflect a protective provision for LE ; it reflects the daily fixed payment . \nTherefore, the annual consideration in the contract is $547,500 ( $1,500 × \n365 days). This amount is allocated among the lease and non- lease ( operations \nand maintenance services) components of the contract (see section 4.4). \nAny variable amounts resulting from operating or standby days ( $500 and $200, \nrespectively) are allocated to t he lease and non- lease components (see \nsection 4.4), and recognized when earned. Days for which the $0 rate applies \nare accounted for as negative variable lease cost (lessee) or negative variable lease income (lessor). \nNote : Protective rights in a contract are intended to protect a supplier’s interest \nin its asset or personnel, but do not necessarily prevent a customer from having \nthe right to direct the use of an asset. The same concept c an be applied to \nlessees whereby the protective right is meant to protect against substantial nonperformance by the lessor or circumstances outside the control of the \nlessee. Identifying protective provisions and related in- substance minimum \nfixed payments that are not protective requires judgment. The view that \nprotective provisions should be ignored when determining the ‘lease payments’ \nunder Topic 842 has been confirmed by the FASB staff . \n[842- 10-15-23] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 331}), Document(page\_content='Leases 331 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 5.4.80 \nSubstantive variability in lease payments \nScenario 1: Lessee operates in jurisdictions with and without sales taxes \nLessee LE enters into a five- year lease agreement with Lessor LR for 20 \ncommercial delivery trucks that LE will use in its delivery business that operates \nacross the United States. Under the terms of the lease agreement, LE makes fixed lease payments to LR of $20,000 per year for each leased truck. \nAdditionally, LE is required to reimburse LR for sales taxes that LR incurs \nrelated to the trucks over the term of the lease.\n1 In this t ransaction, t he sales \ntaxes arise for LR based on where LE operates the trucks (e.g. whether the trucks operate in a jurisdiction with a sales tax or not) and how much LE \noperates those trucks in that jurisdiction. Based on the nature of LE’s business, \nit will operate the trucks in different capacities across the contiguous 48 US \nstates throughout the term of the lease. Sales tax rates vary by state, and some states have no sales taxes. Therefore, the amount of sales taxes that LR will \nincur (and LE will re imburse) will vary from period to period during the lease. \nThe reimbursement of LR’s sales tax obligations does not provide a good \nor service to LE, and therefore is not a component of the contract (see \nsection 4.2). \nNote: \n1. In this example (all scenarios), it is assumed the sales taxes are LR costs (see \nsection 4.2.1 ) and LR does not elect the practical expedient for sales and other similar \ntaxes (see paragraph 4.2. 200). \nThere are no other components of the contract – e.g. ma intenance of the \ntrucks. \nThe total lease payments are $400,000, analyzed as follows. \n— Fixed payments. The fixed annual lease payments under the lease \nagreement are $400,000 ($20,000 × 20 trucks). These are fixed lease \npayments for both LE and LR, so $2,000,000 in total ($400,000 × 5 years). \n— Reimbursement of sales taxes. The amount LR will incur (and LE will \nreimburse) will vary from period to period during the lease based on LE’s use of the trucks and the sales tax rates in each state (which can be \nchanged at any time and for any reason by the relevant taxing authority). \nTherefore, the amount LE will reimburse to LR for sales tax obligations is \nvariable. Because there are only lease components of the contract (20 truck \nleases and no other components), the sales tax reimbursements are all \nvariable lease payments. Those variable lease payments do not depend on \nan index or rate (see paragraph 5.4.115) – they depend on both (1) LE’s \ndecisions about where to operate the trucks and (2) the various states’ \ndecisio ns about whether and how much sales tax to charge. Therefore, the \nsales tax reimbursements are not part of the lease payments. \nScenario 2: Lessee operates only in jurisdictions that currently have a \nsales tax \nAssume the same facts as in Scenario 1, excep t that LE only has operations in a \nlimited number of states that all currently impose sales tax. In addition, the ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 332}), Document(page\_content='Leases 332 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. sales tax obligation that LR will incur does not depend on how much LE uses \nthe trucks; instead, the sales tax obligation incurred by LR is ba sed on the \nperiodic gross lease payment from LE to LR and where the truck was located \nduring the billing period. \nConsistent with Scenario 1, LE and LR conclude that there is not a fixed \nminimum amount of sales tax that LE will be required to pay. This is because \neven though the trucks will only be located in jurisdictions that presently \nimpose a sales tax, those payments are not unavoidable at lease \ncommencement. Each state in which the trucks will reside during the lease \nterm has the ability to change its sales tax rate or eliminate its sales tax entirely \nat any time and for any reason (or no reason). Consequently, LR may not incur, \nand therefore LE may not be required to reimburse, any sales tax. \nScenario 3: Lessee makes payments intended to reimburse lessor costs of \ntaxes and registration based on contractual rates \nAssume the same facts as in Scenario 2, except that, rather than reimburse LR \nfor actual sales tax incurred, the variable payments that depend on the trucks’ \nlocations during the billing perio d are based on a rate table in the contract \nbetween LE and LR. The rate table will not change during the lease term unless \nthe contract is modified. \nIn this scenario, LE and LR determine that there is a fixed minimum that LE will \nbe required to pay that does not depend on LE’s use of the trucks, calculated \nassuming the lowest possible rate in the contract rate table that could apply. \nThat minimum amount is unavoidable, and therefore economically fixed. \nPayments each month in excess of that unavoidabl e minimum amount are \nvariable lease payments. \nNote that even if LR had elected the sales and other similar taxes practical \nexpedient (see Note 1), it would not apply to the variable payments that depend \non the trucks’ locations in this scenario and Scenari o 4, because the variable \npayments do not depend on actual sales taxes incurred, even though they have \nthe primary purpose of reimbursing LR for its sales tax costs. \nScenario 4: Lessee payments depend on operating the trucks \nAssume the same facts as in Scenario 3, except that LR would not owe any \nvariable payments (i.e. those based on the contract rate table) if LE does not operate the trucks. \nIn this scenario, even if LE is virtually certain to operate the trucks every month, \nLE’s payments based on the c ontractual rate table would all be variable lease \npayments, like in Scenarios 1 and 2; there would be no in- substance fixed \nminimum amount of those payments. \n \n Observation \nConcept of in -substance fixed lease payments \nconsistent with previous US GAAP \n5.4.270 The guidance in Topic 842 relies on a principle rather than a series of \nmore detailed requirements or examples, because the Board concluded that \neven an exhaustive list of requirements or examples could never be \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 333}), Document(page\_content='Leases 333 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. comprehensive. In addition, the Board concluded that introducing a new series \nof detailed requirements or examples might create new questions or issues for \na concept that was generally understood and applied before the issuance of \nTopic 842. \n5.4.280 Consistent with that thinking, the B oard’s intent is for the Topic 842 \nguidance on in -substance fixed lease payments to be applied in substantially the \nsame manner as it was applied under previous GAAP. Therefore, previous \nexamples of what constitute in -substance fixed (or disguised or de fa cto) \nminimum lease payments continue to be relevant under Topic 842. \n[ASU 2016- 02.BC204] \n \n5.4.3 Lease incentives \n Excerpt from ASC 842 -10 \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance \n>> Lease Payments \n>>> Lease Incentives \n55-30 Lease incentives include both of the following: \na. Payments made to or on behalf of the lessee \nb. Losses incurred by the lessor as a result of assuming a lessee’s \npreexisting lease with a third party. In that circumstance, the lessor and the \nlessee should independently estimate any loss attributable to that \nassumption. For example, the lessee’s estimate of the lease incentive \ncould be based on a comparison of the new lease with the market rental \nrate available for similar underlying assets or the market rental rate from \nthe same lessor without the lease assumption. The lessor should estimate \nany loss on the basis of the total remai ning costs reduced by the expected \nbenefits from the sublease for use of the assumed underlying asset. \n \n5.4.290 The lessor may offer incentives to the lessee to sign the lease \nagreement. Lease incentives include both: [842- 10-55-30] \n— payments made to or on behalf of the lessee; and \n— losses incurred by the lessor as a result of assuming a lessee’s pre -existing \nlease with a third party. \n5.4.300 Regarding losses attributable to the lessor assuming a lessee’s pre-\nexisting lease, the lessor and lessee should prepare independent estimates. For \nexample: [842- 10-55-30] \n— The lessee’s estimate of the incentive could be based on a comparison of \nthe new lease with the market rental rate available for similar underlying ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 334}), Document(page\_content='Leases 334 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. assets, or the market rental rate from the same lessor without the lease \nassumption. \n— The lessor should estimate any loss based on the total remaining costs \nreduced by the expected benefits from the sublease for use of the \nassumed underlying asset. \n5.4.310 Consistent with other components of lease payments, lease incentives \nmay be an allocated amount . That is, a lessor may grant incentives to a lessee \nin a contract that includes lease and non- lease components. All incentives, \nhowever characterized (i.e. as a lease incentive or otherwise) , reduce the \nconsideration in the contract (see section 4.3), which is allocated to the \ncomponents of the contract either on a relative stand- alone price basis (lessees) \nor in accordance with the transaction price allocation g uidance in Topic 606 \n(lessors). Consequently, a portion of amounts characterized as lease incentives \nmay not be accounted for as such (i.e. may be allocated to a non- lease \ncomponent) and vice versa. \n5.4.320 Section 4.3 discusses in further detail what constitutes an incentive that \nreduces the consideration in the contract. \n5.4.33 0 Lease incentives may be structured to be contingent on future events \nor lessee actions. For example, a lessor may agree to reimb urse a lessee for \nthe cost of leasehold improvements , with payment contingent upon the \nlessee’s construction or installation of the improvements. See Q uestion 6.6. 80 \nfor further discussion on how a lessee accounts for contingent lease incentives . \n \n Questi on 5.4.80 \nDetermining the accounting owner of leasehold \nimprovements \nDoes the determination of the accounting owner of leasehold \nimprovements affect the accounting for a lease? \nInterpretive response: Yes, in multiple respects . \nEffect on the ‘consideration in the contract’ \nAll payments made by a lessor to a lessee are an incentive, reducing the \nconsideration in the contract, unless the payments are for a distinct good or \nservice provided by the lessee to the lessor (e.g. for construction of, or \nmanaging the construction of, the lessor’s assets). In addition, even if the \nlessee provides a distinct good or service to the lessor, any amount of the \nlessor’s payments in excess of the fair value of the distinct good or service is an \nincentive. [842- 10-15-35(a), 606- 10-32-25 – 32-26] \nTherefore, lessor payments to the lessee for leasehold improvements are \nincentives, reducing the consideration in the contract when the leasehold \nimprovements are assets of the lessee for accounting purposes – i.e. they ar e \nnot a payment for a distinct good of the lessor in that case. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 335}), Document(page\_content='Leases 335 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Effect on lease commencement \nAs outlined in section 5.1 (in particular, see Example 5.1.10), the accounting \nowner of leasehold improvements may determine the lease commencement date. \nParagra ph 5.1.20 discusses the possible acc ounting effects of an improperly \ndetermined lease commencement date. \nDetermining the accounting owner \nWe believe the factors outlined below (not exhaustive) provide relevant \nevidence about whether the lessee or the lessor is the accounting owner of \nspecified leasehold improvements. These factors generally consider the \nquestion of accounting ownership from a ‘control’ perspective – i.e. which party \nhas the ability to direct the use of, and obtain substantially all the rema ining \nbenefits from, the asset. \nThis is on the basis that the principle of control generally underlies the \nquesti ons of accounting ownership elsewhere in Topic 842 – e.g. the sale-\nleaseback guidance in Subtopic 842- 40 (including that related to control of an \nunderlying asset before lease commencement). \n[842- 40-25-1(b), 55- 1 – 55-5] \n— If the ‘lease term’ (see section 5.3) for the underlying asset (e.g. the leased building or space) is for at least substantially all of the economic life of the \nimprovements, that would typically be a strong indicator that the lessee is \nthe accounting owner of the improvements if the lessee will have exclusive \nuse of the improvements and the ability to direct their use during the lease \nterm. \nLessee options to renew the lease that are not included in the lease term, \nbut if exercised would extend the lease such that it is for at least substantially all of the economic life of the improvements, may also affect \nthe accounting owner evaluation. This is because those options, in effect, \ngive the lessee the unilateral right to extend the period over which it has \nexclusive use – and the ability to direct the use – of the improvements for \nsubstantially all of their economic life. \n— If the lessee is likely to exercise options that would extend the lease to \nsubstantially all of the improvements ’ economic life, that means it is \nunlikely the lessor will ever be able to direct the use of, or obtain \nsubstantial benefits from, the improvement s during their economic life. \n‘Likely ’ is a lower threshold than ‘reasonably certain’ (see section 5.2) \nbut refers to a probability greater than more likely than not. \nIn the context of a binary accounting owner evaluation – i.e. between \nthe lessee and the lessor – we believe this is a relevant consideration. \n— In contrast, if the lessee is not likely to exercise options that would \nextend the lease to substantially all of the improvements’ economic life, \nother factors, such as those that follow, are likely to influence the \nevaluation more significantly than the lessee’s renewal options. \n— Whether the terms of the lease agreement require the lessee to construct or install the improvements. If the provisions of the lease do not require the \nlessee to construct or install the improvements, that would indicate the \nlessee controlled whether or not to construct or install them . It would ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 336}), Document(page\_content="Leases 336 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. therefore follow that the lessee likely would not undertake that investment \nif it were not able to direct the use of those improvements and obtain \nsubstantially all their remaining benefits. \nIn evaluating whether the lease agreement requires the lessee to construct \nor install specific leasehold improvements, an entity should consider the \nconsequences to the lessee if the lessee fails to construct or install the \nspecified improvements (e.g. whether such failure is a default under which \nthe lessor can require specific performance by the lessee or recover \nmonetary damages). \n— If the provisions of the lease permit the lessee to remove or alter the improvements without the lessor's consent or without adequately \ncompensating the lessor for any corresponding reduction in utility or value \nof the underlying asset (other than returning the underlying asset to its \noriginal condition before construction or installation of the leasehold \nimprovements ), that indic ates the lessee has the ability to direct the use of \nthe improvements (e.g. retain them or discard them) and the sole ability to obtain substantially all their remaining benefits. \n— If the lessee is not permitted to remove or significantly alter the improvements without the consent of the lessor, but the less or must pay \nthe lessee an appropriate fee for them at the end of the lease if they are \nnot permitted to be removed, that would generally suggest the lessee will \neither (1) have control on a basis consistent with the preceding factor or (2) \nhave the ability to direct the use of the assets until the end of the lease and \nat that point receive substantially all the remaining benefits from the asset \n(in the form of the payment from the lessor) , which ca n be used to acquire \nsubstantially equivalent assets. \n— If the leasehold improvements are highly specialized such that neither the \nlessor, nor another lessee, would likely be able to derive significant \neconomic benefit from the improvements after the end of the lease, that \nwould suggest, similar to the basis for the ‘alternative use’ lease \nclassification criterion, that the lessee is directing the use of the asset \nthroughout the period during which substantially all of the remaining \nbenefits of the improvements will be consumed. \n[842- 40-25-2(e)] \nOther considerations, such as who holds legal title to the improvements, who has an insurable interest in the improvements, who has tax basis in the \nimprovements and who has the significant risks of ownership do not, i n \nisolation, determine the accounting owner of the improvements. \nSometimes, a lessor pays the costs of constructing leasehold improvements \ndirectly to a third party rather than reimbursing the lessee for those costs. We \ndo not believe the identity of the party that constructs the leasehold \nimprovements (i.e. the lessee, the lessor or a third party) directly influences the \naccounting ownership assessment. This is because the lessee could have \nsubstantially similar rights to control third- party constructed leasehold \nimprovements (for which the lessor pays the costs to the third party directly) as \nit does improvements that it constructs or that are constructed by a third party \nfor which the lessee is the primary obligor to the third party. \nThe contracting mechanism (i.e. between the lessee and the third party or \nbetween the lessor and the third party) and the payment terms (i.e. lessor pays ", metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 337}), Document(page\_content='Leases 337 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the third party or lessee pays the third party) should generally not be \ndeterminative; the lessor could contract and pay f or lessee- controlled \nleasehold improvements as an incentive in lieu of providing a cash payment to \nthe lessee. \n \n Question 5.4.81 \nAccounting owner of structural leasehold \nimprovements \nIs the lessor automatically the accounting owner of structural \nleasehold improvements ? \nBackground: Question 5.4.80 discusses considerations relevant to determining \nthe accounting owner of leasehold improvements, and indicates that judgment \nis frequentl y required. It also discusses the accounting effects of that \ndetermination. \nSince the adoption of Topic 842, questions have frequently arisen in practice \naround ‘structural’ leasehold improvements. Structural leasehold improvements \ninclude (not exhaustive) HVAC systems, electrical or plumbing infrastructure \nand elevators that are typically integrated into a leased building (or part of a \nbuilding). Because of their integration into the lessor’s owned building, some \nentities have assumed that those improvements must be lessor -owned for \naccounting purposes. \nInterp retive response: No. The lessor is not automatically the accounting \nowner of structural leasehold improvements. The same principle and \nconsiderations that apply to other leasehold improvements apply to structural \nleasehold improvements (see Question 5.4.80). Depending on the facts and \ncircumstances, the accounting owner of structural leasehold improv ements \nmay be the lessee or the lessor. \nExample 5.4.85 illustrates applying the framework in Question 5.4.80 to structural leasehold improvements. \n \n Example 5.4.85 \nDetermining the accounting owner of structural \nleasehold improvements \nScenario 1: Non -cancellable lease term equals economic life of the \nimprovements \nLessee LE and Lessor LR enter into a 15- year non- cancellable lease for a \nbuilding LE will use as a manufacturing facility. LE makes, and pays for, \nsignificant improvements to the facility for its s pecific manufacturing and \nproduction needs. These improvements include a new and advanced HVAC and \nair filtration system. LE selects and purchases th e system. \nOther facts relevant to determining the accountin g owner of the HVAC and air \nfiltration system include the following. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 338}), Document(page\_content='Leases 338 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Renewal/purchase options: None \nEconomic life of new \nHVAC/filtration system : 15 years \nEnd of lease requirements for the \nHVAC/filtration system: LE is not permitted to remove; LR is not required to make any payments to LE. \nAlternative use to LR at end of \nlease: Yes, this HVAC/filtration system would be usable by other types of building occupants; while an \nadvanced system, i t would service occupants with \nlesser needs and potentially be attractive to future \noccupants with similar needs for an advanced \nHVAC/filtration system. \nLE rights to remove or modify the HVAC/filtration system during the lease term: LE can modify or chang e the system during the \nlease term provided that a functioning HVAC/filtration system generally equivalent to that \nin the building when LE took possession thereof \nremains at the end of the lease. \nLR rights to remove or modify \nthe HVAC/filtration system du ring \nthe lease term: None. LR cannot remove or replace the system without LE’s agreement during the lease term. \nThat the HVAC/filtration system will be installed (integrated) into LR’s owned \nbuilding raises the question of whether LR is the accounting owner of the \nsystem. \nHowever, LE and LR each conclude that LE is the accounting owner of the \nHVAC/filtration system in this scenario. In reaching this conclusion, the parties \nconclude that LE has the ability to direct the use of and obtain substantially all of the remaining benefits from the system. This is for the following reasons. \n— The non- cancellable lease term for the building equals the economic life of \nthe system. Therefore, LE has the right to direct the use of the system – \ni.e. through its control over the use of the building, it will control when, \nwhether, how and how much the system is used – for its entire economic \nlife. LE, throughout the building lease term, will decide the temperature, \nhumidity, filtration and other operational settings of the system. \n— In addition, while LE can modify or change the system during the lease term, LR has no rights to remove, replace or render the system inoperable. \nScenario 2: Non -cancellable lease term is significantly less than the \neconomic life of the improvements – lessee has renewal options (1) \nAssume the same facts as in Scenario 1, exce pt that the non- cancellable lease \nterm is five years (instead of 15 years). LE has three, three- year renewal options \nthat make the maximum possible lease term, at LE’s sole option, 14 y ears. \nThere are no contractual or other impediments to LE exercising o ne or all of \nthose renewal options – e.g. off -market rental payments, onerous covenants or \none-time fees /charges. \nLE is likely to exercise all three renewal options \nLE’s significant investment in the HVAC/filtration system, which LE would be expected to need in any alternative manufacturing facility, is an economic factor ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 339}), Document(page\_content='Leases 339 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. that may make it at least likely that LE will exercise one or more of its renewal \noptions in the contract. Because of this and/or other economic factors, LE may \nbe at least likely to exercise all three renewal options; ‘likely’ is a lower \nthreshold of probability than ‘reasonably certain’ (see section 5.2). \nIn that case, LE and LR would likely reach t he same conclusion as that reached \nin Scenario 1. This is because, given the other relevant facts in this scenario, it \nis unlikely LR will be able to derive any substantial economic benefits from the \nsystem at the end of the lease or ever obtain the right to direct its use during its \neconomic life. \nLE is not likely to exercise all three renewal options \nEconomic factors other than LE’s investment in the HVAC/filtration system may \nmean LE is not likely to exercise all of its renewal options. In that case, the \nduration of the lease may be substantively less than the economic life of the \nsystem. \nIn this scenario, at 5 – 11 years, it will comprise only 33% – 73% of the \nsystem’s economic life. Despite this, LE and LR may still conclude that LE is \nthe accounting owner of the system based on the totality of the following . \n— LE was not required by the contract to upgrade the building’s HVAC/filtration; LE elected to do so for its own manufacturing needs. \n— LE selected the system to be installed. \n— LE is permitted to remove or modify the system during, or at the end of, \nthe lease term, as long as the building is returned to LR in the same \ncondition as when LE occupied it – i.e. with less advanced HVAC and air \nfiltration equipment. Note that for cost and portability of the system \nreasons, it is unlikely LE would remove or substantially modify the system once it is installed, including at the end of the lease. \n— LE’s rights to direct the use of the system during the non- cancellable lease \nterm and any renewal periods are identic al to those in Scenario 1, and LE’s \nrenewal options give it the right to continue to do so for substantially all of \nthe system’s economic life. LR, by contrast, can only direct the use of the \nsystem and obtain substantial remaining benefits therefrom (or permit \nanother lessee to do so) if LE elects not to exercise one or more of its \nrenewal options and leaves the system intact at the end of the lease. \nThe following factors , which assume LE does not exercise all of its renewal \noptions and leaves the system i ntact at the end of the lease, are not strong \nenough to override those above. \n— LR would likely be able to derive significant economic benefit from the \nimprovements after the end of the lease. \n— LR does not have to compensate LE for the system’s remaining eco nomic \nvalue. \nScenario 3: Non -cancellable lease term is significantly less than the \neconomic life of the improvements – lessee has renewal options (2) \nAssume the same facts as in Scenario 2, except that: \n— LR was required to be consulted on, and approve, the system and the \ninstallation contractor; ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 340}), Document(page\_content='Leases 340 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — once installed, LE is not permitted to remove or modify the system without \nLR’s approval; and \n— LE must operate the system within certain parameters designed to ensure \nthe system’s longevity and performance (and must pay for repairs or \nmaintenance if it does not) . \nThe changed facts indicate that LE’s rights to direct the use of the system \nduring the lease term are more limited than in Scenario 2. In addition, LR had \nmore influence over the system’s specifications and installation, affecting the \nbenefits able to be derived from the system over its economic life. Lastly, the \noperating parameters on LE in effect assure LR that it will be able to derive \nsignificant economic benefits from the system at the end of the lease if LE \ndoes not exercise all of its building lease renewal options. \nLE is likely to exercise all three renewal options \nThese changed facts notwithstanding, if LE is still likely to exercise all three of \nits building lease renewal options, LE and LR would likely reach the same \nconclusio n as that reached in Scenario 2. \nDespite restrictions on LE’s ability to direct the use of the system in this \nscenario, those restrictions are protective in nature – e.g. to ensure LR does not \nhave to incur an expense to repair or replace the system at the end of the lease if LE does not exercise all of its renewal options; and LE is likely to obtain \nsubstantially all of the system’s economic benefits. \nLE is not likely to exercise all three renewal options \nIf LE is not lik ely to exercise all three of its renewal options, LE and LR would \nlikely conclude that the system is a LR -owned improvement in this scenario. \nThis is because: \n— LR would be able to derive significant economic benefits from the system \nafter the end of the lea se, for which it does not have to compensate LE; \nand \n— LE is prohibited from removing or modifying the system and must operate \nthe system during the lease term in a manner designed to preserve those \nremaining benefits for LR. \nScenario 4: Non -cancellable leas e term is significantly less than the \neconomic life of the improvements – no lessee renewal options \nAssume the same facts as in Scenario 2, except that the non- cancellable lease \nterm is seven years and LE has no renewal or extension options – i.e. the \nmaxi mum possible lease term under the contract is seven years. In addition, LR \nprovides LE with cash lease incentives intended to fund much of LE’s build- out \n(including the new HVAC/filtration system). \nIn this scenario, LE and LR each conclude that LR is the a ccounting owner of \nthe system ; LE does not ha ve the ability to direct the use of and obtain \nsubstantially all of the remaining benefits from this system. LE and LR each \nreach this conclusion based on consideration of the following factors. \n— LE has the abili ty to benefit from the system for only 7 years of its 15 -year \neconomic life; ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 341}), Document(page\_content='Leases 341 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — LE cannot remove and continue to use and benefit from the system at the \nend of the lease; and \n— LR is not required to compensate LE for the significant remaining economic \nvalue of t he system at the end of the lease. \nIn contrast, LR will have the right to the significant remaining economic benefits \nof the system installed in its building at the end of the lease, and will be able to benefit from the advanced system – which is not useful only to LE – in \nmarketing the building (for lease or sale) to others. \n \n Question 5.4.85 \nLessee payments for leasehold improvements \nowned by the lessor \nHow should an entity account for payments by the lessee for \nlessor -owned leasehold improvements ? \nInterpretive response: When the lessor is determined to be the accounting \nowner of improvements to the underlying asset (see Question 5.4.80), lessee payments for those improvements are either: \n— fixed payments, and therefore included in the ‘c onsideration in the \ncontract’; or \n— variable payments excluded from the consideration in the contract. \nMaking a payment for a lessor -owned asset (i.e. the improvements) is \nsubstantively no different from making a cash payment to the lessor. Whether \nthe pay ment is a fixed payment or a variable payment depends on the facts and \ncircumstances. \nFixed payment \nIf the contract stipulates a fixed amount the lessee must pay for (or toward) the \nlessor -owned improvement(s), that amount is included in the consideration in \nthe contract at lease commencement. All or a portion of the amount (i.e. if there \nare non- lease components not combined with the lease component) will be a \n‘lease payment’; the exception being if the entity is the lessor, and it is \naccounting for the lease as part of a single Topic 606 performance obligation (see paragraph 4.4.53). \nVariable payment \nIf the contract requires the lessee to pay for a lessor -owned improvement, but \nthe amount is unknown at lease commencement, such payments are variable \npayments that do not depend on a n index or rate. Therefore, they are not \nincluded in the consideration in the contract at lease commencement. \nThe following occurs once the var iable payment amount becomes fixed. \n— The lessee remeasures the considera tion in the contract for the resolution \nof that contingency (see paragraphs 6.6. 90 and 6.6.140 ). \n— In addition to recognizing its owned asset improvements, the lessor \nrecognizes (see paragraphs 7.3.140 and 7.4.20): \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 342}), Document(page\_content='Leases 342 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — the amount allocable to the lease component as variable lease revenue \n(unless the amount the lessee will pay is a reimbursement to the lessor \nof the nature described in Question 7.4.20) ; and \n— any amount allocable to non- lease components when the requirements \nof the applicable Topic (e.g. Topic 606) are met . \nContract silent at lease commencement \nThe contract may be silent with respect to lessor -owned improvements, and \ntherefore there is no accounting at lease commencement. If lessor -owned \nimprovements are subsequently constructed or installed, and t he lessee is \nrequired to pay for them (which includes costs incurred by the lessee – e.g. if \nthe lessee uses its own personnel to construct or install the improvements), we \nbelieve that is a lease modification. This new requirement changes the \nconsideratio n in the contract, which now includes the amounts paid (or required \nto be paid) for the lessor -owned improvements. See sections 6.7 (lessees) and \n7.6 (lessors) for guidance on accounting for lease modifications. \n \n Example 5.4.90 \nImpact of lease incentives on lease payments \nLessee LE and Lessor LR enter into a 10- year lease with the following terms: \n— Annual rent of $1,500, so $15,000 in total. \n— LR agrees to provide LE with $1,000 to defray the cost of tenant \nimprovements each of the first three years of the lease, so $3,000 in \ntotal. LE will simply reduce its annual payment for Years 1– 3 by $1,000 \neach year. \nThe lease payment s are $12,000 in this exampl e ($15,000 – $3,000 incentive) . \nLE will need to factor in the timing and amount of its payment s in determining \nlease classification (see section 6.2) , and in measuring its lease liability (see \nsection 6.3). \nTherefore, the present value of those lease payments is based on: \n— Years 1 –3: annual lease payment of $500. \n— Years 4 –10: annual lease payment of $1,500. \n \n5.4.4 Purchase options \n5.4.340 The exercise price of a lessee option to purchase the underlying asset is \nincluded in the lease payments if the lessee is reasonably certain to exercise \nthe option. The analysis of whether a lessee is reasonably certain to exercise a \npurchase option considers the same economic factors that are evaluated in \ndetermining whether to include optional periods in the lease term (see \nsection 5.2). [842- 10-30-5(c)] \n5.4.350 When there is a change in the assessment of whether it’s reasonably \ncertain that the lessee will exercise a purchase option, the lessee remeasures \nthe lease payments. Reassessments of lessee purchase options and ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 343}), Document(page\_content='Leases 343 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. remeasurements of the lease payments resulting from a change in the \nassessment of a lessee purchase option are discussed in section 6.6. \n[842- 10-35-4(c)(2)] \n5.4.360 A lessor does not reassess whether the lessee is reasonably certain to \nexercise a purchase option unless the lease is modified and that modification is \nnot accounted for as a separate contract (see section 7. 6). [842- 10-35-3] \n \n Example 5.4.100 \nPurchase option price included in lease payments \nLessee LE leases a warehouse and land. The following facts are relevant. \n— The lease term is five years, with annual fixed lease payments of \n$1,000,000. \n— The lease contract gives LE the option to purchase the warehouse and land \nat a fixed price of $10,000,000 at the end of the lease term. \nBased on an analysis of the economic factors at lease commencement, LE is \nreasonably certain to exercise the purchase option. Therefore, the total lease \npayments are $15,000,000. \n— $5,000,000 in total annual fixed payments for five years; plus \n— $10,000,000 exercise price of the purchase option. \n \n5.4.5 Termination penalties \n Excerpt from ASC 842 -10 \n55 Implementation Guidance and Illustrations \nGeneral \n> Illustrations \n>> Illustration of Lessee Accounting for Termination Penalties \n55-235 Example 26 illustrates how a lessee accounts for termination penalties. \n>>> Example 26 —Termination Penalties \n55-236 Lessee enters into a 10- year lease of an asset, which it can terminate \nat the end of each year beginning at the end of Year 6. Lease payments are \n$50,000 per year during the 10- year term, payable at the beginning of each \nyear. If Lessee terminates the lease at the end of Year 6, Lessee must pay a \npenalty to Lessor of $20,000. The termination penalty decreases by $5,000 in \neach successive year. \n55-237 At the commencement date, Lessee concludes that it is not \nreasonably certain it will continue to use the underlying asset after Year 6, \nhaving considered both the significance of the termination penalty (in absolute ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 344}), Document(page\_content='Leases 344 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. terms and in relation to the remaining l ease payments after the date the \ntermination option becomes exercisable) and the other fac tors in paragraph \n842-10-55-26. \n55-238 Accordingly, Lessee determines that the lease term is six years. At the \ncommencement date, Lessee measures the lease liability on the basis of lease \npayments of $50,000 for 6 years plus the penalty of $20,000 payable at the \nend of Year 6. \n \n5.4.370 The determination of the lease term governs whether a termination penalty \nis included in lease payments. Termination penalties are included in the lease \npayments unless it is reasonably certain that the lessee will not exercise an option \nto terminate the l ease, and therefore will not incur the penalty. [842- 10-30-5(d)] \n5.4.375 Question 6.7.15 addresses when and how to recognize a termination \npenalty paid in connection with a lease modification that only partially \nterminates an existing lease. \n \n Example 5.4.110 \nTermination penalty included in lease payments \nLessee LE leases a floor in an office building from Lessor LR for five years for \nmonthly payments of $20,000. The lease contract allows LE to terminate the \nlease after Year 3 for a lump sum payment of $120,000. At lease \ncommencement, it is not reasonably certain that LE will continue the lease \nbeyond the end of Year 3. \nAs a result, both LE and LR include the termination penalty in the lease payments. Therefore, the total lease payments are $8 40,000: \n— $720,000 for three years of fixed payments ($20,000 × 36); plus \n— $120,000 termination penalty. \n \n5.4.6 Residual value guarantees \n Excerpt from ASC 842 -10 \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance \n>> Lease Payments \n>>>> Residual Value Guarantees \n55-34 A lease provision requiring the lessee to make up a residual value \ndeficiency that is attributable to damage, extraordinary wear and tear, or \nexcessive usage is similar to variable lease payments in that the amount is not \ndeterminable at the commencement d ate. Such a provision does not constitute ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 345}), Document(page\_content="Leases 345 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. a lessee guarantee of the residual value. \n55-35 If the lessor has the right to require the lessee to purchase the \nunderlying asset by the end of the lease term, the stated purchase price is \nincluded in lease payments. That amount is, in effect, a guaranteed residual \nvalue that the lessee is obligated to pay on the basis of circumstances outside \nits control. \n55-36 A residual value guarantee obtained by the lessee from an unrelated \nthird party for the benefit of the lessor should not be used to reduce the \namount of the lessee's lease payments under paragraph 842- 10-30-5(f) except \nto the extent that the lessor explicitly releases the lessee from obligation, \nincluding the secondary obligation, which is if the guarantor defaults, a residual \nvalue deficiency must be made up. Amounts paid in consideration for a \nguarantee by an unrelated third party are executory costs and are not included \nin the lessee's lease payments. \n \n5.4.380 A residual value g uarantee is a guarantee made to a lessor that the \nvalue of an underlying asset returned to the lessor at the end of a lease will be \nat least a specified amount. Residual value guarantees can be provided by the \nlessee or by a third party that is unrelated to the lessee or the lessor. \n[842 Glossary] \n5.4.390 The following chart highlights the different treatment of residual value \nguarantees for lessees versus lessors . [842- 10-30-5(f)] \n \nInclusion of residual value guarantees in lease payments\nLessee Lessor\nInclude amounts probable \nof being owedDo not include \nany amounts1 \nNote: \n1. No residual value guarantee amounts (whether provided by the lessee or by another \nunrelated third party) are included in the ‘ lease payments ’ by the lessor. However, the \nlessor’s ‘lease receivable’ for sales -type and direct financing leases includes the fu ll \namount of any residual value guarantee(s) (see section 7.3). \n5.4.400 A provision requiring the lessee to make up a residual value deficiency \nthat is attributable to damage, extraordinary wear and tear, or excessive usage \nis not a residual value guarant ee. Amounts related to such a provision are \nvariable lease payments (see section 5.4.1). [842- 10-55-34] \n5.4.410 However, if the lessor has the right to require the lessee to purchase \nthe underlying asset by the end of the lease term (i.e. a lessor put opt ion), the \nstated purchase price is included in lease payments by both the lessee and \nlessor. Although it is not a residual value guarantee because the lessee receives ", metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 346}), Document(page\_content='Leases 346 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the underlying asset, the amount is economically similar to a guaranteed \nresidual value. [842- 10-55-35] \n5.4.420 In general, a lessee’s lease payments should not be reduced for any \namounts probable of being owed under a residual value guarantee that are \ncovered by a residual value guarantee obtained from a third party by the lessee. \nHowever, an exception arises when the lessor explicitly releases the lessee \nfrom the residual value guarantee obligation, including a secondary obligation to perform if the third -party guarantor defaults. \n[842- 10-55-36] \n5.4.430 Amounts paid by a lessee for a third-party residual value guarantee are \nalso not lease payments. They are executory costs. [842-10-55-36] \n5.4.440 Residua l value guarantees that are subjec t to the requirement s of \nTopic 842 ar e not withi n the scop e of Topic 815 (derivative s and hedging ) \n(see sectio n 2.2.1 ). [815- 10-15-80] \n5.4.450 When there is a change in the assessment of the amount probable of \nbeing owed under a residual value guarantee, the lessee remeasures the lease \npayments (see section 6.6). [842- 10-35-4(c)(3)] \n5.4.460 The treatment of residual value guarantees by a lessee in short -term \nleases is discussed in chapter 6 (see Q uestion 6.3.30 ). \n \n Observation \nIncluding only amounts probable of being owed \nunder a residual value guarantee increase s \njudgment \n5.4.47 0 The Board’s decision for lessees to include in lease payments only \namounts probable of being owed under a residual value guarantee, rather than \nthe entire amount of the guarantee, result s in the recognition of smaller lease \nliabilities and ROU assets by lessees. However, the judgment that is involved in \ndetermining and reassessing amounts probable of being owed and the \nrequirement to remeasure the lease payments whenever that assessment \nchanges, and potentially to allocate those changes to multiple components of \nthe contract (including non- lease components), add s complexity to the lessee \naccounting model for leases that include a l essee residual value guarantee. \n \n Question 5.4.90 \nDetermining probable amounts owed \nHow should an entity estimate the amount probable of being \nowed under a residual value guarantee it provides to the \nlessor? \nInterpretive response: Topic 842 requires a lessee to estimate, and reassess, \nthe amount probable of being owed under a residual value guarantee it provides \nto the lessor, but does not provide guidance about how to make this estimate. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 347}), Document(page\_content='Leases 347 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 5. 4.120 demonstrates one way in which we believe the lessee could \nestimate the amount probable of being owed in a scenario of that nature. \nAnother approach that we believe would be acceptable is to assign probabilities \nto potential outcomes and to include in the lease payments the minimum \namount that exceeds the ‘probable’ threshold.1 For example, a lessee might \nconsider there to be the following possible outcomes . \nAmount lessee could owe Probability \n$ - 20% \n10 25% \n20 25% \n30 20% \n40 10% \nUnder this approach, the lessee would conclude that it is probable that it will \nowe at least $10 to satisfy the residual value guarantee. While it is possible that \nthe lessee will owe $30 or $40, and it is more likely than not that the lessee will \nowe at least $20, the probability of those outcomes is not likely to occur. \nHowever, both Example 5.4.120 and the above are illustrative only. Because \nTopic 842 does not prescribe how to make the estimate, there may be a \nnumber of acceptable approaches. \nNote: \n1. ‘Probable’ is defined as the future event or events are likely to occur. [842 Glossary] \n \n Example 5.4.120 \nResidual value guarantee as a component of the \nlessee’s lease payments \nLessee LE leases a new semi -trailer truck from Lessor LR for four years for \nannual payments of $24,000. Under the contract, LE guarantees a residual value \nof $60,000 to LR at the end of the lease term. \nIn deciding whether the lease payments include any amount related to LE’s \nresidual value guarantee, LE observes that similar trucks are regularly sold in \nused condition, with detailed listings published on dealer sites. LE resear ches \nthose listings and finds similar trucks around four years of age, for sale or with \nestimated values between $50,000 and $60,000. \nMileage is a key determinant in pricing different trucks of the same age. LE \nexpects to drive the truck 120,000 miles per year, which is at the high end of \nthe range of mileage noted in the used sale listings. Therefore, LE concludes \nthat it is likely that the residual value of the truck will be closer to $50,000 than \n$60,000 at the end of the lease, and therefore that the pr obable amount that \nwill be owed by LE at the end of the lease term will be $10,000. Consequently, \nLE’s leas e payments include the $10,000. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 348}), Document(page\_content='Leases 348 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. LR includes no amounts related to the residual value guarantee in its \nmeasurement of the lease payments. However, if the lease were a sales -type \nor a direct financing lease, the full $60,000 residual value guarantee would be \nincluded in determining LR’s lease receivable (see section 7.3.1 ). \n \n Example 5.4.130 \nLessee accounting for right to receive excess over \nguaranteed residual value \nContinuing Example 5. 4.120, in addition to the guarantee of a residual value of \n$60,000, the contract stipulates that: \n— LR will sell the truck at the end of the four -year lease term; and \n— if LR sells the truck for more than $60,000, LR will pay LE any surplus \nabove that amount. \nLE accounts for the potential gain on sale of the residual asset as a contingent gain under Subtopic 450- 30 (gain contingencies) . Therefore, LE recognizes a \ngain only when the sale is completed and to the extent that the sales price \nexceeds $60,000. \n \n Question 5.4.100 \nGuarantees of lessor debt \nCan a lessee guarantee of a lessor’s debt be considered a \nresidual value guarantee? \nInterpretive response: In some circumstances, yes. \nAs a starting point, lease payments do not include a guarantee by the lessee of \nthe lessor’s debt. [842- 10-30-6(b)] \nHowever, a lessee guarantee of debt related to the underlying asset generally \nwould be considered in substance a residual value guarantee if the debt is \n— nonrecourse to the borrower – i.e. recourse is solely to the underlying \nasset; or \n— recourse to the borrower but the borrower is a special purpose entity with \nno significant assets other than the underlying asset. \nThis is because at the end of the lease term, a payment from the lessee to the lessor’s nonrecourse lender under the loan guarantee would be substantively \nno different from the lessee making a direct payment to the lessor under a \nresidual value guarantee. \nIn this situation, a lessee should include in lease payments the amount that is \nprobable of being owed at the end of the lease term under its guarantee of the \nlessor’s debt. Conversely , the lessor would not account for any of this amount \nas lease payments. However, if the lease were a sales -type or a direct financing \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 349}), Document(page\_content='Leases 349 \n5.Concepts and definitions for lessees and lessors\n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. lease, the full amount of the guarantee would be included in determining the \nlessor’s lease receivable. \nThis same thought process would apply to a lessee loan to a lessor if the \nbalance of the loan outstanding at the end of the lease term is considered in substance a residual value guarantee, unless the lessee has recourse to substantive other assets of the lessor beyond the leased asset. \nA lessee is required to recognize a liability for the fair value of a guarantee of \ndebt related to the underlying asset under Topic 460 (g uarantees ) if the \nguarantee is not an in- substance residual value guarantee. Topic 842 does not \nprovide guidance about where to recognize the corresponding debit. As a result, \nwe believe any of the following could be acceptable if applied consistently: \n— expense the amount at the time the liability is established; \n— capitalize the amount as part of the ROU asset, in a manner similar to an \ninitial direct cost (see section 6.3); or \n— capitalize the amount as an asset separate from the ROU asset. \nQuestion 5.4.110 \nInteraction of Topic 842 with Topic 810 \nCan lease terms create a variable interest in a variable \ninterest entity? \nInterpretive response : In some circumstances, yes. In general, operating \nleases are not variable interests in a variable interest entity (VIE) because they \ncreate rather than absorb risk. [810- 10-55-39] \nHowever, a lessee in an operating lease has a variable interest in a VIE l essor \nthrough its operating lease if it: [810- 10-25-55] \n— has a fixed -price purchase option; or \n— makes a residual value guarantee to the lessor with respect to leased assets with a fair value in excess of 50 percent of the fair value of: \n— the assets of the lessor; or \n— the assets of a silo within the VIE lessor, if the lessor is a VIE for \nreasons ot her than t he lease agreement. \nFor further disc ussion of operating leas es and variable interes ts in a VIE, see \nKPMG Handbook, Consolidation. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 350}), Document(page\_content='Leases 350 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Comparison to legacy US GAAP \nFull amount of residual value guarantees included in Topic 840 minimum \nlease payments \n5.4.48 0 Under Topic 840, the definition of ‘ minimum lease payments ’ for a \nlessee included the full amount of any residual value guarantee that it provided \n(e.g. the $60,000 in Example 5. 4.120 ), rather than just the amount that is \nprobable of being owed. This is one aspect of Topic 842 that result s in a \ndifference in the accounting for finance leases as compared to capital leases. In \ngeneral, the lease liability and the ROU asset are smaller under Topic 842 for a \nfinance lease that includes a lessee residual value guarantee than the capital \nlease obligation and capital lease asset were under Topic 840 . [840 Glossary] \n5.4.49 0 While the definition of minimum lease payments applicable to lessors in \nTopic 840 include d the full amount of any residual value guarantee (provided by \nthe lessee or any other unrelated third party) and the definition of lea se \npayments include d no amounts related to residual value guarantees, this has no \nappreciable difference on a lessor’s accounting under Topic 842 . This is \nbecause: \n— the full amount of any residual value guarantee(s) is included in the lessor’s \nlease receivable (which is a component of the lessor’s net investment in \nthe lease, together with any unguaranteed residual value and deferred selling profit for direct financing leases, if any) for sales -type and direct \nfinancing leases; and \n— operating lessors’ lease income under Topic 840 was calculated based on \nthe minimum rental payments , which excluded guaranteed residual values, \nrather than the minimum lease payments . \n \n5.5 Initial direct c osts \n Excerpt from ASC 842 -10 \n30 Initial Measurement \nGeneral \n> Initial Measurement of the Lease Payments \n>> Initial Direct Costs \n30-9 Initial direct costs for a lessee or a lessor may include, for example, \neither of the following: \na. Commissions \nb. Payments made to an existing tenant to incentivize that tenant to \nterminate its lease. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 351}), Document(page\_content='Leases 351 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 30-10 Costs to negotiate or arrange a lease that would have been incurred \nregardless of whether the lease was obtained, such as fixed employee \nsalaries, are not initial direct costs. The following items are examples of costs \nthat are not initial direct costs: \na. General overheads, including, for example, depreciation, occupancy and \nequipment costs, unsuccessful origination efforts, and idle time \nb. Costs related to activities performed by the lessor for advertising, soliciting \npotential lessees, servicing existing leases, or other ancillary activities \nc. Costs related to activities that occur before the lease is obtained, such as \ncosts of obtaining tax or legal advice, negotiating lease terms and \nconditions, or evaluating a prospective lessee’s financial condition. \n55 Implementation Guidance and Illustrations \nGeneral \n> Illustrations \n>> Illustration of Initial Direct Costs \n55-239 Example 27 illustrates initial direct costs. \n>>> Example 27 —Initial Direct Costs \n55-240 Lessee and Lessor enter into an operating lease. The following costs \nare incurred in connection with the lease: \nTravel costs related to lease proposal $ 7,000 \nExternal legal fees 22,000 \nAllocations of employee costs for time negotiating lease terms and \nconditions 6,000 \nCommissions to brokers 10,000 \nTotal costs incurred by Lessor $ 45,000 \n \nExternal legal fees $ 15,000 \nAllocation of employee costs for time negotiating lease terms and \nconditions 7,000 \nPayments made to existing tenant to obtain the lease 20,000 \nTotal costs incurred by Lessee $ 42,000 \n55-241 Lessor capitalizes initial direct costs of $10,000, which it recognizes \nratably over the lease term, consistent with its recognition of lease income. \nThe $10,000 in broker commissions is an initial direct cost because that cost \nwas incurred only as a direc t result of obtaining the lease (that is, only as a \ndirect result of the lease being executed). None of the other costs incurred by \nLessor meet the definition of initial direct costs because they would have been \nincurred even if the lease had not been exec uted. For example, the employee \nsalaries are paid regardless of whether the lease is obtained, and Lessor would \nbe required to pay its attorneys for negotiating and drafting the lease even if \nLessee did not execute the lease. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 352}), Document(page\_content='Leases 352 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 55-242 Lessee includes $20,00 0 of initial direct costs in the initial \nmeasurement of the right -of-use asset. Lessee amortizes those costs ratably \nover the lease term as part of its total lease cost. Throughout the lease term, \nany unamortized amounts from the original $20,000 are included in the \nmeasurement of the right -of-use asset. The $20,000 payment to the existing \ntenant is an initial direct cost because that cost is only incurred upon obtaining \nthe lease; it would not have been owed if the lease had not been executed. \nNone of the other costs incurred by Lessee meet the definition of initial direct \ncosts because they would have been incurred even if the lease had not been \nexecuted (for example, the employee salaries are paid regardless of whether \nthe lease is obtained, and Lessee wo uld be required to pay its attorneys for \nnegotiating and drafting the lease even if the lease was not executed). \n \n5.5.10 Initial direct costs are incremental costs of a lease that would not have \nbeen incurred if the lease had not been obtained (i.e. not been executed). \n[842 Glossary] \n5.5.20 This section discusses the costs that meet the definition of initial direct \ncosts, and the accounting is discussed in sections 6.3 – 6.4 (lessees) and 7.3 – \n7.4 (lessors). The following are examples of costs that would typically be \nincluded in, or excluded from, initial direct costs. [842- 10-30-9 – 30-10, ASU 2016 -\n02.BC221 –BC222, BC304] \n \nTypical initial direct costs\nInclude Exclude \n— Commissions\n— Payments made to an \nexisting tenant to incentivize that tenant to terminate the lease— Legal fees\n— Costs of evaluating the \nprospective lessee ’s financial \ncondition \n— Costs of negotiating lease \nterms and conditions\n— General overheads \n \n Observation \nNarrowed definition of ‘initial direct costs ’ based on \ncontract acquisition costs guidance in Topic 606 \n5.5.30 The Board’s decisions on defining, allocating and accounting for initial \ndirect costs were intended to align the guidance on initial direct costs by a \nlessor with the guidance for costs to obtain a contract by a seller of similar \ngoods. [ASU 2016- 02.BC306 –BC307] \n5.5.40 Similar to the initial direct costs guidance in Topic 842, the contract cost \nguidance in Subtopic 340- 40 (other assets and d eferred costs related to \ncontracts with c ustomers): \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 353}), Document(page\_content='Leases 353 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — recognizes as a contract cost asset only those incremental costs to obtain a \ncontract that an entity incurs that would not have been incurred if that \ncontract had not been obtained; \n— allocates capitalized costs to the goods and ser vices to which they relate, \nand similarly relies on judgment to make that determination; and \n— amortizes contract cost assets on a systematic basis that is consistent with \nthe transfer to the customer of the goods or services to which the contract \ncost asset relates. The specific accounting for those costs that meet the \ndefinition of initial direct costs under Topic 842 is discussed in sections 6.3 \n– 6.4 (lessees) and 7.3 – 7.4 (lessors). \nSee chapter 12 of KPMG Handbook, Revenue recognition . \n5.5.50 The l ease payments might be an allocated amount when there are \nmultiple lease components, or when there is at least one non- lease com ponent \n(see paragraph 5.4.40). This might also be the case with initial direct costs – e.g. \nin a contract in which a commission is paid for the lease and the non- lease \ncomponent. Judgment is involved in determining whether costs, such as a \ncommission paid to a broker, relate to a lease component, a non- lease \ncomponent or both. Example s 5.5.20 and 5. 5.30 illustrate how this allocation \nmay work under Topic 842. [ASU 2016- 02.BC222, BC306] \n \n Question 5.5.10 \nPayments to existing lessee to induce early \ntermination \nAre payments made by a lessor to a lessee to induce early \ntermination of the lease agreement an initial direct cost? \nInterpretive response: In certain situations, yes. A payment to induce early \ntermination is an example of a potential initial direct cost. However, initial direct \ncosts are only those that are incurred as a result of obtai ning a lease. [842- 10-30-9] \nTherefore, in general, we believe these payments are initial direct costs if \nincurred in connection with a replacement lease. For example, to obtain a lease \nwith a new lessee that has been identified, the lessor may need the exi sting \nlessee to terminate its lease of the underlying asset ; in that case, we believe \nthe payment to the existing lessee is an initial direct cost of obtaining the \nnew lease. \nIn contrast, if a lessor offers to make a payment to a lessee to early terminate a lease solely because the current lease is at a below -market rate (i.e. the lessor \nwants to terminate an out -of-the-money lease) and does not have an identified \nnew lessee, the payment would generally not meet the definition of an initial direct cost. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 354}), Document(page\_content="Leases 354 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 5.5.20 \n‘Key money’ payments \nHow should a new lessee account for 'key money' payments \npaid to an existing lessee ? \nBackground: The term ‘key money payment’ is often used to describe a \nsituation in which a new lessee makes a payment to an existing lessee for the \nright to assume the existing lessee’s lease. \nThe new lessee makes a payment to the existing lessee to essentially buy the \noriginal lessee’s rights under the lease. The lessor is required to extend the \noriginal terms of the lease, which are generally favorable, to the new lessee, \nwhich is why the new lessee is willing to pay the existing lessee for the right to assume the lease. \nInterpretive response: Many lessees account for k ey money payments as \nintangible assets in the scope of Topic 350 (goodwill and other intangibles). Others account for these payments as initial direct costs. We believe either \naccounting approach is acceptable as an accounting policy election, which should be applied consistently. \nIntangible asset \nAmounts paid directly to an existing lessee are separate from the lease \nagreement negotiated with the landlord, and the accounting for such amounts \nis separate from the lessee 's lease accounting. Because it arises from \ncontractual and/or other legal rights, key money paid to existing tenants \nqualifies to be recognized as an intangible asset . \n[350- 30-25-4, 805- 20-25-10] \nIn general, the intangible asset will have a useful life equal to the lease term \nplus applicable option periods (not to exceed the economic life of the leased \npremises) , provided that there are no legal, regulatory, contractual or other \nprovisions limiting the useful life to a shorter period. [350- 30-35-3(c)] \nAmortization of the intangible asset should be over its useful life to its residual \nvalue. Because market conditions dictate the residual value, an entity should \nperiodically reassess its residual value estimate and, if necessary, prospectively \nadjust future amortization. \nThe SEC staff has previously not objected to these accounting conclusions . \nBecause Topic 350 was not amended with the issuance of Topic 842, we \nbelieve the SEC staff’s views remain relevant. \nInitial direct cost \nIf a lessee accounts for key money payments as an initial direct cost, they are \naccounted for in the same manner as any other initial direct costs. This means \nthat the payments are capitalized as part of the cost of the ROU asset, which \nwill be amortized to zero by the end of the lease term (see sections 6.3 and \n6.4). T herefore, the amortization period of the key money payment will not \nextend beyond the lease term. \n", metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 355}), Document(page\_content='Leases 355 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Changing accounting policy \nTopic 250 (accounting changes and error corrections) applies if a lessee elects \nto change its accounting policy for key money payments on or after adoption of Topic 842. \n \n Question 5.5.30 \nSales taxes as initial direct costs \nAre sales or other similar taxes ever initial direct costs? \nInterpretive response: No. This is regardless of whether (1) the entity is the \nlessee or the lessor , (2) the sales or other similar tax is a lessee cost or a lessor \ncost, and (3) the tax is incurred over the lease term or at or before lease \ncommencement. \n— Sales and other similar taxes do not meet the definition of an initial direct \ncost when they are inc urred over the lease term (e.g. assessed on, and as a \npercentage of, each lease payment) because they are not incurred solely as \na result of entering into the lease. \n— Sales and other similar taxes do not meet the definition of an initial direct \ncost even when incurred at or before lease commencement because they \nare not incurred solely as a result of entering into the lease. Rather, whether and how much sales tax is incurred depends, for example, on \ndecisions about where the underlying asset will be l ocated/operated. \nEven though sales and other similar taxes do not meet the definition of an initial direct cost, such taxes incurred at or before lease commencement may be \naccounted for in substantially the same manner as an initial direct cost. \n— A lessee that has elected an accounting policy to capitalize costs incurred to \nprepare the ROU asset for its intended use (see Question 5.1.10) will \ncapitalize the tax as part of the cost of the related ROU asset by analogy to \nTopic 360 (property, plant and equipment). In such case, like an initial direct \ncost, the cost of the tax will be amortized to expense over the lease term. \n— Sales or other similar taxes incurred by lessors that are not manufacturers \nor dealers in sales -type or direct financing leases will be included in the \nlessor’s net investment in the lease (see section 7.3.1). Consequently, the \naccounting for those tax costs will be substantially the same as if they were \nan initial direct cost (which is also included in the net investment in the \nlease – see paragraph 7.3.35). \nOperating lessors will not account for sales or other similar taxes incurred at or \nbefore lease commencement like initial direct costs, but also will not expense \nthe taxes when incurred. Generally, the tax will become part of the cost ba sis of \nthe underlying asset, and therefore recognized to expense over the asset’s \nuseful life. \nQuestion 4.2. 60 discusses lessee and lessor accounting for sales and other \nsimilar taxes in more detail. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 356}), Document(page\_content='Leases 356 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. \n Question 5.5.40 \nThird -party payments to a lessee for executing a \nlease \nHow does a lessee account for payments it receives from a \nthird party for executing the lease ? \nBackground: A lessee may be entitled to a payment from an unrelated third \nparty once a lease contract is executed. For example, the lessee may be \nentitled to a portion of the commission a broker receives from the lessor. \nInterpretive response: If other US GAAP applie s to the payment, that guidance \nshould be followed to account for the payment. For example, Topic 606 (revenue from contracts with customers) applies if the payment is for the lessee’s satisfaction of a performance obligation. \nHowever, if no other US GAAP applies, we believe it is appropriate for the \nlessee to treat the payment as a reduction in the carrying amount of the ROU asset, akin to a negative initial direct cost, reducing the cost of the lease over \nthe lease term. If the payment would reduce the c arrying amount of the ROU \nasset below zero, we believe the excess should be accounted for in the same \nmanner as a lease incentive that would result in a negative ROU asset (see \nQuestion 6.3.15). \n \n Example 5.5.10 \nCosts that are initial direct costs \nLessee LE and Lessor LR enter into a lease. The following are costs that they \nincur in connection with the lease. \nCost Incurred by: \nLE LR \nAllocation of employee costs to negotiate lease terms and \nconditions $ 5,000 $10,000 \nExternal legal fees 12,000 20,000 \nTravel costs related to inspecting the underlying asset 4,000 - \nCommission to tenant’s agent (LE) / listing agent (LR) 20,000 30,000 \nPayment made to existing tenant to terminate the lease - 20,000 \nLE has initial direct costs of $20,000 in connection with this lease that it \nincludes in the initial measurement of the ROU asset for the lease. \n— The $20,000 commission to the tenant’s agent is an initial direct cost \nbecause it is only incurred upon obtaini ng the lease – i.e. it would not have \nbeen owed if the lease had not been executed. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 357}), Document(page\_content='Leases 357 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — None of the other costs incurred by LE are initial direct costs, because they \nwould have been incurred even if the lease had not been obtained. For \nexample, employee salari es are paid regardless of whether the lease is \nobtained; therefore, the allocation of employee costs is not an initial direct cost. In addition, LE would be required to pay its attorneys for negotiating and drafting the lease even if the lease was not exec uted. \nLR has initial direct costs of $50,000. \n— The $30,000 listing agent commission is an initial direct cost for the same reason as it was for LE. In addition, the payment to the existing tenant of \n$20,000 to terminate the existing lease is an initial dire ct cost because it is \npaid only as a consequence of executing the new lease. \n— None of the other costs incurred by LR meet the definition of initial direct \ncosts, because they would have been incurred even if the lease had not \nbeen executed. The allocation of employee costs and the external legal \nfees are not initial direct costs to LR for the same reasons that they were \nnot initial direct costs to LE. \n \n Example 5.5.20 \nAllocation of initial direct costs (1) \nContinuing Example 5.4.10, Lessor LR’s standard practice is to pay a commission to its salesperson on the total value of the contract obtained. \nTherefore, LR concludes that the commission of $25 relates to both the lease \nand the maintenance services, and allocates the commission on the same bas is \nas the consideration in the contract. \nComponent Allocation Calculation \nLease (equipment) $20 25 × 80% \nNon-lease (maintenance) 5 25 × 20% \n $25 \nTherefore, LR has initial direct costs of $20. The $5 allocated to the \nmaintenance services is accounted for in accordance with the incremental costs \nto obtain a contract guidance in Subtopic 340- 40 (see chapter 12 of KPMG \nHandbook, Revenue recognition ). \n \n Example 5.5.30 \nAllocation of initial direct costs ( 2) \nLessee LE and Lessor LR enter into a five- year lease of retail space in a \nshopping center. In addition to providing a right to use the retail space, LR will \nprovide common area maintenance (CAM) . As a result, there are two \ncomponents of the contract: a lease component comprising the right to use the \nretail space, and a non- lease component comprisin g CAM. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 358}), Document(page\_content='Leases 358 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Annual rent payments are fixed at $1,000, while charges for CAM will be billed on \na proportionate basis to all tenants of the shopping center on a monthly basis. \nBoth LE and LR pay a broker commission of $250, which equals five percent of \nthe fixed rent payments in the contract. This percentage is the standard \ncommiss ion paid in this market for real estate leases, regardless of whether the \nlease is a gross lease or a net lease (see section 4. 2), and regardless of whether \nthe lease includes non- lease components like CAM. \nConsequently, both LE and LR conclude that the commission relates solely to \nthe lease component of the contract. The commission was incurred only as a \ndirect result of the lease being executed; therefore, the commission is an initial \ndirect cost to both LE and LR. \n \n Comparison to legacy US GAAP \nFewer costs of lease origination are initial direct costs under Topic 842 \n5.5.60 An entity’s initial direct costs for a lease are substantially less for many \nleases under Topic 842 than they were under Topic 840 . This is because \nTopic 842 defines initial direct costs as only those incremental costs of a lease \nthat would not have been incurred if the lease had not been obtained (i.e. not \nexecuted), while initial direct costs under Topic 840 also include d the following. \n— Other incremental costs that were incurred directly as a result of the lease, \neven if such costs were incurred to negotiate and arrange the lease, and \ntherefore would have been incurred even if the lease was not executed \n(e.g. external legal fees) . \n— A lessor’ s incurred costs, even if not incrementa l to the lease , directl y relate d \nto fulfilling specifie d activitie s to negotiat e or arrang e the lease . Thos e \nspecifie d activitie s were: \n— evaluating the prospective lessee’s financial condition; \n— evaluating and recording guarantees, collateral and other security \narrangements; \n— negotiating lease terms; \n— preparing and processing lease documents; and \n— closing the transaction. \nThe costs directly related to those activities include d only that portion of the \nemployees’ total compensation and payroll -related f ringe benefits directly \nrelated to time spent performing those activities for that lease and other \ncosts related to those activities that would not have been incurred but for \nthe lease. [840- 20-25-17 – 25-19] \n5.5.70 Because of the narrowed definition of initial direct costs, many entities \nwill recognize significant origination costs for a lease as incurred that they did \nnot recognize as incurred under Topic 840. Lessors in that situation will \nrecognize greater margins on their lease income earned over the lease term \n(e.g. operating lease income or interest income on their direct financing leases) \nas compared to Topic 840, while lessees will recognize less lease expense \nduring the lease term as compared to Topic 840. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 359}), Document(page\_content='Leases 359 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 5.5.80 The narrowed definition of initial direct costs in Topic 842 that does not \ninclude allocated internal costs may be simpler to apply than the definition in \nTopic 840 because entities no longer need to have processes and controls to \ntrack employee time spent on negoti ating and arranging leases. \n \n5.6 Discount r ate for the l ease \n Excerpt from ASC 842 -10 \n20 Glossary \nDiscount Rate for the Lease \nFor a lessee, the discount rate for the lease is the rate implicit in the lease \nunless that rate cannot be readily determined. In that case, the lessee is \nrequired to use its incremental borrowing rate . \nFor a lessor , the discount rate for the lease is the rate implicit in the lease. \nIncremental Borrowing Rate \nThe rate of interest tha t a lessee would have to pay to borrow on a \ncollateralized basis over a similar term an amount equal to the lease payments \nin a similar econ omic environment. \nRate Implicit in the Lease \nThe rate of interest that, at a given date, causes the aggregate present value of \n(a) the lease payments and (b) the amount that a lessor expects to derive \nfrom the underlying asset following the end of the leas e term to equal the \nsum of (1) the fair value of the underlying asset minus any related investment \ntax credit retained and expected to be realized by the lessor and (2) any \ndeferred initial direct costs of the lessor. However, if the rate determined in \naccordance with the preceding sentence is less than zero, a rate implicit in the \nlease of zero shall be used. \n \n Excerpt from ASC 842 -20 \n30 Initial Measurement \nGeneral \n> Discount Rate for the Lease \n30-2 The discount rate for the lease initially used to determine the present \nvalue of the lease payments for a lessee is calculated on the basis of \ninformation available at the commencement date . \n30-3 A lessee should use the rate implicit in the lease whenever that rate is \nreadily determinab le. If the rate implicit in the lease is not readily determinable, \na lessee uses its incremental borrowing rate . A lessee that is not a public \nbusiness entity is permitted to use a risk -free discount rate for the lease ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 360}), Document(page\_content='Leases 360 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. instead of its incremental borrowing rate, determined using a period \ncomparable with that of the lease term , as an accounting policy election made \nby class of underlying asset. \n30-4 See Example 2 (paragraphs 842- 20-55-17 through 55- 20) for an illustration \nof the requirements on the discount rate. \n 5.6.10 For a lessee, the discount rate for the lease is the rate implicit in the \nlease unless that rate cannot be readily determined. In that case, the lessee is \nrequired to use its incremental borrowing rate. For a lessor , the discount rate \nfor the lease is the rate implici t in the lease. [842 Glossary, 842- 10-25-4, 842-20-30-3, \n842-30-30-1] \n5.6.20 The discount rate for the lease is determined based on information \navailable at lease commencement. [842- 20-30-2] \n5.6.30 When the rate implicit in the lease is not readily determinable (see \nQuestion 5.6.20), a lessee that is not a public business entity is permitted to \nuse a risk- free discount rate for the lease, instead of its incremental borrowing \nrate, as an accounting policy election by class of underlying asset . The risk -free \nrate is determined using a period comparable to that of the lease term . [842- 20-\n30-3] \n \n Question 5.6.05 \nUse of a risk -free discount rate by certain public \nbusiness entities \nIs a lessee that is a ‘public business entity ’ solely because its \nfinancial statements or summarized financial information are \nincluded in a registrant’s SEC filing permitted to use a risk -\nfree discount rate for its leases ? \nBackground: An entity may qualify as a public business entity (PBE) solely \nbecause it s financial statements or summarized financial information is included \nin a registrant’s SEC filing (i.e. under Rule 3 -05, Rule 3- 09 or Rule 4 -08(g)). An \nentity that meets this definition of a PBE may adopt Topic 842 using the effective dates for ‘other entities’; see Question 13A.1.50 or Question 13B.1.50. \n[842 Glossary, 842- 10-S65-1] \nBecause of this effective date relief, the question arose about whether that \nsame entity is also permitted to use a risk -free discount rate for its leases as \ndescribed in par agraph 5.6.30. \nInterpretive response: No. The SEC staff has stated that it would not be \nacceptable for PBEs, including those that are the subject of this question, to discount their leases using the risk -free discount rate option available to entities \nthat are not PBEs . This includes leases that may have commenced before the \nlessee became a PBE. \n[CAQ SEC Regs Comm 10/2020] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 361}), Document(page\_content='Leases 361 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 5.6.06\*\* \nUse of risk -free discount rate during an IPO \nCan a private entity continue to use a risk- free discount rate \nfor its leases while undergoing an IPO? \nInterpretive response: No. When a private entity becomes a public company, it \nmust follow accounting standards and financial reporting guidelines for public \ncompanies established by the FASB and the SEC. During an IPO process, a \nprivate entity follows the accounting standards that apply to public business \nentities (PBEs) and the rules and regulations of the SEC. The entity converts its \nfinancial statements to the extent its financial statements as a private entity did \nnot reflect these requirements. This includes unwinding any pr ivate company \naccounting alternatives that were previously elected. \nTherefore, if an entity had previously elected the risk -free discount rate practical \nexpedient (see paragraph 5.6.30), it is required to recalculate and recast all \nprevious leases as if i t had always applied the discount rate guidance applicable \nto PBEs. For example, if an entity had determined the discount rate for a lease \nthat commenced two years prior using a 2% risk -free discount rate, it must \nreassess what its incremental borrowing ra te would have been at the \ncommencement date (e.g. 8%) and retrospectively account for the lease as if \nthat had always been the discount rate for the lease. \nThis is required even if the entity is an emerging growth company (EGC). \nBecause of this, a private entity that may become, or is contemplating \nbecoming, a public company should carefully consider the steps and processes \nneeded to unwind and convert its financial statements before electing the risk -\nfree rate practical expedient. \n \n5.6.1 Rate implicit in the lease \n5.6.40 The rate implicit in the lease is the rate of interest that, at a given date, \ncauses the aggregate present value of (a) the lease payments, and (b) the amount that a lessor expects to derive from the underlying asset following the \nend of the lease term to equal the sum of (1) the fair value of the underlying \nasset minus any related investment tax credit retained and expected to be \nrealized by the lessor, and (2) any deferred initial direct costs of the lessor. \nHowever, if the rate determined in accordance with this equation is less than \nzero, a rate of zero should be used. The rate implicit in the lease cannot be less than zero. \n[842 Glossary] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 362}), Document(page\_content='Leases 362 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. PV of l ease paymentsFV of\nunderlying asset1\nRate \nimplicit in \nthe leasePV of lessor ’s estimated \nfuture residual value3 Deferred IDCs2 \nNotes: \n1. For purposes of determining the rate implicit in the lease, the fair value of the underlying \nasset is reduced by the amount of any investment tax credit related to the underlying \nasset that is retained and expected to be realized by the lessor. [842 Glossa ry] \n2. Initial direct costs are not deferred (i.e. they are expensed at lease commencement) if the lease is a sales- type lease and the fair value of the underlying asset differs from its \ncarrying amount at lease commencement (see section 7.3 .1). \n[842-30-25-1(c)] \n3. If a lessee uses the rate implicit in the lease, the estimated future residual value excludes amounts probable of being owed by the lessee to satisfy a residual value guarantee, \nwhich are included in the lease payments (see section 5.4 .6). \n5.6.50 A lessor may be required to use three different discount rates to account \nfor a lease. \n— For purposes of assessing whether a lease is a sales -type lease (i.e. in \nmeasuring the present value of the lease payments and residual values \nguaranteed by the lessee), a lessor uses a rate implicit in the lease that \nassumes no initial direct costs will be deferred if, at lease commencement, \nthe fair value of the underlying asset is different from its carrying amount. \n[842- 10-25-4] \nNote: The lessor uses a rate implicit i n the lease that includes any initial \ndirect costs of the lessor if the fair value of the underlying asset equals its \ncarrying amount. \n— Then, if the lease is not a sales -type lease, to assess whether the lease is a \ndirect financing lease or an operating lea se, the lessor uses a rate implicit in \nthe lease that includes its initial direct costs regardless of whether the fair \nvalue of the underlying asset is different from its carrying amount. \n— A third discount rate may be used if the lease is a direct financing lease that \ngives rise to selling profit. In that case, the selling profit is deferred at lease \ncommencement as a reduction of the net investment in the lease (see \nparagraph 7.3.30). The lessor then uses a rate that would have resulted, at \nlease commencem ent, in the sum of (1) the lease receivable and (2) the \nunguaranteed residual asset equaling (a) the fair value of the underlying \nasset, less (b) the selling profit in determining how to accrete the net \ninvestment in the lease (see Example 7.3.40). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 363}), Document(page\_content='Leases 363 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 5.6.60 The rate ultimately used in determining lease classification is then used \nto initially measure the lessor’s lease receivable and unguaranteed residual \nasset if the lease is a sales- type or direct financing lease (see section 7.3.1 ). \n[842- 30-30-1] \n \n Example 5.6.10 \nLessor determination of the rate implicit in the lease \nLessee LE leases a new truck from Lessor LR for four years. \nThe following facts are relevant. \n— Under the contract, LE pays $24,000 per year, payable annually in advance. \n— LR estimates that the residual value of the truck will be $60,000 at the end \nof the four -year lease term. \n— The lease contains no transfer of ownership provisions, no lessee purchase option, no residual value guarantees and no renewal options. \n— There are no non- lease components (e.g. maintenance services) in the \ncontract. \n— LR incurs $6,000 in initial direct costs associated with executing the lease. \nThese costs will be deferred because LR’s purchase price to acquire the \ntruck at lease commencement (i.e. its carryi ng amount) equals its fair value \n($130,000) (see section 7.3). \n— LR will not retain any investment tax credit associated with the truck (see \nparagraph 5.6.40). \nThe rate implicit in the lease is the rate that balances the following equation, \nwhich is 5.892%: \nPV of l ease payments :\n$96,000FV of truck : \n$130,000\nRate \nimplicit in \nthe leasePV of LR ’s estimated \nresidual value : $60,000Deferred IDCs :\n$6,000\n5.892% \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 364}), Document(page\_content='Leases 364 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 5.6.10 \nSignificant variable lease payments that result in \nnegative implicit rate \nHow is the rate implicit in the lease determined when the \nlease includes significant variable lease payments? \nInterpretive response: For leases with significant variable lease payments (e.g. \nin some renewable energy and other arrangements – see Question 7.3.30), the \nundiscounted sum of (1) the lease payments and (2) the estimated residual \nvalue of the underlying a sset at the end of the lease term may be less than the \nunderlying asset’s fair value and/or carrying amount at lease commencement. As discussed in section 5.4 .1, this is because variable lease payments that do \nnot depend on an index or a rate are excluded from the lease payments. \nIn the event that the rate implicit in the lease would be negative in these \nvariable lease payments scenarios if applying the calculation in the first \nsentence of the definition of ‘rate implicit in the lease’ , an implicit rate of zero \nshould be used. \n[842 Glossary] \nA lessor should not, in such cases, use another discount rate for the lease such \nas the lessee’s incremental borrowing rate or a rate that estimates the variable \npayments. \n5.6.70 [Not used] \n \n Question 5.6.20 \nLessee use of the rate implicit in the lease – readily \ndeterminable \nWill the rate implicit in the lease be readily determinable for a \nlessee? \nInterpretive response: In all but rare cases, n o. This is because the rate implicit \nin the lease is an internal measure, specific to the lessor. To determine this \nrate, the lessee must know both (1) the lessor’s estimate of the residual value \nof the underlying asset (consistent with Topic 840) and (2) the amount of ‘ initial \ndirect costs ’ that the lessor will defer for the lease (see section 5.5) . \nThe lessor’s estimate of the residual value of the underlying asset will typically \nnot be readily determinable because it is based on the lessor’s specific \nexpectations about t he future. However, it may be determinable for some \nfinance leases if the lease includes a provision to convey the asset to the lessee \nat the end of the lease term through an automatic transfer of title or a bargain \npurchase option. In that case, the lessor’s estimated residual value would be zero. \nThe capitalizable initial direct costs incurred by the lessor will generally not be \nknown by the lessee because the costs incurred will be to a third party (e.g. a \nbroker) unrelated to the lessee. However, it is possible the lessee may be able \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 365}), Document(page\_content='Leases 365 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. to conclude that any reasonable estimate of those costs would not affect the \nimplicit rate. \nIt is also possible that in some cases, the lessee would be able to obtain \nrelevant information about the lessor’s estimated residual value and/or \ncapitalizable initial direct costs directly from the lessor. However, such cases \nare likely to be rare given the sensitivity of that information to the lessor. Even \nif the lessor does provide relevant information, the lessee must assess \nwhether this information is reliable and sufficient to determine the rate implicit \nin the lease. \nBecause lessees generally do not have access to both such pieces of information, the rate implicit in the lease will not be readily determinable and \nthey will use their incremental borrowing rate for nearly all leases. \n \n Question 5.6.25 \nLessee use of the rate implicit in the lease when it \nis zero for the lessor \nMust a lessee use the rate implicit in the lease when it is clear \nthat rate is zero ? \nBackground : If the rate implicit in the lease would be negative based on \napplying the calculation in the first sentence of the definition of ‘rate implicit in the lease’ , a rate of zero is used (see Question 5.6.10) . \n[842 Glossary] \nIn situations where the calculation would clearly result in a negative implicit rate \n(see Question 5.6.10 and Example 7.3.30), the question arises as to whether \nthe rate implicit in the lease is readily determinable to the lessee and therefore \nmust be used by the lessee as the discount rate for the lease. \nFor example, consider a ten- year lease of equipment with a 15- year economic \nlife. The lease payments are predominantly variable such that the lessor’s estimated residual value of the underlying asset at t he end of the lease term \nneeds to be most (or all) of the lease commencement date fair value of the underlying asset for the rate implicit in the lease to be positive. It is clear that \nthe lessor’s estimated residual value of the equipment two- thirds of th e way \nthrough the asset’s economic life would be a relatively minor portion of the \nasset’s commencement date fair value. \nInterpretive response: We are aware of different views in relation to this \nquestion. In the absence of further guidance from the FASB or the SEC staff, we believe that either of the views below is acceptable as an accounting policy \nelection. \nAs a practical matter, the response to this question may not have a significant \neffect on the lessee’s accounting. This may be because all of the pay ments in \nthe contract are variable, or because the effect of the difference between the implicit rate and the lessee’s incremental borrowing rate is insignificant – e.g. \nbecause the fixed component of the contractual payments is small . However, \nthe effect may not always be insignificant. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 366}), Document(page\_content='Leases 366 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. View 1: Yes, the implicit rate is readily determinable at zero and therefore \nmust be used \nUsing the background example, it is clear to the lessee that any realistic lessor \nestimate of residual value would result in a negati ve calculated implicit rate. \nTherefore, the lessor is required to use an implicit rate of zero. \nUnder this view, it is not important for the lessee to have the lessor’s actual \ninputs (see Question 5.6.20) to the implicit rate calculation. It matters only that \nthe rate is readily determinable because any realistic lessor estimate of residual \nvalue or deferred initial direct costs could not result in an implicit rate other than \nzero. \nView 2: No, the implicit rate is still generally not readily determinable \nUnder this view, the last sentence of the ‘rate implicit in the lease’ definition is interpreted differently from View 1. That sentence states, “However, if the rate \ndetermined in accordance with the preceding sentence is less than zero, a rate implic it in the lease of zero shall be used.” [Emphasis added] \n[842 Glossary] \nIn contrast to View 1, it is not enough for it to be clear that the calculated rate would be negative. The lessee must be able to readily determine the actual \nnegative rate that would result from the calculated formula in the definition (see \nQuestion 5.6.20) to determine that an implicit rate of zero must be used. \nThis view also considers that ASU 2018- 10, which amended the definition of \n‘rate implicit in the lease’ to create the impli cit rate ‘floor’ of zero, and the \nFASB’s public deliberations of the issue leading to this amendment, discussed the amendment solely in the context of lessors. Therefore, the FASB did not \nintend for the implicit rate ‘floor’ of zero to affect a lessee’s ac counting. \n \n5.6.2 Lessee’s incremental borrowing rate \n5.6.80 The incremental borrowing rate is the rate of interest that a lessee would \nhave to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment. \n[842 Glossary] \n \n Example 5.6.20 \nLessee determination of incremental borrowing \nrate (1) \nAssume the same facts as Example 5. 6.10, except that LE: \n— does not have readily available information to determine LR’s estimated residual value of the truck; or \n— has readily available information to determine LR’s estimated residual value, but does not know LR’s deferred initial direct costs. \nWithout both pieces of information, LE cannot determine the rate implicit in the lease. Therefore, LE uses its incremental borrowing rate as the discount rate for \nthe lease. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 367}), Document(page\_content='Leases 367 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. In determining the incremental borrowing rate, LE considers the rate of interest \nthat it would have to pay on a collateralized borrowing in an amount equal to the \nlease payments ($96, 000) under similar terms (e.g. over three years).1 \nLE also considers that it has an unsecured line of credit with a fixed rate of 7% \nas well as an eight -year term loan with the same national bank, secured by the \nassets of the company, with an original bala nce of $10 million and a fixed \ninterest rate of 4%. LE determines the most efficient way for it to arrive at a \nreasonable incremental borrowing rate is to request its bank to quote a rate for \na three- year loan of $96,000, secured by a commercial vehicle si milar to the \ntruck in the lease, to be repaid over the three years . LE reviews the quote, \nwhich is 5.5%, for reasonableness based on the current risk -free rate and its \ncredit history, and determines that the rate is reasonable. Therefore, LE uses a \n5.5% di scount rate to calculate the present value of the lease payments. \nNote: \n1. LE is paying the annual payments in advance so will have made its final payment at the \nbeginning of Year 4 of the lease, not at the end. \n \n Question 5.6.30 \nLessor vs. lessee discount rates \nWill lessors and lessees use the same discount rate for a \ngiven lease? \nInterpretive response: In general, no. This is because, absent rare \ncircumstances, the rate implicit in the lease used by the lessor and the lessee’s \nincremental borrowi ng rate used by the lessee will be different rates . \n \n Question 5.6.35 \nLessee credit rating \nCan a lessee with a good credit rating assume that its incremental borrowing rate is the same for all leases? \nInterpretive response: No. The definition of incremental borrowing rate \nindicates that it is a rate specific to the lessee, equivalent to what the lessee \nwould have to pay to borrow the ‘lease payments’ on a collateralized basis. \nCredit rating is only one of many factors that lenders consider when \ndetermining how much and at what rate to lend funds to an entity. Generally, \ninterest rates are inversely related to an entity’s credit rating – i.e. the higher \nthe credit rating, the lower the interest rate as it is less likely that a borrower (or \nlessee) with a high credit rating will default on a payment. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 368}), Document(page\_content='Leases 368 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Many factors affect an entity’s credit rating, such as: \n— borrowing and payment history; \n— length of credit history; \n— evidence of default; \n— current ability to repay debts; and \n— future economic outlook. \nTherefore, an entity’s credit rating is subject to change over time and may not \nbe the same at the commencement date of each of its leases. \n \n Question 5.6.40 \nDetermining the discount rate for a portfolio of \nleases \nCan an entity determine a discount rate for a portfolio of \nleases? \nInterpretive response: In some circumstances, yes. As discussed in \nsection 5.8, the Board concluded that the leases guidance in Topic 842 c an be \napplied at a portfolio level by lessees and lessors in some circumstances , rather \nthan on a lease- by-lease basis. \nThe Basis for C onclusions to ASU 2016- 02 and Example 2 in Subtopic 842 -20 \nhighlight that the Board expects that some lessees will be able to use a \nportfolio approach to determine the discount rate for their leases with similar \ncharacteristics. This is permitted if doing so would not materially affect the \nlessees ’ accounting for those leases to which a single discount rate is applied . \nIn the Board’s view, applying a portfolio approach to determine the discount \nrate alleviate s some of the concerns that entities expressed about determining \n(and documenting the basis for) a separate incremental borrowing rate for every \nlease. [842- 20-55-18 – 55-20, ASU 2016- 02.BC201] \nFrom a practical standpoint, an entity may be able to document which discount \nrate to apply for certain portfolios of leases, considering characteristics such as \nlease term, lease currency and geographic location. It could then apply a \ndiscount rate to a portfolio of leases with similar characteristics. The entity \nwould need to design controls around portfolio discount rates to ensure that \nsuch rates are applied only to leases with similar characteristics and that the \nrates are u pdated periodically based on changes in the interest rate \nenvironment and other relevant factors. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 369}), Document(page\_content='Leases 369 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 5.6.50 \nSubsidiary’s use of parent (or group) incremental \nborrowing rate \nIn determining the discount rate for the lease, can a \nsubsidiary use the incremental borrowing rate of its parent ? \nInterpretive response: In some cases, yes. It might be acceptable for a \nsubsidiary that is the lessee in a lease to use the incremental borrowing rate of \nits parent (or consolidated group) as the discount rate for a lease. The basis for \nconclusions to ASU 2016- 02 states this might be appropriate when the \nsubsidiary does not have its own treasury function ( i.e. all funding for the group \nis managed centrally by the parent entity) and the negotiations with the lessor \nresult in the parent entity providing a guarantee of the lease payments to the \nlessor. In that case , the pricing of the lease is more significantly influenced by \nthe credit standing of the parent than that of the subsidiary. [ASU 2016 -02.BC201] \nHowever, we do not believe the parent must guarantee the lease payments for \nthe subsidiary to use the parent (or group) incremental borrowing rate. \nExample 2 in Subtopic 842 -20 concludes that the subsidiaries in the example \nshould use the parent’s incremental borrowi ng rate because the treasury \nfunctions of the group are conducted centrally (i.e. by the parent, rather than by \neach subsidiary) such that the pricing of the lease was influenced by the \ngroup’s credit standing and profile, rather than that of the subsidiar ies entering \ninto the leases. [842- 20-55-18 – 55-20] \nGiven the guidance in Topic 842 and the associated basis for conclusions to \nASU 2016- 02 taken as a whole, we believe Topic 842 establishes a principle \nthat use of the parent (or group) incremental borrowing rate is appropriate if the \ncredit standing and profile of the parent (or group) more significantly affect the \npricing of the lease than the credit standing and profile of the subsidiary \nentering into the lease. \n \n Question 5.6.51 \nAdjustments to parent (or group) incremental \nborrowing rate \nCan a subsidiary ignore adjustments it would otherwise make \nin determining its incremental borrowing rate if using a parent (or group) incremental borrowing rate? \nBackground: Consider a scenario in which a subsidiary enters into a lease in \nBrazil and the parent guarantees the lease payments. The parent has recently \ncommenced similar leases (e.g. same type of underlying asset, similar lease \nterm) in the US and in Europe, but not in Brazil. \nConsistent with Questi on 5.6.50, the subsidiary concludes that it is appropriate \nto use the parent’s incremental borrowing rate (IBR) when determining the \ndiscount rate for its Brazilian lease. The question arises as to whether the \nsubsidiary can use the parent’s IBR determined for its recently commenced, \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 370}), Document(page\_content="Leases 370 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. similar US or European leases without adjustment for the different currency of \nthe lease and the different economic environment (Brazil compared to the US or \napplicable countries in Europe). \nInterpretive response: No. If a pare nt (or group) IBR is based on a lease that \ndiffers from the subsidia ry lease in question (e.g. with respect to currency, \neconomic environment, payment structure or lease term), the subsidiary must adjust the parent (or group) IBR just as it would if using a reference rate based \non a borrowing that differs from the lease. Question 5.6.67 provides example \nadjustments to consider w hen a lessee estimates its IBR from a starting point \nof its existing unsecured borrowings. The same types of adjustments may apply \nwhen a subsidiary starts from a parent’s (or group’s) IBR . \nIn the background example, while the parent (group) IBR for recent, similar leases may be a valid starting point for determining the IBR for the subsidiary’s \nBrazilian lease, the subsidiary should adjust that rate for the effects of foreign \ncurrency and the different economic environment (Brazil compared to the US or \napplicable countries in Europe) as described in Question 5.6.67. \n \n Question 5.6.55 \nIncremental borrowing rate for a lease \ndenominated in a foreign currency \nHow should a lessee determine its incremental borrowing \nrate for a lease denominated in a currency that is different from its functional currency? \nBackground: In some cases, a lease contract may be denominated in a \ncurrency that is different from the company’s functional currency – i.e. the \ncurrency of the primary economic environment in which the entity operates. For \nexample, a company could have an equipment lease denominated in Japanese \nYen, but a functional currency of the US Dollar. \nInterpretive response: The lessee should use a rate at which it would borrow \nin the same currency as that in which the lease is denominated. Therefore, in \nthe background example, the entity would consi der the secured borrowing rate \nit could obtain to borrow an amount of Yen equal to the Yen- denominated lease \npayments over the lease term (see Example 5.6.30). \n \n Question 5.6.60 \n‘Cost of money’ as a potential discount rate \nCan an entity use its 'cost -of-money' rate as the discount rate \nfor the lease? \nInterpretive response: No. The cost -of-money rate used to reimburse entities \nthat are required to comply with the Cost Accounting Standards and the Federal \n", metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 371}), Document(page\_content='Leases 371 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Acquisition Regulation is not an appropriat e proxy for the discount rate for the \nlease. This is because it is not necessarily linked to the lessor’s implicit rate or \nto the lessee’s incremental borrowing rate. [ASU 2016- 02.BC202] \n \n Question 5.6.65 \nSecured and unsecured funding sources to \ndetermine the incremental borrowing rate \nShould a lessee consider secured and unsecured borrowings \nwhen determining its incremental borrowing rate? \nBackground: Under Topic 840, a lessee’s incremental borrowing rate was the \nrate the lessee would have incurred to borrow over a similar term the funds \nnecessary to purchase the leased asset. Topic 840 did not require use of a \nsecured rate; rather, it allowed lessees to consider both secured and unsecured \nfunding sources when determining their incremental borrowing rate. \nUnder Topic 840, lessees may have used a weighted- average rate that \nconsidered secured and unsecured funding sources when they concluded that secured funding would be li mited by a loan -to-value ratio of less than \n100 percent. \nInterpretive response: No. Topic 842 requires the use of a secured rate – i.e. \nthe definition of ‘incremental borrowing rate’ states explicitly that the rate should assume borrowing the lease payments ‘on a collateralized basis’. This \nmeans that the lessee should assume its borrowing of the ‘lease payments’ is 100 percent collateralized (i.e. secured). Therefore, unsecured funding sources \nshould not be used to determine the incremental borrowing rate without \nadjusting for the effect of collateral (see Question 5.6.66). \n[842 Glossary] \nQuestion 5.6.67A discusses whether an over -collateralized reference rate must \nbe adjusted for the effect of over -collateralization. \nTopic 842 does not specify what collateral may be considered when evaluating what a collateralized borrowing rate would be; therefore, the collateral is not \nlimited to the underlying asset. For further discussion about collateral when \nestimating the incremental borrowing rate, see Question 5.6.65A. \n \n Question 5.6.65A \nCollateral to use in estimating incremental \nborrowing rate \nWhat should a lessee assume as collateral when estimating its \nincremental borrowing rate? \nInterpretive response: In general, we believe it is acceptable to assume the \ncollateral to the lease is the underlying asset. This is because the FASB’s basis \nfor requiring a fully collateralized discount rate was that the lessor generally has \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 372}), Document(page\_content='Leases 372 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. recourse to the underlying asset – i.e. it has the right to repossess the \nunderlying asset in the event of lessee non- payment. \nHowever, Topic 842 does not specify what collateral may be considered when \nevaluating what a collateralized incremental borrowing rate would be; therefore, \nas affir med in discussions with the FASB staff, we believe the assumed \ncollateral is not limited to the underlying asset. In general, any form of collateral \navailable to the lessee and that would be expected to be acceptable to a lender \nin lieu of the underlying a sset (e.g. because it is expected to have similar or \ngreater liquidity than the underlying asset) can be considered. \nAs discussed in Question 5.6.67 (see ‘ Effect of collateral’ ), the quality of the \nassumed collateral may affect the incremental borrowing ra te. That is, the \nhigher the quality of the assumed collateral, the lower the incremental \nborrowing rate is likely to be. \n \n Question 5.6.66 \nLessee borrows only on an unsecured basis \nCan unsecured funding sources be used as an input to \nestimate the lessee ’s incremental borrowing rate? \nInterpretive response: Yes. As discussed in Question 5.6.65, a lessee’s \nincremental borrowing rate must assume that the borrowing of the ‘lease \npayments’ is 100% collateralized. However, if the lessee does not have \nsecured (i .e. collateralized) borrowings, it may use its unsecured (i.e. non-\ncollateralized ) borrowings as an input to derive an appropriate incremental \nborrowing rate. \nFor example, the full recourse rate that a lessee is charged on unsecured borrowings may serve as the starting point for determining the lessee’s \nincremental borrowing rate. However, the rate indicated by those unsecured \nborrowings should be adjusted for t he effect of designating collateral (security) \nfor the lease. \nWhen the starting point for the incremental borrowing rate determination is a n \nunsecured rate, the adjustment for the effect of designating collateral to the \nlease ‘borrowing’ should result in a lower rate than the unsecured starting point. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 373}), Document(page\_content='Leases 373 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 5.6.67 \nAdjustments to reach an appropriate incremental \nborrowing rate \nWhat adjustments might a lessee need to make when \nestimating its incremental borrowing rate if it starts with its \nexisting unsecured borrowings ? \nBackground : As outlined in Question 5.6.66, a lessee that does not have \nsecured (i.e. collateralized) borrowings may use its unsecured (non-\ncollateralized) borrowings as an input to derive an appropriate incremental \nborrowing rate (IBR). For example, the rate a lessee is charged on one or more \nrelevant unsecured borrowings may serve as a starti ng point for estimating the \nIBR. However, a n existing borrowing may not be relevant – i.e. may not provide \ninformation relevant to esti mating the IBR for a lease. For example, a borrowing \nwith a term vastly different from the lease term may not provide a logical \nstarting point for estimatin g the IBR for the lease. \nInterpretive response: From the starting point of an unsecured borrowing \n(reference borrowing), the lessee should adjust for differences between the \nreference borrowing and the lease, assuming they have a material effect on \nthe IBR. \nNecessary adjustments may include all of the following (not exhaustive). It is possible that a lessee will not need to make all of these adjustments to achieve \na materially appropriate IBR, even if each item is a difference between the \nreference borrowing and the lease. \n— Effect of collateral. In general, adding collateral (or security) to an unsecured borrowing rate will decrease the IBR being estimated for the \nlease, because it reduces the risk to the lender (i.e. the lessor). The effect \nof the adjustment may be affected by the quality of the lessee’s collateral. \n— Payment structure. The payment structure of the reference borrowing may differ from that of the lease. For example, a reference borrowing may \nrequire interest -only payments until maturity (when all of the principal must \nbe repaid), while the lease payments repay principal throughout t he lease \nterm. Because the payment structure of the lease in this case returns \ncapital to the lender sooner, reducing its risk, the lender would typically \nrequire a lower rate of interest on the borrowing. Therefore, all other things \nbeing equal, in this example the IBR estimated for the lease should be \nlower than the interest rate on the note. \n— Prepayment features. If the reference borrowing includes lessee and/or \nlessor prepayment options and the lease does not, the effect of those \nprepayment options on the interest rate of the borrowing should be \nremoved from the estimated IBR. The effect of prepayment options can \noften be obtained from third- party financial data providers. \n— The lease term. If the lease term differs from the term of the reference \nborrowing (e.g. a 3- year lease term compared to a 7 - or 10- year note), the \nIBR should be adjusted to reflect the effect on the rate of the different \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 374}), Document(page\_content='Leases 374 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. term. It may frequently be the case that a shorter term lowers the \napplicable interest rate because of the decreased risk to the lender. \n— Economic environment. Both of the following reflect example economic environment considerations. \n— Changes from passage of time. If the reference borrowing was \nentered into significantly before the lease commencement date, changes in the economic environment (e.g. changes in the overall \ninterest rate environment) in the intervening period generally need to be \nconsidered and adjusted for. \n— Different economic environment. The discount rate for a lease must \nconsider the economic environment in which it was entered into. If this \ndiffers from the economic environment of the market in which the \nlessee entered into its reference borrowing, those economic \ndifferences generally must be accounted for. For example, prevailing \ninterest rates or other borrowing costs in one country or region may not be the same as those in another country or region. \n— Foreign currency. A lessee should use an IBR tha t reflects the interest rate \nat which it could borrow in that foreign currency (see Question 5.6.55) . If \nthat differs from the rate at which it could presently borrow in the currency of the reference borrowing, an adjustment generally needs to be made. \n— Lessee renewal options. If a lessee elects an accounting policy to \nconsider its ability to renew/extend the lease in determining its discount rate for the lease (see paragraph 6.6.140), unless the reference borrowing \nalso includes similar renewal/extension options, the lessee will need to \nconsider that difference between the reference borrowing and the lease \nwhen making adjustments to the IBR. \n \n Question 5.6.67A \nOver -collateralization \nIs a lessee required to adjust its incremental borrowing rate if \nit reflects over -collateralization? \nBackground: Frequently, as discussed in Question 5.6.67, a lessee may use an \nunsecured (non -collateralized) borrowing as an input to derive its incremental \nborrowing rate (IB R). \nHowever, a lessee may also have one or more secured (collateralized) \nborrowings to use as inputs to estimate its IBR, and it is possible that the \nreference borrowing is over -collateralized. For example, any ‘reference \nborrowing’ (see Question 5.6.67) for which the proceeds are less than the \nsecured principal balance (e.g. the borrower received $90, but is required to \nprovide collateral necessary to secure the $100 principal balance) could be \nconsidered over -collateralized. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 375}), Document(page\_content='Leases 375 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. If a lessee uses an over -collateralized reference borrowing as the starting point \nfor its IBR estimation, the question arises as to whether the lessee must adjust \nfor the effect of over -collateralization. \nInterpretive response: No. While we believe it would be acceptable to adjust \nfor over-collateralization of a reference borrowing when estimating IBR, we do \nnot believe Topic 842 requires a lessee to adjust for the effect of using an over -\ncollateralized reference borrowing starting point. \nWhile Topic 842 is explicit that the lessee’s IBR must be a fully collateralized \nrate (the FASB affirmed its intent on this point at a November 2017 Board \nmeeting), there is no explicit guidance, nor has the FASB commented on, \nwhether an adjustment to the IBR must be made for the effect of over -\ncollat eralization. Thus, we do not believe making an adjustment to the IBR for \nover-collateralization is required. \n \n Question 5.6.67B \nAnomalous incremental borrowing rate \nIs it appropriate to attempt to ‘normalize’ an incremental \nborrowing rate that appears anomalous? \nBackground: A lessee’s incremental borrowing rate (IBR) is a point -in-time \nestimate made at lease commencement, the effective date of a lease \nmodification or the date of certain lessee remeasurements. \nThat point -in-time estimate may appear anomalous – i.e. abnormally high or \nabnormally low – if the estimation date occurs during an expected short -term \nperiod of economic instability (e.g. due to COVID -19). The rate may appear \nanomalous because of a sudden change in (1) interest rates and/or (2) the \nlessee’s borrowing costs (e.g. because its credit rating declines, or because it has drawn down on all existing credit facilities). \nAn IBR determined during such periods may be anomalous to IBRs determined \nduring other periods or what the lessee forecasts its IBR will be again in the \nnear future. \nInterpretive response: No. Although the IBR may in fact be anomalous, we do \nnot believe it is appropriate to attempt to normalize the rate with adjustments \nthe lessee would not otherwise make. \nFor example, if a key input to the IBR is the current risk -free rate (e.g. US \ntreasury bond rate), to which the lessee adds an appropriate credit spread (see \nQuestion 5.6.68), the lessee should not use an average of risk -free rate s from \ndifferent points in time to adjust for a current risk -free rate that is perceived to \nbe abnormally high or abnormally low. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 376}), Document(page\_content='Leases 376 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 5.6.68 \nExisting borrowing as a starting point for \nestimating the incremental borrowing rate \nIs a lessee required to estimate its incremental borrowing \nrate by adjusting to/from an existing borrowing? \nInterpretive response: No. While we believe a lessee may estimate its \nincremental borrowing rate by making adjustments to the interest rate on an \nexisting borrowing, it is not required to take that approach. \nFor example, as illustrated in Example 5.6.30, it may instead be that the lessee \nwill use relevant market and other indications to calculate a credit spread, which \nis the difference in yield between a risk- free debt s ecurity such as a US \nTreasury bond and another debt security with the same maturity but of lesser quality . The lessee then adds the calculated credit spread to an appropriate risk -\nfree rate. The appropriate risk -free rate plus the calculated credit spread will \nequal the incremental borrowing rate to be used as the discount rate for the \nlease. \nThe appropriate risk -free rate to use will depend on the facts and \ncircumstances. For example, as illustrated in Example 5.6.30, the currency in \nwhich the lease is denominated may influence the risk -free rate that should be \nused. \nAs a final note, while we believe a lessee is not required to adjust from an \nexisting borrowing when estimating its incremental borrowing rate, if a lessee \nhas existing publicly traded debt, we believe it would generally not be \nappropriate for the lessee to ignore current market indications about that debt \nwhen estimating its incremental borrowing rate. \n \n Example 5.6.30 \nLessee determination of incremental borrowing \nrate (2) \nTopic 842 does not provide specific guidance for estimating the incremental borrowing rate (IBR) for a lease. Therefore, the following example is not \nnecessarily the only acceptable method for doing so, and the adjustments \nillustrated may not be the only adjustments that a lessee may need to consider. \nBackground \nIn January Year 9, Lessee LE enters into an airplane lease with Lessor LR, a \nJapanese entity . The lease has a non- cancellable term of 10 years with an \noption for LE to renew the lease for an additional 5 years . At lease \ncommencement, it is not reasonably certain that LE will exercise the renewal \noption. LE agrees to pay LR ¥ 40 million (Japanese yen) per year in arrears for \nthe right to use the airpla ne. \nThe rate implicit in the lease is not readily determinable, and LE is not eligible \nfor (or has elected not to use) the risk -free discount rate practical expedient. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 377}), Document(page\_content='Leases 377 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Therefore, LE needs to estimate and use its IBR as the discount rate for the \nlease. \nEffect of LE renewal options \nLE has made a policy election not to consider lessee options to extend the lease that it is not reasonably certain to exercise when estimating the IBR for its \nleases. If LE were to do so, this would affect its IBR estimation. Additionally, \nLE’s election means that if the lease term subsequently changes for this lease, \nthe discount rate for the lease will be updated when remeasuring the lease (see \nparagraph 6.6.140). \nObservable starting points \nLE has a corporate BBB credit rating, and has had that same credit rating for the \npast 5 years. \nIn addition, LE has two borrowings outstanding: \n— A short -term revolving credit facility with a maximum drawdown of \n$45 million paying a floating interest rate of LIBOR plus 175 basis points, \npayable quarterly and secured by the receivables and inventory of LE. \n— A 15-year $50 million senior, unsecured note, issued in February Year 6, \nwith a fixed interest rate of 5.12% per annum. Interest is payable semi -\nannually and principal is repaid at matur ity. The senior note is prepayable by \nLE without a penalty. \nEstimating LE’s IBR \nIn estimating the IBR for its airplane lease with LR, LE considers the definition of IBR and estimates the rate of interest that it would have to pay on a fully \ncollateralize d basis to borrow an amount equal to the total lease payments \n(¥400 million) , repaid in equal payments over 10 years , as of the lease \ncommencement date (estimation date) . \nIn the absence of a borrowing that directly matches the requirements of the \nIBR defi nition, LE will use its own borrowings and market reference points to \nestimate the IBR. LE considers observable inputs as of the estimation date, including its credit rating, existing borrowings and other relevant borrowing \nrates, such as risk- free rates l ike the US Treasury rate or the Japanese \nGovernment Bond rate. \nLE notes that none of those observable inputs provide an appropriate IBR \nwithout adjustment. Using an unadjusted risk -free rate is not appropriate; LE’s \ncredit rating implies a substantially higher borrowing rate than the risk -free rate. \nCommon items for which adjustments to observable market reference points \nmay be necessary include the following (not exhaustive) – see Question 5.6.67: \n— the effect of prepayment or other options in reference debt yields (when \nsuch options do not exist in the lease); \n— the effect of security or collateral – e.g. when the market reference point is \nthe pricing of an unsecured borrowing; \n— level payment (amortizing) structure (versus a structure that repays all of the principal at maturity); \n— lease term – e.g. if shorter or longer than the term(s) of the lessee’s \nexisting borrowing(s); and/or ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 378}), Document(page\_content='Leases 378 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — lease payments denominated in a currency different from the currency of \nthe lessee’s existing borrowings or other market refer ence points. \nFor this lease, items for LE to consider include : \n— LE’s senior unsecured borrowings : \n— have prepayment options; and \n— are not secured ( collateralized ). \n— LE’s borrowings and the risk -free rates identified repay principal at the end \nof the borrowing period, rather than over the borrowing period; \n— LE’s borrowings are for terms that differ from the 10- year lease term ; \n— None of LE’s borrowings are in Japanese Yen; and \n— LE’s borrowings (and the rates reflected in those borrowings) were obtained significantly before the lease commencement date. \nSubject to materiality, LE must make an adjustment from one or more of its \nobservable reference points to arrive at an appropriate IBR for each of the \nabove items. Judgment will be needed to estimat e the effect of each \nadjustment. LE may require assistance from qualified treasury or valuation \nspecialists. \nScenario 1: LE unsecured debt is publicly traded \nAfter considering available observable market inputs, LE decides that \ninformation about its 15- year senior unsecured n otes provides the best starting \npoint (or basis) for estimating its IBR for the subject lease. If a traded market \nindication reflecting this LE unsecured debt is available as of the e stimation \ndate, it must be considered, because it will have a yield observation that \nreflects current market conditions ( see Step 1 below). \nLE concludes that its revolving credit facility reflects a borrowing that is too short -term to be adjusted to the lease term and may or may not reflect a \ncurrent market spread over LIBOR for LE. Risk -free rates do not reflect LE’s \nborrowing rates . \nGiven the choice of starting point, LE takes the following steps to estimate the IBR. In this case, LE decides to estimate an appropriate credit spread (Steps 1-\n4) and add that to an appropriate risk -free rate (Step 5) to arrive at its IBR. \nStep Adjustment1 \nStep 1: Estimate a credit \nspread reflecting the credit \nworthiness of LE. Because the senior unsecured debt is traded, an \nindication of the credit spread for the debt as of the estimation date, remov ing the effect of prepayment \noptions , can be obtained directly from third- party \nfinancial data providers. \nStep 2: Adjust the credit \nspread for payment \nstructure. \n The credit spread obtained in Step 1 represents the \nspread appropriate for a series of interest payments over 12 years (time until maturity of the unsecured \nnote issued in Year 6 ), and then repayment of the \nprincipal at the maturity date. \nThe payment structure of the note does not reflect \nrepayment of principal over its term; therefore, the \ncredit spread should be adjusted to reflect the creditworthiness of LE assuming this repayme nt \nstructure. This adjustment lowers the credit spread, ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 379}), Document(page\_content='Leases 379 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Step Adjustment1 \nbecause payments returning cash to the lender \nsooner reduce lender risk. \nStep 3: Adjust the credit \nspread for the effect of \nsecurity (collateral). The duration- adjusted credit spread reflects an \nunse cured borrowing. An adjustment should be made \nto reflect s ecurity ( collateral). Adding s ecurity to an \nunsecured note decreases the credit spread, leading \nto a lower overall IBR when added to the risk -free rate \nin Step 5. \nStep 4: Adjust for the term \nof the lease. The unsecured note credit spread, adjusted in Steps 1 \nto 3, should be further adjusted to reflect a maturity \nsimilar to the 10 -year lease term. \nStep 5: Add risk -free rate. The credit spread (see Steps 1 through 4), is added to \na level payment adj usted risk -free rate with a 10- year \ntenor. Because the lease payments are in Japanese \nyen, a Japanese sovereign yield is used in this step \n(rather than, for example, a US Treasury rate).2 \nThe credit spread added to the level payment \nadjusted risk -free rat e is the estimated IBR for the \nlease in this example. \nNotes: \n1. Quantifying the effect on the IBR (e.g. in terms of basis points to add or deduct from the \nrate being calculated) will be specific to the facts and circumstances, and may require the \nassistance of qualified treasury/valuation specialists. \n2. Although not the general case, in some markets there is evidence that translation of the \nspread may be warranted. This can be apparent when an issuer issues bonds with the \nsame terms, on the same day in two different countries, but the par interest rate is \ndifferent. In th ese cases, consultation with a specialist may be advisable. \nScenario 2: LE unsecured debt is not publicly traded \nIn this scenario, if the entity has a credit rating that is current as of the \nestimation date, the rating may be used to obtain generic mark et yields or \nspreads from third- party financial data providers to perform Step 1. \nIf no credit rating is available, it is possible to use the interest rate on LE’s debt \nas of the issuance date in Year 6 to imply a credit rating by obtaining the generic \ncredit rating curve with a yield at the maturity of the unsecured debt that is \nclosest to the interest rate of the unsecured note (5.12%). If it is reasonable to \nassume no changes to LE’s credit position, the generic rate available for this \ncredit rating at the estimation date may be a good starting point for Step 1. If \nthere is no way to determine whether there have been changes to LE’s credit \nprofile, then establishing a synthetic (or shadow) credit rating may be required \n(see Scenario 3). \nOnce Step 1 has been completed, the remaining steps are substantially the \nsame as those outlined in Scenario 1. \nScenario 3: LE has no issued debt \nIn this scenario, LE has no outstanding borrowings, and therefore a synthetic \ncredit rating as of the estimation date needs to be developed. A synthetic credit \nrating is an internally generated rating based on factors that a credit rating \nagency (or similar) would typically analyze when establishing an entity’s credit ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 380}), Document(page\_content='Leases 380 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. rating. This synthetic credit rat ing may be estimated (e.g. by a specialist) or \npotentially provided by a bank. Once a rating is estimated, it can be used to \nobtain relevant, comparable market information, such as market implied credit \nspreads for entities with a similar credit profile or yields as of the estimation \ndate. These observable market indications may be a good starting point for \nStep 1. \nOnce Step 1 has been completed, the remaining steps are substantially the \nsame as those outlined in Scenario 1. \n \n Example 5.6.40 \nLessee elects risk -free discount r ate practical \nexpedient \nThis example assumes the same facts and circumstances as in Example 5.6.30, \nexcept that LE is a private company (LE is not defined as either a private or a \npublic company in Example 5.6.30). \nAs a private company, LE elects the risk- free discount rate practical expedient \nfor its leases of airplanes. In addition to selecting a risk -free rate for a period \ncomparable to the 10 -year lease term, LE considers that the lease is \ndenominated in Japanese yen. Therefore, LE uses the same 10- year Japanese \nsovereign yield used in Step 5 of Example 5.6.30, Scenario 1. \n \n Question 5.6.69 \nNegative incremental borrowing rates \nCan the incremental borrowing rate for a lease be negative ? \nInterpretive response: Yes. While we would not expect it to be common, \nthere is nothing in Topic 842 that precludes that result. A negative incremental \nborrowing rate may result if the lease payments are denominated in the \ncurrency of a jurisdiction that i s experiencing negative interest rates at the lease \ncommencement date. \nHowever, even if the lessee starts from a negative interest rate starting point \n(e.g. a negative risk -free interest rate – see Question 5.6.68), adjustments to \nthat starting rate such as those described in Questions 5.6.67 and 5.6.68 may \nresult in the final incremental borrowing rate being positive. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 381}), Document(page\_content='Leases 381 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 5.6.69A\*\* \nNegative risk -free discount rates using practical \nexpedient \nWhen using the risk -free rate practical expedient, can the \ndiscount rate for a lease be negative? \nBackground: Question 5.6.69 observes that a lessee’s incremental borrowing \nrate can be negative. As private entities have adopted Topic 842, the question \nhas arisen about whether the discount rate for a lease determined using the \nrisk-free rate practical expedient (see paragraph 5.6.30) can also be negative. \nSuch a result could arise for similar reasons as described in Question 5.6.69. \nInterpretive response: Yes. Like with a negative incremental borrowing rate, \nthere is nothing in Topic 842 that precludes that result. \nIn addition, we do not believe it would be appropriate to avoid this outcome, for \nexample, by: \n— not using a risk -free discount rate when the les see has previously elected \nthe practical expedient for other leases of that class of underlying asset; \n— using an inappropriate risk -free rate (e.g. from another jurisdiction or using a \nrate for a term not comparable to the lease term); or \n— otherwise adjust ing the rate (including using a floor of zero). \n \n Question 5.6.70 \nGrant received by lessor from a government agency \nHow does a grant received by a lessor from a government \nagency as an incentive to build an underlying asset affect the asset’s fair value? \nInterpretive response: The fair value of an asset is not affected by a grant \nreceived by a lessor from a government agency to build the asset that is not \nongoing or recurring. Fair value is defined as the price that would be received to \nsell an asse t or paid to transfer a liability in an orderly transaction between \nmarket participants at the measurement date. Because a market participant \nwould not pay additional consideration for an asset based on a prior government \ngrant, such a grant does not affec t the fair value of that asset. [Master Glossary] \nHowever, if a lessor is entitled to ongoing tax benefits as a government \nincentive to build an asset , that may affect the fair value of the leased asset if \nthose benefits transfer to an unrelated third- party buyer of the asset if the \nlessor sold the asset. This is because, in that case, a market participant would \ngenerally factor the ongoing tax benefits into the price it would be willing to pay \nfor the asset. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 382}), Document(page\_content='Leases 382 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 5.6.80 \nConsidering loan origination fees in determining \nthe incremental borrowing rate \nShould a lessee factor expected loan origination fees into \ndetermining its incremental borrowing rate? \nInterpretive response: Yes. When the lessee’s incremental borrowing rate is \nused as the discount rate for the lease (see Question 5.6.20), it is intended to \nreflect the interest rate the lessee would pay to obtain a collateralized loan for \nthe amount of the ‘lease payments’, borrowed for a term equal to the ‘lease \nterm’. The effective interest rate a lessee would pay for such a loan would be \naffected by a ny loan origination fees and, therefore, the incremental borrowing \nrate should also consider those fees. \n \n Question 5.6.90 \nEffect on incremental borrowing rate of inability to \nobtain financing \nHow should a lessee determine its incremental borrowing \nrate when it is unable to obtain third- party financing? \nBackground: A lessee’s credit standing or current financial condition may mean \nthe lessee would be unable to obtain a loan from a third- party lender, or issue \ndebt (e.g. notes), in an amount equal to the ‘lease payments’. \nInterpretive response: In such cases, and assuming the rate implicit in the \nlease is not readily determinable (see Question 5.6.20), the lessee must still \nsomehow determine its incremental borrowing rate to establish a discount rate \nfor the lease. Because the lessee may not be able to obtain a bank quote or \nsimilar information (i.e. because the bank would not grant the loan), we believe \nit should base its incremental borrowing rate on available third- party \ninformation. For example, if comparable company collateralized borrowing information is available, that could be used to approximate the lessee’s own \nincremental borrowing rate. Alternatively, if such information is not available, \nthe lessee could use information about interest rates on very low- grade debt \nand adjust a rate determined in that manner for the effect of collateral (see \nQuestion 5.6.66). \n \n Comparison to legacy US GAAP \nUse of lessor’s implicit rate when it is higher than lessee’s incremental \nborrowing rate \n5.6.90 Topic 842 requires the lessee to discount future lease payments using \nthe rate implicit in the lease when it is readily determinable even if it is higher \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 383}), Document(page\_content='Leases 383 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. than the lessee’s incremental borrowing rate. Topic 840, like Topi c 842, \nrequire d the lessee to use the rate implicit in the lease if it was practicable to do \nso, but only if that rate did not exceed the lessee’s incremental borrowing rate. \n[840- 10-25-31(b)] \n5.6.100 This is a difference between Topic 842 and Topic 840 that, in theory, \ncould result in a lessee recognizing smaller lease assets and lease liabilities and \nthat could also affect lease classification – i.e. because the present value of the \nlease payments and any lessee residual value guarantee are less when using a \nhigher discount rate. However, because of the infrequency with which lessees \nare able to determine the rate implicit in the lease, the circumstances in which a \nlessee uses a rate implicit in the lease that is higher than its incremental \nborrowing rate are likely to be rare. \nRequired use of a secured incremental borrowing rate \n5.6.110 The definition of incremental borrowing rate in Topic 842 requires that \nthe rate reflect a secured borrowing rate – i.e. on a ‘collateralized basis’. Under \nTopic 840, the lessee could generally use a secured or unsecured rate as long \nas it was consistent with the financing that would have been used had the \nunderlying asset been purchased, rather than leased. Therefore, Topic 840 did \nnot require the use of a secured borrowing rate like Topic 842 does. \n[840 Glossary] \n‘Funds necessary to purchase the leased asset’ vs. ‘an amount equal to \nthe lease payments’ \n5.6.120 The Topic 840 definition of incremental borrowing rate refer red to the \nrate that the lessee would have i ncurred to borrow the funds necessary to \npurchase the leased asset . Conversely, Topic 842 states that the incremental \nborrowing rate is that which the lessee would pay to borrow on a collateralized \nbasis over a similar term an amount equal to the lease pay ments . [840 Glossary] \n5.6.130 This change to the definition of incremental borrowing rate arose \nbecause under Topic 842 lessees will be capitalizing most leases, rather than \njust capital leases. As a result, the Board concluded that the interest rate a \nparticular entity, with its individual credit rating and other entity -specific \ncircumstances, might have to pay to borrow the funds necessary to purchase \nthe underlying asset in many operating lease scenarios (e.g. a three- or five -year \nlease of real estate or a long- lived asset such as a ship or an airplane) may differ \nsubstantially from the interest rate that same entity would pay to borrow an \namount equal to the lease payments (i.e. the rate to finance the purchase of the \nunderlying asset would typically be higher). \n5.6.140 Therefore, the Topic 840 definition of incremental borrowing rate, if \nused in Topic 842, would likely have resulted in discount rates unrelated to the \nlessor’s pricing in the lease (for which the incremental borrowing rate is \nintended t o serve as a readily determinable proxy) and in inappropriately \nmeasured lease assets and lease liabilities. \nInitial direct costs and the rate implicit in the lease \n5.6.150 Under Topic 840, the rate implicit in the lease did not take into account \nthe less or’s initial direct costs. As defined in Topic 842, the rate implicit in the \nlease is lower than that determined under Topic 840 when the lessor defers \ninitial direct costs. However, this difference is mechanical in nature; instead of \nseparately deferring initial direct costs for sales -type and direct financing leases ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 384}), Document(page\_content='Leases 384 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. as was the case under Topic 840, the initial direct costs are au tomatically \nincluded in the lessor’s net investment in the lease through the determination \nof the implicit rate. Lease income and the lessor’s net investment in the lease are unaffected by this change in mechanics. \n[840 Glossary] \n \n5.7 Economic li fe of the underlying a sset \n5.7.10 The economic life of an asset is either the period over which the asset is \nexpected to be economically usable by one or more users or the number of \nproduction or similar units expected to be obtained from the asset by one or \nmore users. [842 Glossary] \n5.7.20 In contrast to the definition of economic life, the useful life of an asset \n(i.e. the period over which an entity will depreciate the asset) is the period over \nwhich the asset is expected to contribute directly or indirectly to future cash \nflows. The useful life of an asset can differ depending on the asset’s intended use by its current owner. \n[842 Glossary] \n5.7.30 Consistent with Topic 840, the Topic 842 definition of economic life will \nresult in a period that is at least as long as, and typically longer than, the useful \nlife. \n5.7.40 ‘Economically usable’ is not a defined term in US GAAP. However, this \nphrase, when used in the existing def inition of economic life, generally refers to \nthe period over which the asset is expected to be economically viable because the benefits it can produce exceed the costs to replace it or undertak e major \nrepairs or an overhaul. \n5.7.50 The phrase ‘by one or more users’ is intended to convey that the \neconomic life of an asset is an assessment that considers the perspective of the current lessee or owner and any future lessees or owners. \n \n Example 5.7.10 \nEconomic life vs. remaining useful life of an asset \nLessor LR enters into a 15- year lease of a building with Lessee LE. The building \nis 15 years old at lease commencement and LR has owned the building since \nits construction. LR is in the business of leasing buildings and owns other, \nsimilar buildings that it a lso leases. \nLR typically assigns similar buildings a 30 -year useful life because it expects to \nuse the buildings for that period in its leasing business. LR’s customers \ngenerally prefer newer buildings, so LR does not typically keep buildings longer \nthan 30 years. Therefore, at lease commencement, the remaining useful life of the asse t is 15 years (30 – 15 = 15) . \nIn determining the economic life of the leased building , however, LR (and LE) \nconsider the overall condition of the building at lease commencement and \nwhether it remains economically usable past the end of the 15- year lease te rm. \n— From LR’s perspective, it expects to be able to sell the building for more \nthan salvage value at the end of the lease term and that another entity ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 385}), Document(page\_content="Leases 385 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. would be able to make economic use of the building for at least another \n20 years following the lease. Consequently, LR concludes that the building \nhas a remaining economic life of 35 years at lease commencement. \n— Without specific knowledge of LR’s useful life assigned to the building, LE \nsimilarly consider s the age and condition of the building, as well as \ninformation about the economic lives of similar buildings. Based on the \nfacts in this example, LE is likely to also conclude that the remaining economic life of the building at lease commencement is significantly in \nexcess of th e 15- year lease term. \n \n Comparison to legacy US GAAP \nDefinition of estimated economic life \n5.7.60 The Topic 840 definition of estimated economic life for purposes of lease \nclassification was “[t]he estimated remaining period during which the property \nis expected to be economically usable by one or more users, with normal \nrepairs and maintenance, for the purpose for which it was intended at contract \ninception, without limitation by the lease term.” [840 Glossary] \n5.7.70 This differs from the Topic 842 definition of economic life (which \nreplaces the definition in the preceding paragraph in the ASC Master Glossary ), \nfor example, because the Topic 842 definition does not refer to ‘normal repairs and maintenance’ or to 'the purpose for which it was intended at contract \ninception’. However, the two definitions will likely result in similar conclusions \nin most cases. We believe the Board did not intend to significantly change \npractice with respect to the application of ‘ economic life’ ; instead, the wording \nchanges were made to align the wording of the d efinition with IFRS Accounting \nStandards . \n \n5.8 Portfolio a pproach \n Excerpt from ASC 842 -20 \n55 Imple mentation Guidance and Illustrations \nGeneral \n> Illustrations \n>> Illustra tion of Discount Rate \n55-17 Example 2 illustrates the determination of the discount rate for the \nlease. \n>>> Example 2—Portfolio Approach to Establishing the Discount Rate \nfor the Lease \n55-18 Lessee, a public entity, is the parent of several consolidated subsidiaries. ", metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 386}), Document(page\_content='Leases 386 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. During the current period, 2 subsidiaries entered into a total of 400 individual \nleases of large computer servers, each with terms ranging between 4 and \n5 years and annual payments ranging between $60,000 and $100,000, \ndepending on the hardware capacity of the servers. In aggregate, total lease \npayments for these leases amount to $30 million. \n55-19 The individual lease contracts do not provide information about the rate \nimplicit in the lease. Lessee is BBB credit rated and actively raises debt in the \ncorporate bond market. Both subsidiaries are unrated and do not actively \nengage in treasury operations in their respective markets. On the basis of its \ncredit rating and the coll ateral represented by the leased servers, Lessee’s \nincremental borrowing rate on $60,000 through $100,000 (the range of lease \npayments on each of the 400 leases) would be approximately 4 percent. \nLessee notes that 5- year zero- coupon U.S. Treasury instruments are currently \nyielding 1.7 percent (a risk -free rate). Because Lessee conducts its treasury \noperations centrally (that is, at the consolidated group level), it is reasonably \nassumed that consideration of the group credit standing factored into how \neach lease was priced. \n55-20 Lessee may determine the discount rate for the lease for the 400 \nindividual leases entered into on different dates throughout the current period \nby using a portfolio approach. That is, Lessee can apply a single discount rate \nto the portfolio of new leases. This is because during the period, the new \nleases are all of similar terms (four to five years), and Lessee’s credit rating and \nthe interest rate environment are stable. Because the pricing of the lease is \ninfluenced by the credit standing and profile of Lessee rather than the \nsubsidiaries (that is, because Lessee conducts treasury operations for the \nconsolidated group), Lessee concludes that its incremental borrowing rate of \n4 percent is an appropriate discount rate for each of th e 400 leases entered \ninto by Lessee’s 2 subsidiaries during the period. Because Lessee is a public \nentity, it is not permitted to use a risk -free discount rate. \n \n5.8.10 A lessee or lessor may apply the guidance in Topic 842 to a portfolio of \nleases with similar characteristics (size and composition) if the entity reasonably \nexpects that the application of the leases model to the portfolio will not differ \nmaterially from the application to the individual leases in that portfolio. \n[842- 20-55-18 – 55-20, ASU 2016- 02.BC120 –BC121] \n \n Observation \nPortfolio approach guidance aligns with Topic 606 \n5.8.20 The portfolio approach permitted in applying Topic 842 is, and was \nintended by the Board to be, substantially similar to that included in the new \nrevenue recognition standard, which allows entities to apply the accounting for \nan individual contract with a customer to a portfolio of contracts under similar \ncircumstances (see chapter 2 of KPMG Handbook, Revenue recognition ). \n[ASU 2016- 02.BC120 –BC121] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 387}), Document(page\_content='Leases 387 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Observation \nCost vs. benefits of applying a portfolio approach \n5.8.30 The Board does not expect entities to perform quantitative evaluations to \ndetermine whether the portfolio approach differs materially from the application \nof Topic 842 to the individual leases in that portfolio. Instead, entities should be \nable to take a r easonable approach, applying judgment in selecting the size and \ncomposition of the portfolio – e.g. type of underlying asset, lease term, \ngeographic locations . [ASU 2016- 02.BC120] \n5.8.40 The Board noted that the cost relief of applying the portfolio approach \ncould be particularly high for certain aspects of Topic 842 that involve \njudgments and estimates, such as determining the discount rate or determining \nand reassessing the lease term. For example, an entity may be able to establish \na single discount rate applied to all leases in a portfolio because using that \ndiscount rate would not result in a materially different outcome than using a discount rate determined on a lease- by-lease basis. Example 2 in Subtopic 842-\n20 demonstrates application of the portfol io approach to determining the \ndiscount rate. \n[ASU 2016- 02.BC121] \n \n Observation \nAssessing impairment for ROU assets in a lease \nportfolio \n5.8.50 During deliberations of the portfolio approach, the Board expressed a \nview that if some, but not all, ROU assets within a lease portfolio are impaired, \nit would be inappropriate to continue to account for those leases within a \nportfolio if the impairment is material to the entity. \n5.8.60 Section 6.5 discusses application of the Topic 360 impairment guidance \nto leases of lessees, and section 7.3.2 discusses impairment of the lessor’s net \ninvestment in sales -type and direct financing leases . \n \n Question 5.8.10 \nApplying the portfolio approach to multiple \nseparate lease components \nCan a lessee apply the portfolio approach to multiple separate \nlease components assigned to different Topic 360 asset \ngroups? \nBackground: Under Topic 842, the portfolio approach is available for leases (or \nseparate lease components) with similar characteristics when application of the \nleases model to the portfolio will not differ materially from applying it on an \nindividual lease basis (see paragraph 5.8.10). The Board’s intention in allowing \nthe portfolio approach was to address the practical challenges in accounting for \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 388}), Document(page\_content='Leases 388 \n5. Concepts and definitions for lessees and lessors \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. a large number of leases, but not to create material differences in accounting \nresults or conclusions. \nInterpretive response: The answer to this question depends on whether the \nlessee intends to use the portfolio approach: \n— to account for multiple leases as a single lease – i.e. to recognize only a \nsingle ROU asset and lease liability for the portfolio of leases; or \n— to make judgments and estimates (e.g. in determining the discount rate or lease term) about each lease within the portfolio. \nWe do not believe a lessee can use the portfolio approach to account for \nmultiple leases as a single lease if the ROU assets that would result from \naccounting for those multiple leases separately would be assigned to different \nTopic 360 asset groups. To do so would be inconsistent with the requirement \nthat the effects on the financial statements of accounting for those multiple \nleases as a single lease do not differ mater ially from the accounting for the \nleases individually. \nA lessee may, however, use a portfolio approach to make judgments and \nestimates about leases even if the ROU assets resulting from those leases are \nassigned to different Topic 360 asset groups. For exa mple, it is acceptable to \nuse a portfolio approach to determine the discount rate or the lease term for a portfolio of leases with similar characteristics even though the ROU assets for \nthose leases will be assigned to different Topic 360 asset groups. \n \n Example 5.8.10 \nApplying the portfolio approach to leases of vehicles \nLessee LE provides goods to a wide variety of customers. During the first \nquarter of the current year , LE entered into a total of 50 individual leases of \nvehicles for its sales force. The 50 leases have terms ranging from four to \nfive years and commence on different dates (within the span of a calendar \nquarter), and the annual lease payments are between $5,000 and $6,000 for \neach vehicle. \nBecause there is a narrow range of fair v alues and estimated remaining \neconomic lives for the vehicles, LE reasonably expects that the effect of applying the requirements of Topic 842 to its 50 vehicle leases as a portfolio \nwill not differ materially from applying the requirements individually to each \nlease. Therefore, LE decides to use a portfolio approach in determining the discount rate for each of the 50 leases. LE will use a single discount rate in \napplying the measurement requirements in Topic 842 to each of the 50 leases in the portfolio. \nBecause LE is unable to determine the rate implicit in the 50 leases (see \nsection 5.6), it uses its incremental borrowing rate. Because LE applies a \nportfolio approach, it determines the incremental borrowing rate it will use for \neach of the 50 vehicle leas es based on the interest rate it would pay for a \nsecured loan in the amount of the lease payments for a representative lease in the portfolio (i.e. an amount between $5,000 and $6,000) for a representative \nlease term (between four and five years) . ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 389}), Document(page\_content='Leases 389 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 6. Lessee accounting \nDetailed contents \nSection significantly updated : # \nNew item added to this chapter: \*\* \nHow the standard works \n6.1 Overview \nObservation \nA more transparent financial statement representation of leases \nQuestion \n6.1.10 Impact of Topic 842 on performance ratios and financial \ncovenants \n6.2 Lease classification (Step 4) \n6.2.1 Classification tests \n6.2.2 Other classification considerations # \nObservation s \nAlternative use test infrequently met on its own \nFair value practicability exception different from Topic 840 \nQuestions \n6.2.10 Lease classification – lease term test when bright -line \nthresholds are not used \n6.2.15 Lease classification – applying the ‘at or near the end of the \neconomic life’ exception in a reassessment \n6.2.19 Fair value practicability exception – undue cost and effort \n6.2.20 Lease classification – present value test when bright -line \nthreshold is not used \n6.2.21 Lease classification – present value test in classification \nreassessment \n6.2.25 Lease classification – portfolio residual value guarantee by \nthe lessee \n6.2.30 Contractual restrictions and the alternative use test \n6.2.40 Asset evaluated for alternative use \n6.2.50 Legally enforceable terms and conditions in common control \nleases # \n6.2.60 Lessee vs. lessor lease classification ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 390}), Document(page\_content='Leases 390 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Examples \n6.2.10 Lease classification – lease term test \n6.2.15 ‘At or near the end of the economic life’ exception in a \nreassessment \n6.2.20 Lease classification – present value test \n6.2.25 Lessee classification – present value test with lessee \nportfolio residual value guarantee \n6.2.30 Lease classification – alternative use test \nComparison to legacy US GAAP \n6.3 Initial recognit ion and measurement (Step 5) \n6.3.1 Short -term lease recognition exemption \nObservation s \nRecognition or disclosure may be required before the commencement \ndate \nShort -term lease exemption may not create significant structuring \nopportunities \nQuestions \n6.3.10 Capitalization thresholds \n6.3.14 Lease incentives receivable that exceed the unpaid ‘lease \npayments’ for a lease \n6.3.15 Lease incentives that would result in a negative ROU asset \n6.3.17 Leases entered into for R&D purposes \n6.3.20 Applying the short -term lease exemption \n6.3.21 Short -term lease recognit ion exemption – subsequent \nconsideration \n6.3.30 Residual value guarantees in short -term leases \n6.3.40 Reassessment of short -term leases \n6.3.50 Low- value assets lease exemption \nExamples \n6.3.10 Initial measurement of the lease liability and ROU ass et \n6.3.20 Is it a short -term lease? \n6.3.30 Leases with termination options \nComparison to legacy US GAAP \nComparison to legacy US GAAP \n6.4 Subsequent accounting (Step 6) \n6.4.1 Finance leases \n6.4.2 Operating leases ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 391}), Document(page\_content='Leases 391 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 6.4.3 Impact of foreign currency \nObservations \nFocus on lease costs rather than lease expense \nNegative net asset position for most finance leases \nFront -loaded pattern of lease expense recognition for finance leases \nOperating lease ROU assets likely to track more closely to lease liability \nthan finance lease ROU assets \nOperating lease and finance lease expense recognition patterns differ \nQuestions \n6.4.10 Choice of subsequent measurement methods for operating \nlease ROU assets \n6.4.15 Single lease cost attribution – operating lease with non -\nconsecutive period of use that is variable \n6.4.16 Curtailment of the lessee’s right to use the underlying asset \n6.4.20 Accounting for the single lease cost for operating leases denominated in a foreign currency \n6.4.25 Resetting the exchange rate used to remeasure the ROU \nasset into the lessee’s functional currency \nExamples \n6.4.10 Subsequent measurement of a finance lease \n6.4.20 Subsequent accounting for an operating lease – assuming \nno impairments, remeasurements or lease modifications \n6.4.30 Accounting for a lease denominated in a foreign currency \nComparison to legacy US GAAP \n6.5 Impairment testing (Step 7) \n6.5.1 Applying the impairment testing requirements \n6.5.2 Interaction with Topic 360 when asset will be abandoned or subleased \n6.5.3 Interaction with Topic 360 when ROU asset is part of a disposal group that is held for sale \nObservations \nLong -lived assets impairment model for ROU asset impairment \nOperating lease cost post -impairment similar to Topic 840 \nQuestions \n6.5.10 Including lease liabilities in the carrying amount of the asset group in Step 1 of the impairment analysis \n6.5.20 Short -term lease payments in the recoverability test \n6.5.30 Variable lease payments in the recoverability test ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 392}), Document(page\_content='Leases 392 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 6.5.32 Including operating lease liabilities in Step 1 of the \nimpairment analysis results in negative carrying amount for \nthe asset group \n6.5.33 Cash flows used in impairment testing \n6.5.35 Including operating lease liabilities in the carrying amount of \nthe asset group in Step 2 of the impairment analysis \n6.5.36 Effect of including or excluding operating lease liabilities in \nthe carrying amount of the asset group in Step 2 \n6.5.37 Including operating lease liabilities in Step 2 of the \nimpairment analysis results in negative carrying amount for \nthe asset group \n6.5.40 Allocation of impairment losses to an asset group \n6.5.50 Abandonment and subleasing of an ROU asset \n6.5.55 Temporarily idling an underlying asset \n6.5.60 Changes in how a lessee uses an ROU asset and asset \ngroups under Topic 360 \n6.5.65 Effect of temporary sublease on asset grouping \n6.5.66 Bifurcating a single ROU asset for a temporary sublease \n6.5.70 Accounting for the abandonment of an ROU asset \n6.5.80 Accounting for the abandonment of a portion of a single ROU asset \n6.5.90 Accounting for the sublease of a portion of a sing le \nunderlying asset \n6.5.100 Topic 420 and non- lease component costs \n6.5.110 ROU asset held for sublease – held for sale classification \n6.5.120 Lease cost recognition – ROU asset held for sale \n6.5.130 Subsequent changes – ROU asset held- for-sale reclassified \nto held- and-used \nExamples \n6.5.10 Recoverability test for a held- and-used asset group that \nincludes an ROU asset \n6.5.15 Recoverability test for a held- and-used asset group that \nincludes an ROU asset and has a negative carrying amount if \nincluding the operating lease liability \n6.5.17 Fair value test for a held- and-used asset group that includes \nan ROU asset and has a negative carrying amount if \nincluding the operating lease liability \n6.5.20 Operating lease accounting before and after impairment \n6.5.30 Abandonment of an ROU asset that is part of a larger asset \ngroup ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 393}), Document(page\_content='Leases 393 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. 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Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 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Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 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Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. How t he standard works \n— A lessee recognizes on its balance sheet a (financial) lease liability and a \n(nonfinancial) ROU asset for all leases, including operating leases, with a \n‘lease term ’ (see section 5.3) greater than 12 months. \n— A lessee is also permitted, but not required, to recognize a lease liability and an ROU asset for leases with a lease term of 12 months or less. \n— The lease classification distinction (operating versus finance lease) \ncontinues to exist in Topic 842 but now affects how lessees measure and \npresent lease expense and cash flows not whether the lease is on- or off -\nbalance sheet. \n \n Finance \nlease\nOperating \nleaseBalance sheet Income statementProfile of total \nlease cost\n— ROU asset\n— Lease liability— Operating \nexpense : \nAmortization of \nROU asset\n— Interest expense : \nInterest expense on lease liability— Front -loaded\n— ROU asset\n— Lease liability— Operating \nexpense : Lease \nexpense— Generally \nstraight -line \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 397}), Document(page\_content='Leases 397 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 6.1 Overview \n Excerpt from ASC 842 -20 \n05 Overview and Background \nGeneral \n05-1 This Subtopic addresses accounting by lessees for leases that have been \nclassified as finance leases or operating leases in accordance with the \nrequirements in Subtopic 842- 10. Lessees shall follow the requirements in this \nSubtopic as well as those in Subt opic 842- 10. \n15 Scope and Scope Exceptions \nGeneral \n15-1 This Subtopic follows the same Scope and Scope Exceptions as outlined \nin the Overall Subtopic. \n \n6.1.10 The steps in the below chart help frame the big picture of lessee \naccounting that is applied to separate lease components, which is the unit of \naccount in applying Topic 842 (see section 4.1). Steps 1 to 3 deal with concepts \nand definitions that apply to both lessee and lessor accounting; therefore, they \nare included in chapter 5 as an introduction to both accounting models. Each of \nSteps 4 to 9 is discussed in more detail in this chapter. \nStep 1:\nDetermine the ‘lease term ’ \n(see section 5.3)\nStep 2:\nDetermine the ‘lease \npayments ’ (see section 5.4)\nStep 3:\nDetermine the discount rate \nfor the lease\n(see section 5.6)\nStep 4:\nLease classification\n(see section 6.2)The lease term is integral to determining:\n— Whether the lease is a short -term lease\n— The lease payments and the discount rate for the lease\n— Lease classification\nThe lease payments are integral to : \n— Determining the discount rate for the lease\n— Determining lease classification\n— Measuring the ROU asset and the lease liability for \na lease\nLease classification determines :\n— How a lessee measures and presents lease \nexpense and cash flows\n— How a lessee measures the ROU asset after initial \nrecognitionThe discount rate for the lease affects : \n— Lease classification\n— Measurement of the ROU asset and lease liability\n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 398}), Document(page\_content='Leases 398 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Step 5:\nInitial recognition and \nmeasurement(see section 6.3)— A lessee recognizes an ROU asset and a lease \nliability at the commencement date of the lease \n(unless the lease is a short -term lease )\n— The ROU asset and lease liability for finance and operating leases are initially measured in the same way\nStep 6:\nSubsequent accounting\n(see section 6.4)— Subsequent measurement of the lease liability is the \nsame for finance and operating leases\n— Subsequent measurement of the ROU asset differs for finance and operating leases\nStep 7:\nImpairment testing\n(see section 6.5)— ROU assets are evaluated for impairment using the \nlong-lived assets impairment guidance (Topic 360)\n— Impairment of an operating lease ROU asset substantially changes the subsequent accounting \nfor the lease post -impairment\nSteps 8A and 8B:\nReassessments and \nmodifications\n(see sections 6.6 — 6.8)— Lessees may be required to revise the accounting \nfor a lease during the lease term , even if there are \nno lease modifications\n— Lessee accounting for lease modifications depends on the nature of the modification\nStep 9:\nPresentation\n(see section 6.9)— Finance and operating leases are presented \ndifferently in the financial statements \n \n Observation \nA more transparent financial statement \nrepresentation of leases \n6.1.20 Topic 842 was developed principally to improve financial statement users’ \nunderstanding of lessees’ lease obligations. In the Board’s view, the recognition \nof ROU assets and lease liabilities for all leases other than short -term leases \n(see paragraph 6.3.110) w ill: [ASU 2016- 02.BC8] \n— result in a more transparent and faithful representation of the rights and \nobligations arising from leases; \n— improve the understanding and comparability of lessees’ financial commitments regardless of how the lessee finances the assets used in its \nbusiness; and \n— reduce opportunities for entities to structure leases to achieve a particular accounting outcome on the balance sheet. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 399}), Document(page\_content='Leases 399 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 6.1.10 \nImpact of Topic 842 on performance ratios and \nfinancial covenants \nHow will the adoption of Topic 842 affect a lessee’s \nperformance ratios and financial covenants? \nInterpretive response: The requirement to recognize additional assets and \nliabilities arising from lease transactions may affect some key performance \nratios commonly used i n credit and investment -making decisions. For example, \nthe additional lease assets and lease liabilities are likely to result in: \n— lower liquidity ratios, such as th e current ratio (current assets / current \nliabilities) and quick ratio ((cash + short -term i nvestments + receivables) / \ncurrent liabilities) because of increased current liabilities (current portion of \nthe lease liabilities); and \n— higher working capital turnover (revenue / average working capital) due to \nreduced working capital because the lease l iability is partially current, and a \nlower asset turnover (revenue / average total assets) due to increased total \nassets. \nChanges to a lessee’s balance sheet resulting from the new requirements may affect a lessee’s compliance with financial covenants. The existence and \nmagnitude of the effe cts will depend on lessee- specific facts and \ncircumstances. \nHowever, most financial statement users (e.g. investors and analysts) already adjust lessees’ financial statements for operating lease obligations, often \noveres timating lease obligations compared to what will be recognized under \nTopic 842. \nThe Board believes the effects of Topic 842 on financial covenants will not be \nsignificant, in part because many loan agreements contain provisions preventing \nor minimizing def aults solely due to a change in accounting standards; but also \nbecause operating lease liabilities are considered operating liabilities , rather than \ndebt, under Topic 842. \n[ASU 2016- 02.BC14] \nCategorizing operating lease liabilities as operating liabilities , rather than debt, \nmay mean that Topic 842 will not have a significant effect on debt -based ratios \nsuch as the: [ASU 2016- 02.BC14] \n— debt-to-capital ratio (total debt / (total debt + total equity)) and debt -to-equity \nratio (total debt / total equity); and \n— weighted -average cost of capital (WACC). \nHowever, entities negotiating debt or similar arrangements that will contain \nfinancial covenants may nonetheless want to consider the application of \nTopic 842 in their negotiations of financial covenants. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 400}), Document(page\_content='Leases 400 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 6.2 Lease c lassification (Step 4) \n Excerpt from ASC 842 -10 \n25 Recognition \nGeneral \n> Lease Classification \n25-1 An entity shall classify each separate lease component at the \ncommencement date . An entity shall not reassess the lease classification \nafter the commencement date unless the contract is modified and the \nmodification is not accounted for as a separate contract in accordance with \nparagraph 842-10-25-8. In addition, a lessee also shall reassess the lease \nclassification after the commencement date if there is a change in the lease \nterm or the assessment of whether the lessee is reasonably certain to \nexercise an option to purchase the underlying asset . When an entity (that is, a \nlessee or lessor) is required to reassess lease classification, the entity shall \nreassess classification of the lease on the basis of the facts and circumstances \n(and the modified terms and conditions, if applicable) as of the date the \nreassessment is required (for example, on the basis of the fair value and the \nremaining economic life of the underlying asset as of the date there is a \nchange in the lease term or in the assessment of a lessee option to purchase \nthe underlying asset or as of the effective date of a modification not accounted \nfor as a separate contract in accordance with paragraph 842- 10-25-8). \n25-2 A lessee shall classify a lease as a finance lease and a lessor shall \nclassify a lease as a sales -type lease when the lease meets any of the \nfollowing criteria at lease commencement: \na. The lease transfers ownership of the underlying asset to the lessee by the \nend of the lease term. \nb. The lease grants the lessee an option to purchase the underlying asset that \nthe lessee is reasonably certain to exercise. \nc. The lease term is for the major pa rt of the remaining economic life of the \nunderlying asset. However, if the commencement date falls at or near the \nend of the economic life of the underlying asset, this criterion shall not be \nused for purposes of classifying the lease. \nd. The present value of the sum of the lease payments and any residual value \nguaranteed by the lessee that is not already reflected in the lease \npayments in accordance with paragraph 842- 10-30-5(f) equals or exceeds \nsubstantially all of the fair value of the underlying asset. \ne. The underlying asset is of such a specialized nature that it is expected to \nhave no alternative use to the lessor at the end of the lease term. \n25-3 When none of the criteria in paragraph 842 -10-25-2 are met: \na. A lessee shall classify the lease as an opera ting lease. \n25-5 If a single lease component contains the right to use more than one \nunderlying asset (see paragraphs 842 -10-15-28 through 15 -29), an entity shall ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 401}), Document(page\_content='Leases 401 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. consider the remaining economic life of the predominant asset in the lease \ncomponent for pur poses of applying the criterion in paragraph 842- 10-25-2(c). \n25-7 See paragraphs 842 -10-55-2 through 55- 15 for implementation guidance \non lease classification. \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance \n>> Lease Classification \n55-2 When determining lease classification, one reasonable approach to \nassessing the criteria in paragraphs 842- 10-25-2(c) through (d) and 842- 10-25-\n3(b)(1) would be to conclude: \na. Seventy -five percent or more of the remaining economic life of the \nunderlying asset is a major part of the remaining economic life of that \nunderlying asset. \nb. A commencement date that falls at or near the end of the economic life of \nthe underlying asset ref ers to a commencement date that falls within the \nlast 25 percent of the total economic life of the underlying asset. \nc. Ninety percent or more of the fair value of the underlying asset amounts to \nsubstantially all the fair value of the underlying asset. \n55-3 In some cases, it may not be practicable for an entity to determine the fair \nvalue of an underlying asset. In the context of this Topic, practicable means \nthat a reasonable estimate of fair value can be made without undue cost or \neffort. It is a dynamic concept; what is practicable for one entity may not be \npracticable for another, what is practicable in one period may not be practicable \nin another, and what is practicable for one underlying asset (or class of \nunderlying asset) may not be practicable for another. In those cases in which it \nis not practicable for an entity to determine the fair value of an underlying \nasset, lease classification should be determined without consideration of the \ncriteria in paragraphs 842- 10-25-2(d) and 842- 10-25-3(b)(1). \n>>> Transfer -of-Ownership Criterion \n55-4 The criterion in paragraph 842- 10-25-2(a) is met in leases that provide, \nupon the lessee’s performance in accordance with the terms of the lease, that \nthe lessor should execute and deliver to the lessee such docum ents (including, \nif applicable, a bill of sale) as may be required to release the underlying asset \nfrom the lease and to transfer ownership to the lessee. \n55-5 The criterion in paragraph 842- 10-25-2(a) also is met in situations in which \nthe lease requires the payment by the lessee of a nominal amount (for \nexample, the minimum fee required by the statutory regulation to transfer \nownership) in connection with the transfer of ownership. \n55-6 A provision in a lease that ownership of the underlying asset is not \ntransferred to the lessee if the lessee elects not to pay the specified fee \n(whether nominal or otherwise) to complete the transfer is an option to \npurchase the underlying asset. Such a provision does not satisfy the transfer -\nof-ownership criterion in para graph 842- 10-25-2(a). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 402}), Document(page\_content='Leases 402 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. >>> Alternative Use Criterion \n55-7 In assessing whether an underlying asset has an alternative use to the \nlessor at the end of the lease term in accordance with paragraph 842- 10-25-\n2(e), an entity should consider the effects of c ontractual restrictions and \npractical limitations on the lessor’s ability to readily direct that asset for another \nuse (for example, selling it or leasing it to an entity other than the lessee). A \ncontractual restriction on a lessor’s ability to direct an underlying asset for \nanother use must be substantive for the asset not to have an alternative use to \nthe lessor. A contractual restriction is substantive if it is enforceable. A practical \nlimitation on a lessor’s ability to direct an underlying asset for a nother use \nexists if the lessor would incur significant economic losses to direct the \nunderlying asset for another use. A significant economic loss could arise \nbecause the lessor either would incur significant costs to rework the asset or \nwould only be abl e to sell or re -lease the asset at a significant loss. For \nexample, a lessor may be practically limited from redirecting assets that either \nhave design specifications that are unique to the lessee or that are located in \nremote areas. The possibility of the contract with the customer being \nterminated is not a relevant consideration in assessing whether the lessor \nwould be able to readily direct the underlying asset for another use. \n>>> Effect of Investment Tax Credits \n55-8 When evaluating the lease classification criteria in paragraphs 842- 10-25-\n2(d) and 842- 10-25-3(b)(1), the fair value of the underlying asset should be \nreduced by any related investment tax credit retained by the lessor and \nexpected to be realized by the lessor. \n>>> Residual Value Guarantees for a Portfolio of Underlying Assets \n55-9 Lessors may obtain residual value guarantees for a portfolio of \nunderlying assets for which settlement is not solely based on the resid ual \nvalue of the individual underlying assets. In such cases, the lessor is \neconomically assured of receiving a minimum residual value for a portfolio of \nassets that are subject to separate leases but not for each individual asset. \nAccordingly, when an ass et has a residual value in excess of the “guaranteed” \namount, that excess is offset against shortfalls in residual value that exist in \nother assets in the portfolio. \n55-10 Residual value guarantees of a portfolio of underlying assets preclude a \nlessor from determining the amount of the guaranteed residual value of any \nindividual underlying asset within the portfolio. Consequently, no such amounts \nshould be considered when evaluating the lease classification criteria in \nparagraphs 842- 10-25-2(d) and 842- 10-25-3(b)(1). \n>>> Lease of an Acquiree \n55-11 In a business combination or an acquisition by a not -for-profit \nentity , the acquiring entity should retain the previous lease classification in \naccordance with this Subtopic unless there is a lease modificatio n and that \nmodification is not accounted for as a separate contract in accordance with \nparagraph 842- 10-25-8. \n>>> Lease of a Related Party \n55-12 Except for leases between entities under common control accounted for \nin accordance with the practical expedient in paragraph 842 -10-15-3A, leases ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 403}), Document(page\_content='Leases 403 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. between related parties should be classified in accordance with the lease \nclassification criteria applicable to all other leases on the basis of the legally \nenforceable terms and conditions of the lease. Additionally, except for leases \nbetween entities under common control accounted for in accordance with \nparagraph 842- 10-15-3A, the classification and accounting for the leases sh ould \nbe the same as for leases between unrelated parties in the separate financial \nstatements of the related parties. \n>>> Lease Involving Facilities Owned by a Government Unit or \nAuthority \n55-13 Because of special provisions normally present in leases involving \nterminal space and other airport facilities owned by a governmental unit or \nauthority, the economic life of such facilities for purposes of classifying a \nlease is essentially indeterminate. Likewise, it may not be practicable to \ndetermine the fa ir value of the underlying asset . If it is impracticable to \ndetermine the fair value of the underlying asset and such leases also do not \nprovide for a transfer of ownership or a purchase option that the lessee is \nreasonably certain to exercise, they should be classified as operating leases . \nThis guidance also applies to leases of other facilities owned by a \ngovernmental unit or authority in which the rights of the parties are essentially \nthe same as in a lease of airport facilities. Examples of such leases may be \nthose involving facilities at ports and bus terminals. The guidance in this \nparagraph is intended to apply to leases only if all of the following conditions \nare met: \na. The underlying asset is owned by a governmental unit or authority. \nb. The underlying asset is part of a larger facility, such as an airport, operated \nby or on behalf of the lessor. \nc. The underlying asset is a permanent structure or a part of a permanent \nstructure, such as a building, that normally could not be moved to a new \nlocation. \nd. The lessor, or in some circumstances a higher governmental authority, has \nthe explicit right under the lease agreement or existing statutes or \nregulations applicable to the underlying asset to terminate the lease at any \ntime during the lease term, such as by c losing the facility containing the \nunderlying asset or by taking possession of the facility. \ne. The lease neither transfers ownership of the underlying asset to the lessee \nnor allows the lessee to purchase or otherwise acquire ownership of the \nunderlying ass et. \nf. The underlying asset or equivalent asset in the same service area cannot \nbe purchased or leased from a nongovernmental unit or authority. An \nequivalent asset in the same service area is an asset that would allow \ncontinuation of essentially the same service or activity as afforded by the \nunderlying asset without any appreciable difference in economic results to \nthe lessee. \n55-14 Leases of underlying assets not meeting all of the conditions in \nparagraph 842- 10-55-13 are subject to the same criteria for classifying leases \nunder this Subtopic that are applicable to leases not involving government -\nowned property. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 404}), Document(page\_content='Leases 404 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. >>> Lessee Indemnification for Environmental Contamination \n55-15 A provision that requires lessee indemnification for environmental \ncontamination, whether for environmental contamination caused by the lessee \nduring its use of the underlying asset over th e lease term or for preexisting \nenvironmental contamination, should not affect the classification of the lease . \n \n6.2.10 A lessee determines lease classification for each separate lease \ncomponent, which is the unit of account in applying Topic 842 (see section 4.1), \nat the commencement date of the lease (see section 5.1). [842- 10-25-1] \n6.2.20 The lessee accounting model in Topic 842 is generally intended to classify \nleases as finance leases when the lease is economically similar to the purchase \nof a nonfinancial asset. This would be the case when the lessee effectively \nobtains control of the underlying asset (rather than merely obtaining control \nover its use for the lease term) by being able to direct its use and obtain \nsubstantially all of its remaining benefits as a result of the lease. \n[ASU 2016- 02.BC56, BC70] \n6.2.30 However, in determining lease classification, there is n o separate or \nadditional evaluation of this underlying principle. The Board decided that a lease is classified as a finance lease when any one (or more) of five specified tests \nare met, even if an entity does not believe that the lessee effectively obtains \ncontrol of the underlying asset as a result of the lease. \n[ASU 2016- 02.BC70 –BC71] \n6.2.40 Lease classification is not reassessed after the commencement date \nunless either: [842- 10-25-1] \n— there is a change in the assessment of either (1) the lease term, or (2) \nwheth er it is reasonably certain that a lessee purchase option will be \nexercised (see section 6.6); or \n— the contract that is or contains the separate lease component is modified \nand that modification is not accounted for as a separate contract (see \nsection 6.7). \n6.2.50 The following are the lease classification tests that are applied by lessees. \n[842- 10-25-2 – 25-3]', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 405}), Document(page\_content='Leases 405 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Transfer of \nownership\nLessee \npurchase \noption \nLease \nterm\nPresent \nvalue\nAlternative \nuseDoes lease transfer ownership of underlying \nasset to lessee by end of lease term ?\nDoes lease grant lessee an option to \npurchase underlying asset that lessee is \nreasonably certain to exercise ?\nIs lease term for a major part of remaining \neconomic life of underlying asset ?1\nDoes present value of sum of (1) lease payments \nand (2) any lessee residual value guarantee not \nreflected in lease payments , equal or exceed \nsubstantially all of underlying asset’s fair value ?\nIs underlying asset of such a specialized nature \nthat it is expected to have no alternative use to \nlessor at end of lease term ?\nLessee classifies lease as \noperating leaseLessee \nclassifies \nlease as \nfinance \nleaseNo\nNo\nNo\nNo\nNoYesTests :\nYes\nYes\nYes\nYes \nNote : \n1. If the commencement date is at or near the end of the underlying asset’s economic life \n(see paragraph 6.2.90) , which may occur if the underlying asset is used or was leased \npreviously, this te st does not apply . \n \n6.2.1 Classification tests \nTransfer of ownership test \n6.2.60 The transfer of ownership test is met in leases that require: [842- 10-55-4 – \n55-5] \n— the lessor to release the underlying asset from the lease and to transfer \nownership to the lessee upon the lessee’s performance in accordance with \nthe terms of the lease; or \n— the lessee to pay a nominal amount in connection with ownership transfer of \nthe un derlying asset – e.g. a minimum statutory fee to transfer ownership. \n6.2.70 When ownership of the underlying asset transfers to the lessee only if \nthe lessee elects to pay a specified fee (whether nominal or otherwise) to \ncomplete the transfer, it is considered a purchase option that is evaluated the \nsame way as any other lessee purchase option (see paragraph 6.2.80). \n[842- 10-55-6] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 406}), Document(page\_content='Leases 406 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Lessee purchase option test \n6.2.80 The lessee purchase option test is met if it is reasonably certain that the \nlessee will e xercise the option. ‘Reasonably certain’ is a high threshold of \nprobability, and the Board intended the parties to account for lessee options \nonly when the lessee has a compelling economic reason to exercise the option \n(see section 5.2) . [842- 10-30-1] \nLeas e term test \n6.2.90 An entity may use the following thresholds when evaluating the lease \nterm test. [842- 10-55-2] \n— 75 percent or more of the remaining economic life may be considered a major part of the remaining economic life of that underlying asset. \n— A lease that commences with 25 percent or less of the underlying asset’s \ntotal economic life remaining may be considered to commence at or near the end of the asset’s economic life. \n6.2.100 When a single lease component contains the right to use more than one \nunderlying asset (see section 4.1), an entity considers the remaining economic life of the predominant asset in the lease component when applying the lease \nterm test. The assessment of which underlying asset is predominant is a \nqualitative one that requi res entities to conclude on the most important element \nof the lease, which the Board expects to be relatively clear in most cases. If an \nentity is unable to identify the predominant asset, it might be an indicator that \nthere are additional separate lease c omponents in the contract. \n[842- 10-25-5, \nASU 2016- 02.BC74] \n \n Question 6.2.10 \nLease classification – lease term test when bright-\nline thresholds are not used \nHow should a lessee evaluate the lease term classification \ntest when it elects not to use the permitted bright -line \nthresholds? \nBackground: The Board decided to permit, rather than require, using bright -line \nthresholds when evaluating the lease term classification tests. [842- 10-55-2] \nIn deciding to permit these thresholds, the Board observed that entities need to \noperationalize the guidance in a scalable manner, which requires establishing \ninternal accounting policies and controls. However, because these thresholds are characterized as only one acceptable approach to interpreting what ‘major \npart’, ‘substantially all’ and ‘at or near the end’ mean, entities are permitted to \nexercise judgment. That means, for example, that amounts below 90 percent \ncould be considered substantially all in the context of the present value test , or \nthat a lease term tha t is less than 75 percent of the remaining economic life of \nthe underlying asset could be considered a major part of the asset’s remaining \neconomic life in the lease term test.\n [ASU 2016- 02.BC73] \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 407}), Document(page\_content='Leases 407 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Interpretive response: Determining acceptable thresholds to apply to the lease \nterm test when not using the permitted bright lines for major part and at or near \nthe end requires judgment. However, in general, we believe the greater the \nextent to which the judgments reached stray from these bright lines, the more \nlikely they are to potentially be questioned. \nLease term test \nConsideration of the control classification principle may be useful in determining \nan appropriate threshold for applying the lease term test. That is, when \nconsidering what might be an acceptable threshold other tha n 75 percent , an \nentity should consider that the classification test is intended to capture, as \nfinance (sales -type) leases, those leases that give the lessee the ability to both \n(1) direct the use of the underlying asset and (2) obtain substantially all of the remaining benefits of the underlying asset. \n[ASU 2016- 02.BC70] \nThis is because, in determining the qualitative threshold for the lease term test (i.e. major part rather than substantially all), the Board considered that most \nassets, particularly equipment, decline in value in a front -loaded manner; this \nmeans that the earlier years of an asset’s economic life provide a disproportionate percentage of the remaining benefits from the underlying \nasset. Consequently, an entity that controls the use of an asset for only a major \npart of its remaining economic life may still have the ability to direct its use to \nobtain substantially all of its remaining benefits. \n[ASU 2016- 02.BC71(c)] \nThat major part was intended to be a substanti vely lower threshold than \nsubstantially all, also is evidenced by the fact that the 75 percent bright -line \nthreshold for a major part is significantly lower than the 90 percent bright -line \nthreshold for substantially all. This means that a qualitative eval uation of what \nconstitutes a major part of the asset’s economic life should consider the \npattern in which the asset is expected to experience a diminution in economic \nutility or value. \nThis evaluation may differ for different classes of underlying assets . For \nexample, it might be less than 75 percent for an asset with a more front -loaded \ndiminution in economic utility or value, but more than 75 percent for an asset \nthat holds its economic utility or value more steadily over time. \nAt or near the end of the economic life \nIn general, because there is no guidance provided about what ‘ at or near the \nend’ means other than the 25 percent bright -line threshold provided in the \nimplementation guidance, we believe entities generally should adhere to the 25 percent bri ght line. \nUnlike the lease term test, the classification principle provides no insight into \nhow to interpret this threshold because the ‘at or near the end of the economic \nlife’ exception is contrary to the classification principle, rather than an \napplica tion of that principle, and was adopted for cost -benefit reasons. [ASU 2016-\n02.BC71(c)] \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 408}), Document(page\_content='Leases 408 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 6.2.10 \nLease classification – lease term test \nLessee LE and Lessor LR enter into a lease of a piece of used, non- specialized \nproduction equipment. The following facts are relevant at the lease \ncommencement date. \nTransfer of ownership: No \nRenewal/purchase options: None \nTotal economic life of equipment: 20 years \nRVG: None \nLE’s incremental borrowing rate: 5% (implicit r ate cannot be readily determined) \nInitial direct costs: None \nIn addition, LE evaluates lease classification using the bright -line thresholds – \ni.e. the 75%, 25% and 90% thresholds for the lease term and present value \ntests (see paragraphs 6.2.90 and 6.2.110). \nScenario 1: Lease does not begin near \nthe end of the asse t’s economic life Scenario 2: Lease begins near the end \nof the asset’s economic life \nAdditional facts \n— Non-cancellable 5- year lease term. \n— Equipment has a remaining economic \nlife of 6 years at lease \ncommencement. \n— Equipment has a fair value of $30,000 \nat lea se commencement. \n— Present value of lease payments discounted at 5% is $24,245 (fixed \nlease payments of $5,600 per year in \narrears). Additional facts \n— Non-cancellable 4- year lease term. \n— Equipment has a remaining economic life of 4.5 years at lease \ncommencement. \n— Equipment has a fair value of \n$25,000 at lease commencement. \n— Present value of lease payments discounted at 5% is $21,276 (fixed \nlease payments of $6,000 per year in \narrears). \nLease classification \nLE classifies the lease as a finance lease based on the following: Lease classification \nLE classifies the lease as an operating \nlease based on the following: \n— Transfer of ownership test – No — Transfer of ownership test – No \n— Lessee purchase option test – N/A — Lessee purchase option test – N/A \n— Lease term test – Yes (83%) — Lease term test – N/A \n(lease commencement falls at or \nnear the end of the equipment’s \neconomic life) \n— Present value test (see \nparagraph 6.2.110) – No (81%) — Present value test (see \nparagraph 6.2.110) – No (85%) \n— Alternative use test (see \nparagraph 6.2.150) – No — Alternative use test (see \nparagraph 6.2.150) – No \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 409}), Document(page\_content='Leases 409 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 6.2.15 \nLease classification – applying the ‘at or near the \nend of the economic life’ exception in a \nreassessment \nDoes the ‘at or near the end of the economic life’ exception to \nthe lease term test apply when reassessing lease \nclassification? \nBackground: Topic 842 states that the ‘at or near the end of the economic life’ \nexception applies ‘if the commencement date of the lease falls at or near the \nend of the economic life of the underlying asset’. [Emphasis added] [842-10-25-\n2(c)] \nTherefore, the question arises as to whether this exception also applies when \nlease classification is reassessed after the commencement date – e.g. on the \neffective date of a lease modification or, for the lessee, on remeasurement of the lease due to a change in the lease term or a change in the assessment of a \nlessee purchase option. \n \nParagraph 6.2.90 and Question 6.2.10 discuss how to apply the exception. \nInterpretive response: Yes. The ‘at or near the end of the economic life’ lease \nterm test exception applies when lease classification is reassessed after lease \ncommencement. If, at the date of reassessment, the underlying asset is at or \nnear the end of its total economic life, then the exception applies. This is \nregardless of whether the exception also applied at lease commencement or at \nan earlier classification reassessment date. [842- 10-25-15, 25- 16(b), ASU 2016- 02.BC173] \n \n Example 6.2.15 \n‘At or near the end of the economic life’ exception in \na reassessment \nLessor LR leases 10 -year old equipment to Lessee LE that when new has a 20-\nyear economic life. The lease term is 6 years. Because the equipment is only \n50% through its total economic life at lease commencement (10 years \nremaining of 20), the ‘at or near the end of the economic life’ lease term \nclassification test exception does not apply. \nAt the end of the 6 -year lease term (Year 16 of the equipment’s 20- year \neconomic life), LE and LR agree to modify the lease, extending the lease term by 3 years. The modification does not meet the cr iteria to be accounted for as a \nseparate contract because the extension of the lease term does not grant LE an additional right of use (see paragraph 6.7.30, Note 1, and paragraph 6.7.40); \ntherefore, at the modification date, both LE and LR are required to reassess \nlease classification. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 410}), Document(page\_content='Leases 410 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. At the effective date of the modification: \n— the remaining lease term of 3 years is more than a major part of the \nequipment’s then- remaining economic life: 3- year lease term / 4- year \nremaining economic life = 75%; however \n— the equipment is also in the last 20% of its total economic life: 4- year \nremaining economic life / 20- year total economic life = 20%. \nBecause the underlying equipment is near the end of its total economic life at \nthe effective date of the modification (i.e. within the last 25% thereof), LE and \nLR do not apply the lease term test when reassessing classification of the lease \nat that date . \n \nPresent value test \n6.2.110 An entity may use a threshold of 90 percent or more when determ ining \nwhat constitutes substantially all of the fair value of the underlying asset. \n[842- 10-55-2(c)] \n6.2.120 When evaluating lease classification, the fair value of the underlying \nasset is reduc ed by any related investment tax credit retained, and expected to \nbe realized, by the lessor. [842- 10-55-8] \n6.2.130 In some cases, it may not be practicable for a lessee to determine the \nfair value of the underlying asset – i.e. a reasonable estimate of fair value \ncannot be made without undue cost or effort. Topic 842 notes that practicability \nis a dynamic concept in that: [842- 10-55-3] \n— what is practicable for one entity may not be practicable for another; \n— what is practicable in one period may not be practicable in another; and \n— what is practicable for one underlying asset (or class of underlying asset) may not be practicable for another. \n \n Observation \nFair value practicability exception different from \nTopi c 840 \n6.2.131 Topic 840 contained guidance under which an entity would not apply the \npresent value lease classification test if the cost and/or fair value of the \nunderlying asset (specifically, a part of a building) was not ‘objectively \ndeterminable’. [840- 10-25-39, 25- 69] \n6.2.132 Topic 840 also provided guidance about what ‘objectively determinable’ \nmeant in that context. In particular, that guidance stated: [840- 10-25-23 – 25-24] \n— evidence other than sales of similar property could meet the objectivel y \ndeterminable threshold – e.g. reasonable estimates of fair value derived \nfrom an independent appraisal or replacement cost information; but \n— obtaining an appraisal or similar valuation is not a requirement of Topic 840. \n6.2.133 In practice, we believe this guidance was frequently used to justify \noperating lease classification without undertaking the present value test. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 411}), Document(page\_content='Leases 411 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 6.2.134 There is a misconception that the Topic 842 fair value practicability \nexception from the present value classification test (see paragraph 6.2.130) is \nderived from, and therefore intended to be consistent with, the legacy Topic \n840 guidance. However, the FASB never decided to carry forward the Topic 840 \nguidance. Instead, the wording of the Topic 842 practicability exception was \ndrawn from, and is substantially similar to, the fair value practicability exception \nthat existed in Topic 825 (financial instruments) before the adoption of ASU \n2016 -01. [825- 10-50-16 – 50-17] \n6.2.135 Topic 825 included the notion that what is ‘excessive’ in terms of the \ncost (i.e. what constitutes ‘undue cost and effort’) to obtain the fair value of the \nrelevant financial instrument considers both the entity and the materiality of the \ninstrument to the enti ty. That is: [825- 10-50-17] \n— what is excessive for one entity (e.g. a smaller entity) is not necessarily \nexcessive for another entity (e.g. a larger entity); and \n— ‘excessive’ is a higher threshold when the fair value information is more \nmaterial to the entit y’s financial reporting. \n6.2.136 The FASB noted, in the basis for conclusions to FASB Statement No. \n107 (codified in Topic 825), that it expected “in most cases, it will be practicable for an entity to make a reasonable estimate of fair value even of fina ncial \ninstruments that are not readily marketable.” \n[FAS 107.C46] \n \n Question 6.2.19 \nFair value practicability exception – undue cost and \neffort \nWhat constitutes ‘undue cost and effort’ when considering \navailability of the fair value practicability except ion? \nInterpretive response: Consistent with our views on Topic 360 (property, plant \nand equipment), we believe the fair value of individual long- lived assets usually \nshould be determinable either individually or in aggregate without undue cost \nand effort. Therefore, we would generally not expect this exception to apply to \nleases of entire underlying assets (e.g. machine, vehicle, building) or portions of \nentire underlying assets that are legally separable (e.g. condominiums), or groups thereof (e.g. a fleet of vehicles). \nDetermining the fair value of a portion of a larger asset (e.g. floor of a building, \ncell tower rung, satellite transponder, fiber -optic cable strand) will frequently be \nmore complex than determining the fair value of an entire asset. Howev er, that \ndoes not necessarily mean its fair value is not ‘determinable without undue cost \nand effort’. \nGiven, in particular, paragraph 6.2.135, we believe the more material the effect \nof the fair value determination on the entity – which may be greater, in general, \nfor lessors now that operating leases are recognized on the balance sheet by \nlessees – the more difficult it is to argue that the cost and effort to determine \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 412}), Document(page\_content='Leases 412 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the fair value of the underlying asset, including obtaining an appraisal or a \nsimilar valuation, is ‘undue’. For example: \n— If the result of the present value test depends on the fair value of the \nunderlying asset, and that test will determine lessor sales -type or operating \nlease classification for a material lease transaction, significant cost and effort to obtain the underlyi ng asset’s fair value is unlikely to be ‘undue’, \neven if that requires obtaining an appraisal or similar valuation. \n— In contrast, classification of the lease as finance or operating in the same \nlease transaction may not be as material to the lessee’s financ ial reporting \nas it is to the lessor’s because the lease will be recognized on the lessee’s \nbalance sheet regardless of classification. In addition, it may frequently be \nthe case that the cost and effort to determine the fair value of the \nunderlying asset is greater for the lessee – e.g. because it does not have \naccess to information the lessor would reasonably be expected to have. \nTherefore, it is possible the lessee might conclude that the costs and effort \nit would incur to determine the fair value of th e underlying asset are undue. \nHowever, before reaching that conclusion, the lessee still needs to consider the effect of the lease’s classification on its income statement and on key \nratios and metrics important to its financial statement users (e.g. debt ratios \nor EBITDA); on- balance sheet lease recognition alone will not necessarily \nmake classification less material to the lessee than the lessor. \nIn addition, it may frequently be reasonable and appropriate to determine the \nfair value of a portion of a lar ger asset with reference to the fair value of the \nlarger asset. For example, the fair value of one floor of a five- floor office building \nin a nondescript geographical area (i.e. higher floor does not provide a better \nview or command higher rents) and for which the floors are generally \nhomogenous may be reasonably determined as a proportion of the fair value of \nthe building as a whole. In contrast, the fair value of a fiber strand or a satellite \ntransponder may not reasonably be estimated based on the number of other \nfiber strands in the cable or transponders in the satellite; this is because of the dependency the fiber strands and transponders have on other components of \nthe larger asset. \nConsistent with the views of the FASB (see paragraph 6.2.136), we beli eve the \nfair value of an underlying asset should be determinable, without undue cost \nand effort, in most cases. Regardless of whether the underlying asset is an \nentire asset or a portion of a larger asset, an entity that believes the fair value \npracticabil ity exception applies to its facts and circumstances should consult \nwith its auditors and/or other accounting advisors. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 413}), Document(page\_content='Leases 413 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 6.2.20 \nLease classification – present value test when \nbright -line threshold is not used \nHow should a lessee evaluate the pr esent value classification \ntest when it elects not to use the bright -line threshold? \nInterpretive response: In general, we believe there is little leeway from the \n90 percent bright -line threshold in evaluating the present value test. This is \nbecause, unlike ‘ major part ’ or ‘at or near the end’ , ‘substantially all ’ is used \nelsewhere in US GAAP and is interpreted on a mostly consistent basis to mean \napproximately 90 percent; this includes when thinking about whether a \ncustomer is obtaining substantially all of the remaining benefits from an asset in \nother Topics. \n \n Example 6.2.20 \nLease classification – present value test \nLessee LE and Lessor LR enter into a lease of a truck. The following facts are relevant at the lease commencement date. \nNon-cancellable lease term: 7 years \nLease payments: Fixed payments of $2,710 per year in arrears \nTransfer of ownership: No \nRenewal/purchase options: None \nFair value of truck: $28,272 \nTotal economic life of truck: 20 years \nRemaining economic life of truck: 10 years \nLE’s incremental borrowing rate: 4.5% (implicit rate cannot be readily \ndetermined) \nInitial direct costs: None \nRVG (lessee): Guarantees residual value of $14,545 \nAmount probable of being owed under RVG : $1,818 \nPresent value of the lease payments + \nRVG: $26,657 = PV of the ‘lease payments’ of \n$17,305 ([$2,710 × 7] + $1,818 at end of \nYear 7, discounted at 4.5%) + PV of the \namount of the RVG not already included \nin the lease payments of $9,352 \n($12,727 [$14,545 – $1,818] at end of \nYear 7, discounted at 4.5%) \nIn addition, LE evaluates lease classification using the bright -line thresholds – \ni.e. the 75%, 25%, and 90% thresholds for the lease term and present value \ntests (see paragraphs 6.2.90 and 6.2.110). \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 414}), Document(page\_content='Leases 414 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Lease classification \nLE classifies the lease as a finance lease based on the fol lowing. \n— Transfer of ownership test – No \n— Lessee purchase option test – N/A \n— Lease term test – No (70%) \n— Present value test – Yes (94%, or $26,657 / $28,272) \n— Alternative use test – No \n \n Question 6.2.21 \nLease classification – present value test in \nclassification reassessment \nShould unamortized prepaid/accrued lease payments and \nunamortized lease incentives factor into the present value test when reassessing lease classification? \nBackground: Topic 842 requires lessees to reassess lease classificatio n when \neither: [842- 10-25-1] \n— there is a change in the assessment of either (1) the lease term, or (2) \nwhether it is reasonably certain that a lessee purchase option will be \nexercised (see section 6.6); or \n— the contract that is or contains the separate leas e component is modified \nand that modification is not accounted for as a separate contract (see section 6.7). \nClassification is reassessed as of either: \n— the lease term or purchase option reassessment date; or \n— the effective date of the modification. \nIn practice, questions have arisen about what lease payments should be \nconsidered when performing the present value test as of the classification \nreassessment date. In particular, questions have arisen about situations where, \nimmediately before the classificati on reassessment date, there is: \n— a prepaid or accrued rent balance in the existing lease – e.g. arising from a \nsignificant prepayment or the straight -lining of lease cost in an operating \nlease (see paragraph 6.4.190); and/or \n— an unamortized lease incentive. \nInterpretive response: Yes. We believe prepaid and accrued rent, which \nincludes the unamortized balance of lease prepayments, and unamortized lease \nincentives should be factored into the lease payments used in the present value \ntest when reassessing lease classification. \nPrepaid rent \nWhen a lease prepayment has been made before the classification \nreassessment date, the ‘lease payments’ (which include lease prepayments – \nsee section 5.4) for the modified/remeasured lease to be included in the present value test include the unamortized amount thereof. \n[842- 10-30-5(a)] \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 415}), Document(page\_content='Leases 415 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. For example, Lessee has a 10- year lease for which it prepaid the $100,000 in \nlease payments at lease commencement. When the lease is modified at the \nend of Year 3, the unamortized amount of the prepayment ($70,000) is included \nin performing the present value test, together with any new lease payments \nrequired under the modified lease. It would not be appropriate to ignore the \nunamortized prepayment, and consider only the remaining post -modification \nlease payments, when assessing classification of the modified lease. \nIn addition to the extr eme example in the preceding paragraph (i.e. a fully \nprepaid lease) , a prepayment can arise solely from the timing of payments \nunder the existing lease, or because the payments decrease over the lease \nterm. However, although less significant than the unamortized prepayment in \nthe prepaid lease example, we believe any prepaid rent balance resulting from \nthese items would similarly be included in the lease payments of the modified \nor remeasured lease. \nUnamortized lease incentives \nLike lease prepayments, leas e incentives are part of the ‘lease payments’ (see \nsection 5.4.3). [842- 10-30-5(a)] \nTherefore, we believe unamortized lease incentives should be treated in the \nsame manner as unamortized lease prepayments when reassessing the \nclassification of a modified o r remeasured lease. This is even though \nunamortized lease incentives will have the opposite effect on the lease payments considered in the present value test – i.e. such amounts will reduce, \nrather than increase, the lease payments factored into the test by their \ninclusion. \nAccrued rent \nAccrued rent will generally arise if a lease has escalating lease payments (e.g. \n$100 in Year 1, $110 in Year 2, $120 in Year 3) or , less frequent, requires a \nballoon payment at or near the end of the lease. Accrued rent reflects the portion of the lease cost recognized to date attributable to lease payments the \nlessee has not yet made. \nWe believe it is appropriate to treat accrued rent in the same manner as prepaid rent. Consequently, we believe it is appropriate for the lessee to reduce the \nlease payments factored into the present value test by the amount of any \naccrued rent. This will have the same effect on the lease payments considered in the present value test as unamortized lease incentives. \nOperational challenge \nWe a re aware that some leasing IT systems have not been designed to \nseparately track unamortized lease prepayments and lease incentives, or \naccrued rent after lease commencement. This is because those items become \npart of the measurement of the ROU asset (see paragraph 6.3.70), and many leasing IT systems have been programmed on the basis of ‘Method 2’ for measuring the ROU asset post -commencement (see paragraph 6.4.170). \nDespite this operational challenge, we believe each of the items discussed in \nthis questi on should be considered in the present value test when assessing \nthe classification of a modified or remeasured lease. This is especially because Topic 842 describes subsequent measurement of the ROU asset in the manner ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 416}), Document(page\_content='Leases 416 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. of ‘Method 1’ (see paragraph 6.4.170), which involves separate tracking of \nprepaid/accrued rent and lease incentives , rather than Method 2. \n \n Question 6.2.25 \nLease classification – portfolio residual value \nguarantee by the lessee \nHow should a lessee evaluate the present value classification \ntest when it provides a residual value guarantee of a portfolio \nof underlying assets? \nBackground: In some agreements, such as master lease agreements, a lessee \nmay guarantee the residual value of a group of assets instead of the residual \nvalue of each individual asset in the group. For example, a lessee may \nguarantee that the combined residual value of five leased assets will be \n$50,000 at the end of the lease of all five, without making any guarantee as to the residual value of any one of those five assets. \nResidual value guarantees and lease classification \nThe principle in Topic 842 is to classify leases as finance or operating on the \nbasis of whether the lease is akin to a financed purchase of the underly ing \nasset by the lessee because the lessee, in effect, obtains control of (i.e. the ability to direct the use of, and obtain substantially all the remaining benefits \nfrom) the underlying asset through the lease. \n[ASU 2016- 02.BC70] \nThe present value classif ication test includes the maximum amount of the \nlessee’s residual value guarantee. This is because the lessee in effect controls \nthat portion of the underlying asset that it has guaranteed – it has the choice to \neither (1) return the asset to the lessor wi th the required residual value, or (2) \nuse and consume all or a portion of those benefits of the asset and pay the \nresidual value deficiency. [ASU 2016- 02.BC71(d)] \nGuidance on lessor consideration of portfolio residual value guarantees \nTopic 842 contains s pecific guidance applicable to lessors that residual value \nguarantees of a portfolio of underlying assets should generally be ignored when \nperforming the present value lease classification test (see paragraph 7.2.90 and Question 7.2.05). \nHowever, Topic 84 2 does not state whether lessees should similarly ignore a \nportfolio residual value guarantee when performing the present value lease classification test for leases within the portfolio. \n[842- 10-55-10] \nInterpretive response: We believe that a lessee portfolio residual value \nguarantee should be factored into the lessee’s consideration of the present \nvalue lease classification test for each lease within the portfolio to which the \nresidual value guarantee applies. \nAbsent explicit guidance such as that for les sors stating portfolio residual value \nguarantees should be ignored when performing the present value lease \nclassification test, we believe the basis for conclusions to ASU 2016- 02 \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 417}), Document(page\_content='Leases 417 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. supports that lessee residual value guarantees (including those over a portf olio \nof underlying assets) should be considered. \nHow to consider the guarantee \nTopic 842 does not address how a portfolio residual value guarantee should be \nallocated to the individual assets when assessing lease classification . In \ngeneral, we believe an amount equal to the entire portfolio residual value \nguarantee should be assigned to each lease subject to the guarantee (referred \nto as the ‘all -in’ approach) when performing the present value lease \nclassification test. This is because, b y virtue of its un ilateral right to choose \nwhich of the portfolio assets it can consume the remaining benefits of, the \nlessee effectively controls – i.e. has the right to direct the use, and obtain \nsubstantially all of the remaining benefits, of – all of the underlying assets. \nHowever, i n some cases, we believe it would also be acceptable for the lessee \nto allocate the portfolio residual value guarantee to the leases on a pro rata basis when performing the present value classification test. This would be \nacceptable when the leases associated with the portfolio residual value \nguarantee are substantially the same such that the lessee could (regardless of \nwhether it does or does not actually do so) account for them on a portfolio basis \n(see section 5.8). \nUnder th e pro rata approach, a portion of the portfolio residual value guarantee \nis allocated to each lease based on the expected residual value of each \nunderlying asset at the end of the lease term. For example, if the total portfolio \nguarantee for a lease of five assets is $50,000 and the expected residual value for each of the underlying assets is $10,000, twenty percent of the total \nguarantee amount is allocated to each lease. \nIf a lessee elects to use the pro rata approach in those circumstances where it is permitted to do so, it should do so consistently. \n \n Example 6.2.25 \nLessee classification – present value test with lessee \nportfolio residual value guarantee \nLessee LE and Lessor LR enter into four leases of identical pieces of \nequipment. The following facts are relevant for each lease at lease commencement (same date for all four leases). \nNon-cancellable lease term: 7 years \nLease payments: Fixed payments of $2,710 per year in arrears \nTransfer of ownership: None \nRenewal/purchase/termination options: None \nFair value (FV) of equipment: $28,272 \nTotal economic life of equipment: 20 years \nRemaining economic life of equipment: 10 years \nAlternative use to LR at end of lease: Yes ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 418}), Document(page\_content='Leases 418 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Estimated residual value at end of lease: $11,000 per piece of equipment \nLE’s incremental borrowing rate: 4.5% (implicit rate cannot be readily \ndetermined) \nPresent value (PV) of lease payments: $15,969 \nInitial direct costs: None \nIn addition, LE provides a guarantee that the residual value of the four pieces of \nequipment, in aggregate, will be $44,000 at the end of the leases. There is no \namount probable of being owed under the portfolio residual value guarantee at \nlease commencement. The leases a re substantially similar (i.e. same term, \nsame payments, identical underlying assets) such that LE could account for \nthem using a portfolio approach. \nBased on these facts, none of the finance lease criteria other than the present \nvalue test are met for any of the leases. LE evaluates the present value test \nusing the bright -line threshold of 90% (see paragraph 6.2.110). \nScenario 1: Present value test using all -in approach \nLE elects to use the all -in approach, even though LE would be permitted to use \nthe pro rata approach. LE’s application of the all -in approach to the present \nvalue test results in the following. \n Lease #1 Lease #2 Lease #3 Lease #4 \nFV of equipment : $28,272 $28,272 $28,272 $28,272 \nPV of lease payments : 15,969 15,969 15,969 15,969 \nRVG amount: 44,000 44,000 44,000 44,000 \nPV of RVG amount:1 32,332 32,332 32,332 32,332 \nPV for classification test:2 48,301 48,301 48,301 48,301 \nPV test met:3 Yes (171%) Yes (171%) Yes (171%) Yes (171%) \nLease classification: Finance Finance Finance Finance \nNotes: \n1. Net PV of one payment equal to the ‘RVG amount’ to be paid at the end of the lease \nterm, discounted using LE’s incremental borrowing rate of 4.5%. \n2. PV of lease payments + PV of allocated RVG. \n3. PV for classification test / FV of equipment. \nScenario 2: Present value test using pro rata approach \nBecause the leases could be accounted for using a portfolio approach, LE is \npermitted to use the pro rata approach to allocate the portfolio residual value \nguarantee for purposes of perform ing the present value test. LE’s application of \nthe pro rata approach to the present value test results in the following. \n Asset #1 Asset #2 Asset #3 Asset #4 \nAllocated RVG:1 $11,000 $11,000 $11,000 $11,000 \nPV of lease payments: 15,969 15,969 15,969 15,969 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 419}), Document(page\_content='Leases 419 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Asset #1 Asset #2 Asset #3 Asset #4 \nPV of allocated RVG:2 8,083 8,083 8,083 8,083 \nPV for classification test:3 24,052 24,052 24,052 24,052 \nPV test:4 No (85.1%) No (85.1%) No (85.1%) No (85.1%) \nLease classification: Operating Operating Operating Operating \nNotes: \n1. $44,000 total residual value guarantee × ($11,000 estimated residual value for each \npiece of equipment / $44,000 aggregate estimated residual value) = $11,000. \n2. Net PV of one payment equal to the ‘Allocated residual value guarantee’ to be paid at \nthe end of the lease term, discounted using LE’s incremental borrowing rate of 4.5%. \n3. PV of lease payments + PV of allocated RVG. \n4. PV for classification test / FV of equipment. \n \n6.2.140 When it is not practicable for an entity to determine the fair value of the \nunderlying asset, lease classification is determined without consideration of the \npresent value test. [842- 10-55-3] \nAlternative use test \n6.2.150 In assessing whether an underlying asset has an alternative use to the \nlessor at the end of the lease term, an entity considers the effect of contractual restrictions and practical limitations on the lessor’s ability to readily direct the \nunderlying asset for another use. \n[842- 10-55-7] \n— Contractual restrictions on a lessor’s ability to redirect an asset must be \nsubstantive (i.e. enforceable) for the asset not to have an alternative use to \nthe lessor. \n— Practical limitations exist if the lessor would incur signif icant economic \nlosses to direct the underlying asset for another use. A significant economic \nloss could arise because the lessor either would incur significant costs to \nrework the asset that exceed the economic benefits it would be able to \nderive from that rework, or would only be able to sell or re- lease the asset \nat a significant loss. This might occur, for example, with assets that have \nunique design specifications or that are located in remote areas. \n6.2.160 The possibility of a contract with the lessee being terminated is not a \nrelevant consideration for determining whether the lessor would be able to readily direct the underlying asset for another use. \n[842- 10-55-7] \n6.2.170 When an underlying asset has no alternative use to the lessor at the end \nof the lease term, the lessee consumes all (or substantially all) of the remaining \nbenefits from the underlying asset. Absent significant rework or a change in \ncircumstances during the lease term (e.g. the emergence of another potential \ncustomer or a new use for the underlying asset in its present, specialized form), \nthere are no (or minimal) remaining benefits inherent in the underlying asset \nthat revert to the lessor at the end of the lease term. Even if such a change in \ncircumstances does occur during the lease term, classification of the lease is \nnot reassessed. [ASU 2016- 02.BC71(e)] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 420}), Document(page\_content='Leases 420 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 6.2.30 \nLease classification – alternative use test \nLessor LR enters into a contract to customize a piece of production equipm ent \nfor Lessee LE’s specific needs and then to lease that equipment to LE for \nfive years. At the end of five years, LR would incur significant costs to rework \nthe design and functionality of the equipment to be able to lease or sell that \nequipment to anoth er customer ; it is unlikely that LR would be able to recover \nthose costs . \nThe lease is classified as a finance lease by LE (and a sales- type lease by LR). \nThis is regardless of the lease term, the lease payments, whether the lease \nincludes a purchase optio n, and any other terms or conditions of the lease. \n \n Question 6.2.30 \nContractual restrictions and the alternative use test \nHow do contractual restrictions affect the alternative use \ntest? \nInterpretive response: Enforceable contractual restrictions on the lessor after \nthe end of the lease term can affect whether the alternative use classification \ntest is met. However, because the alternative use test explicitly applies only \nwhen the underlying asset is highly specialized or subject to hi ghly specialized \ncircumstances, we believe contractual restrictions alone (e.g. preventing the \nlessor from re -leasing or selling the asset to another customer) do not cause \nthis test to be met if the underlying asset is not of a highly specialized nature or subject to highly specialized circumstances. \n[842- 10-25-2(e), 55- 7] \nContractual restrictions can affect the evaluation of the alternative use test because even a highly specialized asset may have an alternative use to the \nlessor at the end of the lease t erm; for example, there may be other customers, \neven if only a few, that could lease or purchase the asset. \nA contractual restriction may be placed on the lessor if the lessee designed \nsome of the specifications or paid the lessor a premium to develop or include \nthose specifications in the asset; in that case, the lessee may require the \nrestriction to prevent a competitor from benefitting from its investment in the \nasset. If that contractual restriction is enforceable, even though the asset could \nbe redirected for an alternative use, then this test would be met. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 421}), Document(page\_content='Leases 421 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 6.2.40 \nAsset evaluated for alternative use \nWhen evaluating whether the underlying asset has an \nalternative use to the lessor, should the asset be evaluated \nbased on how it will be configured when it is ultimately \nreturned to the lessor? \nInterpretive response: Yes. Consistent with a similar concept under Topic 606, \nwe believe the alternative use of an asset should be assessed based on the \nconfiguration or form that will ultimately be returned to the lessor – e.g. after \ncustomization or modification. \nUnder Topic 606, when considering whether a good or service that will be \ntransferred to the customer has an alternative use to the seller, the seller \nconsiders the characteristics of the a sset that will ultimately be transferred to \nthe customer and whether the asset – in its completed form – could be \nredirected without significant cost of rework. Therefore, this test can be met for \nan asset that only becomes customer -specific at or near the end of the \nproduction, modification or customization process. [ASU 2014- 09.BC136, \nTRG 11-16.56] \nThe equivalent notion under Topic 842 is to consider the characteristics of the \nunderlying asset that will ultimately be returned to the lessor at the end of the \nlease term. While lease classification is assessed at lease commencement, we \nbelieve the asses sment considers all relevant expectations about \ncustomizations or modifications that will be made during the lease term, and \nthat will affect the characteristics of the underlying asset at the point in time it \nis returned to the lessor. \nFor example, if th ere is an agreement for the lessor to make significant \ncustomizations after the commencement date that will result in the underlying \nasset not having an alternative use to the lessor at the end of the lease term, \nthose should be considered at lease commenc ement when performing the \nalternative use test. \nHowever, we believe consideration of the asset that will ultimately be returned \nto the lessor should not take into account customizations or modifications that \nare not already agreed or committed to at lease commencement. If significant \ncustomizations or modifications are made after lease commencement, that may result in a reassessment of the lease classification, among other things; this is \nbecause significant customizations or modifications to an underlying asset will \ngenerally trigger a reassessment of any lessee options in the contract (see section 6.6). \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 422}), Document(page\_content='Leases 422 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Observation \nAlternative use test infrequently met on its own \n6.2.180 The basis for conclusions states, “In general, it is expected that lessors \nwould lease specialized assets that have no alternative use to them at the end \nof the lease term only under terms that would transfer substantially all the \nbenefits (and risks) of the asset to the lessee (therefore, one of the other \ncriteria for a finance lease also likely will be met).” [ASU 2016- 02.BC71(e)] \n6.2.190 We believe this statement is instructive in applying this new test for \ntwo reasons. \n— It suggests that a conclusion that t his test is met without meeting, or nearly \nmeeting, any of the other accompanying tests may be worthy of further \nconsideration; for example, when the lease term is almost a major part of \nthe remaining economic life of the underlying asset, or the present v alue of \nlease payments is almost substantially all of the fair value of the underlying asset. That is not, however, to say it cannot be met in isolation. \n— It emphasizes that this test is focused on capturing scenarios in which the lessor would have to perform significant rework on the underlying asset, or \nthere would have to be a change in circumstances to redirect it for another \nuse. This means that the underlying asset being of a highly specialized \nnature or subject to highly specialized circumstances (e.g. being located in a \nremote area) is, in fact, key to meeting this test. This test is not intended to \nbe a second lease term test whereby it is met solely because the asset will \nhave no alternative use at the end of the lease term because of its age. \n \n6.2.2 Other classification considerations # \nLease of an acquiree \n6.2.200 The acquirer retains the acquiree’s lease classification, unless the lease \nis modified as part of the business combination and that modification is not accounted for as a separate contract ( see section 6.7). \n[842- 10-55-11] \nRelated party leases \n6.2.210 An ent ity classifies a lease between related parties on the basis of the \nlegally enforceable terms and conditions of the lease. An entity does not classify the lease based on an evaluation of its economic substance. The \nclassification and accounting for the leas es should be the same as for leases \nbetween unrelated parties in the stand -alone financial statements of the related \nparties. \n[842- 10-55-12] \n6.2.215\u202f An exception to paragraph 6.2.210 arises if the lease is between related \nparties under common control and the entity elects the practical expedient \noutlined in section 3.1.2. In that case, the entity classifies and accounts for the \nlease based solely on the written terms and conditions between the two \nparties. [842- 10-15-3A] \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 423}), Document(page\_content='Leases 423 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 6.2.50# \nLegally enforceable terms and conditions in \ncommon control leases \nDo the ‘legally enforceable terms and conditions’ of a lease \nbetween entities under common control include terms that \nare outside of the written contract? \nThis question applies only to public companies, private entities before the \nadoption of ASU 2023- 01 and private entities that do not elect the practical \nexpedient in section 3.1.2. \nBackground: Under Topic 842, an entity generally considers that the \nenforceable rights and obligations of two parties may extend beyond those \nwritten into the contract that contains the lease. This is because enforceability \ndepends on the relevant laws and enforcement practices in the governing \njurisdiction to which the contract is subject , and therefore can arise from other \nwritten agreements (outside of the contract that includes the lease), verbally or \nas a result of either entity’s customary business practices. What rights and \nobligations are enforceable may vary across legal jurisdictions, industries and entities. \nInterpretive response: Typically, no. While an entity should generally consider \nthat the enforceable rights and obligations of the parties may extend beyond \nthose written into the contract, in the case of a lease between parties under \ncommon control, we believe it was the Board’s intent to significantly simplify \nthe accounting for such leases by following easily identifiable terms and conditions. Identifying enforceable rights and obligations not included in a \nwritten contract may be extremel y difficult in a lease between parties under \ncommon control because of the related party nature of the arrangement. \nTherefore, while we acknowledge that looking only to the written terms of a \nlease between two parties under common control is inconsistent with looking \nto the enforceable rights and obligations of the entities more broadly in other \nscenarios, we believe this is consistent with the intent of the Board when establishing the related party leasing requirements in Topic 842. \n[ASU 2016- 02.BC374] \nThat said, if the written contract (including if there is no written contract) does \nnot align with other related transactions or agreements – e.g. a one month \nwritten lease term but the lessee is constructing significant leasehold improvements with an econom ic life much longer than the written lease term – \nit should be considered whether there is an unwritten contract or understanding. Involvement of qualified legal counsel may be necessary to \ndetermine if an unwritten contract or understanding creates enforc eable rights \nand obligations on the parties. \n \nFacilities owned by a governmental unit or authority \n6.2.22 0 Because of special provisions normally present in leases of terminal \nspace and other airport facilities owned by a governmental unit or authority, t he \neconomic life of such facilities for lease classification purposes is in effect \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 424}), Document(page\_content='Leases 424 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. indeterminate. It also may not be practicable to determine the underlying \nasset’s fair value. Accordingly, these leases are classified as operating leases if: \n[842- 10-55-13] \n— they do not transfer ownership of the underlying asset to the lessee by the \nend of the lease term; and \n— it is not reasonably certain that the lessee will exercise an option (if there is \none) to purchase the underlying asset. \n6.2.23 0 This guidance also applies to leases of other facilities (e.g. ports and bus \nterminals), but only if all of the conditions in paragraph 842- 10-55-13 are met. \n6.2.24 0 Leases of underlying assets that do not meet all of those criteria are \nassessed using the same criteria for classifying leases that do not involve government -owned property. \n[842- 10-55-14] \nIndemnification for envir onmental contamination \n6.2.250 Lessee indemnification for environmental contamination, whether for \nenvironmental contamination caused by the lessee during its use of the \nunderlying asset over the lease term or for preexisting environmental \ncontamination, does not affect lease classification. [842- 10-55-15] \n \n Question 6.2.60 \nLessee vs. lessor lease classification \nWill a finance lease of a lessee always be classified as a sales -\ntype lease by a lessor? \nInterpretive response: No. While lessees and lessors apply the same criteria \nunder Topic 842 to determine whether a lease is a finance lease (lessee) or a \nsales- type lease (lessor), there will be instances in which a finance lease is not \nclassified as a sales- type lease or vice versa. \nThis may happen because of one or more of the following (not exhaustive) . \n— Differences in the discount rate used to determine the present value of the \nsum of the (1) lease payments and (2) residual value of the underlying asset \n– i.e. because the lessor will always use the rate implicit in the lease and \nthe lessee will generally use its incremental borrowing rate (see section \n5.6). \n— Differences in judgments about the remaining economic life of the \nunderlying asset, the fair value of the underlying asset and/or whether the \nunderlying asset will have an alternative use to the lessor at the end of the \nlease term. \n— Different assessments of lessee options to renew or terminate the lease or \npurchase the underlying asset. \n— The payments for the lease are at least partially variable and sales -type \nclassification by the lessor would give rise to a selling loss. In that case, \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 425}), Document(page\_content='Leases 425 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. even if the lessee classifies the lease as a finance lease, the lessor is \nrequired to classify the lease as an operating lease (see paragraph 7.2.30). \nEven if both the lessee and the lessor conclude the lease is not a fina nce/sales -\ntype lease, different classification can result if the lessee concludes that the lease is an operating lease and the lessor concludes that the lease is a direct \nfinancing lease. Section 7.2 has further discussion of lease classification from \nthe lessor’s perspective. \n \n Comparison to legacy US GAAP \nSimilar but not the same \n6.2.260 While the lease classification tests in Topic 842 are similar to those in \nTopic 840, there may be differences in lease classification even when a lessee \nuses the bright -line thresholds – i.e. the 75%, 25% and 90% thresholds for the \nlease term and present value tests (see paragraphs 6.2.90 and 6.2.110). These \ndifferences arise from the following. [840- 10-10-1, 25- 1, 25 -69] \n— The alternative use test in Topic 842 did not exist under Topic 840. \n— The exception that applies to the lease term test for leases that commence at or near the end of the underlying asset’s economic life applied to both \nthe lease term and the present value tests in Topic 840. Therefore, some \nleases that would have met the present value test under Topic 840 if it \nwere not for the exception may meet that test, and be classified as a finance lease (or sales -type lease for lessors), under Topic 842. \n— Most of the specific asset rules in Topic 840 (e.g. for the classification of a \nlease involving real estate) have not been carried forward to Topic 842. The \nonly specific rule in Topic 840 carried forward is the exception to the lease \nterm test when the lease commences at or near the end of the asset’s econom ic life. \n— There are other differences that are relevant for lessors that are discussed \nin section 7.2. \n6.2.265 Some leases contain nonperformance- related default provisions that \nrequire the lessee to purchase the leased asset or make a lump sum payment if \nthe lessee is in default. Under Topic 840, if any of four specified conditions \nwere not met, the lessee was required to include the maximum possible \namount it could be required to pay when performing the present value lease \nclassification test. Therefore, the default provision might push a lease that \nwould otherwise be classified as an operating lease into capital lease \nclassification. [840- 10-25-14] \n6.2.266 The Topic 840 nonperformance- related default provisions guidance does \nnot exist in Topic 842. Therefore, different present value test conclusions may \nbe reached. However, despite having a less punitive effect on lease \nclassification, entities should continue to identify and monitor these provisions \nas they may trigger changes to the lease payments or gi ve rise to variable lease \npayments. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 426}), Document(page\_content='Leases 426 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 6.2.270 There are other changes reflected in Topic 842 that potentially could \nresult in different lease classification compared with Topic 840, even if the \nlease classification tests were identical. \n— Under Topic 842, ‘ executory costs’ (e.g. lessor property tax and insurance \ncosts paid or reimbursed by the lessee) are not excluded from the ‘lease \npayments’ used to perform the present value classification test. In contrast, \nthose amounts were excluded from the minimum lea se payments for \npurposes of performing the present value lease classification test in \nTopic 840. Therefore, because additional amounts may be included in the \nnumerator of the present value test under Topic 842 as compared with the \nnumerator of the present value test under Topic 840, more leases may be \nclassified as finance leases (sales- type leases for lessors) under Topic 842. \n— Lease payments under Topic 842 may be an allocated amount when there \nis more than one component of a contract (see section 4.4). \n6.2.280 Finally, lease classification under Topic 840 was determined at lease \ninception, as opposed to lease commencement. [840- 10-25-1] \n \n6.3 Initial r ecognition and m easurement (Step 5) \n Excerpt from ASC 842 -20 \n25 Recognition \nGeneral \n25-1 At the commencement date, a lessee shall recognize a right -of-use asset \nand a lease liability . \n30 Initial Measurement \nGeneral \n30-1 At the commencement date , a lessee shall measure both of the \nfollowing: \na. The lease liability at the present value of the lease payments not yet paid, \ndiscounted using the discount rate for the lease at lease commencement \n(as described in paragraphs 842- 20-30-2 through 30- 4) \nb. The right -of-use asset as described in paragraph 842- 20-30-5. \n> Discount Rate for the Lease \n30-2 The discount rate for the lease initially used to determine the present \nvalue of the lease payments for a lessee is calculated on the basis of \ninformation available at the commencement date . \n30-3 A lessee should use the rate implicit in the lease whenever that rate is \nreadily determinable. If the rate implicit in the lease is not readily determinable, \na lessee uses its incremental borrowing rate . A lessee that is not a public \nbusiness entity is permitted to use a ris k-free discount rate for the lease \ninstead of its incremental borrowing rate, determined using a period ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 427}), Document(page\_content='Leases 427 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. comparable with that of the lease term , as an accounting policy election made \nby class of underlying asset. \n30-4 See Example 2 (paragraphs 842- 20-55-17 through 55- 20) for an illustration \nof the requirements on the discount rate. \n> Initial Measurement of the Right -of-Use Asset \n30-5 At the commencement date , the cost of the right- of-use asset shall \nconsist of all of the following: \na. The amount of the initial measurement of the lease liability \nb. Any lease payments made to the lessor at or before the commencement \ndate, minus any lease incentives received \nc. Any initial direct costs incurred by the lessee (as described in \nparagraphs 842-10-30-9 through 30- 10). \n30-6 See Example 3 (paragraphs 842 -20-55-21 through 55 -39) for an illustration \nof the requirements on lessee measurement of the lease term . \n \n6.3.10 A lessee recognizes a n ROU asset and a lease liability at lease \ncommencement. [842- 20-25-1] \n \n Observation \nRecognitio n or disclosure may be required before \nthe commencement date \n6.3.20 The recognition of ROU assets and lease liabilities at the lease \ncommencement date is consistent with the overall lease accounting model for \nlessees. A lessee recognizes a lease asset and a lease liability when it obtains \ncontrol over the use of the underlying asset, which is a t the lease \ncommencement date (see section 5.1). [ASU 2016- 02.BC182] \nOnerous lease contracts \n6.3.30 A lease may be an onerous contract (e.g. the lease payments exceed the \nexpected benefits to be derived from the lessee using the asset) between lease \ninception and lease commencement. In that case, the lessee accounts for the \ncontract in accordance with Topic 450 (contingencies ), which may require \nrecognition of a liability before the lease commencement date. \n[ASU 2016- 02.BC117, BC182] \nDisclosures about leas es before recognition and measurement \n6.3.40 In addition, as discussed in section 12.2, Topic 842 requires a lessee to \ndisclose qualitative information about significant leases that have been entered \ninto as of the reporting date, but which have not yet c ommenced. [842- 20-50-3(b)] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 428}), Document(page\_content='Leases 428 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 6.3.10 \nCapitalization thresholds \nIf adopting a policy not to capitalize leases below a specified \nthreshold, does that threshold need to consider the effects of \nnot recognizing the ROU asset, not recognizing the lease \nliability and not making the required disclosures about the \nlease separately? \nBackground: In the basis for conclusions to ASU 2016- 02, the Board observed \nthat, in addition to accounting for some leases at a portfolio level, entities would \nlikely be able to adopt reasonable capitalization thresholds below which lease \nassets and lease liabilities are not recognized; this should reduce the costs of \napplying the guidance. The Board noted that an entity’s practice in this regard may be consistent with many entities’ accounting policies in other areas of \nUS GAAP – e.g. in capitalizin g purchases of property, plant and equipment. \n[ASU 2016- 02.BC122] \nInterpretive response: Yes. Based on discussions with the SEC staff, we \nbelieve that while use of capitalization thresholds may be acceptable, like any \nother non- GAAP policy, a lessee should separately evaluate the effects of not \nrecognizing the lease liability and the ROU asset on the balance sheet (both individually and in the aggregate) when establishing a capitalization threshold for \nleases. And, if the lessee also intends to exclude leas es below the threshold \nfrom its lease disclosures, the threshold should consider the effect on the \ncompleteness and accuracy of those disclosures. \nIt would not be appropriate to: \n— evaluate the effect of non- recognition on a ‘net’ basis – i.e. considering only \nthe net effect on the balance sheet (ROU asset – lease liability); \n— evaluate without consideration of the effect on disclosures; or \n— default to a threshold used for another non- GAAP policy, such as that used \nfor not capitalizing property, plant and equip ment or prepaid expenses. \nBecause non- recognition of liabilities generally has a greater quantitative and \nqualitative effect on the financial statements than non- recognition of assets, we \nbelieve lease capitalization thresholds would typically need to be lower than \nthose established for the capitalization of property, plant and equipment. \nDepending on the facts and circumstances, consideration of the effect of \nexcluding leases below the threshold from the lessee’s lease disclosures may \nfurther lower the threshold. \nLessees may want to consider the materiality guidance in SAB Topic 1.M when \nconsidering an appropriate lease capitalization threshold. \nNon-recognition of ROU assets only \nWhile we expect most lessees’ consideration of a capitalization threshold would \nrelate to non- recognition of the entire lease (i.e. both the ROU asset and the \nlease liability) on its balance sheet, we believe it would be acceptable for a \nlessee to establish a threshold whereby it recognizes the lease liability, but \ndoes not recognize the ROU asset. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 429}), Document(page\_content='Leases 429 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. That is, for leases below the threshold, the lessee would expense at lease \ncommencement an amount that would otherwise be the initial measurement of \nthe ROU asset and account for the lease liability on an amortized cost basis, \nusing the effective interest method, over the lease term. In that case, for \noperating leases, similar to when an ROU asset has been fully impaired (see \nsection 6.5), we would expect the accret ion of the lease liability to be presented \nas an operating expense, consistent with how the lessee’s single lease cost \nwould be presented if the ROU asset was recognized but impaired. \nIf a lessee adopts a capitalization threshold that applies only to its ROU assets, \nit may be able to use a threshold similar to that used for its owned property, \nplant and equipment because the considerations will generally be similar. \nHowever, the lessee’ s existing property, plant and equipment capitalization \nthreshold that was deemed to be acceptable from a non- GAAP perspective will \nnot have considered the incremental effect to the financial statements of the \nadded non- recognition of ROU assets. Therefore, for the combined effect of not \nrecognizing property, plant and equipment and ROU assets below the threshold \nto be immaterial, that threshold may need to be reconsidered. \nIn addition, consistent with the discussion of non- recognition of ROU assets \nand lea se liabilities, the effect on the lease disclosures of expensing the ROU \nasset at lease commencement will need to be considered. The effect may be \npartially mitigated if: \n— for operating leases, the lessee discloses the amount of expense \nrecognized at lease commencement for the cost of the ROU asset and the \naccretion of the lease liability as operating lease cost in the disclosure \nrequired by paragraph 842- 20-50-4(b); and \n— for finance leases, the lessee discloses the amount of expense recognized at lease comme ncement for the cost of the ROU asset as ROU asset \namortization in the disclosure required by paragraph 842- 20-50-4(a). \n6.3.50 At lease commencement, the lease liability for both finance and operating \nleases equals the present value of the unpaid lease pa yments, discounted at \nthe rate implicit in the lease (if readily determinable), or otherwise at the lessee’s incremental borrowing rate. The discount rate for the lease is \ncalculated on the basis of information available at lease commencement. For a \ndiscus sion on determining the ‘lease payments’, see section 5.4; and on \ndetermining the ‘discount rate for the lease’, see section 5.6. \n[842- 20-30-1 – 30-3] \nLease liabilityPV of unpaid \nlease \npayments \n6.3.60 When the rate implicit in the lease is not readily determinable (see \nQuestion 5.6.20), a lessee that is not a public business entity may use a risk -\nfree discount rate for the lease, instead of its incremental borrowing rate, as a \naccounting policy election by class of underlying asset. The risk -free rate is \ndetermined using a period comparable to that of the ‘lease term’ . [842- 20-30-3] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 430}), Document(page\_content='Leases 430 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 6.3.70 The ROU asset for finance and operating leases is initially measured at \nthe sum of: [842- 20-30-5] \nPrepaid lease \npaymentsInitial \nmeasurement \nof the lease \nliability Lease \nincentives \nreceived\n(section 5.4.3)IDCs\n(section 5.5)\n \n \n Example 6.3.10 \nInitial measurement of the lease liability and ROU \nasset \nLessee LE enters into a contract with Lessor LR for the right to use office \nspace for a 10- year term. The right to use the office space is a lease and there \nare no other components of the contract. The following facts are relevant at the \nlease commencement date. \nLease payments : Fixed payments of $14,527 per year in arrears, \nwith a 3% increase every year after Year 1 \nRenewal options: 5-year extension; payments during that period are \n$19,523 per year in arrears, with a 3% increase \nevery year after Year 1 of the extended period \nTermination/purchase options: None \nTransfer of ownership: No \nRVG: None \nLE’s incremental borrowing rate: 10% (the rate implicit in the lease cannot be \nreadily determined) \nInitial direct costs (LE): $5,000 \nContractual payments \nFor ease of reference in this example and Examples 6.4.10, 6.4.20, 6.5.10, \n6.6.50, 6.7.10 and 6.7.30, the contractual payments for the right to use the \noffice space are presented here. \nNon-cancellable lease period \nExtension period \nYr 1 Yr 2 Yr 3 Yr 4 Yr 5 Total \n$19,523 $20,109 $20,712 $21,333 $21,973 $103,650 \nLease payments \nLE concludes, based on all relevant economic factors at the lease \ncommencement date, that it does not have a compelling economic reason to \nexercise the extension option, and therefore is not reasonably certain to do so. Yr 1 Yr 2 Yr 3 Yr 4 Yr 5 Yr 6 Yr 7 Yr 8 Yr 9 Yr 10 Total \n$14,527 $14,963 $15,412 $15,874 $16,350 $16,841 $17,346 $17,866 $18,402 $18,954 $166,535 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 431}), Document(page\_content='Leases 431 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Therefore, the lease term is 10 year s and the lease payments are the $166,535 \nin payments that will be made during the 10- year lease term. \nLease liability \nAt the lease commencement date, LE recognizes a lease liability of $100,000. \nThis is the present value of the 10 lease payments (starting at $14,527 and \nescalating at 3% per year), discounted at LE’s incremental borrowing rate \nof 10%. \nLease liabilityPV of unpaid \nlease \npayments\n(section 5.4)\n$100 ,000 \nRight -of-use asset \nLE recognizes a corresponding ROU asset of $105,000, which is calculated as \nfollows. \nPrepaid lease \npaymentsInitial \nmeasurement \nof the lease \nliability Lease \nincentives \nreceivedInitial direct \ncosts\n$100 ,000 $5,000 Nil Nil \n \n Question 6.3.14 \nLease incentives receivable that exceed the unpaid \n‘lease payments’ for a lease \nHow should a lessee account for lease incentives receivable \nfrom the lessor that exceed the unpaid lease payments ? \nBackground: Paragraph 5.4.10 outlines that lease incentives reduce the ‘lease \npayments’. Unpaid lease incentives (i.e. lease incentives receivable) reduce the \nrecorded lease liability (see Example 5.4.90). [842- 10-30-5(a)] \nLease incentives may be earned in leases with no, or only a minimal, recorded \nlease liability – e.g. in leases for which the payments for the right to use the \nunderlying asset are mostly or entirely variable. Topic 842 does not address \nhow a lessee should account for lease incentives whose recognition would \nreduce the carrying amount of the lease liability below zero. \nInterpretive response: We believe the lessee should recognize the excess of \nthe lease incentive receivable over the lease liability as a lease receivable. \nIn measuring the lease incenti ve receivable, we believe the lessee should \ndiscount the unpaid incentives using the discount rate for the lease (typically, the lessee’s incremental borrowing rate – see Question 5.6.20). This is \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 432}), Document(page\_content='Leases 432 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. consistent with how the incentive payment inflows would be discounted if they \nwere netted against lease payment outflows in calculating the lease liability. We \ndo not believe the lease incentive receivable should be discounted differently \nbased solely on where it will be presented on the lessee’s balance sheet. \nInterest on the discounted lease incentive receivable should be recognized as a \nreduction of finance lease interest cost (finance leases) or operating lease cost \n(operating leases), which is consistent with how the interest element of a lease \nincentive recei vable affects the lessee’s income statement when the receivable \nis netted within a larger lease liability. \nThis guidance applies equally to contingent lease incentives (see Question \n6.6.90), which may be recorded before they are received/receivable from th e \nlessor if the lessee has elected the ‘estimation at lease commencement’ approach (see Question 6.6. 80). \nAccounting for lease incentive receivables before lease commencement \nA lease incentive receivable may exceed the carrying amount of the lease \nliabilit y because the incentive is earned before lease commencement – i.e. \nbefore a lease liability is recognized (see paragraph 6.3.10). \nIn that case, we believe a lease receivable should be recognized (consistent \nwith the guidance above) together with an equal, offsetting lease incentive \nliability (see Question 6.3.15). \nBecause the discount rate for the lease is not determined until lease \ncommencement, we believe the lessee should estimate the discount rate for the lease, and true up that rate at lease commencem ent; any resulting \nadjustment should be reflected equally in the initial measurement of the lease \nliability and the ROU asset. Interest on the receivable before lease \ncommencement should be added to the carrying amount of the lease incentive \nliability. \nAt lease commencement, the carrying amount of the lease incentive receivable \nshould be reclassified as a reduction of the lease liability to the extent it does \nnot exceed it. See Question 6.3.15 for commencement date accounting for the \nlease incentive liabili ty. \n \n Question 6.3.15 \nLease incentives that would result in a negative \nROU asset \nHow should a lessee account for lease incentives that would \nresult in a negative ROU asset ? \nBackground: As outlined in paragraph 6.3.70, lease incentives that have been \nreceived by the lessee on or before lease commencement are deducted from \nthe initial carrying amount of the ROU asset. Lease incentives receivable (i.e. \nearned but not yet received) reduce the ‘lease payments’, and therefore both the lease liability and the ROU asset (see paragraph 5. 4.10 and Example 5.4.90). \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 433}), Document(page\_content='Leases 433 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Consequently, lease incentives are recognized over the lease term as a \nreduction of ROU asset amortization (finance leases) or single lease cost \n(operating leases). \nTopic 842 does not address how a lessee should account for lease incentives \nwhose recognition would reduce the carrying amount of the ROU asset below \nzero. This might occur in a lease that either (1) has no recognized ROU asset \n(e.g. because all of the payments for the lease are variable), or (2) has an ROU \nasset with a carrying amount that is less than the lease incentive to be recorded \n– e.g. because most of the payments for the lease are variable or the ROU \nasset has been impaired. \nInterpretive response: When a lease incentive has been r eceived and the \namount exceeds the carrying amount of the ROU asset, we believe the lessee \nshould record the excess as a liability that is separate from the lease liability. \nThe liability should be amortized over the lease term, as a reduction of either \nfinance lease ROU asset amortization or operating lease cost, generally on a \nstraight -line basis. This is consistent with how the incentive would affect ROU \nasset amortization or operating lease cost were it recorded net within the ROU \nasset. \nThis guidance applies equally to contingent lease incentives (see \nQuestion 6.6.90), which may be recorded before they are received or become \nreceivable from the lessor if the lessee has elected the ‘estimation at lease \ncommencement’ approach (see Question 6.6. 80). \nIncentives earned before lease commencement \nA lease incentive may exceed the carrying amount of the ROU asset because it is received or becomes receivable before lease commencement – i.e. before an \nROU asset is recognized (see paragraph 6.3.10). \nIn that ca se, we believe a liability should be recognized consistent with the \nguidance in this question. That liability should be reclassified as a reduction of the ROU asset at lease commencement to the extent it does not exceed the \nROU asset. The lease incentive l iability should not be amortized before lease \ncommencement. \nChapter 14 of KPMG Handbook, Statement of cash flows\n, addresses the \npresentation of such incentives in the stat ement of cash flows. \n \n Question 6.3.17 \nLeases entered into for R&D purposes \nHow should leases be accounted for when entered into for \nR&D purposes and there is no alternative future use for the \nROU asset ? \nInterpretive response: The accounting for the lease liability is unaffected by \nthe fact that the lease was entered into for R&D purposes. The lease liability is \naccounted for in the same manner as for any other lease throughout the lease \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 434}), Document(page\_content='Leases 434 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. term, including with respect to income statement presentation of the interest \non a finance lease liability and accretion of an operating lease liability (see \nsection 6.9). \nWe believe the appropriate accounting for the ROU asset depends on the \nclassification of the lease as finance or operating. \nFinance leases \nWe believe the initial measurement of the ROU asset (see paragraph 6.3.70) should be expensed as an R&D cost at lease commencement. \nWhen issui ng Topic 842, the FASB concluded that a finance lease is \neconomically similar to acquiring the underlying asset itself, and that there are \nsubstantial benefits to accounting for ROU assets consistently with other long-\nlived nonfinancial assets. Therefore, because Topic 730 requires expensing an \nitem of PP&E if it is acquired for a particular R&D project and has no alternative future use, the same accounting should be applied to a finance lease ROU \nasset. \n[730- 10-25-2(a), ASU 2016- 02.BC57, BC255] \nOperating l eases \nFor operating leases, in the absence of additional guidance from the FASB or from the SEC staff, we believe either of the following approaches is acceptable \nif applied consistently. \nApproach A : Expense ROU asset at lease commencement \nSimilar to finance lease ROU assets, the initial measurement of the operating \nlease ROU asset (see paragraph 6.3.70) is expensed as an R&D cost at lease \ncommencement. \nThe FASB did not equate operating leases to acquiring the underlying asset. \nHowever, the FASB’s conclusion that there are substantial benefits to \naccounting for ROU assets consistently with other long- lived nonfinancial \nassets applies equally to finance and operating lease ROU assets. In addition, Topic 730 requires the expensing of intangible assets, which many consider \noperating lease ROU assets to be akin to, acquired for a particular R&D project \nand that have no alternative future use. \n[730- 10-25-2(c), ASU 2016- 02.BC57, BC255] \nApproach B: Account for ROU asset like normal \nUnder this approach, the operating lease ROU asset is accounted for in the same manner as any non- R&D lease. \nSupporters of this approach principally cite the FASB’s stated intent not to \nchange the income statement trea tment of operating leases from legacy US \nGAAP (Topic 840). They observe that Approach A would reflect a significant change from how operating leases subject to this question were accounted for \nunder Topic 840, under which lessees would recognize straight -line operating \nlease expense over the lease term even in R&D operating lease scenarios. \n[ASU \n2016- 02.Summary] \nUnrecognized short -term leases \nIf the lease is a short -term lease that the lessee does not recognize on- balance \nsheet, we believe the lessee should generally account for the lease in the same \nmanner as a non- R&D short -term lease (see section 6.3.1). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 435}), Document(page\_content='Leases 435 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Comparison to legacy US GAAP \nInitial measurement \n6.3.80 Under Topic 840 , an entity initially measure d a lease at lease inception – \ni.e. the date on which an agreement is reached, rather than at lease \ncommencement . \n6.3.90 In addition, Topic 840 precluded a lessee in a capital lease from \nmeasuring the asset recognized at an amount that was greater than the fair \nvalue of the underlying asset at lease inception. That requirement is not \nincluded in Topic 842. Consequently, the initial measurement of a n ROU asset \nat the commencement date could potentially exceed the fair value of the underlying asset, although this outcome is unlikely. In such cases, a significant \nexcess of initial carrying amount to fair value may indicate that the ROU asset \nor the asset group to which it belongs in accordance with Topic 360 ( property , \nplant and equipment ) is not recoverable. S ection 6.5 discusses the testing of \nROU assets for impairment. \n[840- 30-30-1, 30- 3] \n6.3.100 Other differences could arise because the ‘lease payments’ under \nTopic 842 are not the same as the ‘minimum lease payments’ under Topic 840 \n(see section 5.4). \n \n6.3.1 Short -term lease recognition exemption \n Excerpt from ASC 842-20 \n25 Recognition \nGeneral \n> Short -Term Leases \n25-2 As an accounting policy, a lessee may elect not to apply the recognition \nrequirements in this Subtopic to short -term leases . Instead, a lessee may \nrecognize the lease payments in profit or loss on a straight -line basis over the \nlease term and variable lease payments in the period in which the obligation \nfor those payments is incurred (consistent with paragraphs 842- 20-55-1 \nthrough 55- 2). The accounting policy election for short -term leases shall be \nmade by class of underlying asset to which the right of use relates. \n25-3 If the lease term or the assessment of a lessee option to purchase the \nunderlying asset changes such that, after the change, the remaining lease term \nextends more than 12 months from the end of the previously determined lease \nterm or the lessee is reasonably certain to exer cise its option to purchase the \nunderlying asset, the lease no longer meets the definition of a short -term lease \nand the lessee shall apply the remainder of the guidance in this Topic as if the \ndate of the change in circumstances is the commencement date. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 436}), Document(page\_content='Leases 436 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 25-4 See Example 1 (paragraphs 842 -20-55-13 through 55 -16) for an illustration \nof the requirements on short -term leases. \n55 Implementation Guidance and Illustrations \nGeneral \n> Illustrations \n>> Illustration of a Short -Term Lease \n55-13 Example 1 il lustrates the assessment of whether a lease is a short -term \nlease. \n>>> Example 1— Short -Term Lease \n55-14 Lessee has made an accounting policy election not to recognize right -of-\nuse assets and lease liabilities that arise from short -term leases for any class of \nunderlying asset. \n55-15 Lessee enters into a 12- month lease of a vehicle, with an option to \nextend for another 12 months. Lessee has considered all relevant factors and \ndetermined that it is not reasonably certain to exercise the option to extend. \nBecause at lease commencement Lessee is not reasonably certain to exercise \nthe option to exten d, the lease term is 12 months. \n55-16 The lease meets the definition of a short -term lease because the lease \nterm is 12 months or less. Consequently, consistent with Lessee’s accounting \npolicy election, Lessee does not recognize the right -of-use asset and the lease \nliability arising from this lease. \n \n6.3.110 Although short -term leases are within the scope of Topic 842, a \nsimplified form of accounting is permitted. A lessee can elect, by class of \nunderlying asset, not to apply the recognition requirements of Topic 842 and \ninstead to recognize the lease payments as leas e cost on a straight -line basis \nover the lease term. This simplified accounting method is consistent with \nTopic 840 operating lease accounting. [842- 20-25-2] \n \n Question 6.3.20 \nApplying the short -term lease exemption \nCan the lease recognition exemption for short -term leases be \napplied to a lease whose term is just over 12 months? \nBackground: Entities may have administrative or other reasons (e.g. \nstandard practice or tax reasons) that result in a lease term slightly gr eater than \n12 months (e.g. 367 days). This may be the case even if the contract period is \nintended to approximate one year. \nInterpretive response: No. The 12- month threshold for the short -term lease \nexemption is a bright -line exception to the lessee recognition requirements in \nTopic 842. As with other exceptions in the accounting literature, it is applied \nnarrowly as written in Topic 842. Consequentl y, leases whose terms extend \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 437}), Document(page\_content='Leases 437 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. beyond one year, no matter by how much (even one day), are not eligible for \nthe short -term lease recognition exemption. \n \n Question 6.3.21 \nShort -term lease recognition exemption – \nsubsequent consideration \nCan a lease that was not eligible for the short -term lease \nexemption at lease commencement subsequently qualify for \nthe exemption? \nBackground: A lease may be modified or the lease term reassessed after lease \ncommencement such that the reassessed lease term is 12 months or less. \nSimilarly, a lessee purchase option that precluded short -term lease \ncategorization because it was assessed as reasonably certain to be exercised \nmay be (1) removed via modification or (2) reassessed. \nInterpretive response: No. The determination about whether a lease meets \nthe definition of a ‘short -term lease’ is made at lease commencement. This is \nbecause the definition of a short -term lease is one that has a lease term of 12 \nmonths or less ‘at the commencement date’. [842 Glossary] \nTopic 842 has specific guidance overriding the definition, requiring on- balance \nsheet recognition regardless of the determination made at lease \ncommencement, when (see paragraph 6.3.130) : [842- 20-25-3] \n— the lease term changes such that the remaining lease term extends more \nthan 12 months from the end of the previously determined lease term; or \n— it becomes reasonably certain that the lessee will exercise a purchase \noption. \nHowever, no simil ar override exists for changes going in the opposite direction. \nTherefore, a lease that is not a short -term lease at lease commencement can \nnever subsequently be eligible for the short -term lease recognition exemption. \n \n Question 6.3.30 \nResidual value guarantees in short -term leases \nDoes a lessee recognize a separate liability for amounts \nprobable of being owed under a residual value guarantee \nfor a short -term lease to which the recognition exemption \nis applied? \nBackground: Under legacy US GAAP, a lessee residual value guarantee of an \nunderlying asset subject to an operating lease was accounted for in accordance \nwith Topic 460 ( guarantees ). The lessee- guarantor recognized the fair value of \nthe guarantee based on the fair value of the guarantee at lease inception, even if no residual value deficiency was probable. An illustration in Topic 460 \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 438}), Document(page\_content='Leases 438 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. indicated that the guarantee liability recognized by the lessee should be \naccounted for as prepaid rent and, therefore, amortized on a straight -line basis \nover the term of the lease. [840- 20-30-1, 35-1, 460-10-15-7(b), 30-2(b), 55-23(d)] \nSubsequent accounting for the guarantee liability after recognition followed the \nguidance in Topic 460. \nInterpretive response: Yes, to the extent that a residual value deficiency \nis probable and estimable – i.e. the liability recognition requirements in \nTopic 450 are met. [450- 20-25-2] \nIf no deficiency is probable and estimable, we do not believe a liability should be \nrecognized. This is because, as a result of an amendment to T opic 460 in \nASU 2016- 02, all lessee guarantees of the residual value of an underlying asset \nat the end of the lease term are excluded from the scope of Topic 460 – i.e. \nthere is no exception to that scoping provision for unrecognized short -term \nleases. [460-10-15-7(b)] \nIf a residual value deficiency is probable and estimable, we believe either of the \nfollowing approaches is appropriate. \n— Recognize the liability immediately. Under this approach, there is an \noffset to prepaid rent, which is amortized on a stra ight-line basis over the \nremainder of the lease term. This approach is broadly consistent with \nadding probable residual value deficiencies for recognized operating or \nfinance leases to the lease liability and the ROU asset (albeit , in this case, at \nan undi scounted amount). \n— Accrue the cost over the lease term. Under this approach, the residual \nvalue deficiency is an incremental lease payment, recognized on a straight -\nline basis over the remainder of the lease term so that the expected liability \nis fully accrued by the time satisfaction of the residual value deficienc y is \nrequired. This approach is consistent with the Board’s intent for lessees to \naccount for unrecognized short -term leases in a manner consistent with \nTopic 840 operating lease accounting because it is consistent with the \nlegacy requirements in Topic 840 for when a residual value deficiency \nbecomes probable in an operating lease. \n6.3.120 The lease term and the lease payments are determined in a manner \nconsistent with all other leases (see sections 5.3 and 5.4). Consequently, the \nshort -term lease exemption may be applied to cancellable leases (e.g. month- to-\nmonth, evergreen and at -will leases) if the lessee is not reasonably certain to \nrenew (or to continue, in the case of a termination option) the lease beyond \n12 months. [842- 20-25-2] \n \n Example 6.3.20 \nIs it a short -term lease? \nScenario 1: Lease meets the definition of a short -term lease \nLessee LE enters into a contract with Lessor LR to lease a piece of non-\nspecialized equipment for 12 months for construction work at one of its \nfactories. The fo llowing facts are relevant at lease commencement. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 439}), Document(page\_content='Leases 439 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Lease payments: Fixed payments of $500 per month in arrears, with a 3% \nincrease every month after Month 1 \nRenewal options: Two 12- month extensions, with no change in payment structure \nTermination options: None \nPurchase option: Option to purchase at then- prevailing fair value at any time \nduring the lease \nAt lease commencement, LE determines it is not reasonably certain to exercise \nthe renewal options or the purchase option considering all relevant economic \nfactors (i.e. based on the renewal lease payments or the purchase option \nexercise price), and the nature of the underlying asset as a non- specialized \nasset with readily available equivalents in the marketplace. \nTherefore, the lease is a short -term lease because the lease term is not more \nthan 12 months and LE is not reasonably certain to exercise the purchase \noption in the contract. \nLE has not already elected an accounting policy for short -term leases. Upon \nentering into th is lease, LE elects to apply the short -term lease exemption to all \nshort -term leases of assets within the same class of underlying asset. Going \nforward, LE will be required to apply the exemption for all other short -term \nleases of that class of underlying asset. \nIn applying the short -term lease exemption, LE recognizes the lease payments \nas lease cost on a straight -line basis over the lease term. \nScenario 2: Short -term lease that still meets the definition after a \nreassessment \nContinuing from Scenario 1, three months after entering into the lease, Lessee LE expands the scope and duration of construction at its factory so that it is \nnow reasonably certain to exercise the first renewal option for the equipment. \nThe equipment is installed at the factory such that it would be cost -prohibitive \nto remove and install a replacement piece of equipment to complete the \nconstruction work. \nThe lease continues to qualify as a short -term lease, because the remaining \nlease term after the reasses sment does not extend more than 12 months from \nthe end of the previously determined lease term. \nHowever, if the renewal period had been for 13 months instead of 12, the lease \nwould no longer have qualified as a short -term lease and LE would have been \nrequi red to apply the requirements of Topic 842 as if the date of the change in \nassessment of the renewal option were the commencement date. In that case, \nLE would have recognized and measured at the end of Month 3 a lease \nliability and an ROU asset for the equipment lease (reflecting a lease term of \n22 months). \nScenario 3: Lease does not meet the definition of a short -term lease \nLessee LE enters into a contract with Lessor LR to lease a car. The lease \nterm is nine months and LE has the option to renew the leas e for another \nsix months. At lease commencement, LE is reasonably certain to exercise the \nrenewal option. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 440}), Document(page\_content='Leases 440 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The lease does not meet the definition of a short -term lease because the lease \nterm is 15 months. \n \n Example 6.3.30 \nLeases with termination options \nScenario 1: Termination option controlled by lessor \nLessee LE enters into a contract with Lessor LR to lease a jackhammer. The \nlease is for 10 months and will be automatically renewed for a further 6 months \nunless the lease is terminated by LR. \nPeriods cov ered by an option to extend (or not to terminate) the lease where \nexercise of the option is controlled by the lessor are included in the lease term \n(see section 5.3). Accordingly, the lease term is 16 months. Therefore, the \nlease does not meet the definiti on of a short -term lease because the lease term \nis more than 12 months. \nScenario 2: Termination option controlled by lessee \nAssume the same facts as in Scenario 1, except that the decision about \nwhether to terminate the lease after 10 months is Lessee LE’s (rather than \nLessor LR’s). At lease commencement, LE is not reasonably certain to continue the lease beyond the 10- month non -cancellable term based on all \nrelevant economic factors . \nThe lease term is 10 months. Therefore, the lease meets the definition of a \nshort -term lease because the lease term is not more than 12 months. \n6.3.13 0 When the assessment of the lease term or a lessee purchase option \nchanges such that the remaining lease term extends more than 12 months from the end of the previously determined lease term, or it becomes reasonably \ncertain that the lessee will exercise a purc hase option, the lease no longer \nqualifies for the recognition exemption. In that case, the lessee applies the \nrequirements of Topic 842, including the recognition and measurement \nrequirements, as if the date of the change were the commencement date of \nthe lease. \n[842- 20-25-3] \n \n Question 6.3.40 \nReassessment of short -term leases \nAre the lease term or purchase option reassessment \nrequirements for short -term leases different from those for \nleases that are not short -term? \nInterpretive response: No. The requirements for when and how to undertake a \nreassessment of the lease term or a lessee purchase option for a short -term \nlease are the same as for all other leases (s ee section 6.6) . \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 441}), Document(page\_content='Leases 441 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 6.3.14 0 A lessee is required to disclose each period its lease cost for short -term \nleases for which it elects the recognition exemption, excluding expenses \nrelating to leases with a lease term of one month or less. [842- 20-50-4(c)] \n6.3.15 0 A lessee applying the short -term lease exemption to a class of \nunderlying assets for which it has short -term leases discloses that fact. In \naddition, if the short -term lease cost for the period is not representative of the \nlessee’s short -term lease commitme nts, the lessee discloses that fact, and the \namount of its short -term lease commitments (see section 12.2). [842- 20-50-8] \n \n Question 6.3.50 \nLow-value assets lease exemption \nDoes Topic 842 include an exemption for low -value assets? \nInterpretive response: No. Topic 842 does not include an exemption for leases \nof low -value assets such as some copiers, some computer and personal IT \nequipment, or office furniture. This is a notable difference compared to lease \naccounting under IFRS 16. \nUnder IFRS 16, a lessee is permitted not to apply the recognition and \nmeasurement requirements to leases of assets that are of ‘ low value’, which \nthe basis for conclusions to IFRS 16 suggests are assets with a value of $5,000 or less when new. The lessee accounts for such quali fying leases \nconsistent with IAS 17 operating lease accounting. This US GAAP/IFRS \nAccounting Standards difference may complicate the comparison of financial \nstatements of some entities reporting under US GAAP and IFRS Accounting \nStandards , given the Board’s decision not to prov ide a similar exemption. \n[IFRS \n16.5(b), IFRS 16.BC100, ASU 2016- 02.BC 421] \nThe Board decided against a low- value asset exemption because current \nguidance on materiality permits a lessee to exclude leases that are immaterial to its financial statements. The Board observed that a lessee may be able to \nadopt reasonable capitalization thresholds below which lease assets and lease \nliabilities are not recognized, consistent with capitalization thresholds currently \nused by some entities in other areas of US GAAP (e.g. for capitalizing purchases of property, plant or equipment). See Quest ion 6.3.10. \n \n Observation \nShort -term lease exemption may not create \nsignificant structuring opportunities \n6.3.160 The Board considered the possibility of leases being structured to \nmeet the definition of a short -term lease. However, there are economic \nconsiderations that are likely to affect the appetite that both the lessee and the \nlessor have to structure short -term leases. For example, lessors who enter into \nshort -term leases will take on more residual asset risk, and therefore may \nrequire increased l ease payments to mitigate that risk. Other lessors may \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 442}), Document(page\_content='Leases 442 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. refuse to take on that additional risk entirely or be unable to do so based on \nthe terms of their financing arrangements to acquire the leased assets. \n[ASU 2016- 02.BC381] \nAdditional accounting consider ations for short -term leases \n6.3.170 For leases with a non- cancellable period of 12 months or less that \ninclude renewal options (including options not to terminate the lease) and/or \npurchase options, the ‘reasonably certain’ assessment (see section 5.2) will, in \neffect, become the on/off -balance sheet test if the lessee elects the short -term \nlease exemption. Therefore, lessees with leases of that nature that elect the \nexemption will need to have processes and controls in place to ensure that the \nexemption is applied appropriately and, because the exemption is an accounting \npolicy election, is applied consistently to all similar leases. \n6.3.180 In addition, the specific disclosure requirements applicable to short -term \nleases mean that lessees will need processes and controls in place to accumulate and maintain the information necessary to comply with those \ndisclosure requirements. This includes processes to differentiate short -term \nleases (i.e. those with a lease term of 12 months or less) from very short -term \nleases (i.e. those with a lease term of one month or less), the costs of which are not disclosed in the short -term lease cost disclosure. The disclosures are \ndiscussed in section 12.2. \n \n Comparison to legacy US GAAP \nShort -term lease exemption not relevant under Topic 840 \n6.3.190 There is a possibility (albeit remote) that some leases that were \nclassified as capital leases under Topic 840 may qualify for the short -term lease \nexemption, and therefore be derecognized as a result of the short -term lease \nexemption. However, the exemption is most likely to apply to current operating leases, which are not required to be recognized on- balance sheet currently. \nSimilar disclosure requirements \n6.3.200 Topic 840 required lessees to disclose rental expense for all leases with \na lease term of more than one month. Therefore, the requirement to disclose \nshort -term lease cost for all such leases with a term greater than one month is \nnot incremental to the Topic 840 disclosure requirem ents. However, the \nrequirement to disclose short -term lease cost each period separately from other \nlease costs (e.g. operating lease cost and variable lease cost) may involve some \nincremental effort. [840- 20-50-1] \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 443}), Document(page\_content='Leases 443 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 6.4 Subsequent a ccounting (Step 6) \n Excerpt from ASC 842 -20 \n25 Recognition \nGeneral \n> Finance Leases \n25-5 After the commencement date , a lessee shall recognize in profit or loss, \nunless the costs are included in the carrying amount of another asset in \naccordance with other Topics: \na. Amor tization of the right -of-use asset and interest on the lease liability \nb. Variable lease payments not included in the lease liability in the period in \nwhich the obligation for those payments is incurred (see paragraphs 842-\n20-55-1 through 55- 2) \nc. Any impairment of the right -of-use asset determined in accordance with \nparagraph 842- 20-35-9. \n> Operating Leases \n25-6 After the commencement date , a lessee shall recognize all of the \nfollowing in profit or loss, unless the costs are included in the c arrying amount \nof another asset in accordance with other Topics: \na. A single lease cost, calculated so that the remaining cost of the lease (as \ndescribed in paragraph 842 -20-25-8) is allocated over the remaining lease \nterm on a straight -line basis unless anot her systematic and rational basis is \nmore representative of the pattern in which benefit is expected to be \nderived from the right to use the underlying asset (see paragraph 842- 20-\n55-3), unless the right -of-use asset has been impaired in accordance with \nparagraph 842- 20-35-9, in which case the single lease cost is calculated in \naccordance with paragraph 842- 20-25-7 \nb. Variable lease payments not included in the lease liability in the period \nin which the obligation for those payments is incurred (see paragraphs 842 -\n20-55-1 through 55- 2) \nc. Any impairment of the right -of-use asset determined in accordance with \nparagraph 842- 20-35-9. \n25-8 Throughout the lease term, the remaining cost of an operating lease for \nwhich the right -of-use asset has not been impaired consists of the following: \na. The total lease payments (including those paid and those not yet paid), \nreflecting any adjustment to that total amount resulting from either a \nremeasurement in accordance with paragraphs 842 -10-35-4 through 35- 5 or \na lease modification ; plus \nb. The total initial direct costs attributable to the lease; minus \nc. The periodic lease cost recognized in prior periods. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 444}), Document(page\_content='Leases 444 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 35 Subsequent Measurement \nGeneral \n35-1 After the commencement date , for a finance lease, a lessee shall \nmeasure both of the following: \na. The lease liability by increasing the carrying amount to reflect interest on \nthe lease liability and reducing the carrying amount to reflect the lease \npayments made during the period. The lessee shall determine the interest \non the lease liability in each period during the lease term as the amount \nthat produces a constant periodic discount rate on the remaining balance of \nthe liability, taking into consideration the reassessment requirements in \nparagraphs 842- 10-35-1 through 35- 5. \nb. The right -of-use asset at cost less any accumulated amortization and any \naccumulated impairment losses, taking into consideration the \nreassessment requirements in paragraphs 842- 10-35-1 through 35- 5. \n35-2 A lessee shall recognize amortization of the right -of-use asset and inte rest \non the lease liability for a finance lease in accordance with paragraph 842-20-\n25-5. \n35-3 After the commencement date, for an operating lease , a lessee shall \nmeasure both of the following: \na. The lease liability at the present value of the lease payments not yet paid \ndiscounted using the discount rate for the lease established at the \ncommencement date (unless the rate has been updated after the \ncommencement date in accordance with paragraph 842- 20-35-5, in which \ncase that updated rate shall be used) \nb. The right-of-use asset at the amount of the lease liability, adjusted for the \nfollowing, unless the right -of-use asset has been previously impaired, in \nwhich case the right -of-use asset is measured in accordance with \nparagraph 842- 20-35-10 after the impairment : \n1. Prepaid or accrued lease payments \n2. The remaining balance of any lease incentives received, which is the \namount of the gross lease incentives received net of amounts \nrecognized previously as part of the single lease cost described in \nparagraph 842- 20-25-6(a) \n3. Unamortized initial direct costs \n4. Impairment of the right -of-use asset. \n> Amortization of the Right -of-Use Asset for a Finance Lease \n35-7 A lessee shall amortize the right -of-use asset on a straight -line basis, \nunless another systematic basis is more representative of the pattern in which \nthe lessee expects to consume the right -of-use asset’s future economic \nbenefits. When the lease liability is remeasured and the right -of-use asset is \nadjusted in accordance with paragraph 842- 20-35-4, amortizatio n of the right -of-\nuse asset shall be adjusted prospectively from the date of remeasurement. \n35-8 A lessee shall amortize the right -of-use asset from the commencement \ndate to the earlier of the end of the useful life of the right -of-use asset or the \nend of the lease term . However, if the lease transfers ownership of the \nunderlying asset to the lessee or the lessee is reasonably certain to exercise \nan option to purchase the underlying asset, the lessee shall amortize the right -', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 445}), Document(page\_content='Leases 445 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. of-use asset to the end of the u seful life of the underlying asset. \n> Amortization of Leasehold Improvements \n35-12 Leasehold improvements , other than those accounted for in accordance \nwith paragraph 842- 20-35-12A, shall be amortized over the shorter of the \nuseful life of those leasehold improvements and the remaining lease term , \nunless the lease transfers ownership of the underlying asset to the lessee or \nthe lessee is reasonably certain to exercise an option to purchase the \nunderlying asset, in which case the lessee shall amortize the leasehold \nimprovements to the end of their useful life. \n35-12A Leasehold improvements associated with a lease between entities \nunder common control shall be: \na. Amortized over the useful life of those improvements to the common \ncontrol group as long as the lessee controls the use of the underlying asset \nthrough a lease. If the lessor obtained the right to control the use of the \nunderlying asset through a lease with another entit y not within the same \ncommon control group, the amortization period shall not exceed the \namortization period of the common control group determined in \naccordance with paragraph 842- 20-35-12. \nb. Accounted for as a transfer between entities under common control \nthrough an adjustment to equity (net assets for a not -for-profit entity ) \nwhen the lessee no longer controls the use of the underlying asset. \n35-12B An entity with leasehold improvements accounted for in accordance \nwith paragraph 842- 20-35-12A shall apply the impairment requirements in \nparagraph 360- 10-40-4, considering the useful life to the common control \ngroup. \n35-12C If after the commencement date the lessee and lessor become within \nthe same common control group or are no longer within the same common \ncontrol group, any change in the required amortization period for leasehold \nimprovements shall be accounted for prospectively as a c hange in accounting \nestimate in accordance with paragraph 250- 10-45-17. \n35-13 Leasehold improvements acquired in a business combination or an \nacquisition by a not -for-profit entity shall be amortized over the shorter of \nthe useful life of the assets and t he remaining lease term at the date of \nacquisition. \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance \n>> Recognition of Costs from Variable Lease Payments \n55-1 A lessee should recognize costs from variable lease payments (in \nannual periods as well as in interim periods) before the achievement of the \nspecified target that triggers the variable lease payments, provided the \nachievement of that target is considered probable . \n55-2 Variable lease costs recognized in accordance with paragraph 842- 20-55-1 \nshould be reversed at such time that it is probable that the specified target will \nnot be met. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 446}), Document(page\_content='Leases 446 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. >> Pattern of Benefit from Use of the Underlying Asset \n55-3 This Subtopic considers the right to control the use of the underlying \nasset as the equivalent of physical use. If the lessee controls the use of \nthe underlying asset, recognition of lease cost in accordance with \nparagraph 842-20-25-6(a) or amortization of the right- of-use asset in \naccordance with paragraph 842- 20-35-7 should not be affected by the extent to \nwhich the lessee uses the underlying asset. \n>> Maintenance Deposits \n55-4 Under certain leases (for example, certain equipment leases), a lessee is \nlegally or contractually responsible for repair and maintenance of the \nunderlying asset throughout the lease term . Additionally, certain lease \nagreements include provisions requiring the lessee to make deposits to the \nlessor to financially protect the le ssor in the event the lessee does not properly \nmaintain the underlying asset. Lease agreements often refer to these deposits \nas maintenance reserves or supplemental rent. However, the lessor is required \nto reimburse the deposits to the lessee on the comple tion of maintenance \nactivities that the lessee is contractually required to perform under the \nlease agreement. \n55-5 Under a typical arrangement, maintenance deposits are calculated on the \nbasis of a performance measure, such as hours of use of the underlyi ng asset, \nand are contractually required under the terms of the lease agreement to be \nused to reimburse the lessee for required maintenance of the underlying asset \non the completion of that maintenance. The lessor is contractually required to \nreimburse the lessee for the maintenance costs paid by the lessee, to the \nextent of the amounts on deposit. \n55-6 In some cases, the total cost of cumulative maintenance events over the \nterm of the lease is less than the cumulative deposits, which results in excess \namounts on deposit at the expiration of the lease. In those cases, some lease \nagreements provide that the lessor is entitled to retain such excess amounts, \nwhereas other agreements specifically provide that, at the expiration of the \nlease agreement, such exces s amounts are returned to the lessee (refundable \nmaintenance deposit). \n55-7 The guidance in paragraphs 842- 20-55-8 through 55- 9 does not apply to \npayments to a lessor that are not substantively and contractually related to \nmaintenance of the leased asset. If at the commencement date a lessee \ndetermines that it is less than probabl e that the total amount of payments will \nbe returned to the lessee as a reimbursement for maintenance activities, the \nlessee should consider that when determining the portion of each payment \nthat is not addressed by the guidance in paragraphs 842- 20-55-8 through 55- 9. \n55-8 Maintenance deposits paid by a lessee under an arrangement accounted \nfor as a lease that are refunded only if the lessee performs specified \nmaintenance activities should be accounted for as a deposit asset. \n55-9 A lessee should evaluate w hether it is probable that an amount on deposit \nrecognized under paragraph 842- 20-55-8 will be returned to reimburse the \ncosts of the maintenance activities incurred by the lessee. When an amount on \ndeposit is less than probable of being returned, it shoul d be recognized in the \nsame manner as variable lease expense. When the underlying maintenance is \nperformed, the maintenance costs should be expensed or capitalized in ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 447}), Document(page\_content='Leases 447 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. accordance with the lessee’s maintenance accounting policy. \n>> Leases Denominated in a Foreign Currency \n55-10 The right -of-use asset is a nonmonetary asset while the lease liability \nis a monetary liability. Therefore, in accordance with Subtopic 830- 10 on \nforeign currency matters, when accounting for a lease that is denominated in a \nforeign currency, if remeasurement into the lessee’s functional currency is \nrequired, the lease liability is remeasured using the current exchange rate, \nwhile the right -of-use asset is remeasured using the exchange rate as of the \ncommencement date . \n> Illust rations \n>> Illustrations of Lessee Recognition and Measurement in an \nOperating Lease \n55-40 Example 4 illustrates how a lessee would recognize lease cost in an \noperating lease and initially and subsequently measure right -of-use assets and \nlease liabilities for that lease. \n>>> Example 4— Recognition and Initial and Subsequent Measurement \nby a Lessee in an Operating Lease \n55-41 Lessee enters into a 10- year lease for 5,000 square feet of office space. \nThe annual lease payment is $10,000, paid in arrears, and increases 5 percent \neach year during the lease term. Lessee’s incremental borrowing rate at lease \ncommencement is 6 percent. Lessee classifies the lease as an operating lease \nin accordance with paragraphs 842- 10-25-2 through 25- 3. Lessee incurs initial \ndirect costs of $5,000. \n55-42 At the commencement date, Lessee receives a $10,000 cash payment \nfrom Lessor that Lessee accounts for as a lease incentive. Lessee measures \nthe lease liability at the present value of the 10 remaining lease payments \n($10,000 in Year 1, increasing by 5 percent each year thereafter), discounted at \nthe rate of 6 percent, which is $90,434. Lessee also measures a right -of-use \nasset of $85,434 (the initial measurement of the lease liability + the initial direct \ncosts of $5,000 – the lease incentive of $10,000). \n55-43 During the first year of the lease, Lessee determines the remaining cost \nof the lease as the sum of the following: \na. The total lease payments of $115,779 (the sum of the 10 escalating \npayments to Lessor during the lease term of $125,779 – the lease \nincentive paid to Lessee at the commencement date of $10,000) \nb. The total initial direct costs attributable to the lease of $5,000. \nThe amount of the remaining lease cost is therefore $120,779 ($115,779 + \n$5,000). Consequently, Lessee determines that the single lease cost to be \nrecognized every year throughout the lease term is $12,078 ($120,779 ÷ \n10 years). This assumes that t here are no remeasurements of the lease \nliability or modifications to the lease throughout the lease term. \n55-44 At the end of Year 1, the carrying amount of the lease liability is $85,860 \n(9 remaining lease payments, discounted at the rate of 6 percent), and the \ncarrying amount of the right -of-use asset is the amount of the liability, adjusted ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 448}), Document(page\_content='Leases 448 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. for the following: \na. Accrued lease payments of $2,578 (the amount of payments to Lessor to \nbe recognized as part of the single lease cost each year during the lease of \n$12,578 [total payments to Lessor of $125,779 ÷ 10 years] – the first \nyear’s lease payment of $10,000) \nb. Unamort ized initial direct costs of $4,500 (gross initial direct costs of \n$5,000 – amounts recognized previously as part of the single lease cost of \n$500 [total initial direct costs of $5,000 ÷ 10 years]) \nc. The remaining balance of the lease incentive of $9,000 (gross lease \nincentive of $10,000 – amounts recognized previously as part of the single \nlease cost of $1,000 [total lease incentives of $10,000 ÷ 10 years]). \nTherefore, at the end of Year 1, Lessee measures the right -of-use asset at the \namount of $78,782 ($85,860 – $2,578 + $4,500 – $9,000). \n55-45 At the beginning of Year 2, Lessee determines the remaining cost of the \nlease to be $108,701 (the total lease payments of $115,779 + the total initial \ndirect costs of $5,000 – the single lease cost recognized in Year 1 of $12,078). \nThe single lease cost to be recognized in Year 2 is still $12,078 ($108,701 ÷ \n9 years). For the purposes of the Example, only the first two years’ \ndetermination of the single lease cost are shown. However, the single lease \ncost will be determined in the same way as in Years 1 and 2 for the remainder \nof the lease and, in this Example, will continue to equal $12,078 every period \nfor the remainder of the lease term assuming that there are no \nremeasurements of the lease liability or modificati ons to the lease. \n55-46 At the end of Year 2, the carrying amount of the lease liability is $80,511, \nand the carrying amount of the right -of-use asset is $71,855 (the carrying \namount of the lease liability of $80,511 – the accrued lease payments of \n$4,656 + the unamortized initial direct costs of $4,000 – the remaining balance \nof the lease incentive received of $8,000). For the purposes of the Example, \nthe subsequent measurement of the lease liability and the subsequent \nmeasurement of the right -of-use asset are shown only for the first two years. \nHowever, Lessee will continue to measure the lease liability and the right -of-\nuse asset for this lease in the same manner throughout the remainder of the \nlease term. \n \n6.4.1 Finance leases \n6.4.10 After lease commencement, a lessee measures the lease liability on an \namortized cost basis. The lease liability is increased to reflect interest on the \nliability and decreased to reflect the lease payments made during the period. \n[842- 20-35-1(a)] \n6.4.20 Interest on the lease liability is determined each period during the lease \nterm as the amount that results in a constant periodic discount rate on the \nremaining balance of the liability. [842- 20-35-1(a)] \n6.4.30 After lease commencement, a lessee measures the ROU asset at cost, \nless accumulated amortization and any accumulated impairment losses (see section 6.5). \n[842- 20-35-1(b)] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 449}), Document(page\_content='Leases 449 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. \nAccumulated \namortizationROU assetAccumulated \nimpairment \nlossesBeginning \nbalance \n6.4.40 A lessee amortizes the ROU asset on a straight -line basis, unless another \nsystematic basis is more representative of the pattern in which the lessee \nexpects to consume the future economic benefits of the ROU asset. After an \nimpairment, amortization is gener ally on a straight -line basis based on the \ncarrying amount of the ROU asset following the impairment. [842- 20-35-7] \n6.4.50 In general, amortization of the ROU asset is recognized over the period \nfrom the commencement date to the earlier of (1) the end of the useful life of \nthe ROU asset, or (2) the end of the lease term. However, if the lease transfers \nownership of the underlying asset to the lessee or the lessee is reasonably \ncertain to exercise a purchase option to acquire the underlying asset, the lessee \namortizes the ROU asset to the end of the underlying asset’s useful life. \n[842- 20-35-8] \n6.4.60 In addition to amortization of the ROU asset and interest on the lease \nliability, a lessee will recognize the following lease costs: variable lease \npayments excluded from initial measurement (see section 5.4) and any \nimpairment of the ROU asset (see section 6.5). The relevant costs are included \nin the income statement each period of the l ease term unless they are included \nin the carrying amount of another asset in accordance with other US GAAP \n(which excludes any impairment charges, which cannot be capitalized as part of \nthe cost of another asset). For example, when an entity leases equipment that \nwill be used to produce inventory, all or a portion of the equipm ent lease cost \nwould typically be included in the cost of the inventory. [842- 20-25-5, 360- 10-45-4] \n \n Observation \nFocus on l ease costs rather than lease expense \n6.4.70 The guidance in Topic 842 refers to lease costs (for finance and operating \nleases) potentially being included in the carrying amount of another asset in \naccordance with other US GAAP. Consistent with Topic 840, some or all of the \ncost of a lease may be capitalized as part of the cost of another asset – e.g. an \nitem of property, plant or equipment or an item of inventory. [842- 20-25-5, 25- 6] \n6.4.80 This focus on lease cost, rather than lease expense, has been carried \nforward to the lessee disclosure requirements (see section 12.2) to ensure that financial statement users have a more complete picture of a lessee’s leasing \nactivity. The Board concluded tha t the adjustments made by many financial \nstatement users would be based on incomplete information if the quantitative \ndisclosures were based on amounts recognized as lease expense in the income statement rather than total lease cost. \n6.4.90 For variable l ease payments based on the achievement of a specified \ntarget, a lessee recognizes the costs in annual periods and in interim periods \nbefore the achievement of the specified target that triggers the variable lease \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 450}), Document(page\_content='Leases 450 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. payments to the extent the achievement of t hat target is considered probable. \nVariable lease costs recognized are reversed if it becomes probable that the \nspecified target will not be met. This means that the cumulative amount of \nvariable lease cost recognized at any point in time during the lease term will be \nthe amount of variable lease payments that are either paid (and nonrefundable) \nor probable of being paid. [842- 20-55-1 – 55-2] \n \n Example 6.4.10 \nSubsequent measurement of a finance lease \nIn Example 6.3.10, Lessee LE recognized a lease liability of $100,000 and an ROU asset of $105,000 for its lease of office space with Lessor LR. Assume \nthat the lease is actually of a piece of equipment (rather than office space), and \nthe following facts a re changed from Example 6.3.10. \nRemaining economic life of equipment: 12 years \nRenewal options: None \nLE classifies the lease as a finance lease. This is based on the lease term test: \n10/12 years equals 83% of the remaining economic life of the equipment (see \nparagraph 6.2.50). \nLE expects to consume the ROU asset’s future economic benefits evenly over \nthe lease term. Accordingly, LE amortizes the ROU asset on a straight -line basis \nover 10 years. \nDuring the lease term, LE will account for the leas e liability and the ROU asset \nas follows (assuming no remeasurements, modifications or impairments). \n Lease liability ROU asset \nYear Beg. \nbalance Interest Pmts . End. \nbalance Beg. \nbalance Amort. End. \nbalance \n1 $100,000 $10,000 $(14,527) $95,473 $105,000 $(10,500) $94,500 \n2 95,473 9,547 (14,963) 90,057 94,500 (10,500) 84,000 \n3 90,057 9,006 (15,412) 83,651 84,000 (10,500) 73,500 \n4 83,651 8,365 (15,874) 76,142 73,500 (10,500) 63,000 \n5 76,142 7,614 (16,350) 67,406 63,000 (10,500) 52,500 \n6 67,406 6,741 (16,841) 57,306 52,500 (10,500) 42,000 \n7 57,306 5,731 (17,346) 45,691 42,000 (10,500) 31,500 \n8 45,691 4,569 (17,866) 32,394 31,500 (10,500) 21,000 \n9 32,394 3,239 (18,402) 17,231 21,000 (10,500) 10,500 \n10 17,231 1,723 (18,954) - 10,500 (10,500) - \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 451}), Document(page\_content='Leases 451 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Observation \nNegative net asset position for most finance leases \n6.4.100 The subsequent measurement guidance in Topic 842 for finance leases \nwill generally result in a negative net asset position for the lessee (in leases \nwith no prepaid rent) throughout the lease term other than at lease \ncommencement and at the end of the lease t erm (assuming a straight -line basis \nof amortization for finance lease ROU assets). The finance lease amortization \nmodel results in a balance sheet effect that is generally consistent with the \neffect that assets entirely acquired with debt financing have on the \nbalance sheet. \n6.4.110 The following chart illustrates these effects for lessees using the fact \npattern in Example 6.4.10. \n \n \n \n Observation \nFront -loaded pattern of lease expense recognition \nfor finance leases \n6.4.120 Because the ROU asset is generally amortized on a straight -line basis \nwhile interest is calculated on the lease liability using the effective interest \nmethod, finance leases will generally result in a front -loaded pattern of total \nexpense recognition. This is ill ustrated in the following chart using the fact \npattern in Example 6.4.10. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 452}), Document(page\_content='Leases 452 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. \n \n \n Comparison to legacy US GAAP \nImportant differences between finance lease accounting and capital lease \naccounting \n6.4.130 As outlined in chapters 4 and 5, there are important separation/allocation \nmodel differences (e.g. allocation of certain executory costs) and definitional \ndifferences (e.g. ‘lease payments’ in Topic 842 versus ‘minimum lease \npayments’ in Topic 840) that mean the accounting for a finance lease under \nTopic 842 will often differ from the accounting for a capital lease under \nTopic 840. \n6.4.140 In addition, while the guidance about how to amortize the ROU asset \nand accrete the lease liability in a finance lease i s substantially the same as that \napplicable to capital leases in Topic 840, the subsequent accounting for a \nfinance lease will differ substantially from a capital lease in the following ways. \n— Having to monitor for reassessment events; for example, a signif icant \nevent requiring a reassessment of the lease term or a change in the \namount probable of being owed under a residual value guarantee (see \nparagraph 6.6.10). \n— Having to remeasure the lease liability (and ROU asset) if a reassessment \nevent occurs (see paragraph 6.6.140). \n— The accounting for modifications to a finance lease (see section 6.7). \n \n6.4.2 Operating leases \n6.4.150 After lease commencement, a lessee measures the lease liability at the \npresent value of the unpaid lease payments discounted at the discount rate for \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 453}), Document(page\_content='Leases 453 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the lease established at the commencement date. An exception to this general \nprinciple occurs when the rate is updated as a result of a lease remeasurement \n(see section 6.6) or lease modification (see section 6.7). [842- 20-35-3(a)] \n6.4.160 Although Topic 842 describes the subsequent measurement of an \noperating lease liability differently from a finance lease liabi lity, the carrying \namount of the lease liability throughout the lease term is not affected by the classification of the lease. The carrying amount will equal the present value of the remaining, unpaid lease payments throughout the lease term. \n6.4.170 After lease commencement, unless the ROU asset has been impaired \n(see section 6.5), the carrying amount of an operating lease ROU asset can be \ndetermined in either one of two ways, which each produce the same carrying amount of the ROU asset throughout the lea se term. \n— Method 1 : The carrying amount of the ROU asset is derived from the \ncarrying amount of the lease liability at the end of each reporting period – \ni.e. a lessee measures the ROU asset as follows . \n[842- 20-35-3(b)] \nPrepaid /\n(accrued )\n lease \npaymentsLease \nliability \ncarrying \namountUnamortized \nbalance of \nlease \nincentives \nreceivedUnamortized \ninitial \ndirect costsor \n— Method 2 : Amortize the ROU asset, calculated as the difference between \nthe straight line lease cost for the period (including amortization of ini tial \ndirect costs) – see paragraph 6.4.19 0 – and the periodic accretion of the \nlease liability using the effective interest method. \nAccumulated \namortizationROU assetBeginning \nbalanceHidden shape \nto keep sizing \nconsistent \n6.4.180 Paragraph 6.5.40 describes how to measure an ROU asset after it has \nbeen impaired in accordance with Topic 360. \n6.4.185 Questions 6.3.14 and 6.3.15 outline how to account for lease incentives \nthat exceed the carrying amount of the lease liability and ROU asset immediately before the incentive is received, respectively. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 454}), Document(page\_content='Leases 454 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 6.4.10 \nChoice of subsequent measurement methods for \noperating lease ROU assets \nIs a lessee’s selection of the method to subsequently measure \noper ating lease ROU assets an accounting policy election that \nmust be used for all of the lessee’s operating leases? \nInterpretive response: No. The lessee’s decision to use Method 1 or Method 2 \nin paragraph 6.4.170 has no effect on the measurement of the ROU asset at \nany point during the lease term – i.e. the measurement of the ROU asset will \nbe the same regardless of which method is applied. \nThe question of which method to use, and whether to use it for all or only some \nof the entity’s leases, is principally an operational one for lessees. While we \nbelieve most entities will choose to use only one method for all their leases, \nthere will be more considerations that come into play when deciding which \nmethod to use. \nDeciding between Method 1 and Method 2 \nSometimes referred to as the ‘display approach’, Method 1 is the only method \ndescribed in Topic 842. The basis for conclusions indicates the Board’s view \nthat thi s method will permit many entities to perform the new accounting for \noperating leases without significant changes to systems or processes. In general, Method 1 is what a lessee would be more likely to use if it does not \nwant to recognize ROU assets and lea se liabilities for operating leases until it \ncloses its books during the financial reporting process. \nUnder this method, rather than maintain ROU assets and lease liabilities in its \ngeneral ledger, at each reporting date, the lessee creates a journal entr y to (1) \ncredit a lease liability for the present value of the remaining unpaid lease payments, (2) reverse other accrual -based operating lease accounting balances \nreflected on the balance sheet (i.e. prepaid or accrued rent, unamortized initial \ndirect cos ts and unamortized lease incentives) and (3) debit an ROU asset for \nthe balancing amount. \nMethod 1 may not be practicable for entities other than those with a smaller \nvolume of leases that are relatively straightforward. Method 1 is inherently a \nmanual process that likely will be unwieldy when applied to a large portfolio of \nleases, especially in the context of the more complex circumstances that will \narise under the guidance in Topic 842 – e.g. modifications, remeasurements, \nimpairments and foreign currenc y translation adjustments. \nWe believe Method 2 will more readily enable a lessee to implement systems, \nprocesses and controls where lease liabilities and ROU assets are tracked \nseparately in a manner more consistent with other assets and liabilities. It is \nmore likely to be effective for addressing the more complex circumstances outlined above that are likely to arise for many lessees. For leases denominated \nin a foreign currency, Method 1 may not be practicable because of the different \nforeign exchange rat es required to be used in relation to the (1) measurement \nand amortization of the ROU asset and (2) measurement and accretion of the \nlease liability (see paragraph 6.4.240 and Question 6.4.20). \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 455}), Document(page\_content='Leases 455 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 6.4.190 After the lease commencement date, a lessee recogniz es the following \namounts in the income statement – except to the extent that the costs are \nincluded in the carrying amount of another asset in accordance with other \nUS GAAP. \n— A single lease cost , calculated so that the remaining cost of the lease is \nallocated over the remaining lease term on a straight -line basis (if another \nsystematic and rational basis is not more representative of the benefit \nexpected to be derived from the right to use the underlying asset), unless \nthe ROU asset has been impaired (see section 6.5). [842- 20-25-6, 25- 8] \nTotal IDCs \nincurred2Remaining\n lease costTotal lease \npayments for \nthe lease term1Periodic lease \ncost \npreviously \nrecognized3 \nNotes: \n1. Paid and unpaid, reflecting any adjustments resulting from a remeasurement (see \nsection 6.6) or a modification (see section 6. 7). \n2. Those attributable to that lease. \n3. The total amount of lease cost recognized (including capitalized as part of the cost of \nanother asset) for the lease in prior periods. \n— Variable lease payments in the period in which the obligation is incurred, \nor achievement of the target that triggers the variable payments becomes \nprobable (see paragraph 6.4.200). \n— Any impairment of the ROU asset (see section 6.5). \n6.4.200 For variable lease payments based on the achievement of a specified \ntarget, a lessee recognizes the costs in annual periods and in interim periods \nbefore the achievement of the specified target that triggers the variable lease \npayments, to the extent the achievement of that target is considered probable. \nVariable lease costs recognized are reversed if it is probable that the specified \ntarget will not be met. This means that the cumulative amount of variable lease \ncost recognized at any point in time during the lease term will be the amount of \nvariable lease payments that are either paid (and nonrefundable) or probable of \nbeing paid. [842- 20-55-1 – 55-2] \n \n Example 6.4.20 \nSubsequent accounting for an operating lease – \nassuming no impairments, remeasurements or \nlease modifications \nScenario 1: S ubsequent measurement using Method 1 \nIn Example 6.3.10, Lessee LE recognized a lease liability of $100,000 and an \nROU asset of $105,000 for its lease of office space with Lessor LR. \nThe following facts in addition to those in Example 6.3.10 are relevant. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 456}), Document(page\_content='Leases 456 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Remaining economic life of office space: 35 years \nFair value of office space: $400,000 \nLE classifies the lease as an operating lease, because none of the tests for \nclassification as a finance lease are met (see paragraph 6.2.50). There are no \nimpairments (see section 6.5), no remeasurements (see section 6.6) or \nmodifications (see section 6.7) during the lease term. \nLE recognizes a single lease cost of $17,154 each year of the 10 -year lease, \nwhich is calculated as follows. \nTotal IDCs \nrecognized\n$5,000Remaining\n lease cost\n$171,535Total lease \npayments for \nthe lease term\n$166,535\nLease term\n10 years \nWhether a lease is classified as an operating or a finance lease, the carrying \namount of the lease liability is the same throughout the lease term. Therefore, \nthe carrying amount of the lease liability in this example is the same throughout \nthe lease term as it is in Example 6.4.10, which at all times equals the present \nvalue of the unpaid lease payments (discounted at 10%, which is the discount rate for the lease determined at lease commencement in Example 6.3.10). \nFollowing the subsequent measurement Method 1 (described and illustrated \nin Topic 842), LE subsequently accounts for the operating lease ROU asset \nas follows. \nYear Lease liab ility \ncarry ing amount Unamortized \nIDCs1 Prepaid \n(accrued) lease \npayments2 ROU asset \ncarry ing amount \n1 $95,473 $4,500 $(2,127) $97,846 \n2 90,057 4,000 (3,818) 90,239 \n3 83,651 3,500 (5,060) 82,091 \n4 76,142 3,000 (5,840) 73,302 \n5 67,406 2,500 (6,144) 63,762 \n6 57,306 2,000 (5,956) 53,350 \n7 45,691 1,500 (5,263) 41,928 \n8 32,394 1,000 (4,050) 29,344 \n9 17,231 500 (2,301) 15,430 \n10 - - - - ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 457}), Document(page\_content='Leases 457 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Notes: \n1. Initial direct costs are amortized on a straight -line basis over the 10- year lease term. \n2. Represents the cumulative difference between the annual straight -line lease cost \n(excluding initial direct costs) of $16,654 and the amount of the lease payments. \nScenario 2: Subsequent measurement using M ethod 2 \nAs described in paragraph 6.4.170, the carrying amount of the ROU asset can \nbe determined using a second method, which produces the same carrying \namount as the method used in Scenario 1 throughout the lease term. \nAccumulated \namortization1 ROU assetBeginning \nbalance \nNote : \n1. The amortization of the ROU asset each period is calculated as the difference between \nthe straight -line lease cost for the peri od (including initial direct costs) and the periodic \naccretion of the lease liability using the effective interest method. \nLE calculates the annual single lease cost for the 10- year lease term of $17,154 \nin the same manner as illustrated above in Scenario 1. \nHowever, the amortization of the ROU asset, and carrying amount of the ROU asset at the end of each period, are determined as follows. \nYear ROU asset amortization ROU asset carrying amount \nStraight -\nline lease \ncost Lease liab. \naccret. ROU \nasset \namort. Beg. \nbalance ROU asset \namort. End. \nbalance \n1 $17,154 $(10,000) $ 7,154 $105,000 $ (7,154) $97,846 \n2 17,154 (9,547) 7,607 97,846 (7,607) 90,239 \n3 17,154 (9,006) 8,148 90,239 (8,148) 82,091 \n4 17,154 (8,365) 8,789 82,091 (8,789) 73,302 \n5 17,154 (7,614) 9,540 73,302 (9,540) 63,762 \n6 17,153 (6,741) 10,412 63,762 (10,412) 53,350 \n7 17,153 (5,731) 11,422 53,350 (11,422) 41,928 \n8 17,153 (4,569) 12,584 41,928 (12,584) 29,344 \n9 17,153 (3,239) 13,914 29,344 (13,914) 15,430 \n10 17,153 (1,723) 15,430 15,430 (15,430) - \nMethod 1 vs. Method 2 \nAs illustrated in this example, the ending balance of the ROU asset is the same \nthroughout the lease term for the two scenarios. In addition, the single lease \ncost recognized by LE each period of the lease and the carrying amount of the ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 458}), Document(page\_content='Leases 458 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. lease liability at the end of each period of the lease is unaffected by which \nsubsequent measurement method LE chooses for the ROU asset. \n \n Observation \nOperating lease ROU assets likely to track more \nclosely to lease liability than finance lease ROU \nassets \n6.4.210 The carrying amount of an operating lease ROU asset is likely to track \nmore closely to the carrying amount of the lease liability throughout the lease \nterm than a finance lease ROU asset. As noted in paragraphs 6.4.100 – 6.4.110, \na finance lease ROU asset wil l generally result in a negative net asset position \nfor a particular lease. The balance sheet effect between an operating lease and \na finance lease may be an important consideration relating to the effect on \nbalance sheet ratios based on assets and liabili ties. \n6.4.220 The following chart illustrates how the ROU asset tracks with the lease \nliability for Example 6.4.20. \n \n \n \n Observation \nOperating lease and finance lease expense \nrecognition patterns differ \n6.4.230 The following chart depicts the differences in lease expense recognition \npatterns between a finance lease and an operating lease under Topic 842 using \nthe fact pattern in Examples 6.4.10 and 6.4.20. The difference in expense \nrecognition pattern may be less dr amatic in a portfolio of leases; for example, \nfor a lessee with a large revolving portfolio of leases that have varying maturities. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 459}), Document(page\_content='Leases 459 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. \n \n \n Question 6.4.15 \nSingle lease cost attribution – operating lease with \nnon-consecutive period of use that is variable \nHow should a lessee recognize lease cost in an operating \nlease with a variable number of non- consecutive use periods ? \nBackground: Assume that a sports tea m (lessee) enters into a lease with a \nstadium owner (lessor) whereby the sports team has the right to use the \nstadium for 41 home games per year for 10 years, plus the right to use the \nstadium for any home playoff games during those 10 years (up to a maximum \nof 16 per year). \nThe sports team has exclusive rights to the s tadium on each game day, and the \nstadium owner must ensure that the stadium is available for any regular season \nand playoff games – i.e. the stadium owner cannot book alternative events that \nit cannot cancel on any date when the sports team might need it. For simplicity, assume t here are no renewal or termination options for either party in the \ncontract. \nAs illustrated in Example 5.3.40, in an operating lease with a non- consecutive \nperiod of use, lease cost will be recognized only during the periods the lessee has the right to use the underlying asset. This is accomplished by, for those \nperiods: \n— ceasing amortization of the ROU asset; and \n— capitalizing the accretion of the lease liability to the ROU asset . \nHowever, for a lease like the background example, the question arises about how much lease cost to recognize during each right of use period, giv en that \nthe total number of such periods is unknown. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 460}), Document(page\_content='Leases 460 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Interpretive response: Topic 842 does not specifically address a situation \nwhere the period of use comprises a variable number of non- consecutive \nperiods . Consequently, we believe there is likely more than one acceptable \napproach to this question. \nApplied to the background example, we believe any one of the following three \napproaches is acceptable. Facts and circumstances may dictate whether all of \nthese approaches, or other approaches, would be acceptable in scenarios that \ndiffer from that example. \nApproach 1: Assume the minimum number of use periods, and treat each \naddition thereto as a change in the lease term \nUnder this approach, the lessee bases its lease cost recognition on the minimum number of per iods it will have the right to use the asset (410 days in \nthe background stadium example). The lessee does not estimate expected \nadditional use periods (e.g. expected playoff games). \nEach time the minimum number of periods the lessee will have the right to use \nthe underlying asset increases, this reflects a change in the lease term. While \nthe term is not necessarily being extended in these cases (i.e. the last non-\nconsecutive use period may still be the same), it is being changed to reflect a \ndifferent number of non- consecutive use periods. \n[842- 10-35-1(c)] \nIn the background example, the sports team changes the lease term and its \nper-use day lease cost amount the first time it makes the playoffs, increasing \nthe minimum total number of use days for the number of guaranteed home \nplayoff games. It repeats this process each time the minimum increases \nthroughout the contract period – e.g. if the first playoff series goes beyond the \nminimum number of home games, if the team makes the second playoff round \nand if the team makes the playoffs in later seasons. \nConsistent with other changes to the lease term, the lessee recognizes the \neffect of the lease term change prospectively, remeasuring both: \n— the per -use period lease cost it will recognize for periods after the lea se \nterm change (without adjusting lease cost previously recognized); and \n— the lease liability (if it is not an unrecognized short -term lease – see \nsection 6.3.1), following the guidance applicable to remeasuring a lease for \nother changes to the lease term (see section 6.6.2). \nApproach 2: Estimate the total number of periods of use at lease \ncommencement, and revise periodically \nUnder this approach, the lessee estimates the total number of periods it will \nhave the right to use the asset using an appropri ate systematic and rational \napproach. In the background example, the sports team estimates the total number of games it will play during the 10- year period, and therefore the \nnumber of days it will have the right to use the stadium during that period. \nLeas e cost is then recognized in equal amounts each period (e.g. each day in \nthe background example) the lessee has the right to use the asset. \nThe lessee revises its estimate of the total number of periods it will have the \nright to use the asset periodically throughout the lease term when facts and \ncircumstances indicate the lessee’s current estimate is no longer reasonable. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 461}), Document(page\_content='Leases 461 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Consistent with Approach 1, we believe a change to the lessee’s estimate \nconstitutes a change to the lease term and the lessee should ac count for such \nchanges in the same manner. \nApproach 3: Treat each year of the contract as the lease cost unit of \naccount \nUnder this approach, which we do not believe will be practicable or appropriate \nin all scenarios involving a period of use with a varia ble number of non-\nconsecutive use periods, the lessee makes its estimates of usage for multiple \nshorter periods within the longer contract period, rather than for the entire \ncontract period. \nApplying this approach to the background example, the sports team considers \nthat it has an enforceable right to use the asset for up to 570 days (i.e. the \nmaximum number of home games the sports team could have over the 10- year \ncontract term), with a maximum of 57 days per year. The stadium owner cannot \nbook events for other teams or artists during the times when home playoff \ngames are possible unless and until the team doesn’t make, or gets eliminated from, the playoffs. \nBased on this, the sports team recognizes an equal amount of lease cost each \nyear of the 10- year con tract term. Each year, the sports team recognizes lease \ncost as games are played based on an estimate of ‘breakage’ for the year. For \nexample, if the team has a strong year and retains its talented players for the \ncoming year, it might assume it will play 50 home games, and therefore \nrecognize 1/50\nth of the annual lease cost as it plays each home game. If it \nbecomes apparent it will play more or fewer games during the season, it will adjust its lease cost attribution for the year on a prospective basis. \nThis approach differs from Approach 2 principally in that it recognizes and \nattributes equal lease cost each year, and estimates games to be played only for the current year. In contrast, Approach 2 would only coincidentally result in \nequal lease cost recogni tion each year, and estimates games to be played for \nthe entire contract period. \n \n Question 6.4.16 \nCurtailment of the lessee’s right to use the \nunderlying asset \nShould the lessee stop recognizing, or recognize reduced, \noperating lease cost (finance lease ROU asset amortization) \nwhen its rights to use the underlying asset have been curtailed? \nBackground: Situations arise in which the lessee’s ability to use, and derive its \nintended economic benefits from using, the underlying asset are signif icantly \ncurtailed. For example, as a result of COVID -19, retail store locations in \nshopping centers were closed to the public such that the retailer (lessee) could \nnot sell its goods from the location, and restaurants were precluded from \nseating customers in their dining rooms (i.e. limiting their operations to carry -out \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 462}), Document(page\_content='Leases 462 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. and/or delivery only). Similar circumstances may arise during periods of civil \nunrest or natural disasters. \nThe question arises as to whether it is appropriate to suspend or reduce \noperati ng lease cost (finance lease ROU asset amortization1) during the \ncurtailment period. \nNote: \n1. For purposes of this question, references to finance lease ROU asset amortization should \nalso be considered to apply to operating lease ROU asset amortization afte r it has been \nimpaired (see paragraphs 6.5.40 – 6.5.50) or scheduled for abandonment (see Question \n6.5.70) . \nInterpretive response: We believe it is inappropriate to suspend or reduce \noperating lease cost recognition (finance lease ROU asset amortization) a s long \nas the lessee retains the right to use the underlying asset, even in a significantly \ncurtailed manner. \nThe retailer in the background example cannot sell to customers from the \nlocation, but it has not vacated the space – e.g. its inventory is still stored there, \nand its leasehold improvements remain in place. Therefore, the retailer still retains control over the use of the space – i.e. control has not reverted to the \nlandlord such that the landlord can use the space itself or re- lease it. \nTopic 842 specifies that control over the use of an underlying asset is the \nequivalent of physical use; the recognition of operating lease cost (or finance lease ROU asset amortization) should not be affected by the extent to which \nthe lessee uses the underlying as set. It would be inconsistent with that \nguidance for lease cost recognition (finance lease ROU asset amortization) to cease or be reduced as long as the lessee retains control over the use of the \nunderlying asset. \n[842- 20-55-3] \n \n6.4.3 Impact of foreign cur rency \n6.4.240 Regardless of lease classification as finance or operating, the ROU asset \nis a nonmonetary asset while the lease liability is a monetary liability. Therefore, for a lease denominated in a foreign currency, remeasurement into the lessee’s \nfunctional currency is requi red using the following rates. \n[842- 20-55-10, 830- 10-45-17 \n– 45-18] \n— Lease liability. The current exchange rate at the reporting date. \n— ROU asset. The historical exchange rate used at the later of initial \nmeasurement (i.e. the commencement date) or the mos t recent \nremeasurement for which a reset of the exchange rate is required (see \nQuestion 6.4.25) or lease modification not accounted for as a separate \ncontract. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 463}), Document(page\_content='Leases 463 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 6.4.20 \nAccounting for the single lease cost for operating \nleases denominated in a foreign currency \nWhat exchange rate(s) should be used to translate the single \nlease cost for an operating lease denominated in a foreign \ncurrency? \nInterpretive response: Although the operating lease cost is described in \nTopic 842 as a single lease cost, the operating lease cost actually consists of \ntwo components: \n— the amortization of the ROU asset; and \n— the expense associated with the accretion of the lease liability \nIn accordance with Topic 830 ( foreign currency matters ): [830- 10-45-17 – 45-18, 830-\n10-55-10 – 55-11] \n— the historical exchange rate determined in accordance with \nparagraph 6.4.240 should be used to remeasure the portion of the \nlease cost associated with the amortization of the nonmonetary ROU asset; \nand \n— the average exchange rate for the period (appropriately weighted by the \nvolume of transactions for the period and considering any major fluctuations \nin exchange rate during the period) should be used to remeasure the \nportion of the lease cost associated with the accret ion of the monetary \nlease liability. \nConsequently, the combined rate that will be used to translate the single lease \ncost for an operating lease is a blended rate. \nIf the entire single lease cost were remeasured using the average exchange \nrate for the period (consistent with how operating lease expense was generally \nremeasured under Topic 840) throughout the lease term, the ROU asset would \nnot amortize to zero by the end of the lease term. \n \n Example 6.4.30 \nAccounting for a lease denominated in a foreign \ncurrency \nLessee LE enters into an operating lease for which the lease payments are \ndenominated in Mexican pesos (MXN). LE’s functional currency is US dollars \n(USD). \nThe following facts are relevant. \nLease term : 5 years \nLease payments in arrears: Year 1: 100,000 MXN \nYears 2 –5: Increasing by 5,000 MXN / year \nIncremental borrowing rate: 6% \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 464}), Document(page\_content='Leases 464 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Initial direct costs and lease incentives: None \nAnnual lease cost (sum of lease payments / 5 years): 110,000 MXN \nExchange rates: \n(Average rate each year = rate at end of year) Transaction date (historic): \n1 USD / 20 MXN \nEnd of Year 1: 1 USD / 24 MXN \nEnd of Year 2: 1 USD / 23 MXN \nEnd of Year 3: 1 USD / 22 MXN \nEnd of Year 4: 1 USD / 25 MXN \nEnd of Year 5: 1 USD / 26 MXN \nThe balances of the lease liability and ROU asset (and respective accretion and \namortization, comprising the single lease cost) for each year in local MXN \ncurrency are as follows. \n(in MXN) Beginning Year 1 Year 2 Year 3 Year 4 Year 5 \nLease liability \nending balance1 460,909 388,564 306,878 215,291 113,208 - \nLease liability \naccretion2 27,655 23,314 18,413 12,917 6,792 \nROU asset amortization\n3 82,345 86,686 91,587 97,083 103,208 \nROU asset \nending balance 460,909 378,564 291,878 200,291 103,208 - \nLease cost 110,000 110,000 110,000 110,000 110,000 \nNote s: \n1. Present value of unpaid lease payments discounted at 6%. \n2. Lease liability × 6%. \n3. Annual straight -line lease cost (110,000 MXN) – lease liability accretion. \nThe remeasured balances for each year in the functional currency of USD (using \nthe average rate to remeasure the lease liability and the historical rate to \nremeasure the ROU asset) are as follows. \n(in USD) Beginning Year 1 Year 2 Year 3 Year 4 Year 5 \nLease liability \nending balance 23,045 16,190 13,343 9,786 4,528 - \nTransaction (gain) \n/ loss (3,840) 704 606 (1,175) (174) \nLease liability \naccretion 1,152 1,014 837 517 261 \nLease payment (4,167) (4,565) (5,000) (4,600) (4,615) \nROU asset \nending balance 23,045 18,928 14,594 10,015 5,161 - \nROU asset \namortization 4,117 4,334 4,579 4,854 5,161 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 465}), Document(page\_content='Leases 465 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The single lease cost in USD for each year (the sum of the lease liability \naccretion and the ROU asset amortization in the chart above) is as follows. \n Year 1 Year 2 Year 3 Year 4 Year 5 \nLease cost1 5,269 5,348 5,416 5,371 5,422 \nNote: \n1. Lease cost = Lease liability accretion + ROU asset amortization . \n \n \n Question 6.4.25 \nResetting the exchange rate used to remeasure the \nROU asset into the lessee’s functional currency \nWhen should a lessee reset the historical exchange rate used \nto remeasure the ROU asset into the lessee’s functional currency? \nInterpretive response: This issue was recently the subject of consultation with \nthe SEC staff. The staff expressed the view that either of the following \napproaches would be acceptable, treated as an accounting policy election \napplied to all of a lessee’s leases. \nAcceptable approaches \nApproach 1 – Single exchange rate approach \nUnder this approach, a single exchange rate is used to remeasure a ROU asset into the lessee’s functional currency, and a lessee reset s the exchange rate \nwhen: \n— there is a lease modification not accounted for as a separate contract (see \nsection 6.7); or \n— the lessee is required to remeasure the lease because of a change in (1) the \nlease term or (2) the assessment of a lessee option to purchase the \nunderlying asset being exercised. ( Category A remeasurements ). \nThe exchange rate is reset in its entirety when there is a modification (not \naccounted for as a separate contract) on the basis that the Board views the \nmodification as terminating the old lease and creating a new lease at the \neffective date of the modification. Therefore, the exchange rate used to \nremeasure the ROU asset should be consistent with the rate that would be \nused if the lease were an entirely new lease at that date. \n[ASU 2016- 02.BC173] \nCategory A remeasurements also trigger the use of an updated exchange rate \nbased on the following: \n— In deciding that Category A remeasurements should result in an updated \ndiscount rate for the lease, the Board considered that, in those Category A \nscenarios, the economics of the lease have changed and those changes should be reflected in the discount rate. Effectively, the lessee takes a \n‘fresh look’ at the lease. This ‘fresh look’ at the lease based on changed \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 466}), Document(page\_content='Leases 466 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. economics includes updating the exchange rate use to remeasure the \nROU asset. \n— The Board, in concluding on the accounting for lease term extension \nmodifications and lease term reassessments, concluded that Category A \nremeasurements and econom ically similar modifications should be \naccounted for consistently. Therefore, if a lessee should reset the exchange \nrate when there is a lease modification (not accounted for as a separate \ncontract), it should also do so for Category A remeasurements. \nIn contrast to modifications (not accounted for as a separate contract) and \nCategory A remeasurements, the exchange rate is not reset by the lessee if \nthere is a remeasurement of the lease resulting only from either (1) a change in \nthe amount probable of being owed under a residual value guarantee, or (2) \nresolution of a contingency that results in variable lease payments becoming fixed. ( Category B remeasurements ) \nDifferentiating between Category A and Category B remeasurements under \nApproach 1 is consistent with Topic 842’s differentiation between these types \nof remeasurements in other areas. For example, in the event of Category A \nremeasurements, a lessee revises i ts discount rate for the lease and \nreassesses the lease classification, but does neither of those in the event of a Category B remeasurement. Those differences exist because, as noted above, \nCategory A remeasurements were viewed by the Board as effectively taking a \nfresh look at the lease, based on changed economics, as of the remeasurement date. In contrast, Category B remeasurements were viewed differently. \nCategory B remeasurements were considered to be solely updates to \njudgments or estimates affecting measurement of the lease, such that it was \ndecided that neither the discount rate, nor lease classification, should \nbe revised. \nApproach 2 – Layered approach \nUnder this approach, the historical exchange rate determined at lease \ncommencement is used to remeasure the original ROU asset, net of \naccumulated amortization, into the lessee’s functional currency throughout the \nlease ( ‘Layer 1’ ). Any increases to the ROU asset based on remeasurement of \nthe lease liability , whether the result of a modification ( not a ccounted for as a \nseparate contract) or any type of reassessment event are remeasured into the \nlessee’s functional currency using the exchange rate in effect at the effective \ndate of the modification/reassessment date ( ‘Layer 2’ ). Additional layers are \nthen added for any further modifications or reassessments that result in an increase to the ROU asset. Therefore, multiple exchange rates may affect the \nremeasurement of the ROU asset into the lessee’s functional currency. \nAs a practical matter, lessees following this approach may collapse multiple \nlayers into a single, “blended” exchange rate used to remeasure the ROU asset \ninto the functional currency . This blended exchange rate will differ from the \nreset exchange rate that would result from the application of Approach 1. \nIf a remeasurement is required that results in a reduction to the carrying amount of the ROU asset and there is only one layer, the historical exchange \nrate will not be updated. However, if there are multiple layers resulting from \nprior remeasurements, determining what exchange rate to apply to the \nremaining, reduced ROU asset may be more complex. In general, we believe ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 467}), Document(page\_content='Leases 467 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. that if the layer to which the remeasurement applies can be specifically \nidentified, the reducti on to the ROU asset should be attributed specifically to \nthat layer, and if a single, blended exchange rate is being used, it should reflect a reduction to that specific layer. For example, a layer may have been created in \na prior remeasurement from a deci sion that a renewal option was reasonably \ncertain to be exercised. If a subsequent reassessment reverses that decision, \nwe believe the decrease to the ROU asset should be attributed specifically to \nthat layer. In contrast, if the layer to which the remeasurement applies cannot \nbe specifically identified (e.g. the remeasurement results from a modification \nthat solely changes the consideration in the contract), we believe the decrease \nto the ROU asset should be attributed to each layer on a pro- rata basis usi ng \nthe layers’ carrying amounts . In either case, if a single, blended exchange rate is \nbeing used, it will likely be different after the remeasurement. \nApproach 2 is predicated on the general principles of Topic 830 (foreign \ncurrency matters ), which indica te that a historical, and not current, exchange \nrate should be used to remeasure nonmonetary assets into the entity’s functional currency. Consistent with the foreign currency accounting for other \nnonmonetary assets, only the new, additional piece (layer) of the ROU asset \n(e.g. added because of an increase in the lease term) should be remeasured into the functional currency using the exchange rate in effect at the date the \nlayer is created. In addition, Approach 2 is based on the premise that Topic 842 \nwas not intended to require lessees to recognize gains or losses from lease \nremeasurements, including for foreign exchange reasons, except when the \nremeasurement results in a reduction of the lease liability that is greater than \nthe unamortized balance of the ROU asset. \n[830- 10-45-17 – 45-18] \nDifferences between the approaches \nThe principal accounting difference between Approach 1 and Approach 2 is that Approach 1 will frequently trigger a foreign exchange gain or loss at the lease \nremeasurement date, while Approach 2 will not. \n \n6.5 Impairment t esting (Step 7) \n Excerpt from ASC 842 -20 \n25 Recognition \nGeneral \n25-7 After a right- of-use asset has been impaired in accordance with \nparagraph 842-20-35-9, the single lease cost described in paragraph 842- 20-25-\n6(a) shall be calculated as the sum of the following: \na. Amortization of the remaining balance of the right -of-use asset after the \nimpairment on a straight -line basis, unless another systematic basis is \nmore representative of the pattern in which the lessee expects to \nconsume the remaining economic benefits from its right to use the \nunderlying asset \nb. Accretion of the lease liability, determined for each remaining period during ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 468}), Document(page\_content='Leases 468 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the lease term as the amount that produces a constant periodic discount \nrate on the remaining balance of the liability. \n35 Subsequent Measurement \nGeneral \n> Amortization of the Right -of-Use Asset for a Finance Lease \n35-7 A lessee shall amortize the right -of-use asset on a straight -line basis, \nunless another systematic basis is more representative of the pattern in which \nthe lessee expects to consume the right -of-use asset’s future economic \nbenefits. When the lease liability is remeasured and the right -of-use asset is \nadjusted in accordance with paragraph 842- 20-35-4, amortization of the right -of-\nuse asset shall be adjusted prospectively from the date of remeasurement. \n> Impairment of a Right- of-Use Asset \n35-9 A lessee shall determine whether a right -of-use asset is impaired and \nshall recognize any impairment loss in accordance with Section 360- 10-35 on \nimpairment or disposal of long- lived assets. \n35-10 If a right -of-use asset is impaired in accordance with paragraph 842- 20-\n35-9, after the impairment, it shall be measured at its carrying amount \nimmediately after the impairment less any accumulated amortization. A lessee \nshall amortize, in accordance with paragraph 842- 20-25-7 (for an operating \nlease) or paragraph 842 -20-35-7 (for a finance lease ), the right -of-use asset \nfrom the date of the impairment to the earlier of the end of the useful life of \nthe right -of-use asset or the end of the lease term . \n35-11 See Example 5 (paragraphs 842- 20-55-47 through 55- 51) for an \nillustration of the requirements for impairment of a right -of-use asset. \n55 Implement ation Guidance and Illustrations \nGeneral \n> Illustrations \n>> Illustration of Impairment of a Right -of-Use Asset \n55-47 Example 5 illustrates impa irment of a right- of-use asset. \n>>> Example 5— Impairment of a Right -of-Use Asset in an Operating \nLease \n55-48 Lessee enters into a 10- year lease of a nonspecialized asset. Lease \npayments are $10,000 per year, payable in arrears. The lease does not transfer \nownership of the underlying asset or grant Lessee an option to purchase the \nunderlying asset. At lease commencement, the remaining economic life of the \nunderlying asset is 50 years, and the fair value of the underlying asset is \n$600,000. Lessee does not incur any initial direct costs as a result of the lease. \nLessee’s incremental borrowing rate is 7 percent, which reflects the fixed rate \nat which Lessee could borrow the amount of the lease payments in the same \ncurrency, for the same term, and with similar collateral as in the lease at \ncommencement. The lease is classified as an operating lea se. \n55-49 At the commencement date, Lessee recognizes the lease liability of \n$70,236 (the present value of the 10 lease payments of $10,000, discounted ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 469}), Document(page\_content='Leases 469 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. at the rate of 7 percent). Lessee also recognizes a right -of-use asset of $70,236 \n(the initial measureme nt of the lease liability). Lessee determines the cost of \nthe lease to be $100,000 (the total lease payments for the lease term). The \nannual lease expense to be recognized is therefore $10,000 ($100,000 ÷ \n10 years). \n55-50 At the end of Year 3, when the car rying amount of the lease liability and \nthe right -of-use asset are both $53,893, Lessee determines that the right -of-\nuse asset is impaired in accordance with Section 360- 10-35 and recognizes an \nimpairment loss of $35,000. The right -of-use asset is part of an asset group \nthat Lessee tested for recoverability because of a significant adverse change in \nthe business climate that affects Lessee’s ability to derive benefit from the \nassets within the asset group. The portion of the total impairment loss for \nthe asset group allocated to the right -of-use asset in accordance with \nparagraph 360- 10-35-28 is $35,000. After the impairment charge, the carrying \namount of the right -of-use asset at the end of Year 3 is $18,893 ($53,893 – \n$35,000). Because of the impairment, t he total expense recognized in Year 3 is \n$45,000 ($10,000 in lease expense + the $35,000 impairment charge). \nBeginning in Year 4, and for the remainder of the lease term, the single lease \ncost recognized by Lessee in accordance with paragraphs 842- 20-25-6(a) and \n842-20-25-7 will equal the sum of the following: \na. Amortization of the right- of-use asset remaining after the impairment \n($18,893 ÷ 7 years = $2,699 per year) \nb. Accretion of the lease liability. For example, in Year 4, the accretion is \n$3,773 ($53,893 × 7%) and, in Year 5, the accr etion is $3,337 ($47,665 \n× 7%). \n55-51 Consequently, at the end of Year 4, the carrying amount of the lease \nliability is $47,665 (that is, calculated as either the present value of the \nremaining lease payments, discounted at 7 percent, or the previous balance of \n$53,893 – $10,000 Year 4 lease payment + the $3,773 accretion of the lease \nliability). The carrying amount of the right -of-use asset is $16,194 (the previous \nbalance of $18,893 – $2,699 amortization). Les see measures the lease liability \nand the right -of-use asset in this manner throughout the remainder of the \nlease term. \n \n6.5.1 Applying the impairment testing requirements \n6.5.10 A lessee uses the long- lived assets impairment guidance (Topic 360) to \ndetermine whether an ROU asset is impaired, and if so, the amount of the \nimpairment loss to recognize. The impairment loss related to an ROU asset is \npresented in the same manner in the income statement as an impairment loss \nrecognized for any other long- lived asset. [842- 20-35-9] \n6.5.20 Topic 842 characterizes operating lease liabilities as operating liabilities, \nrather than as debt. [ASU 2016- 02.BC14(c)] \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 470}), Document(page\_content='Leases 470 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Observation \nLong -lived asset s impairment model for ROU asset \nimpairment \n6.5.30 The Board concluded that a lessee should not continue to recognize an \nROU asset from which it does not expect to obtain future economic benefits or \nto measure that asset at an inflated amount above what the lessee expects to \nrecover. The Topic 360 impairment model is the appropriate one to apply to \nROU assets because the ROU asset in a finance lease or an operating lease is a \nlong-lived, nonfinancial asset. [ASU 2016- 02.BC255] \n \n Question 6.5.10 \nIncluding lease liabilities in the carrying amount of \nthe asset group in Step 1 of the impairment \nanalysis \nShould lease liabilities be included in the carrying amount of \nan asset group that includes ROU assets when performing \nStep 1 of the Topic 360 impairment test? \nBackground: The recoverability test for a held -and-used asset group (step 1 of \nthe impairment test) excludes (1) financial and nonoperating liabilities from the \ncarrying amount of the asset group, and (2) the cash flows attributable to the \nfinancial and nonoperating l iabilities in determining the undiscounted future \nexpected cash flows of the asset group – e.g. both interest and principal \ncomponents of the financial and nonoperating liabilities should be excluded. \nHowever, consistent with Example 1 to Topic 360, an entity should include operating liabilities (e.g. accrued liabilities and accounts payable) in the carrying \namount and the cash flows used in the recoverability test. Any terminal value of \nthe asset group included in the recoverability test should reflect the value \ninclusive of normal operating working capital assets and liabilities and not how \nthe asset group is financed (e.g. through debt or equity). \n[360- 10-55-20 – 55-22, \nASU 2016- 02.BC14] \nInterpretive response: It depends. The conclusion as to whether a l ease \nliability should be included in the carrying amount of the asset group to which the ROU asset relates depends on the classification of the lease as a finance \nlease or an operating lease. \nFinance leases \nFor finance leases, no. T he finance lease liability should be excluded in \ndetermining the carrying amount of the asset group, and the interest and \nprincipal components of the lease liability excluded in determining the \nundiscounted future expected cash flows of the asset group in the \nrecoverability test. \nThis is consistent with the accounting related to capital leases under Topic 840; \ncapital lease obligations were not included in the carrying amount of the asset \ngroup that includes the related capital lease assets. Capital lease obligations are \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 471}), Document(page\_content='Leases 471 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. a financi al liability that is equivalent to debt , and the impairment guidance in \nTopic 360 has long been premised on the view that debt, as simply a form of \ncapitalization other than equity, should not be included in the asset group. \nOperating leases \nFor operating leases, we believe either of the following approaches w ould be \nconsistent with US GAAP, although Approach A appears more consistent with \nhow similar financial, but also operating, obligations (e.g. asset retirement \nobligations) are considered in the long- lived asset impairment gui dance. \nHowever, as demonstrated in Example 6. 5.10, we believe entities should not \ncome to different Step 1 impairment test conclusions regardless of the \napproach taken. \nApproach A \nExclude the carrying amount of the lease liability in determining the carrying \namount of the asset group, and therefore also exclude the operating lease \npayments in determining the undiscounted future expected cash flows of the \nasset group. \nAn operating lease liability is a financial liability even though the Board decided it should be characterized as an operating liability , rather than debt, for \npresentation purposes. We have observed that, in discussions about operating lease liabilities and their characterization as operating liabilities for presentatio n \npurposes, the Board frequently compared those lease liabilities to other discounted, financial liabilities that are also not characterized as debt, including \nthose related to asset retirement obligations (AROs). \nAn analogy to AROs would suggest that Appr oach A is appropriate because, in \naccordance with Topic 360, the carrying amount of an ARO is excluded from the carrying amount of the asset group to which it relates, as are the estimated \ncash flows related to the liability. In addition, the introduction to ASU 2016- 02 \nacknowledges leasing as a form of financing. Because the impairment guidance in Topic 360 is not intended to create different impairment results solely based \non how an entity capitalizes (or finances its operations), this further supports \nour belief that Approach A is an acceptable application of the impairment \nguidance in Topic 360. \n[360- 10-35-18] \nApproach B \nInclude the carrying amount of the lease liability in determining the carrying amount of the asset group, and include the operating lease payments (net of \nthe portion that relates to accretion of the operating lease liability) in determining the undiscounted future expected cash flows of the asset group. \nThe Board explicitly stated that operating lease liabilities are operating in nature. Therefore, consistent with the view that an entity should include operating \nliabilities (e.g. accrued liabilities and accounts payable) in the carrying amount of \nthe asset group and in the undiscounted cash flows of the asset group, we \nbelieve Approach B is also an acceptable application of the impairment guidance \nin Topic 360. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 472}), Document(page\_content='Leases 472 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 6.5.20 \nShort -term lease payments in the recoverability \ntest \nAre short -term lease payments included in determining the \nundiscounted future expected cash flows of the asset group \nto which the lease belongs if the short -term lease is not \nrecognized on the balance sheet? \nInterpretive response: Yes. If a short -term lease is not recognized on the \nbalance sheet ( see paragraph 6.3.110), the s hort-term lease payments should \nbe deducted from the undiscounted future expected cash flows of the asset \ngroup to which the lease relates. \nIf the short -term lease is recognized on the balance sheet, follow the guidance \nin Question 6.5.10 . \n \n Question 6.5.30 \nVariable lease payments in the recoverability test \nAre variable lease payments included in determining the \nundiscounted future expected cash flows of the asset group \nto which the lease belongs? \nInterpretive response: Yes. A lessee should include expect ed variable lease \npayments in determining the undiscounted future expected cash flows of the \nasset group if such variable lease payments are not included in the \nmeasurement of the lease liability, for example because they are dependent on \nan index or rate (see section 5.4) . \n \n Example 6.5.10 \nRecoverability test for a held -and- used asset group \nthat includes a n ROU asset \nThis example is a continuation of Examples 6.3.10 and 6.4.20, in which Lessee \nLE leases office space from Lessor LR for 10 years. \nLE tests one of its asset groups for impairment because of a triggering event. \nThe asset group being tested includes the ROU asset related to the office \nspace that LE leases from LR. The impairment test coincides with the end of \nYear 2 of LE’s lease. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 473}), Document(page\_content='Leases 473 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The foll owing additional facts are relevant. \nCarrying amount of asset group: $770,000 (includes the ROU asset but not the \noperating lease liability) \nUndiscounted future expected cash \nflows: $100,000 annually (before considering the \nlease payments associated with the lease) \nPeriod over which recoverability test performed (for illustrative purposes): 8 years \nTerminal value at the end of Year 8: Nil \nAs outlined in Question 6.5.10 , we believe it may be acceptable for an entity to \napply either one of the following two approaches (A or B) as to inclusion of the \noperating lease liability in the asset group that includes the operating lease ROU \nasset. \nScenario 1: Approach A – do not include operating lease liability in the \nasset group \nLE excludes the operating lease liability in determining the carrying amount of \nthe asset group, and excludes the cash outflows from the lease payments in \ndetermining the undiscounted future expected cash flows of the asset group. Accordingly, LE’s recoverability test is as follows. \n Yr 1 Yr 2 Yr 3 Yr 4 Yr 5 Yr 6 Yr 7 Yr 8 Total \nUndiscounted \nfuture expected \ncash flows \nbefore lease pmts. $100,000 $100,000 $100,000 $100,000 $100,000 $100,000 $100,000 $100,000 $800,000 \nEffect of lease pmts. - - - - - - - - - \nTotal $100,000 $100,000 $100,000 $100,000 $100,000 $100,000 $100,000 $100,000 $800,000 \n \nCarry. amt. of asset group, excl. operating \nlease liab. $770,000 \nLess carry. amt. of operating lease liab. N/A \nCarry. amt. of asset group 770,000 \nTotal undiscounted future expected cash flows 800,000 \nExcess $ 30,000 Asset group does not fail \nthe recoverability test \nScenario 2: Approach B – include operating lease liability in the asset \ngroup \nLE includes the lease liability in determining the carrying amount of the asset \ngroup, and includes the operating lease payments (net of the portion that \nrelates to accretion of the operating lease liability) in determining the \nundiscounted future expected cash flows of the asset group. Accordingly, LE’s \nrecoverability test is as follows, the result of which is the same as under \nApproach A. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 474}), Document(page\_content='Leases 474 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Yr 1 Yr 2 Yr 3 Yr 4 Yr 5 Yr 6 Yr 7 Yr 8 Total \nUndiscounted \nfuture expected cash \nflows before \nlease pmts. $100,000 $100,000 $100,000 $100,000 $100,000 $100,000 $100,000 $100,000 $800,000 \nEffect of lease pmts. (15,412) (15,874) (16,350) \n(16,841) (17,346) (17,866) (18,402) (18,954) (137,045) \nAdd back portion related to lease liab. \naccret. 9,006 8,365 7,614 6,741 5,731 4,569 3,239 1,723 46,988 \nTotal $ 93,594 $ 92,491 $ 91,264 $ 89,900 $ 88,385 $ 86,703 $ 84,837 $ 82,769 $709,943 \n \nCarry ing amount of asset group, excl uding \noperating lease liab ility $770,000 \nLess carrying amount of operating lease liability (90,057) \nCarry ing amount of asset group $679,943 \nTotal undiscounted future expected cash flows 709,943 \nExcess $ 30,000 Asset group does not fail \nthe recoverability test \n \n \n Question 6.5.32 \nIncluding operating lease liabilities in Step 1 of the \nimpairment analysis results in negative carrying \namount for the asset group \nHow is Step 1 of the Topic 360 impairment analysis affected if \nincluding operating lease liabilities in the asset group results in a negative ca rrying amount ? \nBackground : It is possible that the carrying amount of an asset group is \nnegative – i.e. the carrying amount of the liabilities of the asset group exceed \nthe carrying amount of the assets – because the lessee elects to apply \nApproach B in Question 6.5.10 when assessing its asset groups that include \noperating lease ROU assets for impairment under Topic 360. \nA negative carrying amount for an asset group that results from using \nApproach B may occur for a variety of reasons and in different scenarios. \nHowever, we expect it to occur most frequently when: \n— the operating lease ROU asset is the primary asset in the asset group – e.g. \nin many retail store scenarios or when the underlying asset is being \nsubleased and that results in a change in the ass et grouping for the head \nlease ROU asset; and \n— the carrying amount of the lease liability exceeds the carrying amount of the \nROU asset – e.g. when the lease payments escalate during the lease term \nor where the ROU asset has been partially impaired previous ly. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 475}), Document(page\_content='Leases 475 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Interpretive response: We do not believe the evaluation of when the Step 1 \nrecoverability test is required, or how the recoverability test is performed, \ndiffers when the carrying amount of the asset (asset group) is negative versus positive. \nIn either situation, if the undiscounted cash flows of the asset (asset group) are \nless than the carrying amount of the asset (asset group), including when the \nundiscounted cash flows are more negative than the carrying amount of the \nasset (asset group), the lessee proceeds to Step 2 of the impairment analysis. \nThis means that if the carrying amount is negative (e.g. negative $1,000), and \nthe deficit of undiscounted cash outflows to undiscounted cash inflows is \ngreater (e.g. the deficit is $2,000), the entity must proceed to Step 2 of the impairment analysis (i.e. the fair value test). \n \n Example 6.5.15 \nRecoverability test for a held -and- used asset group \nthat includes a n ROU asset and has a negative \ncarrying amount if including the operating lease \nliability \nAssume the same office space lease described in Example 6.5.10, in which \nLessee LE leases office space from Lessor LR for 10 years. However, assume \nthat: \n— the ROU asset is part of a different asset group – i.e. not the same asset \ngroup as in Example 6.5.10; and \n— there is an impairment of the asset group containing the ROU asset at the end of Year 2 of the lease, of which $20,000 was allocated to the ROU asset. \nAfter the impairmen t, the ROU asset balance at the end of Year 2 is $70,239: \n$90,239 ROU asset balance at the end of Year 2 (see Example 6.4.20) less $20,000 allocated impairment. Subsequently, LE amortizes the ROU asset on a \nstraight -line basis over the remaining term of the lease (see paragraph 6.5.40). \nThis results in annual amortization of $8,780 ($70,239 / 8 years remaining lease \nterm). \nAt the end of Year 4 of the lease, LE concludes that significantly deteriorated \neconomic conditions indicate that the already -impaired c arrying amount of the \nasset group that includes the ROU asset may not be recoverable. \nAt the end of Year 4, the carrying amount of the ROU asset is $52,679 ($70,239 \nend of Year 2 carrying amount − $17,560 amortization in Year 3 and Year 4). At \nthe end of Year 4, the asset group comprises: \n— the ROU asset and leasehold improvements (if following Approach A in \nQuestion 6.5.10); or \n— the ROU asset, leasehold improvements and the lease liability (if following \nApproach B in Question 6.5.10). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 476}), Document(page\_content='Leases 476 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Approach A Approach B \nCarrying amount of the ROU asset $52,679 $52,679 \nCarrying amount of leasehold improvements $8,000 $8,000 \nCarrying amount of lease liability N/A $(76,142) \nCarrying amount of asset group $60,679 $(15,463) \nUndiscounted future expected cash flows (before lease \npayments associated with lease) $10,000 annually \n $10,000 \nannually \nPeriod over which recoverability test performed 6 years 6 years \nTerminal value at end of Year 10 Nil Nil \nScenario 1: LE follows Approach A – does not include operating lease \nliability in the asset group \nLE excludes the operating lease liability from the carrying amount of the asset \ngroup, and therefore excludes the lease payments from the undiscounted \nfuture expected cash flows of the asset group. As a result, the following is LE’s \nrecoverability test, reflecting Years 5 -10 of the lease. \n Yr 5 Yr 6 Yr 7 Yr 8 Yr 9 Yr 10 Total \nUndiscounted future \nexpected cash flows \nbefore lease pmts. $10,000 $10,000 $10,000 $10,000 $10,000 $10,000 $60,000 \nEffect of lease pmts. - - - - - - - \nTotal $10,000 $10,000 $10,000 $10,000 $10,000 $10,000 $60,000 \n \nCarry ing amount of asset group $60,679 \nTotal undiscounted future expected cash \nflows 60,000 \nDeficiency $(679) Asset group fails the \nrecoverability test \nScenario 2: LE follows Approach B – includes operating lease liability in \nthe asset group \nLE includes the lease liability in the carrying amount of the asset group, and \ntherefore includes the operating lease payments (net of the portion that relates \nto accretion of the operating lease liability) from the undiscounted future \nexpected cash flows of the asset group. As a result, the following is LE’s \nrecoverability test, reflecting Years 5 -10 of the lease; the result is the same as \nin Scenario 1. \n Yr 5 Yr 6 Yr 7 Yr 8 Yr 9 Yr 10 Total \nUndiscounted future \nexpected cash flows \nbefore lease pmts. $10,000 $10,000 $10,000 $10,000 $10,000 $10,000 $60,000 \nEffect of lease pmts. (16,350) (16,841) (17,346) (17,866) (18,402) (18,954) (105,759) \nAdd back portion related \nto lease liab. accret. 7,614 6,741 5,731 4,569 3,239 1,723 29,617 \nTotal $ 1,264 $ (100) $ (1,615) $ (3,297) $ (5,163) $ (7,231) $(16,142) ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 477}), Document(page\_content='Leases 477 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. \nCarry ing amount of asset group $(15,463) \nTotal undiscounted future expected cash \nflows (16,142) \nDeficiency $(679) Asset group fails the \nrecoverability test \n \n \n Question 6.5.33 \nCash flows used in impairment testing \nHow is the Topic 360 impairment test affected if the \nimpairment triggering event is not also a lease term or purchase option triggering event ? \nBackground: Question 6.6.20 highlights that a Topic 360 impairment triggering \nevent will not necessarily require or permit a reassessment of the lease term or \na lessee purchase option. Question 6.6.20 uses the following ex ample to \nillustrate. \nLessee LE leases a building, to be used as a retail store, from Lessor LR for a \nnon-cancellable period of 10 years. The lease includes one 5- year renewal \noption. At lease commencement , LE concludes that it is reasonably certain to \nexercise the renewal option, and therefore the lease term is 15 years. \nBy Year 9, the retail location is performing poorly for reasons that were not anticipated at lease commencement, and LE decides that it will not exercise its \nrenewal option. However, LE ta kes no action to vacate the retail location and \ndecides that it will not communicate its decision to vacate to the lessor until it is required to do so, which is 60 days before the end of the 10- year non-\ncancellable period of the lease. \nThe poor performance of the retail location is an impairment triggering event \nunder Topic 360, but is not a lease term reassessment event under Topic 842. \n[360- 10-35-21, 842- 10-35-1, 55- 28] \nTherefore, LE does not reassess whether the lease term is still 15 years (likely, \nit would not be) before assessing the ROU asset for impairment, and the \nquestion arises about the assumptions LE should use when performing the \nTopic 360 impairment test. \nInterpretive response: Assuming the lease term or the assessment of a lessee \npurchase option would change if reassessed, both Step 1 and Step 2 of the \nTopic 360 impairment test are affected because the carrying amount of the \nROU asset will generally be greater than if either of the following happened \nbefore undertaking the test: the lease term was reduced, or an assessment that \na lessee purchase option is reasonably certain of exercise was reversed. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 478}), Document(page\_content='Leases 478 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Step 1 recoverability test \nWhen performing the Step 1 recoverability test, the lessee’s assumptions are \nbased on its entity -specific p lans, which are unaffected by whether it is able to \nreassess the lease term or a lessee purchase option first. \nUsing the background example, even though the ROU asset still reflects a 7-\nyear remaining lease term, LE’s Step 1 cash flows will be based on it s plan not \nto renew the lease in 2 years – i.e. to return the remaining 5- year ROU asset to \nLR. \nWhen LE estimates those Step 1 cash flows, there will be two components \nrelated to the ROU asset: [360- 10-35-29 – 35-30] \n— the cash flows from operating the asset for the next 2 years; plus \n— the estimated terminal value of the ROU asset at the end of 2 years. \nWe believe the terminal value of the ROU asset should be its expected fair \nvalue (see Question 6.5.40 for ROU asset fair value considerations) as of the \nplann ed cease- use date. At that point, economically, the ROU asset represents \nLE’s contractual right to renew the lease. \nStep 2 fair value test \nIn contrast to Step 1, Step 2 uses market participant assumptions, rather than \nentity -specific plans for use of the asset. Those market participant assumptions \nshould be based on what a market participant would do if it was the lessee in a lease with a non- cancellable term equal to the unreassessed lease term.\n [360- 10-\n35-17, 35- 36] \nUsing the background example, LE wi ll determine what a market participant \nwould do if it had a 7 -year non- cancellable remaining lease, rather than a 2- year \nremaining lease. A market participant in that situation might be unlikely to \nsimply cease use of the retail location; rather, it might sublease the location to \nanother user or continue to operate the location to generate cash flows. \nGo-forward accounting \nIf the lessee intends to terminate (or not renew) the lease before the end of the \nlease term, that will generally constitute a plan to abandon the ROU asset (see \nQuestion 6.5.50). Accordingly, the remaining carrying amount of the ROU asset (i.e. after any impairment taken) needs to be amortized to its salvage value by \nthe planned lease end date (see Question 6.5.70). \nUsing the ba ckground example, LE will amortize the remaining carrying amount \nof the ROU asset at the beginning of Year 9 to its salvage value at the end of \nYear 10. The ROU asset’s salvage value in this case will be the estimated fair \nvalue as of the planned cease- use date used in the Step 1 recoverability test. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 479}), Document(page\_content='Leases 479 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 6.5.35 \nIncluding operating lease liabilities in the carrying \namount of the asset group in Step 2 of the \nimpairment analysis \nShould operating lease liabilities be included in the carrying \namount of an asset group that includes ROU assets when \nperforming Step 2 of the Topic 360 impairment test ? \nBackground: Under Topic 360, if the undiscounted cash flows used to assess \nrecoverability of the asset (asset group) are less than the carrying amount of the \nasset (asset group), the entity then proceeds to determine the fair value of the \nlong-lived asset group and recognizes an impairment loss if the carrying amount \nexceeds that fair value. This is Step 2 of the Topic 360 impairment test . [360- 10-\n35-17] \nQuesti on 6.5.10 outlines our view that it is acceptable to either include or \nexclude operating lease liabilities from the carrying amount of an asset group \nthat includes associated operating lease ROU assets when performing the \nStep 1 recoverability test. This question addresses whether an entity should \ncontinue to follow its Step 1 approach when performing the Step 2 evaluation. \nInterpretive response: In general, when performing the Step 2 impairment \ntest, we would expect a lessee to follow the same approach that it applied \nwhen performing the Step 1 recoverability test (see Question 6.5.10). \n— If the lessee excludes operating lease liabilities from the carrying amount \nof the asset group when performing the recoverability test (Approach A in \nQuestion 6.5.10), the lessee should exclude those same lease liabilities \nfrom the carrying amount of the asset group when performing Step 2 of the \nimpairment test. \n— If the lessee includes operating lease liabilities in the carrying amount of \nthe asset group when performing the recoverability test (Approach B in \nQuestion 6.5.10), the lessee should include those same lease liabilities in \nthe carrying amount of the asset group when performing Step 2 of the impairment test. \nIrrespective of the approach taken, we would not expect a significant difference in the outcome of Step 2. This is because we would expect the lessee’s \nestimate of the fair value of the asset group to appropriately reflect whether the \nasset group includes or excludes the operating lease liabilities. Quest ion 6.5.36 \ndiscusses the effect on Step 2 of the impairment test of including or excluding \noperating lease liabilities from the carrying amount of the asset group. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 480}), Document(page\_content='Leases 480 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 6.5.36 \nEffect of including or excluding operating lease \nliabilities in the carrying amount of the asset group \nin Step 2 \nHow should inclusion or exclusion of operating lease \nliabilities in the carrying amount of an asset group aff ect the \nStep 2 impairment test ? \nInterpretive response: The effects will differ depending on the approach taken \nto estimate the fair value of the asset group. We believe the most common \napproach will be a discounted cash flow approach, but other approaches, such \nas based on a market price for the asset group, may be used. \nUsing a discounted cash flow approach \nExclude vs. include the lease payments \nIf the lessee excludes the operating lease liabilities from the carrying amount of \nthe asset group (i.e. Approac h A), it sh ould also exclude the lease payments \nfrom the discounted cash flows used to measure the asset group’s fair value. \nThis aligns the treatment of operating lease liabilities when assessing \nimpairment under Topic 360 to asset retirement obligations (AROs), which the \nBoard noted are similar in that they are discounted financial liabilities not characterized as ‘debt’ . Topic 360 is explicit that an asset group’s fair value \ndetermined using discounted cash flows should exclude ARO payments; this is because ARO liabilities are excluded from the carrying amount of the asset \ngroup. This suggest s an asset group’s fair value determined using a discounted \ncash flow approach should exclude operating lease payments when the carrying \namount of the asset group excludes the operating lease liabilities. \n[360- 10-35-18 – \n35-19] \nIn contrast, if the lessee includes the operating lease li abilities in the carrying \namount of the asset group (i.e. Approach B) , it would also include the lease \npayments in the discounted cash flows used to measure the asset group’s fair \nvalue. Unlike the Step 1 recoverability test (see Question 6.5.10) , the enti re \nlease payments would be included, rather than solely the principal portion of the \nlease payments ; this is because the cash flows used to estimate the asset \ngroup’s fair value will be discounted. \nAssumptions made in measuring fair value \nIn using a discounted cash flow approach to measure fair value of the asset \ngroup, there are two key differences from the Step 1 recoverability test. \n— The cash inflows and outflows that are used in measuring fair value are based on the assumptions that a market partic ipant would make – they are \nnot entity -specific. This is discussed in section D of KPMG Q&A, Fair value \nmeasurement . \n[820- 10-35-9] \n— The cash flows are discounted, applying a rate that a market participant would require in assuming the risks associated with those cash flows – it is \nunrelated to the discount rate used by the lessee to account for the lease. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 481}), Document(page\_content='Leases 481 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The discount rate used to discount the cash flows to present value depends \non which approach the entity elects. [820- 10-55-6] \n— Under Approach A, the cash flows exclude the lease payments. To be \nconsistent, the discount rate includes lease financing as an available \nsource of capital. \n— Under Approach B, the cash flows include the lease payments. To be \nconsistent, the discount rate does not consider lease financing as an \navailable source of capital. This is because, in concept, the lease \npayments included in the cash flows are already paying for the ROU \nasset(s). \nIn theory, the two approaches should result in the same fair value \nmeasurement. However, determining an appropriate discount rate, \nincluding adjustments required to observed market rates, may require the \nassistance of qualified valuation specialists. \nUsing a mar ket price approach \nIf the fair value of the asset group in Step 2 is estimated based on a quoted market price, it should reflect the lessee’s decision about whether to include or \nexclude the operating lease liabilities from the carrying amount of the asset \ngroup. If it does not, an appropriate adjustment is made. \n— The quoted market price should be increased if the lessee excludes the \noperating lease liabilities from the carrying amount of the asset group, but \nthe quoted market price reflects the lessee’s obl igation to make the \nassociated lease payment s. \n— The quoted market price should be decreased if the lessee i ncludes the \noperating lease liabilities in the carrying amount of the asset group, but the \nquoted market price does not reflect the lessee’s obligation to make the \nassociated lease payments. \n \n Question 6.5.37 \nIncluding operating lease liabilities in Step 2 of the \nimpairment analysis results in negative carrying \namount for the asset group \nHow is Step 2 of the Topic 360 impairment analysis affected if \nincluding operating lease liabilities in the asset group results \nin a negative carrying amount ? \nBackground : As discussed in Question 6.5.32, it is possible that the carrying \namount of an asset group is negative – i.e. the carrying amount of the liabilities \nof the asset group exceeds the carrying amount of the assets – because the \nlessee elects to apply Approach B in Question 6.5.10 when assessing asset \ngroups that include operating lease ROU assets for impairment under \nTopic 360. \nSimilar to Que stion 6.5.32, a question arises about the effect on the Step 2 \nTopic 360 impairment test of an asset (asset group) having a negative carrying \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 482}), Document(page\_content='Leases 482 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. amount. In particular, can the fair value of the asset group be negative? If not, it \nwould mean that no asset (ass et group) with a negative carrying amount could \nbe impaired, and therefore the exclusion (Approach A in Question 6.5.10) or inclusion (Approach B in Question 6.5.10) of operating lease liabilities in an \nasset group could affect whether an impairment exists . \nInterpretive response: We believe the fair value of an asset (asset group) can \nbe negative if an entity would effectively have to pay a market participant to \ntake the asset group – i.e. because the acquirer would have to assume the \nliabilities that are p art of the group. Accordingly, we do not believe a negative \nrather than a positive carrying amount of the relevant asset (asset group), \nshould affect Step 2 of the impairment test under Topic 360. \nRegardless of whether the carrying amount of the asset (ass et group) is \npositive or negative, if the fair value of the asset (asset group) is less than its \ncarrying amount – including when the fair value is more negative than the \ncarrying amount – the lessee recognizes an impairment loss. \nFor example, if the carr ying amount of an asset group is negative $1,000 \n(because the entity followed Approach B in Question 6.5.10) and the fair value of the asset group is negative $2,200, an impairment loss of $1,200 is \nrecognized, subject to the fair value limitation discussed in Question 6.5.40. \n \n Question 6.5.40 \nAllocation of impairment losses to an asset group \nHow should an impairment loss be allocated to an asset \ngroup that includes one or more ROU assets? \nInterpretive response: An impairment of an asset group generally is allocated \non a pro rata basis to all of the long -lived assets, including ROU assets, in the \ngroup on a relative carrying amount basis. This means that an ROU asset will \noften be written down because of an allocated impairment loss, rather than \nbecause of an event or change in circumstance specific to that ROU asset. \n[360- 10-35-28] \nWhen an asset group includes multiple operating lease ROU assets, all of those \nROU assets will generally receive an allocation of the impairment loss . \nTherefore, all of those leases will be subject to the post -impairment operating \nlease accounting model illustrated in Example 6. 5.20. \nRegardless of the approach (A or B) applied by the lessee in Questions 6.5.10 \nand 6.5.35, liabilities included in the asset group (if any) are not affected by the \nimpairment of the asset group, nor are any assets in the group that are outside \nthe scope of Topic 360. \nUnder Topic 360 , the portion of an impairm ent loss allocated to an individual \nlong-lived asset within an asset group (e.g. a specific ROU asset) cannot reduce \nthe carrying amount of that asset below its fair value if that fair value is \ndeterminable without undue cost and effort (the ‘fair value li mitation’) . In that \ncase, the amount of the impairment that can be allocated to the asset is \nrestricted, with the excess loss being allocated to the other long- lived assets in \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 483}), Document(page\_content='Leases 483 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the group using the relative adjusted carrying amounts of those assets. \nApplying the fair value limitation may mean that the calculated deficit between \nthe fair value and the carrying amount of the asset group is not fully recognized. \nSee Example 6.5.17. [360- 10-35-28, 55 -22] \nDetermining the fair value of an ROU asset may involve judgment, and will be \nbased on its highest and best use to a market participant. Effectively, the fair \nvalue of the ROU asset is the amount that a market participant would pay to \nhave the use of that asset for the lease term without the o bligation to make \nlease payments. Accordingly, an ROU asset will not have a fair value of zero, \nand therefore should not be fully impaired, if it would have utility to a market participant – e.g. if the underlying asset can be used or subleased by a market \nparticipant (regardless of the lessee’s intent to do so). \n[820-10-35-10A – 35-14] \nThe measurement of fair value of an ROU asset for purposes of applying the \nfair value limitation should exclude the effect of the lessee’s obligation to make \nlease payments even if the lessee is applying Approach B in Questions 6.5.10 \nand 6.5.35. This is because allocation of an impairment loss is based on the \nrelative carrying amount of the long- lived assets in the asset group, without \nregard to any liabilities included in the carrying amount of the asset group. \n \n Example 6.5.17 \nFair value test for a held -and- used asset group that \nincludes a n ROU asset and has a negative carrying \namount if including the operating lease liability \nThis example continu es Example 6.5.15, and illustrates Step 2 of the Topic 360 \nimpairment test. \nIn Example 6.5.15, at the end of Year 4 of the lease, Lessee LE performed \nStep 1 of the impairment test, which indicated that the asset group was not \nrecoverable. \nLE now performs Step 2 of the impairment test to calculate any impairment \nloss. LE uses a discounted cash flow (i.e. income) approach to estimate the fair \nvalue of the ass et group. \nAt the end of Year 4, the asset group comprises: \n— the ROU asset and leasehold improvements (if following Approach A in \nQuestion 6.5.10); or \n— the ROU asset, leasehold improvements and the lease liability (if following \nApproach B in Question 6.5.10). \n Approach A Approach B \nCarrying amount of ROU asset $52,679 $52,679 \nCarrying amount of leasehold improvements $8,000 $8,000 \nCarrying amount of lease liability N/A $(76,142) \nCarrying amount of asset group $60,679 $(15,463) ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 484}), Document(page\_content='Leases 484 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Approach A Approach B \nUndiscounted future expected cash flows (before lease \npayments associated with lease) $10,000 annually $10,000 \nannually \nPeriod for which cash flows are considered 6 years 6 years \nTerminal value at end of Year 10 Nil Nil \nDiscount rate for future expected cash flows 8.5356%1 12% \nNote: \n1. The discount rate under Approach A is shown in greater precision so that the \nresults of applying Approach A versus Approach B can be properly illustrated. \nScenario 1: LE follows Approach A – does not include operating lease liability in \nthe asset group \nConsistent with Scenario 1 in Example 6.5.15, LE excludes the operating lease \nliability from the carrying amount of the asset group. On that basis, LE also \nexcludes the cash outflows from the operating lease payments in measuring \nfair value using a discoun ted cash flow approach. \nUsing the discount rate appropriate to those assumptions (see Question \n6.5.35), LE’s Step 2 fair value test is as follows. \n Yr 5 Yr 6 Yr 7 Yr 8 Yr 9 Yr 10 Total \nUndiscounted future \nexpected cash flows \nbefore lease pmts.1 $10,000 $10,000 $10,000 $10,000 $10,000 $10,000 $60,000 \nEffect of lease pmts. - - - - - - - \nUndiscounted cash flows $10,000 $10,000 $10,000 $10,000 $10,000 $10,000 $60,000 \nDiscounted cash flows $ 9,214 $ 8,489 $ 7,821 $ 7,206 $ 6,640 $ 6,117 $45,487 \nNote: \n1. For simplicity, the LE -specific undiscounted future expected cash flows used in \nExample 6.5.15 are assumed to be the same future cash flows that would be expected \nby a market participant (see Question 6.5.35) . \n \nCarry ing amount of asset group $60,679 \nTotal discounted future expected cash flows (fair value of asset group) 45,487 \nIndicated impairment loss $(15,192) \nLE allocates the impairment loss pro rata to the long- lived assets in the asset \ngroup on a relative carrying amount basis. LE determines the stand- alone fair \nvalues of the ROU asset and the leasehold improvements to be $40,000 and \n$4,000, respectively. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 485}), Document(page\_content='Leases 485 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Asset Pre-\nimpairment \ncarrying \namount (A) Pro rata \nimpairment \nallocation Allocated \nimpairment \nloss (B) Post -\nimpairment \ncarrying \namount \n(A – B) \nROU asset $52,679 $13,1891 $12,6792 $40,000 \nLeasehold \nimprovements 8,000 2,0033 2,5134 5,487 \nTotal $60,679 $15,192 $15,192 $45,487 \nNotes: \n1. ($52,679 / $60,679) × $15,192. \n2. The impairment of the ROU asset is limited to $12,679 (see Question 6.5.40), which is \nthe difference between the pre- impairment carrying amount ($52,679) and its fair value \n($40,000). The difference (excess impairment) of $510 ($13,189 – $12,679) is \nreallo cated to the leasehold improvements to the extent the reallocation does not \nresult in impairing those assets below their fair value of $4,000. [360- 10-35-28] \n3. ($8,000 / $60,679) × $15,192. \n4. The entire $510 excess impairment on the ROU asset is allocated to the leasehold \nimprovements because this excess plus the allocated impairment (N ote 3) does not \nimpair those assets below their fair value of $4,000. \nScenario 2: LE follows Approach B – includes operating lease liability in the \nasset group \nConsistent with Scenario 2 in Example 6.5.15, LE includes the operating lease \nliability in the carrying amount of the asset group. On that basis, LE also \nincludes the entire operating lease payments – not just the principal portion – in \nmeasuring fair valu e using a discounted cash flows approach. \nUsing the discount rate appropriate to those assumptions (see \nQuestion 6.5.35), LE’s Step 2 fair value test is as follows. \n Yr 5 Yr 6 Yr 7 Yr 8 Yr 9 Yr 10 Total \nUndiscounted future \nexpected cash flows \nbefore lease pmts.1 $10,000 $10,000 $10,000 $10,000 $10,000 $10,000 $60,000 \nEffect of lease pmts. (16,350) (16,841) (17,346) (17,866) (18,402) (18,954) (105,759) \nUndiscounted cash flows (6,350) (6,841) (7,346) (7,866) (8,402) (8,954) (45,759) \nDiscounted cash flows $ (5,670) $ (5,454) $ (5,229) $ (4,999) $ (4,768) $ (4,536) $(30,655) \nNote: \n1. For simplicity, the LE -specific undiscounted future expected cash flows used in \nExample 6.5.15 are assumed to be the same future cash flows that would be expected \nby a market participant (see Question 6.5.35) . \n \nCarry ing amount of asset group $(15,463) \nTotal discounted future expected cash flows (fair value of asset group) (30,655) \nIndicated impairment loss $(15,192) \nThe impairment loss in Scenario 2 is the same as in Scenario 1 – and will be \nallocated to the ROU asset and leasehold improvements as in Scenario 1 – ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 486}), Document(page\_content='Leases 486 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. highlighting how the assumptions used in each scenario are consistent with the \ndecision of whether to appl y Approach A or Approach B (see Question 6.5.36). \n6.5.40 After the impairment of an ROU asset, the asset is measured at its \ncarrying amount immediately after the impairment less any accumulated \namortization subsequent to the impairment. Regardless of the lease \nclassification, a lessee amortizes the ROU asset after impairment on a straight -\nline basis (unless another systematic basis is more representative of the pattern \nin which the lessee expects to consume the future economic benefits from the \nasset) from the date of impairment to the earlier of the end of the ROU asset’s \nuseful life or the end of the lease term. This accounting continues to apply if the \nROU asset is remeasured due to a change in the lease liability post -impairment \n(see Question 6.6. 120). \nAccumulated \namortization \nafter \nimpairmentROU asset \nbalanceCarrying \namount of \nROU asset \nafter \nimpairment \n6.5.50 If an operating lease ROU asset has been impaired, for each period from \nthe date of impairment through the end of the lease term, the single lease cost \nfor the operating lease (which is still presented in a single income statement \nline item as before the impairment) is calculated as the sum of the following. \n[842- 20-25-7] \nAmortization \nof the ROU \nasset2 Single lease \ncostAccretion of \nthe lease \nliability1 \nNote s: \n1. Determined for each remaining period during the lease term as the amount that produces \na constant periodic discoun t rate on the remaining balance of the liability – i.e. the \neffective interest method. \n2. See paragraph 6.5.40. \n \n Example 6.5.20 \nOperating lease accounting before and after \nimpairment \nAssume that instead of passing the recoverability test in Example 6.5.10, the \nasset group is impaired and the amount of the impairment allocated to the ROU \nasset is $10,000. The following chart illustrates the accounting for the ROU \nasset before and after impairment. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 487}), Document(page\_content='Leases 487 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Year ROU asset carrying amount Lease \nliability Income statement2 \nBeg. \nBalance ROU \nasset \namort. Impair. \ncharge End. \nbalance Carry. \namt. (end. \nbalance)1 Accret. ROU \nasset \namort. Single \nlease cost \n1 $105,000 $ (7,154) $ - $97,846 $95,473 $10,000 $ 7,154 $ 17,154 \n2 97,846 (7,607) (10,000) 80,239 90,057 9,547 7,607 17,154 \n3 80,239 (10,030) - 70,209 83,651 9,006 10,030 19,036 \n4 70,209 (10,030) - 60,179 76,142 8,365 10,030 18,395 \n5 60,179 (10,030) - 50,149 67,406 7,614 10,030 17,644 \n6 50,149 (10,030) - 40,119 57,306 6,741 10,030 16,771 \n7 40,119 (10,030) - 30,089 45,691 5,731 10,030 15,761 \n8 30,089 (10,030) - 20,059 32,394 4,569 10,030 14,599 \n9 20,059 (10,030) - 10,029 17,231 3,239 10,030 13,269 \n10 10,029 (10,029) - - - 1,723 10,029 11,752 \nLease expense recognized during the lease term: $161,535 \nImpairment of ROU asset recognized in Year 2: 10,000 \nTotal lease cost: $171,535 \nNotes: \n1. The lease liability carrying amount at the end of each year is unaffected by the \nimpairment of the ROU asset – i.e. it is the same as in Example 6. 4.20 where the ROU \nasset is not impaired. \n2. The accretion of the lease liability and the ROU asset amortization are shown separately \nfor illustrative purposes only. For an operating lease, a lessee presents a single lease expense in the income statement, whether or not the ROU asset is impaired (and will \nnot calculate these amounts separately before an impairment if the lessee applies Method 1 in subsequently measuring the ROU asset). However, the impairment loss \nallocated to the ROU asset will be presented in the same manner in the income \nstatement as the remainder of the impairment loss allocated to other assets in the \nasset group. \nAs illustrated in this example : \n— The amortization of the ROU asset is determined as follows. \n— Before impairment . Amortization equals the difference between the \nstraight -line lease cost for the period ($17,154) and the periodic \naccretion of the lease liability using the effective interest method. LE \nuses Method 2 for the subsequent measurement of its operating lease \nROU asset (see paragraph 6.4.170). \n— After impairment . Like a finance lease, it is amortized on a straight -line \nbasis over the remaining lease term ( ROU asset carrying amount post -\nimpairment of $80,239 / 8 remaining annual periods). \n— The single lease cost is determined as follows. \n— Before impairment. So that the remaining cost of the lease is allocated \nover the remaining lease term on a straight -line basis (total lease cost at \nlease commencement of $171,535 / 10 annual periods). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 488}), Document(page\_content='Leases 488 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — After impairment. Front -loaded p attern of lease cost recognition due \nto the accretion of the lease liability, and amortization of the ROU \nasset, which is now on a straight -line basis over the remaining lease \nterm (rather than as a balancing amount that increases each period \nthroughout th e lease term). \n \n Observation \nOperating lease cost post -impairment similar to \nTopic 840 \n6.5.60 The front -loaded single lease cost recognition pattern post -impairment for \nan operating lease under Topic 842 has some similarities with the lease cost \nrecognition that result ed for an operating lease under Topic 840 after the \nrecognition of a termination cos t liability under Topic 420 (exit or disposal cost \nobligations). [ASU 2016- 02.BC257– BC259] \n6.5.70 Under Topic 842, the post -impairment single lease cost for the remainder \nof the lease term will be front -loaded – i.e. the combination of the straight -line \namortization of the remaining ROU asset and the accretion of the remaining \nlease liability. Similarly, un der Topic 840, the remaining lease cost after \nrecognition of a Topic 420 liability was front -loaded – i.e. the combination of the \ngenerally straight -line remaining lease expense, if any, and accretion of the \ncontract termination liability. [ASU 2016- 02.BC2 58] \n6.5.80 In some cases, the net effect of those leases on the balance sheet under \nTopic 842 and Topic 840 will be similar. The generally net liability position of the \nlease under Topic 842 (i.e. carrying amount of the ROU asset less the carrying \namount of the lease liability) may not differ substantially from the balance of the \nTopic 420 liability that would be recognized under current US GAAP . \n \n Comparison to legacy US GAAP \nImpairment testing \n6.5.90 Under Topic 840, consistent with the requirements in Topic 842 \napplicable to finance lease ROU assets, capital lease assets were assessed for \nimpairment in accordance with the long- lived assets impairment guidance in \nTopic 360. However, finance lease assets may frequently have different \ncarrying amounts than their capital lease asset counterparts. For example: \n[840- 30-35] \n— A finance lease ROU asset may have a lower carrying amount because it \nincludes only amounts probable of being owed under a residual value \nguarantee rather than the full amount of the guarantee. \n— A finance lease ROU asset may have a greater carrying amount because it \nmay include amounts related to certain executory costs (e.g. payment of the lessor’s costs for property taxes or insurance) that are excluded from a \ncapital lease asset. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 489}), Document(page\_content='Leases 489 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 6.5.100 The differences in carrying amounts will affect the carrying amount of \nthe asset group, and therefore could affect the results of the impairment \nanalysis. \n6.5.110 Topic 840 capital lease obligations were excluded from the carrying \namount of the asset group (that includes the related capital lease assets ) when \nperforming the Topi c 360 recoverability test. Finance lease liabilities are \nsimilarly excluded when determining the carrying amount of the asset group \nthat includes those liabilities. \n6.5.120 There were no operating lease ROU assets under Topic 840; therefore, \nassessing such assets for impairment is a new concept resulting from the \nissuance of Topic 842. \n6.5.130 Charges were recognized for operating leases under Topic 840 based on \nthe contract termination and other associated costs guidance in Topic 420 , as \nwell as sublease guidance that required a lessee to recognize a deficit between \ncosts expected to be incurred under a sublease (e.g. lease payments and \nrelated executory costs) and anticipated sublease income. That guidance differs \nsubstantially from how operating lease ROU assets will be assessed for \nimpairment under the long- lived assets impairment guidance. The sublease \nguidance applied only when a sublease had been entered into. Meanwhile, \ncharges recognized in accordance with Topic 420 are generally only recognized \nat the earlier of: [420- 10-25-12 – 25-13, 840- 20-25-15] \n— when the lessee formally terminates the lease agreement ( i.e. a contractual \ncommitment is made through formal notice of intent to exercise a \ntermination option or agreement is reached mutually with the lessor ) the \ntermination charge is measured at fair value; or \n— when the lessee ceases use of the underlying asset (e.g. when the lessee \nvacates the building) the charge (and related liability) represents costs that \nwill be incurred without economic benefit to the lessee, and is measured at \nfair value. \n6.5.140 In addition to the differences above, another important difference is that \na lessee recognizes charges in accordance with Topic 420 on a specific lease \nbasis – i.e. a charge relates to a specific lease only. Under the long- lived assets \nimpairment guidance, if a n ROU asset is part of a larger asset group, it may \nreceive an allocated impairment charge – i.e. an allocation of a larger \nimpairment charge taken on all, or substantially all, of the asset s in the asset \ngroup even if there is no specific indication that the ROU asset was impaired. \n \n6.5.2 Interaction with Topic 360 when asset will be \nabandoned or subleased \n6.5.150 The following series of questions and examples address a lessee \nceasing use of an underlying asset (or portion thereof), either through \nabandonment or sublease. Although abandonment and subleasing differ in \nterms of the future economic benefits to be derived from the lease by the \nlessee (see Question 6.5.50), the accounting considerations are similar. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 490}), Document(page\_content='Leases 490 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 6.5.160 The following diagram is used throughout this section to differentiate the \ntiming of the accounting considerations that are discussed – in particular, a t the \n‘decision date’, and in the period between the ‘decision date’ and the ‘cease-\nuse date’. In sublease scenarios (see Question 6.5.90), the date that a sublease \nis entered into (i.e. ‘sublease inception’) is also a key date. \n \nLease term\n‘Normal ’ Topic \n842 accountingDecision date to cease -use date Post cease -use date\nLease \ncommencementDecision date1Cease -use date2End of lease \nterm \nNotes: \n1. The ‘decision date’ is the date on which the lessee commits to the plan to either \nabandon the ROU asset or sublease the underlying asset (or portion thereof). \n2. The ‘cease -use date’ is the date on which the lessee stops using the underlying asset in \nits operations – e.g. the date the lessee vacates a leased facility that it is either \nabandoning or will sublease. \n \n Question 6.5.50 \nAbandonment and subleasing of an ROU asset \nHas a lessee abandoned an ROU asset if it has ceased use of \nthe underlying asset but intends to sublease it? \nInterpretive response: No. We believe an ROU asset has not been abandoned \nif the lessee has both the intent and the practical ability to sublease the \nunderlying asset, even if a sublessee has not been identified by the cease- use \ndate. This is because Topic 842 considers sublease payments to be economic \nbenefits from use of the underlying asset. Consequently, a decision by the \nlessee to cea se use of the underlying asset, and instead to sublease it, does \nnot constitute an abandonment. [842- 10-15-17] \nIn contrast, ceasing use of the underlying asset does constitute an \nabandonment of the ROU asset if the lessee either: \n— does not intend to sublease the asset; or \n— does not have the practical ability to sublease the asset. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 491}), Document(page\_content='Leases 491 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 6.5.55 \nTemporarily idling an underlying asset \nShould temporarily idling an underlying asset change the \nlessee’s lease cost recognition? \nBackground: Situations may arise in which a lessee chooses, or is forced, to \nidle an underlying asset. This can occur for a number of economic and/or \nbusiness reasons, and the duration of the idling may initially be unknown. In \nfact, it may be uncertain whether the lessee will begin to use the underlying \nasset again during the lease term at all; however, the lessee has not committed \nto a plan to abandon the ROU asset (see Question 6.5.50). \nIn these situations, the question arises as to whether the pattern of operating lease cost recognition or finance lease ROU asset amortization should change. \nQuestion 6.4.16 addresses lessee lease cost recognition when the lessee’s \nability to use, and derive economic benefits from using, the underlying asset is \ncurtailed, but the lessee has not suspended its use of the underlying asset entirely. \nInterpretive response: No. We believe it is inappropriate to suspend or reduce \noperating lease cost recognition (finance lease ROU asset amortization) as long as the lessee retains the right to use the underlying asset, even if it temporarily \nidles it. This is consistent with ho w entities account for temporarily idled \nproperty, plant and equipment – i.e. entities generally do not suspend or reduce \ndepreciation when such assets are temporarily idled. \nTopic 842 specifies that control over the use of an underlying asset is the equivalent of physical use; operating lease cost recognition (finance lease ROU \nasset amortization) should not be affected by the extent to which the lessee \nuses the underlying asset. It would be inconsistent with that guidance for lease \ncost recognition (fina nce lease ROU asset amortization) to be suspended or \nreduced as long as the lessee retains control over the use of the underlying \nasset, even if it has temporarily idled the asset . \n[842- 20-55-3] \nTemporarily idling an underlying asset is not ‘abandoning’ the ROU asset (see Question 6.5.50). Therefore, it is also inappropriate to accelerate operating lease \ncost recognition (finance lease ROU asset amortization) as outlined in Question \n6.5.70 because the underlying asset is temporarily idled. \n[360- 10-35-47 – 35-49] \nWhen an underlying asset is temporarily idled, the lessee should consider \nwhether that indicates the ROU asset may be impaired (see section 6.5.1). \n6.5.170 The following is a summary of the accounting issues that require \nconsideration, highlighting at which key date accounting assessments are made \nand which Question addresses the issue. \n6.5.180 The accounting steps are similar regardless of whether the whole or a \nportion of the underlying asset is being abandoned or subleased. However, the issues are more complex when only a portion of the underlying asset is \naffected and the lessee is accounting for its lease of the entire underlying asset \nas a single lease component – i.e. one ROU asset and one lease liability. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 492}), Document(page\_content='Leases 492 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Abandon Sublease \nWhole ROU \nasset Portion of \nROU asset Whole \nunderlying \nasset Portion of \nunderlying \nasset \nAt the decision date \nReassess asset \ngroup? Question 6.5.60 \nEvaluate potential impairment Question \n6.5.70 \nQuestion \n6.5.80 Note 1 \nQuestion \n6.5.90 Reevaluate unit of account N/A N/A \nDetermine go -\nforward accounting Question \n6.5.70 Note 1 \nAt the earlier of cease -use date and sublease inception \nReassess asset group? Question 6.5.60 \nReevaluate unit of account N/A Question \n6.5.80 N/A \nQuestion \n6.5.90 Evaluate potential impairment N/A\n2 N/A2 Note 1 \nDetermine go -\nforward accounting Question \n6.5.70 Question \n6.5.80 Note 1 \nNotes: \n1. This section does not include specific Questions or Examples related to the sublease of a \nwhole underlying asset. The other sections of this chapter and chapter 8 address the \naccounting for the sublease of a whole underlying asset. \n2. ROU asset carrying amount is $0 by the cease- use date (see Question 6.5.70). \n \n Question 6.5.60 \nChanges in how a lessee uses an ROU asset and \nasset groups under Topic 360 \nWhen does a lessee reassess its asset groups under \nTopic 360 if it plans to significantly change how it uses an \nROU asset that is part of a larger asset group? \nBackground: Under Topic 360, to recognize and measure an impairment loss, \nlong-lived assets are grouped with other assets and liabilities at the lowest level \nfor which identifiable cash flows are largely independent of the cash flows of \nother assets and liabilities. [360- 10-35-23] \nAs out lined in Question 3.3.110 of KPMG Handbook, Impairment of nonfinancial \nassets, an entity should reassess its asset grouping if it experiences a change in facts and circumstances, including changes in: \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 493}), Document(page\_content='Leases 493 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — operating structure; \n— the manner in which it deploys long -lived assets (other than routine \nchanges in management); or \n— the manner in which the entity expects to recover the asset. \nFor example, a lessee may decide to change how it uses an ROU asset by \nentering into a sublease rather than continuing to use the underlying asset in its \nongoing operations. \nA change in an asset group that results from changes in facts and \ncircumstances is a change in estimat e under Topic 250 (accounting changes \nand error corrections). An entity should comply with the disclosure \nrequirements of Topic 250, including disclosing a change in asset grouping and \nthe circumstances of the change. [250 Glossary, 250 -10-50-4] \nInterpreti ve response: The triggering event for reassessing asset groupings is \ngenerally the change in facts or circumstances, not the commitment to a plan to \nmake the change. This means that committing to a plan to abandon an ROU \nasset or to sublease an underlying asset generally will not, in isolation, trigger a \nreassessment of asset grouping if the lessee is continuing to use the underlying \nasset in substantially the same manner as before committing to the plan. U ntil \nthe lessee has undertaken substantive actions directly relevant to effecting that \nplan, the independence of cash flows likely has not changed for the original \nasset group; however, all facts and circumstances should be considered. \nThe following are examples of actions that would typically trigger a \nreassessment of an ROU asset’s Topic 360 asset grouping (not exhaustive): \n— the lessee enters into a sublease of the underlying asset; \n— the lessee ceases use of the underlying asset; or \n— the lessee significantly changes how the underlying asset is used in its operations – e.g. leased equipment is redeployed from one business unit to \nanother, and the two business units’ long- lived assets are not part of the \nsame asset group. \nIf multiple changes in facts and circumstances occur, the lessee may need to undertake mul tiple asset grouping reassessments as those changes occur. \n \n Question 6.5.65 \nEffect of temporary sublease on asset grouping \nDoes entering into a sublease for only a portion of the \nremaining lease term trigger a change to the Topic 360 asset \ngroup for the affected ROU asset ? \nBackground : A lessee may enter into a sublease for only a portion of the \nremaining head lease term (a ‘temporary sublease’). For example, the lessee \nmay enter into a two- year sublease of office space subject to a head lease with \na remaining lease term of 10 years. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 494}), Document(page\_content='Leases 494 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. In these circumstances, t he question arises as to whether entering into a \ntemporary sublease triggers a change to the asset grouping for the head lease \nROU asset. \nInterpretive response: It depends. Consistent with Question 6.5.60, entering \ninto the temporary sublease is a change in circumstance that would typically \ntrigger a reassessment of the asset group to which the head lease ROU asset \nbelongs. \nHowever, undertaking a reassessment does not automatically mean the asset \ngroup will change as a result. In the case of a temporary sublease, the lessee’s \nplans for the ROU asset after the end of the sublease likely affect whether a \nchange in asset group is appropriate. \nFor example, if the lessee intends to resume using the underlying asset in the manner it was used before entering into the sublease (e.g. reoccupy subleased \noffice space for use by the same business unit at the end of the sublease) and \nthe post -sublease period is not solely a minor portion of the remaining lease \nterm at sublease inception, the temporary sublease would typi cally not trigger a \nchange to the asset group for the head lease ROU asset. In that case, the \nindependence of the identifiable cash flows related to the ROU asset likely has \nnot changed. \nBy contrast, if the lessee intends to continue subleasing the underly ing asset \nafter the end of the temporary sublease for a total sublease period that \ncomprises at least most of the remaining head lease term, it is likely the \nidentifiable cash flows related to the ROU asset are now largely independent of the cash flows of the other assets and liabilities with which it had been grouped \npreviously. \nThe lessee’s specific facts and circumstances need to be considered when determining whether a change in asset group is appropriate, and it is possible \nthat an initial conclusion r eached when a temporary sublease is entered into will \nneed to be revisited if facts and circumstances change. \n \n Question 6.5.66 \nBifurcating a single ROU asset for a temporary \nsublease \nIs it acceptable to bifurcate a single ROU asset into one for \nthe period of a temporary sublease and another for the \nremainder of the head lease term ? \nBackground: Assume the same example as in the background to Question \n6.5.65. In that scenario , the question has also arise n as to whether it is \nacceptable for the head les see/sublessor to bifurcate the original, single ROU \nasset for the office space into two ROU assets, one for the two -year temporary \nsublease term and another for the eight -year remaining lease term post -\nsublease. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 495}), Document(page\_content='Leases 495 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. If an entity is able to bifurcate the 10- year ROU asset, the two -year ROU asset \nlinked to the temporary sublease might qualify as its own asset group (see \nQuestion 6.5.60) , which may be impaired if the sublease is loss -making. \nInterpretive response: No. It is not acceptable to bifurcate a single ROU asset \ninto two or more separate ROU assets based on time periods within the head \nlease term. To do so would be inconsistent with the Topic 842 concept outlined \nmost clearly in the lease modification guidance that an extension of the right to \nuse an underl ying asset is not an ‘additional right of use’. Instead, the period of \ntime over which the lessee has the right to control the use of the underlying asset is an attribute of that singular right of use. \n[842- 10-55-164, ASU 2016-\n02.BC176(b) ] \n \n Question 6.5.70 \nAccounting for the abandonment of an ROU asset \nHow should a lessee account for the abandonment of an ROU \nasset that is part of a larger asset group? \nInterpretive response: We believe the lessee should undertake the following \nsteps to accou nt for the abandonment of an ROU asset (see Question 6.5.50) \nthat is part of a larger Topic 360 asset group. \n1. Evaluate whether the asset group is impaired \nThe lessee continues to evaluate impairment under Topic 360 at the same \nasset group level after commi tting to the plan to abandon the ROU asset as \nbefore committing to the plan (see Question 6.5.60). \nHowever, committing to the plan of abandonment may constitute a triggering \nevent, requiring an assessment of possible impairment for the larger asset \ngroup a t the decision date. That assessment, as well as the recognition of any \nimpairment loss, follows the guidance in Topic 360. An impairment indicator associated with a single ROU asset within a larger asset group may not signify \na need to test the entire ass et group for impairment. A lessee should consider \nthe significance of the to- be-abandoned ROU asset to the asset group as a \nwhole before concluding the asset group needs to be tested for impairment. \n[360- 10-35-21] \nIf the asset group is not impaired, there is no basis in Topic 360 or Topic 842 to \nimmediately write down the carrying amount of the ROU asset that will be \nabandoned. \n2. Determine go -forward accounting \nIt is necessary to consider the go- forward accounting at the decision date if the \nROU asset is eith er not impaired or is only partially impaired in Step 1. \nThe lessee should update its estimate of the useful life of the ROU asset (i.e. shorten it) to ensure that the to- be-abandoned ROU asset is amortized to its \nsalvage value over the period of its remai ning expected use. The salvage value \nof an ROU asset is likely to be zero (except potentially in scenarios consistent \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 496}), Document(page\_content='Leases 496 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. with that in Question 6.5.33) , and the useful life will end at the expected cease-\nuse date. [360- 10-35-47, ASU 2016- 02.BC255] \nWe believe t here are two acceptable approaches to amortize the ROU asset \nover the remainder of its shortened useful life if no impairment of the ROU \nasset has been recognized – i.e. either as a result of Step 1 in this response or \nat any time before the decision date. In contrast, if the ROU asset is partially \nimpaired (even if only by an insignificant amount), only Approach 1 is acceptable (see paragraphs 6.5.40 – 6.5.50). Under both approaches: \n— the ROU asset is amortized to its salvage value (frequently, $0) by the \ncease -use date; \n— the amount of ROU amortization between the decision date and the cease-\nuse date is greater than the amortization that would have been recognized \nif there were no plan to abandon the ROU asset; and \n— there is no change in how the lessee accounts for the leas e liability \nthroughout the remainder of the lease term – i.e. accretion of the lease \nliability remains the same as if there were no plan to abandon the ROU asset, and the lease liability balance will be the same amount it would have \nbeen had there been no abandonment . \nApproach 1: Loss of straight -line lease cost \nThe lessee amortizes the ROU asset over the revised remaining useful life (i.e. from the decision date to the cease- use date) on a straight -line basis. \nBecause the lease liability continues to be ac creted in the same manner as \nbefore the decision date, the single lease cost is front -loaded over the \nremaining lease term similar to what occurs after impairment of an operating lease ROU asset (see Example 6.5.20). \nApproach 2: Adjusted straight -line leas e cost \nRather than amortizing the ROU asset on a straight -line basis from the decision \ndate to the cease- use date, the lessee amortizes the ROU asset to result in \nboth: \n— a ROU asset carrying amount at the cease -use date equal to its salvage \nvalue ; and \n— a straight -line total lease cost from the decision date to the cease- use date \nwhen combined with the accretion of the lease liability. \nIf the ROU asset becomes impaired at any point between the decision date and \nthe cease- use date (e.g. because there is an int ervening impairment of the \nasset group), the lessee is required to revert to Approach 1 from the \nimpairment date (see paragraphs 6.5.40 – 6.5.50 and Example 6.5.20). \nAccounting after the cease -use date \nThere is no specific new accounting after the cease- use date. The single lease \ncost between the cease- use date and the end of the lease term may be \ncomprised solely of the lease liability accretion if the ROU asset is fully \namortized by the cease- use date (i.e. because its salvage value determined to \nbe $0 at that date) . \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 497}), Document(page\_content='Leases 497 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 6.5.30 \nAbandonment of an ROU asset that is part of a \nlarger asset group \nLessee LE enters into a contract with Lessor LR for the right to use a machine \nfor seven years with no renewal options. The right to use the machine is a lease \nand there are no other components of the contract. \nThe following facts are relevant at the lease commencement date. \nLease payments: Fixed payments of $1,000 per year in arrears \nLE’s incremental borrowing rate: 6% (the rate implicit in the lease cannot be \nreadily determined) \nLease liability recognized:1 $5,582 \nROU asset recognized:2 $5,582 \nNotes: \n1. Calculated as the present value of the seven lease payments of $1,000, discounted at \nthe incremental borrowing rate of 6%. \n2. Calculated as the initial measurement of the lease liability because there are no initial \ndirect costs, prepaid lease payments or lease incentives rece ived. \nLE appropr iately classified the lease as an operating lease, because none of the \ntests for classification as a finance lease were met (see paragraph 6.2.50). \nThe ROU asset for the leased machine is part of an asset group comprising \nother ROU assets and owned assets. \nAt the beginning of Year 2 (the decision date), when the carrying amounts of the lease liability and the ROU asset are both $4,917, LE decides that it will \ncease using the machine after Year 5 – i.e. two years before the end of the \nlease term. Between the decision date and the end of Year 5, LE plans to continue using the leased machine in the same manner, and as part of the \nsame operation, as before the decision date. \nEnd Y 7 End Y 5 Beg. Y2 Beg. Y17-year lease term\n‘Normal ’ Topic \n842 accountingDecision date to cease -use date Post cease -use date\nLease \ncommencementDecision date Cease -use date End of lease \nterm \nLE does not intend to sublease the asset. Consequently, LE intends to abandon \nthe ROU asset before the end of the lease term (see Question 6.5.50). \n1. Evaluate whether the asset group is impaired when LE commits to the \nplan to abandon the ROU asset \nConsistent with the response to Question 6.5.60, LE’s decision to cease use of \nthe ROU asset does not trigger a reassessment of the asset group that ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 498}), Document(page\_content='Leases 498 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. contains the ROU asset; therefore, the ROU asset remains part of the larger \nasset group subsequent to the decision date. \nLE concludes there is no impa irment of the asset group that contains the ROU \nasset based on an appropriate analysis under Topic 360. \n2. Determine go -forward accounting \nBecause LE plans to abandon the ROU asset at the end of Year 5, LE updates \nits estimate of the remaining useful life of the ROU asset to ensure it is \namortized to its estimated salvage value of $0 by the end of that revised \nuseful life. \nApproach 1: Loss of straight -line lease cost \nLE recalculates the annual amortization of the ROU asset over its remaining expected usefu l life of four years from the decision date. The total single lease \ncost each period of the remaining lease term equals the sum of the amortization of the ROU asset and the accretion of the operating lease liability. \nAmortization of the ROU asset over the remaining expected useful life of \nfour years from the decision date occurs on a straight -line basis, while the lease \nliability continues to be accreted over the remainder of the 7- year lease term in \nthe same manner as before the decision date. \nYear ROU asset amortization ROU asset carrying amount \nSingle \nlease cost Lease liab. \naccret.2 ROU asset \namort. Beg. \nbalance ROU asset \namort. End. \nbalance \n1 $1,000 $335 $ 665 $5,582 $ (665) $4,917 \n2 1,5241 295 1,2293 4,917 (1,229) 3,688 \n3 1,482 253 1,229 3,688 (1,229) 2,459 \n4 1,437 208 1,229 2,459 (1,229) 1,230 \n5 1,390 160 1,230 1,230 (1,230) - \n6 110 110 - - - - \n7 57 57 - - - - \nNotes: \n1. The single lease cost for an operating lease is generally calculated so that the \nremaining cost of the lease is allocated over the remaining lease term on a straight -line \nbasis. As of the decision date, amortization of the ROU asset is no longer calculated to result in a straight -line total lease cost (see Example 6.5.20). \n2. Calculated as beginning balance of lease liability multiplied by incremental borrowing \nrate: Year 1 = $5,582 × 6%, Year 2 = $4,917 × 6%, etc. \n3. Calculated as balance of ROU asset at beginning of Year 2 divided by remaining expected useful life: $4,917 / 4 years. \nApproach 2: Adjusted straigh t-line lease cost \nLE amortizes the ROU asset to result in both (1) a $0 ROU asset carrying \namount at the cease- use date at the end of Year 5, and (2) a straight -line total \nlease cost for the four years between the decision date and the cease- use date \n(whe n combined with the accretion of the lease liability). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 499}), Document(page\_content='Leases 499 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Year ROU asset amortization ROU asset carrying amount \nSingle \nlease cost Lease liab. \naccret. ROU asset \namort. Beg. \nbalance ROU asset \namort. End. \nbalance \n1 $1,000 $335 $ 665 $5,582 $ (665) $4,917 \n2 1,4581 295 1,163 4,917 (1,163) 3,754 \n3 1,458 253 1,205 3,754 (1,205) 2,549 \n4 1,458 208 1,250 2,549 (1,250) 1,299 \n5 1,459 160 1,299 1,299 (1,299) - \n6 110 110 - - - - \n7 57 57 - - - - \nNote: \n1. Calculated as lease cost for Years 2– 5 divided by remaining estimated useful life: \n($4,917 + $295 + $253 + $208 + $160) / 4 years. \n \n \n Question 6.5.80 \nAccounting for the abandonment of a portion of a \nsingle ROU asset \nHow should a lessee account for the abandonment of a \nportion of a single ROU asset? \nBackground: For purposes of this question, a lessee has leased an entire \noffice building with five floors and accounted for that lease as a single separate \nlease component – i.e. as a single unit of account. Partway through the lease \nterm, the lessee commits to a plan to abandon one of the five floors (see \nQuestion 6.5.50). In other words, the lessee will abandon a portion of its \nROU asset. \nInterpretive response: We believe the lessee should undertake the following \nsteps to account for the abandonment of a portion of an ROU asset. \n1. Evaluate whether the asset group is impaired \nEvaluating whether the asset group is impaired is not substantively different \nfrom the process described in Step 1 in Question 6.5.70. The only difference \nis that it is a portion of an ROU asset that will be abandoned – not an entire \nROU asset. \n2. Reevaluate the unit of account \nA decision about whether the right to use the portion of the underlying asset \nthat will be abandoned should be separated from the larger, existing RO U asset \ncovering the lessee’s right to use the entire underlying asset is important \nbecause it determines the go- forward accounting described in Step 3. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 500}), Document(page\_content='Leases 500 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. At the decision date, we believe the lessee should evaluate why the existing, \nsingle separate lease com ponent is a single unit of account. The lessee should \ndetermine whether this is the case: \n— because there was only a single separate lease component when it was \nassessed in accordance with paragraph 842- 10-15-28 (see section 4.1); or \ninstead \n— because the lessee in effect applied a portfolio approach (see section 5.8) – \ni.e. accounted for multiple separate lease components as a single separate \nlease component. \nAs a practical matter, the lessee may not have previously evaluated this question. For example, the lessee may not have assessed, in deciding to \naccount for the lease of the multi -floor building as a single unit of account, \nwhether the building was a single separate lease component or multiple \nseparate lease components. The assessment may have had no perceived \naccounting effect at that time. However, upon committing to a plan to abandon \na portion of the ROU asset, we believe the lessee needs to evaluate this \nquestion to properly account for the planned abandonment going forward. \nThis assessment undertaken at the decision date is based on the facts and circumstances that existed when this evaluation would have taken place \npreviously, and does not take into account subsequent changes in \ncircumstances – e.g. the changed market desirability of a particular fl oor of an \noffice building. \n3. Determine go -forward accounting \nThe reevaluation of the unit of account when only a portion of the ROU asset will be abandoned makes the analysis of the go- forward accounting more \ncomplex. The following diagram summarizes the additional step in the process, \nwhich is explained in detail in the discussion that follows. \nDid the right to use the to -be-abandoned portion \nof the underlying asset qualify as a separate \nlease component ?\nNo change in \naccountingSeparate the \ncomponents (asset \nand liability ) using \nstand -alone prices\nAmortize ROU asset \nto $0 by \ncease -use dateNo Yes\nPortion to be \nretained\nPortion to be \nabandoned \nNo separation required (single separate lease component previously) \nIf, upon evaluation in Step 2, there was only a single separate lease component, \nthe to- be-abandoned portion of the ROU asset remains part of a single ROU \nasset – i.e. the unit of account for the lessee’s lease accounting is not revised. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 501}), Document(page\_content='Leases 501 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Therefore, neither the ROU asset, nor any portion of the ROU asset, is subject \nto the accelerated amortization model described in Question 6.5.70; this is \nbecause the single ROU asset is not being abandoned. \nThe lessee’s accounting for the lease liability associated with the single ROU \nasset is also unaffected by the lessee’s decision to abandon a portion of the \nROU asset. \nSeparation required (right to use the to -be-abandoned portion of the \nunderlying asset was a separate lease component previously) \nIf the right to use the t o-be-abandoned asset met the criteria to be a separate \nlease component, a portion of the existing ROU asset reflecting that separate \nlease component should be separated from the existing ROU asset and the \naccelerated amortization model in Question 6.5.70 s hould be applied to it. \nA portion of the existing lease liability should also be allocated to the newly \nseparate lease component. The lessee’s accounting for the newly separate \nlease liability is unaffected by the fact that the related ROU asset will be \nabandoned – i.e. the lessee accounts for the lease liability in the same manner \nas if the ROU asset were not going to be abandoned. \nWe believe the lessee should allocate the carrying amount of the existing ROU \nasset and lease liability to (1) the new, separ ate lease component (i.e. the right \nto use the portion of the underlying asset that will be abandoned), and (2) the separate lease component that reflects the remainder of the original lease, on a \nrelative stand -alone price basis. \nBecause Topic 842 does n ot address allocation in this situation, we believe a \nlessee could base the relative stand- alone price allocation on either: \n— the stand- alone prices the lessee would have determined for the two \nseparate lease components had they previously been accounted for separately (historical stand -alone prices); or \n— the stand- alone prices of the two separate lease components at the date \nthe lessee commits to the plan of abandonment (decision date) based on \nthe remaining lease term and the then- current facts and circums tances – \ne.g. current observable stand- alone prices (current stand- alone prices). \nThe lessee’s accounting for the separate lease component that reflects the \nremainder of the original lease is accounted for from the separation date in the \nsame manner as an y other separate lease component. \n \n Example 6.5.40 \nAbandonment of a portion of a leased building \nLessee LE enters into a contract with Lessor LR for the right to use a five- story \noffice building for five years with no renewal options. The right to use the building is a lease and there are no other components of the contract. There have been no modifications to (or remeasurements of) the lease. \nThe following facts are relevant at the lease commencement date. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 502}), Document(page\_content='Leases 502 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Lease payments (gross lease): Fixed payments of $1,000 per year in arrears \nLE’s incremental borrowing rate: 6% (the rate implicit in the lease cannot be \nreadily determined) \nLease liability recognized:1 $4,212 \nROU asset recognized:2 $4,212 \nNotes: \n1. Calculated as the present value of the five lease payments of $1,000, discounted at the \nincremental borrowing rate of 6%. \n2. Calculated as the initial measurement of the lease liability because there are no initial \ndirect costs, prepaid lease payments or lease incentives received. \nLE appropriately classified the lease as an operating lease, because none of the \ntests for classification as a finance lease were met (see paragraph 6.2.50). LE \ndid not separately account for the implied land element of the lease (see \nQuestion 4.1.20) because the accounting effect of doing so would have been \ninsignificant – i.e. the coterminous land and building elements separately would \nhave both been classified as operating leases. \nAt the beginning of Year 2 (the decision date), when the carrying amount of the lease liability and the ROU asset are both $3,465, LE decides that it will cease \nuse of the top floor of the building at the end of Year 3 – i.e. two years before \nthe end of the lease term. Between the decision date and the end of Year 3, LE plans to continue using the top floor of the building in the same manner, an d as \npart of the same operation, as before the decision date. \n \nEnd Y 5 End Y 3 Beg. Y2 Beg. Y15-year lease term\n‘Normal ’ Topic \n842 accountingDecision date to cease -use date Post cease -use date\nLease \ncommencementDecision date Cease -use date \nLE would have the practical ability to sublease the top floor after it ceases use of it, but does not intend to do so. Consequently, LE plans to abandon the ROU asset before the end of the lease term (see Question 6.5.50). \n1. Evaluate whether the asset group is impaired \nConsistent with the response to Question 6.5.60, LE’s decision to cease use of \npart of the building does not trigger a reassessment of the asset group that \ncontains the entire building ROU asset; therefore, the ROU asset remains part \nof the larger asset group subsequent to the decision date. \nLE concludes that there is no impairment of the asset group that contains the \nentire building ROU asset based on an appropriate analysis under Topic 360. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 503}), Document(page\_content='Leases 503 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 2. Reevaluate the unit of account \nWhile LE has accounted for the building lease as a single unit of account (one \nROU asset and one lease liability) to date, upon deciding to abandon the top \nfloor of the building, LE concludes that the top floor of the building previously \nmet the criteria to be accounted for as a separate lease component: \n— LE could benefit from the top floor on its own – i.e. separate from the other \nfour floors of the building. This is evident because: \n— LE can practically sublease the top floor to a third- party sublessee; and \n— LR and other lessors regularly lease different floors in similar office buildings to unrelated lessees. \n— The right to use the top floor is not highly dependent on, nor highly \ninterr elated with, LE’s right to use the remainder of the building. At contract \ninception, the building was already divided into multiple floors such that LR could have granted separate rights to multiple lessees to use different \nfloors of the building or transf erred rights to LE to use the different floors \nwith different commencement dates. \n3. Determine go -forward accounting \nSeparate and allocate the existing ROU asset and lease liability to the two \nseparate lease components created by Step 2 \nBased on the conclusion reached in Step 2, LE separates its lease of the top \nfloor from its lease of the remainder of the office building. LE allocates between \nthe top floor lease component and the lease component for the remainder of \nthe building on a relative stand- alone price basis as follows. In this example, LE \nelects to use historical stand- alone prices (see Question 6.5.80). \nSeparate lease \ncomponent Stand -alone price Allocated ROU \nasset Allocated lease \nliability \nTop floor $1,165 $ 8072 $ 8072 \nRemaining floors 3,835 2,6583 2,6583 \nTotal $5,0001 $3,465 $3,465 \nNotes: \n1. Because LE is using historical rather than current stand -alone prices, those prices are \nbased on two five- year leases. \n2. $807 = ($1,165 / $5,000) × $3,465 (carrying amount at beginning of Year 2). \n3. $2,658 = ($3,835 / $5,000) × $3,465 (carrying amount at beginning of Year 2). \nUpdate useful life for new top floor ROU asset and account for new top \nfloor separate lease component \nBecause LE plans to abandon the top floor ROU asset after Year 3, LE updates \nits estimate of the remaining useful life of the ROU asset to ensure it is fully amortized by the end of that revised useful life. \nLE elects Approach 1 in Question 6.5.70. Theref ore, amortization of the top \nfloor ROU asset over the remaining expected useful life of two years from the \ndecision date occurs on a straight -line basis, while the lease liability continues ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 504}), Document(page\_content='Leases 504 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. to be accreted over the remainder of the five- year lease term in t he same \nmanner as before the decision date. \nYr. Lease liability carry. amt. ROU asset carry. amt. \nSingle \nlease \ncost4 Beg. \nbal. Lease \nliab. \naccret.1 Pmt.2 End. \nbal. Beg. \nbal. ROU \nasset \namort.3 End. \nbal. \n2 $(807) $(48) $233 $(622) $807 $(404) $403 $452 \n3 (622) (37) 233 (426) 403 (403) - 440 \n4 (426) (26) 233 (219) - - - 26 \n5 (219) (14) 233 - - - - 14 \nNotes: \n1. Calculated as beginning balance of lease liability multiplied by incremental borrowing \nrate: Year 2 = $807 × 6%, Year 3 = $622 × 6%, etc. \n2. $233 = ($1,165 / $5,000) × $1,000. \n3. Calculated as balance of ROU asset at beginning of Year 2 divided by remaining expected useful life: $807 / 2 years. \n4. The single lease cost for an operating lease is generally calculated so that the \nremaining cost of the lease is allocated over the remaining lease term on a straight -line \nbasis. As of the decision date, amortization of the ROU asset is no longer calculated so \nas to result in a straight -line total lease cost. \nAccount for remainder of building separate l ease component \nAccounting for the lease component for the remainder of the building from the \ndecision date to the end of the lease term is as follows; this assumes there are \nno modifications to the lease, no reassessment events resulting in \nremeasurement a nd no impairments of the ROU asset. \nYr. Lease liability carry. amt. ROU asset carry. amt. \nSingle \nlease \ncost4 Beg. \nBal. Lease \nliab. \naccret.1 Pmt.2 End. \nbal. Beg. \nbal. ROU \nasset \namort.3 End. \nbal. \n2 $(2,658) $(159) $767 $(2,050) $2,658 $(608) $2,050 $767 \n3 (2,050) (123) 767 (1,406) 2,050 (644) 1,406 767 \n4 (1,406) (84) 767 (723) 1,406 (683) 723 767 \n5 (723) (44) 767 - 723 (723) - 767 \nNotes: \n1. Calculated as beginning balance of lease liability multiplied by incremental borrowing \nrate: Year 2 = $2,658 × 6%, Year 3 = $2,050 × 6%, etc. \n2. $767 = ($3,835 / $5,000) × $1,000. \n3. Calculated as the difference between the single lease cost and the lease liability accretion: Year 2 = $767 – $159, Year 3 = $767 – $123, etc. \n4. The single lease cost is calculated as lease cost for Years 2 –5 divided by remaining \nlease term: $3,068 / 4 years. The $3,068 is calculated using the allocated portion of \ntotal lease payments: ($3,835 / $5,000) × 1,000 × 4. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 505}), Document(page\_content='Leases 505 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Quest ion 6.5.90 \nAccounting for the sublease of a portion of a single \nunderlying asset \nHow should a lessee account for the sublease of a portion of a \nsingle underlying asset? \nBackground: For purposes of this question, a lessee has leased an entire office \nbuilding with five floors and accounted for that lease as a single separate lease \ncomponent. Partway through the lease term, the lessee commits to a plan to \nsublease one of the five floors. In other words, the lessee will sublease a \nportion of what it has previously accounted for as a single unit of account. \nInterpretive response: We believe the lessee should undertake the following \nsteps to account for the sublease of a portion of a single underlying asset. \n1. Evaluate impairment of the asset group \nThe lessee continues to evaluate impairment under Topic 360 at the same \nasset group level after committing to the plan to sublease as before committing \nto the plan (see Question 6.5.60). \nHowever, committing to the sublease plan (i.e. at the decision date) may \ncons titute a triggering event – e.g. if the lessee believes it is likely to incur a \nloss on the sublease or based on other economic facts and circumstances associated with the lessee’s decision to sublease. This would require an \nassessment of possible impairment for the larger asset group to which the \nexisting ROU asset belongs. That assessment, as well as the recognition of any \nimpairment loss, follows the guidance in Topic 360. An impairment indicator associated with a portion of an ROU asset may not signify a need to test the \nentire asset group for impairment. A lessee should consider the significance of \nthe portion of the ROU asset affected by the sublease plan to the asset group \nas a whole, and the circumstances leading to the sublease decision, before \nconc luding the asset group needs to be tested for impairment. \nIf the asset group is not impaired, there is no basis in Topic 360 or Topic 842 to \nimmediately write down the carrying amount of the existing ROU asset. \n2. Reevaluate the unit of account \nA decision about whether the right to use the portion of the underlying asset \nthat will be subleased should be separated from the larger, existing ROU asset \ncovering the lessee’s right to use the entire underlying asset is important \nbecause it determines the go- forward accounting described in Step 3. \nAt the earlier of the cease- use date and sublease inception (‘earlier of’ date), we \nbelieve the lessee should evaluate why the existing, single separate lease \ncomponent is a single unit of account. The lessee should determi ne whether \nthis is the case: \n— because there was only a single separate lease component when it was \nassessed in accordance with paragraph 842- 10-15-28 (see section 4.1); or \ninstead \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 506}), Document(page\_content='Leases 506 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — because the lessee in effect applied a portfolio approach (see section 5.8) – \ni.e. accounted for multiple separate lease components as a single separate \nlease component. \nAs a practical matter, the lessee may not have previously evaluated this question. For example, the lessee may not have assessed, in deciding to \naccount for the lease of the multi -floor building as a single unit of account, \nwhether the building was a singl e separate lease component or multiple \nseparate lease components. The assessment may have had no perceived \naccounting effect at that time. However, at the ‘earlier of’ date, we believe the \nlessee needs to evaluate this question to properly account for both the head \nlease and the sublease going forward. \nThis assessment undertaken at the ‘earlier of’ date is based on the facts and \ncircumstances that existed when this evaluation previously would have taken \nplace, and does not take into account subsequent changes in circumstances – \ne.g. the changed market desirability of a particular floor of an office building. \nIn reevaluating the unit of account for the head lease, we believe the lessee’s \nability to enter into the sublease for a portion of the underlying asset separately \nsuggests that the right to use that portion of the underlying asset previously \nwould have met the criteria to be a separate lease component. An exception \nmay arise, for example, if there have been substantial modifications to the \nunderlying ass et (e.g. converting a warehouse into a multi -story office building) \nafter the date that evaluation would have taken place. \n3A. Determine go -forward accounting: Topic 360 \nThe reevaluation of the unit of account when only a portion of the underlying \nasset wi ll be subleased makes the analysis of the go- forward accounting more \ncomplex. The following diagram summarizes the additional step in the process, \nwhich is explained in detail in the discussion that follows. \nDid the right to use the to -be-subleased part of \nthe underlying asset qualify as a separate lease \ncomponent ?\nNo change in \naccountingSeparate \ncomponents (asset \nand liability ) using \nstand -alone prices\nAccount for head lease and sublease under \nTopic 842 separately from portion to be \nretainedNo Yes\nPortion to be \nretained\nPortion to be \nsubleased \nNo separation requi red (single separate lease component previously) \nIf, upon evaluation in Step 2, there was only a single separate lease component, no portion of the existing ROU asset (or lease liability) should be separated into ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 507}), Document(page\_content='Leases 507 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. its own unit of account for the right to us e the to- be-subleased portion of the \nunderlying asset. \nAs a result, unless the sublease is for a significant portion of the underlying \nasset, it is unlikely that entering into the sublease or ceasing use of the portion \nof the underlying asset that will be subleased (e.g. the floor of the building in \nthe background example) will trigger a change in asset grouping. \nEntering into the sublease or ceasing use of the portion of the asset that will be \nsubleased may constitute a triggering event, requiring an impai rment \nassessment of the asset group. This may be in addition to a triggering event identified in Step 1. For example, either of these events may be an additional \ntriggering event if the terms of the executed sublease are less favorable, or \nexpectations about the lessee’s ability to sublease the asset have deteriorated, \nfrom what was anticipated in Step 1. \nSeparation required (right to use the to -be-subleased portion of the \nunderlying asset was a separate lease component previously) \nIf the right to use the to -be-subleased asset previously met the criteria to be a \nseparate lease component, a portion of the existing ROU asset reflecting that separate lease component should be separated from the existing ROU asset. A \nportion of the existing lease liability should also be allocated to the newly \nseparate lease component. \nWe believe the lessee should allocate the carrying amount of the existing ROU asset and lease liability to (1) the new, separate lease component (i.e. the right \nto use the portion of the under lying asset that will be subleased), and (2) the \nseparate lease component that reflects the remainder of the original lease, on a relative stand -alone price basis. \nBecause Topic 842 does not address allocation in this situation, we believe a lessee could base the relative stand- alone price allocation on either: \n— the stand- alone prices the lessee would have determined for the two \nseparate lease components had they been previously accounted for \nseparately (historical stand -alone prices); or \n— the stand- alone prices of the two separate lease components at the earlier \nof (1) the cease- use date and (2) sublease inception based on the remaining \nlease term and the then- current facts and circumstances – e.g. current \nstand -alone prices (current stand- alone prices). \nNext, the lessee should reassess its Topic 360 asset grouping in accordance \nwith Question 6.5.60. The lessee should assess whether the new, separate \nROU asset (and related assets such as leasehold improvements) is its own \nasset group (as will frequently be the case for a subleased ROU asset) or part of an asset group that is different from its previous group. \nEntering into the sublease or ceasing use of the to -be-subleased portion of the \nunderlying asset may constitute a triggering event for the asset group that contains the newly separate ROU asset, requiring an impairment assessment \nunder Topic 360. For example, if the new ROU asset is its own asset group, or \nthe predominant asset in the group (e.g. a retail space ROU asset when the \nasset group is the store), either of the following would likely constitute a \ntriggering event: ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 508}), Document(page\_content='Leases 508 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — entering into a loss -making sublease; or \n— ceasing use of the asset without a sublease in place if facts and \ncircumstances at the cease -use date call into question the lessee’s ability t o \nobtain a favorable sublease. \n3B. Determine go -forward accounting: Topic 842 \nSimilar to the go -forward accounting under Topic 360, the go- forward \naccounting under Topic 842 depends on the conclusion reached in the \nassessment of the unit of account. \nNo sep aration required (single separate lease component previously) \nIf the existing separate lease component was previously a single separate lease \ncomponent, the lessee accounts for the head lease after the cease- use date or \nsublease inception in the same manner as any other lease, which includes recognizing any Topic 360 impairment loss identified in Step 3A and following \nthe post -impairment lease accounting guidance. Accounting for the sublease \nwould follow the guidance in chapter 8. \nSeparation required (right to use the to -be-subleased portion of the \nunderlying asset was a separate lease component previously) \nIf the right to use the to- be-subleased asset previously met the criteria to be a \nseparate lease component, the newly separate ROU asset and lease l iability are \naccounted for from the separation date (i.e. the ‘earlier of’ date) in the same \nmanner as any other lease of a lessee, which includes recognizing any \nTopic 360 impairment loss identified in Step 3A and following the post -\nimpairment lease accou nting guidance. Accounting for the sublease would \nfollow the guidance in chapter 8. \nThe lessee’s accounting for the separate lease component that reflects the \nremainder of the original lease is accounted for from the separation date in the same manner as any other separate lease component. \n \n Example 6.5.50 \nSublease of a portion of a leased building \nLessee LE enters into a contract with Lessor LR for the right to use a five- story \noffice building for five years with no renewal options. The right to use the \nbuilding is a lease and there are no other components of the contract. There \nhave been no modifications to (or remeasurements of) the lease. \nThe following facts are relevant at the lease commencement date. \nLease payments (gross lease): Fixed payments of $1,000 per year in arrears \nLE’s incremental borrowing rate: 6% (the rate implicit in the lease cannot be \nreadily determined) \nLease liability recognized:1 $4,212 \nROU asset recognized:2 $4,212 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 509}), Document(page\_content='Leases 509 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Notes : \n1. Calculated as the present value of the five lease payments of $1,000, discounted at the \nincremental borrowing rate of 6%. \n2. Calculated as the initial measurement of the lease liability because there are no initial \ndirect costs, prepaid lease payments or lease incentives received. \nLE appropriately classified the lease as an operating lease, because none of the \ntests for classification as a finance lease were met (see paragraph 6.2.50). LE \ndid not separately account for the implied land element of the lease (see \nQuestion 4.1.20) beca use the accounting effect of doing so would have been \ninsignificant – i.e. the coterminous land and building elements separately would \nhave both been classified as operating leases. \nAt the beginning of Year 2 (the decision date), when the carrying amount of the lease liability and the ROU asset are both $3,465, LE decides that it will cease \nuse of the top floor of the building at the end of Year 3 – i.e. two years before \nthe end of the lease term. Between the decision date and the end of Year 3, LE plans to continue using the top floor of the building in the same manner, and as \npart of the same operation, as before the decision date. \nLE intends and has the practical ability to sublease the top floor after it ceases \nuse of it. Consequently, LE does not plan to abandon the ROU asset before the \nend of the lease term (see Question 6.5.50). At the beginning of Year 3 (i.e. \n12 months before LE’s planned cease- use date), LE enters into a sublease for \nthe top floor with Sublessee SE for the remainder of LE’s head lease term. The \nsublease will commence immediately following the cease- use date. \nEnd Y 5 Beg. Y4 Beg. Y2 Beg. Y15-year lease term\n‘Normal ’ Topic \n842 accountingDecision date to cease -use date Post cease -use date\nLease \ncommencementDecision date Cease -use \ndate / Sublease \ncommencementEnd of lease \ntermBeg. Y3\nSublease \ninception \nThe following are the key terms of the sublease. \nLease payments (gross lease): Fixed payments of $120 per year in arrears \nLE’s discount rate for the sublease: 6% (the rate implicit in the sublease cannot \nbe readily determined – see section 8.2.1) \nNote: There are no initial direct costs, prepaid lease payments or lease incentives \nprovided. \n1. Evaluate whether the asset group is impaired \nLE’s decision to sublease the top floor of the building does not trigger a \nreassessment of the asset group that contains the entire building ROU asset, \nbecause LE will continue to use the building (including the top floor) until the \nend of Year 3 in substantially the same manner as before the decision date (see \nQuestion 6.5.60). Therefore, the ROU asset remains part of the larger asset \ngroup subsequent to the decision date. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 510}), Document(page\_content='Leases 510 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. LE further concludes that there is no impairment of the asset group that \ncontains the entire building ROU asset based on an appropriate analysis under \nTopic 360. \nHowever, at the decision date, LE has leasehold improvements on the top floor \nof the building with a carrying amount of $200, whic h LE concludes will no \nlonger provide economic benefits after the cease- use date (end of Year 3); this \nis because they are specific to LE’s use of the top floor and will not provide a \nbenefit associated with the sublease. Consequently, LE concludes that it needs \nto shorten the remaining useful life of those assets to two years as of the \ndecision date. \n2. Reevaluate the unit of account \nWhile LE has accounted for the building lease as a single unit of account (one ROU asset and one lease liability) to date, upon entering into the sublease with \nSE (which precedes the cease- use date), LE concludes that the top floor of the \nbuilding previously met the criteria to be accounted for as a separate lease \ncomponent. \n— LE could benefit from the top floor on its own – i.e. se parate from the other \nfour floors of the building. This is evident because: \n— LE can practically sublease the top floor to a third- party sublessee; and \n— LR and other lessors regularly lease different floors in similar office \nbuildings to unrelated lessees. \n— The right to use the top floor is not highly dependent on, nor highly \ninterrelated with, LE’s right to use the remainder of the building. At contract \ninception, the building was already divided into multiple floors such that LR \ncould have granted separate rights to use different floors of the building to \nmultiple lessees or transferred rights to use the different floors to LE with \ndifferent commencement dates. \n3A. Determine go -forward accounting: Topic 360 \nSeparate and allocate the existing ROU asset and lease liability to the two \nseparate lease components created by Step 2 \nBased on the conclusion reached in Step 2, at the sublease inception date LE \nseparates its lease of the top floor from its lease of the remainder of the office \nbuilding. LE allocates between the top floor lease component and the lease \ncomponent for the remainder of the building on a relative stand- alone price \nbasis. In this example, LE elects to use historical stand -alone prices (see \nQuestion 6.5.90). \nSeparate lease \ncomponent Stand -alone price Allocated ROU \nasset Allocated lease \nliability \nTop floor $1,165 $ 6232 $ 6232 \nRemaining floors 3,835 2,0503 2,0503 \nTotal $5,0001 $2,673 $2,673 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 511}), Document(page\_content='Leases 511 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Notes: \n1. Because LE is using historical rather than current stand -alone prices, those prices are \nbased on two five- year leases. \n2. $623 = ($1,165 / $5,000) × $2,673 (carrying amount at beginning of Year 3). \n3. $2,050 = ($3,835 / $5,000) × $2,673 (carrying amount at beginning of Year 3). \nReassess Topic 360 asset grouping \nLE concludes that the identifiable cash flows associated with the top floor ROU \nasset and leasehold improvements and the top floor lease liability are largely \nindependent of the cash flows of other long- lived assets and related liabilities. \nLE’s cash inflo ws and outflows will principally consist of the sublease payments \nfrom SE and head lease payments to LR. \nAssess impairment under Topic 360 \nLE concludes that there are no impairment indicators with respect to the asset \ngroup that contains the ROU asset for the remaining floors. Therefore, no \nimpairment assessment is undertaken by LE for that asset group as a result of \nsubleasing the top floor of the building. \nLE concludes that entering into the loss -making sublease for the top floor of the \nbuilding and planning to abandon the related leasehold improvements are \nindicators of impairment for the top floor asset group. LE conducts an \nappropriate analysis under Topic 360 and concludes that the asset group is \nimpaired by $320. The impairment charge is allocated to the ROU asset and the \nleasehold improvements on a pro rata basis using the relative carrying amounts of those assets as follows. \n[360- 10-35-28] \nAsset Pre-impairment \ncarrying amount Allocated \nimpairment loss Post -impairment \ncarrying amount \nROU asset $623 $2761 $347 \nLeasehold \nimprovements 100 442 56 \nTotal $723 $320 $403 \nNotes: \n1. $276 = ($623 / $723) × $320. \n2. $44 = ($100 / $723) × $320. \n3B. Determine go -forward accounting: Topic 842 \nAccounting for the top floor lease component \nLE’s accounting for the top floor ROU asset and lease liability after the \nimpairment recognized in Step 3A (at sublease inception) is as follows. \nYr. Lease liability carry. amt. ROU asset carry. amt. \nSingle \nlease \ncost4 Sub-\nlease \ninc. Beg. \nBal. Lease \nliab. \naccret.1 Pmt.2 End. \nbal. Beg. \nBal. ROU \nasset \namort.3 End. \nbal. \n3 $(623) $(37) $233 $(427) $347 $(116) $231 $153 $ - \n4 (427) (26) 233 (220) 231 (116) 115 142 (120) \n5 (220) (13) 233 - 115 (115) - 128 (120) ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 512}), Document(page\_content='Leases 512 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Notes: \n1. Calculated as beginning balance of lease liability multiplied by incremental borrowing \nrate: Year 3 = $623 × 6%, Year 4 = $427 × 6%, etc. \n2. $233 = ($1,165 / $5,000) × $1,000. \n3. Calculated as balance of ROU asset at beginning of Year 2 divided by remaining \nexpected useful life: $347 / 3 years. \n4. The single lease cost for an im paired operating lease is calculated as described in \nparagraph 6.5.50. \nAccounting for the leasehold improvements in the top floor asset group \nSubsequent to reducing the carrying amount of the leasehold improvements by \n$44 in Step 3, LE will continue to depreciate the remaining, post -impairment \ncarrying amount of $56 over the remaining, shortened useful life for those \nassets (which is one year between sublease inception and the cease- use date). \nAccounting for the separate lease component for the remainder of the \nbuilding \nAccounting for the lease component for the remainder of the building from \nsublease inception to the end of the lease term is as follows (assuming no \nlease modifications, no reassessment events resulting in remeasurement, and \nno impairments of the ROU asset). \nYr. Lease liability carry. amt. ROU asset carry. amt. \nSingle \nlease \ncost4 Beg. \nbal. Lease \nliab. \naccret.1 Pmt.2 End. \nbal. Beg. \nbal. ROU \nasset \namort.3 End. \nbal. \n3 $(2,050) $(123) $767 $(1,406) $2,050 $(644) $1,406 $767 \n4 (1,406) (84) 767 (723) 1,406 (683) 723 767 \n5 (723) (44) 767 - 723 (723) - 767 \nNotes: \n1. Calculated as beginning balance of lease liability multiplied by incremental borrowing \nrate: Year 3 = $2,050 × 6%, Year 4 = $1,406 × 6%, etc. \n2. $767 = ($3,835 / $5,000) × $1,000. \n3. Calculated as the difference between the single lease cost and the lease liabil ity \naccretion: Year 3 = $767 – $123. \n4. The sing le lease cost is calculated as lease cost for Years 3 –5 divided by remaining \nuseful life: $2,301 / 3 years. The $2,301 is calculated using the allocated portion of total \nlease payments: ($3,835 / $5,000) × 1,000 × 3. \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 513}), Document(page\_content='Leases 513 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 6.5.100 \nTopic 420 and non -lease component costs \nShould non- lease component costs be accrued under \nTopic 420 when the lessee ceases use of the underlying \nasset ? \nBackground : Costs to terminate a lease are outside the scope of Topic 420 \n(exit or disposal cost obligations) after the adoption of Topic 842. [420- 10-05-2(b), \n15-3b] \nBefore the adoption of Topic 842, a lessee in an operating lease that ceased \nuse of the underlying a sset would accrue the remaining lease payments as of \nthe ‘cease- use date’ (the date the entity ceased using the right conveyed by the \ncontract), net of amounts it could obtain from a sublessee if it chose to \nsublease the asset. The lessee’s accrual included other fixed and estimated \nvariable costs connected to the lease (e.g. future property tax, insurance and \nmaintenance costs) that would continue to be incurred after the cease- use date \nwithout remaining economic benefit to the lessee. \nInterpretive respons e: It depends on whether the lessee has elected the \npractical expedient to not separate lease and non- lease components (see \nsection 4.4.1). \nLessee elects the non -separation practical expedient \nWhen a lessee elects the non- separation practical expedient, the lease \ncomponent and the combined non- lease components are accounted for as a \nsingle lease component (see paragraph 4.4.30). Therefore, all lease component, \nnon-lease component and non- component (e.g. property tax and insurance) \ncosts are accounted for as fixed or variable lease costs. \nAs outlined in the background, after the adoption of Topic 842, costs to terminate a lease are outside the scope of Topic 420. This includes costs \nrelated to the lease that will continue to be incurred without economic benef it \nto the lessee, such as property tax, insurance or common area maintenance \ncosts. Therefore, none of those costs are accrued at the cease- use date after \nadopting Topic 842. \nLessee does not elect the non -separation practical expedient \nCosts to terminate a non-lease component (e.g. a service or the delivery of a \nsupply of goods) remain in the scope of Topic 420. Therefore, at the cease- use \ndate the lessee will accrue: \n— fixed costs allocable to the non- lease component; and \n— estimated variable payments allocabl e to the non -lease component. \nAllocation of fixed and variable payments to the lease and non- lease \ncomponents in this context occurs on the same basis as the ‘consideration in \nthe contract’ was allocated to those components. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 514}), Document(page\_content="Leases 514 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Fixed costs and the portion of estimated variable payments allocable to the \nlease component are outside the scope of Topic 420, and are not accrued at the \ncease -use date. \nExample 6.5.60 illustrates this accounting . \n \n Example 6.5.60 \nApplying Topic 420 to a non- lease component \nLessee LE enters into a five- year retail space lease that includes common area \nmaintenance ( CAM), a non-lease component. There are no other components of \nthe contract. The lease is a net lease (see paragraph 4.2.110). \nLease payments: Base rent payments of $1,000 per year in arrears \nVariable payments: Proportionate share of property taxes, \ninsurance and CAM costs \nRenewal options: None \nTermination/purchase options: None \nLE's incremental borrowing rate: 5% (the rate implicit in the lease cannot \nbe readily determined) \nInitial direct costs (LE): None \nLease/CAM stand- alone price allocation : 90/10 \nAt the end of Year 2, LE ceases use (as defined in Topic 420) of the leased \nspace. At that date, the following facts are relevant. \nEstimated variable CAM costs per year for remaining 3 years of \nthe lease: $400 \nEstimated variable property tax/insurance costs per year for \nremaining 3 years of the lease: $100 \nCredit- adjusted risk -free rate : 6% \nScenario 1: LE elected the non -separation practical expedient \nNo costs are accrued under Topic 420 at the cease- use date. The (1) base rent \nand (2) expected variable property tax, insurance and CAM costs are accounted \nfor as lease payments and variable lea se payments, respectively. Therefore, \nthey are all considered costs to terminate a lease and are outside the scope of Topic 420. \nScenario 2: LE did not elect the non -separation practical expedient \nCAM is accounted for as a non- lease component, separate fr om the lease. \nTherefore, the base rent and all of the variable payments are allocated between the lease and the CAM (90% to the lease, 10% to the CAM). \nAt the cease- use date, LE recognizes a liability for CAM at fair value under \nTopic 420. The liability incorporates the portion of bot h of the following that is \nallocable to the CAM, based on the 90/10 stand- alone price allocation: ", metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 515}), Document(page\_content='Leases 515 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — the remaining unpaid base rent payments; and \n— the estimated variable payments for property taxes, insurance and CAM. \nLE measures the fair value of the liability based on the estimated future cash \nflows, discounted using a credit -adjusted risk -free rate (6%). \nThe following table shows the calculation of the cease -use date Topic 420 \nliability. \nPayments Estimated \ncosts to be \nincurred1 Amount \nallocated to \nCAM2 Topic 420 \nliability3 \nCAM costs $1,200 $120 $107 \nProperty taxes and insurance 300 30 27 \nBase rent 3,000 300 267 \nTotal $4,500 $450 $401 \nNotes: \n1. Annual estimated costs (see facts table above) × 3 years remaining in the lease. \n2. 10% of the total costs to be incurred . \n3. The portion of the three annual payments allocated to CAM, discounted using the \ncredit -adjusted risk -free rate of 6%. \n \n \n6.5.3 Interaction with Topic 360 when ROU asset is part of \na disposal group that is held for sale \n6.5.190 Topic 360 (section 360- 10-45) requires assets within its scope to be \nclassified as ‘held for sale’ when specified criteria are met. [360- 10-45-9 – 45-12] \n6.5.200 Section 360- 10-35 provides guidance on: [360- 10-35-37 – 35-45] \n— the accounting for long- lived assets classified as held for sale; \n— measuring disposal gains and losses; and \n— measuring long- lived assets that are reclassified to held and used. \n6.5.210 Topic 842 explicitly requires that ROU assets (finance and operating) be \nassessed for impairment under Topic 360 (see section 6.5.1). The FASB further \nstates in the basis for conclusions to ASU 2016 -02, “The right -of-use asset is a \nlong-lived, nonfinancial asset and, therefore, should be within the scope of the \nImpairment or Disposal of Long -Lived Assets Subsection of Topic 360,” which \nincludes the guidance on assets held for sale in paragraphs 360- 10-35-37 – 35-\n45. [842- 20-35-9, ASU 2016 -02.BC255] \n6.5.220 The following questions address when an ROU asset is held for sale and \nhow to account for a lease when that is the case. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 516}), Document(page\_content='Leases 516 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 6.5.110 \nROU asset held for sublease – held for sale \nclassification \nIs an ROU asset that is being held out for sublease subject to \nthe held for sale guidance in Topic 360 ? \nInterpretive response: No. The basis for conclusions to ASU 2016 -02 states \nthe FASB’s view that in a head lease- sublease scenario, the head lease ROU \nasset is not considered to be held for sale. [ASU 2016- 02.BC115] \nTherefore, we believe that for an ROU asset to be held for sale either: \n— the entity’s ‘plan’ must be to find a third party to assume (acquire) the \nrelated lease – i.e. relieving the entity of its primary obligation for the lease; \nor \n— it must be part of a disposal group whereby it is expected that the \npurchaser will assume the lease as part of the purchase of the group – i.e. \nthe purchaser will assume the primary obligation for the lease so that it is \nterminated from the entity’s perspectiv e. \n \n Question 6.5.120 \nLease cost recognition – ROU asset held for sale \nShould an ROU asset continue to be amortized while it is held \nfor sale ? \nInterpretive response: No. Consistent with the guidance for other depreciable \nor amortizable long- lived assets, an ROU asset should not be amortized while it \nis held for sale. [360- 10-35-43] \nInterest/accretion \nWhile an ROU asset is classified as held for sale, interest (finance leases) and \naccretion (operating leases) should continue to be recognized. This is because, \nwhile Topic 360 states that amortization should cease on an asset that is held \nfor sale, it specifies immediately thereafter that “Interest and other expenses \nattributable to the liabilities of a disposal group classified as held for sale shall \ncontinue to be accrued.” [360- 10-35-43] \nShort -term leases \nShort -term lease cost for unrecognized short -term leases (see section 6.3.1) \nshould continue to be recognized even if the disposal group to which the lease \nbelongs is held for sale. Because there is no ROU asset recognized for the \nlease, there is nothing subject to the held for sale guidance; therefore, lease \ncost should continue to be recognized just as it should be for any other \nexecutory contract of the disposal group. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 517}), Document(page\_content='Leases 517 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 6.5.130 \nSubsequent changes – ROU asset held -for-sale \nreclassified to held -and-used \nHow should a lessee account for a n ROU asset reclassified \nfrom held- for-sale back to held -and- used? \nBackground: For purposes of this question, assume an ROU asset was \npreviously classified as held -for-sale. Subsequently, circumstances arise that \nresult in a change to the plan of sale for t he disposal group that contained the \nROU asset. Therefore, the ROU asset is reclassified to held- and-used. \nInterpretive response: An ROU asset reclassified to held- and-used from held-\nfor-sale is measured in the same manner as any other long- lived asset sub ject \nto Topic 360. This is regardless of the classification of the underlying lease as \nfinance or operating. See paragraph 6.5.210. \nTherefore, an ROU asset that is reclassified from held -for-sale to held -and-used \nis measured at the lower of: [360- 10-35-44] \n\uf8e7 its carrying amount before it was classified as held- for-sale, adjusted for any \namortization that would have been recognized had the asset been continuously classified as held -and-used; and\n \n\uf8e7 its fair value at the date of the subsequent decision not to sell . \nWhen an ROU asset is reclassified as held -and-used, any adjustment to its \ncarrying amount is reported in the income statement as an impairment charge in continuing operations in the period that the held- for-sale criteria are no longer \nmet. This is consis tent with the requirements applicable to other long- lived \nassets; see Question 4.6.50 in KPMG Handbook, Discontinued operations and held- for-sale disposal groups\n. [360- 10-45-7] \n \n6.6 Lease r eassessments (Step 8A) \n6.6.1 When to reassess \n Excerpt from ASC 842 -10 \n35 Subsequent Measurement \nGeneral \n> Lease Term and Purchase Options \n35-1 A lessee shall reassess the lease term or a lessee option to purchase the \nunderlying asset only if and at the point in time that any of the following \noccurs: \na. There is a significant event or a significant change in circumstances that is \nwithin the control of the lessee that directly affects whether the lessee is \nreasonably certain to exercise or not to exercise an option to extend or \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 518}), Document(page\_content='Leases 518 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. terminate the lease or to purchase the underlying asset. \nb. There is an event that is written into the contract that obliges the lessee \nto exercise (or not to exercis e) an option to extend or terminate the lease. \nc. The lessee elects to exercise an option even though the entity had \npreviously determined that the lessee was not reasonably certain to do so. \nd. The lessee elects not to exercise an option even though the entit y had \npreviously determined that the lessee was reasonably certain to do so. \n35-2 See paragraphs 842 -10-55-28 through 55- 29 for implementation guidance \non reassessing the lease term and lessee options to purchase the underlying \nasset. \n> Subsequent Me asurement of the Lease Payments \n35-4 A lessee shall remeasure the lease payments if any of the following \noccur: \na. The lease is modified, and that modification is not accounted for as a \nseparate contract in accordance with paragraph 842- 10-25-8. \nb. A contingency upon which some or all of the variable lease payments that \nwill be paid over the remainder of the lease term are based is resolved \nsuch that those payments now meet the definition of lease payments. For \nexample, an event occurs that results in variable lease payments that were \nlinked to the performance or use of the underlying asset becoming fixed \npayments for the remainde r of the lease term. However, a change in a \nreference index or a rate upon which some or all of the variable lease \npayments in the contract are based does not constitute the resolution of a \ncontingency subject to (b) (see paragraph 842- 10-35-5 for guidance on the \nremeasurement of variable lease payments that depend on an index or \na rate). \nc. There is a change in any of the following: \n1. The lease term, as described in paragraph 842- 10-35-1. A lessee shall \ndetermine the revised lease payments on the basis of the revised \nlease term. \n2. The assessment of whether the lessee is reasonably certain to \nexercise or not to exercise an option to purchase the underlying asset, \nas described in paragraph 842- 10-35-1. A lessee shall determine the \nrevised lease payments to reflect the change in the assessment of the \npurchase option. \n3. Amounts probable of being owed by the lessee under residual value \nguarantees . A lessee shall determine the revised lease payments to \nreflect the change in amounts probable of being owed by the lessee \nunder residual value guarantees. \n35-5 When one or more of the events described in paragraph 842- 10-35-4(a) or \n(c) occur or when a c ontingency unrelated to a change in a reference index or \nrate under paragraph 842- 10-35-4(b) is resolved, variable lease payments that \ndepend on an index or a rate shall be remeasured using the index or rate as of \nthe date the reassessment is required . \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 519}), Document(page\_content='Leases 519 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. >> Reassessing the Lease Term and Purchase Options \n55-28 Examples of significant events or significant changes in circumstances \nthat a lessee should consider in accordance with paragraph 842- 10-35-1 \ninclude, but are not limited to, the following: \na. Constructing significant leasehold improvements that are expected to have \nsignificant economic value for the lessee when the option becomes \nexercisable \nb. Making significant mod ifications or customizations to the underlying asset \nc. Making a business decision that is directly relevant to the lessee’s ability to \nexercise or not to exercise an option (for example, extending the lease of a \ncomplementary asset or disposing of an alternative asset) \nd. Subleasing the underlying asset for a period beyond t he exercise date of \nthe option. \n55-29 A change in market -based factors (such as market rates to lease or \npurchase a comparable asset) should not, in isolation, trigger reassessment of \nthe lease term or a lessee option to purchase the underlying asset. \n \n6.6.10 A lease reassessment or modification (that is not accounted for as a \nseparate contract) will often result in the remeasurement of the lease liability \nand the ROU asset. The following diagram provides an overview of the \nreassessment and modification requirem ents applicable to lessees, which are \nexplained in this section (reassessments) and in section 6.7 (modifications). \nSection 6.8A addresses accounting for leases, including reassessment requirements, when in bankruptcy. \n[842- 10-35-4] \nLease \nmodification \nnot \naccounted \nfor as a \nseparate \ncontract \n(see section \n6.7)Change in \nlease termChange in \nassessment \nof lessee \npurchase \noption being \nexercisedChange in \namount \nprobable of \nbeing owed \nby lessee \nunder \nresidual \nvalue \nguaranteeRemeasurement of the lease liability and the ROU asset occurs when :\nN/AWhen do I \nreassess ?\nIn remeasuring , \nwhat do I update :Variable \nlease \npayments \nbecome \nlease \npayments \nfollowing \nresolution of \ncontingency\nOnly when there is a \ntriggering event \n(as defined )Whenever relevant facts and \ncircumstances change\nLease payments ?1\nConsideration in the \ncontract ?\nAllocations of \nconsideration in the \ncontract ?2\nDiscount rate ?\nLease \nclassification ? ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 520}), Document(page\_content='Leases 520 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Note s: \n1. This includes updat ing variable lease payments that depend on an index or rate as of the \nremeasurement date using the remeasurement date index or rate. \n2. See Question 6.6. 110. \n6.6.20 The discussion that follows is based on the diagram in paragr aph 6.6.10, \nand deals with lease reassessments. Lease modifications are discussed in \nsection 6.7. \nReassessment of the lease term or a lessee purchase option \n6.6.30 The lease term and the likelihood of a lessee exercising a purchase option \nare only reasses sed when one of the following occurs. [842- 10-35-1, \nASU 2016- 02.BC232] \n— An event written into the contract obliges the lessee to exercise (or not \nexercise) an option. \n— The lessee elects to exercise an option that it had previously determined it \nwas not reasonably certain to exercise. \n— The lessee elects not to exercise an option that it had previously \ndetermined it was reasonably certain to exercise. \n— A ‘triggering event’. \n \n Example 6.6.08\*\* \nReassessment date – failure to give notice \nLessee LE leases a building from Lessor LR for a noncancellable period of five \nyears that commenced on January 1, 20X1. The lease automatically renews for \na second five- year period starting Januar y 1, 20X6 if LE does not notify LR of its \nintention to vacate the building on or before June 30, 20X5. At lease commencement, LE was not reasonably certain to extend the lease beyond the \nnoncancellable five- year period. Therefore, the lease term was five years. \nThrough June 30, 20X5, LE does not notify LR of its intent to end the lea se at \nthe end of the noncancellable five- year period. No other reassessment events \n(see paragraph 6.6.30) have occurred to that point, such that the remaining \nlease term is six months. \nBy not submitting notice to LR, LE has, as of June 30, 20X5, enforceabl y \nelected to renew the lease for the five- year renewal period (i.e. just as if LE had \nsent an affirmative renewal confirmation to LR). Therefore, consistent with paragraph 6.6.30, LE reassesses the lease term and concludes the remaining \nlease term is now f ive years and six m onths (i.e. the six -month remaining initial \nterm plus the five- year renewal term). LE remeasures the lease (see section \n6.6.2) to reflect that remaining lease term. \nIt would be inappropriate for LE not to reassess the lease term as of Ju ne 30, \n20X5 in this scenario. LE’s June 30, 20X5 ROU asset and lease liability would \nbe misstated if it continued to reflect only the six -month remaining initial lease \nterm. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 521}), Document(page\_content='Leases 521 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 6.6.40 A triggering event is a significant event or significant change in \ncircu mstances that both: [842- 10-35-1, ASU 2016- 02.BC232] \n— is within the lessee’s control; and \n— directly affects the assessment of whether the lessee is reasonably certain \nto exercise an option. \n6.6.50 The following are examples of triggering events. [842- 10-55-28, \nASU 2016- 02.BC232] \n Constructing \nsignificant leasehold \nimprovements1Subleasing the asset for a \nperiod beyond the end \nof the lease term2\nSignificantly modifying or \ncustomizing the assetMaking a business\n decision directly relevant \nto option exercise3 \nNote s: \n1. The lessee constructs leasehold improvements that are expected to have significant \neconomic value beyond the end of the previously assessed lease term. For example, \nassume that in Year 6 of the 10- year office space lease in Example 6. 3.10, the \nlessee constructs leasehold improvements that will have significant economic value for \n10 years. The construction of those leasehold improvements might make it reasonably \ncertain that the lessee will extend the lease to obtain the remaining economic benefits \nfrom those leasehold improvements. \n2. For example, subleasing an asset for which the lease term was initially assessed as \n15 years (1 5-year non -cancellable period with two five-year renewal options), to a \nsublessee for a non- cancellable period of 25 years or subleasing it for the remainder of \nthe head lease term with renewal options that the sublessee is reasonably certain to \nexercise. In those cases, fulfilling the sublease makes it reasonably certain that the entity \nwill exercise its renewal options on the head lease. \n3. For example, extending the lease of a complementary asset or disposing of an alternative \nasset. \n6.6.60 Changes in mark et-based factors (e.g. changes in the real estate market) \ndo not, in isolation, trigger the reassessment of a lessee option – i.e. to extend \nor terminate the lease or purchase the underlying asset because they are \ngenerally not within the lessee’s control. [842- 10-55-29, ASU 2016- 02.BC232] \n \n Observation \nOption reassessment guidance will impact \nprocesses and controls \n6.6.70 The reassessment requirements should not require lessees to continually \nreassess the lease term and lessee purchase options. However, given the pervasive and potentially material effect that lease reassessments could have \non a lessee’s financial statements, l essees will need to implement new \nprocesses and controls to address the new risk points. \n[ASU 2016 -02.BC232] \n6.6.80 These include processes and controls to monitor and, where relevant, \naccount for (1) significant events or changes in circumstances (i.e. t riggering \nevents) within their control; (2) the exercise of options or a decision taken not to \nexercise an option; and (3) events specified explicitly in the contract that require \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 522}), Document(page\_content='Leases 522 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the lessee to exercise (or not to exercise) an option. This effort likely wi ll need \nto involve cross -functional coordination to ensure timely identification of events \nrequiring revisions to lease accounting. \n \n Question 6.6.05 \nIdentifying business decision reassessment \ntriggering events \nWhat constitutes a ‘business decision’ reassessment \ntriggering event? \nBackground: Making a business decision that is directly relevant to the \nlessee’s ability to exercise or not to exercise an option – e.g. extending the \nlease of a complementary asset or disposing of an alternative as set – is an \nexample of a triggering event that requires a lessee to reassess the lease term \nor a lessee purchase option over the underlying asset (see paragraphs 6.6.40 and 6.6.50). \n[842-10-55-28(c)] \nInterpretive response: We believe that for a lessee busi ness decision (e.g. to \nrenew or to terminate a lease) to trigger a lease term or purchase option \nreassessment, that decision must not be reversible without substantive \neconomic cost (or consequence) to the lessee, because: \n— Absent that, the decision is no m ore than a changed expression of \nmanagement’s intent. Management intent does not determine the initial lease term or assessment of a lessee purchase option under Topic 842, and \ntherefore it also should not drive a change to either of those. The \nassessment of lease term and lessee purchase options is based on \neconomic factors, such that only a significant event or significant change in \ncircumstances that changes the economics of the lease to the lessee can \ntrigger a reassessment. \n[ASU 2016- 02.BC193] \n— Only a d ecision that is either not reversible at all, or that can be reversed \nonly by incurring a substantive economic cost (or consequence), will be ‘directly relevant to the lessee’s ability to exercise or not to exercise’ the renewal, termination or purchase option in question. \nExample business decisions \nThe following table gives example lessee business decisions, and evaluates \nwhether each one constitutes a reassessment triggering event. \nScenario ‘Business \ndecision’ \ntriggering event? \n(Yes/No) Explanation \nLessee provides legal \nnotification to Lessor that it \nwill terminate (or not renew) \nthe lease. \n Yes Lessee’s termination \nnotification is legally \nenforceable. Lessee has given \nup its right to use the leased \nproperty after the termination \ndate, and Lessor can now enter \ninto a contract with a \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 523}), Document(page\_content='Leases 523 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Scenario ‘Business \ndecision’ \ntriggering event? \n(Yes/No) Explanation \nreplacement tenant . Lessee \ncannot reverse its decision \nwithout Lessor’s agreement. \nLessee CEO decides and \ncommunicates internally that \nthey have decid ed to close \nthe location, but Lessee will not notify Lessor until 60 \ndays before vacating the premises (the date by which \nit is legally required to do so \nto terminate the lease). No Absent any other a ctions, t he \nCEO’s decision and internal \ncommunication can be reversed \nwithout economic cost or consequence to Lessee. \n \nLessee adds space to and \nextends the term of an \nexisting lease for another \nproperty to a ccommodate \nvacating the leased property. \n Yes Lessee’s modification \n(expansion and extension) to its \nother property lease is non -\ncancellable. Therefore , if \nLessee reverses its decision to \ncease use of the leased \nproperty , it would either: \n— be required to negotiate \nanother amendment with \nthe lessor of the other \nproperty; or \n— incur redundant occupancy \ncosts. \nLessee communicates \npublicly (e.g. press release) \nits intent to exit multiple \nproperties. The leased \nproperty is part of Lessee’s \nplan, but the property is not \nidentified in the public communication and Lessee is \nexiting only a fraction of its total leased properties under \nthe plan. No Identifying the property might \nhave carried an economic cost \nor consequence – e.g. making \nLessee’s employees and \nLessor aware of Lessee’s plan. \nHowever, because the \ncommunication does not \nidentify the leased property, in \nitself it does not create an \neconomic cost or consequence for Lesse e if it changes its plan \nfor the specific property. \n \n \n Example 6.6.10 \nIs reassessment required? \nLessee LE leases a building, to be used as a retail store, from Lessor LR for a \nnon-cancellable period of five years. The following facts are relevant at the lease \ncommencement date. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 524}), Document(page\_content='Leases 524 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Renewal options: Two options for 5 years each (at market rentals) \nPurchase option: $250,000 (estimated fair value) at the end of Year 5, \nincreasing by 1% a year if LE exercises one or both of the \nrenewal options \nTransfer of ownership: No \nAt lease commencement, LE concludes that it is not reasonably certain to \nexercise either of the fiv e-year renewal options or the purchase option. \nTherefore, the lease term at commencement is five years. \nScenario 1: Change in market value of underlying asset \nIn addition to the basic facts for this example, assume that at the end of Year 2 \nof the five- year lease term, the city announces a major renovation of the \ndowntown neighborhood in which the building is located. The renovation is \nexpected to significantly increase both (1) the fair value of the building and (2) \nconsumer traffic in the area. \nAs a resul t, the exercise price of the purchase option is expected to be \nsignificantly lower than the fair value of the building, and the rental payments \nduring the two renewal periods are expected to be at a bargain compared to \nmarket rentals. The increased consumer traffic is also expected to substantially \naffect the revenues that will be generated by the retail store once the \nrenovation is complete. \nIn this scenario, LE does not reassess either the lease term (i.e. consider \nwhether it is now reasonably certain to exercise one or both of the renewal \noptions) or the purchase option. This is because the significant event and \nsignificant change in circumstances related to the building were not within the \ncontrol of LE. The city, not LE, undertook the action that is significantly \nchanging the circumstances surrounding this lease. In addition, market -based \nfactors (e.g. a change in the real estate market) not within the control of the \nlessee do not, in isolation, trigger a reassessment of a lessee option. \nScenario 2: Chan ge in business climate \nIn addition to the basic facts for this example, assume the following. \n— LE is operating a retail store that is unproven in the marketplace where the \nleased building is located – e.g. it has not been tested in this part of the \ncountry). \n— By the end of Year 3 of the lease term, the store is far exceeding initial \nexpectations and has developed a devoted customer base in the \nneighborhood for a variety of reasons that were validly not anticipated at \nlease commencement. It is not expected that LE could relocate to another \nlocation within the city and replicate its results at the present location. \nTherefore, LE concludes that it is reasonably certain to exercise at least the \nfirst five -year renewal option. \nDespite the fact that LE now views itself as reasonably certain to exercise the \nfirst five -year renewal option, unless LE actually exercises that option at the end \nof Year 3, LE does not reassess the lease term based on the facts presented. The success of the retail store is not a significant event or significant change in ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 525}), Document(page\_content='Leases 525 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. circumstances undertaken by LE – LE is merely operating the ret ail store in this \nnew location successfully. \nScenario 3: Business decision that affects lessee’s economic reasons to \nexercise (or not to exercise) an option \nIn addition to the basic facts for this example, assume the following. \n— LE has been fulfilling all of its online sales orders from this retail location \nand one other retail location. None of its other retail locations engage in \nonline fulfillment or are equipped, without significant expense, to do so. \n— At the end of Year 4 of t he lease term, LE terminates its lease of the other \nretail location engaged in online fulfillment activities and vacates that \nbuilding. Between the end of Year 4 and the end of the lease term for this \nretail store, LE will be unable to relocate and re- create its fulfillment \nactivities absent significant cost (either to move to an outsourcing model or \npay a premium to acquire the proper space needed and have it customized). \nThe decision to terminate the lease of the other retail location was within the \ncontr ol of LE and affects LE’s economic reasons to exercise (or not exercise) \nthe renewal options related to the building lease in this example. Therefore, LE reassesses the lease term of the building lease in this example. \nUpon reassessment, based on the facts presented and as a result of making \nthe business decision to terminate the lease of the other location, LE concludes \nthat it is now (at the end of Year 4) reasonably certain to exercise the first \nfive-year renewal option. LE will remeasure the lease payments based on a \nrevised remaining lease term of six years from the reassessment date. \n \n Question 6.6.10 \nReassessment of a lessee option \nWill a reassessment of a lessee option always result in a \nremeasurement of the lease liability under Topic 842? \nInterpretive response: No, not always. A reassessment will result in a \nremeasurement of the lease payments when the event leading to the \nreassessment is one of the following. [842- 10-35-1] \n— An event written into the contract obliges the lessee to exercise ( or not to \nexercise) an option. \n— The lessee elects to exercise an option even though it had previously determined that it was not reasonably certain to do so. \n— The lessee elects not to exercise an option even though it had previously determined that it was reasonably certain to do so. \nIn each of those cases, the event will change the lease term or the reasonably \ncertain assessment of a purchase option. \nHowever, because reasonably certain is a high threshold of assurance (see \nsection 5.2), a significant event or significant change in circumstances (within \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 526}), Document(page\_content='Leases 526 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the control of the lessee and directly related to the assessment of the lessee \noption) – i.e. a ‘triggering event’ – may not result in a change to the previous \nassessment of whether the lessee is reasonably certain to exercise an option (or not exercise a termination option). Although reassessments will not always \nresult in a formal change to the assessment of lessee option exercise, we \nbelieve they usually will, particularly if the triggering event is one of t he \nexamples in Topic 842 (see paragraph 6.6.50). \n \n Question 6.6.20 \nImpairment as a reassessment trigger \nDoes a Topic 360 ROU asset impairment triggering event \nautomatically trigger a reassessment of the lease term or likelihood of lessee purchase option exercise? \nBackground: Consider a scenario in which Lessee LE leases a building, to be \nused as a retail store, from Lessor LR for a non- cancellable period of 10 years. \nThe lease includes one 5- year renewal option. At lease commencement , LE \nconcludes that it is reasonably certain to exercise the renewal option , and \ntherefore the lease term is 15 years. \nBy Year 9, the retail location is performing poorly for reasons that were not \nanticipated at lease commencement, and LE decides that it will not exercise its \nrenewal option. However, LE takes no action to vacate the retail location and \ndecides that it will not communicate its decision to vacate to the lessor until it is \nrequired to do so, which is 60 days before the end of the 10 -year non-\ncancel lable period of the lease. \nThe poor performance of the retail location is an impairment triggering event \nunder Topic 360. If LE tests the retail store asset group for impairment at the \nbeginning of Year 9 (see section 6.5.1) without reassessing the lease t erm, a \nsignificant impairment loss may be recognized. [360- 10-35-21] \nIn this situation, the quest ion arises about whether LE should reassess the \nlease term at the beginning of Year 9 before recognizing an impairment loss on \nthe asset group. \n— If LE reassesse s the lease term at the beginning of Year 9, it may conclude \nthat the remaining lease term is only two years (rather than seven years). In that case, the lease term reduction would reduce the carrying amount of \nthe R OU asset significantly, which might sign ificantly reduce (or even \neliminate) impairment of the retail location asset group. \n— Conv ersely, if LE does not reassess the lease term, it may recognize: \n \n— a significant impairment of the retail location asset group (including the \nROU asset) at the beginni ng of Year 9; and \n— a gain , potentially significant, when it formally elects not to exercise the \n5-year renewal option (i.e. notifies the lessor). The gain results from \nreducing the lease liability, but having no (or a reduced) ROU asset to \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 527}), Document(page\_content='Leases 527 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. correspondingly reduce at that point in time (see paragraph 6.6.170). \n[842- 20-35-4] \nInterpretive response: No. Under Topic 842, a reassessment triggering event \nmust be a significant event or change in circumstances within the lessee’s \ncontrol (see paragraph 6.6.40). A change in market -based factors does not, in \nisolation, trigger a reassessment of the lease term or likelihood of lessee \npurchase option exercise (see paragraph 6.6.50). \nTopic 360 asset impairment triggering events can, in contrast, be solely mar ket-\nbased and not within the control of the asset owner. For example, Topic 360 impairment triggers include market -based decreases in the fair value of a long-\nlived asset, or a regulatory change or economic downturn entirely outside the control of the asset owner. Such events or changes in circumstances, which \nare outside the control of the lessee (owner of the ROU asset), do not trigger a \nreassessment of the lease term or likelihood of lessee purchase option \nexercise. \n[360- 10-35-21] \nTherefore, a Topic 360 impairment triggering event may or may not also trigger \na lease reassessment, depending on the nature of the event. \nFor example, a significant change by the lessee in the extent or manner in \nwhich it is using the underlying asset is an example of both a Topic 360 \ntriggering event and a significant event within the control of the lessee that \ndirectly affects whether it is reasonably certain to exercise a renewal or \npurchase option. [360- 10-35-21(b), 842- 10-55-28(c)] \nIn contrast, the poor performance of the r etail location in the background that \ntriggered the Topic 360 impairment analysis is a market -based condition outside \nLE’s control . Because LE has taken no action to vacate the retail location, LE \ndoes not reassess the lease term at the beginning of Year 9 . Instead, LE’s \ncommunication to LR of non- renewal of the lease 60 days before the end of the \nnon-cancellable lease period will be the next trigger for LE to reassess the lease \nterm (absent another trigger between the beginning of Year 9 and LE’s \ncommunica tion to LR). At that point, LE will: \n— remeasure the lease liability – reducing it to reflect that there will be only \n60 days left in the reassessed lease term; and \n— recognize a significant offsetting gain because the ROU asset will already have a carr ying a mount of zero (or near zero; see next paragraph). \nBecause LE does not intend to sublease the location after the end of Year 10, LE treats the plan not to renew the lease as a plan to abandon the ROU asset \nthat will remain at the end of Year 10 (see Questio n 6.5.50). As outlined in \nQuestion 6.5.70, this means that the post -impairment ROU asset (the carrying \namount that remains after taking any beginning of Year 9 Topic 360 impairment) \nwill be amortized in a manner that ensures it is amortized to its salvage value \n(see Question 6.5.33) by the end of Year 10 (when LE will cease use of the \nlocation and end the lease). \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 528}), Document(page\_content='Leases 528 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 6.6.30 \nChanges to amounts probable of being owed under \na residual value guarantee \nIs a lessee only required to reassess amounts probable of \nbeing owed under a residual value guarantee upon the \noccurrence of a triggering event? \nInterpretive response: No. Unlike for reassessments of the lease term or \nlessee purchase options, Topic 842 does not provide specific guidance about \nwhen a lessee must reassess amounts probable of being owed under a residual \nvalue guarantee. However, the basis for conclusions to ASU 2016 -02 suggests \nthat it is the Board’s intent for lessees to remeasure the lease payments whenever facts and circumstanc es change, suggesting that the lease payments \nshould be remeasured for a change in the amount probable of being owed \nunder a residual value guarantee when the previous estimate is no longer \naccurate (subject to materiality considerations). \n[ASU 2016- 02.BC239] \nTherefore, the lease payments may be required to be remeasured, which \nresults in a number of additional accounting steps (see paragraph 6.6.140), \nwhenever there is a change in the estimated residual value of the underlying \nasset at the end of the lease term that affects the amount payable under a \nresidual value guarantee – typically a decrease in the estimated residual value. \nResolution of a contingency \n6.6.90 The resolution of a contingency on which some or all variable lease \npayments to be paid over the remainder of the lease are based may be \nresolved, and result in those payments prospectively meeting the definition of \nlease payments. For example, if the payments for Years 2– 10 of a retail store \nlease will be based on 10 percent of Year 1 retail stor e sales, at the end of \nYear 1 the lease payments for Years 2– 10 become fixed payments. In this \nscenario, a remeasurement of the lease payments is required. This is illustrated \nin Example 6. 6.70. [842- 10-35-4(b), ASU 2016- 02.BC238] \n \n Observation \nResolution of contingencies \n6.6.100 The Board considered scenarios in which entities might attempt to \ncircumvent the lessee ROU asset and lease liability recognition and \nmeasurement requirements by initially structuring the lease payments at a \nnominal amount. For example, lease payments could be set at $10 for Year 1 of \na 10- year lease and then become fixed (or partially fixed) af ter Year 1 for the \nremainder of the lease term based on a percentage of Year 1 sales using a leased building, or based on Year 1 production using a piece of leased equipment. \n[ASU 2016- 02.BC238] \n6.6.110 Absent this requirement, some stakeholders suggested that the \nguidance would not require the lessee to reassess the lease payments and \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 529}), Document(page\_content='Leases 529 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. update its lease liability and ROU asset in those scenarios. If so, the lessee \nmight not recognize a meaningful ROU asset or lease liability throughout the \nlease term even t hough the terms of the lease would require fixed payments \nafter resolution of the contingency. Therefore, the Board decided to specify that \nif variability in some or all of the remaining lease payments is resolved, those \namounts prospectively meet the defi nition of lease payments and should be \nreflected, from that point forward, in the ROU asset and the lease liability. \n[ASU 2016- 02.BC238] \n \n Question 6.6.40 \nVariable lease payments that depend on an index or \nrate and resolution of a contingency \nIs a change in a reference index or rate that will affect variable \nlease payments that depend on an index or rate the \nresolution of a contingency that requires remeasurement of \nthe lease by the lessee? \nInterpretive response: No. The guidance on the resolution of contingencies \ndoes not apply to variable lease payments that depend on an index or rate, even \nwhen the periodic lease payments increase based on the change in CPI, and \nunder the terms of the lease the periodic lease payments will never decrease after the y have increased (i.e. even if CPI w ere to decrease). The payment \nincrease linked to the change in CPI is not captured by this gener al contingency \nguidance. Rather , the guidance applies only to situations related to all other \ntypes of variable lease payments (e.g. those related to usage or performance of \nthe underlying asset). The Board amended Topic 842 to make this explicit in the \nguidance in ASU 2018- 10. \n[842- 10-35-4(b), ASU 2016- 02.BC238] \nHowever, if remeasurement occurs for another reason, variable lease payments \nthat depend on an index or rate are updated to use the index or rate as of the \nremeasurement date. See section 5.4.1 for further discussion of variable lease \npayments that depend on an index or a rate. \n \n Question 6.6.50 \nLessee accounting for reimbursements of capital \nreplacements and repairs \nHow should a lessee account for its obligation to reimburse \nthe lessor for a capital replacement or repair that is not a \npromised good or service ? \nBackground: A lessor frequently has the contractual right to pass through costs \nof capital replacements or repairs to its tenants. For example, if a lessor installs \na new roof on its property, the tenants may be required to reimburse the lessor \nfor those costs , even if the new roof is not a prom ise made to any one of the \ntenants (see Question 4.2.25) . \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 530}), Document(page\_content='Leases 530 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. A common reimbursement structure is for tenants to reimburse the lessor \nconsistent with the useful life of the replacement/repair and consistent with the \nlessee’s proportionate right to use the property. \nIt is also common that the lessee’s reimbursement obligation ends if the lease \nexpires. In contrast, if the lessee early terminates the lease, the lessor often \nhas the right to recover the amounts it would have obtained from the lessee \nrelated to t he capital replacement/repair over the remainder of the lease term. \nInterpretive response: When the lessor completes the capital replacement or \nrepair and the cost of that replacement/repair to be borne by the lessee \nbecomes known, we believe the lessee should treat this as a resolution of a \ncontingency remeasurement event (see paragraphs 6.6. 90 and 6.6.140 – 150). \nIn this case, consistent with other similar events, the contingent event of the lessor completing the capital replacement/repair results in add itional fixed \npayments being due under the lease. The lease liability should be remeasured \nto capture those additional fixed payments – i.e. the portion thereof allocable to \nthe lease if there are non- lease components of the contract. \nFor example, Lessee LE leases 10% of a shopping center’s available retail \nspace for 10 years. At the beginning of Year 2, Lessor LR installs a new \n$450,000 roof on the shopping center that has a 15- year useful life. Under the \nterms of the lease, LE will reimburse LR $3,000 per year for the remaining \n9 years of the lease term ($27,000 total): ($450,000 total cost / 15 years) × 10% \noccupancy. The lease liability is remeasured to reflect the additional, fixed \npayments when those payments become known. \nExample 6.6. 70 illustrates a resolution of a contingency remeasurement and the \npost-remeasurement accounting for that lease. Question 7.4.20 addresses \nlessor accounting for capital replacement/repair reimbursements. \n \n Question 6.6.60 \nCo-tenancy clauses – lessee \nHow should a lessee account for a co- tenancy clause that \nreduces the lessee’s rent when it is triggered? \nBackground: Many retail leases include co -tenancy clauses that reduce the \ntenant’s contractual rent if, for example, a key (or anchor) tenant (e.g. a \ndepartment or ‘big box’ store) or a certain number of tenants vacate the \nproperty. Typically, these clauses stipulate that the tenant must resume paying \nthe contractual rent either after a specified period of time or when the co-\ntenancy event is cured (e.g . a new anchor tenant occupies the relevant space \nvacated by the previous anchor tenant ). \nKey tenants and a minimum level of overall occupancy help to draw customer \ntraffic to retail properties such as shopping malls. Therefore, the presence of \none or mor e key tenants and/or a high level of overall occupancy of a retail \nproperty generally benefits all tenants and is an important consideration for a lessee when deciding where to lease a retail space (and how much the lessee \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 531}), Document(page\_content='Leases 531 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. is willing to pay in rent). Co- tenancy clauses serve to protect lessees from a \npotential drop in sales when a key tenant vacates its space or overall occupancy \nof the retail property declines. \nUnder an example co -tenancy clause, the lessee’s fixed rental payments for a \nfive-year retail s pace lease (e.g. $1,000 per year in arrears) may convert to a \npayment based solely on a percentage of the lessee’s sales from the retail \nspace (e.g. 5% of sales) for a specified period or until the co- tenancy event is \ncured. In that way, the lessee and the lessor share the risk that the co- tenancy \nevent will adversely affect the lessee’s sales from the leased retail space. \nInterpretive response: At lease commencement, we believe the lessee’s \naccounting for the lease should not consider a co- tenancy clause o f this nature. \nIn the background example, the lessee’s accounting at lease commencement should ignore the possibility that the co- tenancy clause will be triggered. \nTherefore, the lessee’s lease liability and ROU asset at lease commencement \nwill reflect ‘l ease payments’ of $5,000 (fixed payments of $1,000 per year for \nfive years). \nIf the co- tenancy clause is triggered during the lease term, we do not believe \nthe lessee would remeasure its lease liability and ROU asset at that time. \nRather, the difference between the following should be treated as negative \nvariable lease cost: \n— the lessee’s actual payments (in the background example, based on 5% of \nthe lessee’s sales from the retail space); and \n— the fixed payment that would apply if the co- tenancy clause had not been \ntriggered. \nUsing the background example, assume the co- tenancy clause is triggered at \nthe beginning of Year 3 and is not cured during the year. If the lessee’s rent \npayment for the year is $800 ($16,000 in store sales × 5%), the lessee would \nincur straight -line operating lease cost of $1,000 and negative variable lease \ncost of ($200), for a net operating lease cost of $800. At the beginning and end of Year 3, the lease liability would continue to be measured based on three \nremaining payments of $1, 000 and two remaining payments of $1,000, \nrespectively. \nWe do not believe triggering the co- tenancy clause meets any of the \nremeasurement requirements in paragraph 842- 10-35-4, including the triggering \nevent in paragraph 842- 10-35-4(b) related to the resol ution of a contingency. We \ndo not believe the co- tenancy event resolves a contingency because inherent to \nthat remeasurement item is that the relevant contingency is resolved for ‘the \nremainder of the lease term’. Therefore, unless the co- tenancy event is \ncontractually irreversible for the remainder of the lease term (i.e. the contract does not permit the lessor to cure the co- tenancy event once it is triggered), we \nbelieve paragraph 842- 10-35-4(b) does not apply. \n[842- 10-35-4, ASU 2016- 02.BC238] \nWhen, and after, the co -tenancy clause is triggered, the lessee should consider \nwhether the co- tenancy event requires it to test the asset group that includes \nthe ROU asset for the leased space for impairment (see section 6.5). \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 532}), Document(page\_content='Leases 532 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 6.6.20 \nLessee accounting for a co- tenancy clause \nLessee LE signs a lease with Lessor LR to occupy a retail space in a center with \nfour anchor tenants. The lease terms are as follows: \nLease payments: Fixed payments of $100 ,000 per year in \narrears , increasing $5,000 each year \nLease term: 5 years \nCo-tenancy clause: If an anchor tenant vacates , LE’s rent will be \n5% of gross sales for the lesser of 24 months \nor the period of anchor vacancy \nIncremental borrowing rate (implicit \nrate is not readily determinable): 5% \nInitial direct costs (LE): $5,000 \nBased on the above, and absent a co- tenancy event, LE accounts for the lease \nas follows: \nYear Lease liability ROU asset \nSingle \nlease cost Beginning \nbalance Accretion Payments Ending \nbalance Beginning \nbalance Amort. Ending \nbalance \n1 $474,132 $23,707 $(100,000) $397,839 $479,132 $ (87,293) $391,839 $111,000 \n2 397,839 19,892 (105,000) 312,731 391,839 (91,108) 300,731 111,000 \n3 312,731 15,637 (110,000) 218,368 300,731 (95,363) 205,368 111,000 \n4 218,368 10,918 (115,000) 114,286 205,368 (100,082) 105,286 111,000 \n5 114,286 5,714 (120,000) - 105,286 (105,286) - 111,000 \nAt the end of Year 1, one of the anchor tenants vacates its space and the co-\ntenancy clause is activated. The landlord does not find a replacement until the \nbeginning of Year 4 of the lease. Under the co- tenancy clause, LE’s rent is \nbased on 5% of its gros s sales during Years 2 and 3, which equates to $75,000 \nand $68,000, respectively. \nAs a result, LE records the following journal entries in Years 2 and 3: \n Year 2 Year 3 \nDebit Credit Debit Credit \nLease expense 111,000 111,000 \nLease liability1 85,108 94,363 \nLease expense2 30,000 42,000 \nROU asset3 91,108 95,363 \nCash 75,000 68,000 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 533}), Document(page\_content='Leases 533 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Notes: \n1. Original lease payment of $105,000 and $110,000, respectively, less accretion of \n$19,892 and $15,637, respectively. \n2. Difference between the lease payments included in the measurement of the lease \nliability ($105,000 and $110,000, respectively) and the percentage rent paid under the \nco-tenancy clause ($75,000 and $68,000, respectively). \n3. Straight- line single lease cost ea ch year ($111,000) less accretion of the lease liability \n($19,892 and $15,637, respectively). \nNote: While not illustrated in this example, LE should consider whether the co -\ntenancy event requires it to test the asset group that includes the ROU asset \nfor the leased space for impairment. \n \n Question 6.6.70 \nMinimum annual guarantee clauses \nWhen a minimum annual payment amount becomes fixed, \ndoes that trigger a remeasurement of the lease? \nBackground: Leases often include minimum annual guarantee (MAG) clauses \nwhereby the payments for the lease are performance- or usage- based (e.g. \nbased on a percentage of sales), subject to a minimum amount that resets each \nyear. For example, the lease may require payments equal to 5% of sales from a \nretail location, subject to a minimum guaranteed amount that resets each year \nbased on the prior year’s sales. \nIn some leases, the MAG amount is permitted to go up or down each year; in others, the MAG cannot decrease during the lease term once it has increased – \ni.e. it can only continue to increase. \nInterpretive response: It depends on whether the MAG amount can go up or \ndown during the lease term, or only up. \nMAG can go up or down from the prior year when it resets \nIf a MAG can go up or down each year, we do not believe the annual reset of \nthe MAG triggers any of the remeasurement requirements in paragraph 842- 10-\n35-4. \nThis includes paragraph 842- 10-35-4(b) related to the resolution of a \ncontingency. We do not believe setting the MAG for any given year represents the resolution of a contingency bec ause the reset MAG is not a fixed amount as \ndescribed in paragraph 6.6. 90 and Example 6.6. 70 after any single year’s MAG \nis established; it can increase or decrease each subsequent year. \nRather, despite the MAG, the variable payments the lessee will make under the \nlease are not substantively different from other variable lease payments based \non performance or usage of the underlying asset (e.g. payments based on a \npercentage of retail location sales). \nTherefore, as illustrated in Example 6.6. 30 (Scenario 1), if only the Year 1 MAG \nis fixed at lease commencement, and there are no other fixed payments under \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 534}), Document(page\_content='Leases 534 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the contract, after that MAG is satisfied, the lessee will have no recognized \nlease liability for the remainder of the lease term absent the occurrence of \nanother remeasurement event. \nMAG can only go up from the prior year when it resets \nIf a MAG cannot decrease during the lease term, the fixed lease payments at \nlease commencement equal the Year 1 MAG times the number of years in the \nlease term. \nIf the MAG increases in a subsequent year, this does trigger a remeasurement \nof the lease payments under paragraph 842- 10-35-4(b). In contrast to the \nscenario where the MAG can go up or down with each year’s reset, upon a \nreset that increases the MAG to a level from which it cannot subsequently \ndecrease, some of the variable lease payments become fixed for the remainder of the lease term. \nFor example, if the MAG increases from $1,000 in Year 1 to $1,100 in Year 2, and the MAG can never again be lower than $1,100, there are now fixed lease \npayments of $1,100 (versus $1,000) times the number of years remaining in the \nlease term. \nUnlike in the scenario where the MAG can go up or down with each year’s \nreset, the lessee will have a recognized lease liability throughout the lease term \nuntil the final year MAG is paid. The lessee’s single lease cost and variable \nlease cost will also differ. \nThe table in paragraph 6.6.14 0 highlights the steps required to account for a \nremeasurement resulting from some of the variable lease pa yments to be paid \nover the remainder of the lease term becoming fixed. \n \n Example 6.6.30 \nMinimum annual guarantee (MAG) payment that \nresets each year \nScenario 1: MAG can go up or down from the prior year when it resets \nLessee LE enters into a five -year lease of a 10,000 square foot retail space from \nLessor LR that commences on January 1, Year 1. There are no renewal or \ntermination options; therefore, the lease term is five years. LE classifies the \nlease as an operating lease, because none of the tests for classification as a \nfinance lease are met (see paragraph 6.2.50). \nThe following additional facts are relevant. \nLease payments: Annual lease payments, payable in arrears, \nequal to 5% of annual sales from the retail \nspace, subject to the MAG \nMinimum annual guarantee (MAG) : $132,000 for Year 1, resets each year at an \namount equal to 5% of the prior year’s sales \nfrom the retail space with no restriction on that \namount being less than in the prior year \nLease term: 5 years ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 535}), Document(page\_content='Leases 535 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Incremental borrowing rate (implicit \nrate is not readily determinable): 10% \nInitial direct costs (for LE), lease \nincentives or lease prepayments: None \nModifications or remeasurement events : None \nNon-lease components : None \nAdditional assumptions about the amount of variable payments that are \nprobable throughout the year are provided in the notes to the lease cost tables. \nInitial measurement \nThe MAG for Year 1 is specified in the contract and is unavoidable. Therefore, it \nis a ‘lease payment’ and included in the measurement of the lease liability at \nlease commencement. Even though significant rental payments in excess of the Year 1 MAG are expected during the lease term, at lease commencement, \nthe only ‘lease payment’ is the Year 1 MAG. A ll other payments expected to be \nmade under the lease are variable at lease commencement and do not depend on an index or a rate. \nAt lease commencement, LE recognizes: \n— lease liability o f $120,000. This is the present value of the Year 1 MAG of \n$132,000, discounted at 10% for one year; and \n— corresponding R OU asset of $120,000, because there are no initial direct \ncosts, lease incentives or lease prepayments. \nSubsequent measurement \nLease lia bility \nThe annual reset of the MAG is not a remeasurement event. Consequently, in \nthis scenario, LE will not remeasure the lease liability each year to reflect the \nnew annual MAG. \nThe lease liability will be reduced to zero on payment at the end of Year 1. \nBecause the lease is not modified or remeasured, once the Year 1 MAG \npayment is made, LE has no further lease liability for the remainder of the \nlease term. \nYear Beg. balance Interest Payments End. balance \n1 $120,000 $12,000 $(132,000) $- \n2 - - - - \n3 - - - - \n4 - - - - \n5 - - - - ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 536}), Document(page\_content='Leases 536 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. ROU asset \nThe amortization of the ROU asset and the carrying amount of the ROU asset at \nthe end of each year are as follows. \nYear ROU asset amortization ROU asset carrying amount \nSingle \nlease cost1 Lease liab. \naccret. ROU asset \namort.2 Beg. \nbalance ROU asset \namort. End. \nbalance \n1 $26,400 $(12,000) $14,400 $120,000 $(14,400) $105,600 \n2 26,400 - 26,400 105,600 (26,400) 79,200 \n3 26,400 - 26,400 79,200 (26,400) 52,800 \n4 26,400 - 26,400 52,800 (26,400) 26,400 \n5 26,400 - 26,400 26,400 (26,400) - \nNotes: \n1. Lease payments of $132,000 / 5 years = $26,400. \n2. Equals single lease cost – lease liability accretion. \nLease cost \nThe following table summarizes the amounts LE recognizes in profit or loss each year of the lease. \nYear Annual \nsales 5% of \nannual sales MAG Variable \nlease cost Single \nlease cost1 Total lease \ncost \n1 $2,700,000 $135,000 $132,000 $ 3,000 $26,400 $ 29,400 \n2 2,850,000 142,500 135,000 142,500 26,400 168,900 \n3 2,750,000 137,500 142,500 142,500 26,400 168,900 \n4 2,700,000 135,000 137,500 137,500 26,400 163,900 \n5 2,800,000 140,000 135,000 140,000 26,400 166,400 \nNote: \n1. In Year 1, lease liability accretion ($12,000 = $120,000 × 10%) plus ROU asset \namortization ($14,400). In Years 2– 5 the single lease cost equals the ROU asset \namortization of $26,400. \nThe following tables further illustrate the variable lease cost that LE recognizes, \nby quarter, in Years 1 and 2. Consistent with paragraph 6.4.200, even though LE \nwill make its lease payment s at the end of each year, it accrues its lease cost in \ninterim period s. Variable lease cost for the interim periods in Years 3– 5 would \nbe calculated in the same way as for Year 2. \nYear 1 \nBecause the Year 1 MAG payment is recognized through the single leas e cost \nof $26,400 per year ($6,600 per quarter) , the variable lease cost for Year 1 is \nsolely the amount owed by LE that is greater than the MAG: $3,000 ($135,000 \n− $132,000). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 537}), Document(page\_content='Leases 537 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Period YTD sales 5% of YTD \nsales Cumulative \nmin. annual \npmt.1 YTD variable \nlease cost2 QTD variable \nlease cost3 \nQ1 Yr 1 $ 700,000 $ 35,000 $ 33,000 $1,500 $1,500 \nQ2 Yr 1 1,300,000 65,000 66,000 1,500 - \nQ3 Yr 1 1,950,000 97,500 99,000 1,500 - \nQ4 Yr 1 2,700,000 135,000 132,000 3,000 1,500 \nNotes: \n1. The MAG for the year, divided by four quarters, multiplied by the number of \nquarters elapsed in the year. In Year 1 this is the MAG of $132 ,000 divided by \nfour quarters ($33,000), multiplied by the number of quarters elapsed ($33,000 × \n3 = $99,000 in Q3) . \n2. Equals the pro rata amount probable LE will owe above the Year 1 MAG for the entire year (e.g. at the end of Q2). The following facts are relevant to how LE \nrecognizes the $3,000 during the quarterly periods. \n\xad At lease commen cement, LE concludes it is not probable that it will owe LR \namounts in excess of the $132,000 Year 1 MAG. \n\xad Based on better than expected Q1 sales, at the end of Q1, LE concludes it is \nprobable that it will owe $6,000 in addition to the $132,000 MAG (or \n$138,000 total). \n\xad After Q2 sales that are substantially weaker than Q1, LE concludes it is no longer probable that it will owe amounts above the $132,000 MAG. \nHowever, in accordance with paragraph 842- 20-55-2, the $1,500 accrued in \nQ1 is not reversed in Q2 or Q 3 because it is not probable that it will not be \nowed. \n\xad It is not until Q4 that LE again concludes that it is probable that it will owe in excess of the $132,000 Year 1 MAG. \n3. Equals the difference between the YTD variable lease cost calculated in Note 2 \nand what has been recognized in prior quarters of Year 1. The corresponding \ncredit to each of these amounts is an accrued liability for the variable lease \npayment that will be paid at the end of the year. \nYear 2 \nPeriod YTD sales 5% of YTD \nsales Cumulative \nmin. annual \npmt.1 YTD variable \nlease cost2 QTD variable \nlease cost3 \nQ1 Yr 2 $ 650,000 $ 32,500 $ 33,750 $ 33,750 $33,750 \nQ2 Yr 2 1,400,000 70,000 67,500 70,000 36,250 \nQ3 Yr 2 2,100,000 105,000 101,250 105,000 35,000 \nQ4 Yr 2 2,850,000 142,500 135,000 142,500 37,500 \nNotes: \n1. See Note 1 in the Year 1 table. \n2. Equals the pro rata amount probable LE will owe for the entire year (e.g. at the \nend of Q2). The following facts are relevant to how LE recognizes the $142,500 \nduring the quarterly periods. \n— At the beginning of Year 1, LE concludes it is not probable that it will owe LR \namounts in excess of the $135,000 Year 2 MAG; LE estimates that Year 2 sales \nwill be consistent with Year 1. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 538}), Document(page\_content='Leases 538 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — After Q2 sales that are substantially stronger than Q1 and consider ation of other \nfactors, LE concludes it is probable that it will owe amounts above the $135,000 \nMAG. LE concludes it is probable that sales in the second half of Year 2 will at least equal those in the first half of the year, which would result in LE owing \n$140,000 to LR in Year 2. Consequently, as of the end of Q2, LE has recognized \n$70,000 in variable lease cost ([$140,000 / 4 quarters] × 2 quarters lapsed). \n— It is not until Q4’s sales that LE concludes that it is probable that it will owe in \nexcess of the $140,000 for all of Year 2. \n3. The amount necessary for the YTD variable lease cost to equal the greater of the \namount calculated in Note 2. The corresponding credit to each of these amounts is an accrued liability for the variable lease payment that will be paid at the end of \nthe year. \nScenario 2: MAG can only go up from the prior year when it resets \nAssume the same facts as in Scenario 1 except that the MAG for any given \nyear cannot be less than the MAG for the prior year – i.e. it can only increase. \nInitial measurement \nBecause the Year 1 MAG cannot decrease in subsequent years of the lease \nterm, the ‘lease payments’ equal $660,000 (Year 1 MAG of $132,000 × 5 years) \nat lease commencement, and are included in the commencement date \nmeasurement of the lease l iability. Payments above the annual MAG at lease \ncommencement ($132,000 per year) are variable lease payments that do not depend on an index or a rate; therefore, they are not included in the lease \npayments and do not affect the commencement date measurement of the lease liability. \nAt lease commencement, LE recognizes the following: \n— lease liability of $500,384. This is the present value of the five lease \npayments totaling $660,000, discounted at 10% ; and \n— corresponding ROU asset of $500,384 because there are no initial direct \ncosts, lease incentives or lease prepayments. \nSubsequent measurement \nAn increase to the MAG triggers a remeasurement of the lease payments \nbecause, in that event, some of the previously variable lease payments to be \npaid over th e remainder of the lease term become fixed. \nThe following table shows Years 1– 5 sales and the resulting MAG and MAG \nincrease for the year (from the prior year). \nYear Annual sales 5% of annual sales MAG increase MAG \n1 $2,700,000 $135,000 $ - $132,000 \n2 2,850,000 142,500 3,000 135,000 \n3 2,750,000 137,500 7,500 142,500 \n4 2,700,000 135,000 - 142,500 \n5 2,800,000 140,000 - 142,500 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 539}), Document(page\_content='Leases 539 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Lease liability \nIn contrast to Scenario 1, the lease liability will be reduced to zero only after the \nYear 5 MAG payment is made. The following table summarizes measurement of the lease liability throughout the lease term. \nYear Beg. \nbalance Interest1 Payments MAG \nremeasurement End. balance \n1 $500,384 $50,038 $(132,000) $ 9,5102 $427,932 \n2 427,932 42,793 (135,000) 18,6514 354,376 \n3 354,376 35,438 (142,500) - 247,314 \n4 247,314 24,731 (142,500) - 129,545 \n5 129,545 12,955 (142,500) - - \nNotes: \n1. Beginning balance × 10% . \n2. Remeasured lease liability of $ 427,932 (Year 2 MAG of $ 135,000 × 4 years, \ndiscounted at 10%) − $418,422 (balance of lease liability immediately before \nremeasurement)3 = $9,510. \n3. $418,422 = $500,384 + $50,038 − $132,000 \n4. Remeasured lease liability of $354,376 (Year 3 MAG of $142,500 × 3 years, \ndiscounted at 10%) − $335,725 (balance of lease liability immediately before \nremeasurement)5 = $18,651.$335,725 = $427,932 + $42,793 − $135,000. \nLE’s remeasurement entries at the end of Year 1 and Year 2, respectively, are \nas follows. There are no remeasurement entries in later years because the \nMAG cannot decrease from its Year 2 level of $142,500. \nEnd of Year 1 \n Debit Credit \nROU asset 9,510 \nLease liability 9,510 \nTo remeasure lease liability and ROU asset for \nYear 2 MAG increase. \nEnd of Year 2 \n Debit Credit \nROU asset 18,651 \nLease liability 18,651 \nTo remeasure lease liability and ROU asset for \nYear 3 MAG increase. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 540}), Document(page\_content='Leases 540 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. ROU asset \nSimilarly, the carrying amount of the ROU asset will differ from that in \nScenario 1. The following table summarizes the measurement of the ROU asset \nthroughout the lease term. \nYr. ROU asset amortization ROU asset carrying amount \nSingle \nlease cost Lease \nliab. \naccret. ROU \nasset \namort.1 Beg. \nbalance ROU \nasset \namort. MAG \nrem.2 End. \nbalance \n1 $132,0003 $(50,038) $ 81,962 $500,384 $ (81,962) $ 9,510 $427,932 \n2 135,0004 (42,793) 92,207 427,932 (92,207) 18,651 354,376 \n3 142,5005 (35,438) 107,062 354,376 (107,062) - 247,314 \n4 142,5005 (24,731) 117,769 247,314 (117,769) - 129,545 \n5 142,5005 (12,955) 129,545 129,545 (129,545) - - \nNotes: \n1. Equals single lease cost – lease liability accretion. \n2. MAG remeasurement equal to the adjustment to the lease liability. \n3. See Year 1 column in remaining lease cost table that follows. \n4. See Year 2 column in remaining lease cost table that follows. \n5. See Year 3 column in remaining lease cost table that follows . \n \nRemaining lease cost Year 13 Year 24 Years 3−55 \nCarrying amount of ROU asset beginning of \nyear $500,384 $427,932 $354,376 \nPlus: Accretion to be recognized on the lease liability over remaining lease term\n6 159,616 112,068 73,124 \nRemaining lease cost $660,000 $540,000 $427,500 \nRemaining lease cost per year $132,000 $135,000 $142,500 \nNote: \n6. Remaining unpaid lease payments − remeasured lease liability. \nLease cost \nThe following table summarizes the amounts LE recognizes in profit or loss \neach year of the lease. \nYear Annual \nsales 5% of \nannual sales MAG Variable \nlease cost Single \nlease cost1 Total lease \ncost \n1 $2,700,000 $135,000 $132,000 $3,000 $132,000 $135,000 \n2 2,850,000 142,500 135,000 7,500 135,000 142,500 \n3 2,750,000 137,500 142,500 - 142,500 142,500 \n4 2,700,000 135,000 142,500 - 142,500 142,500 \n5 2,800,000 140,000 142,500 - 142,500 142,500 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 541}), Document(page\_content='Leases 541 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Note: \n1. See remaining lease cost per year in ROU asset measurement table above. \nThe following tables further illustrate the amounts LE recognizes in profit and \nloss, by quarter, during the lease term. As described in paragraph 6.4.200, even \nthough LE will make its lease payments at the end of each year, it accrues its \nlease cost in interim periods based on the amount that is probable for the year. \nYears 4 and 5 are not illustrated because they should, like Year 3, solely reflect \nquarterly recognition of the single lease cost. LE concludes that it is not \nprobable in any of Years 3– 5 that it will owe LR amounts for the year in excess \nof the $142,500 MAG. \nYear 1 \nPeriod YTD sales 5% of YTD \nsales Cumulative \nsingle lease \ncost1 YTD variable \nlease cost2 QTD \nvariable \nlease cost3 \nQ1 Yr 1 $ 700,000 $ 35,000 $ 33,000 $1,500 $1,500 \nQ2 Yr 1 1,300,000 65,000 66,000 1,500 - \nQ3 Yr 1 1,950,000 97,500 99,000 1,500 - \nQ4 Yr 1 2,700,000 135,000 132,000 3,000 1,500 \nNotes: \n1. $132,000 / 4 quarters = $33,000. \n2. Equals the pro rata amount probable LE will owe above the Year 1 MAG for the entire \nyear (e.g. at the end of Q2). The following facts are relevant to how LE recognizes the \n$3,000 during the quarterly periods. \n— At lease commencement, LE concludes it is not probable that it will owe LR amounts in excess of the $132,000 Year 1 MAG. \n— Based on better than expected Q1 sales, at the end of Q1, LE concludes it is probable that it will owe $6,000 in addition to the $132,000 MAG (or $138,000 \ntotal). \n— After Q2 sales that are substantially weaker than Q1, LE concludes it is no longer \nprobable that it will owe amounts above the $132,000 MAG. However, in \naccordance with paragraph 842 -20-55-2, the $1,500 accrued in Q1 is not reversed \nin Q2 or Q3 because it is not probable that it will not be owed. \n— It is not until Q4 that LE again concludes that it is probable that it will owe in excess of the $132,000 Year 1 MAG. \n3. The amount necessary for the YTD variable lease cost to equal the appropriate pro \nrata portion of the amount LE concludes it is probabl e that it will owe above the MAG \nat the end of the year . The corresponding credit to each of these amounts is an \naccrued liability for the variable lease payment that will be paid at the end of the year. \nYear 2 \nPeriod YTD sales 5% of YTD \nsales Cumulative \nsingle lease \ncost1 YTD variable \nlease cost2 QTD variable \nlease cost3 \nQ1 Yr 2 $ 650,000 $ 32,500 $ 33,750 $ - $ - \nQ2 Yr 2 1,400,000 70,000 67,500 2,500 2,500 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 542}), Document(page\_content='Leases 542 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Period YTD sales 5% of YTD \nsales Cumulative \nsingle lease \ncost1 YTD variable \nlease cost2 QTD variable \nlease cost3 \nQ3 Yr 2 2,100,000 105,000 101,250 3,750 1,250 \nQ4 Yr 2 2,850,000 142,500 135,000 7,500 3,750 \nNotes: \n1. $135,000 / 4 quarters = $33,750. \n2. Equals the pro rata amount probable LE will owe for the entire year (e.g. at the end of \nQ2). The following facts are relevant to how LE recognizes the $142,500 during the \nquarterly periods . \n— At the beginning of Year 1, LE concludes it is not probable that it will owe LR \namounts in excess of the $135,000 Year 2 MAG; LE estimates that Year 2 sales \nwill be consistent with Year 1. \n— After Q2 sales that are substantially stronger than Q1 and consider ation of other \nfactors, LE concludes it is probable that it will owe amounts above the $135,000 \nMAG. LE concludes it is probable that sales in the second half of Year 2 will at \nleast equal those in the first half of the year, which would result in LE owing \n$140,000 to LR in Year 2. Consequently, as of the end of Q2, LE has recognized \n$2,500 in variable lease cost ([$140,000 − $135,000] / 4 quarters × 2 quarters \nlapsed). \n— It is not until Q4’s sales that LE concludes that it is probable that it will owe in \nexcess of the $140,000 for all of Year 2. \n3. The amount necessary for the YTD variable lease cost to equal the appropriate pro rata \nportion of the amount LE concludes it is probable that it will owe above the MAG at \nthe end of the year . The corresponding cred it to each of these amounts is an accrued \nliability for the variable lease payment that will be paid at the end of the year. \nYear 3 \nPeriod YTD sales 5% of YTD \nsales Cumulative \nsingle lease \ncost1 YTD variable \nlease cost2 QTD variable \nlease cost3 \nQ1 Yr 3 $ 650,000 $ 32,500 $ 35,625 $- $- \nQ2 Yr 3 1,300,000 65,000 71,250 - - \nQ3 Yr 3 2,000,000 100,000 106,875 - - \nQ4 Yr 3 2,750,000 137,500 142,500 - - \nNotes: \n1. $142,500 / 4 quarters = $35,625. \n2. Equals the pro rata amount probable LE will owe for the entire year (e.g. at the end of \nQ2). In Year 3, LE never concludes it is probable that it will owe an amount above the \nYear 3 MAG. \n3. The amount necessary for the YTD variable lease cost to equal the appropriate pro-\nrata portion of the amount LE concludes it is probable that it will owe above the MAG at the end of the year . The corresponding credit to each of these amounts is an \naccrued liability for the variable lease payment that will be paid at the end of the year. \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 543}), Document(page\_content='Leases 543 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 6.6.80 \nContingent lease incentives \nShould a lessee remeasure the lease for a lease incentive that \nis paid or becomes payable to the lessee after the \ncommencement date upon the resolution of a contingency? \nBackground: Lessors will often offer lease incentives that are contingent on \nfuture ev ents or lessee actions. For example, lessors will often offer to \nreimburse lessees for all or a portion of the cost of leasehold improvements. To \nreceive the reimbursement, the lessee must construct or install the leasehold \nimprovements and provide evidenc e of the costs incurred. This may result in a \none-time incentive that occurs at a specified point in time after lease \ncommencement or may involve multiple payments made during the lease term \nwhen the lessee incurs incremental leasehold improvement costs – e.g. a \npayment to the lessee or a reduction of rent each year that the lessee incurs \nleasehold improvement costs above a specified amount. \nInterpretive response: It depends. Because Topic 842 does not specifically \naddress how a lessee should account for contingent lease incentives that are not paid or payable at lease commencement, we believe there may be more than one acceptable approach to accounting for a contingent lease incentive. \nChange in lease payments \nWe believe one acceptable approach is to account for any lease incentive that \nbecomes paid or payable to the lessee after the commencement date as a \nchange (i.e. a reduction) in the lease payments. Under this approach, the \nresolution of the contingency that reduces the lease payments – whether the \nincentive is or will be paid to the lessee, or realized through a reduction in future \npayments from the lessee to the lessor – is accounted for in the same manner \nas any other change in the lease payments resulting from the resolution of a contingency. Accordi ngly, the lessee would follow the guidance that requires it \nto remeasure the lease liability to reflect a change in the lease payments. \n[842- 20-35-4] \nAs described in paragraph 6.6.170 and illustrated in Example 6.6. 70, this means \nthat the change in the lea se liability will be accounted for prospectively as an \nadjustment to the carrying amount of the ROU asset – i.e. unless the amount of \nthe remeasurement would reduce the carrying amount of the ROU asset to an \namount less than zero. \nEstimation at lease comme ncement \nWe believe another approach is also acceptable if the occurrence of the future \nevent(s) on which the lease incentive is contingent is (1) probable and (2) within \nthe lessee’s control – e.g. the lessee is constructing leasehold improvements. \nWhen both those conditions are met at lease commencement, we believe it is \nacceptable for the lessee to estimate the lease incentives to which it is \nprobable to be entitled at lease commencement and include such amounts in \nthe lease payments. In that case, the l essee actually becoming entitled to \nreceive those incentives (e.g. when the probable event within the control of the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 544}), Document(page\_content='Leases 544 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. lessee occurs) does not result in a change to the lease payments, and therefore \ndoes not require remeasurement of the lease. However, if the estimated lease \nincentives are not received (e.g. because the lessee ultimately does not \nbecome entitled to receive them), or the lessee becomes entitled to receive \nadditional incentives that were not previously estimated, that would be \naccounted for as a change in the lease payments (i.e. consistent with the \nfirst approach). \nOther approaches \nOther approaches also may be acceptable depending on the facts and circumstances. \nWe believe the approach selected by a lessee or lessor is an accounting policy choice that should be applied consistently to similar facts and circumstances. \n \n Question 6.6.90 \nContingent lease incentives (receivable) that exceed \nthe carrying amount of the ROU asset (lease \nliability) \nHow should a lessee account for contingent lease incentives \n(receivable) that exceed the carrying amount of the ROU asset (lease liability)? \nBackground: Guidance in section 6.3 discusses the accounting when: \n— unpaid lease incentives receivable would reduce the carrying amount of the \nlease liability below zero (Question 6.3.14); and \n— the amount to be recorded for a lease incentive exceeds the carrying \namount of the ROU asset (Question 6.3.15). \nInterpretive response: See Questions 6.3.14 and 6.3.15. We believe the \nguidance in those questions applies equally to contingent lease incentives, \nwhich may be recorded before they are received or become receivable from the lessor if the lessee has elected the ‘estimation at lease commencement’ \napproach (see Question 6.6. 80). \n \n Question 6.6.100 \nVariable lease payment ‘holidays’ \nHow should a lessee account for a variable lease payment \n‘holiday’ in an operating lease ? \nBackground: In some operating leases where the rental payments are entirely \nvariable (e.g. based on a percentage of sales in the c ase of a retail or restaurant \noutlet), as an incentive to enter into the lease, the lessor waives the variable \nrent payments either (1) for a specified period of time – e.g. first three months \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 545}), Document(page\_content='Leases 545 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. of the lease or (2) up to a specified amount – e.g. on the firs t $1,000,000 in \nsales to which the variable rent provision would otherwise apply. \nThe question arises as to whether the ‘free rent’ should be treated as a lease \nincentive and recognized as a reduction to operating lease cost (consistent with \nQuestion 6.6. 90), or instead should result in no rent expense being recognized \nduring the free rent period or until the waived amount is exceeded. \nInterpretive response: We believe in lease scenarios like those described in \nthe background, Topic 842 supports two approa ches, either of which we will \naccept if applied consistently to similar circumstances. Example 6.6. 40 \nillustrates both approaches. \nApproach 1: Recognize waived rent as an incentive over the lease term \nUnder this approach, variable lease cost is theoretical ly incurred (i.e. recognized) \nand simultaneously waived, with the waived amount being recognized as a \nlease incentive. The lease is remeasured at that time as the variable incentive \n(i.e. variable negative lease payment) becomes fixed – i.e. as the contingency \naround the incentive is resolved. \nIn some cases, the incentive is earned based on actions outside of the control \nof the lessee – e.g. third- party customers making purchases (illustrated in \nExample 6.6. 40). In such cases, the lessee is not permitted t o apply the \n‘estimation at lease commencement’ approach to the waived rent incentive \neven if it i s probable it will earn the full amount (see Question 6.6. 80). \nApproach 2: Recognize variable lease cost only once the free rent is \nexhausted \nUnder this approach, variable lease cost is not recognized until the obligation for \nthose payments is incurred. Therefore, no variable lease cost is recognized until \nthe incentive is fully used and the lessee has an obligation to make variable lease payments. \n[842- 20-25-6(b)] \nIn the free rent period scenario described in the background, there is no \nobligation to make variable lease payments during the excluded lease periods. \nSimilarly, in the waived rent amount scenario in the background, there is no \nobligation to make variable lease payments until the specified threshold (e.g. \nstore sales) has been exceeded. Although it is probable that the lessee will \nultimately exceed the specified threshold and therefore be required to make \nvariable lease payments, the guidance in paragraph 6.4.200 to accrue amounts \nbefore exceeding the threshold does not apply. This is because the variable \nlease payments to be made after exceeding the threshold are based solely on \nsales above that threshold – i.e. no payments are owed from reaching the \nexempt sales threshold. \nComparing the two approaches \nApproach 2 is simpler to apply because it does not require remeasurement(s) of \nthe lease, and does not requir e ongoing accounting post -remeasurement for a \nlease incentive. However, Approach 1 achieves a more equal distribution of \nlease expense over the lease term; rather than recognizing the effect of the \nfree (or waived) rent entirely at the beginning of the lease term, it recognizes \nthe effect over the entire lease term. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 546}), Document(page\_content='Leases 546 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 6.6.40 \nVariable lease payment holiday \nLessee LE enters into a five- year restaurant space lease with Lessor LR, under \nwhich LE is entitled to free variable rent on its first $1,000,000 in sales in the \nrestaurant. There are no non- lease components of the contract and no other \nlease incentives pr ovided. \nScenario 1: Waived rent recognized as incentive over lease term \nIn Month 1 , sales are $450,000 s o that the waived rent equals $22,500: \n$450,000 × 5%. LE remeasures the lease to account for this now- fixed lease \nincentive, either reducing the ROU ass et or creating a lease incentive liability \n(see Question 6.6. 90) for the portion that does not relate to Month 1. \n— LE recognizes Month 1 lease expense of $22,125: $22,500 – $375 ($22,500 \n/ 60 months). \n— At the e nd of Mont h 1, the corresponding amount is unamortized lease \nincentive : $22,125. \nIn Month 2 , sales are $550,000 s o that waived rent is $27,500: $550,000 × 5%. \nLE again remeasures the lease to account for this waived rent as a fixed lease \nincentive. \n— LE recognizes Month 2 lease expense of $26,659: waived rent ($27,500) \nnet of incenti ve amortization ($841): $375 ($22,500 / 60 months) + $466 \n($27,500 / 59 m onths). \n— At the end of Month 2 , the unamortized waived rent lease incentive is \n$48,784: ($22,500 – [$375 × 2 months ]) + ($27,500 – [$466 × 1 month]) . \nBeginning with Month 3 and for the remainder of the lease, monthly lease \nexpense equals the variable amount incurred, less monthly amortization of the waived rent lease incentive of $841 ($375 + $466). \nScenario 2: Waived lease cost recognized once free rent exhausted \nIn Month 1 and Month 2, LE recognizes no lease expense and does not \nremeasure the lease for the waived variable rent. \nBeginning with Month 3 and for the remainder of the lease, monthly lease expense equals the variable amount incurred. At no time during the lease term \nunder this approach does LE recognize a lease inc entive. \n \n6.6.2 Accounting for a change arising from a reassessment \n Excerpt from ASC 842 -20 \n35 Subsequent Measurement \nGeneral \n> Remeasurement of the Lease Liability \n35-4 After the commencement date , a lessee shall remeasure the lease ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 547}), Document(page\_content='Leases 547 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. liability to reflect changes to the lease payments as described in \nparagraphs 842-10-35-4 through 35- 5. A lessee shall recognize the amount of \nthe remeasurement of the lease liability as an adjustment to the right -of-use \nasset . However, if the carrying amount of the right -of-use asset is reduced to \nzero, a lessee shall recognize any remaining amount of the remeasurement in \nprofit or loss. \n35-5 If there is a remeasurement of the lease liability in accordance with \nparagraph 842- 20-35-4, the lessee shall update the discount rate for the lease \nat the date of remeasurement on the basis of the remaining lease term and \nthe remaining lease payments unless the remeasurement of the lease liability \nis the result of one of the following: \na. A cha nge in the lease term or the assessment of whether the lessee will \nexercise an option to purchase the underlying asset and the discount rate \nfor the lease already reflects that the lessee has an option to extend or \nterminate the lease or to purchase the un derlying asset. \nb. A change in amounts probable of being owed by the lessee under a \nresidual value guarantee (see paragraph 842- 10-35-4(c)(3)). \nc. A change in the lease payments resulting from the resolution of a \ncontingency upon which some or all of the varia ble lease payments that \nwill be paid over the remainder of the lease term are based (see \nparagraph 842-10-35-4(b)). \n35-6 See Examples 3 and 4 (paragraphs 842- 20-55-21 through 55- 46) for an \nillustration of the requirements on lessee subsequent measurement. \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance \n>> Illustrations of Lessee Recognition, Measurement, and \nReassessment of the Lease Term \n55-21 Example 3 illustrates how a lessee would initially and subsequently \nmeasure right -of-use assets and lease liabilities and how a lessee would \naccount f or a change in the lease term. \n>>> Example 3— Initial and Subsequent Measurement by a Lessee and \nAccounting for a Change in the Lease Term \n>>>> Case A —Initial and Subsequent Measurement of the Right -of-Use \nAsset and the Lease Liability \n55-22 Lessee enters into a 10- year lease of an asset, with an option to extend \nfor an additional 5 years. Lease payments are $50,000 per year during the initia l \nterm and $55,000 per year during the optional period, all payable at the \nbeginning of each year. Lessee incurs initial direct costs of $15,000. \n55-23 At the commencement date, Lessee concludes that it is not reasonably \ncertain to exercise the option to extend the lease and, therefore, determines \nthe lease term to be 10 years. \n55-24 The rate implicit in the lease is not readily determinable. Lessee’s \nincremental borrowing rate is 5.87 percent, which reflects the fixed rate at ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 548}), Document(page\_content='Leases 548 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. which Lessee could borrow a similar amount in the same currency, for the \nsame term, and with similar collatera l as in the lease at the commencement \ndate. \n55-25 At the commencement date, Lessee makes the lease payment for the \nfirst year, incurs initial direct costs, and measures the lease liability at the \npresent value of the remaining 9 payments of $50,000, discounted at the rate \nof 5.87 percent, which is $342,017. Lessee also measures a right -of-use asset \nof $407,017 (the initial measurement of the lease liability plus the initial direct \ncosts and the lease payment for the first year). \n55-26 During the first year of the lease, Lessee recognizes lease expense \ndepending on how the lease is classified. Paragraphs 842- 20-55-27 through 55 -\n30 illustrate the lease expense depending on whether the lease is classified as \na finance lease or as an operating lease. \n>>>>> If the Lease Is Classified as a Finance Lease \n55-27 Lessee depreciates its owned assets on a straight -line basis. Therefore, \nthe right -of-use asset would be amortized on a straight -line basis over the \n10-year lease term. The lease liability is increased to reflect the Year 1 interest \non the lease liability in accordance with the interest method. As such, in Year 1 \nof the lease, Lessee recognizes the amortization expense of $40,702 \n($407,017 ÷ 10) and the interest expense of $20,076 (5.87% × $342,017). \n55-28 At the end of the first year of the lease, the carrying amount of Lessee’s \nlease liability is $362,093 ($342,017 + $20,076), and the carrying amount of the \nright-of-use asset is $366,315 ($407,017 – $40,702). \n>>>>> If the Lease Is Classified as an O perating Lease \n55-29 Lessee determines the cost of the lease to be $515,000 (sum of the \nlease payments for the lease term and initial direct costs incurred by Lessee). \nThe annual lease expense to be recognized is therefore $51,500 ($515,000 ÷ \n10 years). \n55-30 At the end of the first year of the lease, the carrying amount of Lessee’s \nlease liability is $362,093 ($342,017 + $20,076), and the carrying amount of the \nright-of-use asset is $375,593 (the carrying amount of the lease liability plus the \nremaining initial direct costs, which equal $13,500). \n>>>> Case B —Accounting for a Change in the Lease Term \n55-31 At the end of Year 6 of the lease, Lessee makes significant leasehold \nimprovements. Those improvements are expected to have significant \neconomic v alue for Lessee at the end of the original lease term of 10 years. \nThe improvements result in the underlying asset having greater utility to \nLessee than alternative assets that could be leased for a similar amount and \nthat are expected to have significant economic life beyond the original lease \nterm. Consequently, construction of the leasehold improvements is deemed a \nsignificant event or significant change in circumstances that directly affects \nwhether Lessee is reasonably certain to exercise the option to extend the \nlease and triggers a reassessment of the lease term. Upon reassessing the \nlease term, at the end of Year 6, Lessee concludes that it is reasonably certain \nto exercise the option to extend the lease for five years. Taking into \nconsideration the extended remaining lease term, Lessee’s incremental \nborrowing rate at the end of Year 6 is 7.83 percent. As a result of Lessee’s ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 549}), Document(page\_content='Leases 549 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. remeasuring the remaining lease term to nine years, Lessee also would \nremeasure any variable lease payments that depend on an i ndex or a rate; \nhowever, in this Example, there are no variable lease payments that depend on \nan index or a rate. In accordance with paragraph 842- 10-25-1, Lessee \nreassesses the lease classification as a result of the change in the lease term. \nAssume for p urposes of this Example that the reassessment does not \nchange the classification of the lease from that determined at the \ncommencement date. \n55-32 At the end of Year 6, before accounting for the change in the lease term, \nthe lease liability is $183,973 (pr esent value of 4 remaining payments of \n$50,000, discounted at the rate of 5.87 percent). Lessee’s right -of-use asset is \n$162,807 if the lease is classified as a finance lease or $189,973 if the lease is \nclassified as an operating lease (the balance of the remeasured lease liability at \nthe end of Year 6 plus the remaining initial direct costs of $6,000). \n55-33 Lessee remeasures the lease liability, which is now equal to the present \nvalue of 4 payments of $50,000 followed by 5 payments of $55,000, all \ndiscounted at the rate of 7.83 percent, which is $355,189. Lessee increases \nthe lease liability by $171,216, representing the difference between the \nremeasured liability and its current carrying amount ($355,189 – $183,973). The \ncorresponding adjustment is made t o the right -of-use asset to reflect the cost \nof the additional rights. \n55-34 Following the adjustment, the carrying amount of Lessee’s right -of-use \nasset is $334,023 if the lease is a finance lease (that is, $162,807 + $171,216) \nor $361,189 if the lease is an operating lease (that is, $189,973 + $171,216). \n55-35 Lessee then makes the $50,000 lease payment for Year 7, reducing the \nlease liability to $305,189 ($355,189 – $50,000), regardless of how the lease is \nclassified. \n55-36 Lessee recognizes lease expense in Year 7 as follows, depending on \nhow the lease had been classified at the commencement date. \n>>>>> If the Lease Is Classified as a Finance Lease at the \nCommencement Date \n55-37 Lessee depreciates its owned assets on a straight -line basis. Therefore, \nthe right -of-use asset will be amortized on a straight -line basis over the lease \nterm. The lease liability will be reduced in accordance with the interest \nmethod. As such, in Year 7 (the first year following the remeasurement), \nLessee recognizes am ortization expense of $37,114 ($334,023 ÷ 9) and \ninterest expense of $23,896 (7.83% × $305,189). \n>>>>> If the Lease Is Classified as an Operating Lease at the \nCommencement Date \n55-38 Lessee determines the remaining cost of the lease as the sum of the \nfollowing: \na. The total lease payments, as adjusted for the remeasurement, which is the \nsum of $500,000 (10 payments of $50,000 during the initial lease term) and \n$275,000 (5 payments of $55,000 during the term of the lease extension); \nplus \nb. The total initial direct costs attributable to the lease of $15,000; minus \nc. The periodic lease cost recognize d in prior periods of $309,000. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 550}), Document(page\_content='Leases 550 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 55-39 The amount of the remaining cost of the lease is therefore $481,000 \n($775,000 + $15,000 – $309,000). Consequently, Lessee determines that the \nannual expense to be recognized throughout the remainder of the lease term is \n$53,444 ($481,000 ÷ the remaining le ase term of 9 years). \n \n6.6.120 The discussion, diagram and chart that follows complement the \noverview diagram in paragraph 6.6.10, and deal with remeasurements resulting \nfrom lease reassessments. Lease modifications are discussed in section 6.7. \n6.6.130 The accounting steps a lessee must undertake depend on which of the \nfollowing circumstances requires the lessee to undertak e the remeasurement. \n[842- 10-25-1, 35- 4, 842 -20-35-4 – 35-5] \nChange in \namount \nprobable \nof being owed \nunder RVGChange in lease \ntermResolution of a \ncontingencyChange in \nassessment of \nlessee purchase \noption exercise1 2 3 4\n \n6.6.140 The following diagram summarizes the accounting steps a lessee must \nundertake in each of the above circumstances. \nAccounting steps Circumstance \n 1 2 3 4 \nRemeasure and reallocate the ‘consideration in the \ncontract’ to the remaining lease and non -lease \ncomponents of the contract (see chapter 4).3 \uf0fc \uf0fc \uf0fc \uf0fc \nRemeasure the lease liability to reflect the revised lease \npayments, using a ‘discount rate for the lease’ (see \nsection 5.6) determined at the remeasurement date.1,2 \uf0fc \uf0fc \uf0fb \uf0fb \nRemeasure the lease liability to reflect the revised lease \npayments, using the discount rate for the lease in \neffect immediately before the remeasurement .1 \uf0fb \uf0fb \uf0fc \uf0fc \nAdjust the amount of the ROU asset by the amount of \nthe remeasurement of the lease liabilit y. However, \nonce the ROU asset is reduced to zero, then the \nremaining amount of the lease liability remeasurement \nis recognized in the incom e statement. \uf0fc \uf0fc \uf0fc \uf0fc \nReassess lease classification (see section 6.2) at the \nremeasurement date based on the circumstances at \nthe remeasurement date (e.g. fair value and remaining \neconomic life of the underlying asset at the \nremeasurement date). \uf0fc \uf0fc \uf0fb \uf0fb \nIf there is a change in lease classification (see \nsection 6.2), adjust the remaining lease cost recognition \npattern and presentation in the income statement and \nstatement of cash flows prospectively. \uf0fc \uf0fc \uf0fb \uf0fb ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 551}), Document(page\_content='Leases 551 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Notes: [842- 10-35-5, ASU 2016- 02.BC237] \n1. When a lessee remeasures the lease payments, variable lease payments that depend on \nan index or rate are measured using the index or rate as of the remeasurement date. \n2. The discount rate is not updated for circumstances #1 or #2 if the discount rate for the \nlease already reflects that the lessee has an option to extend or terminate the lease or to \npurchase the underlying asset. \n3. See Question 6.6. 110. \n6.6.150 After the commencement date, a lessee remeasures the lease liability to \nreflect the changes to the lease payments. The lease liability is remeasured using \nan updated discount rate only if the remeasurement is due to a change in the \nlease term or a change in the lessee’s assessment of whether it will exercise an \noption to purchase the underlying asset. If the lease liability is remeasured for another reason, the discount rate is not updated. \n[842- 20-35-4 – 35-5] \n \n Observation \nDiscount rate not updated in all cases \n6.6.160 The Board decided that, in general, an entity should not reassess the \ndiscount rate used to measure the lease liability during the lease term because \nthat is generally consistent with the amortized cost accounting for other, similar \nfinancial liabilities. However, the Board concluded that a change in the lease term or in the assessment of a lessee purchase option represent s a significant \nchange in the economics of the arrangement, and ther efore the discount rate \nfor the lease should be adjusted in those cases. \n[ASU 2016- 02.BC240– BC242] \n6.6.170 A lessee recognizes as an adjustment to the ROU asset the amount of \nremeasurement of the lease liability, unless the carrying amount of the ROU \nasset is reduced to zero (in which case any remaining amount of the \nremeasurement is recognized in net income). This means that , unless the \ncarrying amount of the ROU asset is reduced to zero, the effect of the \nremeasurement in the income statement is prospective. [842- 20-35-4] \n6.6.180 Changes to the carrying amount of the ROU asset as a result of \nrevised assessments of the lease term or lessee purchase options also require \nthe lessee to revise useful life estimates for the ROU asset (and related \nassets, such as leasehold improvements) and amortization expense on a \nprospective basis. \n \n Observation \nChanges to the lease liability generally recognized \nas an adjustment to the ROU asset \n6.6.190 Changes in the lease term or lease payments related to a purchase \noption represent a lessee’s expectation that it has acquired more or les s of the \nright to use the underlying asset, and an adjustment to the ROU asset should \nbe made to appropriately measure the total cost of the revised right of use (i.e. \nthe asset controlled by the lessee) . Meanwhile, changes in estimates of the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 552}), Document(page\_content='Leases 552 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. amount proba ble of being owed under a residual value guarantee and changes \nto the lease payments resulting from the resolution of a contingency reflect \nchanges to the cost of the existing ROU asset. [ASU 2016- 02.BC232, BC238 –BC239] \n \n Question 6.6. 110 \nStand -alone prices to use in remeasurement \nscenarios \nDoes a lessee use stand -alone prices as of the remeasurement \ndate when remeasuring and reallocating the consideration in \nthe contract? \nBackground: Topic 842 requires the lessee to remeasure and reallocate the \nconsideration in the contract to the remaining lease and non- lease components \nof the contract whenever a reassessment results in remeasurement of the \nlease. However, some have asserted Topic 842 does not specify whether the \nlessee does so on the basis of updated (i.e. remeasurement date) stand- alone \nprices. \nInterpretive response: We believe either of the following approaches is \nacceptable if applied consistently: \nApproach 1 : Always use updated stand -alone prices \nUse updated stand- alone prices for the lease and non- lease components, \ndetermined as of the remeasurement date, when remeasuring a lease and reallocating the consideration in the contract to those components as a result of \na reassessment. \nApproach 2 : Decide based on remeasurement type \nWhether to update the stand- alone prices for the lease and non- lease \ncomponents used to reallocate the remeasured consideration in the contract \ndepends on the type of remeasurement. Under this approach: \n— Type A remeasurements. The lessee should use updated stand -alone \nprices (i.e. those as of the remeasurement date) when the remeasurement \nis a result of either a change in: \n— the lease term; or \n— the assessment of whether a lessee is reasonably certain to exercise an option to purchase the underlying asset. \n— Type B remeasurements. The lessee should not use updated stand- alone \nprices if the remeasurement is solely the result of either (1) a change in the \namount probable of being owed under a residual value guarantee, or (2) \nresolution of a contingency that results in variable lease payments \nbecoming fixed. \nTopic 842 differentiates between Type A and Type B remeasurements; the \nformer are intended to create a ‘fresh look’ at the lease based on changed \neconomics, and the latter are intended to merely update a judgment or \nestimate. For example, in the event of a Type A remeasurement, the lessee \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 553}), Document(page\_content='Leases 553 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. revises its discount rate for the lease and reassesses the lease classification, \nbut does neither of those in the event of a Type B remeasurement. \nWe believe the underlying concept that Type A remeasurements reflect a fresh \nlook at the lease extends to the stand- alone prices used to reallocate the \nremeasured consideration in the contract. We believe it would be inconsistent with that logic to continue to use histor ical stand -alone prices. Conversely, the \nBoard’s treatment of Type B remeasurements as changes in a judgment or estimate that do not in effect create a new lease provides support for not \nrevisiting the stand- alone prices of the components. \n \n Question 6.6.115 \nTermination penalties added to lease payments \nfrom lease term reassessment \nShould all or a portion of a termination penalty added to the \nlease payments because of a lease term reassessment be recognized in profit or loss at the remeasurement date ? \nBackground: A termination penalty called for by a lease contract is not included \nin the ‘lease payments’ if the lessee is reasonably certain not to exercise the \ntermination option that would trigger the penalty (see section 5.4.5). \nIf the lessee reassesses, and changes, the lease term so that it no longer \nincludes periods after an optional termination date, any termination penalty \nassociated with terminating the lease at that date becomes part of the lease payments for the lease. \nHad the termination payment been included in the lease payments from \ncommencement, the lessee’s lease cost each period to the remeasurement \ndate would have been greater tha n what was recognized. Recognizing the cost \nof the termination payment over only the shortened revised lease term may \nresult in recognizing lease cost during each of the remaining lease periods that \nis: \n— greater than what was recognized each period pre-reassessment; and/or \n— above market rental rates. \nBecause of this, the question arises as to whether it is appropriate to recognize \nall or a portion of the expected termination payment at the time the lease is \nremeasured for the lease term change. This would allocate a portion of the \ntermination payment to the period(s) of the lease that have already passed as of \nthe remeasurement date. \nInterpretive response: No. The profit or loss effect of the termination penalty \nis taken through lease cost over the remainder of the lease term. Although the \neffects described in the background – principally, inflated lease cost over the \nremaining lease term – might be viewed a s uneconomical, the remeasurement \nmodel in Topic 842 that applies to changes resulting from a reassessment is \nprospective. \nAs outlined in paragraph 6.6.140, changes in the lease liability resulting from changes to the lease payments (which include changes to estimated \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 554}), Document(page\_content='Leases 554 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. termination payments) are recognized with a corresponding and equal \nadjustment to the ROU asset. Profit or loss is recognized only at the \nremeasurement date to the extent that the net ROU asset adjustment would reduce the carrying amount of t he ROU asset below zero. The addition of the \ntermination penalty to the lease payments, which increases the lease liability (and therefore, also the ROU asset) will reduce any net amount recognized to \nprofit or loss from the overall remeasurement. \n[842- 20-35-4] \n \n Example 6.6. 50 \nChange in assessment of the lease term \nAssume the same facts as in Examples 6.3.10 and 6.4.20, in which Lessee LE \nleases office space from Lessor LR. \nAt the end of Year 6, LE constructs leasehold improvements that are expected \nto have significant economic value at the end of the 10 -year lease term, such \nthat it becomes reasonably certain that LE will exercise the five- year \nextension option. Lease payments during the original and the revised lease \nterm are as follows. \nNon-cancellable lease period \nYr 1 Yr 2 Yr 3 Yr 4 Yr 5 Yr 6 Yr 7 Yr 8 Yr 9 Yr 10 Total \n$14,527 $14,963 $15,412 $15,874 $16,350 $16,841 $17,346 $17,866 $18,402 $18,954 $166,535 \nExtension period \nYr 11 Yr 12 Yr 13 Yr 14 Yr 15 Total \n$19,523 $20,109 $20,712 $21,333 $21,973 $103,650 \nRemeasuring the lease liability and ROU asset \nBecause the remeasurement of the lease payments results from a change in the assessment of the lease term, LE is required to use a discount rate for the \nlease determined at the remeasurement date (i.e. at the end of Year 6). The \nrate implicit in the lease is not readily determinable. Accordingly, LE uses its \nincremental borrowing rate at the end of Year 6 (12%) as the discount rate for \nthe remeasured lease, taking into account: \n— a remaining lease term of nine years (four years remaining from the original \nlease term plus the five- year extension period); and \n— the remeasured lease payments for the revised lease term of nine years. \nAt the end of Year 6, the carrying amounts of the lease liability and ROU asset \nimmediately before remeasurement are $57,306 and $53,350, respectively (see Example 6.4.20). \nLE remeasures the lease liability at the present value of the remaining lease \npayments for the revised lease term (i.e. Years 7– 15), discounted at 12%, \nwhich is $102,048 (or an increase of $44,742). LE records the following journal \nentry. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 555}), Document(page\_content='Leases 555 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Debit Credit \nROU asset 44,742 \nLease liability 44,742 \nTo remeasure ROU asset and lease liability \nfollowing reassessment of lease term. \nAfter this journal entry, the carrying amount of LE’s ROU asset is $98,092 \n($53,350 + $44,742). \nLease classification reassessment \nLE is required to reassess the original classification of the lease as an operating \nlease (see Example 6.4.20). The fair value of th e office space has increased \nsince lease commencement to $420,000, while the remaining economic life of \nthe building in which the office space resides is 29 years. Therefore, the reassessed lease is an operating lease. \nAccounting subsequent to remeasuremen t \nLE calculates the remaining lease cost for the lease as follows. \nTotal lease payments (including those paid and those not yet paid), \nreflecting the adjustment resulting from the lease term reassessment – \ni.e. all lease payments in Years 1–15 $270, 186 \nPlus: Total initial direct costs 5,000 \nLess: Periodic lease cost recognized in prior periods (straight -line lease \ncost of $17,154 × 6 years before remeasurement) (102, 924) \nRemaining cost of the lease $172,262 \nLE recognizes a single lease cost, calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight -line basis – i.e. \n$19,140 per year for the remaining nine years. \nLE accounts for the lease liability and the ROU asset after the \nremeasurement using the guidance in Topic 842 for an operating lease, as \nillustrated below (using Method 2 to subsequently measure the ROU asset – \nsee paragraph 6.4.170). \nYear ROU asset amortization ROU asset carrying amount \nLease \nliab. \nbalance Straight -\nline lease \ncost Lease \nliab. \naccret. ROU \nasset \namort. Beg. \nbalance ROU \nasset \namort. End. \nbalance \n7 $19,140 $(12,246) $ 6,894 $98,092 $ (6,894) $91,198 $96,948 \n8 19,140 (11,634) 7,506 91,198 (7,506) 83,692 90,716 \n9 19,140 (10,886) 8,254 83,692 (8,254) 75,438 83,200 \n10 19,140 (9,984) 9,156 75,438 (9,156) 66,282 74,230 \n11 19,140 (8,908) 10,232 66,282 (10,232) 56,050 63,615 \n12 19,140 (7,634) 11,506 56,050 (11,506) 44,544 51,140 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 556}), Document(page\_content='Leases 556 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Year ROU asset amortization ROU asset carrying amount \nLease \nliab. \nbalance Straight -\nline lease \ncost Lease \nliab. \naccret. ROU \nasset \namort. Beg. \nbalance ROU \nasset \namort. End. \nbalance \n13 19,140 (6,137) 13,003 44,544 (13,003) 31,541 36,565 \n14 19,141 (4,388) 14,753 31,541 (14,753) 16,788 19,620 \n15 19,141 (2,353) 16,788 16,788 (16,788) - - \n \n \n Question 6.6.120 \nImpaired operating lease ROU asset amortization \npost -remeasurement \nShould a lessee continue to amortize an impaired operating \nlease ROU asset on a straight -line basis if it is remeasured \nafter the impairment ? \nBackground : Paragraphs 6.5.40 and 6.5.50 outline that after an operating lease \nROU asset is impaired: [842- 20-25-7, 35- 10] \n— the ROU asset is generally amortized on a straight -line basis from the \nimpairment date; and \n— the sing le lease cost for the operating lease will be front -loaded, calculated \nas the sum of the straight -line ROU asset amortization and the effective \ninterest method accretion of the lease liability. \nAfter it has been impaired, an operating lease ROU asset might be remeasured \n– e.g. because of a change in the lease term, the assessment of a lessee \npurchase option or the lease payments. In this case, a question arises about \nwhether the requirement to amortize the ROU asset on a straight -line basis, \nand therefore t he requirement to recognize a front -loaded single lease cost, \ncontinues after the remeasurement. \nInterpretive response: Yes. We believe the ROU asset should continue to be \namortized on a straight -line basis. The subsequent measurement guidance for \nimpaired operating lease ROU assets outlined in the background does not \ninclude a provision for a return to pre- impairment accounting. \nAdditionally, in requiring straight -line amortization post -impairment, the FASB \nconcluded that after the ROU asset is impaired, “the link that many perceive \nbetween the economic benefits to be derived from the lease and the lease \npayments, and reference in support of a single, generally straight -line lease cost \nfor operating leases, is effectively ‘broken’ after the right -of use ass et is \nimpaired because the lessee will no longer obtain future economic benefits \nfrom the lease equal to (or greater than) the payments it is required to make to \nthe lessor. In other words, the lease payments no longer have any direct \ncorrelation to the ec onomic benefits the lessee is able to derive from the lease \nbut, instead, represent a liability reflective of a past expectation of economic \nbenefits that could be derived from the lease.” [ASU 2016- 02.BC259(a) ] \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 557}), Document(page\_content='Leases 557 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. After a remeasurement, the ‘link’ referred to by the FASB is not re- established. \nThe carrying amount of the ROU asset, which reflects the economic benefits to \nbe derived from the lease, will remain uncorrelated to the lease payments. \nExample 6.6. 60 illustrates a lessee’s accounting for an operating lease that is \nremeasured after an ROU asset impairment. \n \n Example 6.6.60 \nLease remeasurement post -impairment \nAssume the same facts as in Examples 6.3.10 and 6.5.20, in which Lessee LE \nleases office space from Lessor LR and incurs an impairment charge in Year 2 \nof the lease. \nAt the end of Year 6, a lease term reassessment triggering event occurs. On \nreassessment, LE concludes it is reasonably certain to exercise the available \nfive-year extension option. \nLease payments during the original and the revised lease term are as follows. \nOriginal 10 -year lease term \nYr 1 Yr 2 Yr 3 Yr 4 Yr 5 Yr 6 Yr 7 Yr 8 Yr 9 Yr 10 Total \n$14,527 $14,963 $15,412 $15,874 $16,350 $16,841 $17,346 $17,866 $18,402 $18,954 $166,535 \nExtension period \nYr 11 Yr 12 Yr 13 Yr 14 Yr 15 Total \n$19,523 $20,109 $20,712 $21,333 $21,973 $103,650 \nAccounting before remeasurement \nBecause of the impairment in Year 2, the ROU asset carrying amount was \nreduced by $10,000. After the impairment, LE began amortizing the ROU asset \non a straight -line basis over the remaining original lease term. The following \ntable reflects LE’s accounting for the lease through the end of Year 6 (which is \nthe same LE accounting through Year 6 as in Exampl e 6.5.20). \nYr.. ROU asset carrying amount Lease \nliability Income statement2 \nBeg. \nbalance ROU \nasset \namort. Impair. \ncharge End. \nbalance Carry. \namt. \n(end. \nbalance)1 Accret. ROU \nasset \namort. Single \nlease \ncost Impair. \ncharge \n1 $105,000 $ (7,154) $ - $97,846 $95,473 $10,000 $ 7,154 $17,154 $ - \n2 97,846 (7,607) (10,000) 80,239 90,057 9,547 7,607 17,154 10,000 \n3 80,239 (10,030) - 70,209 83,651 9,006 10,030 19,036 - \n4 70,209 (10,030) - 60,179 76,142 8,365 10,030 18,395 - \n5 60,179 (10,030) - 50,149 67,406 7,614 10,030 17,644 - \n6 50,149 (10,030) - 40,119 57,306 6,741 10,030 16,771 - ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 558}), Document(page\_content='Leases 558 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. At the end of Year 6, the carrying amounts of the lease liability and ROU asset \nare $57,306 and $40,119, respectively. \nAccounting for the remeasurement \nBecause the remeasurement of the lease payments results from a change in \nthe assessment of the lease term, LE is required to use a discount rate for the lease determined at the remeasurement date (i.e. at the end of Year 6). \nThe rate implicit in the lease is not readily determinable. Accordingly, LE uses its incremental borrowing rate at the end of Year 6 (12%), taking into account: \n— a remaining lease term of nine years (four years remai ning from the original \nlease term plus the five- year extension period); and \n— the remeasured lease payments for the revised lease term of nine years. \nLE remeasures the lease liability at the present value of the remaining lease \npayments for the revised lease term (i.e. Years 7– 15), discounted at 12%, \nwhich is $102,048 (or an increase of $44,742). LE records the following journal entry. \n Debit Credit \nROU asset 44,742 \nLease liability 44,742 \nTo remeasure ROU asset and lease liability \nfollowing reassessment of lease term. \nAfter this journal entry, the carrying amount of LE’s ROU asset is $84,861 \n($40,119 + $44,742). \nAccounting post -remeasurement \nLE continues to amortize the ROU asset on a straight -line basis, consistent with \nhow it was being amortized before the remeasurement. \nPost-remeasurement ROU asset straight -line amortization is calculated as \nfollows. \nROU asset carrying amount pre- remeasurement $40,119 \nIncrease to ROU asset from remeasurement 44,742 \nRemeasured ROU asset balance $84,861 \nRemaining years in lease term 9 \nAnnual straight -line amortization $(9,429) \nThe ROU asset will be amortized at $9,429 per year for the remaining 9- year \nlease term. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 559}), Document(page\_content='Leases 559 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The following table shows the accounting for the lease after the \nremeasurement. \nYear ROU asset carrying amount Lease \nliability Income statement \nBeg. \nbalance ROU \nasset \namort. Impair. \ncharge End. \nbalance Carry. \namt. (end. \nbalance) Accret. ROU \nasset \namort. Single \nlease cost \n7 $84,861 $(9,429) $ - $75,432 $96,948 $12,246 $9,429 $21,675 \n8 75,432 (9,429) - 66,003 90,716 11,634 9,429 21,063 \n9 66,003 (9,429) - 56,574 83,200 10,886 9,429 20,315 \n10 56,574 (9,429) - 47,145 74,230 9,984 9,429 19,413 \n11 47,145 (9,429) - 37,716 63,615 8,908 9,429 18,337 \n12 37,716 (9,429) - 28,287 51,139 7,635 9,429 17,064 \n13 28,287 (9,429) - 18,858 36,564 6,137 9,429 15,566 \n14 18,858 (9,429) - 9,429 19,619 4,388 9,429 13,817 \n15 9,429 (9,429) - - - 2,352 9,429 11,781 \n \n \n Example 6.6.70 \nResolution of contingency on which payments are \nbased \nLessee LE leases long- lived equipment (operating lease) to be used in its \nproduction process for a lease term of five years. The following facts are relevant at lease commencement. \nLease payments: Fixed payments of $1,000 per year (in arrears) \nplus $2 each hour that the equipment is used \nRenewal/termination/purchase options: None \nTransfer of ownership: No \nLE’s incremental borrowing rate: 5% (implicit rate cannot be readily determined) \nInitial direct costs: None \nLease incentives: None \nIn addition, the lease contains a clause specifying that the payments will become fixed at $2,500 per year for the remainder of the contract if the \nequipment is used more than 600 hours in Year 1. \nAt lease commencement, LE determines that the total cost for the lease is \n$5,000 ($1,000 × 5 payments). The variable payments that will be made by LE \nare variabl e lease payments. LE measures the lease liability based on the \npresent value of the lease payments, discounted at 5%, which is $4,329. \nBecause there are no initial direct costs or lease incentives, the initial \nmeasurement of the ROU asset is equal to the i nitial measurement of the lease \nliability, $4,329. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 560}), Document(page\_content='Leases 560 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. LE uses the equipment for 675 hours during Year 1. Accordingly, LE’s straight -\nline operating lease cost is $1,000, but LE also incurs variable lease cost of \n$1,350 ($2 × 675 hours) . The carrying amount of the lease liability and the ROU \nasset at the end of Year 1 is $3,545. \nBecause Year 1 usage of the equipment exceeded 600 hours, the payments \ncontingent on use of the equipment become fixed at $1,500 for the remaining lease term. Accordingly, LE remeasures the lease liability, considering four \nremaining lease payments of $2,500 ($1,000 original fixed annual payment + \n$1,500 additional amount that becomes fixed for the remaining four years of the \nlease upon resolution of the contingency), discounted at 5%, wh ich results in a \nrevised lease liability balance of $8,865 (an increase of $5,320). \nLE does not update the discount rate for the lease in remeasuring the lease \nliability because the remeasurement relates to the resolution of a contingency \non which payments for use of the equipment were based. \nLE records the following journal entry at the end of Year 1. \n Debit Credit \nROU asset 5,320 \nLease liability 5,320 \nTo remeasure ROU asset and lease liability \nfollowing resolution of contingency. \nLE does not reassess lease classification because the remeasurement is not \nthe result of a change in the assessment of the lease term, a change in the \nassessment of a lessee purchase option or a lease modification. \nLE calculates the remaining cost of the leas e as follows. \nTotal lease payments (including those paid and those not yet paid), \nreflecting the adjustment resulting from resolution of the contingency – \ni.e. $1,000 for Year 1 and $2,500 thereafter $11,000 \nPlus: Total initial direct costs attributable to the lease - \nLess: Periodic lease cost recognized in prior periods (1,000) \nRemaining lease cost $10,000 \nLE will recognize a single lease cost, calculated so that the remaining lease cost is allocated over the remaining lease term on a straight -line basis – i.e. $2,500 \nper year for each of the remaining four years. \nLE will account for the lease liability and ROU asset from the effective date of \nthe remeasurement using the guidance in Topic 842 for an operating lease, as illustrated below. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 561}), Document(page\_content='Leases 561 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Year ROU asset amortization ROU asset carrying amount \nLease \nliab. \nbalance Straight -\nline lease \ncost Lease \nliab. \naccret. ROU \nasset \namort. Beg. \nbalance ROU \nasset \namort. End. \nbalance \n2 $2,500 $(443) $2,057 $8,865 $(2,057) $6,808 $6,808 \n3 2,500 (340) 2,160 6,808 (2,160) 4,648 4,648 \n4 2,500 (232) 2,268 4,648 (2,268) 2,380 2,380 \n5 2,500 (120) 2,380 2,380 (2,380) - - \n \n \n Example 6.6.80 \nVariable lease payments indexed to CPI \nLessee LE enters into a lease of a building for a five- year term with a two -year \nextension option. At lease commencement, LE does not consider exercise of \nthe extension option to be reasonably certain. \nLE’s base payment under the lease is $100,000 per year (paid in arrears). The \nbase payment will be adjusted each year by the change in CPI after the lease \ncommencement date. The CPI index value at lease commencement is 196.800. \nLE incurs no initial direct costs to enter into the lease, does not prepay any lease payments and does not receive any lease incentives. \nLE cannot readily determine the rate implicit in the lease. Therefore, LE’s \nincremental borrowing rate, which is 6% at lease commencement, is the \ndiscount rate for the lease. \nThe lease is classified as an operating lease. LE initially measures the lease liability as the present value of $100,000 per year for five years, discounted at \n6%. The $100,000 initial payment already reflects the CPI index at the lease \ncommencement date. \nScenario 1: Lease is not modified and lease li ability is not remeasured \nThe following chart summarizes LE’s accounting for the lease assuming that \nthere is no remeasurement of the lease liability and no lease modification. The \nchart assumes that the actual outcomes during the lease term (CPI index) ar e \nknown by LE at lease commencement. \nYear Base \npmts. CPI \nindex Actual \npmts. End. \nROU \nasset End. \nlease \nliab. Single lease cost \nVariable \nlease \ncost Total \nlease \ncost ROU \nasset \namort. Lease \nliab. \naccret. Single \nlease \ncost \n0 $ - 196.800 $ - $421,236 $421,236 $ - $ - $ - $ - $ - \n1 100,000 201.800 102,541 346,510 346,510 74,726 25,274 100,000 2,541 102,541 \n2 100,000 210.036 106,726 267,301 267,301 79,209 20,791 100,000 6,726 106,726 \n3 100,000 210.228 106,823 183,339 183,339 83,962 16,038 100,000 6,823 106,823 \n4 100,000 215.949 109,730 94,339 94,339 89,000 11,000 100,000 9,730 109,730 \n5 100,000 219.179 111,371 - - 94,339 5,661 100,000 11,371 111,371 \n $500,000 $537,191 $421,236 $78,764 $500,000 $37,191 $537,191 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 562}), Document(page\_content='Leases 562 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Scenario 2: Lease liability is remeasured at the end of Year 3 \nAssume the same facts as in Scenario 1, except that at the end of Year 3, LE \nconstructs leasehold improvements that will have significant economic value to \nLE at the end of the original five- year lease term. Because of this triggering \nevent, LE reassesses the lease term, determining it is now reasonably certain \nto exercise the two- year extens ion option. That is, at the end of Year 3, LE \nreassesses the remaining lease term to be four years (two years remaining \nfrom the original lease term plus the two- year extension period). \nAccordingly, LE remeasures the lease liability based on a revised disc ount rate \nfor the lease at the remeasurement date and updated lease payments for the \nrevised lease term. And because the lease payments are remeasured for a \nchange in the lease term, LE also remeasures the variable lease payments \nbased on CPI using the CPI index at the remeasurement date, which is \n210.228. LE’s incremental borrowing rate at the end of Year 3 is 7%, taking into consideration the remaining, revised lease term and the updated lease \npayments. \nThe remeasured lease liability is $361,832 (four payments of $106,823 discounted at 7%). \nLE reassesses the lease classification, based on the facts and circumstances as \nof the reassessment date, and determines that the lease is still an operating \nlease. \nLE calculates the remaining cost for the leas e as follows. \nTotal lease payments (including those paid and those not yet paid), \nreflecting the adjustment resulting from the remeasurement – i.e. \n$100,000 for the first 3 years and $106,823 for the 4 remaining years $ 727,292 \nPlus: Total initial direct costs attributable to the lease - \nLess: Periodic lease cost recognized in prior periods (300,000) \nRemaining lease cost for the lease $ 427,292 \nLE will recognize a single lease cost, calculated so that the remaining cost of \nthe lease is allocated over the remaining lease term on a straight -line basis – i.e. \n$106,823 per year for each of the remaining four years. \nThe following chart summarizes LE’s accounting for the lease before and after \nthe remeasurement. The chart assumes that the actual outcomes during the \nlease term (CPI index) are known by LE at lease commencement. \n Single lease cost \nYear Base \npmts. CPI \nindex Actual \npmts. End. \nROU \nasset End. \nlease \nliab. ROU \nasset \namort. Lease \nliab. \naccret. Single \nlease \ncost Variable \nlease \ncost Total \nlease \ncost \n0 $ - 196.800 $ - $421,236 $421,236 $ - $ - $ - $ - $ - \n1 100,000 201.800 102,541 346,510 346,510 74,726 25,274 100,000 2,541 102,541 \n2 100,000 210.036 106,726 267,301 267,301 79,209 20,791 100,000 6,726 106,726 \n3 100,000 210.228 106,823 183,339 183,339 83,962 16,038 100,000 6,823 106,823 \nRemeasurement of lease liability and \nROU asset 361,832 361,832 \n4 106,823 215.949 109,730 280,337 280,337 81,495 25,328 106,823 2,907 109,730 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 563}), Document(page\_content='Leases 563 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Single lease cost \nYear Base \npmts. CPI \nindex Actual \npmts. End. \nROU \nasset End. \nlease \nliab. ROU \nasset \namort. Lease \nliab. \naccret. Single \nlease \ncost Variable \nlease \ncost Total \nlease \ncost \n5 106,823 219.179 111,371 193,138 193,138 87,199 19,624 106,823 4,548 111,371 \n6 106,823 222.454 113,036 99,835 99,835 93,303 13,520 106,823 6,213 113,036 \n7 106,823 224.765 114,210 - - 99,835 6,988 106,823 7,387 114,210 \n $727,292 $764,437 $599,729 $127,563 $727,292 $37,145 $764,437 \n \n \n Example 6.6.90 \nRemeasurement and reallocation of the \nconsideration in the contract \nOriginal lease \nLessee LE leases a machine from Lessor LR for three years. As part of the \ncontract, LR will maintain the machine for LE. The following facts about the \nunderlying lease (an operating lease, properly classified) are relevant at the lease commencement date. \nFixed payments: Fixed payments of $120,000 per year \n(paid in arrears) \nTransfer of ownership: No \nOptions: A single two- year extension option, not \nreasonably certain of exercise at lease \ncommencement \nFair value of machine: $600,000 \nRemaining economic life of machine: 8 years \nRVG: The first $50,000 that the residual value is \nbelow $350,000 \nIf the extension option is exercised, the first \n$50,000 that the residual value is below \n$220,000 \nAmount probable of being owed \nunder the RVG: $18,000 \nLE’s incremental borrowing rate: 7% (implicit rate can not be readily determined) \nBased on the information above, the consideration in the contract is $378,000. \nFixed payments: $360,000 ($120,000 × 3 years) \nAmount probable of being owed under the RVG : $18,000 \nLE concludes that the contract has two components, the machine lease and the \n(non- lease) machine maintenance, and allocates the consideration in the \ncontract to those components as follows. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 564}), Document(page\_content='Leases 564 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Component Stand -alone price Allocation Calculation \nMachine lease $330,000 $315,000 (330,000 / 396,000) × 378,000 \nMaintenance 66,000 63,000 (66,000 / 396,000) × 378,000 \n $396,000 $378,000 \nAt lease commencement, LE recognizes a lease liability and an ROU asset \nbased on rental payments of $100,0001 per year and a residual value guarantee \npayment of $15,0002 at the end of Year 3. \nLease liability:3 $274,676 \nROU asset:4 $274,676 \nNotes: \n1. ($330,000 / $396,000) × $120,000 annual rental payment = $100,000 . \n2. ($330,000 / $396,000) × $18,000 end -of-lease RVG payment = $15,000. \n3. Present value of the unpaid lease payments (3 annual payments of $100,000 and one \nresidual value guarantee payment of $15,000 probable of b eing owed at the end of th e \nlease term), discounted at 7%. \n4. Equal to the lease liability because there are no initial direct costs, no lease incentives or \nrent prepayments. \nLease reassessment \nAt the end of Year 2, LE decides to exercise its two- year renewal option, \ntriggering a reassessment of the lease term. At that date, the following facts \nare relevant. \nRemaining, reassessed lease term: 3 years \nLease payments: Fixed payments of $120,000 per year (paid in arrears) \nRemaining options: None \nRVG: The first $50,000 that the residual value is below $220,000 \nAmount probable of being owed under the RVG: $6,000 \nLE’s incremental borrowing rate: 6% \nBased on the information above, the remaining consideration in the contract is $366,000. \nFixed payments: $360,000 ($120,000 × 3 years) \nAmount probable of being owed under the RVG : $6,000 \nLE reallocates the remaining consideration in the contract to the machine lease and the machine maintenance based on relative stand- alone prices at the \nremeasurement date. \nComponent Stand -alone price Allocation Calculation \nMachine lease $335,000 $306,525 (335,000 / 400,000) × 366,000 \nMaintenance 65,000 59,475 (65,000 / 400,000) × 366,000 \n $400,000 $366,000 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 565}), Document(page\_content='Leases 565 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. At the end of Year 2, before the reassessment of the lease term, the balance of \nthe ROU asset and the lease liability is: \nLease liability: $107,476 \nROU asset: $97,476 \nDue to the change in the lease term, and based on the allocation of the \nremaining consideration in the contract, LE remeasures the lease payments at \n$306,525, which is based on: \n— allocated rental payments of $100,5001 per year; and \n— an allocation of the residual value guarantee payment at the end of the \nrevised lease term, equal to $5,0252. \nThis results in a lease liability and an ROU asset immediately after the \nremeasurement of: \nLease liability:3 $272,857 \nROU asset:4 $262,857 \nLE recognizes the adjustment from the remeasurement with the following journal entry; there is no income statement effect of the remeasurement. \n Debit Credit \nROU asset5 165,381 \nLease liability5 165,381 \nTo remeasure ROU asset and lease liability \nfollowing reassessment of lease term. \nNotes: \n1. ($335,000 / $400,000) × $120,000 annual payment = $100,500. \n2. ($335,000 / $400,000) × $6,000 end -of-lease RVG payment = $5,025. \n3. Present value of the unpaid lease payments ( three annual payments of $100,500 paid \nin arrears, and one probable residual value guarantee payment of $5,025 at the end of \nthe lease term), discounted at 6% . \n4. $97,476 + ($272,857 – $107,476) = $262,857. \n5. $272,857 – $107,476 = $165,381. \n \n \n Question 6.6.130 \nRemeasurement of non -lease components \nShould a lessee account for the effect of a remeasurement of \na non- lease component on a cumulative effect or prospective \nbasis? \nInterpretive response: We believe either approach is acceptable because \nTopic 842 does not address lessee accounting for non -lease components – e.g. \nhow a lessee should recognize the cost of a non- lease component. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 566}), Document(page\_content='Leases 566 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Consider the fact patt ern in Example 6.6. 90. Lessee LE initially allocates \n$63,000 to the three- year non- lease maintenance component of the contract. \nAssuming that the maintenance is effectively a stand- ready obligation on the \npart of Lessor LR (which may not always be the case), absent the \nremeasurement outlined in Example 6.6. 90, LE would likely recognize that \nallocated amount as operating expense ratably over the three- year lease term \n(which is also the maintenance period). However, after the remeasurement, LE \nallocates $59,475 of the remaining consideration in the contract to the \nremaining three years of maintenance services. \nConsequently, LE might account for the remeasurement as a true- up to a \nfive-year maintenance service, with a total price of $101,475.1 In that case, LE \nwould recognize contra -expense of $1,4102 at the time of remeasurement, with \nan offsetting accrual for that amount. However, because the remeasurement \nresults from a change in estimate, we believe it would be more appropriate for \nLE to simply account for t he remaining maintenance services to be provided \nover the final three years of the revised lease term prospectively; this is \nconsistent with how LE will account for the remainder of the lease. Therefore, \nLE would recognize the $59,475 allocated to the main tenance services ratably \nover the remaining three -year lease term after the remeasurement; no contra -\nexpense amount would be recognized at the remeasurement date. \nNotes: \n1. ([$63,000 initial allocation to the 3- year maintenance service / 3 years] × 2 years) + \n$59,475 allocation after the remeasurement at the end of Year 2 = $101,475. \n2. $40,590 (which equals [$101,475 / 5 years] × 2 years) – $42,000 ([$63,000 / 3 years] × \n2 years) = $(1,410). \n \n Comparison to legacy US GAAP \nRequirement to re measure lease liability represents a significant change \nfrom capital lease accounting under Topic 840 \n6.6.200 A requirement to potentially remeasure the lease liability during the \nlease term is a significant change from Topic 840 requirements for capital \nleases where the liability was not remeasured during the lease term unless the \nlease was modified. [840- 30-35-17] \nResidual value guarantees \n6.6.210 Under Topic 840, any amounts expected to be payable under a residual \nvalue guarantee within an operating lease wer e accrued separately. For a capital \nlease, the full amount of the residual value guarantee was included in the \ndetermination of the capital lease obligation and the capital lease asset and was \nnot separately accounted for. [840- 10-25-6(b), 840- 20-35-1] \nUpdating the discount rate for the lease \n6.6.220 Topic 842’s requirement to reassess the discount rate for the lease in \nspecified cases of remeasurement (see paragraph 6.6.150) represents a shift \nfrom Topic 840 for capital leases where a lessee, subject to c ertain \nrequirements, use d the initial discount rate that was determined at lease ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 567}), Document(page\_content='Leases 567 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. inception to calculate the change in the lease liability as a result of a change in \nthe amount of remaining minimum lease payments due to a lease modification. \n[840- 30-35-8] \n \n6.7 Lease m odifications (Step 8B) \n Excerpt from ASC 842 -10 \n25 Recognition \nGeneral \n> Lease Modifications \n25-8 An entity shall account for a modification to a contract as a separate \ncontract (that is, separate from the original contract) when both of the \nfollowing conditions are present: \na. The modification grants the lessee an additional right of use not included in \nthe original lease (for example, the right to use an add itional asset). \nb. The lease payments increase commensurate with the standalone price \nfor the additional right of use, adjusted for the circumstances of the \nparticular contract. For example, the standalone price for the lease of one \nfloor of an office building in which the lessee already leases other floors in \nthat building may be different from the standalone price of a similar floor in \na different office building, because it was not necessary for a lessor to \nincur costs that it would have incurred for a new lessee. \n25-9 If a lease is modified and that modification is not accounted for as a \nseparate contract in accordance with paragraph 842 -10-25-8, the entity shall \nreassess the classification of the lease in accordance with paragraph 842- 10-\n25-1 as of the effective date of the modification . \n25-10 An entity shall account for initial direct costs, lease incentives, and any \nother payments made to or by the entity in connection with a modification to a \nlease in the same manner as those items would be accounted for in \nconnection with a new lease. \n>> Lessee \n25-11 A lessee shall reallocate t he remaining consideration in the contract \nand remeasure the lease liability using a discount rate for the lease \ndetermined at the effective date of the modification if a contract modification \ndoes any of the following: \na. Grants the lessee an additional right of use not included in the original \ncontract (and that modification is not accounted for as a separate contract \nin accordance with paragraph 842- 10-25-8) \nb. Extends or reduces the term of an existing lease (for example, changes \nthe lease term from five to eight years or vice versa), other than through \nthe exercise of a contractual option to extend or terminate the lease (as \ndescribed in paragraph 842 -20-35-5) ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 568}), Document(page\_content='Leases 568 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. c. Fully or partially terminates an existing lease (for example, reduces the \nassets subject to the lease) \nd. Changes the consideration in the contract only. \n25-12 In the case of (a), (b), or (d) in paragraph 842- 10-25-11, the lessee shall \nrecognize the amount of the remeasurement of the lease liability for the \nmodified l ease as an adjustment to the corresponding right -of-use asset . \n25-13 In the case of (c) in paragraph 842- 10-25-11, the lessee shall decrease \nthe carrying amount of the right -of-use asset on a basis proportionate to the full \nor partial termination of the e xisting lease. Any difference between the \nreduction in the lease liability and the proportionate reduction in the right -of-use \nasset shall be recognized as a gain or a loss at the effective date of the \nmodification. \n25-14 If a finance lease is modified an d the modified lease is classified as an \noperating lease , any difference between the carrying amount of the right -of-\nuse asset after recording the adjustment required by paragraph 842- 10-25-12 \nor 842- 10-25-13 and the carrying amount of the right -of-use asset that would \nresult from applying the initial operating right -of-use asset measurement \nguidance in paragraph 842- 20-30-5 to the modified lease shall be accounted for \nin the same manner as a rent prepayment or a lease incentive. \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance \n>> Lease Modifications \n>>> Lease Modifications in Connection with the Refunding of Tax -\nExempt Debt \n55-16 In some situations, tax -exempt debt is issued to finance construction of \na facility, such as a plant or hospital, that is transferred to a user of the facility \nby lease. A lease may serve as collateral for the guarantee of payments \nequivalent to those required to service the tax -exempt debt. Payments \nrequired by the terms of the lease are essentially the same, as to both amount \nand timing, as those required by the tax -exempt debt. A lease modification \nresulting from a refunding by the lessor of tax -exempt debt (including an \nadvance refunding ) should be accounted for in the same manner (that is, in \naccordance with paragraphs 842- 10-25-8 through 25- 18) as any other lease \nmodification. For example, if the perceived economic advantages of the \nrefunding are passed through to the lessee in the form of reduced lease \npayments , the lessee should account for the modification in accordance with \nparagraph 842- 10-25-12, while the lessor should account for the modification in \naccordance with the applicable guidance in para graphs 842- 10-25-15 through \n25-17. \n>>> Master Lease Agreements \n55-17 Under a master lease agreement, the lessee may gain control over the \nuse of additional underlying assets during the term of the agreement. If the \nagreement specifies a minimum number of units or dollar value of equipment, \nthe lessee obtaining control over the use of those additional underlying assets is \nnot a lease modification . Rather, the entity (whether a lessee or a lessor ) ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 569}), Document(page\_content='Leases 569 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. applies the guidance in paragraphs 842 -10-15-28 through 1 5-42 when identifying \nthe separate lease components and allocating the consideration in the \ncontract to those components. Paragraph 842- 10-55-22 explains that a master \nlease agreement may, therefore, result in multiple commencement dates . \n55-18 If the master lease agreement permits the lessee to gain control over \nthe use of additional underlying assets during the term of the agreement but \ndoes not commit the lessee to doing so, the lessee’s taking control over the \nuse of an additional underlying asset s hould be accounted for as a lease \nmodification in accordance with paragr aphs 842 -10-25-8 through 25 -18. \n> Illustrations \n>> Illustrations of Lease Modifications \n55-159 Examples 15 through 22 illustrate the accounting for lease \nmodifications. \n>>> Lessee \n>>>> Example 15— Modification Accounted for As a Separate Contract \n55-160 Lessee enters into a 10- year lease for 10,000 square feet of office \nspace. At the beginning of Year 6, Lessee and Lessor agree to modify the \nlease for the remaining 5 years to include an additional 10,000 square feet of \noffice space in the same building. The increase in the lease payments is \ncommensurate with the market rate at the date the modification is agreed for \nthe additional 10,000 square feet of office space. \n55-161 Lessee accounts for the modification as a new contract, separate from \nthe original contract. This is because the modification grants Lessee an \nadditional right of use as compared with the original contract, and the increase \nin the lease payments is commensurate with the standalone price of the \nadditional right of use. Accordingly, from the effective date of the modification, \nLessee would have 2 separate contracts, each of which contain a single lease \ncomponent —the original, unmodified contract for 10,000 square feet of office \nspace and the new contract for 10,000 additional square feet of office space, \nrespectively. Lessee would not make any adjustments to the accounting for \nthe original lease as a result of this modification. \n>>>> Example 16— Modification That Increases the Lease Term \n>>>>> Case A —No Change in Lease Classification \n55-162 Lessee and Lessor enter into a 10- year lease for 10,000 square feet of \noffice space in a building with a remaining economic life of 50 years. Annual \npayments are $100,000, paid in arrears. Lessee’s incr emental borrowing rate at \nthe commencement date is 6 percent. The lease is classified as an operating \nlease. At the beginning of Year 6, Lessee and Lessor agree to modify the lease \nsuch that the total lease term increases from 10 years to 15 years. The annual \nlease payments increase to $110,000 per year for the remaining 10 years after \nthe modification. Lessee’s incremental borrowing rate is 7 percent at the date \nthe modification is agreed to by the parties. \n55-163 At the beginning of Year 6, Lessee’s lease liability and its right -of-use \nasset both equal $421,236 (that is, because the lease payments are made ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 570}), Document(page\_content='Leases 570 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. annually in arrears and because the lease payments are even throughout the \nlease term, the lease liability and right-of-use asset will be equal). \n55-164 The modification does not grant an additional right of use to the lessee; \nrather, it changes (modifies) an attribute of the right to use the 10,000 square \nfeet of office space Lessee already controls. That is, aft er the modification, \nLessee still controls only a single right of use transferred to Lessee at the \noriginal lease commencement date. \n55-165 Because the modification does not grant Lessee an additional right of \nuse, the modification cannot be a separate contract. Therefore, at the effective \ndate of the modification, Lessee reassesses classification of the lease (which \ndoes not change in this Example —see Case B [paragraphs 842- 10-55-166 \nthrough 55- 167] for a change in lease classification) and remeasures the lease \nliability on the basis of the 10- year remaining lease term, 10 remaining \npayments of $110,000, and its incremental borrowing rate at the effective date \nof the modification of 7 percent. Consequently, the modified lease liability \nequals $772,594. The increase to the lease liability of $351,358 is recorded as \nan adjustment to the right -of-use asset (that is, there is no income or loss \neffect from the modification). \n>>>>> Case B —Change in Lease Classification \n55-166 Assume the same facts as in Case A (paragraphs 842- 10-55-162 \nthrough 55- 165), except that the underlying asset is a piece of equipment with \na 12- year remaining economic life at the effective date of the modification. \nConsequently, when the lessee reassesses classification of the lease in \naccordance with paragraph 842- 10-25-1 as of the effective date of the \nmodification based on the modified rights and obligations of the parties, the \nlessee classifies the modified lease as a finance lease (that is, because the \nremaining lease term of 10 years is for a major part of the 12 -year remaining \neconomic life of the equipment). \n55-167 Consistent with Case A, at the effective date of the modification, the \nlessee remeasures its lease liability based on the 10- year remaining lease term, \n10 remaining pa yments of $110,000, and its incremental borrowing rate of \n7 percent. Consequently, the modified lease liability equals $772,594. The \nincrease to the lease liability of $351,358 is recorded as an adjustment to the \nright-of-use asset (that is, there is no income or loss effect from the \nmodification). However, different from Case A, beginning on the effective date \nof the modification, Lessee accounts for the 10- year modified lease as a \nfinance lease. \n>>>> Example 17— Modification That Grants an Additional Right of Use \n55-168 Lessee enters into a 10- year lease for 10,000 square feet of office \nspace. The lease payments are $100,000 per year, paid in arrears. Lessee’s \nincremental borrowing rate at lease commencement is 6 percent. At the \nbeginning of Year 6, Lessee and Lessor agree to modify the contract to include \nan additional 10,000 square feet of office space on a different floor of the \nbuilding for the final 4 years of the original 10- year lease term for a total annual \nfixed payment of $150,000 for the 20,000 square feet. \n55-169 The increase in the lease payments (of $50,000 per year) is at a \nsubstantial discount to the market rate at the date the modification is agreed to ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 571}), Document(page\_content='Leases 571 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. for leases substantially similar to that for the new 10,000 square feet of \noffice space that cannot be attributed solely to the circumstances of the \ncontract. Consequently, Lessee does not account for the modification as a \nseparate contract. \n55-170 Instead, Lessee accounts for the modified contract, which contains \n2 separate lease components —first, the original 10,000 square feet of office \nspace and, second, the right to use the additional 10,000 square feet of office \nspace for 4 years that commences 1 year after the effective date of the \nmodification. There are no nonlease components of the modified contract. The \ntotal lease payments, after the modification, are $700,000 (1 payment of \n$100,000 + 4 payments of $150,000). \n55-171 Lessee allocates the lease payments in the modified contract to the \n2 separate lease compone nts on a relative standalone price basis, which, in \nthis Example, results in the allocation of $388,889 to the original space lease \nand $311,111 to the additional space lease. The allocation is based on the \nremaining lease terms of each separate lease component (that is, 5 years for \nthe original 10,000- square- foot lease and 4 years for the additional 10,000 -\nsquare- foot lease). The remaining lease cost for each separate lease \ncomponent is equal to the total payments, as allocated, which will be \nrecognized on a straight -line basis over their respective lease terms. Lessee \nremeasures the lease liability for the original space lease as of the effective \ndate of the modification—the lease classification of which does not change as \na result of the modification —on t he basis of all of the following: \na. A remaining lease term of 5 years \nb. Annual allocated lease payments of $77,778 in Years 6 through 10 (see \nparagraph 842- 10-55-173) \nc. Lessee’s incremental borrowing rate at the effective date of the \nmodification of 7 percent . \n55-172 The remeasured lease liability for the original space lease equals \n$318,904. Lessee recognizes the difference between the carrying amount of \nthe modified lease liability and the carrying amount of the lease liability \nimmediately before the modifi cation of $102,332 ($421,236 – $318,904) as an \nadjustment to the right -of-use asset. \n55-173 During Year 6, Lessee recognizes lease cost of $77,778. At the end of \nYear 6, Lessee makes its lease payment of $100,000, of which $77,778 is \nallocated to the lease of the original office space and $22,222 is allocated to \nthe lease of the additional office space as a prepayment of rent. Lessee \nallocates the lease payment in this manner to reflect even payments for the \neven use of the separate lease components over their respective lease terms. \n55-174 At the commencement date of the separate lease component for the \nadditional office space, which is 1 year after the effective date of the \nmodification, Lessee measures and recognizes the lease liability at $241,896 \non the basis of all of the following: \na. A lease term of 4 years \nb. Four allocated annual payments of $72,222 ([allocated lease payments of \n$311,111 – $22,222 rent prepayment] ÷ 4 years) \nc. Lessee’s incremental borrowing rate at the commencement date of the \nseparate l ease component for the additional office space of 7.5 percent. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 572}), Document(page\_content='Leases 572 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 55-175 At the commencement date, the right -of-use asset for the additional \noffice space lease component is recognized and measured at $264,118 (the \nsum of the lease liability of $241,896 and t he prepaid rent asset of $22,222). \n55-176 During Years 7– 10, Lessee recognizes lease cost of $77,778 each year \nfor each separate lease component and allocates each $150,000 annual lease \npayment of $77,778 to the original office space lease and $72,222 to the \nadditional office space lease. \n>>>> Example 18— Modification That Decreases the Scope of a Lease \n55-177 Lessee enters into a 10- year lease for 10,000 square feet of office \nspace. The annual lease payment is initially $100,000, paid in arrears, and \nincreases 5 percent each year during the lease term. Lessee’s incremental \nborrowing rate at lease commencement is 6 percent. Lessee does not provide \na residual value guarantee. The lease does not transfer ownership of the office \nspace to Lessee or grant Lessee an option to purchase the space. The lease is \nan operating lease for all of the following reasons: \na. The lease term is 10 years, while the office building has a remaining \neconomic life of 40 years. \nb. The fair value of the office space is estimated to be significantly in excess \nof the present value of the lease payments. \nc. The office space is expected to hav e an alternative use to Lessor at the \nend of the lease term. \n55-178 At the beginning of Year 6, Lessee and Lessor agree to modify the \noriginal lease for the remaining 5 years to reduce the lease to only 5,000 \nsquare feet of the original space and to reduc e the annual lease payment to \n$68,000. That amount will increase 5 percent each year thereafter of the \nremaining lease term. \n55-179 The classification of the lease does not change as a result of the \nmodification. It is clear based on the terms of the modi fied lease that it is not a \nfinance lease because the modification reduces both the lease term and the \nlease payments. Lessee remeasures the lease liability for the modified lease at \nthe effective date of the modification on the basis of all of the followi ng: \na. A remaining lease term of 5 years \nb. Lease payments of $68,000 in the year of modification (Year 6), increasing \nby 5 percent each year thereafter \nc. Lessee’s incremental borrowing rate at the effective date of the \nmodification of 7 percent. \n55-180 The remeasured lease liability equals $306,098. \n>>>>> Case A —Remeasuring the Right -of-Use Asset Based on Change \nin Lease Liability \n55-181 The difference between the premodification liability and the \nmodified lease liability is $284,669 ($590,767 – $306,098) . That difference is \n48.2 percent ($284,669 ÷ $590,767) of the premodification lease liability. The \ndecrease in the lease liability reflects the early termination of the right to use \n5,000 square feet of space (50 percent of the original leased space), the \nchange in the lease payments, and the change in the discount rate. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 573}), Document(page\_content='Leases 573 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 55-182 Lessee decreases the carrying amount of the right -of-use asset to \nreflect the partial termination of the lease based on the adjustment to the \ncarrying amount of the lease liability , with any difference recognized in profit or \nloss. The premodification right -of-use asset is $514,436. Therefore, at the \neffective date of the modification, Lessee reduces the carrying amount of the \nright-of-use asset by $247,888 (48.2% × $514,436). Lessee recognizes the \ndifference between the adjustment to the lease liability and the adjustment to \nthe right -of-use asset ($284,669 – $247,888 = $36,781) as a gain. \n>>>>> Case B —Remeasuring the Right -of-Use Asset Based on the \nRemaining Right of Use \n55-183 Lessee determines the proportionate decrease in the carrying amount \nof the right -of-use asset based on the remaining right -of-use asset (that is, \n5,000 square feet corresponding to 50 percent of the original right -of-use \nasset). \n55-184 Fifty percent of t he premodification right -of-use asset is $257,218 (50% \nx $514,436). Fifty percent of the premodification lease liability is $295,384 \n(50% x $590,767). Consequently, Lessee decreases the carrying amount of the \nright-of-use asset by $257,218 and the carrying amount of the lease liability by \n$295,384. At the effective date of the modification, Lessee recognizes the \ndifference between the decrease in the lease liability and the decrease in the \nright-of-use asset of $38,166 ($295,384 – $257,218) as a gain. \n55-185 Lessee recognizes the difference between the remaining lease liability \nof $295,384 and the modified lease liability of $306,098 (which equals $10,714) \nas an adjustment to the right -of-use asset reflecting the change in the \nconsideration paid for the leas e and the r evised discount rate. \n>>>> Example 19— Modification That Changes the Lease Payments Only \n55-186 Lessee enters into a 10- year lease for 10,000 square feet of office \nspace. The lease payments are $95,000 in Year 1, paid in arrears, and \nincrease by $1,000 every year thereafter. The original discount rate for the \nlease is 6 percent. The lease is an operating lease. At the beginning of Year 6, \nLessee and Lessor agree to modify the original lease for the remaining 5 years \nto reduce the lease payments by $7,000 each year (that is, the lease payments \nwill be $93,000 in Year 6 and will continue to increase by $1,000 every year \nthereafter). The modification only changes the lease payments and, therefore, \ncannot be accounted for as a separate contract. The classification of the lease \ndoes not change as a result of the modification. \n55-187 Lessee remeasures the lease liability for the modified lease on the \nbasis of all of the following: \na. Remaining lease term of 5 years \nb. Payments of $93,000 in Year 6, increasing by $1,000 each year for the \nremainder of the lease term \nc. Lessee’s incremental borrowing rate at the effective date of the \nmodification of 7 percent. \n55-188 The remeasured lease liability equals $388,965. Lessee recognizes the \ndifference between the carrying amount of the modified lease liability and the \nlease liability immediately before the effective date of the modification of ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 574}), Document(page\_content='Leases 574 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. $40,206 ($429,171 premodification lease liability – $388,965 modified lease \nliability) as a corresponding reduction to the right -of-use asset. Therefore, the \nadjusted right -of-use asset equals $376,465 as of the effective date of the \nmodification. Lessee calculates its remaining lease cost as $462,500 (the sum \nof the total lease payments, as adjusted for the effects of the lease \nmodification, of $960,000 reduced by the total lease cost recognized in prior \nperiods of $497,500), which it will recognize on a straight -line basis over the \nremaining lease term. \n55-189 During Year 6, Lessee recogni zes lease cost of $92,500 ($462,500 \nremaining lease cost ÷ 5 years). As of the end of Year 6, Lessee’s lease liability \nequals $323,193 (present value of the remaining lease payments, discounted \nat 7 percent), and its right -of-use asset equals $311,193 (the balance of the \nlease liability – the remaining accrued rent balance of $12,000). Lessee \nrecognizes additional lease cost of $92,500 each year of the remaining lease \nterm and measures its lease liability and right -of-use asset in the same manner \nas at the end of Year 6 each remaining year of the lease term. The following \nare the balances of the lease liability and the right -of-use asset at the end of \nYears 7 through 10 of the lease. \n Lease Liability Right -of-Use \nAsset \nYear 7 $ 251,816 $ 241,316 \nYear 8 $ 174,443 $ 166,443 \nYear 9 $ 90,654 $ 86,154 \nYear 10 $ - $ - \n \n6.7.10 A lease modification is a change to the terms and conditions of a contract \nthat results in a change in the scope of or the consideration for a lease – e.g. a \nchange to the terms and conditions of the contract that adds or terminates the \nright to use one or more underlying assets or extends or shortens the \ncontractual lease term is a lease modification. [842 Glossary] \n \n Question 6.7.05 \nContract modifications not in writing \nDo contract modifications have to be in writing? \nInterpretive response: No. Under Topic 842, a contract can be oral or implied \nas long as it creates enforceable rights and obligations on the contracting \nparties. Similarly, a modification to a contract can al so be oral or implied, as long \nas it is enforceable. [842 Glossary ] \nAn example of an implied modification is lessee construction or installation of \nlessor -owned improvements to the underlying asset – e.g. structural \nimprovements to a lease building – not required by the lease contract. Even if \nno amendment is executed, it is implied that the lessor agreed to the lessee’s \nactions. See Question 5.4.85 for further discussion. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 575}), Document(page\_content='Leases 575 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Additional examples of contract modifications that may not result in or from \nwritten changes to the terms and conditions of the lease contract include the \nfollowing (not exhaustive). \n— Substituting the underlying asset, even if permitted or required by the \ncontract – e.g. replacing Asset 1 with equivalent Asset 2. \n— Significantly modifying or enhancing the underlying asset such that it is, in \nsubstance, a different asset – e.g. significantly enhancing the capacity and \nefficiency of a power -generating facility. \n— Decreasing or increasing the number of assets subject to a lease \nagreement that does not specify the number of assets is accounted for as a \nlease modification. For example, a lease for a lessor’s entire fleet of a \nparticular asset is considered modified if the size (number of assets) and/or \ncomposition (some assets are replaced with other assets) of the fleet \nchanges. See also Example 6.7.40. [842- 10-55-17 – 55-18] \n \n Question 6.7.06 \nContract changes only affecting variable or \ncontingent payments \nDoes a lease contract change that affects only variable or \ncontingent payments for the lease qualify as a lease modification? \nBackground: A lessor and lessee may modify the terms of a lease contract in a \nmanner that only adds new, or changes existing, variable or contingent lease \npayments. Relevant examples could include adding or changing: \n— a variable payment based on a percentage of the lessee’s sales or the \nlessee’s usage of the underlying asset; \n— a payment that changes based on increases or decreases in the CPI; or \n— a contingency in the lease contract that could change the amount of the \npayments the lessee will make under the lease. \nIn these circumstances, the ‘lease payments’ (see section 5.4) and/or the \n‘consideration in the contract’ (see section 4.3) may not change, so some have \nquestioned whether these changes are lease modifications under Topic 842. \nInterpretive response: Yes. A lease modification is a change to the terms and \nconditions of a contract that results in a change in the scope of or the \nconsideration for a lease (see paragraph 6.7.10). Variable and contingent \npayments are part of the consideration for a lease; therefore, changes to \n(including the addition of) such pay ments change the consideration for the lease \nand give rise to a lease modification. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 576}), Document(page\_content='Leases 576 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 6.7.07 \nAre rent concessions lease modifications? \nIs a rent concession a lease modification? \nApplicability: This question does not apply to eligible COVID -19 related \nconcessions of a lessee that has elected the practical expedient offered by the \nFASB staff specific to COVID -19 related rent concessions. If the lessee has \nelected the practical expedient and the rent concession in question is COVID -19 \nrelated, see KPMG Hot Topic, FASB staff guidance on accounting for COVID -19 \nrent concessions . \nBackground: Rent concessions may be offered by lessors or negotiated by \nlessees when temporary circumstances arise – e.g. temporary closure or \nchanges to operating hours due to COVID -19, civil unrest or a natural disaster. \nExamples of rent concessions include (not exhaustive ): \n— forgiveness of contractually owed past -due rent; \n— rent abatements (i.e. decreased rent payments) for future periods – e.g. \n50% discount from the original rent payments for the next six months; and \n— interest -free rent deferrals. \nAccounting for rent concessions under Topic 842, regardless of whether \nproactively offered by the lessor or negotiated by the lessee, depends on the \nenforceable rights and obligations of the lessee under the original contract, and \nthe nature of any contractual changes agreed by the parties. \nInterpretive response: It depends. We believe the first step to answer this \nquestion is to determine whether: \n— the lessee had an enforceable right to the concession before it was \ngranted; and \n— other terms and conditions of the contract that affect the scope of or consideration for the lease were changed. \nThe following diagram illustrates the evaluation and its result on the lessee’s \naccounting. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 577}), Document(page\_content='Leases 577 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Does the lessee \nhave an \nenforceable right to \nthe rent concession \nunder the original \nlease contract?\nAccount for the rent \nconcession as a lease \nmodification\nAre any other terms \nand conditions in \nthe original lease \ncontract changed?\nAccount for the rent concession \nunder the original lease contract \n(e.g. as negative variable rent)YesNo\nNoYes \nEnforceable right \nLease contracts may contain force majeure or similar clauses that apply in the \nevent that unforeseen circumstances prevent the parti es to the lease contract \nfrom fulfilling their obligations under (or obtaining their anticipated benefits from) the contract. These clauses may provide for free, reduced or deferred \nrent for the period until the unforeseen circumstances are remedied, after \nwhich rent payments return to the normal amounts as specified under the \noriginal lease agreement. Alternatively, they may provide for prospective rent \nabatements that are intended to compensate the lessee for the effect of the unforeseen circumstances. \nEven if not written into the original lease contract, a lessee may still have an \nenforceable right to a rent concession based on the laws of the jurisdiction \ngoverning the lease contract and that apply to the lease contract. Whether a \nforce majeure or simil ar clause applies, or whether a lessee otherwise has an \nenforceable right to a rent concession, is ultimately a legal question that must \nbe answered based on applicable law and the facts and circumstances giving \nrise to the evaluation. \nChanges to other terms and conditions \nIf the lessee has a contractual, or otherwise enforceable, right to the rent \nconcession, there may still be a lease modification, requiring the lessee to \nundertake lease modification accounting. This is the case if other terms and \nconditions of the original lease contract affecting the scope of or consideration for the lease are changed in connection with the rent concession. \nIn the event of a rent concession, the two parties will be communicating, and \nthey may take the opportunit y to agree on other changes to the contract. For \nexample, the parties may agree on a change to the lease term and/or changes \nto the lease payments, including variable payment terms, not required by a ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 578}), Document(page\_content='Leases 578 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. force majeure clause or the lessee’s other enforceable r ights. In general, \nchanges to the terms and conditions of the contract (which can be written, \nverbal or otherwise – see Question 6.7.05) that affect the scope of or the \nconsideration for the lease other than merely communicating or agreeing on the \namount of a rent concession for the affected periods of the lease, will trigger a \nlease modification. This is the case even if the impetus for the negotiation was \nthe force majeure event. \nEven if no other terms and conditions are explicitly changed, careful \nconsideration should be given to the rent concession. If the substance of the \nrent concession is that it is clearly not related solely to the force majeure event, \na lease modification has likely occurred. For example, the amount of the \nconcession may be disproportionate to the effects of the force majeure event, \nor an additional concession might be offered to induce the lessee to extend or \nnot terminate the lease. \nRent deferrals – concession or not? \nAgreement by the lessor to defer contractually owed lease payments or variable lease payments is a rent concession. \nConsistent with rent forgiveness or abatement concessions, if the lessee does \nnot have an enforceable right to the rent deferral, granting of this concession by \nthe lessor, changing the payment terms and in effect granting the lessee an \ninterest -free loan, is a lease modification. \nConcession required but amount uncertain \nIn some cases, the lessor and lessee may agree that the lessee has an \nenforceable right to the rent concession under the circumstances, but the amount \nof the rent forgiveness or abatement, or duration of the interest -free deferral, to \nwhich the lessee is entitled, is uncertain. Neither the contract, nor the laws of the relevant jurisdiction, may clearly articulate how to determine the required \nconcession. \nFor example, if a shopping center has reduced operating hours, it may be \nunclear how a required rent reduction should be calculated – e.g. pro rata based \non the decreased number of operating hours as compared to normal, or on \nsome other basis if the changed operating hours disproportionately affect low or high- traffic times, such as dinner hours for a restaurant in the food court. \nIn these cases, we believe that agreeing on the amount or duration of a \ncontractually required concession does not in isolation trigger a lease \nmodification. This is consistent in concept with established practice that the two parties to a lease agreeing on the amount of a contractually required fair \nmarket rent lease payment adjustment does not constitute a lease modification. \nHowever, a lease modification will generally still result if other terms and \nconditions of the lease contract affecting the scope of or consideration for the \nlease are changed in connection with communicating or agreeing on the \namount of the rent concession (see above). \nAccounting consequences \nIf there is a lease modification, lessees will account for the modification \nconsistent with any other modification. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 579}), Document(page\_content='Leases 579 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. If the lessee has an enforceable right to the rent concession for the affected \nperiod(s) and there are no other changes to the terms and conditions of the \noriginal lease contract, there is no lease modification. The lessee should continue to account for the lease under the original contract. In the case of a \nrent forgiveness or a temporary rent abatement, we believe the lessee should \ngenerally account for that rent reduction as negative variable lease cost, consistent with lessee accounting for a co- tenancy clause (see Question \n6.6.60) . \n \n Question 6.7.08 \nLessee short payment of rent – lessee accounting \nHow does a lessee account for making rent payments that are \nless than the amount contractually owed (i.e. ‘short \npayment’)? \nBackground: Some lessees may decide, or be forced by their cash flow \ncircumstances, to make rent payments that are less than the amount that is \ncontractually owed (i.e. ‘short pay’). \nInterpretive response: The first step to accounting for a short payment is to \ndetermine whether the lessee is entitled to make the short payment under the \nexisting lease contract – i.e. whether, based on the terms and conditions of the \ncontract, the lessee has the enforceable right to pay the lesser rent amount. \nIf so, we believe the lessee should generally account for the rent reduction as \nnegative variable lease cost of the period to which the short payment relates. \nThis is consistent with lessee accounting for a co- tenancy clause (see Question \n6.6.60). \nIf the enforceable rights and obligations of the lease contract do not permit the lessee to short pay the rent, lease cost will not change for the peri ods of short \npayment, and no remeasurement of the lease liability will occur, before a \nmodification is approved – i.e. the parties agree to a change to the terms and \nconditions of the lease. \nIf a modification is approved, the lessee will apply modification accounting as \nillustrated throughout this section 6.7 from the ‘effective date of the \nmodification’ (see paragraph 6.7.20), treating any forgiven past due rent as a \nlease incentive in accounting for the modified lease. \nNote: An exception to the preceding paragraph arises if the modification is a \nconcession (see Question 6.7.07) resulting from COVID -19, the concession \nqualifies for the FASB staff’s practical expedient for COVID -19 related rent \nconcessions and the lessee has elected the optional practical expedient to \naccount for the concession as if it was required under the original lease \ncontract. See KPMG Hot Topic , FASB staff guidance on accounting for COVID -\n19 rent concessions\n, for guidance. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 580}), Document(page\_content='Leases 580 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 6.7.08 \nLessee accounting for short payments not \npermitted by the contract \nLessee LE enters into a contract with Lessor LR for the right to use retail store \nspace in a shopping mall for 12 months. The right to use the retail space is an \noperating lease and there are no other components of the contract. LE has not \nelected the short -term lease recognit ion exemption. \nThe following additional facts are relevant. \nLease payments: 12 monthly fixed payments of $2,000 paid in advance \nRenewal options: None \nTermination/purchase options: None \nTransfer of ownership: No \nRVG: None \nLE’s incremental borrowing rate: 6% \nInitial direct costs (LE): None \nDuring the lease term, LE will account for the lease liability and the ROU asset \nas follows (assuming no remeasurements, modifications or impairments). \n Lease liability ROU asset \n \nMo. Beginning \nbalance Accretion Payments Ending \nbalance Beginning \nbalance Amort. Ending \nbalance Single lease \ncost \n1 $21,354 $107 ($2,000) $19,461 $23,354 ($1,893) $21,461 $2,000 \n2 19,461 97 (2,000) 17,558 21,461 (1,903) 19,558 2,000 \n3 17,558 88 (2,000) 15,646 19,558 (1,912) 17,646 2,000 \n4 15,646 78 (2,000) 13,724 17,646 (1,922) 15,724 2,000 \n5 13,724 69 (2,000) 11,793 15,724 (1,931) 13,793 2,000 \n6 11,793 59 (2,000) 9,852 13,793 (1,941) 11,852 2,000 \n7 9,852 49 (2,000) 7,901 11,852 (1,951) 9,901 2,000 \n8 7,901 39 (2,000) 5,940 9,901 (1,961) 7,940 2,000 \n9 5,940 30 (2,000) 3,970 7,940 (1,970) 5,970 2,000 \n10 3,970 20 (2,000) 1,990 5,970 (1,980) 3,990 2,000 \n11 1,990 10 (2,000) - 3,990 (1,990) 2,000 2,000 \n12 - - - - 2,000 (2,000) - 2,000 \nDue to unforeseen circumstances (not COVID -19), LE short pays Months 5 and \n6. LE pays $1,000 each month instead of the contractually required $2,000. \nLE does not have an enforceable right to short pay those months’ rent and LR has not agreed to accept the reduced payments in lieu of the contractual \namounts owed. Therefore, LE and LR continue to account for the lease under \nits original terms and conditio ns. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 581}), Document(page\_content='Leases 581 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The contract stipulates that LE incurs a monthly 1% interest charge on any past \ndue rent (plus accrued interest). \nAs a result, LE records the following journal entries in Months 5 and 6. \n Month 5 Month 6 \nDebit Credit Debit Credit \nOperating lease expense1 2,000 2,000 \nLease liability2 1,931 1,941 \nInterest expense3,4 10 20 \nROU asset 1,931 1,941 \nCash \nAccounts payable5 1,000 \n1,000 1,000 \n1,000 \nInterest payable6 10 20 \nNotes: \n1. Straight- line lease cost. This amount does not change from what LE would have \nrecognized had it paid Months 5 and 6 rent in full and on time. \n2. $2,000 contractual payment (50% paid in cash, 50% reclassified to accounts payable) ‒ \nlease liability accretion for the month ($69 in Month 5, $59 in Month 6). \n3. For Month 5: short payment of $1,000 × 1% = $10. \n4. For Month 6: (Months 5 and 6 short payments ($2,000) + Month 5 accrued interest \n($10)) × 1% = $20.10. [Rounded in Month 6 journal entry] \n5. The unpaid portion of the contractually owed mont hly lease payment remains in \naccounts payable when only 50% of it is paid. LE may elect to present this amount in its \ncurrent portion of operating lease liabilities on the balance sheet. \n6. To record the late payment interest due under the terms of the contract. \nLease modification \nAt the beginning of Month 7, LR agrees to forgive the unpaid portion of the \nMonths 5 and 6 rent and interest thereon. The lease remains classified as an \noperating lease after the modification. \nTherefore, at the effective date of the modification (i.e. the beginning of Month \n7), LE writes off its existing payables for the unpaid Months 5 and 6 rent and \naccrued interest forgiven by LR with a corresponding adjustment to the ROU \nasset, consistent with any other lease incentive. LE rec ords the following \njournal entry. \n Month 7 \nDebit Credit \nAccounts payable1 2,000 \nInterest payable2 30 \nROU asset3 2,030 \nNotes : \n1. Calculated as the unpaid portion of the contractually owed monthly lease payment \nresulting from Month 5 ($1,000) + Month 6 ($1,000). \n2. Calculated as the Month 5 accrued interest ($10) + the Month 6 accrued interest ($20). \n3. Reduction to the ROU asset for the payables forgiven. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 582}), Document(page\_content="Leases 582 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. After recognizing the journal entry, LE accounts for the lease from the effective \ndate of the modification consistent with any other modified lease. \n6.7.20 The effective date of a lease modification is the date the modification is \napproved by both the lessee and the lessor. [842 Glossary] \n6.7.30 The following flowchart summarizes the lease modification requirements \napplicable to a lessee. [842- 10-25-8 – 25-14] \nDoes modification \ngrant lessee an \nadditional right of \nuse not included in \noriginal lease ?1Is additional right of \nuse priced \ncommensurate with \nits stand -alone \nprice , adjusted for \nthe contract ’s \ncircumstances ?Account for additional \nright of use as a separate \ncontract\nDoes modification \ndecrease lessee 's \nright of use ?1\nAccount for modification \nas full , or partial , early \nlease termination . \nDecrease carrying amount \nof ROU asset on a basis \nproportionate to full (or \npartial ) termination . \nDifference between \ndecrease in lease liability \nand ROU asset = \ngain or (loss)Adjust lease liability \nand record equal \nand offsetting \nchange to ROU \nasset\nWas original lease \na finance lease and \nthe modified lease \nan operating lease ?Continue to apply \nmeasurement guidance \napplied before the \nmodification\nAccount for as prepaid rent or lease incentive , the \ndifference between : (1) carrying amount of ROU asset \nafter modification measurement and (2) carrying \namount of ROU asset applying initial operating ROU \nasset measurement guidance to the modified leaseYes Yes\nNo No\nNo\nYes\nNo\nYes \nNote: \n1. Lease term is an attribute of the lessee’s right to use the underlying asset – i.e. an \nextension does not grant the lessee an additional right of use. [842-10-25-11(b)] \n6.7.40 An entity accounts for a modification as a separate contract when the \nfollowing c onditions are met: [842- 10-25-8] ", metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 583}), Document(page\_content='Leases 583 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — the modification grants the lessee an additional right of use that was not \nincluded in the original lease – e.g. a right to use an additional asset; and \n— the lease payments increase commensurate with the stand- alone price of \nthe additional right of use, adjusted for the circumstances of the contract. \nFor example, the stand- alone price for the lease of one floor in an office \nbuilding in which the lessee already leases other floors may be different \nfrom the stand- alone price of a similar floor in a similar office building \nbecause the lessor did not have to incur costs it would have incurred for a \nnew lessee. \n \n Question 6.7.09 \nModifications that add a right(s) of use and make \nother changes \nCan a contract modification that adds a lessee right of use, \nbut also includes other changes, be accounted for as a \nseparate contract ? \nBackground: To illustrate, consider a scenario in which a lessee leases three \nfloors of an office building for an original term of five years. In Year 3, the lessee \nenters into an amendment with the lessor to lease a fourth floor. In addition to \nthe fourth floor lease, the lessee and lessor agree to: \n— extend the non -cancellable period for the three original floors to match the \nnon-cancellable period of the new, fourth floor lease; and/or \n— reduce the lease payments for the original three floors to reflect the price \nper square foot the lessee is paying for the four th floor lease. \nInterpretive response: No. A contract modification can only be accounted for \nas a separate contract if the only change to the existing contract is to add an \nadditional right of use to the contract – e.g. adding another floor to an existing \noffice space lease as in the background example. [842-10-25-8] \nIf changes are also made to one or more existing lease components, the \nseparate contract guidance in paragraph 842- 10-25-8 does not apply. In that \ncase, it is not appropriate to bifurcate the a dditional right of use and the other \nchanges, and assess the additional right of use separately under the separate contract guidance. \n[ASU 2016- 02.BC171– BC172] \n6.7.50 The accounting steps an entity performs for a lease modification that is \nnot accounted for as a separate contract are similar to the steps a lessee \nperforms when remeasuring lease liabilities for changes in the lease term or in \nthe assessment of a lessee purc hase option, with some differences for Steps 3 \nand 4 described below. [842- 10-25-9 – 25-13] \nAccounting steps for a lease modification not account ed for as a sepa rate cont ract \n1. Remeasure and reallocate the consideration in the contract to the remaining lease and \nnon-lease components of the contract at the effective date of the modification using \nthen- current stand- alone prices (see chapter 4). \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 584}), Document(page\_content='Leases 584 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Accounting steps for a lease modification not account ed for as a sepa rate cont ract \n2. Remeasure the lease liability to reflect the revised lease payments, using a discount \nrate for the le ase (see section 5.6) determined at the effective date of the \nmodification.1 \n3. Either: \na. If the modification decreases the lessee’s ROU (e.g. reduces the number of assets \nleased or reduces the space leased in a building), the carrying amount of the ROU \nasset is reduced on a proportionate basis to the full (or partial) termination of the \nexisting lease; and any difference between the reduc tion in the lease liability and \nthe reduction in the ROU asset is recognized as a gain (loss) at the effective date \nof the modification. \nb. Otherwise,2 adjust the amount of the ROU asset by the amount of the \nremeasurement of the lease liability. \n4. Account for initial direct costs (see section 5.5), lease incentives (see section 5.4.3), and other payments in connection with the modification in the same manner as for a \nnew lease. \n5. Reassess lease classification in accordance with paragraph 842 -10-25-1 as of the \neffective date of the modification. \n6. If there is a change in lease classification, adjust the remaining lease cost recognition \npattern and presentation in the income statement and statement of cash flows \nprospectively. \nNotes: \n1. When a lessee remea sures the lease liability, variable lease payments that depend on an \nindex or rate are measured using the index or rate as of the remeasurement date. The \nBoard decided that a lessee should remeasure variable lease payments that depend on \nan index or a rate when the lessee remeasures the lease liability for another reason \nbecause it would not be logical to use an outdated index or rate in remeasuring the lease \npayments [842- 10-35-5, ASU 2016- 02.BC237] \n2. Including modifications that: [842-10-25-11] \n— grant the lessee an additional right of use not included in the original contract (and \nthat modification is not accounted for as a separate contract) ; \n— change the term of an existing lease (e.g. extend or reduce the lease term), other than th rough the exercise of an extension or termination option included in the \noriginal contract ; or \n— change the consideration in the contract only. \n \n Observation \nLease modifications vs. lease remeasurements \nresulting from reassessments \n6.7.60 The decisions by the Board to consider the lease term an attribute of the \nlease and to require a reassessment of lease classification for lease \nmodifications that are not accounted for as a separa te contract substantially \naligns the lease modification guidance with the lease reassessment guidance. \nThis minimizes accounting differences between the two models that could have \ncreated structuring opportunities. [ASU 2016- 02.BC176(b) ] \n6.7.70 If a finance lease is modified and the modified lease is classified as an \noperating lease, the lessee accounts for (in the manner of a rent prepayment or \na lease incentive) the difference between: [842- 10-25-14] \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 585}), Document(page\_content='Leases 585 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — the carrying amount of the ROU asset immediately after remeasurement as \na result of the modification; and \n— the carrying amount of the ROU asset that would result from applying the initial measurement guidance for an operating lease ROU asset to the \nmodified lease. \n \n Example 6.7.10 \nModification that a dds a right of use \nScenario 1: Modification is accounted for as a separate contract \nAssume the same facts as in Examples 6.3.10 and 6.4.20, in which Lessee LE \nleases office space from Lessor LR. At the beginning of Year 7, LE and LR \nmodify their contract to grant LE the right to use an additional floor of office \nspace in the same building as the current office space LE leases from LR for \nfour years (making the non- cancellable period coterminous with that of the \noriginal office space lease), with an option to renew the new space lease for five years (consistent with the option LE has to renew the original office space \nlease). The new office space is the same size as the original office space and is \nsimilar in all significant respects. \nThe lease payments for the new office space are 5% lower each year than the \nlease payments for the original office space – the lease payments for the \noriginal office space continue to be considered market rentals for office space \nof that size and characteristics. \nBecause of its existing relationship with LE, LR was able to obtain this lease \nwithout incurring any marketing or commission costs and was able to forgo \ncosts such as those for a credit check because LE is already a tenant in \ngood standing. \nLE (and LR) conclude that this modification should be accounted for as a separate contract – i.e. separate from the original contract that granted LE the \nright to use the original office space. This conclusion is based on the following. \n— The modification gr ants LE an additional right of use – i.e. the right to use \nan additional floor of office space. \n— The increase in the lease payments for the additional office space is \ncommensurate with the stand- alone price for the right to use that office \nspace based on th e circumstances of this contract. Even though the lease \npayments for the new office space are 5% below market rentals, the lower \nlease payments are reflective of sharing with LE the benefit of LR not \nhaving to incur origination costs to obtain this lease – i.e. as noted above, \nLR did not have to market the property or pay a broker’s commission to obtain the new office space lease and did not have to incur other common \norigination costs. \nTherefore, in accounting for the new office space lease, LE does not modify the accounting for the original office space lease. LE accounts for the new office space lease just as it would any other new lease. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 586}), Document(page\_content='Leases 586 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Scenario 2: Modification is not accounted for as a separate contract \nAssume the same facts as in Scenario 1, except that the lease payments are \ndiscounted 20% from those in the original office space lease, the payments for which are still considered to be market rentals. \nLE (and LR) conclude that this modification should not be accounted for as a \nseparate contract. Even t hough, consistent with Scenario 1, the modification \ngrants LE an additional right of use, the increase in the lease payments resulting from the additional right of use is not commensurate with the stand- alone price \nfor that additional right of use, even af ter considering the factors outlined in \nScenario 1 as to the particular circumstances of obtaining this additional lease. \nThe discount from market rentals cannot be considered entirely attributable to \nthe origination costs LR will not have to incur to obta in the new office \nspace lease. \nIn this scenario, because the new office space lease is commencing \nimmediately, and both leases have the same lease term, it does not matter \nwhether LE accounts for the original office space lease and the new office \nspace lea se as separate lease components. However, if the new office space \nlease commenced at the beginning of Year 8, rather than at the beginning of \nYear 7, LE would separately account for the two lease components (original \noffice space and new office space), rem easuring the original lease component \nfor the modification (i.e. for the change in the lease payments that will result \nfrom allocating a portion of those lease payments to the new office space \nlease) as of the effective date of the modification. LE would r ecognize and \nmeasure the new office space lease at the commencement date for that lease. \nScenario 3: Blend and extend \nAssume the same facts as in Scenario 2, except that the right to use the new \noffice space is for a non- cancellable period of nine years fr om the effective date \nof the modification and, as part of the modification, the right to use the original office space is made coterminous with the new office space – i.e. LE also \ncommits to lease the original office space for nine years from the effective date \nof the modification. In addition, the lease payments for the original office space \nare reduced to match those for the additional office space. \nAt the beginning of Year 7 of the original lease (which is the effective date of \nthe modification in this e xample), the carrying amount of the ROU asset and the \nlease liability were (see Example 6.4.20): \nLease liability: $57,306 \nROU asset: $53,350 \nAt the effective date of the modification, the following facts are relevant. \nRate implicit in the lease: Not readily determinable \nLE’s incremental borrowing rate: 9% \nRVG: None \nOptions: There are no lessee or lessor options in the contract \nTransfer of ownership: No ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 587}), Document(page\_content='Leases 587 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Fair value of the combined office space: $840,000 \nRemaining economic life of the office space: 29 years \nAdditional initial direct costs incurred: $1,000 \nBecause LE’s right to use the new office space commences on the effective \ndate of the modification, LE is not required to account for the original office \nspace and the new office space as separate lease components. LE concludes \nthat the single, modified lease component in the contract (for two floors of \noffice space for nine years) is an operating lease. \nThe lease payments for the modified contract are as follows (calculated based on contra ctual lease payments from Exampl e 6.3.10 starting in Year 7 × 80% × \n2). \nThe lease liability for the modified lease is $184,674 (the present value of the \nnine annual lease payments, discounted at 9%). Therefore, LE increases its \nexisting lease liability by $127,368 ($184,674 – $57,306). The offset to that \nadjustment is to the existing ROU asset. LE accounts for the initial direct costs incurred in connection with the modification in the same manner as it would for \na new lease. Therefore, LE recognizes the additional $1,000 in initial direct \ncosts that it incurs as an addition to its remeasured ROU asset. \nConsequently, LE records the following journal entry at the effective date of the \nmodification. \n Debit Credit \nROU asset 128,368 \nLease liability 127,368 \nCash (initial direct costs) 1,000 \nTo recognize lease modification. \nFrom the effective date of the modification, LE accounts for the modified lease in the same manner as for any other lease; see Example 6.4.20 for an example \nof subsequent accounting for an operating lease. \n \n Example 6.7.20 \nModification that extends the lease term only \nModification that extends the lease term only \nAssume all of the same facts as in Example 6. 6.50 (remeasurement resulting \nfrom a change in the lease term) except that, instead of there being a \nremeasurement event at the end of Year 6, the lease did not contain a renewal \noption and the lease is modified at the end of Year 6 to extend the total lease \nterm from 10 years to 15 years. Yr 1 Yr 2 Yr 3 Yr 4 Yr 5 Yr 6 Yr 7 Yr 8 Yr 9 Total \n$27,754 $28,586 $29,445 $30,326 $31,236 $32,174 $33,140 $34,132 $35,156 $281,949 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 588}), Document(page\_content='Leases 588 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The terms for the extension agreed through the modification and the terms of \nthe renewal option in Example 6. 6.50 are the same. That is, Lessee LE and \nLessor LR modify the lease to add an additional period of five years to the \nlease. Lease payments during the extension period start at $19,523 and \nincrease 3% annually, all payable in arrears. There are no initial direct costs, \nlease incentives or other payments between LE and LR as a result of the \nmodification. \nSeparate contrac t analysis \nBecause the modification increases the lease term only (i.e. it does not grant LE \nan additional right of use), the modification cannot be accounted for as a \nseparate contract. \nAccounting for the modification and accounting for the lease post -\nmod ification \nThe accounting for the modification and the accounting for the modified lease \nafter the modification in this example is the same as the accounting for the \nremeasurement and the accounting for the lease after the remeasurement in \nExample 6.6.50. Therefore, see that example for the journal entries recorded to \nremeasure the lease liability and the ROU asset, as well as the accounting that \nresults post -modification. \n \n Example 6.7.25 \nModification – original lease is a finance lease and \nthe modified lease is an operating lease \nAssume all of the same facts as in Example 6.4.10: 10-year finance lease of a \npiece of equipment with a remaining economic life of 12 years and no renewal \noptions. \nAt the end of Year 3, Lessee LE and Lessor LR modify the lease to reduce the \ntotal lease term from 10 to 6 years. There are no initial direct costs, lease \nincentives or other payments between LE and LR stemming from the \nmodification . \nThe following additional facts are relevant. \n— The modified lease does not transfer title to the equipment to LE. \n— The modified lease does not include renewal or purchase options. \n— The leased equipment is not specialized or customized. \n— The fair value of the equipment as of the effective da te of the modification \nis $65,000. \nSeparate contract analysis \nBecause the modification decreases the lease term only (i.e. it does not grant \nLE an additional ROU ), the modification cannot be accounted for as a separate \ncontract. \nNon-cancellable lease perio d \nLease payments under the original lease for the 10- year term were as follows. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 589}), Document(page\_content='Leases 589 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Yr 1 Yr 2 Yr 3 Yr 4 Yr 5 Yr 6 Yr 7 Yr 8 Yr 9 Yr 10 Total \n$14,527 $14,963 $15,412 $15,874 $16,350 $16,841 $17,346 $17,866 $18,402 $18,954 $166,535 \nLease payments under the modified lease are as follows. \nYr 1 Yr 2 Yr 3 Yr 4 Yr 5 Yr 6 Total \n$14,527 $14,963 $15,412 $15,874 $16,350 $16,841 $93,967 \nRemeasuring the lease liability and ROU asset \nIn accordance with paragraph 842- 10-25-11, LE uses an updated discount rate \nfor the lease determined at the effective date of the modification (i.e. at the end \nof Year 3). The rate implicit in the lease is not readily determinable. Accordingly, \nLE uses its incremental borrowing rate at the end of Year 3 (12%) as the \ndiscount rate for the modified lease, taking into account: \n— a remaining lease term of three years (modified lease term of six years less \nthree years into the original lease term); and \n— the remeasured lease payments for the modified remaining lease term of \nthree years. \nAt the end of Year 3, the carrying amounts of the lease liability and ROU asset \nimmediately before remeasurement are $83,651 and $73,500, respectively (see \nExample 6.4.10). \nLE remeasures the lease liability at the present value of the remaining lease payments for the revised lease term (i.e. Years 4– 6), discounted at 12%, which \nis $39,194 (or a decrease of $44,457). LE records the following journal entry. \n Debit Credit \nLease liability 44,457 \nROU asset 44,457 \nTo remeasure lease liability following modification \nof lease term ; corresponding adjustment to ROU \nasset . \nAfter this journal entry, the carrying amount of LE’s ROU asset is $29,043 ($73,500 – $44,457). \nLease classification reassessment \nLE is required to reassess the original finance classifi cation of the lease (see \nExample 6.4.10). The remaining economic life of the equipment is 9 years \n(original remaining economic life of 12 years less three years into the original lease term). Therefore, the reassessed lease is an operating lease. \nUnlike a t commencement of the original lease, where the lease term was for a \nmajor part of the remaining economic life of the equipment (10 year lease term \n/ 12 year remaining economic life = 83%), the modified lease is not for a major \npart of the remaining econom ic life of the equipment at the effective date of the \nmodification (3 year remaining lease term / 9 year remaining economic life = 33%). In addition, based on the facts presented, none of the other finance lease \ncriteria are met. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 590}), Document(page\_content='Leases 590 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Accounting subsequent to r emeasurement \nBecause the original classification of the lease was a finance lease and the \nmodified lease is classified as an operating lease, the difference between: \n— the carrying amount of the ROU asset after remeasurement for the \nmodification [a] and \n— the carrying amount of the ROU asset determined by applying the operating \nlease ROU asset initial measurement guidance to the modified lease [b] \nis accounted for \n— like prepaid rent (if [a] > [b]) or a lease incentive (if [b] > [a]) when \ndetermining the remaining lease cost for the modified operating lease (see \nparagraph 6.7.70). \nLE calculates the difference between [a] and [b] as follows. \nCarrying amount of ROU asset after modification remeasurement [a] $29,043 \nLess: Carrying amou nt of ROU asset applying initial operating ROU \nasset measurement guidance to the modified lease (equal to the \nremeasured lease liability as there are no initial direct costs, lease \nincentives or other payments between LE and LR as a result of the \nmodificat ion) [b] 39,194 \n[a] – [b] $(10,151) \nLE calculates the remaining lease cost for the lease as follows. \nTotal remaining lease payments , reflecting the adjustment resulting \nfrom the lease term modification – i.e. all lease payments in Years 4–6 $49,065 \nLess: Difference between [a] and [b] accounted for like a lease \nincentive (10,151) \nRemaining cost of the lease $38,914 \nAlternatively, LE may calculate the remaining lease cost as follows. \nTotal lease payments (including those paid and those not yet paid), \nreflecting the adjustment resulting from the lease term modification – \ni.e. all lease payments in Years 1–6 $93,967 \nPlus: Total initial direct costs 5,000 \nLess: Periodic lease cost recognized in prior periods (sum of interest cost and ROU asset amortization in Years 1– 3 in Example 6.4.10) (60,053) \nRemaining cost of the lease $38,914 \nLE recognizes a single lease cost, calculated so that the remaining cost of the \nlease is allocated over the remaining lease term on a straight -line basis – i.e. \n$12,971 per year for the remaining three years. \nLE accounts for the lease liability and the ROU asset from the effective date of \nthe modification using the guidance in Topic 842 for an operating lease, as \nillustrated below; LE uses Method 2 to subsequently measure the ROU asset \n(see paragraph 6.4.170). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 591}), Document(page\_content='Leases 591 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Year ROU asset amortization ROU asset carrying amount Lease \nliab. \nending \nbalance Straight -\nline lease \ncost Lease \nliab. \naccret.1 ROU \nasset \namort.2 Beg. \nbalance ROU \nasset \namort. End. \nbalance \n4 $12,971 $(4,703) $8,268 $29,043 $ (8,268 ) $20,775 $28,023 \n5 12,971 (3,363 ) 9,608 20,775 (9,608 ) 11,167 15,036 \n6 12,971 (1,804 ) 11,167 11,167 (11,167) - - \nNotes: \n1. Beginning lease liability balance ($39,194 at the beginning of Year 4, $28,023 at \nbeginning of Year 5, $15,036 at beginning of Year 6) × 12% discount rate for the \nmodified lease. \n2. Straight- line lease cost – Lease liability accretion. \n \n \n Question 6.7.10 \nMethod of accounting for lease modifications that \ndecrease the lessee’s right(s) of use \nShould a lessee apply a consistent method of remeasuring \nthe ROU asset in lease modifications that decrease its right(s) of use? \nBackground: Example 18 in Subtopic 842- 10 demonstrates two acceptable \nmethods for calculating the change in the ROU asset resulting from a lease \nmodification that decreases the lessee’s rights to use one or more underlying \nassets. The first method measures the change in the ROU asset based on the \nchange in the lease liability, while the second method measures that change \nbased on how much of the original right of use remains after the modification. The two methods generally result in different outcomes. Example 6.7.30 also \nillustrates these two accounting methods. \nInterpretive response: We believe a lessee’s decision about the accounting \nmethod to apply to such modifications is an accounting policy election that \nshould be applied consistently to similar lease modifications. The lessee’s \naccounting policy should be disclosed if the effect of this decision is material to \nthe lessee. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 592}), Document(page\_content='Leases 592 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 6.7.11 \nAcceptability of methods for remeasuring ROU \nasset in partial lease termination \nAre both methods of remeasuring an ROU asset in a partial \nlease termination acceptable in all cases? \nBackground : Example 6.7.30 illustrates the two accounting methods for \nremeasuring a lessee’s ROU asset as a result of a lease modification accounted \nfor as a partial lease termination. \nInterpretive response: No. We believe the first method illustrated in Example \n6.7.30 (Scenario 1) is not appropriate if it results in no, or a disproportionate, \ndecrease in the carrying amount of the ROU asset despite the full or partial \ntermination. This is regardless of the lessee’s accounting policy (see Question 6.7.10). \nApplying the first method in these circumstances would lead to results that \nviolate the principle that the ROU asset is to be reduced “ on a basis \nproportionate to the full or partial termination of the existing lease.” For \nexample, this might occur if the terminat ion is accompanied by a significant up-\nfront payment, resulting in no or only an insignificant decrease to the lease \nliability.\n [842-10-25-13] \nIn contrast, we are unaware of any circumstances in which the second method \nillustrated in Example 6.7.30 (Scenario 2) would be inappropriate. Because the \ndecrease in the remeasured ROU asset under that method is based directly on \nthe decrease to the lessee’s remaining right of use, its application is consistent \nwith the ROU asset remeasurement principle. \n \n Question 6.7.15 \nTermination penalties in a partial termination \nscenario \nShould a lessee recognize a termination penalty paid in \nconnection with a partial lease termination up- front or over \nthe lease term as part of lease expense? \nBackground: Example 6.7.30 illustrates a common scenario in which a lessor \npermits a lessee to terminate a portion of a lease, in return for a termination \npayment. In the example, Lessor LR permits Lessee LE to terminate its lease of \n2,500 square feet out of a total leased office space of 10,000 square feet in \nreturn for a $1,000 termination payment. \nIn these scenarios, the question arises about when, if ever, the lessee should recognize the termination payment up- front, or whether the lessee should \nrecognize the termination payment over the remaining lease term of the non-\nterminated space (or assets) as part of the lease cost. \nInterpretive response: Example 6.7.30 illustrates the termination payment in \nthat partial termination modification scenario being recognized over the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 593}), Document(page\_content='Leases 593 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. remaini ng lease term of the non- terminated space, as part of the ongoing lease \ncost, rather than being recognized up- front. \nWe believe Topic 842 requires this accounting, and does not permit recognizing \nthe termination payment up- front – e.g. as of the effective date of the \nmodification or when the payment becomes legally owed. This is based on the \nfollowing reasons. [842- 10-25-11 – 25-13, 842- 10-30-5(d), ASU 2016- 02.BC173– BC174] \n— Termination payments are explicitly included in the definition of ‘lease \npayments’ ( see section 5.4.5), and the addition of a termination penalty to \nthe contract in a contract modification changes the lease payments. \n— The lessee modification model is generally a prospective model, with no \nprofit or loss effect to the lessee at the time of the modification. The lessee \naccounts for the modified lease as if it is a new lease commencing on the \neffective date of the modification (see paragraphs 6.7.30 and 6.7.50). This \nmeans: \n— the lease liability is remeasured based on the remaining, unpaid ‘lease \npayments’ (including any unpaid termination penalty the lessee now \nowes), and the offsetting entry is to the remaining ROU asset; and \n— any lease payments (including the termination penalty) made before the effective date of the modification are lease prepayments, added to the \nremeasurement date ROU asset. \nAn exception arises, and a modification gain or loss recognized, only in a full \nor partial termination scenario, and in a partial ter mination scenario (such as \nExample 6.7.30) that gain or loss is calculated as the difference between (1) \nthe proportional decrease in the lease liability and (2) the proportional \ndecrease in the ROU asset. \n \nChange from Topic 840 \nThe above represents a change from legacy US GAAP (Topic 840 and Topic 420 \non exit or disposal costs). Under the prior guidance, which was changed by ASU \n2016 -02, a lessee may have concluded in some circumstances that either an \nexplicit termination penalty or an increase in the rent al payments over the \nremaining lease term should be recognized at the date of the lease \nmodification. [840- 20-55-4 – 55-6] \n \n Example 6.7.30 \nPartial lease termination \nThis example continues Examples 6.3.10 and 6.4.20, in which Lessee LE \nentered into a lease with Lessor LR to lease office space for a 10- year term. \nThe terms and conditions are the same. Accordingly, the subsequent accounting for the lease in this example is the same as that illustrated in \nExample 6.4.20, absent lease reassessments or modifications. Also assume \nthat the lease was for 10,000 square feet of space. \nAt the end of Year 6, LE and LR modify the lease for the remaining four years to \nreduce the leas e to 7,500 square feet of the original space and to reduce the \nremaining annual lease payments by $3,500 for each of the remaining four ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 594}), Document(page\_content='Leases 594 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. years. In conjunction with the partial termination, LE also agrees to pay LR a \ntermination fee of $1,000. \nAt the end of Year 6 of the original lease (which is the effective date of the \nmodification in this example), the carrying amount of the ROU asset and the \nlease liability were as follows (see Example 6.4.20): \nLease liability : $57,306 \nROU asset : $53,350 \nLease classi fication for the lease does not change as a result of the modification \n– i.e. it remains an operating lease because the modification reduces both the \nlease term and the lease payments. \nLE remeasures the lease liability at the effective date of the modifica tion based \non a remaining lease term of four years, the remeasured lease payments (which \ndecreased by $3,500 per year as compared to the original terms of the lease), and LE’s incremental borrowing rate at the modification date, which is 11%. \nThe lease pay ments for the modified contract are as follows (calculated based \non the contractual annual lease payments from Example 6.3.10 starting in \nYear 7 – $3,500 / year). \nYr 7 Yr 8 Yr 9 Yr 10 Total \n$13,846 $14,366 $14,902 $15,454 $58,568 \nThe remeasured lease liability is $46,210 (an $11,096 or 19.36% decrease from \nthe premodification liability). \nScenario 1: Remeasuring the ROU asset based on the change in lease \nliability \nModification accounting \nThe decrease of 19.36% in the lease liability reflects the early termination of \nthe right to use 2,500 square feet of space (or 25% of the original space), \nthe change in the lease payments, and the change in the discount rate for \nthe lease. \nLE decreases the carrying amount of the ROU asset immediately before \nthe modification (which equaled $53,350) by 19.36% to reflect the partial \ntermination of the lease. This results in a reduction in the ROU asset \nof $10,329. \nThis results in the following journal entry related to the partial lease termination \nat the end of Year 6. \n Debit Credit \nLease liability 11,096 \nROU asset 10,329 \nGain on partial lease termination 767 \nTo recognize lease modification. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 595}), Document(page\_content='Leases 595 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. LE then records the following journal entry to account for the payment of the \n$1,000 termination fee. \n Debit Credit \nLease liability 1,000 \nCash 1,000 \nTo recognize termination payment as immediate \nreduction to lease liability. \nPost -modification accounting \nLE calculates the annual single lease cost to be recognized each year of the 4-\nyear remaining lease term as follows. \nCarrying amount of ROU asset after modification remeasurement1 $43,0 21 \nPlus: Accretion to be recognized on the lease liability over the 4- year \nremaining lease term2 13,358 \nRemaining cost of the lease 56,379 \nAnnual single lease cost (rounded)3 $14,095 \nNotes: \n1. $53,350 − $10,329 = $43,021. \n2. Remaining unpaid lease payments of $59,568 − $46,210 modified lease liability = \n$13,358 . \n3. Remaining cost of the lease / 4 years. \nFrom the effective date of the modification, the following table reflects LE’s accounting for the modified lease throughout the remainder of the lease term. \nYear ROU asset carrying amount Lease \nliability Income statement \nBeg. \nBalance ROU asset \namort. Effect of \nmod. End. \nbalance Carry. \namt. (end. \nbalance) Accret. ROU \nasset \namort. Single \nlease \ncost \n6 $63,762 $(10,412) $(10,329) $43,021 $46,210 $6,741 $10,412 $ 17,153 \n7 43,021 (9,122) - 33,899 36,337 4,973 9,122 14,095 \n8 33,898 (10,098) - 23,801 25,968 3,997 10,098 14,095 \n9 23,801 (11,238) - 12,563 13,923 2,857 11,238 14,095 \n10 12,563 (12,563) - - - 1,531 12,563 14,094 \nLease cost recognized during final 4 years: $ 56,379 \nLease cost recognized during entire 10- year lease term: 158,535 \nTotal cash payments during 10 -year lease term: 158,535 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 596}), Document(page\_content='Leases 596 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Scenario 2: Remeasuring the ROU asset based on the remaining right of \nuse \nModification accounting \nLE determines the proportionate decrease in the carrying amount of the ROU \nasset based on the remaining ROU asset (7,500 square feet representing 75% \nof the original ROU asset). \nAccordingly, LE decreases the carrying amount of the ROU asset by $13,338 \n(25% × pre- modification ROU asset of $53,350) and the carrying amount of the \nlease liability by $14,327 (25% × pre -modification lease liability of $57,306), \nwhic h results in an adjusted lease liability balance of $42,979. The following \njournal entry is recorded. \n Debit Credit \nLease liability 14,327 \nROU asset 13,338 \nGain on partial lease termination 989 \nTo recognize lease modification. \nNext, LE records $3,231 as an adjustment to the carrying amount of the ROU \nasset, reflecting the difference between the remaining lease liability of $42,979 \nand the remeasured lease liability of $46,210 (determined in the introduction to \nthis example ). \n Debit Credi t \nROU asset 3,231 \nLease liability 3,231 \nLE then records the following journal entry to account for the payment of the \n$1,000 termination fee. \n Debit Credit \nLease liability 1,000 \nCash 1,000 \nTo recognize termination payment as immediate \nreduction to lease liability. \nPost -modification accounting \nLE calculates the annual single lease cost to be recognized each year of the 4 \nyear remaining lease term as follows. \nCarrying amount of ROU asset after modification remeasurement1 $43,243 \nPlus: Accretion to be recognized on the lease liability over the 4- year \nremaining lease term2 13,358 \nRemaining cost of the lease $56,601 \nAnnual single lease cost (rounded)3 $14,150 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 597}), Document(page\_content='Leases 597 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Notes: \n1. $53,350 − $13,338 + $3,231 = $43,243. \n2. Remaining unpaid lease payments of $59 ,568 − 46,210 modified lease liability = \n$13,358. \n3. Remaining cost of the lease / 4 years. \nFrom the effective date of the modification, the following table reflects LE’s \naccounting for the modified lease throughout the remainder of the lease term. \nYear ROU asset carrying amount Lease \nliability Income statement \nBeg. \nBalance ROU \nasset \namort. Effect of \nmod. End. \nbalance Carry. amt. \n(end. \nbalance) Accret. ROU \nasset \namort. Single \nlease cost \n6 $63,762 $(10,412) $(10,107) $43,243 $46,210 $6,741 $10,412 $ 17,153 \n7 43,243 (9,177) - 34,066 36,337 4,973 9,177 14,150 \n8 34,066 (10,153) - 23,913 25,968 3,997 10,153 14,150 \n9 23,913 (11,293) - 12,620 13,923 2,857 11,293 14,150 \n10 12,620 (12,620) - - - 1,531 12,620 14,151 \nLease cost recognized during final 4 years: $ 56,601 \nLease cost recognized during entire 10- year lease term: 158,535 \nTotal cash payments during 10 -year lease term: $158,535 \n \n \n Question 6.7.20 \nModifications that both decrease the lessee’s \nright(s) of use and extend the lease term \nHow should a lessee account for a modification that includes \nboth a partial lease termination and a lease extension? \nBackground: For purposes of this Question, consider a scenario in which a \nlease modification decreases the lessee’s right of use from 10,000 square feet \nof office space to 7,500 square feet, while also extending the lease term for the \nreduced 7,500 square feet of office space from 5 years to 10 years. \nInterpretive response: It depends on whether the partial lease termination \ntakes effect as of the ‘ effective date of the modification’ (see paragraph 6.7.20) \nor later (e.g. one year after the effective date of the modification). \nPartial lease termination takes effect as of the effective date of the \nmodification \nThe lessee remeasures the lease liability for the partial lease termination before \nit remeasures t he lease liability for the extended lease term. The partial lease \ntermination is measured using the same approach applied to other partial lease \nterminations (see Question 6.7.10 and Example 6.7.30). The difference \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 598}), Document(page\_content='Leases 598 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. between the reduction in the lease liabil ity and the reduction in the ROU asset \nis recognized as a gain (loss) at the effective date of the modification. \nWhen calculating the revised lease liability for the remainder of the original \nlease term, we believe the lessee should not update the discount rate for the \nlease; instead, it should continue using the discount rate in effect before the \nlease modification. Although Topic 842 does not have explicit guidance on \nwhether to update the discount rate for the lease, the FASB and the IASB \nreached conver ged decisions on accounting for lessee lease modifications, and \nIFRS 16, Example 18 illustrates in a similar, two- step lease modification that the \nlessee should first remeasure the lease liability for the decrease in the scope of \nthe lease using a non -upda ted discount rate. [IFRS 16.IE7 ] \nAfter recognizing the effect of the partial termination, the lessee remeasures the lease liability and ROU asset for the extension of the lease term (see \nExample 6.7.20) based on the change in lease payments for the remaind er of \nthe revised lease term and an updated discount rate for the lease. \nExample 6.7.35 illustrates this accounting. \nPartial lease termination takes effect after the effective date of the \nmodification \nAt the effective date of the modification, the lessee f irst reevaluates the unit(s) \nof account for the lease. We believe the lessee’s ability to terminate the lease \nfor a portion of the underlying asset suggests that the right to use that portion \nof the underlying asset would have met the criteria to be a sepa rate lease \ncomponent; this is similar to when a lessee abandons or subleases a portion of an underlying asset for which its right to use was previously accounted for as a \nsingle unit of account (see section 6.5.2). \nIn the background example, the lessee would generally treat the modified \ncontract as having two separate lease components: (1) one for 7,500 square \nfeet of office space for which the lease term was extended, and (2) one for \n2,500 square feet of office space for which the lease term was shortened (or \nnot extended). \nThe lessee allocates the existing ROU asset and lease liability between the \nnewly separate lease components on a relative stand- alone price basis. It then \naccounts for the modification of each component in the same manner it would for any other separate lease component – i.e. a lease term reduction of one \nseparate lease component, and a lease term extension of the other. In some \ncases, the term of the first separate lease component may not be shortened; \ninstead, it is merely not extended – i.e. it is permitted to expire at the end of the \npre-modification lease term. In that case, there may be no additional accounting \nfor that lease component after it is separated from the component being \nextended. \nAs discussed in Questions 6.5.80 and 6.5. 90, Topic 842 does not address \nallocation between the newly separate lease components in this situation. \nTherefore, we believe a lessee could base the relative stand- alone price \nallocation on either: \n— the stand- alone prices the lessee would have determined for the two \nseparate lease components had they previously been accounted for \nseparately (historical stand -alone prices); or ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 599}), Document(page\_content="Leases 599 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — the stand- alone prices of the two separate lease components at the \neffective date of the modification based on the remaining lease t erm and \nthen- current facts and circumstances – e.g. current observable stand- alone \nprices (current stand- alone prices). \n \n Example 6.7.35 \nModification that both decreases the lessee’s right \nof use (with immediate effect) and extends the \nlease term \nLessee LE enters into a contract with Lessor LR for the right to use 10,000 \nsquare feet of office space for a 5- year term. The right to use the office space is \na lease and there are no other components of the contract. LE classifies the \nlease as an operati ng lease because none of the tests for classification as a \nfinance lease are met (see paragraph 6.2.50). \nThe following facts are also relevant at the commencement date. \nLease payments: Fixed payments of $100,000 per year in arrears, \nwith a 3% increase ev ery year after Year 1 \nLeased space (sq. ft.) : 10,000 \nRenewal options: None \nTermination/purchase options: None \nLE's incremental borrowing rate: 5% (the rate implicit in the lease cannot be \nreadily determined) \nInitial direct costs (LE): None \nAt the end of Year 2, LE and LR modify the lease to reduce the leased space from 10,000 square feet to 7,500 square feet, effective immediately. They also \nextend the term of the remaining, modified lease for the 7,500 square feet from \n5 years (3 years remaining at the effective date of the modification) to 10 years \n(8 years remaining at the effective date of the modification). \nClassification for the modified lease does not change – i.e. it remains an \noperating lease. The following facts are also relevant. \nLease payments: Fixed payments of $85,000 per year in arrears beginning \nwith Year 3, with a 3% increase every year after Year 3 \nLeased space (sq. ft.) : 7,500 \nRenewal options: None \nTermination/purchase options: None \nLE's incremental borrowing rate: 6% (the rate implicit in the lease cannot be \nreadily determined) \nInitial direct costs (LE): None \nTermination fee: None ", metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 600}), Document(page\_content='Leases 600 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The lease payments under the modified contract are as follows. \nYr 3 Yr 4 Yr 5 Yr 6 Yr 7 Yr 8 Yr 9 Yr 10 Total \n$85,000 $87,550 $90,177 $92,882 $95,668 $98,538 $101,494 $104,539 $755,848 \nAt the end of Year 2 of the original lease (i.e. the effective date of the \nmodification ), the carrying amount of the ROU a sset and the lease liability a re \nas follows . \nROU asset : $288,012 \nLease liability : $297,377 \nStep 1: Remeasure lease liability for partial termination \nLE first remeasures the lease liability for the partial lease termination. Assume \nLE accounts for partial lease terminations using the approach illustrated in \nScenario 1 of Example 6.7.30. \nLE remeasures the lease liability for the partial lease termination based on: \n— three years remaining of the original lease term; \n— the reduced lease payments; and \n— the original discount rate for the lease of 5%. \nThe remeasured lease liability is $238,261 (i.e. the present value of the revised \npayments for Years 3– 5 discounted at 5%), which is a $59,116 (19.88%) \ndecrease from the pre -modification lease liability. \nLE correspondingly reduces the pre-modification carrying amount of the ROU \nasset by 19.88% ($57, 257). \nLE records the following journal ent ry for Step 1 . \n Debit Credit \nLease liability 59,116 \nROU asset 57,25 7 \nGain on partial lease termination 1,859 \nTo recognize partial lease termination. \nStep 2: Remeasure lease liability for extension of lease term \nLE then remeasures the lease liability for the extended lease term based on : \n— the eight -year remaining lease term post -modification; \n— the remaining lease payments for Years 3– 10; and \n— the updated discount rate for the lease of 6%. \nThe remeasured lease liability equals $581,436, which is an increase of \n$343,175 from the $238,261 calculat ed in Step 1. \nLE records the following journal entry for Step 2. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 601}), Document(page\_content="Leases 601 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Debit Credit \nROU asset 343,175 \nLease liability 343,175 \nTo recognize extension of lease term. \nLE calculates the annual single lease cost to be recognized each year of the \n8-year remaining lease term as follows. \nCarrying amount of ROU asset after modification remeasurement1 $573,930 \nPlus: Accretion to be recognized on the lease liability over the 8- year \nremaining lease term2 174,412 \nRemaining cost of the lease $748,342 \nAnnual single lease cost (rounded)3 $ 93,543 \nNotes: \n1. $288,012 – 57,25 7 + 343,17 5 = $573,930 . \n2. Remaining unpaid lease payments of $755,848 – $581,436 modified lease liability = \n$174,412 . \n3. Remaining cost of the lease / 8 years. \nFrom the effective date of the modification, the following table reflects LE's accounting for the modified lease throughout the remainder of the lease term. \n ROU asset carrying amount Lease \nliability Income statement \nYr. Beg. \nbalance ROU \nasset \namort. Effect of \nmod.1 End. \nbalance Carry. \namt. \n(end. \nbalance) Accret. ROU \nasset \namort. Single \nlease \ncost \n2 $375,129 $(87,117) $285,918 $573,930 $581,436 $19,066 $87,117 $106,183 \n3 573,930 (58,656 ) - 515,274 531,322 34,887 58,656 93,543 \n4 515,274 (61,664) - 453,610 475,652 31,879 61,664 93,543 \n5 453,610 (65,004) - 388,606 414,014 28,539 65,004 93,543 \n6 388,606 (68,702) - 319,904 345,973 24,841 68,702 93,543 \n7 319,904 (72,785) - 247,119 271,064 20,758 72,785 93,543 \n8 247,119 (77,279) - 169,840 188,789 16,264 77,279 93,543 \n9 169,840 (82,215 ) - 87,625 98,622 11,327 82,215 93,542 \n10 87,625 (87,625 ) - - - 5,917 87,625 93,542 \nLease cost rec ognized over remaining 8 -year lease term: $748,342 \nLease cost recognized over entire 10- year lease term: 958,848 \nTotal lease payments over 10-year lease term: 958,848 \nNote: \n1. $343,175 (Step 2 addition) – $57,257 (Step 1 reduction) = $285,918 . \n \n ", metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 602}), Document(page\_content='Leases 602 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 6.7.36 \nModification that both decreases the lessee’s right of \nuse (with delayed effect) and extends the lease term \nAssume the same facts as in Example 6.7.35, except that the partial lease \ntermination takes effect one year after the effective date of the modification \n(i.e. at the end of Year 3). Correspondingly, the lease payments are reduced to \n$85,000 beginning in Year 4 and increas e by 3% every year thereafter. \nThe lease payments for the modified contract are as follows (the payment for \nYear 3 is unchanged from the pre- modified contract). \nYr 3 Yr 4 Yr 5 Yr 6 Yr 7 Yr 8 Yr 9 Yr 10 Total \n$106,090 $85,000 $87,550 $90,177 $92,882 $95,688 $98,538 $101,494 $757,399 \nStep 1: Reevaluate the unit (s) of account \nLE reevaluates the unit(s) of account, and concludes that the right to use the to -\nbe-terminated portion of the underlying asset qualifies as a separate lease \ncomponent. \nTherefore, LE separates the original lease component into two components: \n— Component 1 : 7,500 square feet of space for which the lease term has \nbeen extended by five years , and therefore has a remaining lease term of \n8 years as of the effective date of the modification \n— Component 2 : 2,500 square feet of space for which the lease term has \nbeen reduced by two year s, and therefore has a remaining lease term of \nonly 1 year as of the effective date of the modification. \nStep 2: Allocate between the two units of account \nLE allocates the pre-modification lease liability and ROU asset as of the end of \nYear 2 between the two components on a re lative stand -alone price basis. In \nthis example, LE has elected to use historical stand- alone prices in similar \nscenarios (see Question 6.7.20). \nComponent Stand -alone \nprice1 Allocation Lease liability ROU asset \nComponent 1 $420,000 75% $223,033 $216,009 \nComponent 2 140,000 25% 74,344 72,003 \nTotal $560,000 100% $297,377 $288,012 \nNote: \n1. Because LE is using historical rather than current stand -alone prices, those prices are \nbased on two five- year leases. LE determines that the historical stand- alone prices in \nthis case are proportional to the size of the space that comprises each component ; \nthat may not be the case in other circumstances. \nLE then allocates the remaining lease payments until the partial lease \ntermination takes effect between Component 1 and Component 2 using the ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 603}), Document(page\_content='Leases 603 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. same 75/25 allocation, and the lease payments for the remaini ng lease term \nafter Component 2 expires 100% to Component 1. Therefore, the remaining \nlease payments are allocated to Component 1 and Component 2 as follows. \nYear Component 1 Component 2 Total \n3 $ 79,568 $26,522 $106,090 \n4 85,000 - 85,000 \n5 87,550 - 87,550 \n6 90,177 - 90,177 \n7 92,882 - 92,882 \n8 95,668 - 95,668 \n9 98,538 - 98,538 \n10 101,494 - 101,494 \nTotal $730,877 $26,522 $757,399 \nStep 3: Account for the modifications of each component \nComponent 1 : Extended lease term \nLE remeasures the lease liability for Component 1 based on: \n— the eight -year remaining lease term post -modification; \n— the remaining lease payments allocable to Component 1 for Years 3– 10; \nand \n— an updated discount rate for the lease of 6%. \nThe remeasured lease liability equals $561,712, which is an increase of $338,679 from the $223,033 calculated in Step 2. \nLE records the following journal entry. \n Debit Credit \nROU asset 338,679 \nLease liability 338,679 \nTo remeasure lease liability of Component 1 for \nextended lease term; corresponding adjustment \nto ROU asset. \nLE concludes that the modified Component 1 lease is an operating lease. \nTherefore, LE calculates the annual single lease cost to be recognized each year \nof the 8 -year remaining lease term as follows. \nCarrying amount of ROU asset after modification remeasur ement1 $554,688 \nPlus: Accretion to be recognized on the lease liability over the 8- year \nremaining lease term2 169,165 \nRemaining cost of the lease $723,853 \nAnnual single lease cost (rounded)3 $ 90,482 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 604}), Document(page\_content="Leases 604 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Notes: \n1. $216,009 + 338,679 = $554,688. \n2. Remaining u npaid lease payments of $730,877 – $561,712 modified lease liability = \n$169,165 . \n3. Remaining cost of the lease / 8 years. \nFrom the effective date of the modification, the following table reflects LE's \naccounting for the modified Component 1 throughout the remainder of the \nlease term. \n ROU asset carrying amount Lease \nliability Income statement \nYr. Beg. \nbalance ROU \nasset \namort. Effect of \nmod. End. \nbalance Carry. \namt. (end. \nbalance) Accret. ROU \nasset \namort. Single \nlease \ncost \n2 $281,347 $(65,338) $338,679 $554,688 $561,712 $14,299 $65,338 $79,637 \n3 554,688 (56,779) - 497,909 515,847 33,703 56,779 90,482 \n4 497,909 (59,531) - 438,378 461,798 30,951 59,531 90,482 \n5 438,378 (62,774) - 375,604 401,956 27,708 62,774 90,482 \n6 375,604 (66,364) - 309,240 335,897 24,118 66,364 90,482 \n7 309,240 (70,328) - 238,912 263,168 20,153 70,328 90,481 \n8 238,912 (74,691) - 164,221 183,290 15,790 74,691 90,481 \n9 164,221 (79,484) - 84,737 95,749 10,997 79,484 90,481 \n10 84,737 (84,737) - - - 5,745 84,737 90,482 \nComponent 2: Reduced lease term \nLE remeasures the lease liability for Component 2 based on: \n— the one- year remaining lease term post -modification; \n— the remaining lease payments allocable to Component 1 for Year 3; and \n— an updated discount rate for the lease of 3%. \nThe remeasured lease liability equals $25,750, which is a decrease of $48,594 from the $74,344 calculated in Step 2. \nLE records the following journal entry. \n Debit Credit \nLease liability 48,594 \nROU asset 48,594 \nTo remeasure lease liability of Component 2 for \nreduced lease term; corresponding adjustment to ROU asset. ", metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 605}), Document(page\_content='Leases 605 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. LE concludes that the modified Component 1 lease is an operating lease. \nTherefore, LE calculates the single lease cost to be recognized in Year 3 as \nfollows. \nCarrying amount of ROU asset after modification remeasurement1 $23,409 \nPlus: Accretion to be recognized on the lease liability over the one- year \nremaining lease term2 772 \nRemaining cost of the lease $24,181 \nNotes: \n1. $72,003 – 48,594 = $23,409. \n2. Remaining u npaid lease payments of $26,522 – $25,750 modified lease liability = \n$772 . \nFrom the effective date of the modification, the following table reflects LE ’s \naccounting for the modified component throughout the remaining lease term. \n ROU asset carrying amount Lease \nliability Income statement \nYr. Beg. \nbalance ROU \nasset \namort. Effect of \nmod. End. \nbalance Carry. \namt. (end. \nbalance) Accret. ROU \nasset \namort. Single \nlease \ncost \n2 $93,782 $(21,779) $(48,594) $23,409 $25,750 $4,766 $21,779 $26,545 \n3 23,409 (23,409 ) - - - 772 23,409 24,181 \n \n \n Question 6.7.25 \nContinued right of use after effective date of \nmodification \nIs a lease modification that does not terminate the lessee’s \nright of use immediately and completely a lease term reduction or a lease termination? \nBackground: Assume Lessee LE and Lessor LR ha ve an existing, ten- year \nlease of office space. At the end of Year 5 of the lease, LE and LR agree to \nearly terminate the lease. LE must vacate the leased office space within two \nweeks; LE retains exclusive use of the space during that period. LE will pay LR \na one- time termination fee. \nAs of the end of Year 5, which is the ‘effective date of the modification’ (see \nparagraph 6.7.20), LE has already relocated most of its personnel and office \nequipment from the office space. During the two- week continued use period, \nLE will relocate the few remaining employees and office equipment to another office space in the same geographic area. \nIn scenarios like this one, the question arises about whether the contract \nmodification is: \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 606}), Document(page\_content='Leases 606 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — a lease termination, which would resu lt in the immediate (1) derecognition \nof the entire ROU asset and lease liability, and (2) recognition of the \ntermination fee on the effective date of the modification (see section 6.8) ; \nor \n— a lease term reduction, which means (1) the ROU asset and lease l iability \nwill be remeasured, but not derecognized entirely, at the effective date of the modification, and (2) the termination fee will be treated as a component \nof the lease cost to be recognized over the two -week remaining lease term \n(see Question 6.7.15). \nInterpretive response: Assuming a lease still exists for the short remaining \nperiod, a lease modification that permits the lessee to continue to use the \nunderlying asset after the effective date of the modification is a lease term \nreduction, not a lease termination. Note: lease identification is reassessed on \ncontract modification (see paragraph 3.1.20). \nThis is regardless of whether the lessee’s right of use is for only a very short period of time and for a limited purpose as compared to the lessee’s original \nright of use, such as short -term storage. Topic 842 does not treat lease term \nreduction modifications differently based on either (1) the duration of the \nremaining lease term (post -reduction) or (2) any new res trictions placed on the \nlessee (e.g. with respect to permitted uses of the underlying asset). \nIn the background scenario, this means LE will account for the modification as a \nlease term reduction, and not a lease termination. \nAccounting before the effectiv e date of the modification \nBefore the modification date, the lessee may commit to a plan to abandon the ROU asset. Section 6.5.2 has guidance on determining if that is the case and, if \nso, the accounting that should result. \n \n Question 6.7.30 \nTerminating one lease and entering into another \nwith the same lessor \nHow does a lessee account for the contemporaneous \ntermination of one lease and inception of another with the same lessor? \nBackground: A common example of lessee substitution with the sa me lessor \nis a lessee moving from one retail space in a shopping center to another in the \nsame shopping center or another lessor -owned shopping center nearby – e.g. \nto accommodate the need for more or less space or for one with a different \nlayout. \nWhen this occurs, whether enacted through a contract amendment or by \nterminating the existing contract and entering into a new one, questions arise \nabout how to account for the modification and in particular how to account for \nany difference between the ca rrying amounts of the original ROU asset and the \nrelated lease liability at the termination date. In a straightforward termination scenario – i.e. the lessee does not exchange its right to use the original \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 607}), Document(page\_content='Leases 607 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. underlying asset for the right to use another underlying asset of the lessor – \nthat difference is recognized in profit or loss (see section 6.8). [842- 20-40-1] \nInterpretive response: The unit of lease accounting under Topic 842 is the \nseparate lease component (see section 4.1). Therefore, we believe the l essee \nmust both: [842- 10-15-28; 842- 20-25-1, 40- 1] \n— derecognize the ROU asset and lease liability for the original lease \ncomponent on the date the original lease is terminated; and \n— recognize the ROU asset and lease liability for the new lease component \nwhen that lease commences. \nHowever, the agreement to terminate the original lease component and enter \ninto the new lease component are contemporaneous and part of a single \ncommercial negotiation. Therefore, regardless of whether these two actions are \npapered as a single contract amendment or separately, they constitute a single \ntransaction based on the Topic 842 contract combination guidance (see section \n4.6). [842- 10-25-19] \nThe resulting accounting depends on whether the ‘effective date of the modification’ (see paragraph 6.7.20) precedes the termination date of the \noriginal lease. \nOriginal lease is terminated on the effective date of the modification \nWe believe any gain or loss from derecognizing the original lease component \n(i.e. the difference between the carrying amounts of the ROU asset and the \nlease liability) should be adjusted for any off -market terms of the new lease \ncomponent. This approach reflects the economic interrelationship of the two \nactions. \nThe lessee calculates whether the pricing for the new lease component is off -\nmarket by comparing the present value of the lease payments to market rental \npayments. The new lease component is not off -market solely because the \npayments for the lease include a significant variable component. \nIn determining whether the new lease component is off -market, the calculation \nshould be performed in the same way as for a sale- leaseback transaction (see \nsection 9.2). The lessee should consider variable payments that it reasonably \nexpects to make on the basis of all reasonably available information (e.g. \nhistorical, current and/or forecasted), as well as the basis on which those variable payments are determined (e.g. the sales - or usage- based royalty rate). \n— If the new lease component is priced below market , the difference \nbetween (1) the present value of the lease payments (including expected variable payments) and (2) the present value of the market rental payments \n(also including expected variable payments) increases the gain or reduces \nthe loss recognized on the termi nation of the original lease component. The \noffset is recognized as a lease prepayment. \n— If the new lease component is priced above market , the difference \nbetween (1) the present value of the lease payments (including expected \nvariable payments) and (2) the present value of the market rental payments \n(also including expected variable payments) reduces the gain or increases \nthe loss recognized on the termination of the original lease component. The \noffset is recognized as a lease incentive. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 608}), Document(page\_content='Leases 608 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. If the new lease c omponent has not commenced at the effective date of the \nmodification, the lessee accounts for the lease prepayment or lease incentive in \nthe same manner as it would any other lease payment made or lease incentive \nearned before commencement of the related l ease (see Question 6.3.15 for \nlease incentives earned pre -commencement). If the new lease component has \ncommenced, the prepayment or incentive affects the initial measurement of \nthe new lease component ROU asset as outlined in paragraph 6.3.70. \nEffective d ate of the modification precedes original lease termination \nThe effective date of the modification may frequently precede both the \ntermination of the original lease component and the commencement of the \nnew lease component. In that case, there are two elem ents to the lease \nmodification: \n— the lease term reduction of the original lease component – i.e. the lease \nterm is reduced to the period from the effective date of the modification to the date it will be terminated; and \n— the addition of the new lease component. \nConsistent with any other lease modification, the lessee must remeasure and \nreallocate the ‘consideration in the contract’ to the remaining lease and non-\nlease components of the contract (if any) at the effective date of the \nmodification using then- current stand- alone prices (see paragraph 6.7.50). At \nthe effective date of the modification, and ignoring any non- lease components, \nthe modified contract contains two separate lease components: (1) the \nshortened original lease component and (2) the new lease component. \nBecause these two lease components will be recognized based on current \nstand -alone prices, no off -market adjustment to any gain that results from \nremeasuring the original lease liability (i.e. because adjusting the ROU asset by \nthe same amount would reduce its carrying amount below zero) at the effective \ndate of the modification is necessary. \n[842- 20-35-4] \nBecause the modification is accounted for ahead of the original lease \ntermination, the ROU asset and lease liability should both have carrying \namounts of zero at the termination date. Therefore, there should not be any \ngain or loss at the termination date. \n \n Question 6.7. 40 \nLessor payment for terminating one lease and \nentering into another \nHow does a lessee account for a payment from a lessor to \nearly terminate one lease and enter into another ? \nBackground: Consider the same scenarios described in Question 6.7.30. In \naddition, the lessor makes a payment to the lessee for agreeing to terminate \nthe original lease and enter into a new lease for a different underlying asset. \nInterpretive response: Considering the accounting framework in Question \n6.7.30, we believe that: \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 609}), Document(page\_content='Leases 609 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. \uf8e7 If the original lease is terminated on the effective date of the modification, \nthe lessor payment should be treated as a lease incentive of the new lease. \nAs such, it will affect the analysis in Question 6.7.30 about whether the \nnew lease component is priced at market. For example, if the new lease \ncomponent would have been at mark et without the lessor payment, it will \nbe priced below market with the payment factored in. Question 6.7.30 outlines the effects of above- or below- market pricing for the new lease \ncomponent. \n[842- 10-30-5(a), 55-30(a)] \n\uf8e7 If the original lease will be termina ted after the effective date of the \nmodification, the lessor payment is part of the remeasured ‘consideration in the contract’ (i.e. reducing it) that gets allocated to the remaining lease and non-lease components of the contract (see paragraph 6.7.50). \n \n Example 6.7.40 \nMaster lease agreement \nLessee LE is a manufacturer of protective packaging and requires extrusion \nequipment for use in its production process. LE is expanding its business to a new location and needs to equip its new manufacturing facility with extrusion \nequipment for its production li nes. LE wants to ramp up its production capacity \nby beginning with 20 new production lines immediately and expanding once \nsales demand is established. \nLE enters into a master lease agreement with Lessor LR to lease up to \n50 extrusion machines for a fixed monthly payment amount of $2,000 per \nmachine for a total term of seven years from delivery of the first machine (at \nthe beginning of Year 1). The monthly per machine payment does not change \ndepending on how many machines are delivered to LE. LE is required to take \ndelivery of 20 machines immediately and to take delivery of a minimum of 10 additional machines from LR by the end of Year 2. There are no residual \nvalue guarantees and the lease payments cannot change (e.g. based on an \nindex or rate) during the s even- year term unless the contract is modified. \nWhen LE takes delivery of any of the 10 mandated additional machines, no \nlease modification is deemed to occur. However, if LE takes delivery of more \nthan 30 machines in total , a lease modification will be de emed to occur when \neach drawdown from the master lease above the guaranteed minimum of 30 occurs. \nEven if LE draws down only the required minimum of 30, while there would be no lease modification resulting from drawing down 10 additional machines after \ntaking delivery of the first 20 machines, some measurement and allocation \ncomplexities could arise if there were, for example, residual value guarantees or \nif the monthly lease payments escalated during the lease term based on an \nindex or rate (e.g. CPI). Qu estion 4.3.4 0 discusses these considerations in \nfurther detail. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 610}), Document(page\_content='Leases 610 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Comparison to legacy US GAAP \nModification guidance is substantially changed from Topic 840 \n6.7.80 The lease modification guidance in Topic 842 is substantially different \nfrom, and more extensive than, the guidance on lease modifications in \nTopic 840. There is virtually no parallel between the two sets of guidance such \nthat entities should take careful not e of the new modifications guidance and not \nassume that anything done with respect to modifications under Topic 840 \napplies under Topic 842. \n \n6.8 Lease t erminations \n Excerpt from ASC 842 -20 \n40 Derecognition \nGeneral \n> Lease Termination \n40-1 A termination of a lease before the expiration of the lease term shall be \naccounted for by the lessee by removing the right- of-use asset and the lease \nliability , with profit or loss recognized for the difference. \n>> Purchase of the Underlying Asset \n40-2 The termination of a lease that results from the purchase of an underlying \nasset by the lessee is not the type of termination of a lease contemplated by \nparagraph 842 -20-40-1 but, rather, is an integral part of t he purchase of the \nunderlying asset. If the lessee purchases the underlying asset, any difference \nbetween the purchase price and the carrying amount of the lease liability \nimmediately before the purchase shall be recorded by the lessee as an \nadjustment of the carrying amount of the asset. However, this paragraph does \nnot apply to underlying assets acquired in a business combination, which are \ninitially measured at fair value in accordance with paragraph 805 -20-30-1. \n \n6.8.10 A termination penalty paid or received upon termination that was not \nalready included in the lease payments is generally included in the gain or loss \non termination. [842- 10-30-5(d), 842 -20-40-1] \n6.8.20 If a lease is terminated because the underlying asset is purchased by the \nlessee before the end of the lease term, the lessee recognizes an adjustment \nto the carrying amount of the asset purchased as follows. [842- 20-40-2] \nAdjustment to \ncarrying \namount of \nassetPurchase priceCarrying \namount of \nlease liability ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 611}), Document(page\_content='Leases 611 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 6.8.30 The provisions of paragraph 6.8.20 do not apply t o situations where the \nunderlying asset is acquired by the lessee in a business combination (see \nsection 11.1). [842- 20-40-2] \n \n Example 6.8.10 \nFull lease termination \nScenario 1: Termination of lease before expiration of lease term \nLessee LE entered into a lease with Lessor LR to lease a building for a 15- year \nterm. At the commencement date of the lease, LE appropriately classified the lease as an operating lease. There were no impairments, remeasurements or \nmodifications during the first 10 y ears of the lease term. There are no other \nexisting business relationships between LE and LR. \nAt the end of Year 10, LE and LR agree to terminate the lease. There was no \ntermination option in the lease agreement. In conjunction with the termination, \nLE als o agrees to pay LR a termination fee of $5,000, which was not previously \nincluded in the lease payments. At the date of termination, LE has the following \nbalances for the operating lease recognized on its balance sheet. \nLease liability: $104,405 \nROU asset: $101,520 \nLE records the following journal entry for the lease termination at the end of Year 10 to derecognize the lease liability and the ROU asset, recognize the \ntermination penalty and record the resulting loss in its income statement. \n Debit Credit \nLease liability 104,405 \nLoss on lease termination 2,115 \nROU asset 101,520 \nCash 5,000 \nTo recognize lease termination and penalty paid. \nScenario 2: Lessee purchases asset during the lease term \nAssume the same facts as Scenario 1, except that at the end of Year 10 LE \nagrees to purchase the building from LR for $110,000. There is no lease \ntermination penalty, and the purchase by LE does not result from a purchase \noption that LE was reasonably certain to exercise . \nLE determines the adjustment to record to the carrying amount of the \npurchased asset as follows. \nPurchase price paid $ 110,000 \nLess: Carrying amount of lease liability immediately before purchase (104,405) \nAdjustment to carrying amount of asset $ 5,595 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 612}), Document(page\_content='Leases 612 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. LE records the following journal entry to recognize the termination of the lease \nand purchase of the underlying asset at the end of Year 10. \n Debit Credit \nLease liability 104,405 \nPP&E – building1 107,115 \nROU asset 101,520 \nCash 110,000 \nTo recognize lease termination and purchase of asset. \nNote: \n1. $101,520 ROU asset + $5,595 adjustment = $107,115 . \n \n \n Question 6.8.10 \nLessee recognition of lease cancellation payment \npremium \nShould a lessee recognize a lease cancellation payment from \nthe lessor in income immediately? \nBackground: Consider a scenario in which Lessee LE is leasing a building from \nLessor LR under a lo. ng-term lease. LE decides that it no longer needs the use \nof the building, and LE and LR agree to cancel the lease. However, because fair \nmarket rent for the building has increased since the original execution of the \nlease, LR pays a premium to LE in return for LE agreeing to cancel the lease. \nInterpretive response: It depends. If the lessee has no remaining obligation to \nthe lessor or the new lessee, the payment is recognized by the lessee in \nincome when it becomes receivable . However, if there is any remaining lease \nobligation on the part of the lessee (e.g. because the cancellation does not take \neffect immediately), the payment from the lessor should be treated in the same \nmanner as a lease incentive (see section 5.4.3 ). \nAdditionally, the lessee needs to consider whether there is any ongoing vendor \nor customer relationship with the lessor. \n— If the l essee has an ongoing customer relationship with the lessor, it \nconsiders the guidance in Topic 705 ( cost of sales and services ). \n— If the lessee is a vendor to the lessor, it considers the guidance in \nTopic 606 with respect to accounting for consideration r eceived (or \nreceivable) from a customer ; see chapter 3 of KPMG Handbook, Revenue \nrecognition . \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 613}), Document(page\_content='Leases 613 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 6.8A Lease accounting – lessee in bankruptcy \n6.8A.10 Guidance on lessee accounting for leases upon entering, and while in, \nbankruptcy is included in section 4.7 of KPMG Handbook, Accounting for \nbankruptcies . \n \n6.9 Presentation (Step 9) \n Excerpt from ASC 842 -20 \n45 Other Presentation Matters \nGeneral \n> Statement of Financial Position \n45-1 A lessee shall either present in the statement of financial position or \ndisclose in the notes all of the following: \na. Finance lease right -of-use assets and operating lease right-of-use \nassets separately from each other and from other assets \nb. Finance lease liabilitie s and operating lease liabilities separately from each \nother and from other liabilities. \nRight -of-use assets and lease liabilities shall be subject to the same \nconsiderations as other nonfinancial assets and financial liabilities in classifying \nthem as current and noncurrent in classified statements of financial position. \n45-2 If a lessee does not present finance lease and operating lease right -of-use \nassets and lease liabilities separately in the statement of financial position, the \nlessee shall disclose which line items in the statement of financial position \ninclude those right -of-use assets and lease liabilities. \n45-3 In the statement of financial position, a lessee is prohibited from \npresenting both of the following: \na. Finance lease right -of-use assets in the same line item as operating lease \nright-of-use assets \nb. Finance lease liabilities in the same line item as operating lease liabilities. \n> Statement of Comprehensive Income \n45-4 In the statement of comprehensive income, a lessee shall present both of \nthe following: \na. For finance leases , the interest expense on the lease liability and \namortization of the right- of-use asset are not required to be presented as \nseparate line items and shall be presented in a manner consistent with \nhow the entity presents other interest expense and depreciation or \namortization of similar assets, respectively \nb. For operating leases , lease expense shall be included in the lessee’s \nincome from continuing operations. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 614}), Document(page\_content='Leases 614 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. > Statement of Cash Flows \n45-5 In the statement of cash flows, a lessee shall classify all of the following: \na. Repayments of the principal portion of the lease liability arising from \nfinance leases within financing activities \nb. Interest on the lease liability arising from finance leases in accordance with \nthe requirements relating to interest paid in Topic 230 on ca sh flows \nc. Payments arising from operating leases within operating activities, except \nto the extent that those payments represent costs to bring another asset \nto the condition and location necessary for its intended use, which should \nbe classified within in vesting activities \nd. Variable lease payments and short -term lease payments not included in \nthe lease liability within operating activities. \n \n6.9.10 The following chart summarizes the financial statement presentation \nrequirements applicable to lessees, which are specified in detail in \nparagraphs 6.9.20 – 6.9.130. [842- 20-45-1 – 45-5] \nFinance\n leases\nOperating\nleasesROU assets\n— Separate line item ; \nor \n— Within another line \nitem, separate from \nwhere operating lease ROU assets are presented\nLease liabilities\n— Separate line item ; \nor\n— Within another line item, separate from \nwhere operating lease liabilites are \npresentedROU asset \namortization\n— Consistent with presentation of depreciation or \namortization of \nsimilar assets \nInterest expense on lease liability \n— Consistent with presentation of other interest expensePrincipal repayments\n— Financing activities\nInterest payments\n— In accordance with \nTopic 230 (typically \nin operating activities )\nVariable lease \npayments\n— Operating activities \nLease payments\n— Operating activities , \nunless payments \nare for costs to put another asset in service\nVariable lease \npayments\n— Operating activitiesLease expense\n— Included in lessee ’s \nincome from \ncontinuing \noperations \n(operating expense )Balance sheet Income statementStatement of cash \nflows\nROU assets\n— Separate line item ; \nor \n— Within another line \nitem, separate from \nwhere finance lease ROU assets are presented\nLease liabilities\n— Separate line item ; \nor\n— Within another line item, separate from \nwhere finance lease \nliabilities are presented \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 615}), Document(page\_content='Leases 615 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 6.9.1 Balance sheet \n6.9.20 A lessee presents on the balance sheet (or discloses in the notes) the \nfollowing. [842- 20-45-1] \n— Finance lease ROU assets and operating lease ROU assets separately from \neach other and from other assets. \n— Finance lease liabilities and operating lease liabiliti es separately from each \nother and from other liabilities. \n6.9.30 If a lessee does not present finance lease and operating lease ROU \nassets and lease liabilities separately on the balance sheet, it discloses the line \nitems in which the ROU assets and lease liabilities are included. [842- 20-45-2] \n6.9.40 ROU assets and lease liabilities are classified as current or noncurrent on \na classified balance sheet in the same manner as any other nonfinancial assets \nand financial liabilities. [842- 20-45-1] \n \n Question 6.9.10 \nClassification of ROU assets and lease liabilities \nAre ROU assets and lease liabilities classified in current and \nnoncurrent portions on the lessee’s balance sheet? \nInterpretive response: For ROU assets, no. Consistent with the treatment of \nproperty, plant and equipment and intangible assets, ROU assets are not \nclassified into current and noncurrent portions. In contrast, lease liabilities are \nclassified into current and noncurrent portions (consistent with other financial \nliabilities). \nWe believe either of the following approaches may be acceptable under Topic 210 (balance sheet) to determine the current portion of the lease liability. \n— Approach 1. The current portion of the lease liability is the amount by \nwhich the total lease liabilit y will be reduced over the next 12 months (or \noperating cycle, if longer). This equals the payment(s) the lessee will make, less interest/accretion of the lease liability. \n— Approach 2. The current portion of the lease liability is equal to the present value of the lease payment(s) scheduled to be made over the next 12 \nmonths (or operating cycle, if longer). \nUnder both approaches, the noncurrent portion of the lease liability is calculated \nas the difference between the carrying amount of the total lease liability and the \ncurrent portion . \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 616}), Document(page\_content='Leases 616 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 6.9.10 \nClassification of lease liabilities \nLessee LE enters into a lease of equipment from Lessor LR. The lease \ncommences on January 1, 20X1, has a lease term of four years and annual \npayments of $100 due in arrears on December 31 of each year. \nAfter the initial payment on December 31, 20X1, LE calculates its remaini ng \nlease liability at December 31, 20X1, 20X2 and 20X3, using its incremental \nborrowing rate at lease commencement of 6% as follows. \n 20X1 20X2 20X3 \nTotal lease liability $ 267 $ 183 $ 94 \nUnder Topic 210, LE classifies liabilities as current when they are expected to be repaid within 12 months. \nScenario 1: LE applies Approach 1 \nUnder Approach 1 in Question 6.9.10, the current portion of the lease liability at \nthe end of 20X1 is $84. This amount represents the portion of the 20X2 annual \npayment of $100 that will reduce the total lease liability from the end of 20X1 to \nthe end of 20X2. $84 is calculated as the end of 20X2 payment of $100, \nreduced by the $16 of expected 20X2 interest (if a finance lease) / accretion (if \nan operating lease) on the lease liability. \nThe following table illustrates the calculation of the current and noncurrent \nlease liability for each year of the lease term. \nPeriod Beg. \nbalance \nA Interest / \naccretion \nB1 Lease \npayment \nC Ending \nbalance \nD = A–\nC+B Current \nlease \nliability \nE2 Noncurr . \nlease \nliability \nD–E \n20X1 $346 $21 $100 $267 $84 $183 \n20X2 267 16 100 183 89 94 \n20X3 183 11 100 94 94 0 \n20X4 94 6 100 0 - - \nNotes : \n1. Calculated as the beginning balance (A) × 6%. \n2. Calculated as the annual lease payment for the next year – interest/accretion for the \nupcoming 12 months (e.g. for end of 20X1, $100 20X2 payment – $16 20X2 \ninterest/accretion = $84). \nScenario 2: LE applies Approach 2 \nUnder Approach 2 in Question 6.9.10, the current portion of the lease liability at the end of 20X1 is $94. This amount represents the end of 20X1 present value \nof the $100 20X2 payment that will be made at the end of 20X2, discounted at \n6%. \nThe following table illustrates the calculation of the current and noncurrent lease liability for each lease period. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 617}), Document(page\_content='Leases 617 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Period Beg. \nbalance \nA Interest / \naccretion \nB1 Lease \npayment \nC Ending \nbalance \nD = A–\nC+B Current \nlease \nliability \nE2 Noncurr. \nlease \nliability \nD–E \n20X1 $346 $21 $100 $267 $94 $173 \n20X2 267 16 100 183 94 89 \n20X3 183 11 100 94 94 0 \n20X4 94 6 100 0 - - \nNotes : \n1. Calculated as the beginning balance (A) × 6% . \n2. Calculated as the present value of the annual lease payment for the next year ($100 \neach year for this lease), discounted at 6% . \n \n6.9.50 A lessee is prohibited from presenting: [842- 20-45-3] \n— finance lease ROU assets in the same balance sheet line item as operating \nlease ROU assets; and \n— finance lease liabilities in the same balance sheet line item as operating lease liabilities. \n6.9.60 Operating lease liabilities are presented and accounted for (e.g. when \nconsidering such amounts in Topic 360 impairment testing – see section 6.5) as \noperating liabilities, rather than as debt. Therefore, when considering how to present these liabilities on t he balance sheet, entities might consider a \npresentation similar to what they do for other discounted financial liabilities that are considered operat ing in nature, such as restructuring liabilities and asset \nretirement obligations. \n[ASU 2016- 02.BC14, BC264] \n \n Observation \nLessee balance sheet presentation focused on user \nneeds \n6.9.70 The balance sheet presentation requirements outlined in \nparagraphs 6.9.20 – 6.9.40 are about ensuring that financial statement users \nget the benefit of what the Board believes is the primary improvement to \nUS GAAP resulting from Topic 842: the recognition of ROU assets and lease \nliabilities for all leases other than short -term leases. The Board wanted users \nto be able to identify the amounts and where they are included o n the balance \nsheet. [ASU 2016- 02.BC262] \n6.9.80 The requirement not to include finance lease ROU assets and lease \nliabilities in the same balan ce sheet line items as their operating lease \ncounterparts (see paragraph 6.9.50) is primarily a function of the Board ’s view \nthat financ e leases and operating leases are two different types of transactions \n– one being more similar to a purchase of the underlying asset; the other being \nsimply a rental of another entity’s owned asset. Therefore, in their view, presenting the assets and liabilities that result from these two different types of \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 618}), Document(page\_content='Leases 618 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. transactions in the same line item on the balance sheet would be mi sleading. \n[ASU 2016- 02.BC263 –BC264] \n6.9.90 The Board concluded that operating lease liabilities, while financial, \nshould be characterized as operating liabilities principally because such liabilities \nare not debt -like in nature – e.g. the treatment of operating lease obligations in \nbankruptcy is gener ally different from the treatment of finance lease \nobligations. [ASU 2016- 02.BC264] \n \n6.9.2 Income statement \n6.9.100 For finance leases, a lessee presents the interest expense on the lease \nliability and the amortization of the ROU asset in a manner consist ent with how \nthe entity presents other interest expense and depreciation or amortization of \nsimilar assets, respectively. They are not required to be presented as separate \nline items. [842- 20-45-4(a)] \n6.9.110 For operating leases, a lessee presents lease expense in income from \ncontinuing operations. [842- 20-45-4(b)] \n \n Question 6.9.20 \nPresentation of variable lease payments \nShould variable lease expense be recognized as an operating \nexpense in the income statement of the lessee? \nInterpretive response: For operating leases, yes. \nTopic 842 does not address this explicitly for finance leases. However , the basis \nfor conclusions to ASU 2016- 02 states, “variable lease payments not included \nin lease liabilities should be classified within operating activities in the \nstatement of cash flows because the corresponding lease cost will be \npresented in income from continuing operations.” Therefore, we believe it \nwould be acceptable to present variable lease expense as an operati ng expense \nwithin income from continuing operations . [ASU 2016- 02.BC271] \nHowever, because (1) the basis for conclusions is not authoritative and (2) the Board has asserted that the new leases guidance was not intended to substantially \nchange lessees’ incom e statements, which may present variable lease expense \nresulting from capital leases as additional interest expense on the capital lease \nobligation under Topic 840 , we believe it is also acceptable for a lessee to \npresent variable lease expense resulting f rom a finance lease as interest \nexpense. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 619}), Document(page\_content='Leases 619 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 6.9.30 \nPresentation of operating lease cost after an \nimpairment or planned abandonment of the ROU \nasset \nHow should a lessee present operating lease cost after the \nROU asset has been impaired or scheduled for abandonment? \nInterpretive response: In general, absent other concurrent events or changes \nin circumstances – e.g. a conclusion that the ROU asset is part of a disposal \ngroup that meets the requirements of a discontinued operation under Subtop ic \n205-20 (discontinued operations) – an impairment or planned abandonment \nshould not change how a lessee presents operating lease cost in the income \nstatement. \nImpairment \nParagraphs 6.5.10 and 6.5.50 highlight the following. \n— The impairment loss related to an ROU asset (operating or finance) is \npresented in the same manner in the income statement as an impairment loss recognized for any other long- lived asset. \n— After an operating lease ROU asset has been impaired, a single lease cost \ncontinues to be recogniz ed, comprising amortization of the ROU asset, if \nany, and lease liability accretion. \nWe believe the post -impairment single lease cost continues to be presented in \nthe income statement consistent with how it was presented pre- impairment – \ni.e. within the s ame line item. This includes if the single lease cost does not \ninclude any ROU asset amortization – e.g. the ROU asset was impaired to $0. \nPlanned abandonment \nQuestion 6.5.70 outlines that if a lessee plans to abandon an ROU asset: \n— amortization should be a ccelerated, using one of two acceptable \napproaches, to ensure the ROU asset is amortized to its salvage value by \nthe cease- use date; and \n— after the ‘decision date’ (see paragraph 6.5.160), a single lease cost continues to be recognized, comprising (1) the a ccelerated amortization of \nthe ROU asset and lease liability accretion before the cease- use date (see \nparagraph 6.5.160) or (2) solely the lease liability accretion after the cease-\nuse date (if the salvage value of the ROU asset was $0 at the cease -use \ndate). \nConsistent with our view on impairment, we believe the single lease cost after \nthe decision date should be presented in the income statement consistent with \nhow it was presented before the decision date – i.e. within the same line item. \nThis includes f or the period after the cease- use date when the single lease cost \nmay comprise solely lease liability accretion . \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 620}), Document(page\_content='Leases 620 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 6.9.40 \nPresentation of lease termination or \nremeasurement gain when the ROU asset was \npreviously impaired or abandoned \nHow should a lessee present a gain from terminating or \nremeasuring a lease that results from the ROU asset being \nimpaired or abandoned? \nBackground: Assume an ROU asset has been impaired or abandoned such that \non terminating the lease or remeasuring the lease l iability downward (e.g. for a \nreduced lease term) a significant gain results. A gain results because recording \nthe decrease in the lease liability as an adjustment to the ROU asset would result in a negative ROU asset, which is prohibited (see paragraph 6. 6.170). \nWhile a gain may be more pronounced in an impairment or abandonment \nscenario, one could arise in other circumstances – e.g. if significant lease \nincentives paid early during the lease result in the ROU asset having a lower \ncarrying amount than the lease liability. \nIn these scenarios, the question arises about the income statement presentation of the gain. \nInterpretive response: Other than when the gain results from a previous ROU \nasset impairment, we believe the lessee should present the gain in the same income statement line item in which it presented the single lease cost for an \noperating lease or the ROU asset amortization for a finance lease, as a \nreduction of the previous lease cost/amortization recognized. \nIf the gain results from a prior ROU asset impairment, we believe it should be \npresented in the same line item in which the impairment was previously \nrecognized up to the amount of the previously recognized impairment; the \nremainder of the gain should be r ecognized consistent with the preceding \nparagraph. However, we believe presenting the entire gain consistent with the \npreceding paragraph is also acceptable. \n \n6.9.3 Statement of cash flows \n6.9.120 A lessee classifies cash flows from leasing transactions as follows. \n[842- 20-45-5, 230- 10-45-25(e)] \n Statement of cash flows \nFinance lease \nRepayment of principal portion of lease \nliability Financing activities \nInterest on the lease liability Apply Topic 230 ( statement of cash \nflows )1 \nVariable lease payments and short -term \nlease payments not included in the lease \nliability Operating activities2 \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 621}), Document(page\_content='Leases 621 \n6. Lessee accounting \n \n \n \n© 20 23 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Statement of cash flows \nOperating lease \nLease payments Operating activities2 \nVariable lease payments and short -term \nlease payments not included in the lease \nliability Operating activities2 \nNote s: \n1. Typically operating activities . \n2. Included in investing activities to the extent the payments represent costs to bring \nanother asset to the condition and location necessary for its intended use. \n6.9.130 The initial recognition of a lease liability and ROU asset is a noncash \ntransaction that is not included in the statement of cash flows but separately \ndisclosed with other noncash transactions. [842- 20-50-4(g)(2)] \n6.9.140 Chapter 14 of KPMG Handbook, Statement of cash flows , provides \nfurther guidance on lease reporting in the statement of cash flows. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 622}), Document(page\_content='Leases 622 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 7. Lessor accounting \nDetailed contents \nNew item added to this chapter : \*\* \nItem significantly updated in this chapter: # \nHow the standard works \n7.1 Overview \nObservation \nLessor accounting largely consistent with Topic 840 \nComparison to legacy US GAAP \n7.2 Lease classification \nQuestions \n7.2.05 Lessor consideration of portfolio residual value guarantees in \nlease classification \n7.2.06 Portfolio residual value guarantee guidance applicability \n7.2.10 Seller guarantee of resale amount – transfer of control \n7.2.20 Lease classification in a lease resulting from a repurchase agreement \nComparison to legacy US GAAP \n7.3 Sales -type and direct financing leases \n7.3.1 Initial recognition and measurement \n7.3.2 Subsequent accounting\n \nObservations \nFair value of the underlying asset for lessors that are not manufacturers \nor dealers \nSelling profit or loss \nLessor costs \nSales and other similar taxes \nNo requirement for lessors to reassess key lease estimates and judgments \nAssessing the entire net investment in the lease for impairment vs. assessing its components separately \nQuestions \n7.3.01 Effect of a government grant toward the cost of an underlying asset on the asset’s fair value\n \n7.3.02 Fair value in a build- to-suit lease ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 623}), Document(page\_content='Leases 623 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 7.3.10 Estimated residual value of land in a long -term sales -type or \ndirect financing lease \n7.3.20 Differences between a lessor’s lease receivable and a \nlessee’s lease liability \n7.3.25 Lease incentives paid before lease commencement \n7.3.26 Contingent lease incentives \n7.3.30 Impact of variable lease payments on the rate implicit in the lease \n7.3.40 Sublessor gross vs. net considerations \n7.3.50 Sublessee rental payments directly to a thi rd party \n7.3.60 Assessing whether a tax is a lessee or lessor cost \n7.3.70 Lessor reassessment of key lease estimates and judgments \n7.3.80 Assessing the net investment in the lease for impairment \nExamples \n7.3.05 Fair value of the underlying asset \n7.3.10 Recognition of selling profit for a direct financing lease \n7.3.20 Accounting for initial direct costs in a sales- type lease \n7.3.25 Contingent lease incentive – sales- type lease \n7.3.30 [Not used] # \n7.3.31 Impact of variable lease payments \n7.3.40 Recognition of selling profit for a direct financing lease \nComparison to legacy US GAAP\n \n7.4 Operating leases \n7.4.1 Initial recognition and measurement \n7.4.2 Subsequent accounting \nObservation \nOperating leases give rise to lease receivables that will not be recognized \nQues tions \n7.4.05 Sale of future operating lease payments that do not meet \ndefinition of a receivable \n7.4.10 Uneven lease payments intended to compensate for \nexpected changes in market rent \n7.4.15 Operating lease income in lease with non -consecutive \nperiod of use \n7.4.16 Single lease cost attribution – operating lease with non-\nconsecutive period of use that is variable at lease commencement ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 624}), Document(page\_content='Leases 624 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 7.4.17 Curtailment of the lessee’s right to use the underlying asset \n7.4.20 Lessor acco unting for reimbursements of capital \nreplacements and repairs in an operating lease \nComparison to legacy US GAAP \n7.5 Collectibility \n7.5.1 Considering collectibi lity issues \n7.5.2 Collectibility of operating lease receivables \n Observation s \nCollectibility guidance for sales -type leases designed to prevent \nstructuring opportunities \nContracts with lease and non- lease components \nQuestion s \n7.5.10 Impact of collectibility reassessment on lessors \n7.5.20 Collectibility of operating lease receivables – lease -by-lease \nbasis \n7.5.30 Collectibility of operating lease receivables – ongoing \nreassessment \n7.5.40 Collectibility of operating lease receivables – leases subject \nto constraint \n7.5.50 Collectibility of operating lease receivables – leases not \nsubject to constraint \n7.5.60 Collectibility of operating lease receivables – accounting for \na general reserve \n7.5.70 Collectibility of operating lease receivables – impact of \nconstraint on general reserve \nComparison to legacy US GAAP \n7.6 Lease modifications \n7.6.1 Overview \n7.6.2 Operating lease modifications \n7.6.3 Direct financing lease modifications \n7.6.4 Sales -type lease modifications \nObservations \nLessor vs. lessee modifications guidance \nLessor modifications guidance substantially aligns with new revenue \nstandard \nQuestions \n7.6.05 Contract modifications not in writing ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 625}), Document(page\_content='Leases 625 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 7.6.05A Contract changes only affecting variable or contingent \npayments \n7.6.06 Rent concessions – lessor \n7.6.06A Lessee short payment of rent – lessor accounting \n7.6.06B Modifications that add a right(s) of use and make other changes \n7.6.07 Lessor consideration of a lessee’s notice to exercise its \npurchase option \n7.6.10 Co-tenancy clauses – lessor \n7.6.20 Lessee exercise of options other than to extend the lease or \npurchase the underlying asset \n \nExamples \n7.6.06A Lessor accounting for short payments not permitted by the contract – operating lease \n7.6.0 7 Modification date – lessee fails to give termination notice \*\* \n7.6.08 Lessor operating lease modification – rent deferral \n7.6.10 Modification accounting – operating lease remains an \noperating lease \n7.6.20 Modification accounting – sales- type lease remains a sales-\ntype lease \n7.6.30 Modification accounting – direct financing lea se becomes an \noperating lease \nComparison to legacy US GAAP \n7.7 Financial statement presentation \nQuestions \n7.7.10 Cash payments received for sales -type and direct financing \nleases \n7.7.20 Presentation and classification of initial direct costs \n7.7.30 Separa te income statement presentation of tenant \nreimbursements \nComparison to legacy US GAAP \n7.8 Leveraged leases \n7.8.1 Overview \n7.8.2 Leveraged lease definition \n7.8.3 Recognition and measurement \n7.8.4 Subsequent measurement\n \n7.8.5 Changes in leveraged leas e assumptions \nObservation \nDecision to grandfather leveraged leases ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 626}), Document(page\_content='Leases 626 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Questions \n7.8.10 Real estate leases and leases in sale -leaseback transactions \n7.8.20 Lease of an existing asset classified as a leveraged lease \n7.8.30 Requirement for a leveraged lease to involve at least thr ee \nparties \n7.8.40 Leveraged lease classification when there are multiple \nlessees and cross -collateralization \n7.8.50 Leveraged lease classification when multiple assets are \nleased to a single lessee \n7.8.60 Impact of nonrecourse debt on lease classification \n7.8.70 Nonrecourse debt obtained after lease inception \n7.8.80 Substantial leverage in a leveraged lease \n7.8.90 Requirement for the investment to decline during the early years and rise during the later years \n7.8.100 Lessor receives no tax benefits \n7.8.110 Lessor is a partnership or a variable interest entity \n7.8.120 Differences in timing between when an investment tax credit is earned and realized \n7.8.130 Impact of intra -entity allocation of leveraged lease tax \nbenefits \n7.8.140 Contingent rent \n7.8.150 Classification of the net investment in a leveraged lease on a classified balance sheet \n7.8.160 Presentation of investment tax credit in the income \nstatement \n7.8.170 Impact of changes in leveraged lease assumptions under Topic 842 \n7.8.180 Change in t he interest rate on nonrecourse debt \n7.8.190 Refinancing nonrecourse debt with recourse debt \n7.8.200 Change in the projected tim ing of income tax cash flows \n7.8.210 Impact of change in income tax rate on the accounting for a leveraged lease \n7.8.220 Payment s under a tax indemnification agreement \n7.8.230 Treatment of a sale of the appreciation in the residual value \nof the underlying asset \n7.8.240 Leveraged lease classification when investment tax credits \nare accounted for differently \n7.8.250 Acquisition of a grandfat hered leveraged lease ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 627}), Document(page\_content='Leases 627 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. How the standard works \nA lessor classif ies a lease as a (1) sales -type, (2) direct financing or (3) operating \nlease using criteria described in s ection 7.2 . The accounting model applied to \neach type of lease depends on the lease classification and is summarized in the \nfollowing diagram . \nSales -type \nand direct \nfinancing \nleases\nOperating \nleasesBalance sheetIncome \nstatementCash flow \nstatement\n— Recognize net \ninvestment in the \nlease\n— Derecognize the \nunderlying asset— Selling profit \n(loss)1 \n— Interest income \nover the lease \ntermCash received \nfrom leases \nclassified as \noperating cash flows\n2\nContinue to \nrecognize the underlying assetLease income \ngenerally on a \nstraight -line \nbasis over the lease termCash received \nfrom leases \nclassified as operating cash flows \nNote s: \n1. Selling profit is recognized at lease commencement for sales -type leases and over the \nlease term for direct financing leases. Selling loss is recognized at lease commencement \nfor both sales- type and direct financing leases. \n2. Lessors that are depository or lending institutions in the scope of Topic 942 (depository \nand lending institutions) cl assify the principal portion of cash payments received from \nleases as investing cash flows; the interest portion is classified as operating cash flows. \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 628}), Document(page\_content='Leases 628 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 7.1 Overview \n Excerpt from ASC 842 -30 \n05 Overview and Background \nGeneral \n05-1 This Subtopic addresses accounting by lessors for leases that have been \nclassified as sales -type leases , direct financing leases , or operating leases \nin accordance with the requirements in Subtopic 842- 10. Lessors should follow \nthe requirements in this Sub topic as well as those in Subtopic 842-10. \n15 Scope and Scope Exceptions \nGeneral \n15-1 This Subtopic follows the same Scope and Scope Exceptions as outlined \nin the Overall Subtopic; see Section 842 -10-15. \n \n7.1.10 The following table shows the key concepts and definitions underlying \nthe lessor accounting model. \nKey concept or definition Meaning in Topic 842 \nNet investment in the lease Lease receivable + unguaranteed residual asset1 \nLease receivable PV of the lease payments \n+ PV of guaranteed portion of estimated residual value \nUnguarantee d residua l asset PV of unguaranteed portion of estimated residual \nvalue \nCommencement date \n(see section 5.1) Date on which the lessor makes the underlying asset available for use by the lessee; date of initial \nrecognition and measurement of a lease \nLease term \n(see section 5.3) Non-cancellable period of the lease \n+ periods covered by lessee option to extend that \nlessee is reasonably certain to exercise \n+ periods subsequent to lessee termination option \nthat lessee is reasonably certain not to exercise \n+ periods covered by a lessor -controlled option to \nextend or not to terminate \nLease payments \n(see section 5.4) Undiscounted fixed (including in- substance fixed) \npayments \n+ optional payments that are reasonably certain to be \npaid \nDiscount rate for the lease \n(see section 5.6) Rate implicit in the lease ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 629}), Document(page\_content='Leases 629 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Key concept or definition Meaning in Topic 842 \nRate implicit in the lease Discount rate that balances the following equation: \n(see section 5.6.1) PV of lease payments + \nPV of estimated residual value = Fair value of the underlying asset + deferred initial \ndirect costs \nNote: \n1. For a direct financing lease, the amount of the net investment in the lease is reduced by \nany selling profit on the lease because it is deferred. \n \n Observation \nLessor accounting largely consistent with Topic 840 \n7.1.20 Topic 842 did not make extensive changes to lessor accounting. \nHowever, despite the overall similarities between the lessor accounting \nguidance in Topic 842 as compared with Topic 840, the Board made certain \nchanges for one or more of the following reasons: [ASU 2016- 02.BC90 –BC92 ] \n— to align the lessor accounting guidance with changes to the lessee accounting guidance; \n— to align the lessor accounting guidance with certain aspects of Topic 606; \nand/or \n— to improve and/or simplify lessor accounting to remediat e a long- standing \ncomplexity or absence of guidance under Topic 840. \n \n Comparison to legacy US GAAP \nKey changes to lessor accountin g \n7.1.30 Although the lessor accounting model under Topic 842 is not \nfundamentally changed from the lessor accounting model under Topic 840, there are important changes that will affect many lessors. \n7.1.40 The following chart summarizes the key changes Topic 842 makes to the \nTopic 840 lessor accounting model. Each change illustrated in the chart includes \nour current general expectation about the frequency with which that change will \narise and the impact we expect the change to have when it does. The actual \nfrequency and impact will vary by lessor. For some of the changes, the \nfrequency of occurrence and/or impact of the change is so specific to the facts \nand circumstances that no general expectation is provided. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 630}), Document(page\_content='Leases 630 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Key change Summary \nChanges in lease classification \nbetween sales -type and direct \nfinancing (see section 7.2) \n \n \nFrequency Impact\n \n \nFrequency Impact\n Sales -type leases and direct financing leases are \nno longer differentiated by whether there is \nmanufacturer/dealer profit or loss. Instead, they \nare differentiated by whether the lessor \neffectively transfers control of the underlying \nasset to the lessee or , instead, transfers \nsubstantially all of the risks and benefits of ownership of the underlying asset to the lessee \nand an unrelated third party. \n— The changes will result in many direct \nfinancing leases under Topic 840 being \nclassified as sales -type leases under Topic \n842. \n \n— A smaller number of sales -type leases under \nTopic 840 will be classified as direct \nfinancing leases under Topic 842. \nRecognition of selling profit (see \nsection 7.3.1) \nFrequency Impact\n If selling profit arises from a direct financing \nlease, it is deferred and recognized over the lease \nterm. \nThis is not expected to occur frequently because selling profit only arises infr equently in a lease \nthat will be classified as a direct financing lease \nunder Topic 842. However, because such leases \nwould have been sales -type leases under Topic \n840, the effect of deferring selling profit that was \npreviously recognized up- front may be s ignificant. \nNarrowed definition of initial direct costs (see section 5.5) \nFrequency Impact\n Under Topic 842, i nitial direct costs include only \nthose incremental costs of a lease that would not \nhave been incurred if the lease had not been \nexecuted. Therefore, some costs (e.g. legal fees \nand allocated internal costs) that an entity \ncapitalize d as initial direct costs under Topic 840 \nwill be expensed as incurred under Topic 842. For \nsome lessors, this will result in recognizing more \nexpenses before the lease commences and \nhigher margins on lease income earned over the \nlease term. \nAllocation of consideration in \nthe contract to lease and non-\nlease (e.g. service) components \n(see sectio n 4.4) \nFrequency Impact\nLessor \nspecificLessor \nspecific Under Topic 842, l essors apply the transaction \nprice allocation guidance in Topic 606, while \nunder Topic 840, lessors applied the relative \nstand -alone selling price approach prescribed by \nSubtopic 605- 25 (revenue recognition – multiple -\nelement arrangements). The alloc ation approach \nunder Topic 606 differs from Subtopic 605- 25 in \nsome respects , particularly the specific guidance \nin Topic 606 on allocating bundled discounts and \nvariable consideration that did not exist under \nSubtopic 605- 25. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 631}), Document(page\_content='Leases 631 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Key change Summary \nExecutory costs (see section 4.2) \nFrequency Impact\n Under Topic 842, lessee payments of lessor \nexecutory costs (e.g. lessor property tax or \ninsurance costs ) are allocated to the lease and \nnon-lease components in the same manner as all \nother payments in the contract; they a re not \nexcluded from lease classification and certain \nother aspects of lease accounting as they were \nunder Topic 840. \n— Section 4.2.1 and the Gross vs. net \nconsiderations in section 7.3.2 provide \nguidance on determining whether taxes and \ninsurance are lessee or lessor costs. \n— Section 4.2 explains that maintenance, which \nwas considered an executory cost under \nTopic 840, is a non -lease component. \nCollectibility (see section 7.5) \nFrequency Impact\n Under Topic 842, l eases with collectibility \nuncertainties are no longer precluded from sales -\ntype lease classification as they were under \nTopic 840. Topic 842 includes specific guidance \nabout lease income recognition when collectibility \nof the lease payments, plus any amounts \nnecessary to satisfy residual value guarantees, is not probable. \nLease modifications (see \nsection 7.6) \nFrequency Impact\nDepends on \nfacts an d \ncircumstances Topic 842 includes guidance on lease \nmodifications that is substantially different from \nTopic 840; it was developed to more closely align \nlessor modification accounting with the contract \nmodification accounting applicable to sellers of \ngoods or services in Topic 606 . \nLease classification is reassessed on a lease \nmodification that is not accounted for as a \nseparate contract. The lessor accounting for a \nlease modification depends on the classification \nof the original and the modified lease. \nLeveraged leases (see \nsection 7.8) \nFrequency Impact\n Leveraged lease classification and accounting is \neliminated by Topic 842 for all leases that \ncommence on or after the effective date of \nTopic 842. \nLessors continue to account for leveraged leases \nthat commenced before the effective date in \naccordance with Topic 840 , unless the lease is \nmodified on or after the effective date (which \nincludes exercise of a renewal that was not \nalready factored into the lease term) . \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 632}), Document(page\_content='Leases 632 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 7.2 Lease classification \n Excerpt from ASC 842 -10 \n25 Recognition \nGeneral \n> Lease Classification \n25-1 An entity shall classify each separate lease component at the \ncommencement date . An entity shall not reassess the lease classification \nafter the commencement date unless the contract is modified and the \nmodification is not accounted for as a separate contract in accordance with \nparagraph 842- 10-25-8. In addition, a lessee also shall reassess the lease \nclassification after the commencement date if there is a change in the lease \nterm or the assessment of whether the lessee is reasonably certain to \nexercise an option to purchase the underlying asset . When an entity (that is, a \nlessee or lessor) is required to reassess lease classification, the entity shall \nreassess classification of the lease on the basis of the facts and circumstances \n(and the modified terms and conditions, if applicable) as of the date the \nreassessment is required (for example, on the basis of the fair value and the \nremaining economic life of the underlying asset as of the date there is a \nchange in the lease term or in the assessment of a lessee option to purchase \nthe underlying asset or as of the effective date of a modification not accounted \nfor as a separate contract in accordance with paragraph 842- 10-25-8). \n25-2 A lessee shall classify a lease as a finance lease and a lessor shall \nclassify a lease as a sales -type lease when the lease meets any of the \nfollowing criteria at lease commencement: \na. The lease transfers ownership of the underlying asset to the lessee by the \nend of the lease term. \nb. The lease grants the lessee an option to purchase the underlying asset that \nthe lessee is reasonably certain to exercise. \nc. The lease term is for the major part of the remaining economic life of the \nunderlying asset. However, if the commencement date falls at or near the \nend of the economic life of the underlying asset, this criterion shall not be \nused for purposes of classifying the lease. \nd. The present value of the sum of the lease payments and any residual \nvalue guaranteed by the lessee that is not already reflected in the lease \npayments in accordance with paragraph 842- 10-30-5(f) equals or exceeds \nsubstantially all of the fair value of the underlying asset. \ne. The underlying asset is of such a specialized nature that it is expected to \nhave no alternative use to the lessor at the end of the lease term. \n25-3 When none of the criteria in paragraph 842 -10-25-2 are met: \nb. A lessor shall classify the lease as either a direct financing lease or an \noperating lease. A lessor shall classify the lease as an operati ng lease \nunless both of the following criteria are met, in which case the lessor shall \nclassify the lease as a direct financing lease: ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 633}), Document(page\_content='Leases 633 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 1. The present value of the sum of the lease payments and any residual \nvalue guaranteed by the lessee that is not already r eflected in the lease \npayments in accordance with paragraph 842- 10-30-5(f) and/or any other \nthird party unrelated to the lessor equals or exceeds substantially all of \nthe fair value of the underlying asset. \n2. It is probable that the lessor will collect the lease payments plus any \namount necessary to satisfy a residual value guarantee. \n25-3A Notwithstanding the requirements in paragraphs 842- 10-25-2 through \n25-3, a lessor shall classify a lease with variable lease payments that do not \ndepend on an index or a rate as an operating lease at lease commencement if \nclassifying the lease as a sales- type lease or a direct financing lease would \nresult in the recognition of a selling loss . \n25-4 A lessor shall assess the criteria in paragraphs 842 -10-25-2(d) and 842- 10-\n25-3(b)(1) using the rate implicit in the lease . For purposes of assessing the \ncriterion in paragraph 842- 10-25-2(d), a lessor shall assume that no initial \ndirect costs will be deferred if, at the commencement date, the fair value of \nthe underlying asset is different from its carrying amount. \n25-5 If a single lease component contai ns the right to use more than one \nunderlying asset (see paragraphs 842- 10-15-28 through 15- 29), an entity shall \nconsider the remaining economic life of the predominant asset in the lease \ncomponent for purposes of applying the criterion in paragraph 842 -10-25-2(c). \n55 Implementation Guidance and Illustrations \n>>> Effect of Investment Tax Credits \n55-8 When evaluating the lease classification criteria in paragraphs 842 -10-25-\n2(d) and 842- 10-25-3(b)(1), the fair value of the underlying asset should be \nreduced by any related investment tax credit retained by the lessor and \nexpected to be realized by the lessor. \n>>> Residual Value Guarantees for a Portfolio of Underlying Assets \n55-9 Lessors may obtain residual value guarantees for a portfolio of \nunderlying assets for which settlement is not solely based on the residual \nvalue of the individual underlying assets. In such cases, the lessor is \neconomically assured of receiving a minimum residual value for a portfolio of \nassets that are subject to separate leases but not for each individual asset. \nAccordingly, when an asset has a residual value in excess of the “guaranteed” \namount, that excess is offset against shortfalls in residual value that exist in \nother assets in the portfolio. \n55-10 Residual value guarantees of a portfolio of underlying assets preclude a \nlessor from determining the amount of the guaranteed residual value of any \nindividual underlying asset within the portfolio. Consequently, no such amounts \nshould be considered when evaluating the lease classification criteria in \nparagraphs 842 -10-25-2(d) and 842 -10-25-3(b)(1). \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 634}), Document(page\_content='Leases 634 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Excerpt from ASC 842 -30 \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance \n>> Sales of Equipment with Guaranteed Minimum Resale Amount \n55-1 This implementation guidance addresses the application of the provisions \nof this Subtopic in the following circumstances. A manufacturer sells \nequipment with an expected useful life of several years to end users \n(purchasers) utilizing various sales incenti ve programs. Under one such sales \nincentive program, the manufacturer contractually guarantees that the \npurchaser will receive a minimum resale amount at the time the equipment is \ndisposed of, contingent on certain requirements. \n55-2 The manufacturer provides the guarantee by agreeing to do either of the \nfollowing: \na. Reacquire the equipment at a guaranteed price at specified time periods as \na means to facilitate its resale \nb. Pay the purchaser for the deficiency, if any, between the sales proceeds \nreceived for the equipment and the guaranteed minimum resale value. \nThere may be dealer involvement in these types of transactions, but the \nminimum resale guarantee is the responsibility of the manufacturer. \n55-3 A sales incentive program in which an entity (for example, a \nmanufacturer) contractually guarantees that it ha s either a right or an obligation \nto reacquire the equipment at a guaranteed price (or prices) at a specified time \n(or specified time periods) as a means to facilitate its resale should be \nevaluated in accordance with the guidance on satisfaction of perfor mance \nobligations in paragraph 606- 10-25-30 and the guidance on repurchase \nagreements in paragraphs 606- 10-55-66 through 55- 78. If that evaluation \nresults in a lease, the manufacturer should account for the transaction as a \nlease using the principles of lease accounting in Subtopic 842- 10 and in this \nSubtopic. \n55-4 A sales incentive program in which an entity (for example, a \nmanufacturer) contractually guarantees that it will pay a purchaser for the \ndeficiency, if any, between the sales proceeds recei ved for the equipment and \nthe guaranteed minimum resale value should be accounted for in accordance \nwith Topic 460 on guarantees and Topic 606 on revenue from contracts \nwith customers. \n55-5 The lease payments used as part of the determination of whether t he \ntransaction should be classified as an operating lease, a direct financing \nlease, or a sales -type lease generally will be the difference between the \nproceeds upon the equipment’s initial transfer and the amount of the \nresidual value guarantee to the pur chaser as of the first exercise date of \nthe guarantee. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 635}), Document(page\_content='Leases 635 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. >> Fair Value of the Underlying Asset \n55-17A Notwithstanding the definition of fair value, if a lessor is not a \nmanufacturer or a dealer, the fair value of the underlying asset at lease \ncommencement is its cost, reflecting any volume or trade discounts that may \napply. However, if there has been a significant lapse of time between the \nacquisiti on of the underlying asset and lease commencement, the definition of \nfair value shall be applied. \n \n7.2.10 A lessor determines lease classification for each separate lease \ncomponent, which is the unit of account in applying Topic 842 ( see section 4 .1), \nat the lease commencement date. [842- 10-25-1] \n7.2.20 Lease classification is only reassessed if the lease is modified and the \nmodification is not accounted for as a separate contract (see section 7. 6). \n[842- 10-25-1] \n7.2.30 For the lease classification test , a lessor applies a ‘Step 0’ test before it \nproceeds to the Part A and B tests. [842- 10-25-2 – 25-3A] \n— Step 0. A lessor is required to classify a lease as operating if: \n— the payments for the lease are partially or entirely variable; and \n— sales- type or direct financing classification would result in a \ncommencement date (‘ Day 1’) loss. \nIf only one or neither of these criteria are met, the lessor proceeds to the \nPart A tests. \n— Part A. These tests determine whether a lease is a sales -type lease and are \nthe same as the classification tests for lessees. The outcome of these tests \nis either (1) the lease is a sales -type lease, or (2) further testing is required \n(Part B) to classify the lease. \n— Part B. These tests determine whether the lease is an operating lease or a \ndirect financing lease. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 636}), Document(page\_content='Leases 636 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Transfer of \nownership\nLessee \npurchase \noption \nLease \nterm\nPresent \nValue (A)\nAlternative \nuseDoes lease transfer ownership of underlying \nasset to lessee by end of lease term ?\nDoes lease grant lessee an option to \npurchase underlying asset that lessee is \nreasonably certain to exercise ?\nIs lease term for a major part of remaining \neconomic life of underlying asset ?1\nDoes present value of sum of (1) lease payments \nand (2) any lessee residual value guarantee not \nreflected in the lease payments , equal or exceed \nsubstantially all of underlying asset’s fair value ?2\nIs underlying asset of such a specialized nature \nthat it is expected to have no alternative use to \nlessor at end of lease term ?\nGo to Part B testsLessor \nclassifies \nlease as \nsales -type \nleaseNo\nNo\nNo\nNo\nNoYesPart A tests :\nYes\nYes\nYes\nYes\n \nNotes: \n1. If the commencement date is at or near the end of the underlying asset’s economic life, \nthis test does not apply. See Questions 6.2.10 and 6.2.15 in section 6.2. \n2. How to determine the fair value of the underlying asset differs depending on whether \nthe lessor is a manufacturer or dealer (see paragraph 7.3.41 ). \n7.2.40 Because the Part A lease classification tests are the same for lessors as \nthey are for lessees, our discussion of the application of t hose tests is mostly in \nsection 6.2. \n7.2.50 However, there are two additional points relevant to lessors in applying \nthe Part A classification tests. [842- 10-25-4] \n— The lessor determines the present value of the lease payments and residual \nvalue guarantees using the rate implicit in the lease (see section 5.6.1 ) – i.e. \nunlike lessees, a lessor always uses the rate implicit in the lease. \n— For purposes of determ ining whether a lease is a sales- type lease, a lessor \nassumes that no initial direct costs will be deferred when calculating the \nrate implicit in the lease if, and only if , at the commencement date the fair \nvalue of the underlying asset is different from i ts carrying amount. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 637}), Document(page\_content='Leases 637 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. No\nYes\nLessor classifies \nlease as a direct \nfinancing leasePresent \nvalue (B)\nCollectibilityDoes present value of sum of (1) lease payments \nand (2) any residual value guarantee from lessee \nor third party unrelated to lessor , equal or exceed \nsubstantially all of underlying asset ’s fair value ?\nIs it probable that lessor will collect lease \npayments plus any amount necessary to satisfy a \nresidual value guarantee ?Lessor \nclassifies \nlease as \noperating \nleasePart B tests :\nYesNo\n \n7.2.60 The Part B classification tests focus on whether substantially all of the \nlessor’s risk in the lease is credit risk. When the lessor effectively converts its \nrisk in the nonfinancial residual asset to credit risk (e.g. through a residual value \nguarantee provided by an unrelated third party) and collectibility of the lease \npayments (plus any amount necessary to satisfy the residual value guarantee(s) \nprovided to the lessor) is probable, the leas e is a direct financing lease. \nOtherwise, it is an operating lease. \n7.2.70 The primary difference between the present value test in Part A and the \npresent value test in Part B is the inclusion in Part B of a residual value guarantee provided by a third party unrelated to the lessee or the lessor (in addition to any \nresidual value guarantee provided by the lessee in the Part A present value test). \nConsistent with the present value test in Part A, a lessor may use a threshold of \n90 percent or more when determining whether the sum of the present value of (1) the lease payments and (2) any residual value guarantees amount to \n‘substantially all’ of the fair value of the underlying asset. Section 6.2 provides \nadditional discussion about substantially all. \n[842- 10-25-2 – 25-4] \n7.2.80 Additionally, in determining the rate implicit in the lease for purposes of \nthe Part B present value test , the lessor always assumes any initial direct costs \nwill be deferred when calculating the rate implicit in the lease; this is regardless \nof whether the fair value of the underlying asset is different from its carrying amount. As a result, the rate implicit in the lease used for purposes of \nperforming the present value test may be different in the Part A and Par t B \ntests. \n[842 Glossary, 842- 10-25-4] \n7.2.90 Residual value guarantees of a portfolio of underlying assets generally \npreclude a lessor from determining the amount of the guaranteed residual value of any individual underlying asset within the portfolio. Consequently, such \namounts are usually ignored when performing the present value lease \nclassification test, whether Part A or Part B. \n[842- 10-55-10] \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 638}), Document(page\_content='Leases 638 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 7.2.05 \nLessor consideration of portfolio residual value \nguarantees in lease classification \nWhen is it acceptable for a lessor to consider a portfolio \nresidual value guarantee when performing the present value \nlease classification test? \nBackground: Paragraph 842- 10-55-10 was included in Topic 842 with the intent \nto retain guidance similar to the SEC guidance that was codified in Topic 840. \n[840- 30-S99-1] \nIn practice under Topic 840 (including when considering the SEC staff’s view in \nparagraph 840- 30-S99-1) there were limited conditions under which it was \nconsidered acceptable for a lessor to include portfolio residual value guarantees \nin the ‘minimum lease payments’ used to perform the present value lease \nclassification test. Those conditions were: \n— the leases have the same commencement and ending dates; \n— the underlying assets are i nterchangeable (i.e. essentially the same); and \n— there is a high correlation in the variability of the expected residual values of \nthe leased assets. \nInterpretive response : Because the guidance in paragraph 842- 10-55-10 was \nintended to preserve the accounting that occurred under Topic 840, we believe it remains acceptable under Topic 842 for a lessor to consider a portfolio \nresidual value guarantee in performing the present value lease classification test \nwhen the conditions outlined in the background are met. \nSee Question 6.2.25 for consideration of portfolio residual value guarantees for lessees under Topic 842. \n \n \n Question 7.2.06 \nPortfolio residual value guarantee guidance \napplicability \nDoes the portfolio residual value guarantee guidance apply to \na portfolio of only two, non- homogenous underlying assets ? \nBackground: See paragraph 7.2.90 and Question 7.2.05. \nInterpretive response: Yes, we believe the portfolio residual value guarantee \nguidance referred to in the background applies even when the ‘portfolio’ \ncomprises only two, non -homogenous underlying assets such as land and a \nbuilding. \nFirst, as outlined in Question 7.2.05, we believe homogeneity within the \nportfolio makes it more likely to be acceptable to consider a portfolio residual \nvalue guarantee when performing the present value lease classification test . \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 639}), Document(page\_content='Leases 639 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Second, ‘portfolio’ is not a defined term in Topic 842; therefore, there is nothing \nto suggest that a portfolio must comprise more than two underlying assets for \nthe portf olio residual value guarantee guidance to apply . \n \n Question 7.2.10 \nSeller guarantee of resale amount – transfer of \ncontrol \nDoes a seller guarantee of any deficiency between the \npurchaser’s resale proceeds from the asset and a guaranteed resale amount mean the purchaser does not obtain control of \nthe asset? \nBackground: Under Topic 840, a seller guarantee of this nature resulted in \naccounting for the arrangement as a lease. The FASB and IASB discussed \nwhether this type of guarantee precludes tr ansfer of control of the asset to the \npurchaser at the January 2013 joint Board meeting and included discussion in \nthe Basis for Conclusions to ASU 2014- 09. \nInterpretive response: It depends. If a purchaser would otherwise obtain \ncontrol of an asset absent the seller resale guarantee, the terms of the \nguarantee will affect whether it precludes the purchaser from obtaining control \nof the asset. \nASU 2014- 09 states that “when the enti ty guarantees that the customer will \nreceive a minimum amount of sales proceeds, the customer is not constrained \nin its ability to direct the use of, and obtain substantially all of the benefits from, \nthe asset.” That could be read to suggest that the Boar ds believe a seller resale \nguarantee cannot affect the transfer of control conclusion. However, at the \nJanuary 2013 FASB/IASB Board meeting at which the FASB and IASB reached \nthis conclusion, the FASB and IASB staffs explained that the seller resale \nguarantee is substantively just a seller residual value guarantee. The staffs \nexplained that “when an entity guarantees the residual value, the customer is \nnot encumbered in its ability to utilize the asset or enjoy substantially all the \nremaining benefits from the asset … in these cases the customer could choose \nto keep the asset, thus maintaining legal title and physical possession, or should \nthe customer decide to sell the asset, the customer would be entitled to any \nsales proceeds in excess of the guaranteed amount if they were able to sell the \nasset for a higher amount.” [ASU 2014 -09.BC431, IASB Agenda Paper 7B/FASB Agenda \nPaper 166B] \nTherefore, while this suggests that the Board generally does not believe a seller \nresale guarantee would prevent the purcha ser from obtaining control of the \nasset, there is language in the staff agenda paper that suggest s a seller resale \nguarantee could prevent a purchaser from obtaining control of the asset \ndepending on the terms of the resale guarantee. For example, the staf f \nguidance refers to the purchaser’s unencumbered ability to utilize the asset and retain any resale proceeds in excess of the guaranteed amount. Therefore, if \nthe terms of the arrangement were such that the purchaser was required to sell \nthe asset after a specified period of time and the seller was entitled to any \nresale proceeds that exceed the guaranteed resale amount, we believe the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 640}), Document(page\_content='Leases 640 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. purchaser typically would be constrained in its ability to direct the use of the \nasset and obtain substantially all of its remaining benefits (thus, would not \nobtain control of the asset). \nIf there is a sale of the asset (i.e. control of the asset transfers to the customer) \nin accordance with Topic 606, the seller accounts for the guaranteed resale \namount provision in accord ance with Topic 460 ( guarantees) . [842- 30-55-4] \nIf a seller resale guarantee precludes the purchaser from obtaining control of the asset, it is accounted for as a lease in accordance with Topic 842. \n \n Question 7.2. 20 \nLease classification in a lease resulting from a \nrepurchase agreement \nCan a lease arising as a result of a repurchase agreement be \nclassified as a sales -type lease? \nBackground: In a sale transaction, the customer does not obtain control of the \nasset being sold if the seller has a forward or a call option or the customer has a \nput option that it has a ‘significant economic incentive’ to exercise. In those \ncases, if the repurchase pr ice is less than the original sales price, the seller \naccount s for the contract as a lease ; see cha pter 7 of KPMG Handbook, \nRevenue recognition. [606- 10-55-68, 55-72] \nInterpretive response: Yes. The guidance in Topic 606 merely states that the \ncontract should be accounted for as a lease. Therefore, if the lease meets one \nof the criteria to be classified as a sales- type lease (e.g. the length of the \nrepurchase agreement, which would represent the lease term, is for a major \npart of the asset’s remaining economic life), the seller (lessor) will account for \nthe lease as such (see section 7.3). \nThis means despite Topic 606 stating that, as a result of the repurcha se \nagreement, the customer does not obtain control of the asset (i.e. no sale \noccurs), the seller (lessor) will still (1) derecognize the underlying asset and (2) \nrecognize selling profit. \n \n Comparison to legacy US GAAP \nLease classification \n7.2.100 In general, the lease classification guidance in Topic 842 result s in \noperating lease classification for most leases that were classified as operating \nleases under Topic 840. \n7.2.110 The following table s summarize the key differenc es in lease \nclassification for lessors under Topic 840 and Topic 842. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 641}), Document(page\_content='Leases 641 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Topic 840 Topic 842 \nSales -type lease \nResult ed when the lease met: \n— any of the criteria in paragraph 840-\n10-25-1; \n— both of the criteria in paragraph 840-10-25-42; and \n— the fair value of the underlying asset did not equal its carrying amount. Results when the lease passes Step 0 \nand then passes any of the five Part A \ntests in paragraph 7.2.30. \nImpact \nMany leases that were classified as direct financing leases under Topic 840 will be \nclassified as sales -type leases under Topic 842; however, the accounting effect of that \ndifference in classification will typically be insignificant. \nIn contrast, relatively few leases that were classified as sales- type leases under \nTopic 840 will be classified as direct financing leases under Topic 842; but the \naccounting effect will be significant for those leases, because the selling profit, which \nwas recognized at lease commencement under To pic 840, will be deferred and \nrecognized over the lease term instead under Topic 842 (see sec tion 7.3). \n \nTopic 840 Topic 842 \nDirect financing lease \nResulted when the lease met: \n— any of the criteria in paragraph 840-\n10-25-1; \n— both of the criteria in paragraph 840-\n10-25-42; and \n— the fair value of the underlying asset \nequals its carrying amount. Results when the lease: \n— passes Step 0 ; \n— passes none of the Part A tests ; but \n— passes both Part B tests. \nImpact \nThe same as discussed for sales -type leases. \n \nTopic 840 Topic 842 \nLeveraged leases \nResulted when the lease met: \n— the criteria to be classified as a direct financing lease; and \n— three additional specified criteria in \nparagraph 840- 10-25-43(c). Leveraged lease classification and \naccounting no longer exists prospectively \nfrom the effective date of Topic 842 (see \nsection 13.6). \nImpact \nLeases that commence on or after the effective date of Topic 842 that would have \nbeen classified as leveraged leas es under Topic 840 will be accounted for differently \nunder Topic 842. In addition, any grandfathered leveraged leases that are modified on \nor after the effective date are no longer accounted for as leveraged leases after the \nmodification under Topic 842. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 642}), Document(page\_content='Leases 642 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Topic 840 Topic 842 \nReal estate leases \nReal estate leases were subject to \nclassification requirements different from \nother leases. For example, a real estate \nlease could only be a sales -type lease if \nownership was transferred to the lessee. Real estate leases no longer have special \nrules; they are subject to the same \nguidance as all other leases. \nImpact \nLease classification for real estate leases under Topic 842 will differ more significantly from Topic 840 than for other leases. More real estate leases will be classified as \nsales- type or direct financing leases under Topic 842. \n \nTopic 840 Topic 842 \nCollectibility uncertainties \nIf collectibility of the minimum lease \npayments was not reasonably predictable, \nthe lease was classified as an operating lease. An exception existed when the \nunderlying asset was real estate and \nownership transferred to the lessee. Collectibility uncertainties do not preclude a lease from being classified as a sales -\ntype lease. However, a lease cannot be \nclassified as a direct financing lease if the \ncollectibility test is failed (see flowchart \nin paragraph 7.2.50 ). \nImpact \nSome leases previously classified as operating leases because of collectibility \nuncertainties under Topic 840 will be classified as sales- type leases under Topic 842. \nFor a discussion of collectibility considerations for lessors , see section 7. 5. \n \nTopic 840 Topic 842 \nUnreimburseable costs \nIf there were important uncertainties as to \nthe amount of unreimburseable costs that the lessor would incur under the lease, \nthe lease was classified as an operating \nlease. For example, a commitment by the \nlessor to guarantee the performance of the underly ing asset that was more \nextensive than a typical product warranty or to effectively protect the lessee from \nobsolescence of the underlying asset \nresulted in operating lease classification. \nAn exception existed when the underlying asset was real estate and ownership \ntransferred to the lessee. There is no similar lease classification test in Topic 842. \nImpact \nSome leases previously classified as operating leases under Topic 840 because of \nfailing to meet this criterion will be classified as sales -type or direct financing leases \nunder Topic 842. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 643}), Document(page\_content='Leases 643 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 7.3 Sales-type and direct financing leases \n7.3.1 Initial recognition and measurements \n Excerpt from ASC 842 -30 \n25 Recognition \nGeneral \n> Sales -Type Leases \n25-1 At the commencement date , a lessor shall recognize each of the \nfollowing and derecognize the underlying asset in accordance with \nparagraph 842-30-40-1: \na. A net investment in the lease, measured in accordance with \nparagraph 842-30-30-1 \nb. Selling profit or selling loss arising from the lease \nc. Initial direct costs as an expense if, at the commencement date, the fair \nvalue of the underlying asset is different from its carrying amount. If the fair \nvalue of the underlying asset equals its carrying amount, initial direct costs \n(see paragraphs 842- 10-30-9 through 30- 10) are deferred at the \ncommencement date and included in the measurement of the net \ninvestment in the lease. The rate implicit in the lease is defined in such a \nway that those initial direct costs eligible for deferral are included \nautomatically in the net investment in the lease; there is no need to add \nthem separa tely. \n> Direct Financing Leases \n25-7 At the commencement date , a lessor shall recognize both of the \nfollowing and derecognize the underlying asset in accordance with \nparagraph 842-30-40-1: \na. A net investment in the lease, measured in accordance wi th \nparagraph 842-30-30-2 \nb. Selling loss arising from the lease, if applicable. \n25-8 Selling profit and initial direct costs (see paragraphs 842- 10-30-9 through \n30-10) are deferred at the commencement date and included in the \nmeasurement of the net investment in the lease. The rate implicit in the \nlease is defined in such a way that initial direct costs deferred in accordance \nwith this paragraph are included automatically in the net investment in the \nlease; there is no need to add them separately. \n30 Initial Measurement \nGeneral \n> Sales -Type and Direct Financing Leases \n30-1 At the commencement date , for a sales -type lease, a lessor shall \nmeasure the net investment in the lease to include both of the following: ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 644}), Document(page\_content='Leases 644 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. a. The lease receivable , which is measured at the present value, discounted \nusing the rate implicit in the lease , of: \n1. The lease payments (as described in paragraph 842- 10-30-5) not yet \nreceived by the lessor \n2. The amount the lessor expects to derive from the underlying asset \nfollowing the end of the lease term that is guaranteed by the lessee or \nany other third party unrelated to the lessor \nb. The unguaranteed residual asset at the present value of the amount the \nlessor expects to derive from the underlying asset following the end of the \nlease term that is not guaranteed by the lessee or any other third party \nunrelated to the lessor, discounted using the rate implicit in the lease. \n30-2 At the commencement date, for a direct financing lease , a lessor shall \nmeasure the net investment in the lease to include the items in paragraph 842-\n30-30-1(a) through (b), reduced by the amount of any selling profit. \n30-3 See Example 1 (paragraphs 842- 30-55-18 through 55- 43) for an illustration \nof the requirements for sales -type and direct financing leases. \n40 Derecognition \nGeneral \n> Sales -Type and Direct Financing Leases \n40-1 At the com mencement date , a lessor shall derecognize the carrying \namount of the underlying asset (if previously recognized) unless the lease is a \nsales -type lease and collectibility of the lease payments is not probable (see \nparagraph 842- 30-25-3). \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance \n>> Fair Value of the Underlying Asset \n55-17A Notwithstanding the definition of fair value, if a lessor is not a \nmanufacturer or a dealer, the fair value of the underlying asset at lease \ncommencement is its cost, reflecting any volume or trade discounts that may \napply. However, if there has been a significant lapse of time between the \nacquisiti on of the underlying asset and lease commencement, the definition of \nfair value shall be applied. \n> Illustrations \n>> Illustration of Lessor Accounting \n55-18 Example 1 illustrates how a lessor would account for sales -type leases \nand direct fi nancing leases. \n>>> Example 1— Lessor Accounting Example \n>>>> Case A —Lessor Accounting —Sales -Type Lease \n55-19 Lessor enters into a 6- year lease of equipment with Lessee, receiving \nannual lease payments of $9,500, payable at the end of each year. Lessee \nprovides a residual value guarantee of $13,000. Lessor concludes that it is ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 645}), Document(page\_content='Leases 645 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. probable it will collect the lease pa yments and any amount necessary to satisfy \nthe residual value guarantee provided by Lessee. The equipment has a 9- year \nestimated remaining economic life, a carrying amount of $54,000, and a fair \nvalue of $62,000 at the commencement date. Lessor expects the residual \nvalue of the equipment to be $20,000 at the end of the 6- year lease term. The \nlease does not transfer ownership of the underlying asset to Lessee or contain \nan option for Lessee to purchase the underlying asset. Lessor incurs $2,000 in \ninitial direct costs in connection with obtaining the lease, and no amounts are \nprepaid by Lessee to Lessor. The rate implicit in the lease is 5.4839 percent. \n55-20 Lessor classifies the lease as a sales- type lease because the sum of the \npresent value of the lease payments and the present value of the residual \nvalue guaranteed by the lessee amounts to substantially all of the fair value of \nthe equipment. None of the other criteria to be classified as a sales- type lease \nare met. In accordance with paragraph 842- 10-25-4, the discount rate used to \ndetermine the present value of the lease payments and the present value of \nthe residual value guaranteed by Lessee (5.4839 per cent) for purposes of \nassessing whether the lease is a sales -type lease under the criterion in \nparagraph 842-10-25-2(d) assumes that no initial direct costs will be capitalized \nbecause the fair value of the equipment is different from its carrying amount. \n55-21 Lessor measures the net investment in the lease at $62,000 at lease \ncommencement, which is equal to the fair value of the equipment. The net \ninvestment in the lease consists of the lease receivable (which includes the \n6 annual payments of $9,50 0 and the residual value guarantee of $13,000, both \ndiscounted at the rate implicit in the lease, which equals $56,920) and the \npresent value of the unguaranteed residual value (the present value of the \ndifference between the expected residual value of $20,000 and the residual \nvalue guarantee of $13,000, which equals $5,080). Lessor calculates the selling \nprofit on the lease as $8,000, which is the difference between the lease \nreceivable ($56,920) and the carrying amount of the equipment net of the \nunguaranteed residual asset ($54,000 – $5,080 = $48,920). The initial direct \ncosts do not factor into the calculation of the selling profit in this Example \nbecause they are not eligible for deferral on the basis of the guidance in \nparagraph 842- 30-25-1(c) (that is , because the fair value of the underlying asset \nis different from its carrying amount at the commencement date). \n55-22 At the commencement date, Lessor derecognizes the equipment \n(carrying amount of $54,000) and recognizes the net investment in the lease of \n$62,000 and the selling profit of $8,000. Lessor also pays and recognizes the \ninitial direct costs of $2,000 as an expense. \n[The remainder of Example 1 Case A is not included in this section because it is \nnot relevant – it is included in section 7.3.2] \n>>>> Case C —Lessor Accounting —Direct Financing Lease \n55-31 Assume the same facts and circumstances as in Case A \n(paragraphs 842-30-55-19 through 55- 24), except that the $13,000 residual \nvalue guarantee is provided by a third party, not by Lessee. Collectibility of the \nlease payments and any amount necessary to satisfy the third -party residual \nvalue guarantee is probable. \n55-32 None of the criteria in paragraph 842- 10-25-2 to be classified as a sale s-\ntype lease are met. In accordance with paragraph 842 -10-25-4, the discount ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 646}), Document(page\_content='Leases 646 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. rate used to determine the present value of the lease payments (5.4839 \npercent) for purposes of assessing whether the lease is a sales -type lease \nunder the criterion in paragraph 842- 10-25-2(d) assumes that no initial direct \ncosts will be capitalized because the fair value of the equipment is different \nfrom its carrying amount. \n55-32A Rather, Lessor classifies the lease as a direct financing lease because \nthe sum of the present value of the lease payments and the present value of \nthe residual value guaranteed by the third party amounts to substantially all of \nthe fair value of the equipment , and it is probable that Lessor will collect the \nlease payments plus any amount necessa ry to satisfy the third -party residual \nvalue guarantee. The discount rate used to determine the present value of the \nlease payments and the present value of the third -party residual value \nguarantee for purposes of assessing whether the lease meets the crit erion in \nparagraph 842- 10-25-3(b)(1) to be classified as a direct financing lease is the \nrate implicit in the lease of 4.646 percent, which includes the initial direct costs \nof $2,000 that Lessor incurred. . \n55-33 At the commencement date, Lessor derecognizes the equipment and \nrecognizes a net investment in the lease of $56,000, which is equal to the \ncarrying amount of the underlying asset of $54,000 plus the initial direct costs of \n$2,000 that are included in the measurement of the net investment in t he lease \nin accordance with paragraph 842 -30-25-8 (that is, because the lease is classified \nas a direct financing lease). The net investment in the lease includes a lease \nreceivable of $58,669 (the present value of the 6 annual lease payments of \n$9,500 and the third -party residual value guarantee of $13,000, discounted at the \nrate implicit in the lease of 4.646 percent), an unguaranteed residual asset of \n$5,331 (the present value of the difference between the estimated residual value \nof $20,000 and the thir d-party residual value guarantee of $13,000, discounted at \n4.646 percent), and deferred selling profit of $8,000. \n55-34 Lessor calculates the deferred selling profit of $8,000 in this Example as \nfollows: \na. The lease receivable ($58,669); minus \nb. The car rying amount of the equipment ($54,000), net of the unguaranteed \nresidual asset ($5,331), which equals $48,669; minus \nc. The initial direct costs included in the measurement of the net investment \nin the lease ($2,000). \n[The remainder of Example 1 Case C is not included in this section because it \nis not relevant – it is included in section 7.3.2 ] \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 647}), Document(page\_content='Leases 647 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 7.3.10 For sales -type and direct financing leases, a lessor recognizes a net \ninvestment in the lease on its balance sheet and derecognizes the underlying \nasset. [842- 30-25-1, 25- 7, 40-1] \nLessor LesseeLease payments\nRight to use \nunderlying asset\nTotal net \ninvestment in \nthe lease1Lease \nreceivableUnguaranteed \nresidual asset \nNote: \n1. If the lease is a direct financing lease, any selling profit is deferred and the deferred \nselling profit reduces the net investment in the lease. \nNet investment in the lease \n7.3.20 For a sales -type lease, t he lessor’s net investment in the lease \ncomprises: [842- 30-30-1] \n— a lease receivable (see paragraph 7.3.50) ; and \n— an unguaranteed residual asset for the lessor’s inter est in the underlying \nasset’s estimated future value at the end of the lease term that is not \nguaranteed by either: \n— the lessee; or \n— another third party unrel ated to the lessor . \n7.3.30 For a direct financing lease, the lessor’s net investment in the lease \ncomprises: [842- 30-25-8, 30- 2] \n— a lease receivable and an unguaranteed residual asset (calculated in the \nsame way as for a sales- type lease); less \n— any selling profit on the lease, which is deferred and recognized over the \nlease term; it is not recognized at lease commencement as it is for a sales -\ntype lease. \n7.3.35 For both sales -type and direct financing leases , any initial direct costs of \nthe lessor that are deferred are automatically included in the net investment in \nthe lea se based on how the rate implicit in the lease is calculated (see \nsections 5.5 and 5.6.1, and paragraph 7.3.60) . They are not deferred separately. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 648}), Document(page\_content='Leases 648 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 7.3.40 The sell ing profit or selling loss for a sales- type or direct financing \nlease is: [842 Glossary] \n— the lower of: (1) the fair value of the underlying asset (see paragraph 7. 3.41) \nor (2) the sum of the lease receivable + any prepaid lease payments; \n— minus th e carrying amount of the underlying asset, net of any unguaranteed \nresidual asset; \n— minus any initial direct costs (see section 5.5) of the lessor that are deferred \n(i.e. capita lized) (see paragraph 7.3.60) . \n7.3.41 The fair value of the underlying asset for purposes of lessor accounting \nunder Topic 842 differs depending on whether the lessor is a manufacturer or \ndealer. [842- 30-55-17A] \n— For lessors that are manufacturers or dealers, the fair value of the \nunderlying asset is determined in accordance with Topic 820 (fair value measurement). \n— For lessors that are not manufacturers or dealers (typically, financial \ninstitutions), the fair value of the underlying as set is its cost, reflecting \nvolume or trade discounts. Cost includes acquisition costs such as those \narising from sales taxes, shipping/ delivery and installation . An exception \narises if a significant period of time elapse s between asset acquisition and \nlease commencement. In those cases, the lessor determines fair value in \nthe same way as a man ufacturer or dealer lessor. \n \n Example 7.3.05 \nFair value of the underlying asset \nLessor LR (a bank) leases a machine to Lessee LE for use in its production \nfacility for three years. LE selected the make and model machine it wanted LR \nto acquire and lease to LE and negotiated the purchase price of the machine \nwith the manufacturer. \nThe following reflects costs incurred by LR in connection with acquiring the machine. \nMachine purchase price: $100,000 \nSales tax (7% of the purchase price) :1 $7,000 \nDelivery charge:2 $1,000 \nInstallation charge :3 $2,000 \nTotal LR payments $110,000 \nNotes: \n1. LE will operate the machine in a US state that imposes sales tax on the purchase of \nthe machine, based on its purchase price, rather than on the lease payments that LE \nwill make to LR. \n2. Represents the charge from the manufacturer for delivering the machine to LE’s \nproduction facility. \n3. Manufacturer installs the machine in LE’s production facility , which is necessary for its \nuse. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 649}), Document(page\_content='Leases 649 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. LR acquired the machine, based on the date it obtained title, on the same day \nthat the machine was delivered to LE and installed at LE’s production facility. \nThe fair value of the machine to LR for purposes of applying lessor accounting \nunder Topic 842 is $110,000. Because (1) LR is not a manufacturer or dealer, \nand (2) LR’s acquisition date of the machine coincides with t he lease \ncommencement date, the fair value of the machine includes the sales taxes and \nthe delivery and installation charges incurred to acquire the machine, bring it to \nLE’s location and ready it for its intended use. \n \n Observation \nFair value of the underlying asset for lessors that are \nnot manufacturers or dealers \n7.3.42 The guidance in paragraph 7.3.41 was added to Topic 842 by ASU 2019-\n01 (issued in March 2019), and changes how lessors that are not manufacturers \nor dealers determine the fair value of the underlying asset when applying the \nTopic 842 lessor accounting requirements. \n7.3.43 Before the issuance of ASU 2019- 01, all lessors subject to Topic 842 were \nrequired to determine the fair value of the underlying asset bas ed on the \nguidance in Topic 820 (fair value measurement). Applying Topic 820, lessors \ngenerally concluded that acquisition costs – costs to acquire the underlying \nasset (e.g. sales taxes) and place it into service (e.g. delivery and installation \ncosts) – would not be included in the underlying asset’s fair value. \n7.3.44 The most important consequence was that the lessor in a sales -type or \ndirect financing lease would expens e those costs ( i.e. recogniz e a loss) at lease \ncommencement. This is because the cos t basis of the asset to be derecognized \nwould include those costs, while the net investment in the lease (which is \nmeasured at the fair value of the underlying asset plus any deferred initial direct \ncosts) would not. [ASU 2019- 01.BC8, BC12] \n7.3.45 The lessor in this scenario would recover the up- front loss through \ninterest income earned over the lease term. The lessor’s interest income \nwould be greater than what results from applying the new guidance in \nparagraph 7.3.41 because the lower fair value (before ASU 2019- 01) resulted in \na higher rate implicit in the lease. [ASU 2019- 01.BC12] \n7.3.46 Lessors, in particular financial lessors (e.g. banks), expressed to the FASB \nthat the accounting did not reflect the economics of their lease arrangements: \nrecording an up -front loss for acquisition costs on sales -type leases that do not \ngive rise to selling profit (or loss) and direct financing leases, and then \nrecognizing higher interest income over the lease term to recover that loss; in \nsubstance , the arrangements are just loans to the lessee. The acquisition costs \nare, in those arrangements, just part of the total loan being provided to the \nlessee, intended in total to be recovered (with interest) by the lessor over the lease term. Lessors asserted that trea ting the acquisition cost portion of the \nloan differently from the remainder of the loan was illogical. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 650}), Document(page\_content="Leases 650 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 7.3.47 The FASB, in issuing ASU 2019- 01, agreed with the lessors, and noted \nthat it was not the Board’s intent when creating Topic 842 to change financi al \nlessors’ accounting in this manner. [ASU 2019- 01.BC13] \n \n Question 7.3.01 \nEffect of a government grant toward the cost of an \nunderlying asset on the asset’s fair value \nHow does a grant, received by a lessor from a governmental \nagency as an incentive to build a n asset to be leased , affect \nthe asset's fair value? \nBackground: A governmental agency offers a lessor a $2 million incentive to \nbuild a manufacturing facility in a specific location that it will lease to a \nmanufacturer . The agency beli eves the incentive will induce a manufacturer to \nconduct its manufacturing in the area, creating jobs and increasing the local tax \nbase. The incentive is available to a ny lessor willing to enter into an agreement \nto construct such a facility. \nInterpretive response: If the lessor is neither a manufacturer nor a dealer (e.g. \na financial institution) , the fair value of the underlying asset at lease \ncommencement is its cost ; cost reflect s any volume or trade discounts that \nmay apply (see paragraph 7.3.41) . Beca use the government grant is available to \nany lessor that would construct the facility, we believe the total cost of the \nfacility should be reduced by the government grant to determine its fair value. \n \n Question 7. 3.02 \nFair value in a build -to-suit lease \nIf construction of a new asset takes significant time, and is \ncompleted close to the lease commencement date, should the cost of the asset be considered its fair value if the lessor is not a manufacturer or dealer? \nInterpretive response: Yes. We believe the construction completion date \nshould be considered the acquisition date of the asset. Therefore, i f the lessor \nis not a manufacturer or dealer, and there is not a significant time lapse \nbetween the construction completion date and lease commencement, the fair \nvalue of the asset is its cost, reflective of any volume or trade discounts \napplied. \n \n \n", metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 651}), Document(page\_content='Leases 651 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 7.3.10 \nEstimated residual value of land in a long -term \nsales -type or direct financing lease \nWhen a long- term land lease is determined to be a sales -type \nor direct financing lease, can the estimated residual value of \nthe land (undiscounted) exceed its fair value at the lease \ncommencement date? \nBackground: Land will frequently appreciate in value over a given lease term, \nparticularly over a lengthy lease term, such that the value a lessor would expect \nto derive from leased land following the end of the lease term may exceed the \nland’s fair value at lease commencement. \nThe estimated residual value of an underlying asset affects the measurement of \nthe lease receivable (to the extent it is guaranteed by the lessee or a third party \nunrelated to the lessor) and/or the unguaranteed residual asset (to the extent it \nis not guaranteed). \nUnder Topic 840, the estimated residual value was limited to the fair value of \nthe land at lease inception. \nInterpretive response: No. We believe the estimated , undiscounted residual \nvalue of the land in a long- term sales -type or direct financing lease is limited to \nits fair value as of the lease commencement date. Using an estimated residual \nvalue that exceeds the commencement date fair value of the land (or any \nunderlying asset) would inappropriately result in accounting for potential future \nfair value increases, including recognizing additional selling profit on a sal es-\ntype lease. \n \nLease receivable \n7.3.50 For a sales -type lease or a direct financing lease, the lessor initially \nmeasures the lease receivable at the present value of the following, discounted \nat the rate implicit in the lease (see section 5.6.1 ): [842-30-30-1(a), 30 -2] \n— future lease payments receivable over the lease term; and \n— any portion of the estimated residual value at the end of the lease term that \nis guaranteed (either by the lessee or by a third party unrelated to the \nlessor). \nPV of RVGsLease \nreceivablePV of future \nlease \npayments \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 652}), Document(page\_content='Leases 652 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Selling profit/ (loss) and initial direct costs \n7.3.60 At lease commencement, a lessor recognizes any selling profit /(loss) and \ninitial direct costs as follows. [842- 30-25-1, 25- 7 – 25-8, 30- 2] \nSales -type lease Direct financing lease \nSelling profit \nRecognize at lease commencement . Defer as a reduction of the net investment \nin the lease . \nSelling loss \nRecognize at lease commencement . \nInitial direct costs \nIf the fair value of the underlying asset does not equal its carrying amount: \n— expense at lease commencement ; \nand \n— exclude from determination of the \nrate implicit in the lease (see \nExample 7.3.20, Scenario 1) . \nIf the fair value of the underlying asset \nequals its carrying amount: \n— defer and include in the net \ninvestment in the lease ;1 and \n— include in determination of the rate \nimplicit in the lease (see \nExample 7.3.20, Scenario 2) . Defer and include in the net investment in \nthe lease .1 \nInclude in determination of the rate \nimplicit in the lease (see Examples 7.3.10 \nand 7.3.40) . \nNote: \n1. The rate implicit in the lease is defined in such a way that the initial direct costs eligible \nfor deferral are automatically included in the net investment in the lease; there is no need \nto add them separately. \nUnguaranteed residual asset \n7.3.70 A lessor initially measures the unguaranteed residual asset as the present \nvalue of the amount that the lessor expects to derive from the underlying asset \nfollowing the end of the lease term that is not guaranteed by the lessee or any \nother third party unrelated to the lessor, discounted using the rate implicit in the \nlease. [842- 30-30-1(b), 30 -2] \nCollectibility considerations \n7.3.80 Notwithstanding the guidance on the initial recognition and measurement \nof a sales- type lease included in the preceding paragraphs (7.3.10 – 7.3.70) , an \nexception arises if collectibility of the lease payments and any lessee residual value guarantee is not probable. For a discussion of the accounting that applies \nif collectibility of the lease payments and any lessee residual value guarantee is \nnot probable (see section 7. 5). \n[842- 30-25-3 – 25-6] \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 653}), Document(page\_content='Leases 653 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 7.3.10 \nRecognition of selling profit for a dir ect financing \nlease \nLessor LR leases a non- specialized machine to Lessee LE for three years. The \nfollowing facts are relevant at the lease commencement date. \nLease payments: Fixed payments of $10,500 per year in arrears \nRenewal/purchase options: None \nTransfer of ownership: No \nFair value of machine: $40,000 \nCarrying amount of machine: $36,000 \nRemaining economic life of machine: 5 years \nEstimated future residual value: $12,500 \nResidual value guarantee (third party other than LE): $9,200 \nRate implicit in the lease: 3.15% \nInitial direct costs: $1,000 \nIn addition: \n— At the commencement date, the present value of the future lease \npayments is 9 5% of the fair value of the machine (with the residual value \nguarantee), and 74 % of the fair value of the machine (without the residual \nvalue guarantee). \n— There are no prepaid lease payments. \nLease classification \nIn this example, the lease is a direct financing lease as a result of the third- party \n(non- lessee) residual value guarantee, which is included in the present value \ntest only in Part B (see flowchart in paragraph 7.2.50). \nInitial measurement \nAt the commencement date, LR records the following journal entry. \n Debit Credit \nLease receivable1 37,994 \nUnguaranteed residual asset2 3,006 \nPP&E – machine 36,000 \nDeferred profit3 4,000 \nCash4 1,000 \nTo recognize direct financing lease. \nNotes: \n1. Present value of contractual lease payments ($10,500 × 3) + residual value guarantee \n($9,200), discounted at 3.15%. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 654}), Document(page\_content='Leases 654 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 2. Present value of unguaranteed residual asset of $3,300 ($12,500 – $9,200), \ndiscounted at 3.15%. \n3. Fair value of underlying asset ($40,000) – carrying amount ($36,000). This is the same \nas the difference between the lease receivable ($37,994) and the carrying amount of \nthe machine, net of the unguaranteed residual asset ($32,994), less deferred initial \ndirect costs ($1,000). \n4. Represents lessor cas h outlay for initial direct costs. \nThis example is continued in Example 7.3.40 (subsequent a ccounting). \n \n Example 7.3.20 \nAccounting for initial direct costs in a sales -type \nlease \nScenario 1: Fair value of underlying asset does not equal its carrying \namount \nLessor LR leases a commercial truck to Lessee LE for five years. The following \nfacts are relevant at the lease commencement date. \nLease payments: Fixed payments of $10,500 per year in \narrears ; none are prepaid \nRenewal/purchase options: None \nTransfer of ownership: No \nFair value of truck: $56,000 \nCarrying amount of truck: $53,000 \nTotal economic life of truck: 12 years \nRemaining economic life of truck: 6 years \nEstimated future residual value: $15,000 \nInitial direct costs: $400 \nLease classification \nIn this example, the lease is a sales- type lease because the lease term of five \nyears represents a major part (i.e. 83%) of the underlying asset’s remaining economic life (see flowchart in paragraph 7.2.30). \nCalculation of rate impli cit in the lease \nAt lease commencement, the fair value of the truck is different from its carrying \namount. Therefore, the initial direct costs will be expensed at lease \ncommencement and the rate implicit in the lease is determined based on the \nfair value of the underlying asset, without regard to initial direct costs. The rate \nimplicit in the lease is therefore 5.68%, determined as follows. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 655}), Document(page\_content='Leases 655 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Year Initial \ninvestment Lease \npayments Residual \nvalue Net receipts/ \npayments \n0 $(56,000) $ - $ - $(56,000) \n1 10,500 - 10,500 \n2 10,500 - 10,500 \n3 10,500 - 10,500 \n4 10,500 - 10,500 \n5 10,500 15,000 25,500 \n Rate 5.68% \nScenario 2: Fair value of underlying asset equals its carrying amount \nAssume the same facts as Scenario 1, except that, at the lease commencement \ndate, the truck has a fair value and a carrying amount to LR of $56,000. \nIn this scenario, because the fair value of the truck equals its carrying amount at lease commencement, the initial di rect costs of $400 are considered when \ndetermining LR’s implicit rate, and are deferred as part of the net investment in the lease as a result of the implicit rate determined. The rate implicit in the lease is therefore 5.45%, determined as follows. \nYear Initial \ninvestment Lease \npayments Residual \nvalue Net receipts/ \npayments \n0 $(56, 400) $ - $ - $(56,400) \n1 10,500 - 10,500 \n2 10,500 - 10,500 \n3 10,500 - 10,500 \n4 10,500 - 10,500 \n5 10,500 15,000 25,500 \n Rate 5.45% \nComparing Scenarios 1 and 2 \nIncluding the initial direct costs of $400 when determining the rate implicit in the lease in Scenario 2 results in deferring the initial direct costs and \nrecognizing them in net income through lower interest income over the lea se \nterm as compared to Scenario 1 (in which the initial direct costs are expensed \nat lease commencement) . \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 656}), Document(page\_content='Leases 656 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Observation \nSelling profit or loss \nSelling profit deferred for direct financing leases at lease commencement \nand recognized over the lease term \n7.3.90 Lessors are required to defer selling profit arising from a direct financing \nlease. Direct financing leases exist in Topic 842 because the Board concluded \nthat a lease is not a sales- type lease unless the customer, in effect, obtains \ncontrol of – i.e. the ability to direct the use of, and obtain substantially all the \nremaining benefits from – the underlying asset as a result of the lease. This \ncustomer perspective is consistent with the customer perspective of a sale in \nTopic 606. The Boa rd considered that it would be inappropriate, and would \npotentially create structuring opportunities for entities that are typically sellers (rather than lessors), to recognize selling profit by structuring a transaction in which control does not pass to t he customer as a lease. \n[ASU 2016- 02.BC95] \n7.3.100 However, the Board still recognized that a lessor might effectively \nconvert its risk arising from ownership of the underlying asset (i.e. asset risk) into credit risk. It concluded that the most faithful representation of the \nlessor’s involvement in a leas e in that case is to recognize a financial net \ninvestment in the lease and financia l (interest) income on that net investment.\n[ASU 2016- 02.BC96] \nSelling loss recognized at lease commencement for sales -type and direct \nfinancing leases \n7.3.110 Even t hough a lessor defers selling profit arising from a direct financing \nlease under Topic 842, it recognizes at lease commencement any selling loss \non a direct financing lease. If the lessor considers other applicable guidance \n(e.g. the long -lived asset s or inventory impairment guidance), that guidance \nwould generally result in recognition of a loss on the underlying asset. For \nexample, the pricing in the lease might be evidence that the cash flows to be \nderived from the underlying asset will be less than its carrying amount, resulting \nin the recognition of an impairment. Therefore, the approach of recognizing a \nselling loss up -front is consistent with the idea that the presence of the selling \nloss might just be indicative of an existing impairment. [ASU 2016- 02.BC98] \n \n Question 7. 3.20 \nDifferences between a lessor’s lease receivable and \na lessee’s lease liability \nIs the measurement of the lessor’s lease receivable and the \nlessee’s lease liability expected to be the same? \nInterpretive response: Generally, n o. The measurement of the lessor’s lease \nreceivable will typically differ from the measurement of the lessee’s lease \nliability. The following are just some of the reasons for that difference. \n— The lessor’s lease receivable includes the present value of any residual \nvalue guarantee (whether obtained from the lessee or another third party \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 657}), Document(page\_content='Leases 657 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. unrelated to the lessor). The lessee’s lease liability includes only the \npresent value of amounts that it is probable will be owed to the l essor \nunder a residual value guarantee that it provides. \n— The lessor always uses its implicit rate as the discount rate for the lease. \nThe lessee typically uses its incremental borrowing rate as the discount rate \nfor the lease because the information it would need to determine the \nlessor’s implicit rate is generally not readily determinable (see \nQuestion 5.6.20). \n— In addition to the fact that the amount of initial direct costs for the lessee \nand the lessor typically differs, the lessor either expenses initial direct costs \nat lease commencement or includes such amounts in its net investment in \nthe lease – i.e. because the initial direct costs are deferred through the \nimplicit rate, they are included in both the lease receivable and the unguaranteed residual ass et. In contrast, the lessee includes initial direct \ncosts in the measurement of its ROU asset, rather than as part of its lease \nliability. \nOther measurement differences will arise in practice due to information asymmetry; for example, different assessments as to whether it is reasonably \ncertain that the lessee will exercise a renewal or a purchase option. \n \n Question 7.3.25 \nLease incentives paid before lease commencement \nHow should a lessor account for a lease incentive paid before \nlease commencement ? \nInterpretive response: If a lessor pays a lease incentive to a lessee before \nlease commencement , the lessor records the lease incentive paid as a deferred \ncost. The accounting at lease commencement then depends on t he \nclassification of the le ase. \n— For sales -type and direct financing leases, the deferred cost is \nderecognized: \n— as a reduction of the selling profit (or increase of the selling loss) arising \nfrom the lease (see paragraph 7.3.40); or \n— against sales/product revenue if the lessor presents revenue and cost \nof goods sold for its leases separately (see paragraph 7.7.20) . \n— For operating leases, the lessor commences amortization of the deferred \ncost, which will be recognized as a reduction of lease income over the lease term on the same basi s as lease income (generally, straight -line) (see \nsection 7.4). \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 658}), Document(page\_content='Leases 658 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 7.3.26 \nContingent lease incentives \nHow should a lessor account for contingent lease incentives it \noffers to the lessee? \nBackground: Lessors frequently offer lease incentives that are contingent on \nfuture events or lessee actions – i.e. the incentives are not paid or payable – at \nlease commencement. \nFor example, lessors offer to reimburse lessees for all or a portion of the cost of \nleasehold improvements. To receive the reimbursement, the lessee must \nconstruct or install the leasehold improvements and provide evidence of the costs incurred. This may result in a one- time incentive that occurs at a specified \npoint in time after lease comme ncement or may involve multiple payments \nmade during the lease term when the lessee incurs incremental leasehold \nimprovement costs – e.g. a payment to the lessee or a reduction of rent each \nyear that the lessee incurs leasehold improvement costs above a specified \namount (i.e. tenant improvement allowance). \nQuestion 6.6.80 addresses lessee accounting for contingent lease incentives. \nInterpretive response: We believe that i f the occurrence of the future event or \nchange in circumstance that triggers the cont ingent lease incentive (or portion \nthereof) is probable at lease commencement and the amount is reasonably \nestimable, the expected amount should be estimated and accounted for by the \nlessor as a negative in -substance fixed lease payment – i.e. as a reducti on of \n‘lease payments’ . The expected timing of payment should also be considered \nwhen discounting the lease payments for classification and measurement \npurposes. \nUsing the background example, if a lessor offers a payment to the lessee or a \nreduction of rent each year that the lessee incurs leasehold improvement costs \nabove a specified amount, it may be probable that the lessee will earn the full \namount it negotiated. In that case, we believe the incentive should be \naccounted for at lease commencement as a r eduction of the remaining lease \npayments due under the contract. \nThe reduction to the lease payments affects the classification of the lease and \nresults in a lower implicit rate for the lease (see sections 7.2 and 5.6.1, \nrespectively). Consequently, as compared to a lease without a similar incentive: \n— for a sales- type or direct financing lease, the interest income recognized \nover the lease term will be lower (see Example 7.3.25); and \n— for an operating lease, operating lease income recognized over the lease \nterm will be lower (see section 7.4.2). \nIf the lessor does not include a contingent lease incentive in the lease \npayments at lease commencement – i.e. because payment of the incentive is \nnot probable and/ or not reasonably estimable – we believe the lessor c an elect \nas an accounting policy either of the following approaches to account for the \ncontingent incentive. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 659}), Document(page\_content='Leases 659 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Approach 1 : Account for the incentive as a variable lease payment \nAccount for the incentive as a ‘negative’ variable lease payment (i.e. a reducti on \nof lease income) in the period in which the change in facts and circumstances \non which the relevant payment is based occurs. \nApproach 2: Recognize the incentive as a change in the lease payments \nAccount for a contingent incentive that becomes probable of being owed and \nreasonably estimable as a change in the ‘lease payments’, recognizing the \neffect of the change to lease income over the remaining lease term either: \n— with cumulative effect; or \n— prospectively. \n \n Example 7.3.25 \nContingent lease incentive – sales -type lease \nThis example compares a sales- type lease without a contingent lease incentive \nto a sales- type lease with a contingent lease incentive. \nScenario 1: No lease incentive \nAssume the same facts as Example 7.3.20 ( Scenario 1 ). In that scenario, the \nlease is a sales- type lease and the rate implicit in the lease is 5.68% . \nThe following table summarizes the amounts arising on Lessor LR’s balance \nsheet (on which LR presents its net investment in the lease, rather than the components in the table) and income statement. \nBalance sheet Income statement \nEnd \nof \nyear Lessee \npayments \nreceivable1 Incentive \npayable1 Unguar. \nresidual \nasset Net \ninvest. \nin lease ² Interest on \nlease \nreceivable, \nnet³ Residual \naccretion³ Selling \nprofit4 Total \nincome \n0 $44,620 $ - $11,380 $56,000 $ - $ - $3,000 $3,000 \n1 36,654 - 12,026 48,680 2,533 647 - 3,180 \n2 28,235 - 12,709 40,944 2,081 683 - 2,764 \n3 19,338 - 13,431 32,769 1,604 721 - 2,325 \n4 9,936 - 14,194 24,130 1,098 763 - 1,861 \n5 - - 15,000 15,000 564 806 - 1,370 \n Totals $7,880 $3,620 $3,000 $14,500 \nNotes: \n1. The lessee payment s receivable and incentive payable together comprise the ‘lease \nreceivable’ . \n2. The components of the net investment in the lease are measured at present value \nusing the rate implicit in the lease of 5.68%. \n3. Interest on the lease receivable and unguaranteed residual asset accretion are \ncalculated using the rate implicit in the lease of 5.68% . \n4. Selling profit (recognized at lease commencement) is the difference between the \nlease receivable, net ($44,620) and the carrying amount of the equipment net of the \nunguaranteed residual asset ($53,000 – $11,380 = $41,620). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 660}), Document(page\_content='Leases 660 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Scenario 2: Lessor pays incentive fee in Y ear 2 \nAssume the same facts as Scenario 1, except that the lease contract requires \nLR to pay LE an incentive of up to $2,500 for LE costs of tenant improv ements. \nLR expects LE to install tenant improvements significantly in excess of $2,500, \nso concludes that payment of the incentive is both probable and the amount \nreasonably estimable at lease commencement. LR anticipates LE completing \nthe improvements at or near the end of Year 2 of the lease, so expects to pay \nthe incentive at that time. \nThe estimated incentive reduces the lease payments but could not affect the \nsales- type classification of the lease because, regardless of the incentive, the \nlease term i s for a major part of the remaining economic life of the underlying \nasset. \nThe rate implicit in the lease is calculated as follows . \nYear Initial \ninvestment Lease \npayments1 Residual \nvalue Net receipts/ \npayments \n0 $(56,000) $ - $ - $ - \n1 10,500 - 10,500 \n2 8,000 - 8,000 \n3 10,500 - 10,500 \n4 10,500 - 10,500 \n5 10,500 15,000 25,500 \n Rate 4.41% \nNote: \n1. The lease payment in Year 2 is net of the estimated incentive payment of $2,500. \nThe following table summarizes the amounts arising on LR’s balance sheet (on \nwhich LR presents its net investment in the lease, rather than the components in the table ) and income statement. \nBalance sheet Income statement \nEnd \nof \nyear Lessee \npayments \nreceivable1 Incentive \npayable1 Unguar. \nresidual \nasset Net \ninvest. \nin lease ² Interest on \nlease \nreceivable ³ Residual \naccretion³ Selling \nprofit4 Total \nincome³ \n0 $46,206 $(2,293) $12,087 $56,000 $ - $ - $3,000 $ 3,000 \n1 37,745 (2,394) 12,620 47,971 1,938 533 - 2,471 \n2 28,911 - 13,177 42,088 1,560 557 - 2,117 \n3 19,687 - 13,759 33,446 1,276 582 - 1,858 \n4 10,056 - 14,366 24,422 869 607 - 1,476 \n5 - - 15,000 15,000 444 634 - 1,078 \n Totals $6,087 $2,913 $3,000 $12,000 \nNotes: \n1. The lessee payment s receivable and incentive payable together comprise the ‘lease \nreceivable ’. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 661}), Document(page\_content='Leases 661 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 2. The components of the net investment in the lease are measured at present value \nusing the rate implicit in the lease of 4.41%. \n3. Interest on the lease receivable and unguaranteed residual asset accretion are \ncalculated using the rate implicit in the lease of 4.41%. \n4. Selling profit (recognized at lease commencement) of $3,000 is the difference \nbetween the lease receivable ($46,206 – $2,293 = $43,913) and the carrying amount \nof the equipment net of the unguaranteed residual asset ($53,000 – 12,087 = \n$40,913). \nComparing Scenario 1 and Scenario 2 \nThe incentive lowers the rate implicit in the lease from 5.68% in Scenario 1 to \n4.41% in Scenario 2. \nThe following table compares the lease commencement date carrying amounts \nof the components of the net investment of the lease under Scenario 1 to those \nunder Scenario 2. \nBalance sheet ( initial measurement at lease commencement) \n Lessee \npayment \nreceivable Incentive \npayable Unguaranteed \nresidual asset Net \ninvestment \nin lease \nScenario 1 $44,620 $ - $11,380 $56,000 \nScenario 2 46,206 (2,293) 12,087 56,000 \nDifference $1,586 $(2,293) $707 $ - \nWhile the carrying amounts of the individual components of the net investment \nin the lease are different in the two scenarios because of the incentive, the net \ninvestment in aggregate is the same. This is because of how the rate implicit in \nthe lease is calculated. \nThe following table compares the selling profit and interest income recognized \nunder each scenario. \nIncome statement ( total during lease term) \n Interest on \nlease \nreceivable Residual \naccretion Selling profit Total income \nScenario 1 $7,880 $3,620 $3,000 $14,500 \nScenario 2 6,087 2,913 3,000 12,000 \nDifference $(1,793) $(707) $ - $(2,500) \nTotal income to be recognized is lower in Scenario 2 than in Scenario 1 by the \namount of the estimated incentive. \n— Interest income to be recognized on the lease receivable and from \naccretion of the unguaranteed residual asset is lower in Scenario 2 than in \nScenario 1 because of the lower implicit rate. \n— Selling profit is the same in both scenarios. The lower implicit rate in \nScenario 2, which affects the carrying amounts of the components of the ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 662}), Document(page\_content='Leases 662 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. net investment in the lease (and drives the calculation of selling profit – see \nparagraph 7. 3.40), offsets the effect of the lease incentive. \nSelling profit calculation \n Scenario 1 Scenario 2 \nLease receivable $44,620 $43,913 \n+ prepaid lease payments - - \n− carrying amount of \nunderlying asset (net of \nunguaranteed residual asset) (41,620) (40,913) \nSelling profit $3,000 $3,000 \n \n \n Question 7. 3.30 \nImpact of variable lease payments on the rate \nimplicit in the lease \nHow does the lessor determine the rate implicit in the lease \nwhen the lease includes variable lease payments? \nBackground : It is not uncommon in certain industries for a lease to be \ncomprised primarily, or even entirely, of variable lease payments. The following \nare examples (not exhaustive): \n— In the oil and gas industry, an entity may contract with a third- party \nmidstream company to lease the necessary equipment to extract and process oil or gas from certain well sites. The midstream company may \naccept a lease agreement that includes entirely variable lease payments based on the volume of oil or gas extracted and processed if data suggests \nthe well sites include a significant volume available for extraction. \n— In the energy sector, power purchase agreements with renewable energy \nfacilities are commonly structured with payments based on a set price per \nunit of electricity output, but the total volume purchased in a given period is \nvariable. For ex ample, an entity contracts to purchase the total electricity \noutput of a wind farm at a fixed price per unit. The volume of electricity purchased in a given month is variable depending on the volume of \nelectricity produced. If the agreement meets the defin ition of a lease (see \nchapter 3), the lease payments would be variable in their entirety. \n— In the health care industry, service providers may contract with medical \ndevice companies to lease equipment that is dependent on the service \nprovider’s continued purchase of materials from the medical device \ncompany necessary to operate the equipment as designed – i.e. the \nequipment is leased ‘for free’ based on the expectation that the service \nprovider will purchase materials from the medical device company over t he \nlease term. The medical device company may be willing to accept a lease \nagreement where payments for the equipment are entirely dependent on \nthe volume of materials purchased because it expects that the service \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 663}), Document(page\_content='Leases 663 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. provider will require a sufficient volume of materials to operate the \nequipment such that the contract as a whole will be profitable. \nInterpretive response: For leases with variable lease payments , especially \nthose with significant variable lease payments , the undiscounted sum of (1) the \nlease pay ments and (2) the estimated residual value of the underlying asset at \nthe end of the lease term may be less than the underlying asset’s fair value \nand/or carrying amount at lease commencement. As discussed in section 5.4.1 , \nthis is because variable lease p ayments that do not depend on an index or a \nrate are excluded from the lease payments. \nIn the event that the rate implicit in the lease would be ne gative from applying \nthe calculated formula in the implicit rate definition because of the variable \nlease pa yments , a discount rate of zero is used. A lessor does not, in such \ncases, use another discount rate for the lease such as the lessee’s incremental \nborrowing rate or a rate that estimates the variable lease payments . \n \n Example 7.3.31 \nImpact of variable lease payments \nScenario 1: Lease comprised entirely of variable lease payment s \nLessor LR enters into a contract with Lessee LE to lease a non- specialized \nmachine for five years. The contract is structured such that payments from LE \nto LR related to use of the underlying asset are based entirely on LE’s use of \nthe machine. LR intends to sell the machine at auction after the lease with LE \nends. \nThe following facts are relevant at the lease commencement date. \nVariable lease payments: 3% of LE ’s monthly sales of units produced \nusing the machine \nRenewal/purchase options: None \nTransfer of ownership: No \nFair value of machine: $40,000 \nCarrying amount of machine: $36,000 \nLease term: 5 years \nRemaining useful life of machine: 5 years \nRemaining economic life of machine: 6 years \nEstimated future residual value: $12,500 \nResidual value guarantee: None \nClass ification and initial measurement \nLR is unable to calculate a rate implicit in the lease that is greater than zero \nbecause the sum of (1) the lease payments ($0, because the lease payments \nare entirely variable) and (2) the estimated residual value of the machine at the ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 664}), Document(page\_content='Leases 664 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. end of the lease term ($12,500) is less than the machine’s fair value at the lease \ncommencement date. Therefore, LR uses a 0% discount rate . \nBecause the amount that would be recognized as the net investment in the \nlease ($12,500) if the lease were classified as a sales -type or direct financing \nlease is less than the machine’s carrying amount ($36,000) at the lease \ncommencement date such that a selling loss would result, LR classifies the \nlease as an operating lease (see paragraph 7.2.30) . \nSubsequent accounting \nAs an operating lease, LR continues to recognize the machine and depreciate it over its useful life. LR records the v ariable lease payments (the only payments \nfor the lease under the contract) as revenue in the period(s) in which the sales \nof units produced using the machine occur . \n Balance sheet Income statement \nEnd of \nyear PP&E (net) Depn. \nexpense2 Variable lease \nincome1 Total earnings \nimpact \n0 $36,000 $ - $ - $ - \n1 31,300 (4,700) 12,000 7,800 \n2 26,600 (4,700) 9,500 4,800 \n3 21,900 (4,700) 14,500 9,800 \n4 17,200 (4,700) 9,000 4,300 \n5 12,500 (4,700) 10,000 5,300 \n ($23,500) $55,000 $ 31,500 \nNotes: \n1. Assumed variable lease payments, which are based on 3% of hypothetical LE \nmonthly sales of units produced using the machine. \n2. Calculated on a straight -line basis ($36,000 carrying amount less the estimated \nresidual value of $12,500) over the machine’s 5 -year useful life. \nScenario 2: Lease comprised partially of variable lease payment s \nAssume the same facts as Scenario 1, except that a portion of the lease \npayments are variable (1.5% of LE’s monthly sales of units produced using the \nmachine) and a portion are fixed ($5,500 per year). \nClassification and initial measurement \nLR is unable to calculate a rate implicit in the lea se that is greater than zero \nbecause the sum of (1) the lease payments ($ 27,500) and (2) the estimated \nresidual value of the machine at the end of the lease term ($12,500) equals the \nmachine’s fair value at the lease commencement date. Therefore, LR uses a \n0% discount rate. \nBecause the amount that would be recognized as the net investment in the \nlease ($40,000) if the lease were classified as a sales -type or direct financing \nlease is greater than the machine’s carrying amount ($36,000) at the lease \ncommencement date, the lease passes the Step 0 classification test (see \nparagraph 7.2.30). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 665}), Document(page\_content='Leases 665 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Applying the Part A lease classification tests (see paragraph 7.2.30), the lease is \na sales- type lease because the lease term of five years represents a major part \n(83%) of the machine’s remaining economic life. \n Debit Credit \nUnguaranteed residual asset1 12,500 \nLease receivable2 27,500 \nPP&E – machine 36,000 \nSelling profit3 4,000 \nTo recognize unguaranteed residual asset, lease \nreceivable and up -front selling profit, and \nderecognize underlying asset at commencement \ndate. \nNotes: \n1. Estimated future residual value ($12,500) discounted at 0%. \n2. Fixed lease payments ($5,500 × 5) discounted at 0%. \n3. Sum of (1) the lease payments ($27,500) and (2) any prepaid lease payments ($0) – \nthe net of (1) the carrying amount of the machine ($36,000) and (2) the unguaranteed \nresidual asset ($12,500). \nSubsequent accounting \nBecause the discount rate is 0%, there is no accretion of the unguaranteed \nresidual asset or interest on the lease receivable during the lease term. LR \nrecognizes the variable lease payments as revenue in the period(s) in which the \nsales of units produced using the machine occur. The foll owing table \nsummarizes the income statement effect to LR throughout the lease term. \n Income statement \nEnd of \nyear Net investment \nin the lease1 Interest on \nresidual \nasset/lease \nreceivable Variable lease \npayments2 Total earnings \nimpact \n0 $40,000 $ - $ - $ 4,0003 \n1 34,500 - 6,000 6,000 \n2 29,000 - 4,750 4,750 \n3 23,500 - 7,250 7,250 \n4 18,000 - 4,500 4,500 \n5 12,500 - 5,000 5,000 \n $ - $27,500 $31,500 \nNotes: \n1. Because the rate implicit in the lease is zero, the changes in the balance of the net \ninvestment in the lease reflect solely the periodic (non- variable) lease payment of \n$5,500 per year. \n2. Assumed variable lease payments, which are based on 1.5% of hypothetical LE \nmonthly sales of units produced using the machine. \n3. Represents the selling profit in the initial measurement journal entry. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 666}), Document(page\_content='Leases 666 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Comparing Scenario s 1 and 2 \nThe following table summarizes the total earnings effect to LR by year under \nScenarios 1 and 2. \n Earnings impact \nYear Scenario 1 Scenario 2 \n0 $ - $ 4,000 \n1 7,800 6,000 \n2 4,800 4,750 \n3 9,800 7,250 \n4 4,300 4,500 \n5 5,300 5,000 \n $31,500 $31,500 \nEven though the total earnings effect to LR over the lease term is the same \nunder both scenarios, the lease classification significantly affects the timing of \nthe earnings effect in LR’s financial statements. \nThe following table compares LR’s balance sheet at lease commencement and \nat the end of each year under Scenarios 1 and 2. \n Balance sheet comparison \n \nScenario 1 \nPP&E (net) Scenario 2 \nLease receivable and \nunguaranteed residual asset \nYear Current1 Noncurrent2 Current3 Noncurrent4 \n0 $ - $36,000 $ 5,500 $ 34,500 \n1 - 31,300 5,500 29,000 \n2 - 26,600 5,500 23,500 \n3 - 21,900 5,500 18,000 \n4 - 17,200 5,500 12,500 \n5 - 12,500 - 12,500 \nNotes: \n1. There is no current period portion of a PP&E asset (i.e. the machine). This column \nis presented to show the difference in current assets between Scenario 1 and \nScenario 2. \n2. Represents the carrying amount (net of accumulated depreciation) of the \nmachine at the end of each reporting period. \n3. The current portion consists of nonvariable lease payments due within the \nfollowing 12 -month period. \n4. The noncurrent balance includes the unguaranteed residual asset ($12,500) and \nfixed lease payments due after the following 12- month period. \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 667}), Document(page\_content='Leases 667 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 7.3.2 Subsequent accounting \n Excerpt from ASC 842-30 \n25 Recognition \nGeneral \n> Sales -Type Leases \n25-2 After the commencement date, a lessor shall recognize all of the \nfollowing: \na. Interest income on the net investment in the lease, measured in \naccordance with paragraph 842- 30-35-1(a) \nb. Variable lease payments that are not included in the net investment in \nthe lease as income in profit or loss in the period when the changes in \nfacts and circumstances on which the variable lease payments are based \noccur \nc. Impairment of the net investment in the lease (as described in \nparagraph 842-30-35-3). \n> Direct Financing Leases \n25-9 After the commencement date, a lessor shall recognize all of the \nfollowing: \na. Interest income on the net investment in the lease, measured in \naccordance with paragraph 842- 30-35-1(a) \nb. Variable lease payments that are not included in the net investment in \nthe lease as income in profit or loss in the period when the changes in \nfacts and circumstances on which the variable lease payments are based \noccur \nc. Credit losses on the net investment in the lease (as described in \nparagraph 842-30-35-3). \n35 Subsequent Measurement \nGeneral \n> Sales -Type and Direct Financing Leases \n35-1 After the commencement date , a lessor shall measure the net \ninvestment in the lease by doing both of the following: \na. Increasing the carrying amount to reflect the interest income on the net \ninvestment in the lease. A lessor shall determine the interest income on \nthe net investment in the lease in each period during the lease term as the \namount that produces a constant periodic discount rate on the remaining \nbalance of the net investment in the lease. \nb. Reducing the carrying amount to reflect the lease payments collected \nduring the period. \n35-2 After the commencement date, a lessor shall not remeasure the net \ninvestment in the lease unless the lease is modified and that modification is ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 668}), Document(page\_content='Leases 668 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. not accounted for as a separate contract in accordance with paragraph 842 -10-\n25-8. \n>> Loss Allowance on the Net Investment in the Lease \n35-3 A lessor shall determine the loss allowance related to the net \ninvestment in the lease and shall record any loss allowance in accordance \nwith Subtop ic 326 -20 on financial instruments measured at amortized cost. \nWhen determining the loss allowance for a net investment in the lease, a \nlessor shall take into consideration the collateral relating to the net investment \nin the lease. The collateral relating to the net investment in the lease \nrepresents the cash flows that the lessor would expect to receive (or derive) \nfrom the lease receivable and the unguaranteed residual asset during and \nfollowing the end of the remaining lease term . \n>> Sale of the Lease Receivable \n35-4 If a lessor sells substantially all of the lease receivable associated with a \nsales -type lease or a direct financing lease and retains an interest in the \nunguaranteed residual asset , the lessor shall not continue to accrete the \nunguaranteed residual asset to its estimated value over the remaining lease \nterm . The lessor shall report any remaining unguaranteed residual asset \nthereafter at its carrying amount at the date of the sale of the lease receivable \nand apply Topic 360 on property, plant, and equipment to determine whether \nthe unguaranteed residual asset is impaired. \n>> Accounting for the Underlying Asset at the End of the Lease Term \n35-5 At the end of the lease term , a lessor shall reclassify the net investment \nin the lease to the appropriate category of asset (for example, property, plant, \nand equipment) in accordance with other Topics, measured at the carrying \namount of the net investment in the lease. The lessor shal l account for the \nunderlying asset that was the subject of a lease in accordance with other \nTopics. \n40 Derecognition \nGeneral \n> Sales -Type and Direct Financing Leases \n>> Lease Termination \n40-2 If a sales -type lease or a direct financing lease is terminated before the \nend of the lease term , a lessor shall do all of the following: \na. Measure the net investment in the lease for credit losses in accordance \nwith Subtopic 3 26-20 on financial instruments measured at amortized cost \nand record any credit loss identified \nb. Reclassify the net investment in the lease to the appropriate category of \nasset in accordance with other Topics, measured at the sum of the \ncarrying amounts of the lease receivable (less any amounts still expected \nto be rece ived by the lessor) and the residual asset \nc. Account for the underlying asset that was the subject of the lease in \naccordance with other Topics. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 669}), Document(page\_content='Leases 669 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance \n>> Guarantee Payments Received \n55-16 Indemnification payments related to tax effects other than the \ninvestment tax credit should be reflected by the lessor in income consistent \nwith the classification of the lease . That is, the payments should be accounted \nfor as an adjustment of the lessor’s net investment in the lease if the lease is \na sales -type lease or a direct financing lease or recognized ratably over the \nlease term if the lease is an operating lease . \n>> Fair Value of the Underlying Asset \n55-17A Notwithstanding the definition of fair value, if a lessor is not a \nmanufacturer or a dealer, the fair value of the underlying asset at lease \ncommencement is its cost, reflecting any volume or trade discounts that may \napply. However, if there has been a significant lapse of time between the \nacquisition of the underlying asset and lease commencement, the definition of \nfair value shall b e applied. \n> Illustrations \n>> Illustration of Lessor Accounting \n55-18 Example 1 illustrates how a lessor would account for sales -type leases \nand direct financing leases. \n>>> Example 1— Lessor Accounting Example \n>>>> Case A—Lessor Accounting —Sales -Type Lease \n55-19 Lessor enters into a 6 -year lease of equipment with Lessee, receiving \nannual lease payments of $9,500, payable at the end of each year. Lessee \nprovides a residual value guarantee of $13,000. Lessor concludes that it is \nprobable it will collect the lease pa yments and any amount necessary to satisfy \nthe residual value guarantee provided by Lessee. The equipment has a 9- year \nestimated remaining economic life, a carrying amount of $54,000, and a fair \nvalue of $62,000 at the commencement date. Lessor expects the residual \nvalue of the equipment to be $20,000 at the end of the 6- year lease term. The \nlease does not transfer ownership of the underlying asset to Lessee or contain \nan option for Lessee to purchase the underlying asset. Lessor incurs $2,000 in \ninitial direct costs in connection with obtaining the lease, and no amounts are \nprepaid by Lessee to Lessor. The rate implicit in the lease is 5.4839 percent. \n55-20 Lessor classifies the lease as a sales- type lease because the sum of the \npresent value of the lease payments and the present value of the residual \nvalue guaranteed by the lessee amounts to substantially all of the fair value of \nthe equipment. None of the other criteria to be classified as a sales -type lease \nare met. In accordance with paragraph 842- 10-25-4, the discount rate used to \ndetermine the present value of the lease payments and the present value of \nthe residual value guaranteed by Lessee (5.4839 percent) for purposes of \nassessing whether the lease is a sales –type lease under the criterion in ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 670}), Document(page\_content='Leases 670 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. paragraph 842 -10-25-2(d) assumes that no initial direct costs will be capitalized \nbecause the fair value of the equipment is different from its carrying amount. \n55-21 Lessor measures the net investment in the lease at $62,000 at lease \ncommencement, which is equal to the fair value of the equipment. The net \ninvestment in the lease consists of the lease receivable (which includes the \n6 annual payments of $9,500 and the residual value guarantee of $13,000, both \ndiscounted at the rate impli cit in the lease, which equals $56,920) and the \npresent value of the unguaranteed residual value (the present value of the \ndifference between the expected residual value of $20,000 and the residual \nvalue guarantee of $13,000, which equals $5,080). Lessor c alculates the selling \nprofit on the lease as $8,000, which is the difference between the lease \nreceivable ($56,920) and the carrying amount of the equipment net of the \nunguaranteed residual asset ($54,000 – $5,080 = $48,920). The initial direct \ncosts do not factor into the calculation of the selling profit in this Example \nbecause they are not eligible for deferral on the basis of the guidance in \nparagraph 842- 30-25-1(c) (that is, because the fair value of the underlying asset \nis different from its carrying amount at the commencement date). \n55-22 At the commencement date, Lessor derecognizes the equipment \n(carrying amount of $54,000) and recognizes the net investment in the lease of \n$62,000 and the selling profit of $8,000. Lessor also pays and recogniz es the \ninitial direct costs of $2,000 as an expense. \n55-23 At the end of Year 1, Lessor recognizes the receipt of a lease payment \nof $9,500 and interest on the net investment in the lease (the beginning \nbalance of the net investment in the lease of $ 62,000 × the rate implicit in the \nlease of 5.4839% = $3,400), resulting in a balance in the net investment of the \nlease of $55,900. For disclosure purposes, Lessor also calculates the separate \ncomponents of the net investment in the lease: the lease receiv able and the \nunguaranteed residual asset. The lease receivable equals $50,541 (the \nbeginning balance of the lease receivable of $56,920 – the annual lease \npayment received of $9,500 + the amount of interest income on the lease \nreceivable during Year 1 of $3,121, which is $56,920 × 5.4839%). The \nunguaranteed residual asset equals $5,360 (the beginning balance of the \nunguaranteed residual asset of $5,081 + the interest income on the \nunguaranteed residual asset during Year 1 of $279, which is $5,081 × \n5.4839%) . \n55-24 At the end of Year 6, Lessor reclassifies the net investment in the lease, \nthen equal to the estimated residual value of the underlying asset of $20,000, \nas equipment. \n>>>> Case C—Lessor Accounting —Direct Financing Lease \n55-31 Assum e the same facts and circumstances as in Case A \n(paragraphs 842-30-55-19 through 55- 24), except that the $13,000 residual \nvalue guarantee is provided by a third party, not by Lessee. Collectibility of the \nlease payments and any amount necessary to satisfy the third-party residual \nvalue guarantee is probable. \n55-32 None of the criteria in paragraph 842- 10-25-2 to be classified as a \nsales- type lease are met. In acco rdance with paragraph 842- 10-25-4, the \ndiscount rate used to determine the present value of the lease payments \n(5.4839 percent) for purposes of assessing whether the lease is a sales -type ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 671}), Document(page\_content='Leases 671 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. lease under the criterion in paragraph 842 -10-25-2(d) assumes that no initial \ndirect costs will be capitalized because the fair value of the equipment is \ndifferent from its carrying amount. \n55-32A Rather , Lessor classifies the lease as a direct financing lease because \nthe sum of the present value of the lease payments and the present value of \nthe residual value guaranteed by the third party amounts to substantially all of \nthe fair value of the equipment , and it is probable that Lessor will collect the \nlease payments plus any amount necessary to satisfy the third -party residual \nvalue guarantee. The discount rate used to determine the present value of the \nlease payments and the present value of the third- party residual value \nguarantee for purposes of assessing whether the lease meets the criterion in \nparagraph 842- 10-25-3(b)(1) to be classified as a direct financing lease is the \nrate implicit in the lease of 4.646 percent, which includes the initial direct costs \nof $2,000 that Lessor incurred. \n55-33 At the commencement date, Lessor derecognizes the equipment and \nrecognizes a net investment in the lease of $56,000, which is equal to the \ncarrying amount of the underlying asset of $54,000 plus the initial direct costs \nof $2,000 that are included in the measurement of the net investment in the \nlease in accordance with paragraph 842- 30-25-8 (that is, because the lease is \nclassified as a direct financin g lease). The net investment in the lease includes \na lease receivable of $58,669 (the present value of the 6 annual lease \npayments of $9,500 and the third- party residual value guarantee of $13,000, \ndiscounted at the rate implicit in the lease of 4.646 perc ent), an unguaranteed \nresidual asset of $5,331 (the present value of the difference between the \nestimated residual value of $20,000 and the third- party residual value \nguarantee of $13,000, discounted at 4.646 percent), and deferred selling profit \nof $8,000. \n55-34 Lessor calculates the deferred selling profit of $8,000 in this Example \nas follows: \na. The lease receivable ($58,669); minus \nb. The carrying amount of the equipment ($54,000), net of the unguaranteed \nresidual asset ($5,331), which equals $48,669; minus \nc. The initial direct costs included in the measurement of the net investment \nin the lease ($2,000). \n55-35 At the end of Year 1, Lessor recognizes the receipt of the lease payment \nof $9,500 and interest on the net investment in the lease of $4,624 (the \nbeginning balance of the net investment in the lease of $56,000 × the discount \nrate that, at the commencement date, would have resulted in the sum of the \nlease receivable and the unguaranteed residual asset equaling $56,000, \nwhich is 8.258 percent), resulting in a balance in the net investment of the \nlease of $51,124. \n55-36 Also at the end of Year 1, Lessor calculates, for disclosure purposes, the \nseparate components of the net investment in the lease: the lease receivable, \nthe unguaranteed resi dual asset, and the deferred selling profit. The lease \nreceivable equals $51,895 (the beginning balance of the lease receivable of \n$58,669 – the annual lease payment received of $9,500 + the amount of \ninterest income on the lease receivable during Year 1 of $2,726, which is \n$58,669 × 4.646%). The unguaranteed residual asset equals $5,578 (the \nbeginning balance of the unguaranteed residual asset of $5,331 + the interest ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 672}), Document(page\_content='Leases 672 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. income on the unguaranteed residual asset during Year 1 of $247, which is \n$5,331 × 4.646% ). The deferred selling profit equals $6,349 (the initial deferred \nselling profit of $8,000 – $1,651 recognized during Year 1 [the $1,651 is the \ndifference between the interest income recognized on the net investment in \nthe lease during Year 1 of $4,624 ca lculated in paragraph 842- 30-55-35 and the \nsum of the interest income earned on the lease receivable and the \nunguaranteed residual asset during Year 1]). \n55-37 At the end of Year 2, Lessor recognizes the receipt of the lease payment \nof $9,500 and interest on the net investment in the lease (the beginning of \nYear 2 balance of the net investment in the lease of $51,124 × 8.258%, which \nis $4,222), resulting in a carrying amount of the net investment in the lease \nof $45,846. \n55-38 Also at the end of Year 2, Lessor calculates the separate components of \nthe net investment in the lease. The lease receivable equals $44,806 (the \nbeginning of Year 2 balance of $51,895 – the annual lease payment received of \n$9,500 + the interest income earned on the l ease receivable during Year 2 of \n$2,411, which is $51,895 × 4.646%). The unguaranteed residual asset equals \n$5,837 (the beginning of Year 2 balance of the unguaranteed residual asset of \n$5,578 + the interest income earned on the unguaranteed residual asset during \nYear 2 of $259, which is $5,578 × 4.646%). The deferred selling profit equals \n$4,797 (the beginning of Year 2 balance of deferred selling profit of $6,349 – \n$1,552 recognized during Year 2 [the $1,552 is the difference between the \ninterest income r ecognized on the net investment in the lease during Year 2 of \n$4,222 and the sum of the interest income earned on the lease receivable and \nthe unguaranteed residual asset during Year 2]). \n55-39 At the end of Year 6, Lessor reclassifies the net invest ment in the lease, \nthen equal to the estimated residual value of the underlying asset of $20,000, \nas equipment. \n \n7.3.14 0 After the lease commencement date, the lessor recogni zes: \n— interest income on the net investment in the lease, as described in \nparagraph 7.3.340; \n— variable lease payments as income in the income statement in the period in \nwhich the changes in facts and circumstances on which those payments \nare based occur; and \n— impa irment of the net investment in the lease, as described in \nparagraph 7.3.380. [842- 30-25-2, 25 -9] \n7.3.150 A lessor recognizes variable non- lease payments as income in the \nincome statement when the requirements of the applicable Topic (e.g. \nTopic 606) are met. [842- 10-15-40] \nGross vs. net considerations \n7.3.160 Lessors frequently incur costs in their role as lessor or as owner of the \nunderlying asset that they aim to recover from the lessee. Examples include \nproperty, ad valorem and other taxes , and insurance covering the underlying \nasset. [842- 10-15-30(b), ASU 2018- 20.BC14] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 673}), Document(page\_content='Leases 673 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 7.3.170 Lessors typically aim to recover th ese costs from the lessee, the \npayments for which do not result in the transfer of a good or service to the \nlessee in addition to t he lease and any non- lease goods or services included in \nthe contract. [842- 10-15-30(b), ASU 2018- 20.BC14] \n— In a gross lease, the lessor recovers the costs through fixed lease payments. \n— In a net lease, the lessee makes variable payments, either to the lessor or \ndirectly to the third party to whom the cost is owed (e.g. a taxing authority \nor insurer). \n7.3.180 In a gross lease, the lessor’s costs and the lessee’s fixed lease \npayments are recognized separately ( i.e. on a gross basis) as operating \nexpenses and lease income. If the lease includes non- lease components , there \nwill be lease and non- lease income arising from the payments . \n7.3.190 In a net lease, gross or net income statement presentation depends on \nwhether the lessee or the lessor pays the relevant third party for the cost, \nunless the cost is a sales or other similar tax (see paragraph 7.3.210). [842- 10-15-\n40A] \n— If the lessee remits payment to the third party , the lessor presents the cost \nand the lessee’s payment to the third party thereof on a net basis – i.e. with \nzero effect on the income statement. The lessor, in effect, treats the cost \nas a lessee cost. Example 4.2.50 in secti on 4.2.1 illustrates this scenario. \n— If the lessor remits payment to the third party , the lessor presents the cost \nand the lessee’s variable payments thereof on a gross basis – i.e. as its \nown cost and income. Example 4.2.40 in section 4.2.1 illustrates this \nscenario. \n7.3.200 In applying paragraph 7.3.190, it does not matter whether the lessor or \nlessee is primarily obligated to the third party for the cost incurred, or who \nprimarily benefits from the cost. The accounting by lessors differs from the accounting by lessees in this respect (see Question 4.2.40). \nSales and other similar taxes \n7.3.210 The guidance in paragraphs 7.3.180 – 7.3.200 does not apply to sales \nand other similar taxes if the lessor elects the practical expedient to present all \nsales tax collections from lessees ( whether fixed or variable) net of the related \nsales tax e xpense for all of its leases . Questions 4.2.60 and 4.2.70 outline a \nlessor’s accounting for sales and other similar taxes. [842- 10-15-39A] \n7.3.220 ‘Sales and other similar taxes ’ refers to taxes assessed by a \ngovernmental authority that are both imposed on and concurrent with a specific \nlease revenue- producing transaction. Other similar taxes include use, value -\nadded taxes (VAT) and some excise taxes. Such taxes exclude (1) gross \nreceipts taxes and (2) taxes assessed on the lessor as owner of the underlyin g \nasset. [842- 10-15-39A] \n7.3.230 Taxes assessed on the lessor as owner of the underlying asset include \n(not exhaustive): \n— most property taxes; and \n— sales taxes assessed on the owner’s purchase of the underlying asset. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 674}), Document(page\_content='Leases 674 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 7.3.240 A lessor that does not elect the practical expedient applies the guidance \nin paragraphs 7.3.180 – 7.3.200 to sales and other similar taxes. \n7.3.250 For transition considerations, see section 13A.4.3 ( effective date \ntransition method) or section 13B.4.3 (comparative transition method) . The \nconsiderations depend on whether or not lessors adopted Topic 842 before the \nDecember 2018 issuance of ASU 2018- 20. \n \n Observation \nLessor costs \nLessor costs paid by the lessee directly to a third party \n7.3.260 It is not uncommon for a lessor not to know (or expect to know) the \namount of a lessor cost the lessee pays directly to a third party. For example, a \nlessee may be required to obtain insurance on the underlying asset as a \ncondition of the lease and for which the lessor is the primary beneficiary of that \npolicy (see Question 4.2.42), but not be required to provide policy premium \ninformation to the lessor. \n7.3.270 Because the premium may be affected by numerous lessee -specific \nfactors (e.g. credit r ating, claims history, discounts for multiple policies), or \nbecause an umbrella insurance policy covers the underlying asset, the lessor may not know what the premium is. In that case, the lessor will not be able to \npresent the lessee’s payments and its as sociated costs on a gross basis \nwithout estimating the premium. \n7.3.280 The guidance in paragraph 7.3.190, added by ASU 2018- 20, addresses \nlessor operational concerns about estimating lessee payments of lessor costs made directly to a third party. Becaus e neither the costs nor the lessee \npayments thereof are reflected in the lessor’s income statement, lessors will \nnot need to make such estimates. \nLessor costs paid by the lessee to the lessor \n7.3.290 When the guidance in paragraph 7.3.190 was deliberated, some \nstakeholders suggested that net presentation in the income statement should \nalso be mandated for lessor costs paid by the lessor and reimbursed by the \nlessee (lessee- reimbursed costs). Those stakeholders asserted that the \nunderlying economics are not different for lessee direct pay costs and lessee-\nreimbursed costs, so should not be presented differently. [ASU 2018 -20.BC18] \n7.3.300 The FASB rejected this view in favor of the requirements in \nparagraphs 7.3.180 and 7.3.190. The FASB explained that it intended to require \nnet presentation for those lessor costs for which there is uncertainty for the \nlessor as to the amount of the cost and the lessee’s payment thereof ; however, \nthere is no uncertainty about the amount of the cost or the lessee’s payment i f \nthe lessor pays the cost and collects the lessee’s payment. [ASU 2018- 20.BC22] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 675}), Document(page\_content='Leases 675 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Observation \nSales and other similar taxes \n7.3.310 A lessor may operate in numerous taxing jurisdictions. Similarly, the \nlessor’s customers (i.e. the lessees) may operate the lessor’s underlying assets \nin numerous taxing jurisdictions . The primary obligor to the taxing authority for \nsales or other similar taxes can vary by jurisdiction – e.g. the primary obligor for \nsales or use taxes in one US state may be the lessor, while in another US state \nit may be the lessee. Because of this, lessors told the FASB that assessing \ndifferent in- scope taxes on a jurisdiction- by-jurisdiction basis would be costly \nand complex. \n7.3.320 If elected, the practical expedient in paragraph 7.3.210, added by \nASU 2018- 20, means that the lessor will not assess whether it or the lessee is \nthe primary obligor for in- scope taxes. A le ssor will also not account for in- scope \ntaxes collected from the customer on a gross basis , as it will any other taxes for \nwhich it, rather than the lessee, remits payment to the taxing authority. Instead, \nall in-scope taxes will be accounted for as lessee costs, without having to make \nany further evaluation and regardless of who remits payment to the relevant \ntaxing authority . \n \n Question 7.3.40 \nSublessor gross vs. net considerations \nDoes a sublessor follow the gross vs. net considerations \nguidance for sublessee payments of lessor costs? \nBackground: Consider a scenario in which Head Lessee (Sublessor) LE and \nHead Lessor LR enter into a five- year lease of a building. Under the head lease, \nLE is required to make variable pa yments of LR’s property taxes and insurance \ndirectly to the taxing authority and insurer, respectively. LE subsequently \nsubleases the building to Sublessee SE and the sublease agreement transfers \nto SE the obligation to pay the property taxes and insurance on the building to \nthe taxing authority and insurer. There are no non- lease components in either \nthe head lease or sublease contracts. \nInterpretive response: Yes. The gross versus net considerations in \nparagraphs 7.3.160 – 7.3.200 apply equally to head le ssors and sublessors. This \nis because sublessors apply Topic 842’s lessor accounting requirements to the \nsublease (see paragraph 8.2.60). \nUsing the background scenario to illustrate, LE presents its head lease building \nproperty tax and insurance costs and SE’s variable payments thereof on a net basis – i.e. LE does not recognize either variable head lease cost or variable \nsublease income because those amounts are equal and therefore net to zero. \nChanging the background scenario, assume LR pays the taxing a uthority and \nthe insurer for the property taxes and insurance, LE is required to reimburse LR, and SE is required to reimburse LE in turn. In that scenario, LE would present \nits variable property tax and insurance payments to LR and SE’s variable \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 676}), Document(page\_content='Leases 676 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. property tax and insurance payments to LE on a gross basis – i.e. as variable \nhead lease cost and variable sublease income, respectively. \n \n Question 7.3.50 \nSublessee rental payments directly to a third party \nDo the gross vs. net lessor cost requirements apply to \nvariable rent payments? \nBackground: It may be the case that a sublessee is required to make variable \nrent payments directly to the head lessor, rather than to the sublessor. \nFor example, Head Lessee (Sublessor) LE may sublease a building and its \nunderlying land to Sublessee SE. LE previously owned the building and leased \nthe underlying land from Landowner. LE sold the building and leases it back from Head Lessor LR. After the sale- leaseback transaction with LR, LE retains \nthe requirement to make variable rent payments to Landowner for the ground \nlease. However, SE assumes the obligation to make those variable rent \npayments to Landowner as part of the sublease. \nIn this scenario, the question arises as to whether LE should present the variable rent paid by SE directly to Landowner on a gross or a net basis. \nInterpretive response: No. We believe the requirements in paragraph 7.3.190 \ndo not apply to variable rent payments, or any variable payments that relate to a non-lease component of the contract. \nAt a February 2018 FASB meeting, the Board affirmed the view of the FASB \nstaff that the guidance in paragraph 7.3.190 applies only to lessee payments of \nthe types of costs contemplated by paragraph 842- 10-15-30(b) – i.e. costs \nincurred by the lessor in its role as lessor or as owner of the underlying asset, \nsuch as those from property taxes or insuring the underlying asset. The basis \nfor conclusions to ASU 2018 -20 effectively defines ‘lessor costs’ for the \npurposes of the guidance in paragraph 7.3.190 in that manner. \n[ASU 2018- 20.BC14] \nIn the background example , this means that LE should account for SE’s variable \nrent payments to Landowner on a gross basis – i.e. separately recognizing \nvariable lease cost and variable sublease income. This is regardless of whether \nSE reports the amount of the payments to LE; if SE does not do so, LE must \nestimate the amount of the payments. \nChanging the background scenario, assume LR is providing maintenance services for the building under the head lease contract, and SE ass umes LE’s \nhead lease obligation to reimburse LR’s actual maintenance costs. Because \nmaintenance is a non -lease service, the guidance in paragraph 7.3.190 does not \napply. LE should account for SE’s variable maintenance payments to LR on a \ngross basis – i.e. separately recognizing non- lease maintenance cost and non-\nlease maintenance revenue. Consistent with the preceding paragraph, this is \nregardless of whether SE reports the amount of the maintenance payments to \nLE; if SE does not do so, LE must estimate their amount . \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 677}), Document(page\_content='Leases 677 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 7.3. 60 \nAssessing whether a tax is a lessee or lessor cost \nHow does a lessor determine whether a tax is a lessee or a \nlessor cost ? \nBackground: Lessees may operate lessor assets (such as railcars or trucks) in \nnumerous jurisdictions. The primary obligor of property or other taxes on those \nassets can vary by jurisdiction – e.g. the primary obligor for property or other \ntaxes in one US state may be the lessor, while in another US state it may be \nthe lessee. It can also vary for other rea sons such as the type of leased asset. \nThis can add complexity to determining whether the lessee’s payment of property and other taxes is payment of a lessor cost (which therefore should be \nincluded in lease or variable lease income). \nBefore ASU 2018 -20 wa s issued, enacting the guidance in paragraphs 7.3.180 – \n7.3.190, Topic 842 required a lessor to evaluate whether it wa s the primary \nobligor for each type of tax in each taxing jurisdiction (e.g. each state, county or \ncity). This was required to determine whether the tax wa s a lessee or a lessor \ncost, and therefore whether the tax and the lessee’s payment thereof should \nbe presented net or gross. \nInterpretive response: After the issuance of ASU 2018- 20, lessors will no \nlonger determine whether a tax is a lessee or a lessor cost based on who is the \nprimary obligor of the tax. \nInstead, the following will apply regardless of who is the primary obligor of the \ntax. \n— If the lessee remits payment for the tax to the taxing authority (e.g. pays the property tax on a leased property directly to the relevant city, county or \ntown), the lessor will account for the tax as a cost of the lessee. \n— If the lessor remits payment for the tax to the taxing authority, the lessor will account for the tax as its own cost. \nAs an exception, the guidance in paragraphs 7.3.210 – 7.3.240 applies if the \nlessor elects the sales and other similar taxes practical expedient and the tax is an ‘in -scope’ tax. \n7.3.330 After the lease commencement date, the lessor measures t he net \ninvestment in the lease by: [842- 30-35-1] \n— increasing the carrying amount to reflect interest income resulting from \naccretion of the lease receivable and the unguaranteed residual asset (and \nrecognition of deferred selling profit, if any, for direct financing leases); and \n— reducing the carrying amount to reflect lease payments received. \n7.3.340 The lessor uses the effecti ve interest method to both (1) amortize the \nlease receivable and (2) accrete the unguaranteed residual asset to its \nestimated future value at the end of the lease term. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 678}), Document(page\_content='Leases 678 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 7.3.350 A lessor only remeasures its net investment in the lease after initial \nmeasurement if the lease is modified and that modification is not accounted for \nas a separate contract (see section 7. 6). [842- 30-35-2] \n \n Question 7. 3.70 \nLessor reassessment of key lease estimates and \njudgments \nDo lessors reassess key lease estimates and judgments after \nlease commencement? \nInterpretiv e response: Unlike lessees (see section 6.6), lessors do not \nreassess key lease estimates and judgments after lease commencement – e.g. \nlease classification, lease term, the likelihood of the lessee to exercise a \npurchase option, or the discount rate on sales -type and direct financing leases – \nunless the lease is modified and that modification is not accounted for as a \nseparate contract (see section 7.6). \n \n Observation \nNo requirement for lessors to reassess key lease \nestimates and judgments \n7.3.360 The Board decided not to subject lessors to the same reassessment \nrequirements as lessees primarily because of its decision to substantially retain \nlessor accounting under legacy US GAAP in Topic 840. This simplifies lessor \naccounting compared to lessee accounting and may limit volatility in the lessor’s financial statements. Excluding lessors from the reassessment \nrequirements also helps to align the lessor accounting guidance in Topic 842 with the guidance in Topic 840. \n[ASU 2016- 02.BC314] \n7.3.370 However, while lessors will not reassess key lease estimates and \njudgments, in some cases a lessor will be required to reassess estimates of variable consideration that specifically relates to a non- lease component of the \ncontract – i.e. variable considera tion that is part of the ‘consideration in the \ncontract’ (see sec tion 4.3). \n \nImpairment of the net investment in the lease \n7.3.380 The lessor assesses its entire net investment in the lease for \nimpairment, and recognizes any impairment loss, in accordance with the \nimpairment guidance for financial instruments ; see chapter 16 of KPMG \nHandbook, Credit impairment . A lessor does not separately evaluate the \nunguaranteed residual asset for impairment (except in accordance with \nparagraph 7.3.420), or review the estimated residual value of the underlying \nasset as lessors do under Topic 840. When estimating the loss allowance for a \nnet investment in the lease, the lessor considers the collateral relating to the \nnet investment in the lease. The collateral represents the cash flows that the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 679}), Document(page\_content='Leases 679 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. lessor would expect to derive from the underlying asset during the remaining \nlease t erm (e.g. from the sale or re- lease of the asset for the remainder of the \nlease term) , including an expected lump- sum payment related to the residual \nvalue of the asset at the end of the lease term (see Question 7.3.80). [842- 30-\n35-3, ASU 2016 -02.BC311] \nSee Example 16.2.10 of KPMG Handbook, Credit impairment , for additional \ninformation and illustrations of one potential method of estimating expected \ncredit losses for a lease portfolio. \n \n Question 7. 3.80 \nAssessing the net investment in the lease for \nimpairment \nDoes the lessor consider expected cash flows from the \nunderlying asset after the end of the lease term when \nevaluating its net investment in a sales -type or direct \nfinancing lease for impairment? \nBackground: A lessor considers the collateral relating to the net investment in \nthe lease when determining the loss allowance, if any, for its net investment in \nthe lease. [842- 30-35-3] \nParagraph 842-30-35-3 (as originally issued in ASU 2016- 02) stated that “the \ncollateral relating to the net investment in the lease represents the cash flows \nthat the lessor would expect to derive from the underlying asset during the \nremaining lease term, which excludes the cash flows that the lessor would \nexpect to derive from the underlying asset following the end of the lease term.” \nThis language appear ed to limit the consideration of collateral to the cash flows \nexpected to be derived from the asset dur ing the lease term, but excluded any \ncash flows expected to be derived following the lease term – e.g. from sale of \nthe asset. \nBecause a lessor assesses the entire net investment in the lease for \nimpairment, which includes any guaranteed or unguaranteed residual value of \nthe underlying asset, not considering expected cash flows to be derived \nfollowing the lease term could have result ed in impairment recognition. \nInterpretive response: Yes. The Board amended paragraph 842- 30-35-3 in \nASU 2018- 10 to better reflect the Board’s intent that the cash flows that can be \nobtained from sale or re- lease of the underlying asset following the end of the \nlease term should be considered as part of the collateral relating to the net \ninvestment in the lease when assessing the net investment for impairment . \n[842-30-35-3] \nThe unit of account for assessing impairment of the net investment in the lease \nis the entire net investment in the lease, inclusive of any residual asset. A lessor evaluates its entire net inv estment in the lease for impairment using the \ncash flows associated with the leased asset during and following the lease term . Those cash flows include an assumed lump -sum payment related to the \nresidual asset at the end of the lease term (e.g. from sale of the asset at \nauction) . \n[ASU 2016- 02.BC311] \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 680}), Document(page\_content='Leases 680 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. A lessor would determine this assumed lump- sum payment amount based on \nthe expected cash flows associated with the residual asset following the lease \nterm, considering the possible amounts it might realize from the residual asset \nbased on its expected market value at the end of the lease. E ven though the \nrisk associated with the lump- sum payment for the residual asset is risk related \nto the end- of-lease value of the residual asset, rather than credit risk (i.e. \nbecause the lessor will typically sell the asset either for cash or only to a party \nthat is creditworthy at the end of the lease term), a current expected loss model \nis used to measure the residual asset risk . This accomplish es the Board’s goal \nof using a s ingle impairment model for the entire net investment in the lease \n(despite it having a financial and nonfinancial component). \nThis is supported by guidance in Subtopic 326- 20 (credit losses on financial \ninstruments) that requires an entity to “recognize an allowance for credit losses \non net investment in leases recognized by a lessor … An entity should include \nthe unguaranteed residual asset with the lease receivable, net of any deferred \nselling profit, if applicable ( i.e. the net inv estment in the lease).”See chapter 16 \nof KPMG Handbook, Credit impairment . While this only appli es to lessors who \nhave adopted Subt opic 326 -20, we believe the unit of account for purposes of \nmeasuring a credit impairment is the same, regardless of whether a lessor is \napplying Topic 310 (receivables) or Subtopic 326-20. [326- 20-55-8] \n \n Observation \nAssessing the entire net investment in the lease for \nimpairment vs. assessing its compone nts separately \n7.3.390 Although the unguaranteed residual asset does not meet the definition \nof a financial asset, the Board thought it would be complex and provide little benefit to financial statement users to require entities to separately assess the \ncomponents of the net inv estment for impairment – i.e. assess the lease \nreceivable in accordance with the financial instruments impairment guidance and the unguaranteed residual asset in accordance with long- lived assets \nimpairment guidance. \n[ASU 2016- 02.BC310] \n7.3.400 Additional ly, to be classified as a sales- type lease or a direct financing \nlease, the unguaranteed residual asset will generally be small compared to the \nlease receivable. Or, in some cases, there may be no unguaranteed residual \nasset at all – e.g. if the lease is c lassified as a sales- type lease because it \ntransfers ownership of the underlying asset to the lessee, or grants the lessee a \npurchase option that the lessee is reasonably certain to exercise. \n7.3.410 Because most of the net investment in the lease will comprise the lease \nreceivable (i.e. a financial asset), it was deemed appropriate for a lessor to \nassess the entire net investment in the lease for impairment based on the \nfinancial instruments impairment guidance. [ASU 2016- 02.BC311] \n \nSale of t he lease receivable \n7.3.420 If the lessor sells all, or substantially all , of the lease receivable and \nretains an interest in the unguaranteed residual asset, the lessor no longer \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 681}), Document(page\_content='Leases 681 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. accretes the unguaranteed residual asset to its estimated future value over the \nlease term. The lessor reports any remaining unguaranteed residual asset at its \ncarrying amount at the date of the sale of the lease receivable, and applies \nTopic 360 ( property, plant and equipment) to determine whether the \nunguaranteed residual asset is impaired. If the lessor retains more than an insignificant portion of the lease receivable, it will continue to accrete the \nunguaranteed residual asset.\n [842- 30-35-4] \n7.3.425 The sale of a sales- type or direct financing lease receivable is accounted \nfor under Topic 860 (transfers and servicing). [860- 10-55-6, ASU 2016 -02.BC317] \nAccounting for the underlying asset at the end of the lease \nterm \n7.3.430 At the end of the lease term, the lessor reclassifies the net \ninvestment in the lease to the appropriate asset category in accordance with \nother US GAAP, measured at the carrying amount of the net investment in the \nlease. The lessor accounts for the underlying asset in accordance wi th other \nUS GAAP. [842- 30-35-5] \nAccounting for lease terminations \n7.3.440 If a sales- type or direct financing lease is terminated before the end of \nthe lease term, the lessor: \n— tests t he net investment in the lease for impairment under Topic 310 \n(before the lessor adopts Subtopic 326 -20) or Subtopic 326- 20 – see \nchapter 16 of KPMG Handbook, Credit impairment ; \n— reclassifies the net investment in the lease to the appropriate asset category in accordance with other US GAAP, measured at the sum of the \ncarrying amount of the lease receivable (less amounts still expected to be \nreceived by the lessor) and the residual asset; and \n— accounts fo r the underlying asset in accordance with other US GAAP.\n[842- 30-40-2] \n7.3.450 If a lease agreement is replaced by a new lease agreement with a new \nlessee, the lessor accounts for the termination of the original lease (see \nparagraph 7.3.440) and accounts for the new lease in the same manner as it \nwould any other new lease. \n \n Example 7.3.40 \nRecognition of selling profit for a direct financing \nlease \nThis example is a continuation of Example 7.3.10, which looked at the initial \nmeasurement of the lease. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 682}), Document(page\_content='Leases 682 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. End of Year 1 \nLessor LR records the following journal entry at the end of Year 1. \n Debit Credit \nCash 10,500 \nUnguaranteed residual asset1 95 \nDeferred profit2 1,657 \nLease receivable3 9,301 \nInterest income4 2,951 \nTo recognize interest, accretion and deferred \nselling profit in Year 1. \nNotes: \n1. Accretion of unguaranteed residual asset ($3,006 × 3.15%). \n1. Total lease income of $2,951 ($37,000 net investment in the lease × 7.98%) – interest \non lease receivable ($1,199) – accretion of unguaranteed residual asset ($95). 7.98% \nis the discount rate that would have been required at lease commencement for the \nlease receivable + the unguaranteed residual asset to equal $37,000. \n2. Cash payment of $10,500 – interest on lease receivable of $1,199 ($37,994 × 3.15%). \n3. Accretion of unguaranteed residual asset ($95) + interest on lease receivable ($1,199) \n+ release of deferre d profit ($1,657 ). Alternative calculation: $37 ,000 × 7.98%. \nImpact on the financial statements \nThe following table summarizes the amounts arising on LR’s balance sheet ( on \nwhich LR presents its net investment in the lease, rather than the components \nin the table ) and income statement. \nBalance sheet Income statement \nEnd of \nyear Lease \nreceivable Unguar. \nresid. \nasset Deferred \nprofit1 Net \ninvest. in \nlease \nInterest on \nreceivable ² Residual \naccretion ² Earned \nprofit ³ Total \nincome ³ \n0 $37,994 $3,006 $(4,000) $37,000 $ - $ - $ - $ - \n1 28,693 3,101 (2,34 3) 29,451 1,199 95 1,657 2,951 \n2 19,098 3,199 (996) 21,301 905 98 1,347 2,350 \n3 9,200 3,300 - 12,500 602 101 996 1,699 \n Totals $2,706 $294 $4,000 $7,000 \nNotes: \n1. Subsequent to lease commencement, deferred selling profit recognition = total \nincome – interest on the lease receivable – unguaranteed residual asset accretion. \n2. Interest on the lease receivable and unguaranteed residual asset accretion are \ncalculated using the rate implicit in the lease that is derived by using the machine’s \nfair value at lease commencement of $40,000 less deferred initial direct costs of \n$1,000 as the initial investment (3.15%). \n3. Total income, including release of deferred profit, is allocated so that it is recognized \nat a constant rate equal to the discount rate that would have been necessary at lease \ncommencement for the lease receivable + the unguaranteed residual asset to equal $37,000 (7.98% ). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 683}), Document(page\_content='Leases 683 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. End of lease \nLR records the following journal entry at the end of the lease. \n Debit Credit \nPP&E – machine 12,500 \nNet investment in the lease 12,500 \nTo recognize termination of direct financing lease. \n \n \n Comparison to legacy US GAAP \nThe concept of deferred selling profit did not exist under Topic 840 \n7.3.460 Under Topic 840, any selling profit in a lease that met one of the criteria \nin paragraph 840- 10-25-1 and both criteria in paragraph 840- 10-25-42 was \nrecognized at lease commencem ent. Selling profit was never deferred as it will \nbe for a direct financing lease under Topic 842. \nThe population of initial direct costs is changed, but the accounting is \nunchanged \n7.3.470 Section 5.5 discusses that Topic 842 substantially narrowed the \ndefinition of initial direct costs from the definition in Topic 840. As a result, \nmany entities will expense significant origination costs for a lease as incurred \nthat they did not expense as incurred under Topic 840. Lessors in that situation \nwill recogniz e greater margins on their lease income earned over the lease term \n(e.g. operating lease income or interest income on their direct financing leases) \nas well as potentially on selling profit earned at lease commencement . That is, \nif a sales- type lessor incurred origination costs that were expensed at lease \ncommencement under Topic 840 – at the same time selling profit was \nrecognized – but expenses those origination costs as incurred under Topic 842, \nthe lessor’s commencement date selling profit under Topic 842 will not be \nreduced by any deferred initial direct costs . [842 Glossary] \n7.3.48 0 The accounting for those costs that meet the definition of initial direct \ncosts under Topic 842 is substantially consistent with the accounting for those \ncosts that met the definition of initial direct costs under Topic 840 (see \nparagraph 7.3.60). \nHowever, there is a mechanical difference in the accounting. \n— Under Topic 840, initial direct costs for direct financing leases were \nrecognized as an asset and that asset was amo rtized to income together \nwith unearned income so as to produce a constant periodic rate of return on the net investment in the lease using the effective interest method. \n[840- 30-30-11] \n— Under Topic 842, the rate implicit in the lease is such that initia l direct costs \neligible for deferral are included automatically in the net investment in the \nlease; there is no need to add them separately (see paragraph 7.3.60). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 684}), Document(page\_content='Leases 684 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 7.3.49 0 The result is that the rate implicit in the lease is the same as the \nconstant periodic rate of return on the net investment in the lease under \nTopic 840. Although the accounting for initial direct costs under Topic 842 is \nmechanically different from Topic 840 for those costs that meet the definition \nof initial direct costs, those changed mechanics will not affect total assets or \nperiodic net income. \n7.3.500 Lessor accounting for initial direct costs for operating leases is \nconsistent with Topic 840 – i.e. recognize initial direct costs as a separate asset \nand amortize to expense over the lease term on the same basis as lease income (see paragraphs 7.4.10 – 7.4.20). \n[840- 20-25-16, 35- 2] \nRecognition of variable lease payments remains substantially unchanged \n7.3.510 Under Topic 842, variable lease payments are recognized as income by \nthe lessor in the income statement in the period in which the changes in facts \nand circumstances on which those payments are based occur. This is \nconsistent with the recognition requirements in legacy US GAAP for contingent \nrent. SEC guidance stipulated that contingent rental income should be accrued \n(i.e. it should be recognized as income) when the changes in the factor(s) on \nwhich the contingent lease payments was (were) based actually occurred. \n[SAB Topic 13 , 605- 10-S99-1] \n \n7.4 Operating leases \n7.4.1 Initial recognition and measurement \n Excerpt from ASC 842 -30 \n25 Recognition \nGeneral \n> Operating Leases \n25-10 At the commencement date, a lessor shall defer initial direct costs. \n30 Initial Measurement \nGeneral \n> Operating Leases \n30-4 A lessor shall continue to measure the underlying asset subject to an \noperating lease in accordance with other Topics. \n \n7.4.10 For operating leases, at the commencement date the lessor : \n— continues to recognize the underlying asset and will continue to depreciate \nit over its estimated useful life; [842-30-30-4] \n— continues to measure the underlying asset in accordance with other \nUS GAAP, including testing for impairment in accordance with the \nguidance on impairment or disposal of long- lived assets; and [842-30-35-6] \n— defers any initial direct costs. [842-30-25-10] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 685}), Document(page\_content='Leases 685 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Lessor Lessee\nNo derecognition of \nunderlying assetLease payments\nRight to use \nunderlying asset \n \n7.4.2 Subs equent accounting \n Excerpt from ASC 842 -30 \n25 Recognition \nGeneral \n> Operating Leases \n25-11 After the commencement date, a lessor shall recognize all of the \nfollowing: \na. The lease payments as income in profit or loss over the lease term on a \nstraight -line basis unless another systematic and rational basis is more \nrepresentative of the pattern in which benefit is expected to be derived \nfrom the use of the underlying asset , subject to paragra ph 842- 30-25-12 \nb. Variable lease payments as income in profit or loss in the period in which \nthe changes in facts and circumstances on which the variable lease \npayments are based occur \nc. Initial direct costs as an expense over the lease term on the same basis as \nlease income (as described in (a)). \n35 Subsequent Measurement \nGeneral \n> Operating Leases \n35-6 A lessor shall continue to measure, including testing for impairment in \naccordance with Section 360 -10-35 on impairment or disposal of long -lived ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 686}), Document(page\_content='Leases 686 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. assets, the underlying asset subject to an operating lease in accordance with \nother Topics. \nGeneral \n> Implementation Guidance \n>> Sales of Equipment with Guaranteed Minimum Resale Amount \n55-6 If the transaction qualifies as an operating lease, the net proceeds upon \nthe equipment’s initial transfer should be recorded as a liability in the \nmanufacturer’s balance sheet. \n55-7 The liability is then subsequently reduced on a pro rata basis over the \nperiod to the first exercise date of the guarantee to the amount of the \nguaranteed residual value at that date with corresponding credits to revenue in \nthe manufacturer’s income statem ent. Any further reduction in the guaranteed \nresidual value resulting from the purchaser’s decision to continue to use the \nequipment should be recognized in a similar manner. \n55-8 The equipment should be included in the manufacturer’s balance sheet \nand depreciated following the manufacturer’s normal depreciation policy. \n55-9 The Impairment or Disposal of Long- Lived Assets Subsections of \nSubtopic 360 -10 on property, plant, and equipment provide guidance on the \naccounting for any potential impai rment of the equipment. \n55-10 At the time the purchaser elects to exercise the residual value guarantee \nby selling the equipment to another party, the liability should be reduced by the \namount, if any, paid to the purchaser. The remaining undeprecia ted carrying \namount of the equipment and any remaining liability should be removed from \nthe balance sheet and included in the determination of income of the period of \nthe equipment’s sale. \n55-11 Alternatively, if the purchaser exercises the residual value guarantee by \nselling the equipment to the manufacturer at the guaranteed price, the liability \nshould be reduced by the amount paid to the purchaser. Any remaining liability \nshould be included in the determination of income of the period of the exerci se \nof the guarantee. \n55-12 The accounting for a guaranteed minimum resale value is not in the \nscope of Topic 815 on derivatives and hedging. In the transaction described, \nthe embedded guarantee feature is not an embedded derivative instrument \nthat mu st be accounted for separately from the lease because it does not meet \nthe criterion in paragraph 815- 15-25-1(c). \n55-13 Specifically, if freestanding, the guarantee feature would be excluded \nfrom the scope of paragraph 815- 10-15-59(b) because of both of the following \nconditions: \na. It is not exchange traded. \nb. The underlying on which settlement is based is the price of a nonfinancial \nasset of one of the parties, and that asset is not readily convertible to cash. \nIt is assumed that the equipment is not rea dily convertible to cash, as that \nphrase is used in Topic 815. \n55-14 Paragraph 815- 10-15-59(b)(2) states that the related exception applies \nonly if the nonfinancial asset related to the underlying is owned by the party ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 687}), Document(page\_content='Leases 687 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. that would not benefit under the contract from an increase in the price or \nvalue of the nonfinancial asset . (In some circumstances, the exclusion in \nparagraph 815- 10-15-63 also would apply.) \n55-15 Lastly, Topic 460 on guarantees does not affect the guarantor’s \naccounting for the guarantee because that Topic does not apply to a guarantee \nfor which the underlying is related to an asset of the guarantor. Because the \nmanufacturer continues to recognize the residual value of the equipment \nguaranteed by the manufacturer as an asset (included in the seller -lessor’s net \ninvestment in the lease) if recording a sal es-type lease, that guarantee does \nnot meet the characteristics in paragraph 460- 10-15-4 and is, therefore, not \nsubject to the guidance in Topic 460. Additionally, if the lease is classified as an \noperating lease, the manufacturer does not remove the asset from its books, \nand its guarantee would be a market value guarantee of its own asset. A \nmarket value guarantee of the guarantor’s own asset is not within the scope of \nTopic 460, and the guidance in paragraphs 842- 10-55-32 through 55- 33 for an \noperating lease is not affected. As a result, the guarantor’s accounting for the \nguarantee is unaffected by Topic 460. \n>> Pattern of Benefit from Use of the Underlying Asset \n55-17 This Subtopic considers the right to control the use of the underlying \nasset as the equivalent of physical use. If the lessee controls the use of the \nunderlying asset, recognition of lease income in accordance with \nparagraph 842-30-25-11(a) should not be affected by the extent to which the \nlessee uses the underlying asset. \n \n7.4.20 After the commencement date: [842-10-15-40, 842-30-25-11] \n— Lease payments under the contract are recorded as receivables only when \nthey are due and payable by the lessee. Consequently, there is no interest income recognition. \n— Lease income i s recognized on a straight -line basis unless another \nsystematic and rational basis is more representative of the pattern in which \nincome is earned from the underlying asset. \n— Variable lease payments are recorded as income in the income statement in \nthe per iod in which the changes in facts and circumstances on which those \npayments are based occur. \n— Variable non- lease payments are recorded as income in the income \nstatement when the requirements of the applicable Topic (e.g. Topic 606) \nare met. Initial direct c osts are recognized as expense over the lease term \non the same basis as lease income. \n7.4.22 The sale of operating lease receivables (see paragraph 7.4.20) is \naccounted for under Topic 860 (transfers and servicing), consistent with any other sale of a financial asset. However, the sale of future operating lease \npayments that do not meet the definition of a receivable – including those \namounts that arise solely from the requirement in Topic 842 to recognize operating lease income on a straight -line basis bu t do not meet the definition of \na receivable – are not subject to Topic 860. See Question 7.4.05. \n[860- 10-15-5, 15 -\n4(b)] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 688}), Document(page\_content='Leases 688 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 7.4.23 If the lessor sells the underlying asset to a third party, the sale is \naccounted for under: [606-10-15-2, 610- 20-15-2] \n— Topic 606 if the third party is a customer; and \n— Subtopic 610 -20 (other income) if the third party is not a customer. \n \n Question 7.4.05 \nSale of future operating lease payments that do not \nmeet definition of a receivable \nHow does a lessor account for the sale of future operating \nlease payments that do not yet meet the definition of a receivable subject to Topic 860 ? \nBackgro und: See paragraphs 7.3.425 and 7.4.22. \nInterpretive response: We believe the proceeds from the sale of these \npayments should be treated as debt in a manner consistent with the accounting \nthat applies to proceeds received from the sale of future revenues under Topic \n470 (debt) when the seller has significant continuing involvement in the \ngeneration of the revenues. Section 3.7.30 of KPMG Handbook, Debt and \nequity financing , provides guidance on the accounting for the sale of future \nrevenues. \n \nGross vs. net considerations \n7.4.25 The same gross versus net considerations outlined in section 7.3.2 for \nlessors in sales- type or direct financing leases appl y to lessors in operating \nleases. \n \n Question 7. 4.10 \nUneven lease payments intended to compensate \nfor expected changes in market rent \nShould a lessor recognize lease income on a cash basis if \nuneven payments are intended to reflect the parties’ \nexpectation s about market rental prices throughout the lease \nterm? \nBackground: The basis for c onclusions to ASU 2016- 02 could be read to \nsuggest that a lessor can (or should) recognize lease income arising from \nuneven lease payments (i.e. lease payments that change during the lease term) \non a cash basis if the changes in the payments are intended to reflect expected \nchanges in the market value of the lease. [ASU 2016- 02.BC327] \nFor example, a lease of real estate may have scheduled rent increases of five \npercent per year that are intended to reflect what the parties expect market \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 689}), Document(page\_content='Leases 689 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. rental prices to be in the future. In this scenario, the question is whether it is \nappropriate to recognize lease income each year equal to the annual lease \npayment. \nInterpretive response: No. Operating lease income must be recognized on a \nstraight -line basis unless another systematic and rational basis is more \nrepresentative of the pattern in which benefit is expected to be derived from the use of the underlying asset. Changes in market rent that are expected to \noccur during the lease term do not reflect changes in expected usage of the \nunderlying asset , and therefore are not an appropriate basis on which to deviate \nfrom straight- line income recognition. \n[842- 30-25-11, 55- 17] \nIn discussions, the FASB staff has confirmed that lessors should apply the \nauthoritative guidance in paragraphs 842-30-25-11 and 55- 17 and that it would \nnot be appropriate to recognize lease income arising from uneven lease \npayments on a cash basis unless that attribution reflect s the pattern in which \nthe lessor expects the lessee to derive benefit from use of the asset. \n \n Question 7.4.15 \nOperating lease income in lease with non -\nconsecutive period of use \nShould a lessor in an operating lease with a non- consecutive \nperiod of use recognize lease income during periods the \nlessee does not have the right to use the underlying a sset? \nBackground: Example 5.3.40 illustrates an operating lease with a non-\nconsecutive period of use, concluding that lease cost should be recognized only \nduring the periods the lessee has the right to use the underlying asset. \nInterpretive response: No. Operating lease income should be recognized only \nduring the periods the lessee has the right to use the underlying asset. [842- 30-\n25-11(a)] \nFor example, consider a simplified version of Example 5.3.40 (Scenario 1). A \nlessee leases retail store space in a s hopping mall from the lessor during the \nholiday season (October 15 through January 15) each year for three years in a \nlease classified as an operating lease. In this case, the lessor should recognize \noperating lease income (including any variable lease inc ome) only during \nOctober 15 through January 15 each year; no lease income should be recognized outside of that time window. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 690}), Document(page\_content='Leases 690 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 7.4.16 \nSingle lease cost attribution – operating lease with \nnon-consecutive period of use that is variable at \nlease commencement \nHow should a lessor recognize lease income in an operating \nlease with a variable number of non- consecutive use periods ? \nBackground: Assume that a sports team (lessee) enters into a lease with a \nstadium owner (lessor) whereby the sports team has the right to use the \nstadium for 41 home games per year for 10 years, plus the right to use the \nstadium for any home playoff games during those 10 years (up to a maximum \nof 16 per year). \nThe sports team has exclusive rights to the s tadium on each game day, and the \nstadium owner must ensure that the stadium is available for any regular season \nand playoff games – i.e. the stadium owner cannot book alternative events that \nit cannot cancel on any date when the sports team might need it. For simplicity, \nassume there are no renewal or termination options for either party in the \ncontract. \nFor this lease, the question arises about how much lease income should be \nrecognized during each right of use period, given that the total number of such \nperiods is unknown. \nQuestion 6.4.15 addresses this question from the lessee perspective, and \nQuestion 7.4.15 explains that operating lease income should not be recognized \nduring periods the lessee does not have the right to use the underlying asset. \nInterpretive response: Topic 842 does not specifically address this question. \nConsequently, and in the absence of additional guidance in GAAP or from the \nSEC staff, we believe the three approaches outlined in Question 6.4.15 for lessees are also acceptable for le ssors in operating l ease scenarios similar to \nthe background example. \n \n Question 7.4.17 \nCurtailment of the lessee’s right to use the \nunderlying asset \nShould an operating lessor stop recognizing, or recognize \nreduced, operating lease revenue when the lessee’s rights to use the underlying asset have been curtailed? \nBackground: Situations arise in which the lessee’s ability to use, and derive its \nintended economic benefits from using, the underlying asset are significantly \ncurtailed. For example, as a result of COVID -19, retail store locations in \nshopping centers were closed to the public such that the retailer (lessee) could not sell its goods from the location, and restaurants were precluded from \nseating customers in their dining rooms (i.e. limiting their operations to c arry-out \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 691}), Document(page\_content='Leases 691 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. or delivery only). Similar circumstances may arise during periods of civil unrest \nor natural disasters. \nThe question arises as to whether it is appropriate to suspend or reduce \noperating lease revenue recognition during the curtailment period. \nInterpretive response: We believe it is inappropriate to suspend or reduce \noperating lease revenue recognition as long as the lessee retains the right to \nuse the underlying asset, even in a significantly curtailed manner. \nThe retailer in the background exa mple cannot sell to customers from the \nlocation, but it has not vacated the space – e.g. its inventory is still stored there, \nand its leasehold improvements remain in place. Therefore, the retailer still retains control over the use of the space – i.e. control has not reverted to the \nlandlord such that the landlord can use the space itself or re- lease it. \nAs long as the lessee retains its right to use the underlying asset, the lessor is \nstill performing (fulfilling its obligation) under the lease, and shoul d not suspend \nits revenue recognition. And because Topic 842 equates control over the use of an underlying asset with physical use, the lessor should not change its straight -\nline revenue recognition pattern during the curtailment period ba sed on any \nestima te of the reduced utility or economic benefits from use of the asset to \nthe lessee. \n[842- 20-55-3] \n \n Question 7.4.20 \nLessor accounting for reimbursements of capital \nreplacements and repairs in an operating lease \nWhen should a lessor recognize revenue from lessee \nreimbursements of a capital replacement/repair that is not a promise to the customer in an operating lease ? \nBackground: A lessor frequently has the contractual right to pass through costs \nof capital replacements or repairs to its tenant s. For example, if a lessor installs \na new roof on its property, the tenants may be required to reimburse the lessor \nfor those costs. \nA common reimbursement structure is for tenants to reimburse the lessor \nconsistent with the useful life of the replacement/repair and consistent with the \nlessee’s proportionate right to use the property. \nIt is also common that the lessee’s reimbursement obligation ends if the lease \nexpires. In contrast, if the lessee early terminates the lease, often the lessor \nhas the right to recover the amounts it would have obtained from the lessee related to the capital replacement/repair over the remainder of the lease term. \nFor example, Lessee LE leases 10% of a shopping center’s available retail \nspace for 10 years. At the beginning of Year 2, LR installs a new $450,000 roof \non the shopping center that has a 15- year useful life. Under the terms of the \nlease, LE will reimburse LR $3,000 per year for the remaining 9 years of the lease term ($27,000 total): ($450,000 total cost / 15 years ) ×10% occupancy. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 692}), Document(page\_content='Leases 692 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. In this example (and similar scenarios), the question arises as to whether LR \nshould recognize the entire reimbursement ($27,000) on a discounted basis on \ncompletion of the capital replacement/repair, or instead should recognize \n$3,000 ea ch year when it has the contractual right to the payment. \nInterpretive response: We believe the lessor should recognize the \nreimbursement amount to which it expects to be entitled from a lessee for \ncapital replacements/repairs that are not promises to the customer (see \nQuestion 4.2.25) in an operating lease over the remainder of the lessee’s lease \nterm – i.e. $3,000 per yea r in the background example. \nThis amount should not include additional reimbursements to which the lessor \nwill be entitled if the lease term is extended. A lessor should not recognize the \nfull amount of the reimbursement when the replacement/repair is com pleted. \nEven though the capital replacement/repair is complete and the amount of the \nreimbursement is known, the reimbursement is not earned, and therefore \nshould not be recognized, at that point in time. This is because Topic 842 treats \noperating leases a s executory contracts for lessors only . Therefore, the lessor’s \nentitlement to the reimbursement amount depends on it continuing to fulfill the executory operating lease – i.e. continuing to permit the lessee to use the \nunderlying asset. \nQuestion 6.6. 50 addresses lessee accounting for capital replacement/repair \nreimbursements. \n \n Observation \nOperating leases give rise to lease receivables that \nwill not be recognized \n7.4.30 The Board concluded that all leases, including operating leases, give rise \nto a lease receivable for the lessor. When the lessor makes the underlying \nasset available for use by the lessee, the lessor has fulfilled its obligation to \ntransfer the right to use that asset to the lessee – the lessee controls that right \nof use and has a liability to make lease payments. Accordingly, the lessor has a \nlease receivable. The lessor controls that right to payment – e.g. it can decide to \nsell or securitize that right. [ASU 2016- 02.BC75] \n7.4.40 In deciding not to substantially change lessor accounting (and therefore to \nnot require lessors to recognize those lease receivables for operating leases ), \nthe Board made a cost -benefit decision that the conceptual merits for a \nsubstantial change to lessor accounting did not provide sufficient benefits to \nfinancial statement users ( e.g. investors , analysts and bankers) to justify the \ncosts to lessors of enacting that change. [ASU 2016- 02.BC88– BC90] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 693}), Document(page\_content='Leases 693 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Comparison to legacy US GAAP \nLessor accounting for operating leases \n7.4.50 Lessor accounting for operating leases is (in broad terms) substantially \nthe same as operating lease accounting under Topic 840. \n7.4.60 However , a difference is most likely to arise because of changes to the \nguidance on identifying and separating components of a contract, and allocating \nconsideration in the contract to lease and non -lease components (see \nchapter 4). For example, differences in the s eparation and allocation guidance \ncan affect the amount of lease and non -lease income recognized. T his will \nresult, in some cases, from lessors applying the allocation guidance in \nTopic 606. In addition, lessors may also see effects from applying Topic 606 \nto their revenue recognition for non- lease components – i.e. potentially how \nthey recognize revenue for some services or supply arrangements that \naccompany the lessor’s leases. \n \n7.5 Collectibility \n Excerpt from ASC 842-30 \n25 Recognition \nGeneral \n> Sales -Type Leases \n25-3 The guidance in paragraphs 842 -30-25-1 through 25 -2 notwithstanding, if \ncollectibility of the lease payments , plus any amount necessary to satisfy a \nresidual value guarantee provided by the lessee, is not probable at the \ncommencement date, the lessor shall not derecognize the underlying asset but \nshall recognize lease payments received —including variable lease payments —\nas a deposit liability until the earlier of either of the following: \na. Collectibil ity of the lease payments, plus any amount necessary to satisfy a \nresidual value guarantee provided by the lessee, becomes probable. If \ncollectibility is not probable at the commencement date, a lessor shall \ncontinue to assess collectibility to determine whether the lease payments \nand any amount necessary to satisfy a residual value guarantee are \nprobable of collection. \nb. Either of the following events occurs: \n1. The contract has been terminated, and the lease payments received \nfrom the lessee are nonrefundabl e. \n2. The lessor has repossessed the underlying asset, it has no further \nobligation under the contract to the lessee, and the lease payments \nreceived from the lessee are nonrefundable. \n25-4 When collectibility is not probable at the commencement date, at the date \nthe criterion in paragraph 842 -30-25-3(a) is met (that is, the date at which ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 694}), Document(page\_content='Leases 694 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. collectibility of the lease payments plus any amount necessary to satisfy a \nresidual value guarantee provided by the lessee is assessed as probable), the \nlessor shall do all of the following: \na. Derecognize the carrying amount of the underlying asset \nb. Derecognize the carrying amount of any deposit liability recognized in \naccordance with paragraph 842- 30-25-3 \nc. Recognize a net investment in the lease on the basis of the rema ining \nlease payments and remaining lease term , using the rate implicit in the \nlease determined at the commencement date \nd. Recognize selling profit or selling loss calculated as: \n1. The lease receivable; plus \n2. The carrying amount of the deposit liability; minus \n3. The carrying amount of the underlying asset, net of the unguaranteed \nresidual asset. \n25-5 When collectibility is not probable at the commencement date, at the date \nthe criterion in paragraph 842- 30-25-3(b) is met, the lessor shall derecognize \nthe carrying amount of any deposit liability recognized in accordance with \nparagraph 842- 30-25-3, with the corresponding amount recognized as lease \nincome. \n25-6 If collectibility is probable at the commencement date for a sales -type \nlease or for a direct financing lease , a lessor shall not reassess whether \ncollectibility is probable. Subsequent changes in the credit risk of the lessee \nshall be accounted for in accordance with the credit loss guidance applicable to \nthe net investment in the lease in paragraph 842- 30-35-3. \n> Operating Leases \n25-12 If collectibility of the lease payments plus any amount necessary to \nsatisfy a residual value guarantee (provided by the lessee or any other \nunrelated third party) is not probable at the commencement date, lease \nincome shall be limited to the lesser of the income that would be recognized in \naccordance with paragraph 842- 30-25-11(a) through (b) or the lease payments, \nincluding variable lease payments, that have been collected from the less ee. \n25-13 If the assessment of collectibility changes after the commencement \ndate, any difference between the lease income that would have been \nrecognized in accordance with paragraph 842- 30-25-11(a) through (b) and the \nlease payments, including vari able lease payments, that have been collected \nfrom the lessee shall be recognized as a current -period adjustment to lease \nincome. \n25-14 See Example 1 (paragraphs 842- 30-55-18 through 55- 43) for an \nillustration of the requirements when collectibility is not probable. \n55 Implementation Guidance and Illustrations \nGeneral \n> Illustrations \n>> Illustration of Lessor Accounting ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 695}), Document(page\_content='Leases 695 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. >>> Example 1— Lessor Accounting Example \n>>>> Case B —Lessor Accounting —Sales -Type Lease— Collectibility of \nthe Lease Payments Is Not Probable \n55-25 Assume the same facts and circumstances as in Case A \n(paragraphs 842-30-55-19 through 55- 24), except that it is not probable \nLessor will co llect the lease payments and any amount necessary to satisfy \nthe residual value guarantee provided by Lessee. In reaching this conclusion, \nthe entity observes that Lessee’s ability and intention to pay may be in doubt \nbecause of the following factors: \na. Lessee intends to make the lease payments primarily from income derived \nfrom its business in which the equipment will be used (which is a business \nfacing significant risks because of high competition in the industry and \nLessee’s limited experience) \nb. Lessee ha s limited credit history and no significant other income or assets \nwith which to make the payments if the business is not successful. \n55-26 In accordance with paragraph 842- 30-25-3, Lessor does not derecognize \nthe equipment and does not recognize a net investment in the lease or any \nselling profit or selling loss. However, consistent with Case A, Lessor pays and \nrecognizes the initial direct costs of $2,000 as an expense at the \ncommencement date. \n55-27 At the end of Year 1, Lessor reassesses whether it is probable it will \ncollect the lease payments and any amount necessary to satisfy the residual \nvalue guarantee provided by Lessee and concludes that it is not probable. In \naddition, neither of the events in paragraph 842- 30-25-3(b) has occurred. The \ncontract has not been terminated and Lessor has not repossessed the \nequipment because Lessee is fulfilling the terms of the contract. \nConsequently, Lessor accounts for the $9,500 Year 1 lease payment as a \ndeposit liability in accordance with paragraph 842 -30-25-3. Lessor recognizes \ndepreciation expense on the equipment of $7,714 ($54,000 carrying value ÷ \n7-year useful life). \n55-28 Lessor’s accounting in Years 2 and 3 is the same as in Year 1. At the end \nof Year 4, Lessee makes the fourth $9,500 a nnual lease payment such that the \ndeposit liability equals $38,000. Lessor concludes that collectibility of the lease \npayments and any amount necessary to satisfy the residual value guarantee \nprovided by Lessee is now probable on the basis of Lessee’s paym ent history \nunder the contract and the fact that Lessee has been successfully operating its \nbusiness for four years. Lessor does not reassess the classification of the \nlease as a sales- type lease. \n55-29 Consequently, at the end of Year 4, Lessor der ecognizes the equipment, \nwhich has a carrying amount of $23,143, and recognizes a net investment in \nthe lease of $35,519. The net investment in the lease consists of the lease \nreceivable (the sum of the 2 remaining annual payments of $9,500 and the \nresidua l value guarantee of $13,000, discounted at the rate implicit in the lease \nof 5.4839 percent determined at the commencement date, which equals \n$29,228) and the unguaranteed residual asset (the present value of the \ndifference between the expected residual v alue of $20,000 and the residual \nvalue guarantee of $13,000, which equals $6,291). Lessor recognizes selling ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 696}), Document(page\_content='Leases 696 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. profit of $50,376, the difference between (a) the sum of the lease receivable \nand the carrying amount of the deposit liability ($29,228 lease recei vable + \n$38,000 in lease payments already made = $67,228) and (b) the carrying \namount of the equipment, net of the unguaranteed residual asset ($23,143 – \n$6,291 = $16,852). \n55-30 After the end of Year 4, Lessor accounts for the remaining two years of \nthe lease in the same manner as any other sales -type lease. Consistent with \nCase A, at the end of Year 6, Lessor reclassifies the net investment in the \nlease, then equal to the estimated residual value of the underlying asset of \n$20,000, as equipment. \n>>>> Case D —Lessor Accounting —Collectibility Is Not Probable \n55-40 Assume the same facts and circumstances as Case C (paragraphs 842 -\n30-55-31 through 55- 39), except that collectibility of the lease payments and \nany amount necessary to satisfy the residual value guarantee provided by the \nthird party is not probable and the lease payments escalate every year over the \nlease term. Specifically, the lease payment due at the end of Year 1 is $7,000, \nand subsequent payments increase by $1,000 every year for the remainder of \nthe lease term. Because it is not probable that Lessor will collect the lease \npayments and any amount necessary to satisfy the residual value guarantee \nprovided by the third party in accordance with paragraph 842- 10-25-3, Lessor \nclassifies the lease as an operating lease. \n55-41 Lessor continues to measure the equipment in accordance with \nTopic 360 on property, plant, and equipment. \n55-42 Because collectibility of the lease payments is not probable, Lessor \nrecogniz es lease income only when Lessee makes the lease payments, and in \nthe amount of those lease payments. Therefore, Lessor only recognizes lease \nincome of $7,000 at the point in time Lessee makes the end of Year 1 \npayment for that amount. \n55-43 At the end of Year 2, Lessor concludes that collectibility of the remaining \nlease payments and any amount necessary to satisfy the residual value \nguarantee provided by the third party is probable; therefore, Lessor recognizes \nlease income of $12,000. The amount of $12,000 is the difference between \nlease income that would have been recognized through the end of Year 2 \n($57,000 in total lease payments ÷ 6 years = $9,500 per year × 2 years = \n$19,000) and the $7,000 in lease income previously recognized. Collectibilit y of \nthe remaining lease payments remains probable throughout the remainder of \nthe lease term; therefore, Lessor continues to recognize lease income of \n$9,500 each year. \n \n \n7.5.1 Considering collectibility issues \nReassessment of lease classification \n7.5.10 A lessor does not reas sess lease classification unless the lease is \nmodified and that modification is not accounted for as a separate contract (see \nsection 7.6). Therefore, changes in the assessment of collectibility after the \ncommencement date do not affect the classification of the lease, regardless of ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 697}), Document(page\_content='Leases 697 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. whether the change is positive (i.e. collectibility becomes probable) or negative \n(i.e. collectibility is determined to no longer be probable). For example, a lease \nthat was classifie d as an operating lease at lease commencement solely \nbecause of collectibility issues is not reclassified as a direct financing lease if \ncollectibility subsequently becomes probable. [842- 10-25-3(b)(2), 842- 30-55-25 – 55-30, \n55-40 – 55-43] \nSales -type leases \n7.5.20 The collectibility of the lease payments and any amount necessary to \nsatisfy a lessee residual value guarantee is assessed after a lease has been \nclassified as a sales- type lease. The collectibility assessment does not affect \nthe classification of the lea se, but it can change the accounting from that \noutlined in section 7.3. \n7.5.30 If collectibility of the lease payments, plus any amount necessary to \nsatisfy a lessee residual value guarantee, is not probable at the commencement \ndate, the lessor does not derecognize the underlying asset. Instead, the lessor \nrecognizes lease payments received, including variable lease payments, as a \ndeposit liability until the earlier of either of the following: [842- 30-25-3] \n1. collectibility of the lease payments/les see residual value guarantee \nbecomes probable; or \n2. either: \n— the contract has been terminated, and the lease payments received from the lessee are nonrefundable; or \n— the lessor has repossessed the underlying asset, has no further \nobligation under the contract to the lessee, and the lease payments \nreceived are nonrefundable. \n7.5.40 At the date that criterion (1) in paragraph 7.5.30 is met, the lessor: \n[842- 30-25-4] \n— derecognizes the carrying amount of the underlying asset; \n— derecognizes the carrying amount of any deposit liability; \n— recognizes a net investment in the lease on the basis of the remaining \nlease payments and the remaining lease term, using the rate implicit in the lease determined at the lease commencement date; and \n— recognizes sel ling profit (loss), calculated as: \nCarrying \namount of\n deposit \nliabilitySelling \nprofit (loss)Carrying amount \nof underlying \nasset , net of \nunguaranteed \nresidual assetLease \nReceivable \n7.5.50 At the date that criterion (2) in para graph 7.5.30 is met, the lessor \nderecognizes the carrying amount of any deposit liability, with a corresponding \namount recognized as lease i ncome. [842- 30-25-5] \n7.5.60 If collectibility is subsequently assessed as probable for a sales -type lease \n(i.e. after it was initially assessed as not probable at lease commencement), in \naccounting for that lease subsequent to the collectibility reassessment, the ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 698}), Document(page\_content='Leases 698 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. lessor uses the rate implicit in the lease determined at the lease \ncommencement date. [842- 30-25-4(c)] \n7.5.70 If collectibility is probable at the commencement date for a sales -type \nlease, the lessor does not reassess whether collectibility is probable after the \ncommencement date. Subsequent changes in the credit risk of the lessee are \naccounted for in accordance with the impairment guidance applicable to the net \ninvestment in the lease (see paragraph 7.3.380). [842- 30-25-6] \nOther leases \n7.5.80 If collectibility is probable at the commencement date for a direct \nfinancing lease, the lessor does not reassess whether collectibility is probable \nafter the commencement date. Subsequent changes in the credit risk of the \nlessee are accounted for in accordance with the impairment guidance applicable \nto the net investment in the lease (see paragraph 7.3.380). [842-30-25-6] \n7.5.90 If collectibility of the lease payments plus any amount necessary to \nsatisfy a residual value guarantee (provided by the lessee or another unrelated \nthird party) is not probable at the commencement date: [842- 30-25-12] \n— the lease cannot be classified as a direct financing lease (see flowchart \nin paragraph 7.2.50), and is therefore an operating lease; and \n— cumulative lease income is limited to the lesser of (a) the income that \nwould be recognized in accordance with the guida nce applicable to all \noperating leases, or (b) the amount of the lease payments, including variable lease payments, that have been collected from the lessee. \n7.5.100 If the assessment of collectibility changes after the commencement \ndate, any difference between (a) and (b) in paragraph 7.5.90 is recognized as a \ncurrent -period adjustment to lease income. [842- 30-25-13] \n \n Observation \nCollectibility guidance for sales -type leases designed \nto prevent structuring opportunities \n7.5.110 The guidance that applies to sales -type leases when collectibility of the \nlease payments, plus any amounts necessary to satisfy a lessee residual value \nguarantee, is not probable is similar to that applied by sellers of goods under \nTopic 606. The lessor guidance was developed in this manner to ensure that \nsellers of goods cannot circumvent the collectibility guidance in Topic 606 – i.e. \nrecognize revenue earlier than would be permitted by Topic 606 – by structuring \nthem as sales- type leases. [ASU 2016- 02.BC104] \n7.5.120 In contrast, because in the Board’s view operating leases and direct \nfinancing leases are not similar to sales of the underlying asset, the Board concluded that the relevant collectibility guidance did not need to align with \nTopic 606. I nstead, the guidance is mostly consistent with the collectibility \nguidance in Topic 840. \n[ASU 2016- 02.BC105] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 699}), Document(page\_content='Leases 699 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 7. 5.10 \nImpact of collectibility reassessment on lessors \nHow do the collectibility reassessment requirements in \nTopic 842 affect lessors? \nInterpretive response: Topic 842 includes ongoing monitoring efforts for \nlessors with respect to collectibility. These include all of the following. \n— For any lease for which collecti bility of the lease payments and amounts \nnecessary to satisfy a residual value guarantee is not probable at lease \ncommencement, the lessor continually reassesses whether collec tibility \nbecomes probable. \n— If the lease with collectibility concerns is a sales -type lease, the lessor \nmonitors for either of the two specified events in paragraph 7.5.30 that \nwould permit income recognition even in the absence of a conclusion that \ncollectibility is probable. \n— For operating leases only, the lessor monitors whether coll ectibility remains \nprobable after lease commencement. \nThe following is a summary of how collectibility is assessed for different leases. \nType of lease Collectibility probable \nat lease \ncommencement? After initia l recognition \nSales -type Yes No ongoing monitoring of collectibility; \nperform impairment test of net \ninvestment in lease (see \nparagraph 7.3.380). \nNo Ongoing monitoring of collectibility. \nDirect \nfinancing1 Yes No ongoing monitoring of collectibility; \nperform impairment test of net investment in lease (see \nparagraph 7.3.380). \nOperating Yes Ongoing monitoring of collectibility. \nNo Ongoing monitoring of collectibility. \nNote: \n1. A lease cannot be classified as a direct financing lease if collectibility is not probable at \nlease commencement. \nBecause lessors are not required to reassess collectibility in the same way as \nunder Topic 840, additional processes or controls may need to be implemented \nto monitor for changes in collectibility and/or the occurrence of events that \nwould tr igger lease income recognition in relation to sales -type leases. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 700}), Document(page\_content='Leases 700 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Comparison to legacy US GAAP \nImpacts of collectibility uncertainties on lessor accounting \n7.5.130 The following table summarizes the effects of collectibility uncertainties \non lessor accounting under Topic 842 compared with Topic 840 . [840- 10-25-42(a)] \nTopic 840 Topic 842 \nSales -type lease \n— Lease classified (and accounted for) as \nan operating lease. \n— No restriction on cumulative lease \nincome to lease payments (and variable \nlease payments) received (but applied \nby some in practice). — No effect on lease classification. \n— Underlying asset not derecognized. \n— No lease income recognized; lease \npayments (and variabl e lease \npayments) received recognized as a \ndeposit liability. \nDirect financing lease \n— Lease classified (and accounted for) as an operating lease. \n— No restriction on cumulative lease \nincome to lease payments (and variable \nlease payments) received (but applied \nby some in practice). — Lease classified (and accounted for) as \nan operating lease. \n— Cumulative lease income restricted to \nlease payments (and variable lease \npayments) received. \nOperating lease \n— Lease classified (and accounted for) as an operating lease. \n— No restriction on cumulative lease \nincome to lease payments (and variable \nlease payments) received (but applied \nby some in practice). — Lease classified (and accounted for) as \nan operating lease. \n— Cumulative lease income restricted to lease payments (and variable lease \npayments) received. \nLeveraged lease \n— Lease classified (and accounted for) as \nan operating lease. \n— No restriction on cumulative lease \nincome to lease payments (and variable \nlease payments) received (but applied \nby some in practice). — N/A \nCollectibility issues generally more punitive to lessors under Topic 842 \n7.5.140 The accounting result of collectibility issues is generally more punitive \nunder Topic 842 than it was under Topic 840 . Consider both of the following. \n— The requirement to recognize nonrefundable lease payments (and variable \nlease payments) as a deposit liability for sales -type leases result s in (1) later \nlease income recognition than under Topic 840 and (2) the recognition of \nliabilities by the lessor that were generally not recognized under Topic 840 . \n— The provision limiting cumulative lease income on operating leases with \ncollectibility concerns to the lease payments (and variable lease payments) \nthat have been received generally result s, for the same operating lease, in ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 701}), Document(page\_content='Leases 701 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. delayed income recognition as compared with Topic 840, which did not \ninclude a similar requirement when collectibility of the minimum lease \npayments were not reasonably predictable. \nReassessing collectibility \n7.5.150 Topic 842 includes ongoing monitoring efforts for lessors with respect to \ncollectibility that were not required under Topic 840. Additional lessor processes \nor controls may be required to monitor for changes in collectibility and/or the occurrence of events that wou ld trigger lease income recognition in relation to \nsales- type leases. \n \n7.5.2 Collectibility of operating lease receivables \n7.5.160 Topic 842 (like Topic 840 before it) does not include guidance about the \nvaluation of operating lease receivables. \n7.5.170 Before the adoption of Topic 326 (financial instruments —credit losses) , \nTopic 310 (receivables) directs entities to Subtopic 450 -20 (loss contingencies) \nwhen assessing the impairment of receivables that are not specifically \naddressed by other Topics. [310- 10-35-2] \n7.5.180 Topic 326 supersedes the guidance in Topic 310 on the impairment of \nreceivables, but operating lease receivables are explicitly excluded from the \nscope of Topic 326. [326- 20-15-3(g)] \n \n Observation \nContracts with lease and non -lease compo nents \n7.5.190 The FASB decided to exclude operating lease receivables from the scope \nof Topic 326, while including trade receivables and contract assets arising from \nnon-lease components subject to Topic 606 (revenue from contracts with \ncustomers) in its scope. Because many operating lease contracts include non -\nlease components, the FASB’s decision may create operational complexity for \nthose lessors that enter into operating lease contracts that include non- lease \ncomponents. \n7.5.200 Unles s the lessor can account for the operating lease and any non- lease \ncomponent(s) of the contract as a single component using the optional lessor practical expedient to not separate lease and non- lease components (see \nsection 4.4.1), the receivables arising from the contract will be subject to two \ndifferent credit impairment models. \n7.5.210 In July 2019, the FASB staff responded to a multi -faceted technical \ninquiry about lessors’ accounting for operating lease receivables after the \nadoption of Topic 842 . Many aspects of the inquiry arose because of the \nFASB’s decision to exclude operating lease receivables from the scope of the credit losses guidance in Topic 326. Questions 7.5.20 through 7.5.70 relate to \nthis technical inquiry. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 702}), Document(page\_content='Leases 702 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 7.5.20 \nCollectibility of operating lease receivables – lease-\nby-lease basis \nDoes Topic 842 require lessors to assess collectibility for \noperating lease s on a lease -by-lease basis? \nInterpretive response: Yes. Collectibility must be assessed for each operating \nlease individually. While we believe this is established by the guidance in \nSubtopic 842 -30, it was also affirmed by the FASB staff as part of their \nresponse to the technical inquiry (see paragraph 7.5.210) . [842- 30-25-12 – 25-13, ASU \n2016- 02.BC105] \n \n Question 7.5.30 \nCollectibility of operating lease receivables – \nongoing reassessment \nDoes Topic 842 require lessors to reassess collectibility \nthroughout the lease term? \nInterpretive response: Yes. Subtopic 842 -30 includes guidance about \naccounting for changes in the assessment of collectibility for an operating lease \n‘after the commencement date’. This clearly indicates that collectibility for an \noperating lease is an ongoing assessment throughout the lease term. The intent \nof the guidance in this regard was affirmed by the FASB staff as part of their \nresponse to the technical inquiry (see paragraph 7.5.210) . [842- 30-25-13] \n \n Question 7.5.40 \nCollectibility of operating lease receivables – leases \nsubject to constraint \nShould operating lease receivables for leases subject to the \ncollectibility constraint be fully reserved for on the lessor’s \nbalance sheet? \nInterpretive response: Yes. If, at lease commencement, an operating lease is \nsubject to the collectibility constraint, no receivables for that lease should be \nrecognized on the lessor’s balance sheet until collectibility of substantially all of \nthe lease payments becomes probable. A lessor may accomplish this by either \nnot recognizing the receivables, or fully reserving for those receivables through \nan allowance. \nIf an operating lease is not subject to the collectibility constraint at lease \ncommencement, but becomes subject to it during the lease term, a reserve \nshould be established for 100% of any outstanding lease rec eivables. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 703}), Document(page\_content='Leases 703 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 7.5.50 \nCollectibility of operating lease receivables – leases \nnot subject to constraint \nShould a lessor recognize a reserve for operating lease \nreceivables not of leases subject to the collectibility \nconstraint after the adoption of Topic 842? \nInterpretive response: Based on the technical inquiry with the FASB staff (see \nparagraph 7.5.210) , we believe either of the following approaches is acceptable \nas an accounting policy election to be applied consistently. \nApproach 1: Follow Subtopic 842 -30 guidance only \nThe basis for conclusions to ASU 2018- 19 could be read to indicate that the \nSubtopi c 842 -30 collectibility guidance is the only guidance to apply when \nconsidering impairment of operating lease receivables. [ASU 2018- 19 Summary, ASU \n2018- 19.BC14] \nConsequently, operating lease receivables should be impaired (i.e. written off or \nreserved f or) only when the lease is subject to the collectibility constraint. No \n‘general reserve’ should be established or maintained for other operating lease \nreceivables. \nApproach 2: Establish a general reserve based on Subtopic 450 -20 \nIn deciding to exclude operating lease receivables from the scope of Topic 326, \nthe FASB reiterated its intent, originally expressed in the basis for conclusions \nto ASU 2016 -02, not to significantly change lessors’ accounting for operating \nleases. [ASU 2016- 02.BC90– BC92, ASU 2018- 19.BC13] \nExcluding operating lease receivables from the scope of Topic 326 was \nintended to be consistent with the intent not to significantly change operating \nlease accounting, not to preclude lessors from recording a general reserve for \noperating lease receivables after applying the collectibility constraint guidance in \nSubtopic 842 -30. Therefore, the FASB staff believes it is acceptable for a lessor \nto recognize a reserve under Subtopic 450- 20 for its operating lease receivables \nnot subject to the collectibility constraint. \nApplying Approach 2 does not affect a lessor’s requirement to fully reserve for operating lease receivables subject to the collectibility constraint (see Question \n7.5.40). \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 704}), Document(page\_content='Leases 704 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 7.5.60 \nCollectibility of operating lease receivables – \naccounting for a general reserve \nIf a lessor follows Approach 2 in Question 7.5.50, should the \ngeneral reserve be recorded through a reduction to lease \nrevenue or bad debt expense? \nInterpretive response: Based on the technical inquiry with the FASB staff (see \nparagraph 7.5.210) , we believe either of the following approaches is acceptable \nas an accounting policy election to be applied consistently. \nApproach 1: Record changes to the r eserve through lease revenue \nAll changes to the balance of the general reserve (i.e. increases and decreases) \nestablished under Subtopic 450- 20 are recorded through lease revenue. This \napproach generally results in consistency between the line items in the income \nstatement that lessors record (1) changes to their general reserve, and (2) the \neffect of a lease becoming subject to, or leaving, the collectibility constraint. \nApproach 2: Record bad debt expense \nAll changes to the balance of the general reserve (see Question 7.5.50) are \nrecorded through bad debt expense. In accepting this approach, the FASB staff \nagain cited the FASB’s expressed intent not to significantly change lessors’ \naccounting for operating leases, and noted that lessors have typically established, and recorded changes to, general operating lease receivable \nreserves through bad debt expense. \n[ASU 2018- 19 Summary, ASU 2018- 19.BC14] \n \n Question 7.5.70 \nCollectibility of operating lease receivables – impact \nof constraint on general reserve \nHow should a lessor record the effect of becoming subject to \nthe collectibility constraint after lease commencement if it maintains a general reserve? \nBackground: For purposes of this question, consider the following example. \n— Lessor LR is the lessor in an operating lease with Lessee LE that has a \n$100 outstanding lease receivable balance – arising from the straight- lining \nof lease revenue – at the date LR concludes that collectibility of \nsubstantially all the remaining lease payments is not probable. \n— LR maintains a general reserve under Subtopic 450- 20 for its operating \nlease receivables not subject to the collectibility constraint. \n— Using a systematic and rational approach, LR can determine that $5 of the \ngeneral reserve is attributable to the lease with LE. To make this \ndetermination, LR evaluates its general reserve including and excluding the \nlease with LE. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 705}), Document(page\_content='Leases 705 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — LR’s assessment of collectibility does not change again during the lease \nterm. \nInterpretive response: Based on the technical inquiry with the FASB staff (see \nparagraph 7.5.210) , we believe any one of the following three approaches is \nacceptable as an accounting policy election to be applied consistently. \nThere is no financial reporting difference between the approaches for a lessor \nthat follows Approach 1 to Question 7.5.60 – i.e. records all changes to its \ngeneral operating lease receivable reserve through lease revenue. Therefore, this response assumes the les sor elects Approach 2 to Question 7.5.60 – i.e. \nrecords changes to its general reserve through bad debt expense. \nApproach 1: Record the effects on a gross basis \nThe lessor first reserves for the entire outstanding balance of the receivables \nfor the operating lease through a reduction to lease revenue. The lessor then \nrecords any necessary change to the general reserve for the effects of \nremoving the troubled lease from the general reserve portfolio through bad debt \nexpense. From the date of reassessment, the lessor recognizes lease revenue \non a cash basis, unless the assessment of collectibility changes again before \nthe end of the lease term. \nUsing the background example, at the date LR’s assessment of collectibility for the lease changes, LR will recognize: \n— a $100 specific reserve for LE’s outstanding receivables, offset by a $100 \ncurrent period reduction to lease revenue; and \n— a $5 reduction to the general operating lease receivable reserve, offset by a \n$5 reduction to cur rent period bad debt expense. \nFrom the reassessment date, LR will recognize revenue on the lease equal to \ncash received. \nApproach 2: Record the effects on a net basis \nThe lessor records a reduction to lease revenue that is net of the portion of the \ngeneral reserve that can be attributed to the lease receivables that are now \nsubject to the collectibility constraint. Consistent with Approach 1, from the \ndate of reassessment, the lessor recognizes lease revenue on a cash basis, \nunless the assessment of collect ibility changes again before the end of the \nlease term. \nUsing the background example, at the date LR’s assessment of collectibility for \nthe lease changes, LR will: \n— reallocate the $5 of the general reserve that can be attributed to the LE \nlease to a specifi c reserve for the LE lease; and \n— recognize an additional $95 specific reserve for the LE lease, offset by a \n$95 current period reduction to lease revenue. \nFrom the reassessment date, LR will recognize revenue on the lease equal to cash received. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 706}), Document(page\_content='Leases 706 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Approach 3: Consider the nature and purpose of the lessor’s general \nreserve \nConsistent with Approaches 1 and 2, from the date of reassessment, the lessor \nrecognizes lease revenue on a cash basis, unless the assessment of collectibility changes again before the end of the lease term. \nHowever, under this approach (in contrast to the others), a lessor may not \nrecord a reduction to lease revenue in the period that the lessor’s assessment of collectibility changes. This would be the case if the lessor’s general reserve \nmethodology contemplates, and therefore establishes general reserves \nsufficient to absorb, periodic lease- specific credit impairments (like the \nbackground example). In that case, if collectibility of a lease that became \nsubject to the collectibility constraint during the lease term subsequently \nbecomes probable, the remainder of the specific reserve for the lease \nreceivables should be reallocated to the general reserve. The reversal of the \nspecific reserve arising from the collectibility constraint should not result in \nadditional lease revenue or a reduction to bad debt expense; this is because it was originally established through an allocation from the general reserve. \nDetermining whether a lessor’s general reserves are sufficient to absorb lease-\nspecific cre dit impairments will likely involve judgment. However, we believe \nthat if the lessor needs to significantly increase its general reserve at or shortly after a lease -specific credit impairment event – to address the risk of non -\ncollection for its remaining population of operating leases not subject to the \ncollectibility constraint – that would be evidence contrary to concluding that the \nlessor’s general reserve is sufficient to absorb lease- specific credit \nimpairments. \nUsing the background example, assume that LR’s general reserve is determined to be sufficient to absorb the LE lease credit impairment. At the \ndate LR’s assessment of collectibility for the lease changes, LR will reallocate \n$100 of the general reserve to a specific reserve for the LE lease; no reduction \nto lease revenue or additional bad debt expense will be recorded. \nFrom the reassessment date, LR will recognize revenue on the lease equal to \ncash received. \n \n7.6 Lease modifications \n Excerpt from ASC 842-1 0 \n25 Recognition \nGeneral \n> Lease Modifications \n25-8 An entity shall account for a modification to a contract as a separate \ncontract (that is, separate from the original contract) when both of the \nfollowing conditions are present: ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 707}), Document(page\_content='Leases 707 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. a. The modification grants the lessee an additional right of use not included in \nthe original lease (for example, the right to use an add itional asset). \nb. The lease payments increase commensurate with the standalone price \nfor the additional right of use, adjusted for the circumstances of the \nparticular contract. For example, the standalone price for the lease of one \nfloor of an office buildi ng in which the lessee already leases other floors in \nthat building may be different from the standalone price of a similar floor in \na different office building, because it was not necessary for a lessor to \nincur costs that it would have incurred for a new lessee. \n25-9 If a lease is modified and that modification is not accounted for as a \nseparate contract in accordance with paragraph 842 -10-25-8, the entity shall \nreassess the classification of the lease in accordance with paragraph 842- 10-\n25-1 as of the effective date of the modification . \n25-10 An entity shall account for initial direct costs , lease incentives, and any \nother payments made to or by the entity in connection with a modification to a \nlease in the same manner as those items would be accounted for in \nconnection with a new lease. \n>> Lessor \n25-15 If an operating lease is modified and the modification is not accounted \nfor as a separate contract in accordance with paragraph 842- 10-25-8, the \nlessor shall account for the modification as if it were a termination of the \nexisting lease and the creation of a new lease that commences on the \neffective date of the modification as follows: \na. If the modified lease is classified as an operating lease, the lessor shall \nconsider any prepaid or accrued lease rentals relating to the original lease \nas a part of the lease payments for the modified lease. \nb. If the modified lease is classified as a direct financing lease or a sales -\ntype lease, the lessor shall derecognize any deferred rent liability or \naccrued rent asset and adjust the selling profit or selling loss accordingly. \n25-16 If a direct financing lease is modified and the modification is not \naccounted for as a separate contract in accordance with paragraph 842-10-25-\n8, the lessor shall account for the modified lease as follows: \na. If the modified lease is classified as a direct financing lease, the lessor shall \nadjust the discount rate for the modified lease so that the initial net \ninvestment in the modified l ease equals the carrying amount of the net \ninvestment in the original lease immediately before the effective date of \nthe modification. \nb. If the modified lease is classified as a sales- type lease, the lessor shall \naccount for the modified lease in accordance with the guidance applicable \nto sales -type leases in Subtopic 842- 30, with the commencement date of \nthe modified lease being the effective date of the modification. In \ncalculating the selling profit or selling loss on the lease, the fair value of \nthe unde rlying asset is its fair value at the effective date of the \nmodification and its carrying amount is the carrying amount of the net \ninvestment in the original lease immediately before the effective date of \nthe modification. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 708}), Document(page\_content='Leases 708 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. c. If the modified lease is classif ied as an operating lease, the carrying \namount of the underlying asset equals the net investment in the original \nlease immediately before the effective date of the modification. \n25-17 If a sales- type lease is modified and the modification is not acc ounted for \nas a separate contract in accordance with paragraph 842- 10-25-8, the lessor \nshall account for the modified lease as follows: \na. If the modified lease is classified as a sales- type or a direct financing lease, \nin the same manner as described in paragraph 842- 10-25-16(a) \nb. If the modified lease is classified as an operating lease, in the same \nmanner as described in paragraph 842- 10-25-16(c). \n25-18 See Examples 15 through 22 (paragraphs 842- 10-55-159 through 55- 209) \nfor illustrations of the requirements on lease modifications . \n35 Subsequent Measurement \nGeneral \n> Lease Term and Purchase Options \n35-3 A lessor shall not reassess the lease term or a lessee option to purchase \nthe underlying asset unless the lease is modified and that modification is not \naccounted for as a separate contract in accordance with paragraph 842- 10-25-\n8. When a lessee exercises an option to extend the lease or purchase the \nunderlying asset that the lessor previously determined the lessee was not \nreasonably certain to exercise or exercises an option to t erminate the lease \nthat the lessor previously determined the lessee was reasonably certain not to \nexercise , the lessor shall account for the exercise of that option in the same \nmanner as a l ease modification . \n> Subsequent Measurement of the Lease Payments \n35-6 A lessor shall not remeasure the lease payments unless the lease is \nmodified and that modification is not accounted for as a separate contract in \naccordance with paragraph 842- 10-25-8. \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance \n>> Illustrations of Lease Modifications \n>>> Lessor \n>>>> Example 20— Modification of an Operating Lease That Does Not \nChange Lease Classification \n55-190 Lessor enters into a 10- year lease with Lessee for 10,000 square feet \nof office space. The annual lease payments are $100,000 in the first year, \nincreasing by 5 percent each year thereafter, payable in arrears. The lease \nterm is not for a major part of the remaining economic life of the office space \n(40 years), and the present value of the lease payments is not substantially all \nof the fair v alue of the office space. Furthermore, the title does not transfer to \nLessee as a consequence of the lease, the lease does not contain an option for \nLessee to purchase the office space, and the asset is not specialized such that ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 709}), Document(page\_content='Leases 709 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. it clearly has an alternati ve use to Lessor at the end of the lease term. \nConsequently, the lease is classified as an operating lease. \n55-191 At the beginning of Year 6, Lessee and Lessor agree to amend the \noriginal lease for the remaining 5 years to include an additional 10,000 square \nfeet of office space in the same building for a total annual fixed payment of \n$150,000. The increase in total consideration is at a discount both to the \ncurrent market rate for the new 10,000 square feet of office space and in the \ncontext of that particular contract. The modified lease continues to be \nclassified as an operating lease. \n55-192 At the effective date of the modification (at the beginning of Year 6), \nLessor has an accrued lease rental asset of $76,331 (rental income recognized \non a straight -line basis for the first 5 years of the lease of $628,895 \n[$1,257,789 ÷ 10 years = $125,779 per year] less lease payments for the first \n5 years of $552,564 [that is, $100,000 in Year 1, $105,000 in Year 2, $110,250 \nin Year 3, $115,763 in Year 4, and $121,551 in Year 5]). \n55-193 Because the change in pricing of the lease is not commensurate with \nthe standalone price for the additional right -of-use asset, Lessor does not \naccount for the modification as a new lease, separate from the original 10 -year \nlease. Instead, Lessor accounts for the modified lease prospectively from the \neffective date of the modification, recognizing the lease payments to be made \nunder the modified lease of $750,000 ($150,000 × 5 years), net of Lessor’s \naccrued rent asset of $76,331, on a straight -line basis over the remaining \n5-year lease term ($673,669 ÷ 5 years = $134,734 per year). At the end of the \nlease, Lessor will have recognized as lease income the $1,302,564 in lease \npayments it receives from Lessee during the 10- year lease term. \n>>>> Example 21— Modification of an Operating Lease That Changes \nLease Classification \n>>>>> Case A —Operating Lease to Sales -Type Lease \n55-194 Lessor enters into a four -year lease of a piece of nonspecialized \nequipment. The annual lease payments are $81,000 in the first year, increasing \nby 5 percent each year thereafter, payable in arrears. The estimated residual \nvalue of the equipment is $90,000, of which none is guaranteed. The remaining \neconom ic life of the equipment at lease commencement is seven years. The \ncarrying amount of the equipment and its fair value are both $425,000 at the \ncommencement date. The lease is not for a major part of the remaining \neconomic life of the equipment, and the pr esent value of the lease payments is \nnot substantially all of the fair value of the equipment. Furthermore, title does \nnot transfer to Lessee as a result of the lease, the lease does not contain an \noption for Lessee to purchase the underlying asset, and because the asset is \nnonspecialized, it is expected to have an alternative use to Lessor at the end of \nthe lease term. Consequently, the lease is classified as an operating lease. \n55-195 At the beginning of Year 3, Lessee and Lessor agree to extend the \nlease term by two years. That is, the modified lease is now a six -year lease, as \ncompared with the original four -year lease. The additional two years were not \nan option when the original lease was negotiated. The modification alters the \nLessee’s right to use the equipment; it does not grant Lessee an additional ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 710}), Document(page\_content='Leases 710 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. right of use. Therefore, Lessor does not account for the modification as a \nseparate contract from the original four -year lease contract. \n55-196 On the effective date of the modification, the fair value of the \nequipment is $346,250, and the remaining economic life of the equipment is \n5 years. The estimated residual value of the equipment is $35,000, of which \nnone is guaranteed. The modified lease is for a major part of the remaining \neconomic li fe of the equipment at the effective date of the modification (four \nyears out of the five- year-remaining economic life of the equipment). \nConsequently, the modified lease is classified as a sales -type lease. \n55-197 In accounting for the modification, Lessor determines the discount rate \nfor the modified lease (that is, the rate implicit in the modified lease) to be \n7.6 percent. Lessor recognizes the net investment in the modified lease of \n$346,250 and derecognizes both the accrued rent and the equipment at the \neffective date of the modification. Lessor also recognizes, in accordance with \nparagraph 842- 10-25-15(b), selling profit of $34,169 ($320,139 lease receivable \n– $8,510 accrued rent balance – the $277,460 carrying amount of the \nequipment derecogniz ed, net of the unguaranteed residual asset [$277,460 = \n$303,571 – $26,111]). After the effective date of the modification, Lessor \naccounts for the modified lease in the same manner as any other sales -type \nlease in accordance with Subtopic 842 -30. \n>>>>> Case B —Operating Lease to Direct Financing Lease \n55-198 At the beginning of Year 3, Lessee and Lessor enter into a modification \nto extend the lease term by 1 year, and Lessee agrees to make lease \npayments of $108,000 per year for each of the remai ning 3 years of the \nmodified lease. No other terms of the contract are modified. Concurrent with \nthe execution of the modification, Lessor obtains a residual value guarantee \nfrom an unrelated third party for $40,000. Consistent with Case A \n(paragraphs 842-10-55-194 through 55- 197), at the effective date of the \nmodification the fair value of the equipment is $346,250, the carrying amount \nof the equipment is $303,571, and Lessor’s accrued rent balance is $8,510. \nThe estimated residual value at the end of the modified lease term is $80,000. \nThe discount rate for the modified lease is 7.356 percent. \n55-199 Lessor reassesses the lease classification as of the effective date of \nthe modification and concludes that the modified lease is a direct financing \nlease because none of the criteria in paragraph 842- 10-25-2 and both criteria in \nparagraph 842- 10-25-3(b) are met. \n55-200 Therefore, at the effective date of the modification, Lessor recognizes a \nnet investment in the modified lease of $312 ,081, which is the fair value of the \nequipment ($346,250) less the selling profit on the lease ($34,169 = $313,922 \nlease receivable – $8,510 accrued rent balance – the $271,243 carrying amount \nof the equipment derecognized, net of the unguaranteed residual asset \n[$271,243 = $303,571 – $32,328]), which is deferred as part of the net \ninvestment in the lease. After the effective date of the modification, Lessor \naccounts for the modified lease in the same manner as any other direct \nfinancing lease in a ccordance with Subtopic 842- 30. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 711}), Document(page\_content='Leases 711 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. >>>> Example 22— Modification of a Direct Financing Lease \n55-201 Lessor enters into a six -year lease of a piece of new, nonspecialized \nequipment with a nine- year economic life. The annual lease payments are \n$11,000, payable in arrears. The estimated residual value of the equipment is \n$21,000, of which $15,000 is guaranteed by a third- party unrelated to Lessee \nor Lessor. The lease does not contain an option for Lessee to purchase the \nequipment, and the title does not transfer to Lessee as a consequence of the \nlease. The fair value of the equipment at lease commencement is $65,240, \nwhich is equal to its cost (and carrying amount). Lessor incurs no initial direct \ncosts in connection with the lease. The rate impli cit in the lease is 7.5 percent \nsuch that the present value of the lease payments is $51,632 and does not \namount to substantially all of the fair value of the equipment. \n55-202 The Lessor concludes that the lease is not a sales -type lease because \nnone of the criteria in paragraph 842- 10-25-2 are met. However, the sum of the \npresent value of the lease payments and the present value of the residual \nvalue of the underlying asset guaranteed by the third- party guarantor is \n$61,352, which is substantially a ll of the fair value of the equipment, and \ncollectibility of the lease payments is probable. Consequently, the lease is \nclassified as a direct financing lease. Lessor recognizes the net investment in \nthe lease of $65,240 (which includes the lease receivabl e of $61,352 and the \npresent value of the unguaranteed residual value of $3,888 [the present value \nof the difference between the expected residual value of $21,000 and the \nguaranteed residual value of $15,000]) and derecognizes the equipment with a \ncarryin g amount of $65,240. \n55-203 At the end of Year 1, Lessor receives a lease payment of $11,000 from \nLessee and recognizes interest income of $4,893 ($65,240 × 7.5%). Therefore, \nthe carrying amount of the net investment in the lease is $59,133 ($65,240 + \n$4,893 – $11,000). \n>>>>> Case A —Direct Financing Lease to Direct Financing Lease \n55-204 At the end of Year 1, the lease term is reduced by 1 year and the \nannual lease payment is reduced to $10,000 for the remaining 4 years of the \nmodified leas e term. The estimated residual value of the equipment at the end \nof the modified lease term is $33,000, of which $30,000 is guaranteed by the \nunrelated third party, while the fair value of the equipment is $56,000. The \nremaining economic life of the equipm ent is 8 years, and the present value of \nthe remaining lease payments, discounted using the rate implicit in the \nmodified lease of 8.857 percent, is $32,499. Lessor concludes that the \nmodified lease is not a sales -type lease because none of the criteria in \nparagraph 842- 10-25-2 are met. However, the sum of the present value of the \nlease payments and the present value of the residual value of the underlying \nasset guaranteed by the third- party guarantor, discounted using the rate \nimplicit in the modified leas e of 8.857 percent, is $53,864, which is \nsubstantially all of the fair value of the equipment, and collectibility of the lease \npayments is probable. As such, the modified lease is classified as a direct \nfinancing lease. \n55-205 In accounting for the modification in accordance with paragraph 842- 10-\n25-16(a), Lessor carries forward the balance of the net investment in the lease \nof $59,133 immediately before the effective date of the modification as the ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 712}), Document(page\_content='Leases 712 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. opening balance of the net investment in the modifi ed lease. To retain the \nsame net investment in the lease even while the lease payments, the lease \nterm, and the estimated residual value have all changed, Lessor adjusts the \ndiscount rate for the lease from the rate implicit in the modified lease of \n8.857 percent to 6.95 percent. This discount rate is used to calculate interest \nincome on the net investment in the lease throughout the remaining term of \nthe modified lease and will result, at the end of the modified lease term, in a \nnet investment balance that equals the estimated residual value of the \nunderlying asset of $33,000. \n>>>>> Case B —Direct Financing Lease to Sales -Type Lease \n55-206 At the end of Year 1, the lease term is extended for two years. The \nlease payments remain $11,000 annually, paid in arrears, for the remainder of \nthe lease term. The estimated residual value is $6,500, of which none is \nguaranteed. The rate implicit in the modified lease is 7.58 percent. At the \neffective date of the modification, the remaining economic life of the \nequipment is 8 years, and the fair value of the equipment is $62,000. Because \nthe modified lease term is now for the major part of the remaining economic \nlife of the equipment, the modified lease is classified as a sales -type lease. \n55-207 On the ef fective date of the modification, Lessor recognizes a net \ninvestment in the sales -type lease of $62,000, which is equal to the fair value \nof the equipment at the effective date of the modification, and derecognizes \nthe carrying amount of the net investment in the original direct financing lease \nof $59,133. The difference of $2,867 is the selling profit on the modified lease. \nAfter the effective date of the modification, Lessor accounts for the sales -type \nlease in the same manner as any other sales -type leas e in accordance with \nSubtopic 842-30. \n>>>>> Case C —Direct Financing Lease to Operating Lease \n55-208 At the end of Year 1, the lease term is reduced by 2 years, and the \nlease payments are reduced to $9,000 per year for the remaining 3- year lease \nterm. The estimated residual value is revised to $33,000, of which only \n$13,000 is guaranteed by an unrelated third party. The fair value of the \nequipment at the effective date of the modification is $56,000. The modified \nlease does not transfer the title of the equipment to Lessee or grant Lessee an \noption to purchase the equipment. The modified lease is classified as an \noperating lease because it does not meet any of the criteria to be classified as \na sales -type lease or as a direct financing lease. \n55-209 Therefore, at the effective date of the modification, Lessor \nderecognizes the net investment in the lease, which has a carrying amount of \n$59,133, and recognizes the equipment at that amount. Collectibility of the \nlease payments is probable; therefore, Lessor will recognize the $27,000 \n($9,000 × 3 years) in lease payments on a straight -line basis over the 3- year \nmodified lease term, as well as depreciation on the rerecognized equipment. \n \n7.6.1 Overview \n7.6.10 A lease modification is a change to the terms and conditions of a \ncontract that results in a change in the scope of or the consideration for a lease; ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 713}), Document(page\_content='Leases 713 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. for example, a change that adds or terminates the right to use one or more \nunderlying assets or extends or shortens the contractual lease term. \n[842 Glossary] \n \n Question 7.6.05 \nContract modifications not in writing \nDo contract modifications have to be in writing? \nInterpretive response: No. Under Topic 842, a contract can be oral or implied \nas long as it creates enforceable rights and obligations on the contracting parties. Similarly, a modification to a contract can also be oral or implied, as long \nas it is enforceable. \n[842 Glossary ] \nAn example of an implied modification is lessee construction or installation of \nlessor -owned improvements to the underlying asset – e.g. structural \nimprovements to a leased building – not required by the lease contract. Even if \nno amendment is executed, it i s implied that the lessor agreed to the lessee’s \nactions. See Question 5.4.85 for further discussion. \nAdditional examples of contract modifications that may not result in or from \nwritten changes to the terms and conditions of the lease contract include the \nfollowing (not exhaustive). \n— Substituting the underlying asset, even if permitted or requir ed by the \ncontract – e.g. replacing Asset 1 with equivalent Asset 2. \n— Significantly modifying or enhancing the underlying asset such that it is, in substance, a different asset – e.g. significantly enhancing the capacity and \nefficiency of a power -generating facility. \n— Decreasing or increasing the number of assets subject to a lease \nagreement that does not specify the number of assets is accounted for as a \nlease modifica tion. For example, a lease for a lessor’s entire fleet of a \nparticular asset is considered modified if the size (number of assets) and/or \ncomposition (some assets are replaced with other assets) of the fleet changes. See also Example 6.7.40. \n[842- 10-55-17 – 55-18] \n— Lessee actions of the nature described in paragraphs 7.6.80 – 7.6.90. \n[842- 10-35-3] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 714}), Document(page\_content='Leases 714 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 7.6.05A \nContract changes only affecting variable or \ncontingent payments \nDoes a lease contract change that affects only variable or \ncontingent payments for the lease qualify as a lease \nmodification? \nBackground: A lessor and lessee may modify the terms of a lease contract in a \nmanner that only adds new, or changes existing, variable or contingent lease \npayments. Relevant examples could include adding or changing: \n— a variable payment based on a percentage of the les see’s sales or the \nlessee’s usage of the underlying asset; \n— a payment that changes based on increases or decreases in the CPI; or \n— a contingency in the lease contract that could change the amount of the \npayments the lessee will make under the lease. \nIn thes e circumstances, the ‘lease payments’ (see section 5.4) and/or the \n‘consideration in the contract’ (see section 4.3) may not change, so some have \nquestioned whether these changes are lease modifications under Topic 842. \nInterpretive response: Yes. A lease modification is a change to the terms and \nconditions of a contract that results in a change in the scope of or the \nconsideration for a lease (see paragraph 7.6.10). Variable and contingent \npayments are part of the consideration for a lease; therefore, changes to \n(including the addition of) such payments change the consideration for the lease \nand give rise to a lease modification. \n \n Question 7.6.06 \nRent concessions – lessor \nIs a rent concession a modification? \nApplicability: This question does not apply to eligible COVID -19 related \nconcessions of a lessor that has elected the practical expedient offered by the \nFASB staff specific to COVID -19 related rent concessions. If the lessor has \nelected the practical expedient and the r ent concession in question is COVID -19 \nrelated, see KPMG Hot Topic, FASB staff guidance on accounting for COVID -19 \nrent concessions . \nBackground: Rent co ncessions may be offered by lessors or negotiated by \nlessees when temporary circumstances arise – e.g. temporary closure or \nchanges to operating hours due to COVID -19, civil unrest or a natural disaster. \nExamples of rent concessions include (not exhaustiv e): \n— forgiveness of contractually owed past -due rent; \n— rent abatements (i.e. decreased rent payments) for future periods – e.g. \n50% discount from the original rent payments for the next six months; and \n— interest -free rent deferrals. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 715}), Document(page\_content='Leases 715 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Accounting for rent conces sions under Topic 842, regardless of whether \nproactively offered by the lessor or negotiated by the lessee, depends on the \nenforceable rights and obligations of the lessor under the original lease contract, \nand the nature of any contractual changes agreed by the parties. \nInterpretive response: It depends. We believe the first step to answer this \nquestion is to determine whether: \n— the lessee had an enforceable right to the concession before it was \ngranted; and \n— other terms and conditions of the contract that affect the scope of or \nconsideration for the lease were changed. \nThe following diagram illustrates the evaluation and its result on the lessor’s \naccounting. \nDoes the lessee \nhave an \nenforceable right to \nthe rent concession \nunder the original \nlease contract?\nAccount for the rent \nconcession as a lease \nmodification\nAre any other terms \nand conditions in \nthe original lease \ncontract changed?\nAccount for the rent concession \nunder the original lease contract \n(e.g. as negative variable rent)YesNo\nNoYes \nEnforceable obligation \nLease contracts may contain force majeure or similar clauses that apply in the event that unforeseen circumstances prevent the parties from fulfilling their \nobligations under (or obtaining their anticipated benefits from) the contract. \nThese clauses may pr ovide for free, reduced or deferred rent for the period until \nthe unforeseen circumstances are remedied, after which rent payments return \nto the normal amounts as specified under the original lease contract. \nAlternatively, they may provide for prospective rent abatements that are \nintended to compensate the lessee for the effect of the unforeseen \ncircumstances. \nEven if not written into the original lease contract, the lessee may still have an \nenforceable right to (and the lessor may still have an enforceabl e obligation to \ngrant) a rent concession based on the laws in the jurisdiction that apply to the contract – e.g. forced closure or inability of lessee to access or operate the \nunderlying asset. Whether a force majeure or similar clause applies, or whether ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 716}), Document(page\_content='Leases 716 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the lessee otherwise has an enforceable right to a rent concession, is ultimately \na legal question that must be answered based on applicable law and the facts \nand circumstances giving rise to the evaluation. \nChanges to other terms and conditions \nIf the lessee has a contractual, or otherwise enforceable, right to the rent \nconcession, there may still be a lease modification, requiring the lessor to \nundertake lease modification accounting. This is the case if other terms and \nconditions of the original lease c ontract affecting the scope of or consideration \nfor the lease are changed in connection with the rent concession. \nIn the event of a rent concession, the two parties will be communicating, and \nthey may take the opportunity to agree on other changes to the t erms and \nconditions of the contract. For example, the parties may agree on a change to the lease term and/or changes to the lease payments, including variable \npayment terms, not required by a force majeure clause or other enforceable \nrights and obligations . \nIn general, changes to the terms and conditions of the contract (which can be \nwritten, verbal or otherwise – see Question 7.6.05) that affect the scope of or \nthe consideration for the lease other than merely communicating or agreeing on \nthe amount of a r ent concession for the affected periods of the lease, will \ntrigger a lease modification. This is the case even if the impetus for the negotiation was the force majeure event. \nEven if no other terms and conditions are explicitly changed, careful \nconsiderati on should be given to the rent concession. If the substance of the \nrent concession is that it is clearly not related solely to the force majeure event, a lease modification has likely occurred. For example, the amount of the \nconcession may be disproportionate to the effects of the force majeure event, \nor an additional concession might be offered to induce the lessee to extend or \nnot terminate the lease. \nRent deferrals – concession or not? \nAgreement by the lessor to defer contractually owed lease payments or variable \nlease payments is a rent concession. \nConsistent with rent forgiveness or abatement concessions, if the lessee does \nnot have an enforceable right to the rent deferral, granting of this concession by \nthe lessor, changing the payment terms and in effect granting the lessee an \ninterest -free loan, is a lease modification. \nConcession required but amount uncertain \nIn some cases, the lessor and lessee may agree that the lessee has an \nenforceable right to the rent concession under the circumstances, but that the \namount of the rent forgiveness or abatement, or duration of the interest -free \ndeferral, to which the lessee is entitled, is uncertain. Neither the contract, nor \nthe laws of the relevant jurisdiction, may clearly articulate how to determine the \nrequired concession. \nFor example, if a shopping center has reduced operating hours, it may be \nunclear how a required rent reduction should be calculated – e.g. pro rata based \non the decreased number of operating hours as compared to normal, or on ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 717}), Document(page\_content='Leases 717 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. some other basis if the changed operating hours disproporti onately affect low \nor high- traffic times, such as dinner hours for a restaurant in the food court. \nIn these cases, we believe that agreeing on the amount or duration of a \ncontractually required concession does not in isolation trigger a lease \nmodification . This is consistent in concept with the established practice that the \ntwo parties agreeing on the amount of a contractually required fair market rent \nlease payment adjustment does not constitute a lease modification. \nHowever, a lease modification will gen erally still result if other terms and \nconditions of the lease contract affecting the scope of or consideration for the \nlease are changed in connection with communicating or agreeing on the \namount of the rent concession (see above). \nAccounting consequence s \nIf there is a lease modification, lessors will account for the modification consistent with any other modification. \nIf the lessee has an enforceable right to the rent concession for the affected \nperiod(s) and there are no other changes to the terms and conditions of the \noriginal lease contract, there is no lease modification. The lessor should \ncontinue to account for the lease under the original contract. In the case of a \nrent forgiveness or a rent abatement, we believe the lessor should generally \naccoun t for the rent reduction as negative variable lease revenue, consistent \nwith lessor accounting for a co- tenancy clause (see Question 7.6.10). \n \n Question 7.6.06A \nLessee short payment of rent – lessor accounting \nHow does a lessor account for a lessee making rent payments \nthat are less than the amount contractually owed (i.e. ‘short payment’)? \nBackground: Some lessees may decide, or be forced by their cash flow \ncircumstances, to make rent payments that are less than the amount that is \ncontractual ly owed (i.e. ‘short pay’). \nInterpretive response: The first step to accounting for a short payment is to \ndetermine whether the lessee is entitled to make the short payment under the \nexisting lease contract – i.e. whether, based on the terms and conditions of the \ncontract, the lessee has the enforceable right to pay the lesser amount. \nIf so, we believe the lessor should generally account for the rent reduction as \nnegative variable lease income of the period to which the short payment \nrelates. This is cons istent with how a lessor accounts for a co- tenancy clause \n(see Question 7.6.10). \nIf the enforceable rights and obligations of the lease contract do not permit the lessee to short pay the rent, the lessor will continue to account for the lease \nunder its ori ginal terms and conditions unless and until a modification is \napproved. In general, this means the following. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 718}), Document(page\_content='Leases 718 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — In an operating lease, lease income will continue to be based on the rental \npayments to which the lessor is entitled. However, an exception arises if \nthe lessor concludes that the lessee’s short payment makes it no longer \nprobable that the lessor will collect at least substantially all of the lease \npayments to which it is entitled under the original contract. See section \n7.5.2 for information about a lessor’s accounting when this occurs. [842- 30-\n25-13] \n— In a sales- type or direct financing lease, while the lessor will contin ue to \naccount for the lease under its original terms and conditions, collectibility is \nnot reassessed under Topic 842 after the commencement date, even for \nsignificant events or changes in circumstances. Subsequent changes in the \ncredit risk of the lessee are accounted for under the impairment guidance \nthat applies to the net investment in the lease – i.e. Topic 326 for \ncompanies that have adopted ASU 2016- 13 (credit losses), or otherwise \nTopic 310. [842- 30-25-6, 35- 3] \nIf a modification is approved, the les sor will apply modification accounting as \nillustrated throughout this section 7.6 from the ‘effective date of the \nmodification’ (see paragraph 7.6.30). \nNote: An exception to the preceding paragraph arises if the modification \nconstitutes a concession (see Question 7.6.06) resulting from COVID -19, the \nconcession qualifies for the FASB staff’s practical expedient for COVID -19 \nrelated rent concessions and the lessor has elected the optional practical \nexpedient to account for the concession as if it was require d under the original \nlease contract. See KPMG Hot Topic, FASB staff guidance on accounting for \nCOVID -19 rent concessions , for guidance. \n \n Example 7.6.06A \nLessor accounting for short payments not permitted \nby the contract – operating lease \nLessee LE enters into a contract with Lessor LR for the right to use retail store \nspace in a shopping mall for 12 months. The following facts are relevant. \nLease payments: 12 monthly fixed payments of $2,000 paid in advance \nRenewal options/purchase options: None \nTransfer of ownership: No \nFair value of retail store: $500,000 \nRemaining economic life: 15 years \nThe lease is an operating lease; it does not meet any of the criteria to be \nclassified as a sales- type or direct financing lease. \nDue to unforeseen circumstances (not COVID -19), LE short pays Months 5 and \n6. LE pays $1,000 each month instead of the contra ctually required $2,000. \nLE does not have an enforceable right to short pay those months’ rent and LR has not agreed to accept the reduced payments in lieu of the contractual \namount owed. Therefore, LR continues to account for the lease under its ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 719}), Document(page\_content='Leases 719 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. original terms and conditions. LR further concludes, based on the facts and \ncircumstances, that LE’s short payment of the Months 5 and 6 payments does \nnot call into question whether collectibility of at least substantially all of the \nlease payments is probable. \nThe contract stipulates that LE incurs a monthly 1% interest charge on any past \ndue rent (plus accrued interest). As a result, LR records the following journal entries in Months 5 and 6. \n Month 5 Month 6 \nDebit Credit Debit Credit \nCash1 1,000 1,000 \nOperating lease receivable1 1,000 1,000 \nInterest receivable2,3 10 20 \nOperating lease income4 2,000 2,000 \nInterest income 10 20 \nNotes: \n1. $2,000 contractual payment (50% paid in cash, 50% reclassified to lease receivable). \n2. For Month 5: short payment of $1,000 × 1% = $10. \n3. For Month 6: (Months 5 and 6 short payments ($2,000) + Month 5 accrued interest \n($10)) × 1% = $20.10. [Rounded in Month 6 journal entry] \n4. $24,000 in total lease payments ÷ 12 -month lease term = $2,000. \nLease modification \nAt the beginning of Month 7, LR agrees to forgive the unpaid portion of the \nMonths 5 and 6 rent and interest thereon. LR concludes that the lease remains \nan operating lease. \nAs a result, LR records the following journal entry. \n Month 7 \nDebit Credit \nDeferred lease incentive 2,030 \nInterest receivable 30 \nOperating lease receivable 2,000 \nAfter recognizing the journal entry, LR accounts for the lease from the effective \ndate of the modification consistent with any other modified lease. \n7.6.20 A lease modificatio n includes a change to the terms and conditions of the \ncontract that contains the lease if that contract modification changes the \n‘consideratio n in the contract’, and therefore changes the lease payments (see \nsection 5.4) – i.e. changes the consideration for the lease. \n7.6.30 The effective date of a lease modification is the date that the modification \nis approved by both the lessee and the lessor. [842 Glossary] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 720}), Document(page\_content='Leases 720 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 7.6.40 A key question that drives the accounting for a modification is whether \nthe modification should be accounted for as a separate contract. \nAccounted for as a separate contract ?\nApply Topic 842 to the \nnew contractOriginal lease is modified \nand classification is \nreassessedYes No\n \n7.6.50 A modification is accounted for as a separate contract (see \nExam ple 6.7.10) when it both: [842- 10-25-8] \n— grants the lessee an additional right of use that was not included in the \noriginal contract – e.g. the right to use an additional asset; and \n— the lease payments increase commensurate with the stand- alone price for \nthe additional right of use, as adjusted for the circumstances of the \nparticular contract. \n7.6.60 An increase to the lease term (e.g. a modification changing the lease \nterm from four to six years) does not grant the lessee an additional right of use. \n[842- 10-25-11] \n \n Question 7.6.06B \nModifications that add a right(s) of use and make \nother changes \nCan a contract modification that adds a lessee right of use, \nbut also includes other changes, be accounted for as a \nseparate contract ? \nBackground: To illustrate, consider a scenario in which a lessee leases three \nfloors of an office building from a lessor for an original term of five years. In \nYear 3, the lessor enters into an amendment with the lessee to lease it a fourth \nfloor. In addition to the fourth floor lease, they agree to: \n— extend the non- cancellable period for the three original floors to match the \nnon-cancellable period of the new, fourth floor lease; and/or \n— reduce the lease payments for the original three floors to reflect the price per square foot the lessee is paying for the fourth floor lease. \nInterpretive response: No. A contract modification can only be accounted for \nas a separate contract if the only change to the existing contract is to add an \nadditional right of use to the contract – e.g. adding another floor to an existing \noffice space lease as in the background example. \n[842-10-25-8] \nIf changes are also made to one or more existing lease components, the \nseparate contract guidance in paragraph 842- 10-25-8 does not apply. In that \ncase, it is not appropriate to bifurcate the additional right of use and the other \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 721}), Document(page\_content='Leases 721 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. changes, and assess the ad ditional right of use separately under the separate \ncontract guidance. [ASU 2016 -02.BC171– BC172] \n7.6.70 If a lease is modified and that modification is not accounted for as a \nseparate contract, the entity reassesses the classification of the lease as o f the \neffective date of the modification, based on the modified terms and conditions \nand the facts and circumstances as of that date – e.g. the fair value and \nremaining economic life of the underlying asset at that date. The accounting for \nlease modificati ons not accounted for as a separate contract depends on the \nclassification of the modified lease. [842- 10-25-9] \n7.6.80 When a lessee exercises an option to extend a lease (including by \nelecting not to exercise a termination option) or to purchase the underlying \nasset that the lessor previously determined the lessee was not reasonably \ncertain to exercise, the lessor accounts for the exercise of that option as a lease \nmodification. [842- 10-35-3] \n7.6.90 Likewise, if a lessee does not exercise an option the lessor previously \ndetermined the lessee was reasonably certain to exercise, the non -exercise of \nthe option is accounted for as a lease modification. For example, if a lessee was \ndeemed to be reasonably certain to exercise a renewal option, when it elects \nnot to do so, that is accounted for as a lease modi fication. Similarly, if a lessee \nexercises a termination option it was previously reasonably certain not to \nexercise, that is accounted for as a lease m odification. [842-10-35-3] \n7.6.95 A ‘modification’ that results from the exercise of a termination option or a \npurchase option is effectively one that terminates the lease. That is, a lease no \nlonger exists once the lessee has either terminated t he lease or has purchased \nthe underlying asset. \n \n Question 7.6.07 \nLessor consideration of a lessee’s notice to exercise \nits purchase option \nHow should a lessor account for the notification that a lessee \nplans to exercise a purchase option that was not previously considered to be reasonably certain of exercise? \nBackground: A lessor leases an asset to a le ssee under an operating lease. \nAssume that the lease contains an option for the lessee to purchase the \nunderlying asset. The l essor had concluded at lea se commencement that the \npurchase option was not r easonably certain of exercise. The l essee provides \nwritten notice in accordance with the lease agreement that it plans to exercise \nits option to p urchase the underlying asset in six months . \nInterpretative response: The lessor evaluates whether the lessee’s \nnotification of its intent to exercise the purchase option creates or changes the \nenforceable rights and obliga tions of the lease arrangement. [842 Glossary, 606- 10-\n25-10, 842- 10-35-3] \n— If the notification legally obligates the lessee to purchase the underlying \nasset, the lessor should account for the notification as a modification of the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 722}), Document(page\_content='Leases 722 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. lease arrangement, using the notification date as the ‘effective date of the \nmodification’ (see paragraph 7.6.30) . \n— If the notification does not legally obligate the lessee to purchase the \nunderlying asset, there is no modification of the agreement . As a result, \nthere is no change to the lessor’s accounting for the operating lease. \nConsistent with paragraph 7.6.40, if there is a modification based on the \npreceding paragraph, the lessor first determines whether the modification should be accounted for as a separate contract. Because a lessee’s notification \nof its intent to exercise a purchase option does not grant the lessee the right to \nuse an additional underlying asset , the modification cannot be accounted for as \na separate contract (see paragraph 7.6.50) . Therefore, the lessor accounts for \nthe modification as a change to the existing lease. \nLessor accounti ng for lease modifications depends on the classification of the \nlease before and after the modification. Regardless of lease classification before \nthe modification, the lessee’s legally enforceable notice to exercise its purchase \noption will result in sale s-type lease classification for the modified lease by the \nlessor. This is because the transfer- of-ownership criterion (see ‘Part A’ tests in \nparagraph 7.2.30) will be met. Any required lease payments between the \nnotification and exercise dates and the exer cise price of the purchase option \nwill be included in the l essor’s net investment in the modified lease. \nSections 7.6.2, 7.6.3 and 7.6.4 provide guidance about lessor accounting for \nlease modifications depending on whether the pre- modification lease was \nclassified as operating, direct financing or sales -type, respectively . \n \n Example 7.6.07\*\* \nModification date – lessee fails to give termination \nnotice \nLessee LE leases a building from Lessor LR for a noncancellable period of five \nyears that commenced on January 1, 20X1. The lease automatically renews for \na second five- year period starting January 1, 20X6 if LE does not notify LR of its \nintention to vacate the building on or before June 30, 20X5. \nAt lease commencement, LR appropriately conclud ed that LE was not \nreasonably certain to extend the lease beyond the noncancellable five- year \nperiod. Therefore, the lease term was five years. LR also appropriately \nconcluded the lease was an operating lease (see section 7.2). \nThrough June 30, 20X5, LE does not notify LR of its intent to end the lease at \nthe end of the noncancellable five- year period. No other lease modifications \nhave occurred to that point, such that the remaining lease term is six months. \nBy not submitting notice to LR, LE has, as of June 30, 20X5, enforceably \nelected to renew the lease for the five- year renewal period (i.e. just as if LE had \nsent an affirmative renewal confirmation to LR). Therefore, consistent with paragraph 7.6.90, LR ac counts for LE’s election to renew the lease, which was \nnot reasonably certain, as a lease modification. The ‘effective date of the modification’ is June 30, 20X5; therefore, it would be inappropriate for LR not to \naccount for the lease modification as of J une 30, 20X5 in this scenario. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 723}), Document(page\_content='Leases 723 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Assuming the modified lease remains an operating lease, LR accounts for the \nlease modification in the same manner as any other operating lease \nmodification in which the modified lease remains an operating lease (see \nsection 7.6.2). \n \n7.6.2 Operating lease modifications \n7.6.100 If an operating lease is modified and the modification does not result in a \nseparate contract, the lessor accounts for the modification as if the original \nlease is terminated, and a new lease comm ences on the effective date of the \nmodification. [842- 10-25-15] \nOperating\nOperatingOperating\nSales -type or \ndirect financingOriginal Lease Requirements Modified Lease\nLessor includes any prepaid or \naccrued lease rentals relating to the original lease in the lease \npayments for the modified lease .\nLessor derecognizes any deferred \nrent liability or accrued rent asset and adjusts the selling profit (loss) \naccordingly , which is deferred in \nthe case of a direct financing lease .\n \n \n Example 7.6.08 \nLessor operating lease modification – rent deferral \nLessor LR is a lessor of a residential building and enters into a 12- month lease \nwith Lessee LE that runs from January 1 to December 31. Lease payments of \n$100 are due on the first of each month of the lease term, and there are no \nother components of the contract. LR classifies the lease as an operating lease \non the basis that none of the s ales-type classification criteria are met and there \nis no third -party residual value guarantee. Collectibility of at least substantially all \nthe lease payments is considered probable at lease commencement. \nLE paid the January – March rent timely; however, LE does not make the $100 \nApril 1 payment. As a result, LR records a $100 operating lease receivable on its \nbooks. \nOn April 30, LR and LE agree to a deferred payment plan whereby LE will repay \nthe $100 April rent over the period June through September 2020 ($25 extra \nper month, in addition to the $100 rent owed for each of those months). The \nlease remains classified by LR as an operating lease. \nAssuming collectibility of substantially all the lease payments remains probable \n(see Section 7.5), the $100 recei vable remains recognized by LR post -\nmodification (see paragraph 7.6.100). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 724}), Document(page\_content='Leases 724 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The amount that LE will repay post -modification reduces the lease payments LR \nwill receive post -modification for purposes of calculating the total lease income \nto recognize on a str aight -line basis over the remaining 8 months of the lease \nterm (May – December) – i.e. $900 of lease payments for April through \nDecember less the $100 for April equals $800 to straight -line. Effectively, there \nis no change in lease revenue that will be rec ognized by LR each month \nthroughout the remainder of lease from what it would have recognized pre-\nmodification. \nLR’s lease revenue and lease receivable recognition for April – December of the \nlease will be as follows: \nMonth Lease \nrevenue \n(straight -\nline) Lease \npayments \nreceived Receivable \nat end of \nmonth \nApril $ 100 $ - $ 100 \nMay 100 100 100 \nJune 100 125 75 \nJuly 100 125 50 \nAugust 100 125 25 \nSeptember 100 125 - \nOctober 100 100 - \nNovember 100 100 - \nDecember 100 100 - \nIt would not be appropriate for LR to write off the $100 receivable against April lease revenue (resulting in no April lease revenue for this lease) and recognize \nthe deferred April lease payment ($100) together with the May through \nDecember rent ($800 in total) on a straight -line basis over May through \nDecember (approximately $112 per month). \n \n Question 7.6.10 \nCo-tenancy clauses – lessor \nHow should a lessor account for a co- tenancy clause that \nreduces the lessee’s rent when it is triggered? \nBackground: Many retail leases include co -tenancy clauses that reduce the \ntenant’s contractual rent if, for example, a key (or anchor) tenant (e.g. a \ndepartment or ‘big box’ store) or a certain number of tenants vacate the \nproperty. Typically, these clauses stipulate that the tenant must resume paying \nthe contractual rent either after a specified period of time or when the co-\ntenancy event is cured (e.g. a new anchor tenant occupies the relevant space \nvacated by the previous anchor tenant ). \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 725}), Document(page\_content='Leases 725 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Key tenants and a minimum l evel of overall occupancy help to draw customer \ntraffic to retail properties such as shopping malls. Therefore, the presence of \none or more key tenants and/or a high level of overall occupancy of a retail \nproperty generally benefits all tenants within the mall and is an important \nconsideration for a lessee when deciding where to lease a space (and how much the lessee is willing to pay in rent). Co- tenancy clauses serve to protect \nlessees from a potential drop in sales when a key tenant vacates its space or \noverall occupancy of the retail property declines. \nUnder an example co -tenancy clause, the lessee’s fixed rental payments for a \nfive-year retail space lease (e.g. $1,000 per year in arrears) may convert to a \npayment based solely on a percentage of the les see’s sales from the retail \nspace (e.g. 5% of sales) for a specified period of time or until the co -tenancy \nevent is cured. In that way, the lessee and the lessor share the risk that the \nco-tenancy event will adversely affect the lessee’s sales from the leased \nretail space. \nInterpretive response: At lease commencement, we believe the lessor’s \naccounting for the lease should not consider the co- tenancy clause being \ntriggered . \nIn the background example, the lessor would measure the lease payments at \n$5,000 ($1,000 × 5 years) – i.e. without consideration of the possibility that the \nlessee’s ultimate payments during the lease could differ from that if the co-\ntenancy clause is triggered. \nIf the co- tenancy clause is triggered during the lease term, this would not be \nconsidered a lease modification by the lessor because: \n[842 Glossary, 842- 10-35-3] \n— there has been no change to the terms and condit ions of the lease; and \n— the lessee has not exercised an option to extend the lease or purchase the underlying asset it was not reasonably certain to exercise previously. \nTherefore, the lease would not be remeasured. Instead, the difference between the lessee’s actual payments (i n the background example, based on 5% of the \nlessee’s sales from the retail space) and the fixed payment that would have \napplied if the co- tenancy clause had not been triggered should be treated as \nnegative variable rent. \nUsing the background example, ass ume the co- tenancy clause is triggered at \nthe beginning of Year 3 and is not cured during the year. If the lessee’s rent \npayment for the year is $800 ($16,000 in store sales × 5%), the lessor would \nrecognize straight -line operating lease income of $1,000 a nd negative variable \nlease income of ($200), which would net to operating lease income of $800 in \nthe income statement . \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 726}), Document(page\_content='Leases 726 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 7.6.20 \nLessee exercise of options other than to extend the \nlease or purchase the underlying asset \nHow does a lessor account for lessee exercise of an option \nother than to extend the lease or purchase the underlying \nasset? \nBackground: Topic 842 requires that w hen a lessee exercises an option to \nextend a lease or to purchase the underlying asset that the lessor previously \ndeter mined the lessee was not reasonably certain to exercise, the lessor \naccounts for the exercise of that option as a lease modification (see paragraph \n7.6.80) . [842- 10-35-3] \nTopic 842 does not specifically address other lessee options that may exist in a \nlease contract. In an example of one such option, Lessor LR leases equipment \nto Lessee LE for three years. The contractual payments for the lease include a \nfixed ($80/month) a nd a variable (per usage) element. However, LE has a \nunilateral option under the contract to increase the fixed payments to \n$100/month and eliminate the per usage variable fees. It can exercise this \noption before the start of any month to which the new pay ment structure \nwould apply. LE’s exercise of the option is irreversible – i.e. it cannot revert to \nthe fixed and variable payment structure. \nThe question therefore arises as to LR’s accounting if, at the end of Year 1, LE \nexercises the option such that LE will make fixed $100/month payments for the \nremaining 24 months of the lease and no variable, per -usage payments. \nInterpretive response: In the absence of specific lessor guidance around \nlessee options other than those to extend the lease or purchase the underlying \nasset, we believe it is appropriate for a lessor to analogize to that guidance. \nThat is, we believe a lessor should account for a lessee’s exercise of any \nunilateral lessee option not already factored into the lessor’s pre- exercise lease \naccount ing, such as illustrated in the background example, as a lease \nmodification. \nWe believe this is consistent with the US GAAP principle of first looking to other authoritative GAAP that applies to the entity for similar transactions or \nevents when there is no authoritative US GAAP guidance for the specific \ntransaction or event in que stion. In this case, the guidance referred to in the \nbackground applies to all lessors, and we believe a lessee’s exercise of an option such as that described in the background, albeit a different type of option, is a similar transaction or event. \n[105-10-05-2] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 727}), Document(page\_content='Leases 727 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 7.6.3 Direct financing lease modifications \n7.6.110 Lessor accounting for a direct financing lease modification that does not \nresult in a separate contract can be summarized as follows. [842- 10-25-16] \nModified lease is :\nCarrying amount of underlying asset \n= \nNet investment in original lease \nimmediately before effective date of modificationOperating lease\nAccount for modified lease in accordance with sales -\ntype lease guidance in Subtopic 842-30 with effective \ndate of modification as commencement date of lease1Sales -type lease\nDirect financing leaseAdjust discount rate so initial net investment in \nmodified lease \n= \nCarrying amount of net investment in original lease \nimmediately before effective date of modification \nNote : \n1. In calculating the selling profit (loss) on the lease (see paragraph 7.3.40): \n— the fair value of the underlying asset is its fair value at the effective date of the \nmodification; and \n— the carrying amount of the underlying asset is the carrying amount of the net investment in the original lease immediately before the effective date of the \nmodification. \n \n7.6.4 Sales -type lease modifications \n7.6.120 Lessor accounting for a sales -type lease modification that does not \nresult in a separate contract can be summarized as follows. [842- 10-25-17] \nCarrying amount of underlying asset \n= \nNet investment in original lease \nimmediately before effective date of modification\nSales -type or direct \nfinancing leaseAdjust discount rate so initial net investment in \nmodified lease \n= \nCarrying amount of net investment in original lease \nimmediately before effective date of modification Modified lease is :\nOperating lease\n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 728}), Document(page\_content='Leases 728 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 7.6.10 \nModification accounting – operating lease remains \nan operating lease \nOriginal lease \nLessee LE enters into a four -year lease with Lessor LR to lease a new crane for \nuse in a construction project that LE expects will take four years to complete. \nLR also agrees to maintain the crane throughout the lease term. \nPayments: Fixed payments of $60,000 per year in \narrears \nRenewal/purchase options: No \nTransfer of ownership: None \nFair value of crane: $500,000 \nRemaining economic life of crane: 15 years \nThe lease is an operating lease; it does not meet any of the criteria to be classified as a sales- type or direct financing lease. \nLR is required to allocate the consideration in the contract to the separate lease \nand non- lease components based on each component’s stand- alone selling \nprice (see chapter 4). LR allocates the consideration in the contract as follows. \nComponent Stand -alone \nprice Allocation Calculation \nCrane lease $230,000 $220,800 (230,000 / 250,000) × 240,000 \nMaintenance 20,000 19,200 (20,000 / 250,000) × 240,000 \n $250,000 $240,000 \nTotal consideration in the contract allocated to the lease component is $220,800, and therefore the lease payments equal $220,800. LR will recognize \nannual lease income of $55,200 ($220,800 / 4 years). LR will account for the \nnon-lease component in accorda nce with Topic 606. \nLease modification \nAt the beginning of Year 4, the construction project is expected to take three \nmore years to complete, and LE and LR agree to extend the original lease by \ntwo years – i.e. the original four -year lease is extended to s ix years. \nThe additional two years were not an option when the original lease was \nnegotiated. The modification alters LE’s right to use the crane, but it does not \ngrant LE an additional right of use (see paragraph 7.6.60). Therefore, LR does \nnot account f or the modification as a separate contract. \nAt the effective date of the modification ( the beginning of Year 4 when LE and \nLR agree to the modification), the annual payments increase to $70,000, which \nincludes the annual maintenance services. Total consideration in the modified \ncontract for the remainder of the lease term is now $210,000 ($70,000 × \n3 years). The modified lease continues to be classified as an operating lease ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 729}), Document(page\_content='Leases 729 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. based on the remaining lease term (3 years) as compared to the remaining \neconomic l ife of the crane (12 years) and the fair value of the crane ($375,000). \nFor simplicity, assume that the stand -alone selling prices for a three- year lease \nand the related maintenance services at the beginning of Year 4 are the same \nas the stand -alone sellin g prices for the original four -year lease and the original \nfour years of maintenance services. LR reallocates the remaining consideration \nin the modified contract at the effective date of the modification as follows. \nComponent Stand -alone \nprice Allocation Calculation \nCrane lease $230,000 $193,200 (230,000 / 250,000) × 210,000 \nMaintenance 20,000 16,800 (20,000 / 250,000) × 210,000 \n $250,000 $210,000 \nThe remaining consideration in the contract allocated to the lease component is \n$193,200, and therefore the remaining lease payments for the modified lease \nequal $193,200. Consequently, LR will recognize annual lease income of \n$64,400 ($193,200 / 3 years) for the three years remaining on the lease. LR will \ncontinue to account for the non- lease component in accordance with Topic 606. \n \n Example 7.6.20 \nModification accounting – sales -type lease remains \na sales -type lease \nOriginal lease \nLessee LE enters into a 15- year lease for a passenger aircraft with Lessor LR. \nThe following facts are relevant at the commencement date. \nPayments: Fixed payments of $1 million per year in arrears \nRenewal/purchase options: None \nTransfer of ownership: No \nFair value and carrying amount of aircraft: $10 million \nRemaining economic life of aircraft: 17 years \nEstimated future residual value: $2 million \nRate implicit in the lease: 6.76% \nAt the commencement date, the lease term is for the major part (i.e. ≥ 75%) of \nthe remaining economic life of the aircraft (it represents 88%). In addition, the \npresent value of the lease payments amounts to substantially all (i.e. ≥ 90%) of \nthe fair value of the aircraft (it represents $9.25 million, or 93% of the aircraft’s \nfair value) . Accordingly, the lease is classified as a sales- type lease (see \nflowchart in paragraph 7.2.30). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 730}), Document(page\_content='Leases 730 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Lease modification \nAt the beginning of Year 3, LE decides to gradually phase this aircraft model out \nof its fleet. LE asks LR to renegotiate the terms of the lease and LR agrees to a \nmodification. The following facts are relevant at the effective date of the \nmodification. \nRemaining lease term: 8 years \nRemaining lease payments: Fixed payments of $1.025 million per \nyear in arrears \nRenewal/purchase options: None \nTransfer of ownership: No \nFair value of aircraft: $9.35 million \nCarrying amount of net investment in the lease: $9.33 million \nEstimated future residual value: $5.5 million \nResidual value guarantee (lessee): $5 million \nRate implicit in the lease: 6.94% \nThe present value of the lease payments, plus the present value of the \nguaranteed residual value, is $9.06 million, or 97% of the fair value of the \naircraft. Because the sum of (a) the present value of the lease payments and (b) \nthe present v alue of the lessee residual value guarantee continues to equal or \nexceed substantially all the fair value of the aircraft, the lease continues to be a \nsales- type lease (see diagra m in 7.2.30). \nOn the effective date of the modification, LR carries forward t he balance of the \nnet investment in the lease from immediately before the effective date of the modification of $9.33 million as the opening balance of the net investment in \nthe modified lease. \nTo retain the same net investment in the lease even though the lease \npayments, the lease term and the estimated residual value have all changed, LR \nadjusts the discount rate for the lease from the rate implicit in the modified \nlease of 6.94% to 6.98%. This adjusted rate of 6.98% is used to calculate \ninterest income o n the net investment in the lease throughout the remaining \nterm of the modified lease and will result, at the end of the modified lease \nterm, in a net investment balance that equals the estimated residual value of the underlying asset (guaranteed + unguara nteed) of $5.5 million. \n \n Example 7.6.30 \nModification accounting – direct financing lease \nbecomes an operating lease \nOriginal lease \nLessee LE enters into a four -year lease for a piece of new, non- specialized \nequipment with Lessor LR. The following facts are relevant at the lease commencement date. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 731}), Document(page\_content='Leases 731 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Lease payments: Fixed payments of $17,000 per year in arrears \nRenewal/purchase options: None \nTransfer of ownership: No \nFair value and carrying amount of equipment: $80,000 \nRemaining economic life of equipment: 12 years \nEstimated future residual value: $24,000 \nResidual value guarantee (third party): $18,000 \nRate implicit in the lease: 5.01% \nIn addition, both LE and the third- party residual value guarantor (unrelated to LR) \nare creditworthy counterparties. \nThe lease does not meet any of the criteria to be classified as a sales -type lease \n(see flowchart in paragraph 7.2.30). Therefore, the lease is classified as a direct \nfinancing lease because the sum of (a) the present value of the lease payments \n($60,264) and (b) the present value of the third -party residual value guarantee \n($14,802) is substantially all (94%) of the fair value of the equipment ($75,066 / \n$80,000), and collectibility of the lease payments, plus any amount from t he \nthird party necessary to satisfy the residual value guarantee, is probable. \nAt the lease commencement date, LR recognizes the following journal entry. \n Debit Credit \nLease receivable 75,066 \nUnguaranteed residual asset 4,934 \nPP&E – equipment 80,000 \nTo recognize direct financing lease. \nAt the end of Year 1, LR receives a lease payment of $17,000 from LE and \nrecognizes interest income of $4,009 ($80,000 × 5.01%). Therefore, the \ncarrying amount of the net investment in the lease is $67,009 ($80,000 + \n$4,009 – $17,000). \nLease modification \nAt the beginning of Year 3, LE and LR agree to modify the lease to extend the \nterm by two years – i.e. the original four -year lease is extended to six years \ntotal. \nThe following facts are relevant at the effective date of the modification. \nLease payments: Fixed payments of $17,000 per year in arrears \nRenewal/purchase options: None \nTransfer of ownership: No \nFair value of equipment: $65,000 \nRemaining economic life of equipment: 12 years \nCarrying amount of net investment in the lease: $53,368 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 732}), Document(page\_content='Leases 732 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Estimated future residual value: $16,000 \nResidual value guarantee: None \nRate implicit in the lease: 9.88% \nThe modified lease does not transfer title of the equipment to LE, and it does \nnot meet any of the other criteria to be classified as a sales -type lease or the \ncriteria to be classified as a direct financing lease (see flowcharts in \nparagraphs 7.2.30 and 7.2.50). Theref ore, the modified lease is classified as an \noperating lease and, at the effective date of the modification, LR derecognizes \nthe net investment in the lease, and recognizes the equipment at that amount. \n Debit Credit \nPP&E – equipment 53,368 \nNet investment in the lease 53,368 \nTo recognize direct financing lease. \nBecause collectibility of the lease payments is still probable (i.e. LE remains a \ncreditworthy counterparty), LR will recognize the $68,000 ($17,000 × 4 years) in \nlease payments on a straight -line basis over the four -year remaining term of the \nmodified lease. LR will also recognize depreciation on the equipment. \n \n Observation \nLessor vs. lessee modifications guidance \n7.6.130 The lessee and lessor modifications guidance is not aligned either \nconceptually or mechanically. For example, the lessee modifications guidance is \nbased on the view that time periods within a lease are not distinct from each \nother, that the lessor transfers a ‘good’ (i.e. a n ROU asset) at lease \ncommencement. In contrast, the lessor modifications guidance is based on the \ncost-benefit decision to account for most leases as executory contracts (see \nparagraphs 7.4.30 – 7.4.40), and therefore each period within a lease (e.g. each \nday, month, year) is distinct from those periods that precede it. \n7.6.14 0 The fact that the supplier (lessor) and customer (lessee) modification \nmodels are not symmetrical is consistent with the fact that the core lessee and \nlessor accounting models are not symmetrical within Topic 842. Instead, the \nBoard concluded, for both conceptual and practical reasons, that the lessor \nmodifications guidance should be premised on the contract modifications \nguidance in Topic 606. [ASU 2016- 02.BC179] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 733}), Document(page\_content='Leases 733 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Observation \nLessor modifications guidance substantially aligns \nwith new revenue standard \n7.6.15 0 The generally prospective accounting for lessor lease modifications, \nincluding the guidance on when to account for a modification as a separate \ncontract, is substantially aligned with the contract modifications guidance in \nTopic 606, which also accounts prospectively for modifications in which the \nremaining goods or services to be transferred after the modification are distinct \nfrom those transferred before the modification. Similarly, Topic 606 accounts \nfor a modification that adds one or more distinct goods or services as a \nseparate contract if the increase in the transaction price is commensurate with \nthe stand- alone selling price for the additional distinct good(s) or service(s) ; see \nchapter 11 of KPMG Handbook, Revenue recognition. [ASU 2016- 02.BC179] \n7.6.16 0 Aligning the modifications guidance makes the accounting for \nmodifications to contracts that include lease and non- lease components simpler \nthan under Topic 840 in which the modification guidance was not aligned with \nTopic 605. [ASU 2016- 02.BC179] \n \n Comparison to legacy US GAAP \nLessor modifications guidance substantially changed \n7.6.17 0 The Board received feedback that the lessor lease modification \nrequirements under Topic 840 were overly complex. Topic 842 introduces more \ndetailed, operable and understandable guidance for how a lessor should \naccount for a lease modification, including illustrative examples , and is \nsubstantially aligned with the contract modifications model in Topic 606. [840- 10-\n25-51 – 25-52, 840- 30-35-26 – 35-30] \nOperating lease modifications that do not change the lease classification \n7.6.18 0 Topic 842 modifications to an operating lease that does not (1) qualify to \nbe accounted for as a separate contract and (2) change lease classification are \naccounted for in a manner substantially similar to lessor accounting for \nmodifications of this nature under Topic 840. \n \n7.7 Financial statement presentation \n Excerpt from ASC 842 -30 \n45 Other Presentation Matters \nGeneral \n> Sales -Type and Direct Financing Leases \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 734}), Document(page\_content='Leases 734 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. >> Statement of Financial Position \n45-1 A lessor shall present lease assets (that is, the aggregate of the lessor’s \nnet investment in sales -type leases and direct financing leases ) separately \nfrom ot her assets in the statement of financial position. \n45-2 Lease assets shall be subject to the same considerations as other assets \nin classification as current or noncurrent assets in a classified balance sheet. \n>> Statement of Comprehensive Incom e \n45-3 A lessor shall either present in the statement of comprehensive income \nor disclose in the notes income arising from leases . If a lessor does not \nseparately present lease income in the statement of comprehensive income, \nthe lessor shall disclo se which line items include lease income in the \nstatement of comprehensive income. \n45-4 A lessor shall present any profit or loss on the lease recognized at the \ncommencement date in a manner that best reflects the lessor’s business \nmodel(s). Examples of presentation include the following: \na. If a lessor uses leases as an alternative means of realizing value from the \ngoods that it would otherwise sell, the lessor shall present revenue and \ncost of goods sold relating to its leasing activities in separate line items so \nthat income and expenses from sold and leased items are presented \nconsistently. Revenue recognized is the lesser of: \n1. The fair value of the underlying asset at the commencement date \n2. The sum of the lease receivable and any lease payments prepaid by \nthe lessee. \nCost of goods sold is the carrying amount of the underlying asset at the \ncommencement date minus the unguaranteed residual asset . \nb. If a lessor uses leases for the purposes of providing finance, the lessor \nshall present the profit or loss in a single line item. \n>> Statement of Cash Flows \n45-5 In the statement of cash flows, a lessor shall classify cash receipts from \nleases within operating activities. However, if the lessor is within the scope of \nTopic 942 on financial services –-depository and lending, it shall follow the \nguidance in paragraph 942- 230-45-4 for the presentation of principal payments \nreceived from leases. \n> Operating Leases \n>> Statement of Financial Position \n45-6 A lessor shall present the underlying asset subject to an operating \nlease in accordance with other Topics. \n>> Statement of Cash Flows \n45-7 In the statement of cash flows, a lessor shall classify cash receipts from \nleases within operating activities. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 735}), Document(page\_content='Leases 735 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Excerpt from ASC 942 -230 \n45 Other Presentation Matters \n45-4 Entities within the scope of this Subtopic shall classify principal payments \nreceived under sales -type and direct financing leases within investing activities. \n \n7.7.1 0 A lessor is required to present the following items arising from leases in \nthe scope of Topic 842. \nBalance sheet \nSales -type and \ndirect financing \nleases Present the net investment in sales -type and direct financing \nleases separately from other assets. \nThe net investment is subject to the same classification \nconsiderations as other assets on a classified balance sheet \n– i.e. current versus noncurrent1. \nOperating leases Present the underlying asset and related depreciation \nexpense in accordance with other US GAAP (e.g. Topic 360), \nas applicable. \nIncome statement \nAll leases Present lease income separately or disclose the line item(s) \nin the income statement in which lease income is included. \nSales -type and \ndirect financing \nleases Present selling profit or loss recognized at lease \ncommencement in a manner that best reflects the lessor’s \nbusiness model (see paragraph 7.7.20). \nStatement of cash flows2 \nAll leases Classify all cash receipts from leases as cash flows from \noperat ing activities . An exception applies if the lessor is a \nfinancial institution in the scope of Topic 942 and the lease is \na sales- type or direct financing lease.3 [842- 30-45-5, 942- 230-\n45-4] \nNote s: \n1. See section 12.3 for the financial statement disclosures required for the components of \nthe total net investment in sales- type and direct financing leases – i.e. the carrying \namount of lease receivables, unguaranteed residual assets and any deferred selling profit on direct financing leases. \n2. For additional and more detailed guidance on lessor reporting of leases in the statement \nof cash flows see Chapter 14 of KPMG Handbook, Statement of cash flows . \n3. See Question 7.7.10. \n7.7.20 If the lessor uses leases as an alternative to selling (e.g. many \nmanufacturers and dealers), the lessor presents profit or loss at lease \ncommencement on a gross basis as separate line items – i.e. as revenue and \ncost of goods sold. Revenue and cost of goods sold are recognized as follows. \n[842- 30-45-4(a)] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 736}), Document(page\_content='Leases 736 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Sum of lease \nreceivable and any \nprepaid lease \npaymentsRevenue\nCarrying amount of \nunderlying asset at \ncommencement dateFV of underlying\nasset at \ncommencement dateor\nUnguaranteed assetCost of \ngoods soldthe lesser of\n \n7.7.30 If the lessor uses lease arrangements for the purpose of providing \nfinancing, the lessor presents profit or loss at lease commencement on a net \nbasis in a single line item (e.g. as a gain within other income). [842- 30-45-4(b)] \n \n Question 7.7.10 \nCash payments received for sales -type and direct \nfinancing leases \nMay a lessor classify cash payments from a lessee for a sales -\ntype or direct financing lease as cash received from investing \nactivities in its statement of cash flows? \nInterpretive response: No, unless the lessor is a financial institution in the \nscope of Topic 942 (financial services – depository and lending) . Despite the \nfact that some lessors adopted that practice under Topic 840, Topic 842 is \nexplicit that all cash payments from leases are classified in the statement of \ncash flows as cash received from operating activities. [842- 30-45-5, 45- 7] \nFor financia l institutions in the scope of Topic 942, the following guidance \napplies . [842- 30-45-5, 942- 230-45-4] \nLease is classified as … \nSales -type or direct financing Operating \n— Classify the principal portion of \nlessee payments received as cash \nflows from investing activities . \n— Classify the interest portion of \nlessee payments received as cash \nflows from operating activities . — Classify all lessee payments \nreceived as cash flows from \noperating activities . \n \n \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 737}), Document(page\_content='Leases 737 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 7.7.20 \nPresentation and classification of initial direct costs \nHow should a lessor present initial direct costs on a classified \nbalance sheet? \nInterpretive response: \nSales -type and direct financing leases \nFor sales -type and direct financing leases, deferred initial direct costs are \nbifurcated into current and noncurrent portions because they are part of the \nlessor’s net investment in the lease (see paragraph 7.3.60), which is required to \nbe bifurcated (see paragraph 7.7.10). [842- 30-45-2] \nOperating leases \nFor an operating lease, a lessor’s initial direct costs are deferred at the \ncommencement date and recognized as an expense over the lease term on the \nsame basis as le ase income (see paragraphs 7.4.10 – 7.4.20). \nBecause lessors do not recognize a net investment in the lease for operating \nleases, initial direct costs are recognized as a separate asset on the balance \nsheet. Consistent with our view of costs to obtain a co ntract that are capitalized \nin accordance with Subtopic 340- 40 (other assets and deferred costs – \ncontracts with customers), we believe initial direct costs are akin to a customer \nrelationship intangible asset and generally should be presented similarly. \nAccordingly, we believe it is preferable for lessors not to bifurcate initial direct \ncost assets arising from operating leases into current and noncurrent portions. \nHowever, because Topic 842 does not specify whether to classify initial direct \ncost assets arising from operating leases for lessors , and because we have \nobserved diversity in practice for the balance sheet presentation of contract \ncost assets under Subtopic 340- 40, we believe such bifurcation also would be \nacceptable as an accounting policy election applied to all of a lessor’s initial direct cost assets. \n \n Question 7.7.30 \nSeparate income statement presentation of tenant \nreimbursements \nIs a lessor that elected the lessor non- separation practical \nexpedient permitted to separately present tenant \nreimbursements in its income statement? \nBackground : Under Topic 840, lessors (particularly real estate lessors) \nfrequently adopted a practice for net leases (see paragraph 7.3.170) of \npresenting the following separately: \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 738}), Document(page\_content='Leases 738 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — revenue from the base renta l payments due under a lease; and \n— tenant reimbursem ents of lessor executory costs such as property taxes, \ninsurance and maintenance (including common area maintenance). \nMany lessors have elected (or will elect) the practical expedient to not separate \nlease and non- lease components (see paragraphs 4.4.51 – 4.4.57). In addition, \nas discussed in paragraph 7.3.190, lessors are required to recognize tenant \nreimbursements of lessor costs on a gross basis (i.e. as additional lease \nrevenue). Some of these lessors have questioned whether it is acceptable \nunder Topic 842 to continue to present the revenue from the base rental payments due under a lease separately from tenant reimbursements of lessor \nproperty tax, insurance and/or common area maintenance (CAM) costs. \nInterpretive response: No. If a lessor has elected the non- separation practical \nexpedient, it is not permitted to present these tenant reimbursements \nseparately from the lease revenue related to the base rent. This is because all \nof the payments (base re nt payments and tenant reimbursements) relate to a \nsingle lease (or non- lease – see paragraph 4.4.53) component. It would not be \nappropriate to separately present revenue from the two different payment streams for the same component. \nHowever, there is one exception that might apply. As discussed in \nparagraph 4.4.52, a contract might contain a non- lease component that does not \nqualify for the non- separation practical expedient. In that case, any portion of a \ntenant’s reimbursements appropriately allocated t o that non- lease component \nmay be recognized in an income statement line item separate from the lessor’s \nlease revenue. For example, a portion of a variable payment for the reimbursement of lessor property taxes may – depending on the facts and \ncircumstances – be allocated to a non- lease component such as a supply of \ngoods that is not eligible to be combined with the lease component, and is \nrequired to be presented in an income statement line item different from where \nthe lessor presents revenue for the lea se. \nQuestion 12.3.20 discusses a related question about the separate disclosure of \ntenant reimbursements. \n \n Comparison to legacy US GAAP \nCash receipts from sales -type/direct financing leases \n7.7.40 Under Topic 842, a lessor (other than a financial institution in the scope of \nTopic 942 – see Question 7.7.10) classifies all cash receipts from leases as cash \nflows from operating activities. This may be a difference for some lessors that \npreviously classified cash receipts from sales- type or direct financing leases as \ncash flows from investing activities. \nLessor presentation requirements generally consistent with Topic 840 \n7.7.50 In all other respects, the lessor financial statement presentation \nrequirements in Topic 842 are substantial ly the same as those in Topic 840. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 739}), Document(page\_content="Leases 739 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 7.8 Leveraged l eases \n Excerpt from ASC 842 -50 \n20 Glossary \nLeveraged Lease \nFrom the perspective of a lessor , a lease that was classified as a leveraged \nlease in accordance with the leases guidance in effect before the effective \ndate and for which the commencement date is before the effective date . \n \n Excerpt from ASC 84 0-10 \n25 Recognition \nLessors \n> Lessor App lication of Lease Classification Criteria \n25-43 If the lease at inception meets any of the four lease classification criteria \nin paragraph 840- 10-25-1 and both of the criteria in the preceding paragraph, it \nshall be classified by the lessor as a sal es-type lease, a direct financing lease, a \nleveraged lease, or an operating lease as follows: \na. a. Sales -type lease. A lease is a sales- type lease if it gives rise to \nmanufacturer’s or dealer’s profit (or loss) to the lessor (that is, the fair value \nof the leased property at lease inception is greater or less than its cost or \ncarrying amount, if different) and meets either of the following conditions: \n1. It invol ves real estate and meets the criterion in paragraph 840- 10-25-\n1(a) (in which circumstance , neither of the criteria in paragraph 840- 10-\n25-42 applies). \n2. It does not involve real estate and meets any of the criteria in paragraph \n840-10-25-1 and both of the criteria in paragraph 840- 10-25-42. \nFor implementation guidance on the interaction of lease classification and \nlessor activities, see paragraph 840- 10-55-41. \na. Direct financing lease. A lease is a direct financing lease if it meets all of \nthe following conditions: \n1. It me ets any of the criteria in paragraph 840- 10-25-1 and both of the \ncriteria in the preceding paragraph. \n2. It does not give rise to manufacturer's or dealer's profit (or loss) to the \nlessor. \n3. It does not meet the criteria for a leveraged lease in (c). \nb. Leveraged lease. Leases that meet the criteria of sales -type leases set \nforth in (a) shall not be accounted for as leveraged leases but shall be \naccounted for as prescribed in paragraph 840- 30-25-6. A lease is a \nleveraged lease if it has all of the following characteristics: \n1. It meets the criteria in (b)(1) a nd (b)(2) for a direct financing lease. \n2. It involves at least three parties: a lessee, a long -term creditor, and a ", metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 740}), Document(page\_content="Leases 740 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. lessor (commonly called the equity participant) . \n3. The financing provided by the long -term creditor is nonrecourse as to \nthe general credit of the lessor (although the creditor may have \nrecourse to the specific property leased and the unremitted rentals \nrelating to it). The amount of the financing is sufficient to provide the \nlessor with substantial leverage in the transaction. \n4. The less or's net investment (see paragraph 840- 30-25-8) declines \nduring the early years once the investment has been completed and \nrises during t he later years of the lease before its final elimination. Such \ndecreases and increases in the net investment balance ma y occur \nmore than once. \n \n Excerpt from ASC 842-50 \n25 Recognition \nGeneral \n25-1 A lessor shall record its investment in a leveraged lease. The net of the \nbalances of the following accounts as measured in accordance with this \nSubtopic shall represent the lessor’s initial and continuing investment in \nleveraged leases: \na. Rentals receivable \nb. Investment -tax-credit receivable \nc. Estimated residual value of the leased asset \nd. Unearned and deferred income. \n25-2 In a business combination or an acquisition by a not -for-profit entity , \nthe acquiring entity shall retain the classification of the acquired entity’s \ninvestment as a lessor in a leveraged lease at the date of the combination. \nThe net investment of the acqui red leveraged lease shall be disaggregated into \nits component parts, namely net rentals receivable, estimated residual value, \nand unearned income including discount to adjust other components to \npresent value. \n30 Initial Measurement \nGeneral \n30-1 A lessor shall initially measure its investment in a leveraged lease net of \nthe nonrecourse debt (as discussed in paragraph 842- 50-25-1). The net of the \nbalances of the following accounts shall represent the initial and continuing \ninvestment in leveraged leas es: \na. Rentals receivable, net of that portion of the rental applicable to principal \nand interest on the nonrecourse debt. \nb. A receivable for the amount of the investment tax credit to be realized on \nthe transaction. \nc. The estimated residual value of the leased asset. The estimated residual \nvalue shall not exceed the amount estimated at lease inception except if \nthe lease agreement includes a provision to escalate minimum lease \npayments either for increases in construction or acquisition cost of the ", metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 741}), Document(page\_content='Leases 741 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. leased prope rty or for increases in some other measure of cost or value \n(such as general price levels) during the construction or preacquisition \nperiod. In that case, the effect of any increases that have occurred shall be \nconsidered in the determination of the estima ted residual value of the \nunderlying asset at lease inception. \nd. Unearned and deferred income consisting of both of the following: \n1. The estimated pretax lease income (or loss), after deducting initial \ndirect costs, remaining to be allocated to income over t he lease term . \n2. The investment tax credit remaining to be allocated to income over the \nlease term. \n30-2 In a business combination or an acquisition by a not -for-profit entity , \nthe acquiring entity shall assign an amount to the acquired net investment in \nthe leveraged lease in accordance with the general guidance in Topic 805 on \nbusiness combinations, based on the remaining future cash flows and giving \nappropriate recognition to the estimated future tax effects of those cash flows. \n35 Subsequent Measurement \nGeneral \n> Leveraged Lease Acquired in a Business Combination or an \nAcquisition by a Not -for-Profit Entity \n35-1 In a business combination or an acquisition by a not -for-profit entity , \nthe acquiring entity shall subseque ntly account for its acquired investment as a \nlessor in a leveraged lease in accordance with the guidance in this Subtopic \nas it would for any other leveraged lease. \n35-2 The investment in leveraged leases minus deferred taxes arising from \ndifferences between pretax accounting income and taxable income shall \nrepresent the lessor’s net investment in leveraged leases for purposes of \ncomputing periodic net income from the leveraged lease. Given the original \ninvestment and using the projected cash receipts and disbursements over the \nterm of the lease, the rate of return on the net investment in the years in \nwhich it is positive shall be computed. The rate is that rate that, when applied \nto the net investment in the years in which the net investment is positive, will \ndistribute the net income to those years and is distinct from the interest rate \nimplicit in the lease. In each year, whether positive or not, the difference \nbetween the net cash flow and the amount of income recognized, if any, shall \nserve to increase or reduce the net investment balance. The use of the term \nyears is not intended to preclude application of the accounting prescribed in \nthis paragraph to shorter accounting periods. \n35-3 The net inc ome (or loss) that a lessor recognizes on a leveraged lease \nshall be composed of the following three elements: \na. Pretax lease income (or loss) \nb. Investment tax credit \nc. Tax effect of pretax lease income (or loss). \n35-4 The pretax lease income (or loss) and investment tax credit elements shall \nbe allocated in proportionate amounts from the unearned and deferred income \nincluded in the lessor’s net investment (as described in paragraph 842-50-30-\n1(d)). The tax effect of the pretax lease income (or los s) recognized shall be \nreflected in tax expense for the year. The tax effect of the difference between ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 742}), Document(page\_content='Leases 742 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. pretax accounting income (or loss) and taxable income (or loss) for the year \nshall be charged or credited to deferred taxes. \n35-5 If, at any time d uring the lease term the application of the method \nprescribed in this Subtopic would result in a loss being allocated to future \nyears, that loss shall be recognized immediately. This situation might arise in \ncircumstances in which one of the important assu mptions affecting net income \nis revised (see paragraphs 842- 50-35-6 through 35 -15). \n>> Changes in Assumptions \n35-6 Any estimated residual value and all other important assumptions \naffecting estimated total net income from the leveraged lease shall be \nreviewed at least annually. The rate of return and the allocation of income to \npositive investment years shall be recalculated from lease inception following \nthe method described in paragraphs 842- 50-35-2 through 35- 4 and using the \nrevised assumption if, during the lease term , any of the following \nconditions occur: \na. The estimate of the residual value is determined to be excessive, and the \ndecline in the residual value is judged to be other than temporary. \nb. The revision of another important assumption changes the estimated total \nnet income from the lease. \nc. The projected timing of the income tax cash flows is revised. \n35-7 The lessor shall update all assumptions used to calculate total and \nperiodic income if the lessor is performing a recalculation of the leveraged \nlease. That recalculation shall include actual cash flows up to the date of the \nrecalculation and projected cash flows following the date of recalculation. \n35-8 The accounts constituting the net investment balance shall be adjusted to \nconform to the recalculated balances, and the change in the net investment \nshall be recognized as a gain or loss in the year in which t he assumption is \nchanged. The gain or loss shall be recognized as follows: \na. The pretax gain or loss shall be included in income from continuing \noperations before income taxes in the same line item in which leveraged \nlease income is recognized. \nb. The tax effect of the gain or loss shall be included in the income tax line \nitem. \nc. An upward adjustment of the estimated residual value (including any \nguaranteed portion) shall not be made. \n35-9 The projected timing of income tax cash flows generated by the \nleveraged lease is an important assumption and shall be reviewed annually, or \nmore frequently, if events or changes in circumstances indicate that a change \nin timing has occurred or is projected to occur. The income effect of a change \nin the income tax rat e shall be recognized in the first accounting period ending \non or after the date on which the legislation effecting a rate change \nbecomes law. \n35-10 A revision of the projected timing of the income tax cash flows applies \nonly to changes or projected changes in the timing of income taxes that are \ndirectly related to the leveraged lease transaction. For example, a change in \ntiming or projected timing of the tax benefits generated by a leveraged lease as ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 743}), Document(page\_content='Leases 743 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. a result of any of the following circumstances wou ld require a recalculation \nbecause that change in timing is directly related to that lease: \na. An interpretation of the tax law \nb. A change in the lessor’s assessment of the likelihood of prevailing in a \nchallenge by the taxing authority \nc. A change in the lessor’s expectations about settlement with the taxing \nauthority. \n35-11 In contrast, as discussed in paragraph 842- 50-35-20, a change in timing \nof income taxes solely as a result of an alternative minimum tax credit or \ninsufficient t axable income of the lessor would not require a recalculation of a \nleveraged lease because that change in timing is not directly related to that \nlease. A recalculation would not be required unless there is an indication that \nthe previous assumptions about total after- tax net income from the leveraged \nlease were no longer valid. \n35-12 Tax positions shall be reflected in the lessor’s initial calculation or \nsubsequent recalculation on the recognition, measurement, and derecognition \ncriteria in paragraphs 740-10-25-6, 740- 10-30-7, and 740- 10-40-2. The \ndetermination of when a tax position no longer meets those criteria is a matter \nof individual facts and circumstances evaluated in light of all available evidence. \n35-13 If the lessor expects to enter into a settlement of a tax position relating \nto a leveraged lease with a taxing authority, the cash flows following the date \nof recalculation shall include projected cash flows between the date of the \nrecalculation and the date of any projected settlement and a projected \nsettlement amount at the date of the projected settlement. \n35-14 The recalculation of income from the leveraged lease shall not include \ninterest or penalties in the cash flows from the leveraged lease. \n35-15 Advance payments and deposits made with a taxing authority shall not \nbe considered an actual cash flow of the leveraged lease; rather, those \npayments and deposits shall be included in the projected settlement amount. \n> Effect of Alternative Minimum Tax \n35-16 An entity shall include assumptions about the effect of the alternative \nminimum tax, considering its consolidated tax position, in leveraged lease \ncomputations. \n35-17 Any difference between alternative minimum tax depreciation and the \ntax depreciation ass umed in the leveraged lease or between income \nrecognition for financial reporting purposes and alternative minimum tax \nincome could, depending on the lessor’s overall tax situation, result in \nalternative minimum tax or the utilization of alternative minimum tax credits. \n35-18 If alternative minimum tax is paid or an alternative minimum tax credit is \nutilized, the total cash flows from the leveraged lease could be changed and \nthe lessor’s net investment in the leveraged lease and income recognition \nwould be affected. \n35-19 If a change to the tax assumptions changes total estimated after -tax net \nincome, the rate of return on the leveraged lease shall be recalculated from \ninception, the accounts constituting the lessor’s net investment shall be ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 744}), Document(page\_content='Leases 744 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. adjusted, and a gain or loss sha ll be recognized in the year in which the \nassumption is changed. \n35-20 However, an entity whose tax position frequently varies between \nalternative minimum tax and regular tax shall not be required to recalculate the \nrate of return on the leveraged l ease each year unless there is an indication \nthat the original assumptions regarding total after -tax net income from the \nlease are no longer valid. In that circumstance, the entity shall be required to \nrevise the leveraged lease computations in any period in which total net \nincome from the leveraged lease changes because of the effect of the \nalternative minimum tax on cash flows for the lease. \n> Transfer of Minimum Rental Payments \n35-21 If a lessor sells substantially all of the minimum rental pa yments \nassociated with a leveraged lease and retains an interest in the residual value \nof the leased asset, the lessor shall not recognize increases in the value of the \nlease residual to its estimated value over the remaining lease term . The lessor \nshall r eport any remaining interest thereafter at its carrying amount at the date \nof the sale of the lease payments . If it is determined subsequently that the \nfair value of the residual value of the leased asset has declined below the \ncarrying amount of the inter est retained and that decline is other than \ntemporary, the asset shall be written down to fair value, and the amount of the \nwrite -down shall be recognized as a loss. That fair value becomes the asset’s \nnew carrying amount, and the asset shall not be increa sed for any subsequent \nincrease in its fair value before its sale or disposition. \n45 Other Presentation Matters \nGeneral \n45-1 For purposes of presenting the investment in a leveraged lease in the \nlessor’s balance sheet, the amount of related deferred taxes shall be \npresented separately (from the remainder of the net investment). In the \nincome statement or the notes to that statement, separate presentation (from \neach other) shall be made of pretax income from the leveraged lease, the tax \neffect of pre tax income, and the amount of investment tax credit recognized as \nincome during the period. \n> Income Taxes and Leveraged Leases \n45-2 Integration of the results of income tax accounting for leveraged leases \nwith the other results of accounting for income taxes under Topic 740 on \nincome taxes is required if deferred tax credits related to leveraged leases are \nthe only source (see paragraph 740- 10-30-18) for recognition of a tax benefit for \ndeductible temporary differences and carryforwards not rela ted to leveraged \nleases. A valuation allowance is not necessary if deductible temporary \ndifferences and carryforwards will offset taxable amounts from future recovery \nof the net investment in the leveraged lease. However, to the extent that the \namount of d eferred tax credits for a leveraged lease as determined in \naccordance with this Subtopic differs from the amount of the deferred tax \nliability related to the leveraged lease that would otherwise result from \napplying the guidance in Topic 740, that difference is preserved and is not a \nsource of taxable income for recognition of the tax benefit of deductible \ntemporary differences and operating loss or tax credit carryforwards. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 745}), Document(page\_content='Leases 745 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 45-3 This Subtopic requires that the tax effect of any difference between the \nassigned value and the tax basis of a leveraged lease at the date of a business \ncombination or an acquisition by a not -for-profit entity shall not be \naccounted for as a deferred tax credit. Any tax effects included in unearned \nand deferred income as requi red by this Subtopic shall not be offset by the \ndeferred tax consequences of other temporary differences or by the tax benefit \nof operating loss or tax credit carryforwards. However, deferred tax credits that \narise after the date of a combination shall be accounted for in the same \nmanner as for leveraged leases that were not acquired in a combination. \n50 Disclosure \n> General \n50-1 If leveraged leasing is a significant part of the lessor’s business activities \nin terms of revenue, net income, or assets, t he components of the net \ninvestment balance in leveraged leases as set forth in paragraph 842- 50-25-1 \nshall be disclosed in the notes to financial statements. \n50-2 For guidance on disclosures about financing receivables, which include \nreceivables relating to a lessor’s rights to payments from leveraged leases, see \nthe guidance in Subtopic 326- 20 on financial instruments measured at \namortized cost . \n50-3 If accounting for the effect on leveraged leases of the change in tax rates \nresults in a significant variation from the customary relationship between \nincome tax expense and pretax accounting income and the reason for that \nvariation is not otherwise apparent, the lessor shall disclose the reason for that \nvariation. \n55 Impl ementation Guidance and Illustrations \n> Implementation Guidance \n>> Leveraged Lease Involving an Existing Asset of a Regulated Entity \n55-1 Although the carrying amount of an asset acquire d previously may not \ndiffer significantly from its fair value, it is unlikely that the two will be the \nsame. However, regulated utilities have argued that the carrying amounts of \ncertain of their assets always equal the fair value based on the utility’s ab ility to \nrecover that cost in conjunction with a franchise to sell a related service in a \nspecified area. That argument is not valid when considering the value of the \nasset to a third -party purchaser that does not own that franchise. \n>> Delayed Equity Investment \n55-2 A delayed equity investment frequently obligates the lessor to make up \nthe shortfall between rent and debt service in the first several years of the \ntransaction. The type of recourse debt resulting from the delayed equity \ninvestment does not contradict the notion of nonrecourse and, therefore, does \nnot preclude leveraged lease accounting as long as other requirements of \nleveraged lease accounting are met. The lessor’s related obligation should be \nrecorded as a liability at present val ue at lease inception . \n55-3 Recognition of the liability would increase the lessor’s net investment on \nwhich the lessor bases its pattern of income recognition. While the increase to ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 746}), Document(page\_content="Leases 746 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the net investment results in an increase in income, it may be offs et by the \naccrual of interest on the liability. \n>> Income Taxes Related to Leveraged Leases \n55-4 The accounting for income taxes related to leveraged leases set forth in \nthis Subtopic is not consistent with the guidance in Topic 740 on income ta xes. \n55-5 The integration of the results of accounting for income taxes related to \nleveraged leases with the other results of accounting for income taxes as \nrequired by Topic 740 is an issue if all of the following exist: \na. The accounting for a leveraged lease requires recog nition of deferred tax \ncredits. \nb. The guidance in Topic 740 limits the recognition of a tax benefit for \ndeductible temporary differences and carryforwards not related to the \nleveraged lease. \nc. Unrecognized tax benefits in this par agraph could offset taxable amounts that \nresult from future recovery of the net investment in the leveraged lease. \n> Illustrations \n>> Example 1: Lessor's Accounting for a Leveraged Lease \n55-6 This Example illustrates a lessor’s accounting for a leveraged lease in \naccordance with the guidance in this Subtopic. It also illustrates one way of \nmeeting the disclosure requirements in paragraphs 842- 50-45-1 and 842- 50-50-\n1 as applied to a leveraged lease. The Example does not encompass all \ncircumstances that may arise about leveraged leases; rather, the Example is \nbased on a single instance of a leveraged lease. The elements of accounting \nand reporting illustrated for this Example of a leveraged lease are as follows: \na. Cash flow analysis b y years (see paragraph 842- 50-55-8) \nb. Allocation of annual cash flow to investment and income (see \nparagraph 842-50-55-9) \nc. Journal entries for lessor’s initial investment and first year of operation (see \nparagraph 842- 50-55-10) \nd. Financial statements includi ng notes at end of second year (see \nparagraph 842-50-55-11) \ne. Accounting for a revision in the estimated residual value of the leased \nasset assumed to occur in the eleventh year of the lease (from $200,000 \nto $120,000): \n1. Revised allocation of annual cash fl ow to investment and income (see \nparagraph 842- 50-55-12) \n2. Balances in investment accounts at beginning of the eleventh year \nbefore revised estimate (see paragraph 842- 50-55-13) \n3. Journal entries (see paragraph 842- 50-55-14) \n4. Adjustment of investment account s (see paragraph 842- 50-55-15). ", metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 747}), Document(page\_content='Leases 747 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 55-7 This Example has the following terms and assumptions. \nCost of leased asset \n(equipment) $1,000,000 \nLease term 15 years, dating from January 1, 1975 \nLease rental payments $90,000 per year (payable last day of each year) \nResidual value $200,000 estimated to be realized 1 year after lease termination; in the \neleventh year of the lease the estimate is reduced to $120,000 \nFinancing: \nEquity investment by lessor $400,000 \nLong- term nonrecourse debt $600,000, bearing interest at 9% and repayable in annual installments (on \nlast day of each year) of $74,435.30 \nDepreciation allowable to lessor \nfor income tax purposes 7-year asset depreciation range life using double- declining- balance method \nfor the first 2 years (with the half -year convention election applied in the first \nyear) and sum -of-years digits method for remaining life, depreciated to \n$100,000 salvage value \nLessor’s income tax rate \n(federal and state) 50.4% (assumed to continue in existence throughout the term of the lease) \nInvestment tax credit 10% of equipment cost or $100,000 (realized by the lessor on last day of \nfirst year of lease) \nInitial direct costs For simplicity, initial direct costs have n ot been included in the illustration \n55-8 Cash flow analysis by years follows. \n \n1 \n2 \n3 \n4 \n5 \n6 \n7 \n8 \n9 \nYear Gross Lease \nRentals and \nResidual \nValue Depreciation \n(for Income \nTax \nPurposes) Loan \nInterest \nPayments Taxable \nIncome \n(Loss) (Col. \n1-2-3) Income Tax \nCredits \n(Charges) \n(Col. 4 × \n50.4%) Loan \nPrincipal \nPayments Investment \nTax Credit \nRealized Annual \nCash Flow \n(Col. 1 -3 + \n5-6 + 7) \nCumulative \nCash Flow \nInitial \nInvestment \n- \n- \n- \n- \n- \n- \n- \n$ (400,000) \n$ (400,000) \n1 $ 90,000 $ 142,857 $ 54,000 $ (106,857) $ 53,856 $ 20,435 $ 100,000 169,421 (230,579) \n2 90,000 244,898 52,161 (207,059) 104,358 22,274 - 119,923 (110,656) \n3 90,000 187,075 50,156 (147,231) 74,204 24,279 - 89,769 (20,887) \n4 90,000 153,061 47,971 (111,032) 55,960 26,464 - 71,525 50,638 \n5 90,000 119,048 45,589 (74,637) 37,617 28,846 - 53,182 103,820 \n6 90,000 53,061 42,993 (6,054) 3,051 31,442 - 18,616 122,436 \n7 90,000 - 40,163 49,837 (25,118) 34,272 - (9,553) 112,883 \n8 90,000 - 37,079 52,921 (26,672) 37,357 - (11,108) 101,775 \n9 90,000 - 33,717 56,283 (28,367) 40,719 - (12,803) 88,972 \n10 90,000 - 30,052 59,948 (30,214) 44,383 - (14,649) 74,323 \n11 90,000 - 26,058 63,942 (32,227) 48,378 - (16,663) 57,660 \n12 90,000 - 21,704 68,296 (34,421) 52,732 - (18,857) 38,803 \n13 90,000 - 16,957 73,043 (36,813) 57,478 - (21,248) 17,555 \n14 90,000 - 11,785 78,215 (39,420) 62,651 - (23,856) (6,301) \n15 90,000 - 6,145 83,855 (42,263) 68,290 - (26,698) (32,999) \n16 200,000 100,000 - 100,000 (50,400) - - 149,600 116,601 \nTotals $ 1,550,000 $ 1,000,000 $516,530 $ 33,470 $ (16,869) $ 600,000 $ 100,000 $ 116,601 \n 55-9 Allocation of annual cash flow to investment and income follows. \n 1 2 3 4 5 6 7 \n Annual Cash Flow Components of Income(a) \nYear Lessor’s Net \nInvestment \nat \nBeginning \nof Year Total (from \nCol. 8 of \nParagraph \n842-50-55-8) Allocated to \nInvestment Allocated to \nIncome(b) Pretax \nIncome Tax Effect of \nPretax \nIncome Investment \nTax Credit \n1 $ 400,000 $ 169,421 $ 134,833 $ 34,588 $ 9,929 $ (5,004) $ 29,663 \n2 265,167 119,923 96,994 22,929 6,582 (3,317) 19,664 \n3 168,173 89,769 75,227 14,542 4,174 (2,104) 12,472 \n4 92,946 71,525 63,488 8,037 2,307 (1,163) 6,893 \n5 29,458 53,182 50,635 2,547 731 (368) 2,184 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 748}), Document(page\_content='Leases 748 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 6 (21,177) 18,616 18,616 - - - - \n7 (39,793) (9,553) (9,553) - - - - \n8 (30,240) (11,108) (11,108) - - - - \n9 (19,132) (12,803) (12,803) - - - - \n10 (6,329) (14,649) (14,649) - - - - \n11 8,320 (16,663) (17,382) 719 206 (104) 617 \n12 25,702 (18,857) (21,079) 2,222 637 (321) 1,906 \n13 46,781 (21,248) (25,293) 4,045 1,161 (585) 3,469 \n14 72,074 (23,856) (30,088) 6,232 1,789 (902) 5,345 \n15 102,162 (26,698) (35,532) 8,834 2,536 (1,278) 7,576 \n16 137,694 149,600 137,694 11,906 3,418 (1,723) 10,211 \nTotals $ 516,601 $ 400,000 $ 116,601 $ 33,470 $ (16,869) $ 100,000 \n a. Lease income is recognized as 8.647% of the unrecovered investment at the beginning of each year in which the net \ninvestment is positive. The rate is that rate which, if applied to the net investment in the years in which the net investment is \npositive, will distribute the net income (net cash flow) to those years. \nb. Each com ponent is allocated among the years of positive net investment in proportion to the allocation of net income in \ncolumn 4. \n55-10 Illustrative journal entries for the year ending December 31, 1975, \nfollow. \nLessor’s Initial Investment Debit Credit \nRentals receivable (table in paragraph 842- 50-55-8, total of column 1 minus \nresidual value, minus totals of columns 3 and 6) $ 233,470 \nInvestment tax credit receivable (table in paragraph 842- 50-55-8, column 7) 100,000 \nEstimated residual value (paragraph 842- 50-55-7) 200,000 \nUnearned and deferred income (table in paragraph 842 -50-55-9, totals of \ncolumns 5 and 7) $ 133,470 \nCash 400,000 \nRecord lessor’s initial investment \nFirst Year of Operation \nJournal Entry 1 \nCash 15,565 \nRentals receivable (table in paragraph 842- 50-55-8, column 1 minus \ncolumns 3 and 6) 15,565 \nCollection of first year’s net rental \nJournal Entry 2 \nCash (a) 100,000 \nInvestment tax credit receivable (table in paragraph 842 -50-55-8, \ncolumn 7) 100,000 \nReceipt of investment tax credit \nJournal Entry 3 \nUnearned and deferred income 9,929 \nIncome from leveraged leases (table in paragraph 842- 50-55-9, column 5) 9,929 \nRecognition of first year’s portion of pretax income allocated in the same \nproportion as the allocation of total income \n(34,558 ÷ 116,601) × 33,470 = 9,929 \nJournal Entry 4 \nUnearned and deferred income 29,663 \nInvestment tax credit recognized (table in paragraph 842- 50-55-9, \ncolumn 7) 29,663 \nRecognition of first year’s portion of investment tax credit allocated in the same \nproportion as the allocation of total income \n(34,558 ÷ 116,601) × 100,000 = 29,663 \n Debit Credit \nJournal Entry 5 \nCash (table in paragraph 842- 50-55-8, column 5) (a) 53,856 \nIncome tax expense (table in paragraph 842- 50-55-9, column 6) 5,004 \nDeferred taxes 58,860 \nTo record receipt of first year’s tax credit from lease operation, to cha rge \nincome tax expense for tax effect of pretax accounting income, and to \nrecognize as deferred taxes the tax effect of the difference between pretax \naccounting income and the tax loss for the year, calculated as follows: \nTax loss (table in paragraph 842- 50-55-8, column 4) $ (106,857) \nPretax accounting income 9,929 \nDifference $ (116,786) \nDeferred taxes ($116,786 × 50.4%) $ 58,860 \n \na. Receipts of the investment tax credit and other tax benefits are shown as cash receipts for simplicity only. Those receipts \nprobably would not be in the form of immediate cash inflow. Instead, they likely would be in the form of reduced payments ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 749}), Document(page\_content='Leases 749 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. of taxes o n other income of the lessor or on the combined income of the lessor and other entities whose operations are \njoined with the lessor’s operations in a consolidated tax return. \n55-11 The following are illustrative partial financial statements includi ng notes. \nBALANCE SHEET \nASSETS LIABILITIES \n December 31, December 31, \n 1976 1975 1976 1975 \nInvestment in leveraged \nleases $ 334,708 $ 324,027 Deferred taxes arising from \nleveraged leases $ 166,535 $ 58,860 \n \nINCOME STATEMENT \n(Ignoring all income and expense items other than those relating to leveraged leasing) \n 1976 1975 \nIncome from leveraged leases $ 6,582 $ 9,929 \nIncome before taxes and investment tax credit 6,582 9,929 \nLess: Income tax expense (a) (3,317) (5,004) \n 3,265 4,925 \nInvestment tax credit recognized (a) 19,664 29,663 \nNet income $ 22,929 $ 34,588 \n a. These two items may be netted for purposes of presentation in the income statement, provided that the separate amounts \nare disclosed in a note to financial statements. \nThe following are notes to the illustrative financial statements included in this \nExample. \nInvestment in Leveraged Leases \nEntity is the lessor in a lever aged lease agreement entered into in 1975 under \nwhich mining equipment having an estimated economic life of 18 years was \nleased for a term of 15 years. Entity’s equity investment represented 40 \npercent of the purchase price; the remaining 60 percent was furnished by third-\nparty financing in the form of long- term debt that provides for no recourse \nagainst Entity and is secured by a first lien on the property. At the end of the \nlease term, the equipment is turned back to Entity. The residual value at that \ntime is estimated to be 20 percent of cost. For federal income tax purposes, \nEntity receives the investment tax credit and has the benefit of tax deductions \nfor depreciation on the entire leased asset and for interest on the long- term \ndebt. During the early y ears of the lease, those deductions exceed the lease \nrental income, and substantial excess deductions are available to be applied \nagainst Entity’s other income. In the later years of the lease, rental income will \nexceed the deductions and taxes will be pay able. Deferred taxes are provided \nto reflect this reversal. Entity’s net investment in leveraged leases is \ncomposed of the following elements. \n December 31, \n 1976 1975 \nRentals receivable (net of principal and interest on the nonrecourse debt) $ 202,340 $ 217,905 \nEstimated residual value of leased assets 200,000 200,000 \nLess: Unearned and deferred income (67,632) (93,878) \nInvestment in leveraged leases 334,708 324,027 \nLess: Deferred taxes arising from leveraged leases (166,535) (58,860) \nNet investment in leveraged leases $ 168,173 $ 265,167 \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 750}), Document(page\_content='Leases 750 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 55-12 Allocation of annual cash flow to investment and income follows, revised \nto include new residual value estimate. \n 1 2 3 4 5 6 7 \n Annual Cash Flow Components of Income \nYear Lessor’s Net \nInvestment \nat \nBeginning \nof Year Total Allocated to \nInvestment Allocated to \nIncome(a) Pretax \nIncome Tax Effect of \nPretax \nIncome Investment \nTax Credit \n1 $ 400,000 $ 169,421 $ 142,458 $ 26,963 $ (16,309) $ 8,220 $ 35,052 \n2 257,542 119,923 102,563 17,360 (10,501) 5,293 22,568 \n3 154,979 89,769 79,323 10,446 (6,319) 3,184 13,581 \n4 75,656 71,525 66,425 5,100 (3,085) 1,555 6,630 \n5 9,231 53,182 52,560 622 (377) 190 809 \n6 (43,329) 18,616 18,616 - - - - \n7 (61,945) (9,553) (9,553) - - - - \n8 (52,392) (11,108) (11,108) - - - - \n9 (41,284) (12,803) (12,803) - - - - \n10 (28,481) (14,649) (14,649) - - - - \n11 (13,832) (16,663) (16,663) - - - - \n12 2,831 (18,857) (19,048) 191 (115) 58 248 \n13 21,879 (21,248) (22,723) 1,475 (892) 450 1,917 \n14 44,602 (23,856) (26,862) 3,006 (1,819) 916 3,909 \n15 71,464 (26,698) (31,515) 4,817 (2,914) 1,469 6,262 \n16 102,979 109,920 102,979 6,941 (4,199) 2,116 9,024 \nTotals $ 476,921 $ 400,000 $ 76,921 $ (46,530) $ 23,451 $ 100,000 \na. The revised allocation rate is 6.741%. \n55-13 Balances in investment accounts before revised estimate of residual \nvalue follow. \n 1 2 3 4 5 6 7 \n Unearned and \nDeferred Income \n Rentals \nReceivable \n(a) Estimated \nResidual \nValue Investment \nTax Credit \nReceivable Pretax \nIncome \n(Loss) (b) Investment \nTax Credit (c) Deferred \nTaxes (d) Net \nInvestment \n(Col. \n1+2+3) less \n(Col. \n4+5+6) \nInitial \ninvestment \n$ 233,470 $ 200,000 $ 100,000 $ 33,470 $ 100,000 $ - $ 400,000 \nChanges in \nyear of \noperation \n \n \n \n \n \n \n1 (15,565) - (100,000) (9,929) (29,663) 58,860 (134,833) \n2 (15,565) - - (6,582) (19,664) 107,675 (96,994) \n3 (15,565) - - (4,174) (12,472) 76,308 (75,227) \n4 (15,565) - - (2,307) (6,893) 57,123 (63,488) \n5 (15,565) - - (731) (2,184) 37,985 (50,635) \n6 (15,565) - - - - 3,051 (18,616) \n7 (15,565) - - - - (25,118) 9,553 \n8 (15,564) - - - - (26,672) 11,108 \n9 (15,564) - - - - (28,367) 12,803 \n10 (15,565) - - - - (30,214) 14,649 \nBalances, \nbeginning of \neleventh year \n$ 77,822 $ 200,000 $ - $ 9,747 $ 29,124 $ 230,631 $ 8,320 \n a. Table in paragraph 842 -50-55-8, column 1, excluding residual value, minus columns 3 and 6. \nb. Table in paragraph 842- 50-55-9, column 5. \nc. Table in paragraph 842 -50-55-9, column 7. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 751}), Document(page\_content='Leases 751 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. d. 50.4% of difference between taxable income (loss) in column 4 of the table in paragraph 84 2-50-55-8 and pretax accounting \nincome (loss) in column 5 of the table in paragraph 842 -50-55-9. \n55-14 Illustrative journal entries involving a reduction in residual value follow. \n Debit Credit \nJournal Entry 1 \nPretax income ( or loss ) $ 60,314 \nUnearned and deferred income 27,450 \nPretax income (loss): \nBalance at end of tenth year $ 9,747 (a) \nRevised balance (9,939) (b) \nAdjustment (19,686) \nDeferred investment tax credit: \nBalance at end of tenth year 29,124 (c) \nRevised balance 21,360 (d) \nAdjustment (7,764) \nInvestment tax credit recognized $ 7,764 \nEstimated residual value 80,000 \nTo record: \na. The cumulative effect on pretax income and the effect on future income \nresulting from the decrease in estimated residual value: \nReduction in estimated residual value $ 80,000 \nLess portion attributable to future years (unearned and deferred income) (19,686) \nCumulative effect (charged against current income) $ 60,314 \nb. The cumulative and future effect of the change in allocation of the \ninvestment tax credit resulting from the reduction in estimated residual \nvalue \n Debit Credit \nJournal Entry 2 \nDeferred taxes 30,398 \nIncome tax expense 30,398 \nTo recognize deferred taxes for the difference between pretax accounting \nincome (or loss) and taxable income (or loss) for the effect of the \nreduction in estimated residual value: \nPretax accounting loss per Journal Entry 1 $ (60,314) \nTax income (or loss) - \nDifference $ (60,314) \nDeferred taxes ($60,314 × 50.4%) $ (30,398) \n \na. Table in paragraph 842 -50-55-13, column 4. \nb. Table in paragraph 842- 50-55-12, total of column 5 minus amounts applicable to the first 10 years. \nc. Table in paragraph 842- 50-55-13, column 5. \nd. Table in paragraph 842 -50-55-12, total of column 7 minus amounts applicable to the first 10 years. \n55-15 Adjustment of investment accounts for revised estimates of residual \nvalue follows. \n 1 2 3 4 5 6 \n Unearned and \nDeferred Income Net \nInvestment \n Rentals \nReceivable Estimated \nResidual \nValue Pretax \nIncome \n(Loss) Investment \nTax Credit Deferred \nTaxes (Col. 1 + 2) \nless (Col. 3 \n+ 4 + 5) \nBalances, beginning of \neleventh year (table in \nparagraph 842- 50-55-13) \n$ 77,822 $ 200,000 $ 9,747 $ 29,124 $ 230,631 $ 8,320 \nAdjustment of estimated \nresidual value and unearned \nand deferred income (table in \nparagraph 8 42-50-55-14, \nJournal Entry 1) \n- (80,000) (19,686) (7,764) - (52,550) \nAdjustment of deferred taxes \nfor the cumulative effect on \npretax accounting income \n(table in paragraph 842- 50-55-\n14, Journal Entry 2) \n- - - - (30,398) 30,398 \nAdjusted balances, beginning \nof eleventh year \n$ 77,822 $ 120,000 $ (9,939) $ 21,360 $ 200,233 $ (13,832)(a) \na. Table in paragraph 842- 50-55-12, column 1. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 752}), Document(page\_content='Leases 752 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. >> Example 2: Income Taxes Related to a Leveraged Lease \n55-16 This Example illustrates integration of the results of a lessor’s income \ntax accounting for leveraged leases (in accordance with the guidance in this \nSubtopic) with the other results of accounting for income taxes as required by \nTopic 740. \n55-17 At the end of Year 1 (the current year), an entity has two temporary \ndifferences. \n55-18 The first temporary difference is for a leveraged lease that was entered \ninto in a prior year. During Year 1, the enacted tax rate for Year 2 and thereafter \nchanges from 40 percent to 35 percent. \n55-19 After adjusting for the change in estimated total net income from the \nlease as a result of the change in tax rates, the components of the investment \nin the leveraged lease at the end of Year 1 are as follows. \nNet rentals receivable plus residual value minus unearned pretax income $ 150,000 \nReduced by: \nDeferred investment tax credit $ 9,000 \nDeferred tax credits 39,000 48,000 \nNet investment in leveraged lease for financial reporting $ 102,000 \n55-20 The second temporary difference is a $120,000 estimated liability for \nwarranty expense that will result in a tax deduction in Year 5 when the liability \nis expected to be paid. Absent consideration of the deferred tax credits \nattributable to the leveraged l ease, the weight of available evidence indicates \nthat a valuation allowance is needed for the entire amount of the deferred tax \nasset related to that $120,000 deductible temporary difference. \n55-21 The tax basis of the investment in the leveraged lease at the end of \nYear 1 is $41,000. The amount of the deferred tax liability for that leveraged \nlease that would otherwise result from the application of guidance in Topic 740 \non income taxes is determined as follows. \nNet rentals receivable plus residual value minus unearned pretax income $ 150,000 \nTemporary difference for deferred investment tax credit 9,000 \n 141,000 \nTax basis of leveraged lease 41,000 \nTemporary difference $ 100,000 \nDeferred tax liability (35 percent) $ 35,000 \n 55-22 Loss carryback (to Year 2) and loss carryforward (to Year 20) of the \n$120,000 tax deduction for warranty expense in Year 5 would offset the \n$100,000 of taxable amounts resulting from future recovery of the net \ninvestment in the leveraged lease over the remainder of the lease term. \n55-23 At the end of Year 1, the entity recognizes a $42,000 ($120,000 at \n35 percent) deferred tax asset and a related $7,000 valuation allowance. The \neffect is to recognize a $35,000 net deferred tax benefit for the reduction in \ndeferred tax credits attributable to the leveraged lease. Deferred tax credits \nattributable to the leve raged lease determined under the guidance in this ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 753}), Document(page\_content="Leases 753 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Subtopic are $39,000. However, the deferred tax liability determined is only \n$35,000. The $4,000 difference i s not available for offsetting. \n>> Example 3: Effect of Advance Payments and Deposits on \nRecalculation of a Leveraged Lease \n55-24 This Example illustrates how (in accordance with the guidance in \nparagraph 842- 50-35-13 and other paragraphs) a lessor would include advance \npayments and deposits in a recalculation of a leveraged lease resulting from a \ndetermination by the lessor that it would enter into a settlement of a tax \nposition arising from a leveraged lease. \n55-25 This Example assumes that the lessor has concluded that the position \noriginally taken on the tax return would m eet the more- likely -than- not threshold \nin Subtopic 740 -10 on income taxes. It also assumes that the lessor would \nconclude that the estimate of $50 for the projected lease- in, lease -out \nsettlement is consistent with the measurement guidance in that Subtopic . \n55-26 A lessor makes an advance payment of $25 on July 1, 2007, $10 of \nwhich is estimated to be associated with issues arising from a lease- in, lease-\nout transaction. On July 1, 2007, the lessor changes its assumption about the \ntiming of the tax c ash flows and projects a settlement with the Internal \nRevenue Service on September 1, 2009. The projected settlement would \nresult in a payment to the taxing authority of $125 of which $50 is associated \nwith the lease- in, lease -out transaction. On July 1, 2 007, when the lessor \nrecalculates the leveraged lease, the lessor would include a $50 cash flow on \nSeptember 1, 2009, as a projected outflow in the leveraged lease recalculation. \n>> Example 4: Leveraged Lease Acquired in a Business Combination or \nan A cquisition by a Not -for-Profit Entity \n55-27 This Example illustrates one way that a lessor’s investment in a \nleveraged lease might be valued by the acquiring entity in a business \ncombination or an acquisition by a not -for-profit entity and the subs equent \naccounting for the investment in accordance with the guidance in this \nSubtopic. The elements of accounting and reporting illustrated for this Example \nare as follows: \na. Acquiring entity’s cash flow analysis by years (see paragraph 842 -50-55-29) \nb. Acquiring entity’s valuation of investment in the leveraged lease (see \nparagraph 842- 50-55-30) \nc. Acquiring entity's allocation of annual cash flow to investment and income \n(see par agraph 842- 50-55-31) \nd. Journal entry for recording allocation of purchase price to net investment in \nthe leveraged lease (see paragraph 842- 50-55-32) \ne. Journal entries for the year ending December 31, 1984 (Year 10 of the \nlease) (see paragraph 842- 50-55-33). \n55-28 This Example has the following terms and assumptions. \nCost of leased asset (equipment) $1,000,000 \nLease term 15 years, dating from January 1, 1975 \nLease rental payments $90,000 per year (payable last day of each year) ", metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 754}), Document(page\_content='Leases 754 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Residual value $200,000 estimated to be realized 1 year after lease termination \nFinancing: \nEquity investment by lessor $400,000 \nLong- term nonrecourse debt $600,000, bearing interest at 9% and repayable in annual installments \n(on last day of each year) of $74,435.30 \nDepreciation allowable to lessor for \nincome tax purposes 7-year asset depreciation range life using double- declining- balance \nmethod for the first 2 years (with the half -year convention election \napplied in the first year) and sum -of-years digits method for remaining \nlife, depreciated to $100,000 salvage value \nLessor’s income tax rate (federal and \nstate) 50.4% (assumed to continue in existence throughout the term of the \nlease) \nInvestment tax credit 10% of equipment cost or $10 0,000 (realized by the lessor on last day \nof first year of lease) \nInitial direct costs For simplicity, initial direct costs have not been included in the \nillustration \nDate of business combination January 1, 1982 \nTax status of business combination Nontaxable transaction \nAppropriate interest rate for valuing net -\nof-tax return on investment 4½% \n55-29 Acquiring entity’s cash flow analysis by years follows. \n 1 2 3 4 5 6 7 \nYear Gross Lease \nRentals and \nResidual \nValue Depreciation \n(for Income \nTax \nPurposes) Loan \nInterest \nPayments Taxable \nIncome (Col. \n1 – 2 – 3) Income Tax \n(Charges ) \n(Col. 4 × \n50.4%) Loan \nPrincipal \nPayments Annual \nCash Flow \n(Col. 1 – 3 + \n5 – 6) \n8 $ 90,000 - $ 37,079 $ 52,921 $ (26,672) $ 37,357 $ (11,108) \n9 90,000 - 33,717 56,283 (28,367) 40,719 (12,803) \n10 90,000 - 30,052 59,948 (30,214) 44,383 (14,649) \n11 90,000 - 26,058 63,942 (32,227) 48,378 (16,663) \n12 90,000 - 21,704 68,296 (34,421) 52,732 (18,857) \n13 90,000 - 16,957 73,043 (36,813) 57,478 (21,248) \n14 90,000 - 11,785 78,215 (39,420) 62,651 (23,856) \n15 90,000 - 6,145 83,855 (42,263) 68,290 (26,698) \n16 200,000 $ 100,000 - 100,000 (50,400) - 149,600 \nTotals $ 920,000 $ 100,000 $ 183,497 $ 636,503 $ (320,797) $ 411,988 $ 3,718 \n \n55-30 Acquiring entity’s valuation of investment in the leveraged lease follows. \nCash Flow Present \nValue at \n4½% Net-of-\nTax Rate \n1. Rentals receivable (net of principal and interest on the nonrecourse debt) ($15,564.70 at the end of each \nyear for 8 years) $ 102,663 \n2. Estimated residual value ($200,000 realizable at the end of 9 years) 134,581 \n3. Future tax payments (various amounts payable over 9 years – see the table in paragraph 842- 50-55-29) (253,489) \nNet present value $ (16,245) \n 55-31 Acquiring entity’s allocation of annual cash flow to investment and \nincome follows (see footnote (a)). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 755}), Document(page\_content='Leases 755 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 1 2 3 4 5 6 \n Annual Cash Flow Components of Income (b) \nYear Net Investment at \nBeginning of Year Total from \nCol. 7 of the \nTable in \nParagraph \n842-50-55-29 Allocated to \nInvestment Allocated to \nIncome (a) Pretax Income Tax Effect of \nPretax \nIncome \n8 $ (16,245) $ (11,108) $ (11,108) - - - \n9 (5,137) (12,803) (12,803) - - - \n10 7,666 (14,649) (14,973) $ 324 $ 5,530 $ (5,206) \n11 22,639 (16,663) (17,621) 958 16,353 (15,395) \n12 40,260 (18,857) (20,561) 1,704 29,087 (27,383) \n13 60,821 (21,248) (23,822) 2,574 43,937 (41,363) \n14 84,643 (23,856) (27,439) 3,583 61,160 (57,577) \n15 112,082 (26,698) (31,4 43) 4,745 80,995 (76,250) \n16 143,525 149,600 143,525 6,075 103,698 (97,623) \nTotals $ 3,718 $ (16,245) $ 19,963 $ 340,760 $ (320,797) \na. Lease income is recognized as 4.233% of the unrecovered investment at the beginning of each year in which the net \ninvestment is positive. The rate is that rate which, if applied to the net investment in the years in which the net investment is \npositive, will distribute the net income (net cash flow) to those years. \nb. Each component is allocated among the years of positive net investment in proportion to the allocation of net income in \ncolumn 4. Journal Entry 2 in the table in paragraph 842 -50-55-33 includes an example of this computation. \n55-32 Illustrative journal entry for recording allocation of purchase price to net \ninvestment in the leveraged lease follows. \nRentals receivable (table in paragraph 842- 50-55-29, total of column 1 minus residual value, \nminus totals of columns 3 and 6) $ 124,515 \nEstimated residual value (paragraph 842- 50-55-28) 200,000 \nPurchase price allocation clearing account (paragraph 842- 50-55-30, present value) 16,245 \nUnearned and deferred income (paragraph 842- 50-55-30, present value, minus total of \nrentals receivable and estimated residual value) $ 340,760 \n 55-33 Illustrative journal entries for year ending December 31, 19Y4, follows. \nThird Year of Operation after the Business Combination \n(Year 10 of the Lease) \nJournal Entry 1 \nCash $ 15,565 \nRentals receivable (table in paragraph 842- 50-55-29, column 1 minus columns 3 and 6) $ 15,565 \nCollection of year’s net rental \nJournal Entry 2 \nUnearned and deferred income $ 5,530 \nIncome from leveraged leases (table in paragraph 842- 50-55-31, column 5) $ 5,530 \nRecognition of pretax income for the year allocated in the same proportion as the allocation of \ntotal income computed as follows: \n([$324 ÷ $19,963] × $340,760 = $5,530) \n \nJournal Entry 3 \nDeferred taxes (table in paragraph 842- 50-55-29, column 5, minus table in paragraph 842- 50-55-\n31, column 6) $ 25,008 \nIncome tax expense (table in paragraph 842- 50-55-31, column 6) 5,206 \nCash (table in paragraph 842- 50-55-29, column 5) $ 30,214 \nTo record payment of tax for the year \n \n7.8.1 Overview \n7.8.10 Leveraged leasing transactions typically provide significant tax and \nfinancial reporting benefits for lessors applying US GAAP. Leveraged leases ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 756}), Document(page\_content='Leases 756 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. usually involve capital intensive assets such as airplanes and power plants that \nare leased for extended periods (e.g. 25 years or more). However, these \ntransactions have become more infrequent in recent years due to changes in \ninterest rates and investment tax incentives. \n7.8.20 Topic 842 eliminates leveraged lease accounting for leases that \ncommence on or after the effective date. Instead, a lessor accounts for all \nleases as sales- type, direct financing or operating leases. Leveraged leases that \ncommence before the effective date of Topic 842 are not subject to its \nrequirements (i.e. leveraged lease account ing continues ) unless they are \nmodified after the effective date of Topic 842. Leveraged leases that are \nmodified after the effective date of Topic 842 are subject to Topic 842 at the \neffective date of the modification – i.e. grandfathering is terminated (see \nsection 13.6) . [842- 10-65-1(z), 842-50] \n7.8.30 The exercise of a renewal option by the lessee ‘that it was not previously \nreasonably assured to exercise’ under Topic 840 is considered a lease \nmodification. If this occurs, the lease is no lo nger a leveraged lease and the \nlessor applies Topic 842 to the lease from the date of exercise – i.e. the lease \nloses its grandfathered status. [842- 50-15-1] \n7.8.40 The exercise of a lessee renewal option that is in the lease contract, \nregardless of whether the lessee was reasonably certain to exercise that \noption, is not considered a lease modification under any other circumstance in \nTopic 842. \n \n7.8.2 Leveraged lease definition \n7.8.50 A leveraged lease is a lease that has the following characteristics at its \ninception: \n— the lease meets the criteria to be classified as a direct financing lease \nunder 840-10-25-43(b) ; \n— the lease involves at leas t three parties: a lessee, a long- term credito r and a \nlessor (commonly called the equity participant) ; \n— the financing provided by the long -term creditor is nonrecourse as to the \ngeneral credit of the lessor , and t he amount of the financing is sufficient to \nprovide the lessor with substantial leverage i n the transaction; and \n— the lessor’s net investment declines during the early years once the \ninvestment has been completed and rises during the later years of the \nlease before its final elimination – such decreases and increases in the net \ninvestment balanc e may occur more than once. [840- 10-25-43(c)] \n7.8.60 When each of these characteristics are present, the lessor accounts for \nthe lease as a leveraged lease. Leveraged lease accounting is not relevant to \nthe lessee involved in the lease. [842 Glossary, 840- 10-25-43(c)] \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 757}), Document(page\_content='Leases 757 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 7. 8.10 \nReal estate leases and leases in sale-leaseback \ntransactions \nAre real estate leases or leases in sale- leaseback transactions \nprohibited from being classified as leveraged leases by a \nlessor? \nInterpretive response: No. The leveraged lease criteria do not prohibit real \nestate leases or lea ses in sale -leaseback transactions from being classified as \nleveraged leases. [840- 10-25-43(c)] \n \n Question 7. 8.20 \nLease of an existing asset classified as a leveraged \nlease \nCan a lessor that leases an asset it already owns classify the \nlease as a leveraged lease? \nInterpretive response: Generally , no. As noted at paragraph 7.8.50, to qualify \nfor leveraged lease classification, a lease must meet the Topic 840 criteria to be \nclassified as a direct financing lease. The cost, or carrying amount, and the fair \nvalue of the asset need to be the same at inception of the lease for it to be \nclassified as a direct financing lease under Topic 840. [840- 10-25-43(b), 25- 43(b)(2)] \nAlthough an asset already owned by a lessor that has been placed into service \nmay have a carrying amount that is close to its fair value, in nearly all \ncircumstances the two amounts will not be equal. As a result, classification as a \ndirect financing lease, and thereby qualification for classification as a leveraged \nlease, w ill generally only be appropriate when the lessor purchases the asset to \nbe leased at or near inception of the lease. \nThe requirement for the carrying amount and fair value of the underlying asset \nto be equal to qualify for direct financing lease classific ation no longer applies \nunder Topic 842. However, for a leveraged lease to be grandfathered under \nparagraph 842- 10-65-1(z), it must have met the criteria to be classified as a \nleveraged lease under the provisions of Topic 840 (see section 13.6 ). \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 758}), Document(page\_content='Leases 758 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Questio n 7.8.30 \nRequirement for a leveraged lease to involve at \nleast three parties \nIs leveraged lease classification appropriate if one entity \nrepresents two of the three required parties? \nBackground : Paragraph 840- 10-25-43(c)(2) requires a leveraged lease to involve \nat least three parties : a lessee, a long -term creditor, and a lessor or equity \nparticipant. \nInterpretive response: No. If one entity serves as more than one of the three \nparties required by paragraph 840- 10-25-43(c)(2) – e.g. the lessor is also the \nlong-term creditor – leveraged lease classification is not appropriate. \nSimilarly, when related parties that are consolidated serve as two of the \nthree parties to the lease, leveraged lease accounting is not appropriate in the \nconsolidated financial statements. For example, if a subsidiary entered into a lease as the lessor and secured nonrecourse financing from its parent, \nleveraged lease accounting in the parent’s consolidated financial statements \nwould not be appropriate. However, the subsidiary may meet the criteria for \nleveraged lease classification in its stand -alone financial statements. \n \n Question 7. 8.40 \nLeveraged lease classification when there are \nmultiple lessees and cross -collateralization \nIs lev eraged lease classification appropriate when a lessor \nleases the same type of asset to multiple unrelated lessees \nand finances all of the leased assets through nonrecourse \ndebt from a single creditor with the debt collateralized by all of the leased assets ? \nInterpretive response: No. In this situation, the leases would not meet the \ncriteria for leveraged lease classification under paragraph 840- 10-25-43(c)(3) \nbecause the debt would be recourse to multiple assets leased by multiple \nlessees. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 759}), Document(page\_content='Leases 759 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 7. 8.50 \nLeveraged lease classification when multiple assets \nare leased to a single lessee \nQuestion 1: Is leveraged lease classification appropriate when \na lessor leases multiple assets of the same type to a single \nlessee? \nQuestion 2: If the answe r to Question 1 is yes, would \nleveraged lease classification still be appropriate if that lessee \nsubleased those assets to multiple unrelated sublessees? \nInterpretive response: \nQuestion 1: Yes. In this case, the debt would be recourse only to the assets \nleased to the individual lessee and the criterion in paragraph 840- 10-25-43(c)(3) \nwould be satisfied. If the lease satisfied the remaining criteria in paragraph 840-\n10-25-43(c), leveraged lease classification would be appropriate. \nQuestion 2: Maybe. In this circumstance, we believe all of the following \nconditions should be met for leveraged lease classification to apply. \n— The lessee to the master lease agreement is clearly the principal in the \ntransaction with the lessor and has substance of its own separ ate from the \nsublessees. This would not be the case if the lessee to the master lease agreement is only required to make lease payments to the lessor if it \nreceives lease payments from its sublessees or is clearly otherwise unable \nto perform if the subless ees do not perform (e.g. is nominally capitalized). If \nthe lessee to the master lease agreement is not clearly the principal in the transaction with the lessor or does not have substance on its own separate \nfrom the sublessees, the agreement represents a l ease of multiple \nindividual assets to multiple lessees and leveraged lease classification would not be appropriate for the same reason provided in Question 7.8.40. \n— If the lessor has obtained residual value insurance for the master lease agreement to meet t he criteria for direct financing lease classification, the \nlessor and the residual value insurer are unrelated third parties and the residual value insurance is provided at an individual leased asset level rather \nthan an aggregate portfolio basis as requir ed by paragraph 840- 30-S99-1 \n(see paragraphs 842 -10-55-9 – 55-10). \n— It is appropriate to assess lease classification on a portfolio basis for the \nmaster lease. Generally, to qualify for portfolio basis lease classification and \naccounting, the assets leased as part of the master lease agreement \nshould have similar characteristics (size and composition) and should \nindividually meet the criteria for direct financing lease classification under \nparagraph 840- 10-25-43(b). The lessor should also reasonably expect t hat \nthe accounting for the portfolio will not differ materially from the accounting \nfor the individual leases in that portfolio (see section 5.8 ). \nIf the above condi t\nions are not met, leveraged lease classification would not be \nappropriate. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 760}), Document(page\_content='Leases 760 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 7. 8.60 \nImpact of nonrecourse debt on lease classification \nDoes a lessor’s use of nonrecourse debt to finance the \nmanufacture of a leased asset affect lease classification when \nthe lease would otherwise qualify for sales -type lease \nclassification under paragraph 840 -10-25-43(a)? \nInterpretive response: No. Paragraph 840- 10-25-43(c) states that “leases that \nmeet the definition of sales -type leases set forth in (a) shall not be accounted \nfor as leveraged leases but shall be accounted for as prescribed in \nparagraph 840-30-25-6 [which prescribes the accounting for sales -type leases].” \nAs a result, even if a lessor finances the manufacture of a leased asset through \nnonrecourse debt, which is one of the criteria for leveraged lease classification, \nsales- type lease classification should be used when the criteria in 840- 10-25-\n43(a) are met. \nHowever, if the lessor sells the leased asset and the related nonrecourse debt \nto a third party before adopti ng Topic 842, we believe the acquiring entity could \nconclude that leveraged lease classification is appropriate if the criteria in \nparagraph 840- 10-25-43(c) are met. This may be the case because the fair value \nand carrying amount of the leased asset will be the same for the acquiring \nentity at the acquisiti on date, potentially resulting in direct financing lease \nclassification. \n \n Question 7. 8.70 \nNonrecourse debt obtained after lease inception \nCan a lease meet the leveraged lease classification criteria if \nthe lessor obtains nonrecourse debt subsequent to lease inception? \nInterpretive response: No. Paragraphs 840- 10-25-1 and 840- 10-25-43 require \nlease classification to be determined at lease inception. As a result, if at the \ninception date the lessor has not obtained nonrecourse financing from a long -\nterm creditor (thereby not meeting the criterion in paragraph 840- 10-25-43(c)(3)), \nthe lease is not a leveraged lease. \nParagraph 840- 10-35-4 stipulates that if the lessee and lessor agree to change \nthe lease provisions and the change in terms woul d have resulted in a different \nlease classification had those terms been in place at lease inception, it is \ntreated as a new lease agreement that is assessed for classification. However, \na change in the method of financing by the lessor would not be consid ered a \nchange in lease provisions , and therefore lease classification is not subject \nto change. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 761}), Document(page\_content='Leases 761 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 7. 8.80 \nSubstantial leverage in a leveraged lease \nWhat represents ‘substantial leverage’ when evaluating the \nleveraged lease classification criterio n in paragraph 840 -10-25-\n43(c)(3)? \nBackground : Paragraph 840- 10-25-43(c)(3) requires that a lessor obtain \nnonrecourse financing from a long- term creditor that provides the lessor \nsubstantial leverage in the transaction to meet leveraged lease classification. \nHowever, no guidance is given in Topic 840 about what constitutes \nsubstantial leverage. \nInterpretive response: We believe a lessor has substantial leverage in the \ntransaction if the nonrecourse debt represents at least 50 percent of the cos t of \nthe leased asset. Topic 840 does not preclude leveraged lease classification if \nthe lessor uses recourse financing in addition to nonrecourse financing if the \nnonrecourse financing is sufficient to provide the lessor substantial leverage in \nthe transa ction – i.e. at least 50 percent of the cost of the leased asset. \n \n Question 7. 8.90 \nRequirement for the investment to decline during \nthe early years and rise during the later years \nHow much does the lessor’s net investment in the lease need \nto decline, and for how long does it need to decline, to meet \nthe criterion in paragraph 840 -10-25-43(c)(4) for leveraged \nlease classification? \nBackground : To quali fy for leveraged lease classification, the lessor’s net \ninvestment in the lease must decrease during the early years of the lease once \nthe investment has been completed and then rise during the later years before \ncompletion of the lease. However, no guidance is given on what level of \ndecrease needs to occur in the early part of the lease, or how long that \ndecrease needs to occur, to meet the criterion in paragraph 840- 10-25-43(c)(4). \nInterpretive response: We believe the decline, and in turn the subsequent \nincrease, in the lessor’s net investment must be more than insignificant relative to the initial net investment. Additionally, we believe the decline in the net \ninvestment and the subsequent increase should each last at least one quarter. However, we do not believe it is necessary for the net investment to become \nnegative for a lease to qualify for leveraged lease classification. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 762}), Document(page\_content='Leases 762 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 7. 8.100 \nLessor receives no tax benefits \nIs leveraged lease accounting appropriate when a lessor \nreceives no tax benefits associated with ownership of the \nleased asset? \nBackground : Typically, a lease meets the criterion for leverage lease \nclassification under paragraph 840- 10-25-43(c)(4) because recognition of tax \nbenefits early in the lease term causes the net investment in the lease to \ndecline before increasing later in the lease t erm. However, there could be \nsituations where a lessor receives no tax benefits associated with ownership of the leased asset, such as when the lessor operates in a jurisdiction that is not \nsubject to income taxes. A lease could still have the characterist ic that the \nlessor’s net investment declines during the early years before increasing in the \nlater years without the effect of tax benefits associated with ownership of the \nasset, depending on how rent and debt payments are structured. \nInterpretive response: Yes, if all of the leveraged lease classification criteria in \nparagraph 840- 10-25-43(c) are met. The criteria for leveraged lease classification \nin Topic 840 do not require a lessor to recognize any tax benefit associated with \nowning the leased as set. \n \n Question 7. 8.110 \nLessor is a partnership or a variable interest entity \nWhen the lessor is a partnership, can a noncontrolling partner \nlook through the partnership structure to view itself as an \nequity participant in an underlying lease in determining if \nleveraged lease classification is appropriate for equity method accounting? \nBackground : When a lessor is structured as a partnership, the tax benefits \nassociated with the lease are not recognized by the partnership because it is \nnot a taxable ent ity. The tax benefits are passed through to the partners and \nreflected in their financial statements. As a result, at the partnership level, leveraged lease classification will often not be appropriate because the lack of \nincome tax benefits causes the cri terion in paragraph 840- 10-25-43(c)(4) to not \nbe met . However, the lack of income tax benefits on the part of the lessor \nmay not always cause leveraged lease classification to not be met ( see \nQuestion 7.8.100) . \nInterpretive response: No. We do not believe a noncontrolling partner should \nlook through the partnership in assessing leveraged lease classification. The \nnoncontrolling partner should not reassess lease classification determinations \nthat were made at the partnership level when applying the e quity method of \naccounting. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 763}), Document(page\_content='Leases 763 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Similar issues arise when the lessor partnership is a variable interest entity (VIE) \nand the partner with the majority voting interest is not the primary beneficiary of \nthe VIE based on the requirements of Subtopic 810- 10 (consolidation) ; see \nchapter 4 of KPMG Handbook, Consolidation of v ariable interest entities . As a \nresult, the partner with the majority voting interest is precluded from \nconsolidating the partnership, which may result in leveraged lease accounting \nnot being appropriate if the criteria in paragraph 840- 10-25-43(c) are not met at \nthe partnership level. \n \n7.8.3 Recognition and measurement \n7.8.70 The lessor in a leveraged lease recognizes and measures its initial \ninvestment net of the nonrecourse debt. That net investment, recognized on \nthe lessor’s balance sheet, comprises : \n— rentals receivable, net of that portion of the rental applicable to principal and \ninterest on the nonrecourse debt; \n— a receivable for the amount of the investment tax credit to be realized on \nthe transaction; \n— the estimated residual value of the leased asset; and \n— unearned and deferred income comprising (1) the estimated pretax lease \nincome (or loss), after deducting initial direct costs, remaining to be \nallocated to income over the lease term , and ( 2) the investment tax credit \nremaining to be allocated to income over the lease term. [842- 50-30-1] \n7.8.8 0 The estimated residual value of the leased asset shall not exceed the \namount estimated at lease inception except if the lease agreement includes a \nprovision to escalate minimum lease payments either for increases in \nconstruction or acquisition cost of the leased property or for increases in some \nother measure of cost or value (such as general price levels) during the \nconstruction or preacquisition period . \n7.8.90 While deferred taxes are included in the net investment in the leveraged \nlease for purposes of calculating the lessor’s income, they are presented on the \nlessor’s balance sheet with other deferred tax balances accounted for in \naccordance with Topic 740 (income taxes) and are not netted against the net \ninvestment in the leveraged lease. Deferred taxes on leveraged leases are \naccounted for in accordance with guidance in Topic 842 and are specifically excluded from the accounting for income taxes in Topic 740. \n[842- 50-45-1] \n7.8.100 If at inception of a leveraged lease the projected net cash receipts over \nthe term of the lease are less than the initial investment in the leveraged lease, \nthe lessor recognizes a loss at lease inception for that difference. \n \n7.8.4 Subsequent measurement \n7.8.11 0 The investment in the leveraged lease net of the related deferred taxes \nrepresents the lessor’s net investment in the leveraged lease and is used to \ndetermine periodic income from the lease. The determination of the net ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 764}), Document(page\_content='Leases 764 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. investment in the leveraged lease and the amount of income recognized are \ninterrelated. The income on the leveraged lease is determined using a rate that, \nwhen applied to the net investment in the years when the net investment is \npositive, will distribute the net income to those years. The result is the \nrecognition of lease income at a level rate of return on the net investment in \nthose periods where the net investment is positive as of the beginning of the \nperiod. [842- 50-35-2] \n7.8.12 0 Generally, the net investment in a leveraged lease will be positive in its \nearly years based on the initial investment in the leased property, become \nnegative in the middle years due to tax deductions from accelerated tax \ndepreciation and interest payments on the nonrecourse debt, return to positive \nin the later years due to reversal of accelerated depreciation and reduced interest payments, and end at zero when the property is sold and the residual \nvalue is realized. \n7.8.13 0 The income or loss that is recognized by a lessor on a leveraged lease is \nsegregated into: [842- 50-35-3] \n— pretax lease income; \n— tax effect of pretax lease income; and \n— investment tax credit. \n7.8.140 The amount of each element recognized during each accounting period \nis based on the ratio of the after -tax net income for the period to the total after \ntax net income from the lease times the total of those three elements (total \npretax lease income, total tax effect of pretax lease income and total \ninvestment tax credit ). If at any time during the lease term the determination of \nlease income would result in allocation of a loss to future periods , that loss is \nrecognized immediately. [842- 50-35-3 – 35-4] \n \n Question 7. 8.120 \nDifferences in timing between when an investment \ntax credit is earned and realized \nWhen a lessor recognizes the tax benefits of an investment \ntax credit in one period but does not receive the cash benefit until a subsequent period, how should the lessor treat the \nassumed cash flows associated with the investment tax \ncredit for purposes of determining income recognition for the \nleveraged lease? \nInterpretive response: Income recognition for a leveraged lease is structured \nbased on the timing of expected cash flows. This suggests that the lessor \nshould use the period when the investment tax credits are realized when \ndetermining the timing of expected cash flows. However, some lessors have \nincluded investment tax credits in expected cash flows in the period they are \nearned. We believe either approa ch is acceptable. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 765}), Document(page\_content='Leases 765 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 7. 8.130 \nImpact of intra -entity allocation of leveraged lease \ntax benefits \nHow should a lessor determine the after -tax cash flows \nassociated with a leveraged lease when it is a member of a \nconsolidated group and the tax benefi ts paid to it by the \nparent are different from the overall tax benefits applicable to \nthe consolidated entity? \nBackground : A lessor that is a member of a consolidated group might receive \ntax benefits from the parent that differ from the overall tax benefits applicable \nto the consolidated entity if, for example, the lessor is paid only those tax \nbenefits by the parent that would be realizable by the subsidiary on a stand-alone basis . \nInterpretive response: Current and deferre d tax expense for a group that files \na consolidated tax return should be allocated among the members of the group \nfor their stand -alone financial statements using a method that is systematic, \nrational and consistent with the broad principles established by Topic 740. \nAlthough Topic 740 does not prescribe a single allocation method, in practice, \nintercorporate tax allocations are generally calculated using the separate return \nmethod or the pro rata method (see chapter 10 of KPMG Handbook, Accounting \nfor income taxes) . \nIn the lessor ’s stand -alone financial statements, the leveraged lease after -tax \ncash flows should be consistent with the allocation method used by the consolidated entity, whether under the separate return or pro rata method. \nHowever, in the consolidated financial statements the leveraged lease after -tax \ncash flows should be based on the entity’s consolidated tax position. \n \n Question 7. 8.140 \nContingent rent \nHow should a lessor account for contingent rent in a \nleveraged lease? \nInterpretive response: We believe contingent rent in a leveraged lease should \nbe accounted for consistently with contingent rent in other lease arrangements \nand ac crued as it is earned. Additionally, the contingent rent should be recorded \nwhen earned separately from the leveraged lease account balances and does \nnot affect the net investment in the lease. This means that contingent rentals \nare not assumptions that need to be established by the lessor as part of \nprojecting leveraged lease cash flows. \nHowever, we believe there could be situations in which contingent rent in a \nleveraged lease is considered a leveraged lease assumption. This would be the \ncase if the conti ngent rent payment is based on changes in the interest rate on \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 766}), Document(page\_content='Leases 766 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the lessor’s nonrecourse debt. In this case , treating the contingent rent \nresulting from the change in interest rate as an important assumption is \nconsistent with the treatment of the mechanism that triggered the contingent \nrent – i.e. a component of the leveraged lease. \n \n Question 7. 8.150 \nClassification of the net investment in a leveraged \nlease on a classified balance sheet \nHow should a lessor classify its net investment in a leveraged \nlease on a classified balance sheet? \nBackground: As described in paragraph 7.8.70, in a lessor’s net investment in a \nleveraged lease the lease receivable is presented net of the nonrecourse debt. \nIf an entity classified a portion of the net investment in the lease as current on \nthe balance sheet, that current portion could become negative as a result of accretion of unearned income. \nInterpretive response: We believe a lessor should classify its net investment \nin a leveraged lease entirely as noncurrent on a classified balance sheet. \n \n Question 7. 8.160 \nPresentation of investment tax credit in the income \nstatement \nHow should a lessor present amortization of its investment \ntax credits on leveraged leases in the income statement? \nBackground: Some lessors record the amortization as operating income \nbecause it is viewed as an important part of the rate of return on financing the \nlease. Other lessors record the amortization as part of the income tax provision. \nInterpretive response: We believe it is acceptable to present the amortization \nof investment tax credits on leveraged leases as either a component of \noperating income or a component of income tax expense. This is an accounting \npolicy choice that should be consistently applied. \n \n7.8.5 Changes in l everaged lease assumptions \n7.8.15 0 Topic 842 requires a lessor to review the estimated residual value of the \nleased asset and all other important assumptions affecting estimated total net \nincome on at least an annual basis. If, as a result of reviewing those important \nassumptions, the lessor determines that one of the following conditions exists, \nthe lessor recalculates the rate of return and the allocation of lease income to the positive net investment periods from lease inception: \n[842- 50-35-6 – 35-8] \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 767}), Document(page\_content='Leases 767 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — the estimate of the residual v alue is determined to be excessive, and the \ndecline is other than temporary ; \n— the revision to another important assumption changes the estimated total \nnet income from the lease; or \n— the projected timing of the income tax cash flows is revised. \n7.8.16 0 On recalculation of the rate of return and allocation of lease income to \nthe positive investment periods after a change in an important assumption, the \nlessor adjusts the net investment in the leveraged lease to equal the recalculated balance and a gain or loss is recognized. \n[842- 50-35-8] \n \n Question 7. 8.170 \nImpact of changes in leveraged lease assumptions \nunder Topic 842 \nWould a change in an important assumption be considered a \nmodification that would cause grandfathering of leveraged \nlease accounting to be terminated? \nInterpretive response: No. Leveraged lease accounting requires lessors to use \ncertain assumptions at inception of the leveraged lease and throughout its term. \nThose assumptions are monitored and revised, as necessary, during the term of \nthe leveraged lease and updates to the assumptions in accordance with \nparagraph 7.8.1 50 would not be considered a contract modification. \nHowever, if the terms of the leveraged lease agreement were changed, that \nwould represent a modification and grandfathering of leveraged lease accounting would be terminated. \n[842- 10-65-1(z)] \n \n Question 7. 8.180 \nChange in the interest rate on nonrecourse debt \nHow should a lessor account for a change in the interest rate \non the nonrecourse debt for a leveraged lease? \nInterpretive response: The interest rate on the nonrecourse debt is an \nimportant assumption that would be subject to reassessment on at least an \nannual basis. During the term of the leveraged lease, the lessor may refinance \nthe debt, resul ting in a change to the lessor’s cash flow assumptions for the \nleveraged lease. In this scenario, the revised cash flow assumptions are \nrecognized immediately as a catch -up adjustment in the period of the change in \naccordance with paragraph 7.8.1 50. \nIf the refinanc ing of the nonrecourse debt results in a change in the amount of \nprincipal (i.e. the lessor borrows an amount greater than the original loan), the incremental borrowing is not offset in the net investment in the leveraged \nlease . Instead, it is presented separately in the financial statements and the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 768}), Document(page\_content='Leases 768 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. cash flows related to the incremental borrowing are not included in the \naccounting for the leveraged lease. \n \n Question 7. 8.190 \nRefinancing nonrecourse debt with recourse debt \nWhat is the effect of the lessor refinancing nonrecourse debt \nwith recourse debt after inception of a leveraged lease? \nInterpretive response: When the lessor refinances the nonrecourse debt with \nrecourse debt , we believe this is similar to a delayed equity contribution. If, at \nthe point in time the lessor refinances the debt, the amount of the nonrecourse \ndebt continues to create ‘substantial leverage’ , leveraged lease classification is \nretained and the changes in projected cash flows are treated as a change in an \nimportant assu mption. \nHowever, if the change in financing structure would have resulted in failing to qualify for leveraged lease classification at lease inception, leveraged lease \nclassification should be discontinued and the lease accounted for prospectively \nas a dire ct financing lease. The direct financing lease would be accounted for \nwithout a cumulative catch -up adjustment that would be necessary had \nleveraged lease classification been retained. \n \n Question 7. 8.200 \nChange in the projected timing of income tax cash \nflows \nHow should a lessor that has classified a lease as a leveraged \nlease account for a change in the projected timing of income tax cash flows? \nInterpretive response: The projected timing of the income tax cash flows is \nparticularly important becau se of its effect on the periodic income recognized \nby the lessor. The tax benefits are often recognized by the lessor in the early \npart of the lease term, resulting in a disproportionally higher amount of income \nrecognized in the earlier periods of the lea se. If the projected timing of those \nincome tax cash flows is revised, for example as a result of settlements with taxing authorities due to challenges in the timing of tax deductions, the lessor \nrecalculates the rate of return and the allocation of income to positive \ninvestment years consistent with paragraph 7.8.1 50. In the case of a settlement \nwith taxing authorities, this may include related interest and penalties, which \nshould not be considered a change in the estimated total income from the \nleveraged lease. \n[842- 50-35-9 – 35-15] \nThe projected timing of the income tax cash flows could also be affected for \nother reasons. For example, to the extent that a lessor is unable to use \nanticipated tax benefits in the period they are earned, the projected timing of \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 769}), Document(page\_content='Leases 769 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the cash flows may be sign ificantly affected even though total net income may \nnot change if the lessor ultimately expects to be able to fully realize the tax \nbenefits in future periods. In this situation, the lessor should not view the \nchange in projected timing of income tax cash flows as a change in an \nimportant assumption because the estimated total net income for the lease is \nnot changed. To the extent the lessor believes it will not ultimately be able to \nuse the tax benefits, it would be viewed as a change in an important \nassum ption, requiring recalculation of the rate of return and the allocation of \nincome to positive investment years. \n \n Question 7. 8.210 \nImpact of change in income tax rate on the \naccounting for a leveraged lease \nHow should a lessor treat the effect of a change in income tax \nrate on its accounting for a leveraged lease? \nInterpretive response: If there is a change in the applicable tax rate, the lessor \nrecognizes the effect of the rate change as a gain or loss in the accounting \nperiod during which the legislation affecting the change in income tax rate is \nenacted. \n \n Question 7. 8.220 \nPayments under a tax indemnification agreement \nHow should a lessor treat payments received from a lessee \nthat are a result of tax inde mnification agreements? \nBackground: Lease agreements may include indemnification agreements \nwhere the lessor is protected from adverse changes in law. For example, in the \nevent of changes in tax legislation that increase applicable income tax rates, the \nlease agreement may provide that payment from the lessee will increase to \ncompensate the lessor for its increased tax costs. \nInterpretive response: A lessor should treat tax indemnification payments that \nit has received, or expects to receive based on ena cted legislation, as a change \nin an important assumption if the lessor’s total estimated net income under the \nleveraged lease is affected as a result of the indemnification. When the \nindemnification is structured such that the lessor is compensated by the lessee in the amount of any increase in tax obligations resulting from changes in rates, \nthe lessor’s total estimated net income and timing of cash flows may not be affected and no reassessment of the leveraged lease may be necessary. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 770}), Document(page\_content='Leases 770 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 7. 8.230 \nTreatment of a sale of the appreciation in the \nresidual value of the underlying asset \nHow should a lessor account for a sale to a third- party \ninvestor of any appreciation in the residual value of the \nunderlying asset in a leveraged lease? \nBackground: Under Subtopic 842- 50, a lessor does not recognize any upward \nadjustment to the residual value of the underlying asset. However, during the \nterm of a leveraged lease, the lessor may realize the economic benefits of an \nincrease in the residual value of the underlying asset by selling an interest to a \nthird party in any appreciation in the residual value. [842- 50-35-8(c)] \nInterpretive response: The lessor sho uld include any payment from the third-\nparty investor to purchase the interest in the appreciated value of the underlying \nasset’s residual value as a change in a leveraged lease assumption under \nparagraph 842-50-35-6 (see paragraph 7.8.15 0) and recalculate the projected \ncash flows from the leveraged lease by including the payment received in the current period. Income tax effects of the payment should be included in the \nrevised projected cash flows in the period in which the tax will be assessed. \nThe lessor should record a gain or loss in the period in which the change in \nassumption was made (see paragraph 7.8.16 0). \nNo change should be made to the expected residual value of the underlying \nasset established at inception of the lease if there is no indication that the value \nhas declined. \n \n Question 7. 8.240 \nLeveraged lease classification when investment tax \ncredits are accounted for differently \nWhen investment tax credits are accounted for other than as \nprescribed in paragraphs 842 -50-30-1 and 35- 4, how should a \nlessor account for the leveraged lease? \nBackground: An investment tax credit may be accounted for other than as \nprescribed in Topic 842, as approved by Congress in the Revenue Act of 1971. \nInterpretive response: A lease meeting the definition i n paragraph 840- 10-25-\n43(c) should be accounted for by the lessor using the method described in \nSubtopic 842-50. An exception arises if the investment tax credit is accounted \nfor other than as stated in paragraphs 842- 50-30-1 and 35- 4, in which case \nthe lease should be classified in accordance with the requirements of \nparagraphs 842-10-25-2 through 25-3A (i.e. not as a leveraged lease). \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 771}), Document(page\_content='Leases 771 \n7. Lessor accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 7. 8.250 \nAcquisition of a grandfathered leveraged lease \nIs a leveraged lease acquired on or after the effective date of \nTopic 842 still accounted for as a leveraged lease? \nInterpretive response: The acquisition of a grandfathered leveraged lease on \nor after the effective date of Topic 842 does not change that lease’s \nclassification as a leveraged lease (i. e. the lease remains subject to the \nleveraged lease guidance in Subtopic 842- 50) unless it is modified as part of the \nacquisition. A grandfathered leveraged lease loses its grandfathered status only \nif it is modified on or after the effective date, includi ng modifications that occur \nin an asset acquisition or business combination. [842- 10-65-1(z)] \n \n Observation \nDecision to grandfather leveraged leases \n7.8.17 0 The Board’s decision to eliminate leveraged lease accounting was \nintended to reduce complexity in the lessor accounting requirements and to converge with IFRS Accounting Standards , which ha ve no specialized \naccounting for leveraged leases. \n7.8.18 0 However, the Board decided to grandfather leveraged leases that \ncommence before the effective date of Topic 842, on the basis that the costs \nfor lessors to unwind their accounting would exceed the benefit s to financial \nstatement users of doing so. This dec ision requires lessors with leveraged \nleases to retain their existing systems and controls for those transactions until \nthe leases are terminated, which may be several decades. [ASU 2016- 02.BC397] \n7.8.19 0 Therefore, lessor accounting for similar leases may differ solely \ndepending on whether the lease commences shortly before or shortly after the \neffective date of Topic 842. As a result, the decision to grandfather existing \nleveraged leases may make it difficult for financial statement users to com pare \nthe financial statements of those lessors to those of other lessors prepared \nunder US GAA P and IFRS Accounting Standards . \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 772}), Document(page\_content='Leases 772 \n8. Subleases \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 8. Subleases \nDetailed contents \nHow the standard works \n8.1 General requirements \n8.1.1 Sublease classification \n8.1.2 Sublessor \n8.1.3 Sublessee \nObservation \nSublease classification \nQuestions \n8.1.10 Accounting for the head lease when a sublease exists \n8.1.20 Impact of sublease renewal options on head lease term \n8.1.30 Impact of sublease purchase options on assessment of \nhead lease \n8.1.40 Sublessor reassessments \n8.1.50 Impact of sublessee actions on sublessor accounting for the head lease\n \n8.2 Accounting by the sublessor \n8.2.1 Step 1: Determine the discount rate for the sublease \n8.2.2 Step 2: Determine the classification of the sublease \n8.2.3 Step 3: Account for the sublease \nQuestions \n8.2.10 Use of the rate implicit in the sublease \n8.2.20 Sublessor relieved of its primary obligation \n8.2.25 Underlying asset use rights before an assignment occurs \n8.2.30 Sublessor recognition of profit (loss) on a sales -type or direct \nfinancing sublease \n8.2.35 Loss -making sublease entered into before head lease \ncommencement \n8.2.40 Sublease presentation by sublessors \n8.2.50 Gross vs. net presentation of sublease income \nExample \n8.2.10 Classification and accounting for a sublease transaction by a \nsublessor \nComparison to legacy US GAAP ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 773}), Document(page\_content='Leases 773 \n8. Subleases \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. How the standard works \nThe following flow chart summar izes the accounting for each party to a lease \nand sublease transaction. \n \nHead lessor\nHead lessee /\nintermediate lessor \n(sublessor )\nSublesseeApply lessor accounting (see chapter 7)\n— Apply lessee accounting to the head \nlease (see chapter 6)\n— Apply lessor accounting to the sublease \n(see chapter 7)\n— Generally present gross\nApply lessee accounting (see chapter 6)\n \nWe expect that most subleases under Topic 842 will be classified as operating \nleases by sublessors. \nSection 6.5.2 includes important considerations for when a lessee subleases a portion of an underlying asset (e.g. one floor of an entire leased building). \n \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 774}), Document(page\_content='Leases 774 \n8. Subleases \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 8.1 General r equirements \n8.1.1 Sublease classification \n Excerpt from ASC 842-10 \n25 Recognition \nGeneral \n25-6 When classifying a sublease, an entity shall classify the sublease with \nreference to the underlying asset (for example, the item of property, plant, or \nequipment that is the subject of the lease) rather than with reference to the \nright -of-use asset . \n \n8.1.10 The sublessor and sublessee classify a sublease by reference to the \nunderlying asset subject to the lease, rather than by reference to the ROU \nasset. This means that, in determining the classification of the sublease, the \nsublessor and the sublesse e consider: \n— the term of the sublease as compared to the remaining economic life of the \nunderlying ass et – rather than, for example, the remaining term of the head \nlease; and \n— the present value of the sum of the sublease payments and any residual \nvalue guarantee provided by the sublessee as compared to the fair value of \nthe underlying asset – rather than the fair value of the head lease ROU \nasset. \n \n Observation \nSublease classification \n8.1.20 A sublessor classifies a sublease by reference to the underlying asset, not \nthe ROU asset arising from the head lease. The Board determined that applying \nthe lease classification guidance by reference to the underlying asset would be \nmore operational for sublessors because, for example, it may be difficult to \ndetermine the fair value of the ROU asset in the head lease. [ASU 2016- 02.BC116] \n8.1.30 The Board also reasoned that classifying a subl ease by reference to the \nunderlying asset would result in more consistent lease classification outcomes for similar leases. For example, if sublease classification were determined on \nthe basis of the remaining economic life of the head lease ROU asset, it would \nbe difficult to understand and explain the following when the same underlying asset is being leased, under potentially similar terms, and with similar periods of \nuse: why the head lessor (or any other lessor) would classify the head lease as \nan opera ting lease, while the sublessor might classify the sublease as a sales-\ntype or direct financing lease.\n [ASU 2016- 02.BC116] \n8.1.40 The sublease classification requirements in Topic 842 will generally result \nin operating lease classification for most subleases. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 775}), Document(page\_content='Leases 775 \n8. Subleases \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 8.1.2 Sublessor \n Excerpt from ASC 842-30 \n35 Subsequent Measurement \nGeneral \n> Subleases \n35-7 If the original lessee enters into a sublease or the original lease \nagreement is sold or transferred by the original lessee to a third party, the \noriginal lessor shall continue to account for the lease as it did before. \n40 Derecognition \nGeneral \n> Sales -Type and Direct Financing Leases \n>> Subleases \n40-3 If the original lease agreement is replaced by a new agreement with a \nnew lessee, the lessor shall account for the termination of the original lease as \nprovided in paragraph 842- 30-40-2 and shall classify and account for the new \nlease as a separate transaction. \n40-4 For guidance on the acquisition of the residual value of an underlying \nasset by a third party, see paragraph 360 -10-25-2. \n \n Question 8.1.10 \nAccounting for the head lease when a sublease \nexists \nDoes entering into a sublease with a term longer than the \nremaining head lease term trigger a remeasurement of the \nhead lease? \nInterpretive response: Yes. Two parties may enter into a sublease where the \nnon-cancellable period of the sublease, or the sublease term (i.e. including one \nor more optional periods), exceeds the lease term for the head lease. The act of \nentering into the sublease is a significant ev ent within the control of the \nsublessor that directly affects the assessment of the lease term. Therefore, the sublessor needs to update the head lease ter m to be at least equal to the \nsublease term, which will then trigger a remeasurement of the head lease. See \nsection 6.6.1 for add itional examples of events that trigger a reassessment of \nthe lease term. \n[842- 10-55-28] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 776}), Document(page\_content='Leases 776 \n8. Subleases \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 8.1. 20 \nImpact of sublease renewal options on head lease \nterm \nDoes the head lease term include all renewal options that \nthe he ad lessee (sublessor) can be required to exercise \nunder the terms of a sublease? \nInterpretive response: Not necessarily. Based on discussions with the FASB \nstaff, the substance of which were discussed and affirmed by the Board at a \nNovember 2016 Board meeting, we believe entering into a sublease that \nincludes renewal options that could compel the sublessor to exercise one or \nmore renewal options it has in the head lease does not automatically trigger a \nchange to the head lease term. \nEntering into the s ublease is a significant event within the control of the head \nlessee such that the head lessee needs to reassess the lease term at that time. However, unless the sublessee is reasonably certain (see section 5.2) to \nexercise its renewal option (which would compel the head lessee to do likewise \n– see Question 8.1.10), the sublessee’s renewal option will not, in isolation, \ntrigger a change to the head lease term (and therefore a remeasurement of the \nhead lease liability). \n[842- 10-35-1, 55 -28] \n \n Question 8.1. 30 \nImpact of sublease purchase options on assessment \nof head lease \nDoes a sublessee option to purchase the underlying asset \ntrigger a remeasurement of the head lease by the head \nlessee? \nBackground: A head lessee may convey its option to pur chase the underlying \nasset to a sublessee as part of a sublease. \nInterpretive response: It depends. Entering into the sublease is a triggering \nevent that requires the head lessee to reassess its option to purchase the \nunderlying asset (as well as the head lease term) – see section 6.6.1 . The head \nlessee will remeasure the lease if it or the sublessee is reasonably certain to \nexercise the purchase option. \nIf neither the head lessee, nor the sublessee, is reasonably certain to exercise the purchase option, the head lessee will not remeasure the lease (assuming no \nother changes – e.g. to the lease term or to the amount probable of being owed \nunder a residual value guarantee – trigger a remeasurement). \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 777}), Document(page\_content='Leases 777 \n8. Subleases \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 8.1. 40 \nSublessor reassessments \nDo sublessors ever reassess their accounting for a sublease \nabsent a modification? \nInterpretive response: No. Topic 842 requires sublessors to apply the lessor \naccounting guidance to the sublease. Therefore, sublessors do not reassess \ntheir accounting for the sublease – e.g. reassess the sublease term or \nsublessee purchase options – after the commencement date unless the \nsublease is modified (and that modification is not accounted for as a separate \ncontract – see section 7.6). \nBecause the sublessor is also a lessee (i.e. in the head lease), the differences \nbetween the lessee and the lessor reassessment requirements may result in \ncircumstances in which the sublessor will reassess its accounting for the head lease, but make no changes to its accounting for the s ublease. \n \n Question 8.1. 50 \nImpact of sublessee actions on sublessor \naccounting for the head lease \nDo sublessee actions trigger reassessments of the head \nlease by the sublessor? \nInterpretive response: In general, no. W e believe that sublessors are not \nrequired to monitor for any changes to the sublessee’s facts or circumstances \nin accounting for the head lease. Rather, consistent w ith any other lease for \nwhich the sublessor is a lessee (i.e. those leases not subject to a sublease), the \nsublessor only reassesses its accounting for the head lease upon the \noccurrence of a significant event or change in circumstances within its control. \nFor example, while the sublessor may be aware of the sublessee constructing \nsignificant leasehold improvements or making significant customizations to the \nunderlying asset, assuming such actions are not within the sublessor’s control \n(i.e. the sublessor is not requiring those improvements or modifications) , they \nwould not trigger a reassessment. \nHowever, if a sublessor has provided a residual value guarantee to the head \nlessor, the sublessor will need to monitor whether there are changes in the \namount probable of being owed to the head lessor under the residual value \nguarantee. \n \n8.1.3 Subless ee \n8.1.50 A sublessee classifies and accounts for the sublease as it would any \nother lease ( see chapter 6 ). From the sublessee’s perspective, the fact that the \nlease is a sublease has no effect on its accounting for the lease. Practically, this \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 778}), Document(page\_content='Leases 778 \n8. Subleases \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. is because a sublessee may not know the terms and conditions of the head \nlease, and on some occasions may not even know that the lease is a sublease, \nmaking it difficult to apply the lease classification guidance by reference to the \nhead lease ROU asset. \n \n8.2 Accounting by the s ublessor \n Excerpt from ASC 842-20 \n35 Subsequent Measurement \nGeneral \n> Subleases \n35-14 If the nature of a sublease is such that the original lessee is not relieved \nof the primary obligation under the original lease, the original lessee (as \nsublessor) shall continue to account for the original lease in one of the \nfollow ing ways: \na. If the sublease is classified as an operating lease, the original lessee shall \ncontinue to account for the original lease as it did before commencement \nof the sublease. If the lease cost for the term of the sublease exceeds the \nanticipated sublea se income for that same period, the original lessee shall \ntreat that circumstance as an indicator that the carrying amount of the \nright -of-use asset associated with the original lease may not be \nrecoverable in accordance with paragraph 360- 10-35-21. \nb. If the original lease is classified as a finance lease and the sublease is \nclassified as a sales -type lease or a direct financing lease , the original \nlessee shall derecognize the original right -of-use asset in accordance with \nparagraph 842- 30-40-1 and continue to account for the original lease \nliability as it did before commencement of the sublease. The original \nlessee shall evaluate its investment in the sublease for impairment in \naccordance with paragraph 842- 30-35-3. \nc. If the original lease is classified as an operating lease and the sublease is \nclassified as a sales- type lease or a direct financing lease, the original \nlessee shall derec ognize the original right -of-use asset in accordance with \nparagraph 842- 30-40-1 and, from the sublease commencement date , \naccount for the original lease liability in accordance with paragraphs 842- 20-\n35-1 through 35 -2. The original lessee shall evaluate it s investment in the \nsublease for impairment in accordance with paragraph 842- 30-35-3. \n35-15 The original lessee (as sublessor) in a sublease shall use the rate \nimplicit in the lease to determine the classification of the sublease and to \nmeasure the net investment in the sublease if the sublease is classified as a \nsales- type or a direct financing lease unless that rate cannot be readily \ndetermined. If the rate implicit in the lease cannot be readily determined, the \noriginal lessee may use the discount rate for the lease established for the \noriginal (or head) lease. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 779}), Document(page\_content='Leases 779 \n8. Subleases \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 40 Derecognition \nGeneral \n> Subleases \n40-3 If the nature of a sublease is such that the original lessee is relieved of \nthe primary obligation under the original lease , the transaction shall be \nconsidered a termination of the original lease. Paragraph 842- 20-35-14 \naddresses subleases in which the original lessee is not relieved of the primary \nobligation under the original lease. Any consideration paid or received upon \ntermination that was not already included in the lease payments (for example, \na termination payment that was not included in the lease payments based on \nthe lease term ) shall be included in the determination of profit or loss to be \nrecognized in accordance with paragraph 842- 20-40-1. If a sublease is a \ntermination of the original lease and the original lessee is secondarily liable, the \nguarantee obligation shall be recognized by the lessee in acc ordance with \nparagraph 405 -20-40-2. \n \n8.2.10 The head lease and the sublease will generally be accounted for \nseparately – i.e. as two separate units of account. This is because, even if the \ncontracts are entered into at or near the same date, the subless ee is generally a \nthird party unrelated to the head lessor. Two or more contracts are potentially \ncombined under Topic 842 only if they are entered into at or near the same time \nand with the same counterparty (or a related party of the counterparty) – see \nsection 4. 6. [842-10-25-19, ASU 2016- 02.BC115] \n8.2.20 In accounting for the sublease, the sublessor follows these steps. \nStep 1: Determine the discount rate for the sublease \nStep 2: Determine the classification of the sublease \nStep 3: Account for the sublease \n \n8.2.1 Step 1: Determine the d iscount rate for the sublease \n8.2.30 The sublessor in a sublease transaction uses the rate implicit in the \nsublease to determine classification of the sublease, and to measure the net investment in the sublease if it is classified as a sales- type or direct financing \nlease. The rate implicit i n the sublease is the rate that balances the following \nequation. \n[842- 20-35-15] \nFV of head \nlease ROU \nasset1PV of sublease \npaymentsSublessor \ndeferred IDCs2PV of residual \nvalue of head \nlease ROU \nasset1\n \nNotes: \n1. The residual value and the fair value of the head lease ROU asset are estimated as of the \nsublease commencement date. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 780}), Document(page\_content='Leases 780 \n8. Subleases \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 2. These are initial direct costs that relate to the sublease. They do not include the \nsublessor’s initial direct costs of the head lease. \n8.2.40 However, if the rate implicit in the lease cannot be readily determined, a \nsublessor may use the discount rate established for the head lease; for \nexample, the sublessor’s incremental borrowing rate at the commencement \ndate of the head lease. [842- 20-35-15] \n \n Question 8. 2.10 \nUse of the rate implicit in the sublease \nWhen should sublessors and sublessees use the rate implicit \nin the sublease as the discount rate for the sublease? \nBackground: Topic 842 does not provide explicit guidance for determining the \nrate implicit in a sublease; however, we believe that the definition of rate \nimplicit in the lease and the specific guidance i n Topic 842 means that the rate \nwould be calculated as outlined in paragraph 8.2.30. \nInterpretive response: Sublessors and sublessees will use the rate implicit in \nthe sublease as the discount rate when that rate is ‘readily determinable’. \nSublessor \nWe believe that the rate implicit in a sublease will often not be ‘readily \ndeterminable’ for the sublessor becaus e determining the fair value of a n ROU \nasset may be highly subjective in many cases. Therefore, in classifying and \naccounting for the sublease, a sublessor will likely use the discount rate for the \nhead lease. \nSublessee \nTopic 842 is not explicit as to whet her the Board intended for the sublessee to \nuse the sublessor’s implicit rate in determining the discount rate for the lease if that rate is readily determinable. However, we expect that the rate implicit in \nthe sublease will almost never be readily determ inable for a sublessee. This is \nbecause the sublessee would need to have insight into all of the following to \ndetermine that rate: \n— the fair value of the sublessor’s ROU asset, which will likely be impossible \nto determine in most cases because the sublessee will likely not know the \nterms and conditions of the head lease; \n— the sublessor’s estimated residual value of the head lease ROU asset, \nwhich it will likely not have; and \n— the sublessor’s initial direct costs resulting from the sublease, which the \nsublessee will likely not know unless the sublessor provides that information to the sublessee. \nConsequently, we believe that a sublessee will, in virtually all if not all cases, use its incremental borrowing rate as the discount rate for the sublease. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 781}), Document(page\_content="Leases 781 \n8. Subleases \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 8.2.2 Step 2: Determine the c lassification of the sublease \n8.2.50 The classification of the sublease as a sales- type, direct financing or \noperating lease is determined in the same manner as any other lease ( see \nchapter 7). [842- 10-25-2 – 25-3A] \n \n8.2.3 Step 3: Account for the sublease \n8.2.60 The sublease is accounted for as a sales -type, direct financing or \noperating lease in the same ma nner as any ot her sales -type, direct financing or \noperating lease (see chapter 7). \n8.2.70 The accounting for the head lease depends on whether the sublessor is \nrelieved of its primary obligation under that lease. Paragraph 8.2.80 describes \nthe accounting by a sublessor that is not relieved of primary obligation for the \nhead lease; paragraphs 8.2.100 – 8.2.120 address the accounting by the \nsublessor when it is relieved of that obligation. \n \n Question 8. 2.20 \nSublessor r elieved of its primary obligation \nHow should a sublessor determine whether it has been \nrelieved of its ‘primary obligation’ under the head lease when it enters into a sublease? \nInterpretive response: Determining who is primarily obligated under a lease \nand when that obligation terminates is a legal mat ter that depends on the terms \nof the head lease and, if the lessor under the head lease is a party to the \nsublease agreement, the sublease. Consultation with qualified legal counsel \nmay be necessary to determine whether a lessee is relieved of its primary \nobligation under the head lease as a result of entering into a sublease. \nThe sublessor may consider whether the following scenarios apply in determining whether it has been relieved of its primary obligation. \n— If the lessor under the head lease is not a pa rty to the sublease and the \nprovisions of the head lease do not provide for any change in the head \nlessor's rights and the head lessee's obligations in the event that the \nproperty is subleased, the sublease generally should not be accounted for as a termin ation of the head lease agreement. \n— If the head lessor has equal recourse to the head lessee and the sublessee, \nthe sublease generally should not be accounted for as a termination of the \nhead lease. \n— If the head lessor continues to have recourse to the hea d lessee, the terms \nof the head lease or the sublease (if the head lessor is a party to the \nsublease agreement) generally would need to provide that the lessor must \nenforce its rights under the head lease against the sublessee before \nseeking performance for a shortfall from the head lessee to be able to \n", metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 782}), Document(page\_content='Leases 782 \n8. Subleases \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. conclude that the sublease should be accounted for as a termination of the \noriginal lease agreement. In effect, the terms of the head lease or the \nsublease, as applicable, would need to provide for the head lessee to function as a guarantor only. \nWe believe that a sublessor may be relieved of its primary obligation under the \noriginal head lease when: \n— a new lessee is substituted under the original head lease agreement and \nbecomes the primary obligor (the origi nal lessee may or may not be \nsecondarily liable); or \n— a new lessee is substituted through an altogether new lease agreement – \nwith the original head lease agreement being cancelled. \n \nSublessor not relieved of its primary obligation under the \nhead lease \n8.2.80 If the sublessor is not relieved of its primary obligation under the head \nlease, the sublessor accounts for the head lease and the sublease in one of the \nfollowing ways depending on the classification of the sublease. [842- 20-35-14] \n— Sublease is an ope rating lease. The sublessor: \n— continues to account for the head lease as it did before sublease commencement (see chapter 6); \n— continues to assess the head lease ROU asset for impairment (see \nsection 6.5). However, if the lease cost of the head lease for the term of the sublease exceeds the sublease income anticipated for that same \nperiod, this is an indicator that the carrying amount of the head lease \nROU asset may n ot be recoverable; and \n— recognizes sublease income over the lease term (see section 7.4). \n— Sublease is a sales -type or a direct financing lease, and the head lease \nis a finance lease. The sublessor : \n— derecognizes the head lease ROU asset using the guidance in \nSubtopic 842-30 on the derecognition of underlying assets by lessors in \nsales- type and direct financing leases (see section 7.3.1 ); \n— continues to account for the head lease liability as it did before the \ncommencement of the subl ease (see section 6.4) ; \n— recognizes the net investment in the sublease (see section 7.3.1 ); and \n— assesses its net investment in the sublease for impairment using the \nfinancial instruments impairment guidance (see section 7.3.2). \n— Sublease is a sales -type or a direct financing lease, and the head lease \nis an operating lease. The sublessor: \n— derecognizes the head lease ROU asset using the guidance in \nSubtopic 842-30 on the derecognition of underlying assets by lessors in \nsales- type and direct financing leases (s ee section 7.3.1 ); ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 783}), Document(page\_content='Leases 783 \n8. Subleases \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — each period following sublease commencement, increases the head \nlease liability to reflect interest on the lease liability using the effective \ninterest method, and reduces the head lease liability to reflect lease \npayments made during the period (i.e. accounts for the head lease \nliability under the finance lease provis ions of the lessee accounting \nguidance – see section 6.4) ; \n— recognizes the net investment in the sublease (see section 7.3.1 ); and \n— assesses its net investment in the sublease for impairment using the financial instruments impairment guidance (see section 7.3.2). \n \n Question 8.2.25 \nUnderlying asset use rights before an assignment \noccurs \nHow does a lessee account for a lease it has agreed to assign \nto a third party if the third party takes control over the use of \nthe underlying asset before the assignment occurs ? \nBackground : Consider a scenario in which an entity sells a business unit to a \nthird-party acquirer. The entity has a series of leases that it and the acquirer \nagree will be assigned to the acquirer. In this scenario, the legal assignment of \nthe lease will relieve the entity of its primary obligation for the lease (see \nQuestion 8.2.20). \nHowever, some of those leases are not yet assigned by the acquisition date \n(e.g. because some of the lessors have yet to agree to the assignments), \ndespite the acquirer having control over the use of the underlying assets from \nthat date. \nIn this scenario, the question arises about how the entity should account for \nthose leases. \nInterpretive response: If a lessee has relinquished control over the use of an \nunderlying asset to a third party, but has not yet legally assigned the lease to \nthe third party in a way that it is relieved of its primary obligation under the lease, we believe the lessee has, in effect, granted the third party a sublease. \nParagraph 8.2.80 addresses accounting for a sublease when the lessee has not \nbeen relieved of its primary obligation under the head lease. \nWhen the lessee is ultimately relieved of its primary obligation under the head lease (e.g. when the lease gets assigned in the ba ckground scenario), it applies \nparagraphs 8.2.100 – 8.2.120. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 784}), Document(page\_content='Leases 784 \n8. Subleases \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 8. 2.30 \nSublessor recognition of profit (loss) on a sales -type \nor direct financing sublease \nWhen should a sublessor recognize selling profit or loss on a \nsales -type or direct financing sublease? \nInterpretive response: Because a sublessor applies the same guidance a head \nlessor applies, it will recognize any selling profit or loss on the sublease in the \nsame manner as it would for a sales -type or direct financing head lease. \n— Selling profit is recognized at sublease commencement for a sales -type \nsublease and over the lease term for a direct financing sublease (see \nsection 7.3.1 ). \n— Selling loss is recognized at sublease commencement for any sublease, \nregardless of whether it is cla ssified as a sales- type or direct financing \nsublease. \n \n Question 8.2.35 \nLoss -making sublease entered into before head \nlease commencement \nDoes a sublessor recognize a loss accrual on entering into a \nloss-making sublease before the head lease commencement \ndate? \nBackground: Assume a sublessor enters into a ten -year non- cancellable head \nlease. Before head lease commencement, the sublessor enters into a sublease. \nThe sublease rental payments are less than the head lease payments such that \nthe sublessor will incur a loss on the sublease. \nIn this scenario, the question arises as to whether the sublessor is required (or permitted) to rec ognize the sublease loss at sublease inception. \nInterpretive response: No, we believe the sublessor should not record a \nsublease loss accrual at sublease inception. Our view is based on the combined \neffect of the following. \n— The FASB has previously stated that sublease losses are outside the scope of Topic 450 (contingencies). Because the scope of Topic 450 was not \namended by the new leases guidanc e, we believe sublease losses remain \noutside its scope. \n[FIN 27.10] \n— Lessors do not recognize onerous contract provisions for loss -making \nleases; a loss- making lease affects whether the underlying asset is \nimpaired. And as stated in paragraph 8.2.60, sublessors account for \nsubleases in the same manner as a head lessor would account for the \nsame lease . This means a sublessor should consider whether the head \nlease ROU asset is impaired in a loss -making sublease . That the head lease \nROU asset is not yet recognized means that the sublessor undertakes the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 785}), Document(page\_content='Leases 785 \n8. Subleases \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. impairment analysis at head lease commencement; it does not mean the \nsublessor should adopt a different accounting model for the lease. \n— The FASB has stated that, for lessors, leasing is ‘fundamentally, a revenue-\ngenerating activity’. Further, vendors in revenue contracts under Topic 606 \nrecognize loss accruals only in specific circumstances (see chapter 13 of \nKPMG Handbook, Revenue recognition ) that are not analogous to lease \ncontracts generally accounted for as either product sales (sales -type/direct \nfinancing leases) or executory service contracts (operating leases). [ASU \n2016- 02.Summary, BC92] \n— It is unclear how such accruals would be accounted for at and after head lease commencement. For example, would an existing sublease loss \naccrual continue to be separately recognized, or would it be subsumed into \nthe head lease ROU asset? Topic 842 does not mention existing s ublease \nloss accruals when accounting for a lease at the commencement date; this at least suggests such loss accruals were not contemplated. \n \n Question 8. 2.40 \nSublease presentation by sublessors \nHow should a sublessor present its net investment in a \nsales -type or direct financing sublease? \nInterpretive response: Topic 842 does not provide explicit guidance on the \npresentation of the net investment in a sales -type or direct financing sublease \nfor sublessors. Topic 842 simply says that sublessors apply the lessor \naccounting requirements in Subtopic 842- 30. This indicates that sublessors are \nrequired to present their net investment in subleases separately from other \nassets on the balance sheet. But it is not clear whether an entity’s net \ninvestment in sales -type and direct financing subleases should be presented \nseparately from its net investment in sales -type and direct financing leases for \nwhich it is the head lessor. \nDetermining the appropriate presentation – i.e. presenting the entity’s net \ninvestment in sales -type and direct financing subleases separately from the \nentity’s net investment in sales -type and direct financing head leases – may \ndepend on the extent of the differences in risks between the two types of net \ninvestment. However, we expect these instances to be infrequent, because the \nnumber of entities with sales -type or direct financing head leases and sales -\ntype or direct financing subleases may be small and because we believe that \nrelatively few subleases for any entity will be sales -type or direct financing \nsubleases. \n8.2.90 The sublessor generally presents the expense on the head lease \nseparately from the income on the sublease (i.e. gross presentation) in its income statement. At a June 2014 meeting, the FASB decided a n exc eption \nwould apply if the sublessor records its sublease income as revenue and acts as an agent with respect to the lease under the principal -agent guidance in \nTopic 606 (see chapter 9 of KPMG Handbook , Revenue recognition) . However, \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 786}), Document(page\_content='Leases 786 \n8. Subleases \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. based on the final definition of a lease (see chapter 3) and the amendments \nmade to the Topic 606 principal- agent guidance subse quent to this Board \ndecision , we generally believe it would not be possible to both have a lease and \nbe an agent to the sublease. Therefore, we expect that application of this \nexception would be extremely rare, if ever. [606- 10-55-36 – 55-40] \n \n Question 8 .2.50 \nGross vs. net presentation of sublease income \nIs it acceptable to net sublease income against head lease \nexpense in the income statement? \nBackground: The guidance in paragraph 8.2.90 reflects a joint decision reached \nby the FASB and the IASB at their June 2014 meeting and is consistent with \neach Board’s publicly available summary of the decisions reached. However, \nthe FASB did not include explicit guidance to the effect of paragraph 8.2.90 in \nTopic 842 or discuss it explicitly in the basis for conclusions to ASU 2016- 02. \nConsequently, some have questioned whether it would be acceptable for a head lessee to present sublease income together with the related head lease expense in the income statement – i.e. on a net basis. \nNote: If the sublessor is not relieved of its primary obligation under the head \nlease, it is never appropriate to account for the head lease and the sublease on a net basis on the balance sheet. \nInterpretive response: There are differing views in practice, and we believe \nthat either of the following approaches is acceptable. \nApproach A: Gross presentation in all cases \nSome believe that gross presentation of head lease expense and sublease \nincome is required in all cases other than as described in paragraph 8.2.90. \nNotwithstanding the lack of explicit guidance, the basis for conclusions does \nstate that an entity should account for a head lease and a sublease as two \nseparate contracts unless those contracts meet the contract combinations \nguidance, which can only occ ur if the head lessor and the sublessee are related \nparties (which is generally uncommon). It also states that it is appropriate for a \nhead lease and sublease to be accounted for separately. \n[ASU 2016- 02.BC115] \nProponents of this approach believe the Board has been clear that the head \nlease and sublease are separate contracts, and therefore they should be accounted for separately in all cases. \nApproach B: Net presentation is acceptable in some cases \nOthers believe that net presentation is acceptable, but not required, if: \n— subleasing is not a significant business activity for the entity (i.e. it is not \npart of the entity’s ongoing major or central operations); and \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 787}), Document(page\_content='Leases 787 \n8. Subleases \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — the entity’s customary business practice in subleasing is to manage \noccupancy costs and provid e it with flexibility to expand and contract \noccupancy space to meet changing business needs. \nGross presentation is required otherwise. \nProponents of this approach highlight that net presentation under similar circumstances was acceptable under Topic 840 and the FASB has stated that \nTopic 842 was not intended to significantly change income statement \npresentation for lessees. In addition, Topic 842 addresses only the balance \nsheet presentation of subleases, and net presentation in the circumstances \ndescribed appropriately reflects the economics of the lease/sublease \ntransaction. \n \nSublessor relieved of its primary obligation under the head \nlease \n8.2.100 If the sublessor is relieved of its primary obligation under the head lease \n(see Question 8. 2.20), the head lease is considered terminated, and the \nsublessor derecognizes the head lease ROU asset and head lease liability, with \nthe difference recognized as profit or loss. [842- 20-40-3] \n8.2.110 Any consideration paid or received on termination that was not already \nincluded in the lease payments is generally included in the calculation of the \nprofit or loss recognized on lease termination. Such consideration might arise, \nfor example, if the lease term of the head lease did not reflect the lessee \nexercisi ng a termination option. [842- 20-40-3] \n8.2.120 If a sublease is a termination of the head lease and the head lessee is \nsecondarily liable, the sublessor (as head lessee) recognizes the guarantee \nobligation using the guidance in Topic 405 (liabilities) . Whether or not explicit \nconsideration was paid for that guarantee, the head lessee becomes a \nguarantor. The guarantee obligation is initially measured at fair value, and that \namount reduces (increases) the profit (loss) recognized on lease termination. \n[842- 20-40-3, 405- 20-40-2] \n \n Example 8.2.10 \nClassification and accou nting for a sublease \ntransaction by a sublessor \nSublessor SR leases a non- specialized warehouse for designing paint schemes \nfor cars that it manufactures. \nHead lease \nThe following facts about the head lease (operating lease) at the \ncommencement date are relevant. \nNon-cancellable lease term: 15 years \nRenewal options: 15 years (3 options of 5 years each) \nPurchase option/transfer of ownership: None ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 788}), Document(page\_content='Leases 788 \n8. Subleases \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. RVG: None \nLease payments: Fixed payments of $30,000 per year in arrears, \nwith a 3% increase each year after Year 1 \nPresent value of lease payments: $349,914 \nFair value of warehouse: $500,000 \nRemaining economic life of warehouse: 30 years \nSR’s incremental borrowing rate: 6% (rate implicit in the lease not available) \nSR is not reasonably certain to exercise any of the renewal options at lease \ncommencement. \nSublease \nAt the end of Year 2 of the lease, SR acquires on- line design software that \neliminates its need for the warehouse. SR subleases the warehouse to \nSublessee S E for the remainder of the head lease term, but SR is not relieved \nof its primary obligation to the head lessor under the head lease. \nThe following additional facts about the sublease at the sublease \ncommencement date are relevant. \nNon-cancellable lease term: 13 years \nRenewal options: None \nPurchase option/transfer of ownership: None \nRVG: None \nLease payments: Fixed payments of $32,0001 per year in arrears, \nwith a 3% increase each year after Year 1 \nPresent value of lease payments: $332,257 \nFair value of warehouse: $505,000 \nRate implicit in the sublease: Not readily determinable2 \nNotes: \n1. The anticipated sublease income exceeds SR’s head lease cost for the period of the \nsublease because of an increase in market rents during the first two years of the head \nlease. \n2. The rate implicit in the sublease is not readily determinable because the fair value of the \nhead lease ROU asset is not read ily determinable. \nStep 1: Determine the discount rate for the sublease \nBecause the rate implicit in the sublease is not readily determinable, SR uses \nthe discount rate it established for the head lease: 6%. \nStep 2: Determine the classification of the sublease \nSR classifies the sublease as an operating lease, based on the following ( see \nsection 7.2): ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 789}), Document(page\_content='Leases 789 \n8. Subleases \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — there is no transfer of ownership and there is no option for SE to purchase \nthe warehouse; \n— the sublease term represents only 46% (i. e. not a major part) of the \nremaining economic life of the warehouse – i.e. of the underlying asset, not \nthe ROU asset; this is calculated based on a sublease term of 13 years, and \na remaining economic life of the warehouse at sublease commencement of \n28 years; \n— the present value of the sublease payments represents only 66% \n(i.e. not substantially all) of the fair value of the warehouse at sublease \ncommencement; and \n— the warehouse is not highly specialized. \nStep 3: Account for the sublease \nIn this example, SR is not relieved of its primary obligation to the head lessor. \nThe accounting is therefore as follows. \n— Because the sublease is classified as an operating lease, SR does not make \nany accounting entries for the sublease of the warehouse to SE at the \nsublease commencement date. \n— Because sublease income anticipated during the sublease term exceeds \nSR’s expected lease cost for the head lease over that same period of time, \nthe execution of the sublease is not an indicator that the head lease ROU \nasset may be impai red. \n— Absent additional events (e.g. a change to the head lease term resulting \nfrom a reassessment or a modification to the head lease or the sublease), \nSR will continue to account for the head lease throughout the remainder of \nthe head lease term as if it had not entered into the sublease. \n— SR will account for the sublease as it would for any other operating lease \nfor which it is the lessor. \nThe following calculations illustrate the above solution. \nFrom head lease commencement through sublease commencement (at \nend of Year 2) – balance sheet for head lease \n ROU asset Lease liability \nBalance at head lease commencement $349,914 $349,914 \nROU asset amortization/lease liability reduction first \ntwo years (32,946) (19,450) \nBalance immediately after sublease \ncommencement $316,968 $330,464 \nJournal entry at sublease commencement \nBecause the sublease is classified as an operating lease, SR does not make any \naccounting entries for the sublease of the warehouse to SE at the sublease commencement date. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 790}), Document(page\_content='Leases 790 \n8. Subleases \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. From sublease commencement to end of sublease term – balance sheet \nEnd of year ROU asset (head lease) Lease liability (head lease) \n2 $316,968 $330,464 \n3 299,598 318,465 \n4 281,508 304,791 \n5 262,597 289,313 \n6 242,758 271,894 \n7 221,874 252,387 \n8 199,819 230,634 \n9 176,459 206,469 \n10 151,649 179,714 \n11 125,234 150,180 \n12 97,048 117,664 \n13 66,910 81,950 \n14 34,629 42,810 \n15 - - \nFrom sublease commencement to end of sublease term – income \nstatement (presented gross) \nEnd of year Sublease income Head lease expense Net income (loss) \n2 $ - $ - $ - \n3 38,443 (37,198) 1,245 \n4 38,443 (37,198) 1,245 \n5 38,443 (37,198) 1,245 \n6 38,443 (37,198) 1,245 \n7 38,443 (37,198) 1,245 \n8 38,443 (37,198) 1,245 \n9 38,443 (37,198) 1,245 \n10 38,443 (37,198) 1,245 \n11 38,444 (37,198) 1,246 \n12 38,444 (37,197) 1,247 \n13 38,444 (37,197) 1,247 \n14 38,444 (37,197) 1,247 \n15 38,444 (37,197) 1,247 \nTotal $499,764 $(483,570) $16,194 \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 791}), Document(page\_content='Leases 791 \n8. Subleases \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Comparison to legacy US GAAP \nClassification and accounting for subleases by sublessors \n8.2.130 In practice, subleases are very common. Topic 842 does not have a \nsignificant effect on a sublessor’s accounting for the sublease compared to \nTopic 840; for example, sublease classification and sublease income recognition \nis effectively unchanged from Topi c 840. \n8.2.140 In addition, sublessor head lease accounting is substantially unchanged \nfor finance leases; under both Topic 840 and Topic 842, the sublessor continues \nto recognize the finance lease asset and liability unless the sublessor is relieved \nof its primary obligation under the head lease. [840- 30-35-12] \n8.2.15 0 However, the sublessor’s recognition of an ROU asset and lease liability \nfor a head operating lease is a substantial change to the sublessor’s accounting for the head operating lease from Topic 840. \n[840- 30-35-12] \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 792}), Document(page\_content='Leases 792 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . 9. Sale-leaseback accounting \nDetailed contents \nNew item added to this chapter: \*\* \nHow the standard works \n9.1 Determining whether a s ale/purchase has occurred \nObservations \nLeaseback does not preclude sale/purchase accounting \nNo sale -leaseback accounting for a finance/sales -type leaseback \nAppr oach to repurchase options different from Topic 606 \nQuestions \n9.1.10 Asset sold is different from the asset leased back \n9.1.12 Sale-leaseback guidance applicability – finance lease \nmodified to become an operating lease \*\* \n9.1.15 Sale or assignment of a lessee purchase option \n9.1.18 Sale of construction- in-progress to be leased back in \ncompleted form \n9.1.20 Lease- leasebacks \n9.1.21 Sale-leaseback with seller -lessee leasing portion of the asset \nback under a finance/sales -type lease \n9.1.22 Accounting for portion of a transferred asset subject to a \nfailed sale/purchase that is not leased back \n9.1.25 Sale/purchase recognition before commencement of the \nleaseback \n9.1.30 Seller -lessee repurchase option involving real estate \n9.1.40 Assessing whether assets are ‘substantially the same’ \n9.1.45 Repurchase option for which the exercise price can ex ceed \nthen- current fair value \n9.1.50 Seller -lessee’s right of first offer \n9.1.60 Limitations of risk related to the underlying as set \n9.1.70 Conflicting transfer of control indicators \n9.1.80 Seller -lessee participation in buyer -lessor financing \n9.1.90 Seller -lessee’s ability to share in income or profits \n9.1.100 Different conclusions by the seller -lessee and buyer -lessor ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 793}), Document(page\_content='Leases 793 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . 9.1.110 Unit of account for determining whether a sale/ purchase has \noccurred \nExamples \n9.1.05 Seller -lessee accounting for failed sale- leaseback transaction \nwhen only a portion of the transferr ed asset is leased back \n9.1.10 Determining whether a sale/purchase has occurred \nComparison to legacy US GAAP \n9.2 Accounting for sale -leaseback transactions \n9.2.1 Determining whether the sales price is off -market \n9.2.2 Adjusting the gain or loss for off -market terms \n9.2.3 Accounting for the leaseback \nObservations \nGain recognition consistent with that for any nonfinancial asset \nAccounting for related party transactions based on contractual terms \nQuestion s \n9.2.05 Presentation of a sale- leaseback in the income \nstatement \n9.2.10 Which formula to apply \nExamples \n9.2.10 Gain recognized by seller -lessee in a sale -leaseback \ntransaction \n9.2.20 Accounting for a sale- leaseback transaction with o ff-market \nterms \n9.2.30 Accounting for a rent -free lease in a sale -leaseback \ntransaction \nComparison to legacy US GAAP \n9.3 Accounting for failed sale -leaseback transactions \nQuestions \n9.3.10 Useful life of the underlying asset in a failed sale- leaseback \ntransaction \n9.3.20 Negative accretion assessed in the aggregate \n9.3.25 Adjusting the interest rate on a failed sale- leaseback \ntransaction during the financ ing period \n9.3.30 Reassessing lease classification in a failed sale -leaseback \n9.3.40 Buyer -lessor accounting for initial direct costs incurred in a \nfailed sale -leaseback transaction ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 794}), Document(page\_content='Leases 794 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . 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Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Comparison to legacy US GAAP \n9.5 Transfer of tax benefits \nQuestion \n9.5.10 Sale of tax benefits \nComparison to legacy US GAAP \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 796}), Document(page\_content='Leases 796 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . How the standard works \nIn a sale -leaseback transaction, one entity (the seller -lessee) transfers an asset \nto another entity (the buyer -lessor) and then leases that asset back from the \nbuyer -lessor. \nParty A sells the underlying asset to Party B\nParty B transfers the right to use the underlying asset to Party AParty A\n(Seller -Lessee )Party B\n(Buyer -Lessor ) \nDriving the accounting is whether a sale (seller -lessee) and purchase (buyer -\nlessor) has occurred. This determination is made by each party applying the \nguida nce in Topic 606 to determine whether (1) there is a contract between the \nparties, and (2) a customer has obtained control of a good. \nHas there been a sale of the underlying asset ?\nApply sale -leaseback \naccountingAccount for the entire \ntransaction as a \nfinancingYes No \nIf a lessee controls the underlying asset before lease commencement , the sale -\nleaseback tran saction guidance applies – i.e. the lessee and the lessor will each \nhave to consider whether or not a sale/purchase occurs and, depending on \nthat conclusion, account for the transaction as a sale and a leaseback (see \nsection 9.2) or a financing transaction (see section 9.3). In the case of a \nfinancing, the lessee continues to recognize (and depreciate) the underlying \nasset until the sale requirements are met. A transaction that does not meet the \ncriteria to be accounted for as a sale/purchase (i.e. that is a ‘failed \nsale/purchase’ ) remains a failed sale/purchase until the requirements to account \nfor it as a sale/purchase are met . \nA lessee may control an underlying asset that is being constructed for it to \nlease at the end of th e construction period (commonly referred to as a ‘build -to-\nsuit’ lease arrangement). In that case , the lessee recognizes the construction -in-\nprocess asset and a related financial liability for the lessor’s construction costs \non its balance sheet. When the construction period ends, the sale- leaseback \nguidance applies as outlined in the preceding paragraph. If the sale meets the \nSubtopic 842 -40 sale/purchase recognition requirements, the underlying asset \nand the financial liability for the lessor’s constructi on costs are derecognized. In \nthe case of a failed sale/ purchase, the lessee continue s to recognize the \nunderlying asset (no longer construction in process , so depreciation ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 797}), Document(page\_content='Leases 797 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . commences ) and the financial liability for the lessor’s construction costs ; the \nlessee accounts for the contractual lease payments as debt service on the \nfinancial liability until the sale/purchase recognition requirements are met . \n \n Excerpt from ASC 842 -40 \n05 Overview and Background \nGeneral \n05-1 This Subtopic addresses accounting for sale and leaseback transactions \nwhen a lease has been accounted for in accordance with Subtopic 842- 10 and \neither Subtopic 842- 20 or Subtopic 842 -30. \n15 Scope and Scope Exceptions \nGeneral \n15-1 This Subtopic follows the same Scope and Scope Exceptions as outlined \nin the Overall Subtopic; see Section 842- 10-15. \n15-2 If an entity (the seller -lessee) transfers an asset to another entity (the \nbuyer -lessor) and leases that asset back from the buyer -lessor, both the seller -\nlessee and the buyer -lessor shall account for the transfer contract and the \nlease in accordance with Sections 842- 40-25, 842- 40-30, and 842- 40-50. \n15-3 See paragraphs 842 -40-55-1 through 55- 21 for implementation guidance \non the scope of this Subtopic. See Ex ample 3 (paragraphs 842- 40-55-39 \nthrough 55- 44) for an illustration of the scope of this Subtopic. \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance \n>> Sale Subject to a Preexisting Lease \n55-8 An entity owns an interest in an underlying asset and also is a lessee \nunder an operating lease for all or a portion of the underlying asset. \nAcquisition of an ownership interest in the underlying asset and consummation \nof the lease occurred at or near the same time. This owner -lessee relationship \ncan occur, for example, when the entity has an investment in a partnership that \nowns the underlying asset (or a larger asset of which the underlying asset is a \ndistinct portion). The entity subsequently sells its interest or the partnership \nsells the underlying asset to an independent third party, and the entity \ncontinues to lease the underlying asset under the preexisting operating lease. \n55-9 A transaction should b e subject to the guidance in this Subtopic if the \nscope or price of the preexisting lease is modified in connection with the sale. \nIf the scope or the price of the preexisting lease is not modified in conjunction \nwith the sale, the sale should be accounted for in accordance with other \nTopics. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 798}), Document(page\_content='Leases 798 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . 55-10 A lease between parties under common control should not be \nconsidered a preexisting lease. Accordingly, the guidance in this Subtopic \nshould be applied to transactions that include nonfinancial assets within its \nscope, except if Topic 980 on regulated operations applies. That is, if one of \nthe parties under common control is a regulated entity with a lease that has \nbeen approved by the appropriate regulatory agency, that lease should be \nconsidered a preexisting l ease. \n \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 799}), Document(page\_content='Leases 799 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . 9.1 Determining w hether a s ale/purchase has \noccurred \n Excerpt from ASC 842 -40 \n25 Recognition \nGeneral \n> Determining Whether the Transfer of the Asset Is a Sale \n25-1 An entity shall apply the following requirements in Topic 606 on revenue \nfrom contracts with customers when determining whether the transfer of an \nasset shall be accounted for as a sale of the asset: \na. Paragraphs 606- 10-25-1 through 25- 8 on the existence of a contract \nb. Paragraph 606- 10-25-30 on when an entity satisfies a performance \nobligation by transferring control of an asset. \n25-2 The existence of a leaseback (that is, a seller -lessee’s right to use the \nunderlying asset for a period of time) does not, in isolation, prevent the buyer -\nlessor from obtaining control of the asset. However, the buyer -lessor is not \nconsidered to have obtai ned control of the asset in accordance with the \nguidance on when an entity satisfies a performance obligation by transferring \ncontrol of an asset in Topic 606 if the leaseback would be classified as a \nfinance lease or a sales -type lease. \n25-3 An option for the seller -lessee to repurchase the asset would preclude \naccounting for the transfer of the asset as a sale of the asset unless both of \nthe following criteria are met: \na. The exercise price of the option is the fair value of the asset at the time \nthe option is exercised. \nb. There are alternative assets, substantially the same as the transferred \nasset, readily available in the marketplace. \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance \n>> Sale-Leaseback- Sublease Transact ions \n55-18 An entity enters into a sale and leaseback of an asset that meets either \nof the following criteria: \na. The asset is subject to an operating lease . \nb. The asset is subleased or intended to be subleased by the seller -lessee to \nanother party under an operating lease. \n55-19 A sale -leaseback- sublease transaction is within the scope of this \nSubtopic. The existence of the sublease (that is, the operating lease in \nparagraph 842- 40-55-18(a) or (b)) does not, in isolation, prevent the buyer -lessor \nfrom obtai ning control of the asset in accordance with paragraphs 842- 40-25-1 \nthrough 25 -3, nor does it prevent the seller -lessee from controlling the asset ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 800}), Document(page\_content='Leases 800 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . before its transfer to the buyer -lessor (that is, the seller -lessee is subject to the \nsame requirements for determining whether the transfer of the asset is a sale \nas it would be without the sublease). All facts and circumstances should be \nconsidered in determining whether the buyer -lessor obtains control of the \nunderlying asset from the seller -lessee in a sale -leaseback- sublease \ntransaction. \n>> Seller -Lessee Guarantee of the Residual Value \n55-20 The seller -lessee may guarantee to the lessor that the residual value will \nbe a stipulated amount at the end of the lease term . If the transfer of the asset \nis a sale in accordance with paragraphs 842- 40-25-1 through 25- 3, the seller -\nlessee residual value guarantee should be accounted for in the same manner \nas any other residual value guarantee provided by a lessee . \n55-21 The residual value guarantee does not, on its own, preclude accounting \nfor the transaction as a sale and leaseback, but should be considered in \nevaluating whether control of the asset has transferred to the buyer -lessor in \naccordance with paragraph 606- 10-25-30. For example, a significant residual \nvalue guarantee by the seller -lessee may affect an entity’s consideration of the \ntransfer of control indicator in paragraph 606 -10-25-30(d). \n \n9.1.10 For a sale (and purchase) to occur in the context of a sale- leaseback \ntransaction, the following conditions must be met: [842- 40-25-1, 606- 10-25-1 – 25-8, \n25-30] \n— there is a contract between the parties based on the contract existence \ncriteria in Topic 606 ; and \n— the seller -lessee has transferred control of the underlying asset to the \nbuyer -lessor based on the guidance on satisfying performance obligations in \nTopic 606. \n9.1.20 The transaction can be monetary or nonmonetary. For example, an entity \nmay contrib ute assets to an unrelated entity in exchange for an equity interest , \nand concurrently lease back the assets. This arrangement may quali fy as a sale -\nleaseback transaction. \n \n Question 9.1.10 \nAsset sold is different from the asset leased back \nIs a transaction in which the seller -lessee sells an asset to the \nbuyer -lessor subject to sale -leaseback accounting if the asset \nleased back is different from the asset sold ? \nInterpretive response: It depends. If the sale and the lease are included in \nthe same contract or in two or more contracts that must be combined (see \nsection 4.6), we believe the transaction is in the scope of the sale- leaseback \nguidance if the asset substitution is non -substantive. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 801}), Document(page\_content='Leases 801 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . For example, we believe the substitution of the leased as set for the one sold is \nnot substantive and the arrangement should be subject to sale- leaseback \naccounting in the following cases: \n— a red Model X car is sold to the buyer -lessor, while a blue Model X car is \nleased back by the seller -lessee; or \n— the cash flows of the two parties are not substantively affected by the \nlease involving a different asset from the one sold. \n \n Question 9.1.12\*\* \nSale-leaseback guidance applicability – finance \nlease modified to become an operating lease \nIs modifying a finance lease such that it becomes an \noperating lease a sale- leaseback transaction? \nBackground: Under Topic 840, if a change in the provisions of a capital lease \ngave rise to a new agreement classified as an operating lease, the transaction \nwas accounted for under the sale -leaseback requirements of Subtopic 840- 40. \n[840- 40-15-6] \nBecause of this legacy guidance, the question has arisen as to whether the \nsame conclusion would be reached under Topic 842. In addition to lease \nmodifications, this question has arisen in scenarios structured as a finance lease \ntermination, with a forward starting (e.g. in two years) operating lease of the same underlying asset. \nFor example, assume a lessee (LE) leased a plot of land from a lessor (LR) for \n60 years and appropriately classif ied the lease as a finance lease. LE intended \nto construct a facility on the leased land. In Year 2, LE and LR agree instead to have LR finance and construct the facility. LE and LR terminate the existing \nfinance lease agreement and enter into a 20- year le ase of the facility, expected \nto be an operating lease, that will commence upon completion of the facility (expected to take approximately two years). The 20- year lease of the facility \nincludes an implied lease of the underlying land (see paragraphs 4.1.120 – \n4.1.130) previously subject to the finance lease. \nInterpretive response: No. Topic 842 does not include guidance such as that in \nTopic 840 described in the background. Further, the FASB expressly observed \nin ASU 2016- 02 that finance leases, while simil ar, are not the same as \npurchases of assets, and the rights a lessee obtains under a finance lease are \ndifferent from the rights obtained from asset ownership. \n[ASU 2016- 02.BC57] \nThere is nothing in Subtopic 842- 40 that suggests that sale -leaseback \naccoun ting applies, or was intended to apply, to a non- owned asset – i.e. an \nasset the entity cannot sell or transfer control of (i.e. the ability to direct the use \nof and obtain substantially all the remaining benefits from) to another entity \nbecause it does not own (i.e. control) it. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 802}), Document(page\_content='Leases 802 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Question 9.1.15 \nSale or assignment of a lessee purchase option \nIs a transaction in w hich a lessee sells or assigns its purchase \noption to a third party subject to sale -leaseback accounting if \nthe lessee leases the asset from the third party after it \nexercises the option? \nBackground: A lessee may sell or assign its option to purchase the underlying \nasset to a third party ( e.g. a financing entity) that is obligated, as a condition of \nacquiring the option, to exercise the option and lease the asset back to the \nlessee. The following diagram illustrates this transaction. \nLessor LR\nLessee LE Third partyLE leases an asset from \nLR with purchase option1\nLE sells purchase option \nto a third party\nLessee LEThird party exercises the \noption and is now the \nowner of the assetThird party is now \nthe lessor to LEThird party New Lessor2\n=\n3 4 \nInterpretive response: In general, we believe accounting for a transaction of \nthis nature is fundamentally the same as the lessee exercising the purchase \noption itself and then entering into an explicit sale- leaseback transaction with \nthe third party. \nHowever, because the lessee must control the underlying asset before the \nsale to the third party (new lessor) for the transaction to be in the scope of \nSubtopic 842-40, the specific facts and circumstances may affect whether the \ntransaction is a sale -leaseback. \nWe believe this type of tr ansaction is in the scope of Subtopic 842 -40 if the \npurchase option meets all of the following conditions: \n— it is substantive – e.g. it is not at a strike price or subject to other terms that \nno rational economic participant would pay or accept; \n— its exerci sability is not contingent on the occurrence of a future event or \ncircumstance that is outside the control of the lessee; and \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 803}), Document(page\_content='Leases 803 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . — consistent with paragr aph 842- 40-25-3 (see paragraph 9.1.50), its strike \nprice is not the exercise- date fair value of the asset unless there are no \nassets, substantially the same as the asset subject to the purchase option, \nreadily available in the marketplace (see Question 9.1.30). \nWhen these conditions are met, we believe the lessee controls the underlying asset through its purchas e option, similar to a lessee controlling an asset under \nconstruction that it will lease on completion when it has an option to acquire the \nasset during the construction period (see paragraph 9 .4.70). \n[842- 40-55-5(a)] \nIf the option is not substantive, or i ts exercisability is contingent on an event or \ncircumstance outside the lessee’s control at the time of the option sale, the \nlessee does not have the ability to direct the use of, and obtain substantially all \nthe remaining benefits from, the asset before s ale of the option. \nSimilarly, if the strike price of the option is the exercise- date fair value of the \nasset, and there are assets substantially the same as the asset subject to the \noption readily available in the marketplace, the owner of the underlying asset \n(i.e. the original lessor) is not constrained in its ability to direct the use of and \nobtain substantially all the remaining benefits from the asset . [ASU 2014- 09.BC425, \nASU 2016- 02.BC352(c)] \nGiven the nuances of the analysis in relation to the facts and circumstances, \nand the potential for differing interpretations in practice, entities entering into these transactions may want to consult with their accounting advisers before \nfinalizing their accounting treatment. \n \n Question 9.1.18 \nSale of construction- in-progress to be leased back \nin completed form \nIf a lessee sells construction -in-progress to an unrelated third \nparty that agrees to finish construction and lease the \ncompleted asset back to the lessee, is the transaction a sale-leaseback? \nBackground: An entity (seller) may begin construction of an asset before \ntransferring that asset to an unrelate d third party (buyer) that will finance \ncompletion of the asset and then lease the completed asset to the seller. The \nprogress toward completion of the construction- in-progress (CIP) at the time of \nsale may vary. \nFor exampl e, in the case of a building, it may be that: \n— the land has been cleared and/or graded to prepare for construction; \n— a physical structure has begun to be erected – e.g. a foundation laid and \nsteel beams erected; \n— it is a cold shell – typically a building that lacks heating and cooling, ceilings \nand interior wall finishings; or \n— it is a warm shell – typically a building that includes interior ceilings and \nwalls, as well as lighting, h eating/cooling and plumbing. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 804}), Document(page\_content='Leases 804 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Interpretive response: It depends. Topic 842 does not address this question, \nand the FASB did not publicly discuss it during the deliberations of Topic 842. \nConsequently, multiple views have emerged in practice. \nThose views range from: \n— accounting for the transaction as a sale -leaseback, subject to Subtopic 842-\n40, once any ‘hard costs’ have been incurr ed (e.g. costs to clear and grade \nthe land on which a building will be constructed), no matter how \ninsignificant; to \n— accounting for the transaction as a sale -leaseback only if the CIP is \n‘substantially similar’ to the completed asset – i.e. substantially all of the \nconstruction is complete. \nIn between these two ends of the spectrum, others have concluded that sale-lease back accounting should apply either: \n— once a physical structure (e.g. foundation and steel or wood framing for a \nbuilding) has begun to be erected that will be part of the completed asset; \nor \n— once a substantial portion of the construction is complete, which is typically \nviewed as far less than the ‘substantially all’ envisaged in the second view \nin the preceding paragraph. \nIn response to this question, the FASB and SEC staffs have expressed the view \nthat there are likely multiple acceptable interpretations a bout when a \ntransaction of the nature described in the background should be subject to the \nsale-leaseback guidance in Subtopic 842 -40, including all of those outlined in the \npreceding paragraphs. \nConsequently, we believe entities have flexibility, between the two ends of the \nspectrum described, to establish an accounting policy as to when transactions of this nature are sub ject to the sale- leaseback guidance in Subtopic 842- 40. \nEntities should apply their policy consistently to similar transactions. \nDeterm ining progress toward completion \nDuring the discussions with the FASB and SEC staffs, progress toward \ncompletion of construction at the sale date was principally couched in \nqualitative terms (e.g. ‘substantially similar’, ‘substantial portion’ or ‘more tha n \ninsignificant’), r ather than quantitative terms, such as numerical values. \nTherefore, we do not believe there are bright -line thresholds related to any of \nthe approaches that were discussed. \nHowever, we believe it is generally accepted that if an entity is adopting an approach dependent on progress toward completion of construction at the sale \ndate, the entity would compare either: \n— the fair value of the CIP at the sale date to the expected fair value of the \ncompleted asset at lease commencement; or \n— the costs of construction incurred to the sale date to the expected total \nconstruction costs of the completed asset (including those incurred before \nand after the sale date). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 805}), Document(page\_content='Leases 805 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . If the transaction is not a sale -leaseback \nUnder some of the views being accepted in pr actice, it is likely that many \ntransactions that would have been subject to the sale- leaseback guidance in \nTopic 840 will not be accounted for as sale- leasebacks under Topic 842. This is \nbecause Topic 840 generally viewed construction to have commenced on an \nasset if any hard costs had been incurred at the time of sale (no matter how \ninsignificant). [840- 40-55-44] \nBecause of this, the question arises as to the accounting that applies if the transaction is not accounted for as a sale -leaseback under Subtopic 842-40. In \nthose cases, we believe the following considerations are relevant. \n— Because the underlying asset that will be leased is under construction, both \nthe lessee (seller) and the lessor (buyer) will need to consider whether the \nlessee is the accounting owner of the CIP during the remainder of the \nconstruction period (see section 9.4). If so, the lessee (seller) should not \nrecognize a sale of the CIP only to immediately re- recognize the CIP on its \nbalance sheet as accounting owner thereof under Topic 842’s build- to-suit \nguidance. Doing so would, in effect, recognize a round -trip sale, which the \nFASB expressed its desire to avoid under Topic 842 (see paragraph \n9.1.100). \n— If the lessee is not the accounting owner of the CIP during the remainder of \nthe const ruction period, the lessee (seller) will apply Topic 606 (if the buyer \nis a customer) or Subtopic 610- 20 (if the buyer is not a customer) to decide \nwhether and when a sale of the CIP occurs. Concurrently, because the \nsymmetrical accounting requirements of Subtopic 842- 40 do not apply, the \nbuyer will account for the purchase of the CIP in accordance with other \nappropriate US GAAP (e.g. Topic 360 or Topic 330). \n \n Question 9.1.20 \nLease -leasebacks \nShould a lease -leaseback, often referred to as a lease- in, \nlease- out (LILO), be accounted for as a sale -leaseback \ntransaction? \nBackground: The owner of an asset may lease the asset to a third party and \nthen lease that same asset back from the third party. For example, Entity A may \nlease an asset to Entit y B for 10 years and lease it back from Entity B for \nthree years, concurrently. \nInterpretive response: If the lease and the leaseback are each part of the \nsame contract, or each part of two or more contracts that are combined (see section 4.6), we do not believe there is a lease and a leaseback for \naccounting purposes. \nRather, in the Entity A/Entity B example, no lease exists until the three- year \nleaseback term ends; it is only then that Entity B obtains the right to control the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 806}), Document(page\_content='Leases 806 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . use of the identified asset . This conclusion is consistent in principle with the \nBoard’s conclusion that it is not appropriate to recognize a sale and \nfinance/sales -type leaseback because that would constitute, in effect, a ‘round-\ntrip’ sale (see paragraph 9.1.100). Similarly, we be lieve it is not appropriate to \nconclude that an entity obtains the right to control the use of an identified asset \nfrom another entity only for that control to immediately revert back to the \nother entity. \nAccounting for the transaction before the end of the three- year leaseback term \ndepends on the structure of the arrangement. For example, the substance of \nthe transaction may be that of a financing if the lease payments for the 10- year \nlease (or a significant portion thereof) are prepaid. \n9.1.30 Control of an asset refers to the ability to direct the use of, and obtain \nsubstantially all of the remaining benefits from, the asset. Control includes the \nability to prevent other entities from directing the use of, and obtaining the \nbenefits from, an asset. [606- 10-25-25] \n9.1.40 The following are indicators that control of the asset has transferred that \nshould be considered together with an overall evaluation of the control principle. \n[606- 10-25-30] \nIndicators that control has passed include a customer having ...\nA present \nobligation to \npayPhysical \npossessionLegal titleAccepted the \nassetRisks and \nrewards of \nownership \n9.1.50 The existence of the leaseback does not, by itself, preclude an entity \nfrom concluding that control of the underlying asset has been transferred to the \nbuyer -lessor. However, the buyer -lessor has not obtained control of the \nunderlying asset if: [842- 40-25-2 – 25-3] \n— the leaseba ck results in a lease that would be classified as a finance lease \n(by the seller -lessee) or as a sales- type lease (by the buyer -lessor); or \n— the contract contains a substantive seller -lessee repurchase option with \nrespect to the transferred asset, unless the option: \n— is exercisable only at the fair value of the asset on the exercise date; \nand \n— there are alternative assets, substantially the same as the transferred \nasset, readily available in the marketplace. \n9.1.60 The term ‘readily available’ is used in multiple places within Topic 842, \nand we believe its use is intended to be consistent throughout the Topic . \nAccordingly, in the context of the seller -lessee repurchase option criterion, we \nbelieve the test is whether another asset, substantially the same, is available for \npurchase separately from the buyer -lessor or from other suppliers. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 807}), Document(page\_content='Leases 807 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Observation \nLeaseback does not preclude sale/purchase \naccounting \n9.1.70 The Board’s decision that the presence of the leaseback does not, in \nisolation, prevent the buyer -lessor from obtaining control of the underlying asset \nappears to potentially conflict with the following in Topic 606: \n— defining control of an asset as the ability to direct the use of, and obtain \nsubstantially all of the remaining benefits from, the asset; and [606- 10-25-25] \n— the Board’s description of the ability to direct the use of an as set as the \ncustomer’s right to deploy that asset in its activities, to allow another entity to deploy that asset in its activities, or to restrict another entity from deploying that asset. \n[ASU 2014- 09.BC120] \n9.1.80 Following that guidance, it appears tha t the buyer -lessor in a sale -\nleaseback transaction does not obtain the ability to direct the use of the asset (as defined in Topic 606) until the end of the leaseback term , other than \npotentially having the ability to sell the asset subject to the lease or enter into a \nforward -starting lease with another entity that will commence after the \nleaseback term ends . \n9.1.90 Consequently, the Board’s decision appears to be based largely on its \nview that the accounting for a lease should not differ solely because t he lessor \npurchased the underlying asset from the lessee rather than from a third party. \nThe Board observed that a sale- leaseback scenario is not substantively different \nfrom many lessor scenarios in which the lessor purchases the underlying asset from a third party only after the terms and conditions of the lease are agreed \nwith the lessee. In those scenarios, similar to a sale- leaseback transaction, the \nlessor may not take possession of the underlying asset before commencement \nof the lease (i.e. it may be delivered directly to the lessee) and has no ability to \ndirect its use until after the end of the lease term , other than as described in \nparagraph 9.1.80. \n[ASU 2016- 02.BC352(a)] \n \n Observation \nNo sale -leaseback accounting for a f inance/sales -\ntype leaseback \n9.1.100 The Board concluded that in a finance (seller -lessee perspective) or \nsales- type (buyer -lessor perspective) lease, the lessee in effect obtains control \nof the underlying asset rather than solely a right to control the use of the underlying asset. Therefore, the Board decided that it would be inappropriate to \naccount for a sale and finance/sales- type leaseback transaction as a sale and a \nleaseback; that would be akin to permitting recognition of a gain by the seller -\nlesse e on a round- trip sale – i.e. the buyer -lessor would obtain control of the \nasset only to immediately transfer control of the asset back to the seller -lessee. \nInstead, the Board decided that no sale from the seller -lessee to the buyer -\nlessor occurs in the f irst place. \n[ASU 2016- 02.BC352(b)] \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 808}), Document(page\_content='Leases 808 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Question 9.1.21 \nSale-leaseback with seller -lessee leasing portion of \nthe asset back under a finance/sales -type lease \nIf a seller -lessee transfers an asset to a buyer -lessor, but \nleases back a distinct portion of the asset in a lease that \nwould be classified as a finance/sales -type lease, is the \ntransfer of the asset a failed sale? \nBackground: Certain assets are, or have the ability to be, divided into distinct \nunits. For example, a building may be divided into separable units (e.g. floors, \noffice suites), and a cellular tower includes separable, physically distinct spaces \nwhere different parties can attach their telecommunications equipment. In \nsome cases, a larger asset such as a building will be legally subdivided (condominiumized). \nThe question arises about whether a sale occurs if an asset is transferred, but the seller -lessee leases back a portion of that ass et (e.g. one or more floors of \nthe building, space on the cellular tower) under terms that would result in \nclassifying the leaseback as a finance/sales- type lease. \nInterpretive response: It depends. If the transferred asset has not been legally \nsubdivided, we believe a finance leaseback of a portion of that asset will result \nin accounting for the transfer of the asset as a failed sale/purchase unless the \nportion being leased back is only a minor portion of the legally transferred asset. \nFor example, if a s eller-lessee sells a 40- story office building and concurrently \nenters into a finance leaseback of 18 floors, we believe the transfer of the asset \nwould be accounted for as a failed sale/purchase by the seller -lessee and the \nbuyer -lessor. In contrast, a fin ance leaseback of two floors, as only a minor \nportion of the transferred building, would not preclude accounting for the \ntransfer of the building as a sale/purchase. \nIf the transferred asset has been legally subdivided, we believe each legally subdivided portion of the larger asset should be evaluated separately. If the \nprevious 40- story building had been legally subdivided (condominiumized) into \n40 units, the finance leaseback of 18 floors (units) would not preclude \naccounting for the transfer of the other 22 floors (units) as sales . And, in that \ncase, there is no sale -leaseback transaction for the 22 floors (units) , because \nthe seller -lessee is not leasing those floors back from the buyer -lessor after \nthey are sold. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 809}), Document(page\_content='Leases 809 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Question 9.1.22 \nAccounting for porti on of a transferred asset \nsubject to a failed sale/purchase that is not leased \nback \nHow does an entity account for the portion of a transferred \nasset that is not leased back to the seller -lessee when the \ntransaction is accounted for as a failed sale/purchase ? \nBackground: Question 9.1.21 includes the example of a transferred 40- story \noffice building that fails sale/purchase accounting because the seller -lessee is \nleasing back 18 floors of the building under leasebacks that would be classified \nas finance leases. \nConsidering that example, the question arises about how the seller -lessee and \nthe buyer -lessor should account for this transaction in which 22 floors of the \nbuilding are not subject to the contractual leaseback. \nInterpretive response: From a n accounting perspective, in a failed sale \ntransaction, the seller -lessee remains the accounting owner of the transferred \nasset (i.e. the 40- story building in the background example), just as if it had \nnever entered into the sale- leaseback transaction with the buyer -lessor. \nHowever, in the background scenario, the buyer -lessor controls the use of the \n22 floors that the seller -lessee is not contractually leasing back – i.e. the buyer -\nlessor can use those floors or lease them to other entities, despite the s eller-\nlessee’s continued accounting ownership of the building. \nTherefore, in addition to the other failed sale/purchase accounting impacts (see \nsection 9.3), we believe it is appropriate for both the seller -lessee and the \nbuyer -lessor to account for the lease of those floors from the seller -lessee to \nthe buyer -lessor (i.e. the seller -lessee as accounting lessor, and the buyer -lessor \nas accounting lessee) just as they would any other lease (see chapters 7 and 6, respectively). This includes evaluating the cl assification of the implied lease, \nwhich could result in sales -type (seller -lessee) or finance (buyer -lessor) lease \nclassification because there is nothing in Topic 842 that would prohibit those \nclassifications in this scenario. \nAssuming the buyer -lessor has paid the purchase price for the building upfront, \nthis results in treating a portion of the purchase proceeds as prepaid rent for the \ndeemed lease by the buyer -lessor of the 22 floors. This reduces the financial \nliability and receivable recognized by t he seller -lessee and buyer -lessor for the \nfailed sale/purchase, respectively. \nTopic 842 does not prescribe or illustrate how to account for this type of scenario. Therefore, the above may not be the only acceptable approach. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 810}), Document(page\_content='Leases 810 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Example 9.1.05 \nSeller -lessee accounting for failed sale -leaseback \ntransaction when only a portion of the transferred \nasset is leased back \nSeller -Lessee SL enters into a contract (that meets the contract existence \ncriteria in Topic 606) with Buyer -Lessor BL for the sale of a two- story office \nbuilding. The contractual purchase price of $1.5 million is paid in full and title to \nthe building transfers to BL immediately. The two floors have not been legally \nsubdivided. \nAs part of the sale contract, SL and BL agree that BL wil l lease the second floor \nof the office building back to SL. The transfer of the building will not qualify as a sale/purchase until the end of the five- year contractual leaseback term on the \nbasis of an option for SL to repurchase the building at the end of the leaseback \nterm. \nThe following additional facts are relevant. \nBuilding remaining useful life: 15 years \nNet carrying amount of building (PP&E) \non contractual sale date: $1,250,000 \nFair value of building on contractual sale date: $1,500,000 \nAnnual building depreciation:1 $83,333 \nNoncancellable leaseback period: 5 years \nLeaseback renewal options: None \nExpected residual value of the first floor to SL at end of five -year implied lease \nterm to BL:\n2 $0 \nNet carrying amount of each floor on \ncontractual sale date :1 $625,000 \nFair value of each floor on contractual \nsale date:3 $750,000 \nContractual leaseback payments:4 Fixed payments of $75,000 / year (in \narrears) \nNotes: \n1. The carrying amount of the building has been attributed to the two floors of the building on a \nrelative fair value basis (see Note 3) , which results in an equal allocation of depreciation to \neach floor ($83,333 / 2 = $41,667). \n2. Because legal title to the entire building has transferr ed as a part of the contractual sale and \nBL has paid the full cash consideration (i.e. any associated imputed rental income would be \nprepaid in nature), there would be no residual value to SL at the end of the lease term. \n3. The fair value of the building has been attributed to the two floors of the building equally on \nthe basis that the floors are substantially equivalent, and that each floor’s location relative to \nthe ground (first versus second floor) would not substantively affect its fair value. \n4. The contractual leaseback payments are at market. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 811}), Document(page\_content='Leases 811 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . In accounting for this transaction, SL considers that it remains the accounting \nowner of the entire two- story building throughout its contractual leaseback term \nof five years, while BL controls the use of the first floor office space during that same time period. Consequently, for accounting purposes (see Question \n9.1.22), SL concludes it is leasing (i.e. as lessor) the first floor of the building to \nBL for this five -year period. SL concludes the lease to BL is a sales- type lease \nbecause title to the entire building, including the leased first floor office space, \ntransfers to BL by the end of the lease term (see section 7.2) and the ‘Step 0’ \ntest (see paragraph 7.2.30) does not apply because none of the payments for \nthis lease are variable. \nCommencement date accounting \nAll of the lease payments for the sales -type first floor lease are prepaid; BL’s \ncontractual $1.5 million payment to legally acquire the entire building is the only \npayment BL will make to SL under this contract. Consequently, there is no \nlease receivable. Additionally, there is no residual value of the first floor to SL \nbecause BL owns it; therefore, there is no net investment in this first floor \nlease. \nAccordingly, SL’s accounting at the lease commencement date (which is the contractual sale date) is as follows. \n Debit Credit \nCash1 1,500,000 \nPP&E2 625,000 \nSelling profit3 \nFinancial liability4 125,000 \n750,000 \nNotes: \n1. The total cash received for the legal sale of the building. \n2. The carrying amount of the first floor being leased for accounting purposes to BL. \n3. The two floors were determined to have an equal fair value. Therefore, SL \nallocates the $1.5 million proceeds for the entire building to the two floors equally \nfor purposes of determining the (1) prepaid lease payments for the first floor \nlease to BL and (2) financial liability resulting from the failed sale of the building. \n$750,000 ‒ $625,000 = $125,000. \n4. 50% of the $1.5 million building sale proceeds. \nSubsequent accounting \nSL has no additional accounting to undertake for the sales -type first floor lease \nafter lease commencement. \nHowever, it must continue to account for the building and its payments to BL \nfor the contractual leaseback. Based on all the above, SL’ s accounting \nthroughout the 5- year contractual leaseback term of Floor 2 results in the \nfollowing. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 812}), Document(page\_content='Leases 812 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Alternative 1: Retain pre- transaction building useful life \nPeriod Asset \ncarrying \namount Financial \nliability \nbalance Principal \nportion \nof paymt Depn \nexpense Interest \nexpense Gain on \nsale \nCommencement $ 625,000 $ 750,000 $ - $ - $ - $ - \nYear 1 583,3331 708,7502 41,2503 41,6671 33,7504 - \nYear 2 541,666 665,644 43,106 41,667 31,894 - \nYear 3 499,999 620,598 45,046 41,667 29,954 - \nYear 4 458,332 573,525 47,073 41,667 27,927 - \nYear 5 416,665 524,334 49,191 41,667 25,809 - \nLease end - - - - - 107,6695 \nNotes: \n1. Carrying amount at the start of Year 1 ($625,000) minus annual depreciation of $41,667 \n(rounded) for five years. Consistent with one acceptable approach outlined in Question \n9.3.10, SL continues to depreciate the building over its pre- existing useful life of 15 years. \n2. Financial liability balance of $708,750 = the balance at the beginning of the period minus \nthe principal portion of the Year 1 payment ($750,000 ‒ $41,250). \n3. Principal portion of payment ($41,250) = the contractual leaseback payment ($75,000) \nminus the portion that reflects interest ($33,750). \n4. Interest expense is calculated by multiplying the outstanding balance of the financial liability \nby the interest rate determined in accordance with paragraphs 835- 20-25-12 – 25-13 \n($750,000 x 4.5%). \n5. $524,334 ‒ $416,665 = $107,669. \nAlternative 2: Adjust remaining building useful life to 5 years (salvage value \nequal to remaining financial liability balance) \nPeriod Asset \ncarrying \namount Financial \nliability \nbalance Principal \nportion \nof paymt Depn \nexpense Interest \nexpense Gain on \nsale \nCommencement $ 625,000 $ 750,000 $ - $ - $ - $ - \nYear 1 604,8671 708,7502 41,2503 20,1331 33,7504 - \nYear 2 584,734 665,644 43,106 20,133 31,894 - \nYear 3 564,601 620,598 45,046 20,133 29,954 - \nYear 4 544,468 573,525 47,073 20,133 27,927 - \nYear 5 524,334 524,334 49,191 20,134 25,809 - \nLease end - - - - - -5 \nNotes: \n1. Carrying amount at the start of Year 1 ($625,000) minus annual depreciation of $20,133. In \ncontrast to Alternative 1, SL depreciates the building assuming a five -year remaining useful \nlife (with a salvage value equal to the financial liability that will be relieved upon sale, \nconsistent with one acceptable approach outlined in Question 9.3.10). \n2. Financial liability balance of $708,750 = the balance at the beginning of the period minus \nthe principal portion of the Year 1 payment ($750,000 ‒ $41,250). \n3. Principa l portion of payment ($41,250) = the contractual leaseback payment ($75,000) \nminus the portion that reflects interest ($33,750). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 813}), Document(page\_content='Leases 813 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . 4. Interest expense = prior year financial liability balance ($750,000) x interest rate determined \nin accordance with paragraphs 835- 20-25-12 – 25-13 (4.5%). \n5. $524,334 ‒ $524,334 = $0. \n \n \n Question 9.1.25 \nSale/purchase recognition before commencement \nof the leaseback \nCan a sale/purchase in a sale- leaseback transaction be \nrecognized by the seller -lessee or the buyer -lessor before the \ncommencement date of the leaseback? \nBackground: While infrequent in conventional sale- leaseback transactions, \ntwo entities may enter into a forward -starting leaseback. For example, the \nseller -lessee transfers the asset to the buyer -lessor on January 1, 20X1 and the \nleaseback commences July 1, 20X1. \nMore commonly, this issue may arise in build- to-suit lease arrangements (see \nsection 9.4) when the lessee is deemed the accounting owner of the asset \nunder construction. A call option or another feature of the arrangement that \nresulted in the lessee’s accounting ownership may be ‘cured’ before the lease \ncommencement date – e.g. a call option the l essee had over the construction-\nin-process may expire before the end of the construction period. \nInterpretive response: No. We do not believe a sale (seller -lessee) or \npurchase (buyer -lessor) can occur before the lease commencement date. This \nis because lease classification directly affects whether a sale/purchase occurs \nin a sale -leaseback transaction (see paragraph 9.1.50 and the observation in \nparagraph 9.1.100), and lease classification is required to be assessed at \nlease commencement. \nDespite the fact that there may be a high level of confidence about how the \nlease will be classified, an entity cannot be certain of the lease classification \nuntil the lease commencement date. This is because multiple estimates that \naffect lease classification, such as th e fair value of the underlying asset, the \nunderlying asset’s remaining economic life, and the discount rate for the lease, \ncould all be affected by intervening events before the lease commencement \ndate. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 814}), Document(page\_content='Leases 814 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Question 9.1.30 \nSeller -lessee repurchase option in volving real \nestate \nDoes a seller -lessee repurchase option in a sale- leaseback \ntransaction involving real estate always result in a failed \nsale/purchase? \nInterpretive response: Yes. The Board has stated that, in its view, no two real \nestate assets are ‘substantially the same .’ This includes, for example, two \nadjacent store fronts in the same shopping center or two adjoining townhouses \nor condominiums. Therefore, a repurchase option (at any strike price) for a real \nestate asset will never meet the criter ion for there to be alternative assets that \nare substantially the same as the real estate asset readily available in the marketplace (see paragraph 9.1.50), and will always result in a failed \nsale/purchase in a sale -leaseback transaction. \n[ASU 2016 -02.BC352(c)] \n \n Question 9.1.40 \nAssessing whether assets are ‘substantially the \nsame’ \nWhat does ‘substantially the same’ mean? \nBackground: For a seller -lessee repurchase option with an exercise- date fair \nvalue strike price to not preclude sale accounting, there must be alternative \nassets, substantially the same as the underlying asset, readily available in the \nmarketplace (see paragraph 9.1.50) . \nInterpretive response: As discussed in Question 9.1. 30, when applying the \ncriterion described in paragraph 9.1.50, no two real estate assets are \nconsidered to be substantially the same. [ASU 2016- 02.BC352(c)] \nFor non- real estate assets, we believe ‘subs tantially the same’ is a high \nthreshold. An asset that is merely ‘similar’ to another asset is not substantially \nthe same as that asset. Judgment will be required to determine whether two \nnon-real estate assets are substantially the same, but in general we believe \nthose two assets will have to be nearly identical – e.g. for a piece of equipment, \none that is of the same make and model, and manufactured at or near the \nsame time. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 815}), Document(page\_content='Leases 815 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Question 9.1.45 \nRepurchase option for which the exercise price can \nexceed then -current fair value \nDoes a repurchase option preclude sale/purchase accounting \nif the repurchase price can exceed the then -current fair value \nof the asset ? \nBackground: Paragraph 9.1.50 outlines that a seller -lessee repurchase option \ndoes not pr eclude sale/purchase accounting if both: [842- 40-25-3] \n— it is exercisable only at the fair value of the asset on the exercise date \n(‘then- current fair value’); and \n— there are alternative assets, substantially the same as the transferred asset, \nreadily avail able in the marketplace. \nWhen both of these conditions exist, the buyer -lessor is not constrained in its \nability to direct the use of and obtain substantially all the remaining benefits \nfrom the asset – i.e. it still obtains control of the asset. This is because the \nbuyer -lessor could use the fair value proceeds from the repurchase to acquire a \nsubstantially equivalent asset in the marketplace. [ASU 2016.02.BC 352(c) ] \nGiven this, the question then arises about whether a repurchase option for which the exerci se price can exceed, but not be less than, then -current fair \nvalue precludes sale/purchase accounting given the explicit guidance in \nparagraph 842- 40-25-3. \nFor example, consider a sale- leaseback arrangement for a piece of equipment \nwith an unrelated buyer -lessor that includes both: \n— an option for the seller -lessee to repurchase the equipment at the end of \nthe lease term at its then- current fair value; and \n— a seller -lessee guarantee of the residual value of the equipment at the end \nof the lease term. \nThe combi nation of these two clauses means that if the fair value of the \nequipment at the end of the lease term is less than the guaranteed residual \nvalue, the seller -lessee must pay the greater guaranteed residual amount to \nreacquire the equipment. In this example, t he specific question, assuming there \nare no other impediments to a successful sale/purchase, is whether these two \nclauses together preclude sale/purchase accounting. \nInterpretive response: No. As outlined above, when the two criteria in \nparagraph 9.1.50 are met, the buyer -lessor obtains control of the underlying \nasset despite the repurchase option. The buyer -lessor can either: \n— use the fair value proceeds from the seller -lessee’s repurchase to acquire a \nsubstantially equivalent asset that is readily available in the marketplace; or \n— acquire an equivalent asset to deliver to the seller -lessee for which it will \nreceive equal compensation in the form of seller -lessee fair value payment. \nStill assuming there are substantially equivalent assets r eadily available in the \nmarketplace, a seller -lessee repurchase option that can only pay the buyer -\nlessor more than the then- current fair value of the underlying asset does not \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 816}), Document(page\_content='Leases 816 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . negate the buyer -lessor’s ability to undertake either of the options in the \npreceding paragraph. For example, if the then- current fair value of the asset is \n$100, but the seller -lessee must pay the buyer -lessor $105, the buyer -lessor \ncan still use $100 of the $105 in proceeds to effect either option. \nTherefore, we believe a repurcha se option that can only be exercised at or \nabove then- current fair value does not prevent the buyer -lessor from obtaining \ncontrol of the underlying asset, and consequently does not preclude \nsale/purchase accounting when there are substantially equivalent a ssets readily \navailable in the marketplace. \nIn contrast, a repurchase option that could result in the seller -lessee paying less \nthan then- current fair value, however unlikely that outcome might be, always \nprecludes sale/purchase accounting, and therefore r esults in a failed \nsale/purchase. \n \n Question 9.1.50 \nSeller -lessee’s right of first offer \nUnder what circumstances would a right of first offer by a \nseller -lessee preclude sale -leaseback accounting? \nBackground: A sale -leaseback agreement may include a provision that allows \nthe seller -lessee to make an offer to repurchase the asset before the buyer -\nlessor obtains offers from third parties, commonly referred to as a right of \nfirst offer. \nInterpretive response: We believe a right of first offer would preclude sale \naccounting in a sale- leaseback transaction if either (1) the buyer -lessor is \neconomically or contractually compelled to accept the seller -lessee’s offer or (2) \nthe seller -lessee is economically or contractually compelled to make a n offer. \nIn the case of (1), the right of first offer is effectively a repurchase option for the \nseller -lessee, which precludes sale and leaseback accounting in all cases if the \nunderlying asset is real estate (see Question 9.1. 30) and precludes sale -\nlease back accounting in all other cases unless the criteria described in \nparagraph 9.1.50 are met . \nIn the case of (2), the right of first offer is effectively a forward. Consequently, a \nsale/purchase does not occur because, in accordance with the repurchase \nagreements implementation guidance in Topic 606, the buyer -lessor does not \nobtain control of the underlying asset. [606- 10-55-68] \nWe believe an entity’s analysis of contractual compulsion should consider the enforceable rights and obligations of the contract. In cases of significant \nuncertainty about enforceability, the entity may need legal interpretation by \nqualified counsel. \nMeanwhile, we believe an entity’s analysis of economic compulsion should \nconsider all relevant economic factors, including those that are contract -\nbased, asset -based, market -based and entity -based. We believe these factors \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 817}), Document(page\_content='Leases 817 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . would generally be consistent with those for assessing lessee options \nto extend or terminate a lease or purchase the underlying asset (see \nparagraph 5.2.60). \nWe believ e a right of first offer is neither an obligation nor an option to \nrepurchase the underlying asset if (1) the buyer -lessor is not economically or \ncontractually compelled to accept the seller -lessee’s offer, and (2) the seller -\nlessee is not economically or contractually compelled to make an offer. Absent a conclusion that a right of first offer is in substance a repurchase option or a \nrepurchase obligation, the right of the seller -lessee to make an offer to \nrepurchase the underlying asset from the buyer -lessor, which the buyer -lessor \ncan refuse (both legally and constructively), does not, by itself, prevent the \nbuyer -lessor from obtaining control over the underlying asset in accordance \nwith paragraph 842- 40-25-1. \n \n Observation \nApproach to repurchase options different from \nTopic 606 \n9.1.110 The Board’s decision to permit sale/purchase accounting in a sale -\nleaseback transaction when the seller -lessee has a repurchase option in limited \ncircumstances appears to be a departure from the Board’s stated aim of \nrecognizing a sale/purchase only when the requirements for a sale in Topic 606 \nare met. This is because Topic 606 precludes accounting for a transaction as a \nsale if the seller has any substantive option to repurchase the good sold, \nregardless of the strike price or the nature of the good, i.e. whether or not there \nare alternative assets substantially the same as the transferred asset readily \navailable in the marketplace. [ASU 2016- 02.BC352(c)] \n9.1.120 The Board’s decision to permit sale/pur chase accounting in those limited \ncircumstances reflects the discomfort that some Board members had with a \nseller -lessee recognizing a liability for the consideration received from the \nbuyer -lessor solely because it has the option to reacquire the asset and may \nonly do so by paying its fair value when the option is exercised. Other Board \nmembers, when reaching this decision, noted that a repurchase option \npermitting the seller to repurchase an asset that is readily available in the \nmarketplace at its then -prevailing fair value does not constrain a customer in its \nability to direct the use of, and obtain substantially all the benefits from, the \nasset. [ASU 2014- 09.BC425] \n9.1.130 If a contract exists and the buyer -lessor obtains control of the underlying \nasset, the transaction is accounted for as a sale and a leaseback by both the \nseller -lessee and the buyer -lessor. [842- 40-25-4] \n9.1.140 If the transfer of the asset to the buyer -lessor does not meet the \ncriteria to be accounted for as a sale, both parties to the transaction account for \nthe transfer of the underlying asset as a financing arrangement – i.e. as a \n‘failed sale’ by the seller -lessee, and as a ‘failed purchase’ by the buyer -lessor. \nThe accounting for failed sale- leaseback transactions is discussed in section 9.3. \n[842- 40-25-5] \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 818}), Document(page\_content='Leases 818 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . 9.1.150 In some cases, an entity enters into a sale- leaseback transaction in \nwhich the asset is either: [842- 40-55-18] \n— subject to an existing operating lease; or \n— subleased or intended to be subleased by the seller -lessee to another entity \nunder an operating lease – i.e. the entity is or will be a sublessor. \n9.1.160 The existence of a sublease does not, by itself, prevent the buyer -lessor \nfrom obtaining control of the asset – i.e. from concluding that a sale/purchase \nhas occurred and also does not prevent the seller -lessee from controlling the \nasset before its transfer to the buyer -lessor. The seller -lessee is subject to the \nsame requir ements for determining whether the transfer of the asset is a sale \nwith or without the sublease. [842- 40-55-19] \n9.1.170 A seller -lessee residual value guarantee of the transferred asset does \nnot automatically preclude a conclusion that a sale/purchase has occurred. \nHowever, a seller -lessee residual value guarantee may suggest that the buyer -\nlessor has not taken on the significant risks and rewards of ownership of the \nasset, which is one of the indicators to consider , together with the control \nprinciple, when evaluating whether a customer has obtained control of an asset \nin Topic 606 (see paragraph 9.1.40). [842- 40-55-21, 606- 10-25-30] \n \n Question 9.1.60 \nLimitations of risk related to the underlying asset \nDo guarantees or indemnities provided by the seller -lessee to \nthe buyer -lessor affect whether a sale -leaseback transaction \nmeets the criteria for sale/purchase accounting? \nBackground: The seller -lessee in a sale -leaseback transaction will frequently \nprovide guarantees or indemnities to the buyer -lessor, or arrange for a third \nparty to do so – e.g. through insurance that the seller -lessee purchases. For \nexample, these may include one or more of the following (not exhaustive): \n— a residual value guarantee related to the underlying asset; \n— indemni fying the buyer -lessor for environmental conditions that existed \nbefore the asset is transferred to the buyer -lessor; \n— indemnifications with respect to preexisting tax liabilities related to the underlying asset; and/or \n— indemnifications against other contingent losses. \nInterpretive response: In general, no. The provision of a guarantee or \nindemnification typically does not, by itself, preclude a sale- leaseback \ntransaction from meeting the criteria for sale/purchase accounting under \nSubtopic 842-40. \nWhether or not a transaction qualifies for sale/purchase accounting depends on \nwhether control of the underlying asset transfers to the buyer -lessor. Control, in \nthe context of the sale of an asset (see paragraph 9.1.30), refers to the ability of \nthe buyer -lessor to direct the use of , and obtain substantially all the remaining \nbenefits from , the asset. \n[606- 10-25-25] \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 819}), Document(page\_content='Leases 819 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Having the significant risks and rewards of ownership is only one indicator to be \nconsidered in determining when control of the asset transfers to the buyer -\nlessor. However, we believe the definition of control suggests that the absence of exposure to significant risks (e.g. because of a seller -lessee guarantee or an \nindemnification) will typically not, in isolation, affect whether the buyer -lessor \nhas the present ability to direct the use of , and obtain substantially all the \nremaining benefits from , the asset. \n[606- 10-25-25, 25 -30] \nFor example, a residual value guarantee, or an indemnification against \nenvironmental claims or future clean- up costs, even if significant, would \ntypically not prevent the buyer -lessor from being able to direct the use of, and \nobtain substantially all the remaining benefits from, the asset in the same \nmanner as a typical lessor not involved in a sale -leaseback transaction (see \nparagraphs 9.1.70 – 9.1.90). \nAll terms and conditions surrounding the guarantee or indemnification should be \nconsidered. If, as a condition of providing the guarantee or indemnification, the \nbuyer -lessor forfeits substantial rights that a ‘normal’ lessor would typically \ncontrol, it may not obtain control of the asset. For example, if the buyer -lessor \ncommits not to sell the asset, even subject to the leaseback, or lease it to competitors of the seller -lessee at the end of the leaseback term, one might \nconcl ude the buyer -lessor does not obtain the ability to direct the use of the \nasset. Similarly, if the buyer -lessor agrees to provide all (or substantially all) of \nany variable upside to the seller -lessee if it re sells the asset, that may suggest \nthe buyer -lessor does not have the right to obtain substantially all the remaining \nbenefits from the asset. \nRegardless of its effect on the sale/purchase accounting conclusion, the seller -\nlessee will need to consider whether Topic 460 ( guarantees) applies, such as \nfor guarantees other than a residual value guarantee of the underlying asset. \nThe fair value of a Topic 460 guarantee will affect the allocation of the \ntransaction price to the sale in a successful sale -leaseback because a portion of \nthe transaction price will be allocated to the guarantee. [460- 10-15-7(b), 606- 10-15-2, \n15-4] \n \n Question 9.1.70 \nConflicting transfer of control indicators \nHow should an entity evaluate whether a sale/purchase has \noccurred in a sale -leaseback transaction when the transfer of \ncontrol indicators provide conflicting evidence? \nBackground: The transfer of control indicators in paragraph 606- 10-25-30 will \nalmost always provide conflicting evidence in a sale -leaseback transaction. The \nbuyer -lessor will typically obtain title to, and have a present obligation to pay the \nseller -lessee for, the asset; however, the seller -lessee typically retains physical \npossession of the asset. The indicator about customer acceptance will \nfrequently not apply . Consequently, the indicator that the ‘customer has the \nsignificant risks and rewards of ownership of the asset’ may often receive \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 820}), Document(page\_content='Leases 820 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . significant attention in the evaluation, because it is the indicator that may most \nlikely vary from transaction to transaction. For example, a significant seller -\nlessee residual value guarantee of the asset may suggest that the buyer -lessor \ndoes not have the significant risks and rewards of ownership of the asset. In \nthat case, the control indicators would be split. [ASU 2016- 02.BC353] \nInterpretive response: When evaluati ng whether a sale/purchase occurs in a \nsale-leaseback transaction, it is important to remember that the indicators \nshould be considered together with, and in the context of , the control principle \n– which is that control refers to the ability to direct the use of, and obtain \nsubstantially all the remaining benefits from, an asset (see paragraph 9.1.30). \n[606- 10-25-25, 25- 30] \nTherefore, if the control indicators conflict, more weight should be given to \ninformation that provides evidence about whether the buyer -lessor has the \nability to direct the use of, and obtain substantially all the remaining benefits \nfrom, the asset. \nFor example, as indicated in Question 9.1. 60, guarantees or indemnifications \nmay reduce the risk the buyer -lessor assumes in the asset, but that mitigation \nof risk may have little relevance to whether the buyer -lessor controls the asset. \nIn contrast, the buyer -lessor having valid title to the asset may directly affect \nwhether the buyer -lessor can direct the use of the asset (e.g. sell the ass et or \nenter into an enforceable forward- starting lease) and obtain its remaining \nbenefits (e.g. sell the asset, subject to the leaseback, to take advantage of an increase in its market value). \n \n Example 9.1.10 \nDetermining whether a sale/purchase has occurred \nSeller -Lessee SL enters into a contract (that meets the contract existence \ncriteria in Topic 606) with Buyer -Lessor BL for the sale -leaseback of a machine. \nThe machine has a remaining economic life of five years, and its fair value is \n$100,000. Title to the machine transfers to BL, and the transaction price for the \nmachine is pa yable to SL at commencement of the leaseback. \nScenario 1: Seller -lessee repurchase option does not preclude \nsale/purchase accounting \nIn addition to the basic facts, the following facts are relevant. \nLeaseback term: 3 years \nLeaseback payments: Fixed payments of $28,000 per year in arrears \nSL’s incremental borrowing rate1: 7% \nExpected residual value: $30,000 \nRVG: None \nPurchase option: Fair value of machine at date of exercise \nNote: \n1. The rate implicit in the lease is not readily determinable. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 821}), Document(page\_content='Leases 821 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . In addition: \n— The machine is produced widely s o alternative machines, substantially the \nsame as the transferred machine, are readily available in the marketplace. \n— The leaseback would not be classified as a finance lease by SL, or as a \nsales- type lease by BL, applying the relevant criteria for lease classification \nin section 6.2 (lessees) and section 7.2 (lessors). \nBoth SL and BL conclude that the transaction qualifies for sale/purchase \naccounting for the machine on the basis that BL obt ains rights to control the \nmachine that are generally consistent with that of any other lessor (see paragraphs 9.1.70 – 9.1.90). Further, neither of the specific exclusions to \naccounting for the transaction as a sale/purchase exist : \n— The leaseback would not be classified as a finance/sales- type lease; and \n— SL’s repurchase option does not preclude sale/purchase accounting, because: \n— The strike price is the fair value of the machine on the exercise date; \nand \n— There are alternative machines, substantially the same as the \ntransferred machine, readily available in the marketplace. \nLastly, the transfer of control indicators in Topic 606 also support that control of \nthe asset transfers to BL at commencement of the leaseback. This is because, \neven tho ugh SL retains physical possession of the machine, the following occur \nat commencement: \n— title transfers to BL; \n— SL has a present right to payment of the transaction price for the machine; \nand \n— BL assumes the significant risks and rewards of ownership – e.g. BL is \nnow at risk for (or will benefit from) changes in the residual value of the \ntransferred machine. \nScenario 2: Seller -lessee repurchase option results in failed sale/purchase \nAssume the same as in Scenario 1, except that the machine has been designed \nand modified specifically for Seller -Lessee SL’s commercial needs. Therefore, \nthere are no alternative assets substantially the same as the transferred \nmachine readily available in the marketplace. \nIn this scenario, the transaction does not qualify for sale/purchase accounting. \nSL’s repurchase option precludes sale/purchase accounting for both SL and \nBuyer -Lessor BL. \nIn addition, while assumed not to be the case in this scenario, in a similar \nscenario the specialized design and modification of the machine could lead to a conclusion that the machine will have no alternative use to BL at the end of the \nleaseback term, and therefore the leaseback is a finance/sales- type lease (also \nresulting in a failed sale/purchase). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 822}), Document(page\_content='Leases 822 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Scenario 3: Seller -lessee residual value guarantee \nAssume the same facts as in Scenario 1, except that: \n— Seller -Lessee SL guarantees $20,000 of the expected $30,000 residual \nvalue of the machine; and \n— SL does not have a repurchase option. \nConsistent with Scenario 1, even though SL retains physical possession of the \nmachine, the following occur at commencement: \n— title transfers to Buyer- Lessor BL; and \n— SL has a present right to payment. \nThese indicators provide evidence that BL has obtained control of the machine. \nHowever, SL retains physical possession of the machine, and the significant \nresidual value guarantee provided by SL calls into question whether BL has the \nsignificant risks and re wards of ownership, which both indicat e that control may \nnot have transferred to BL. While BL can potentially obtain the rewards of \nownership, the residual value guarantee substantially limits BL’s risk. Because \nof the conflicting control indicators, there is judgment in determining whether \ncontrol of the machine transfers to BL at commencement of the leaseback. \nIn this scenario, both SL and BL determine that the transaction qualifies for \nsale/purchase accounting. They base their conclusions on the following : \n— BL can direct the use of the machine in the same way that any other lessor \ncan direct the use of an asset subject to a lease – e.g. it can sell the asset \n(subject to the leaseback); and \n— BL can obtain substantially all of the remaining benefits related t o the \nmachine – i.e. it is entitled to either the entirety of the proceeds from a \nsale, or to the cash payments from the leaseback and the residual benefits \nof the machine after the leaseback term. \nScenario 4: Leaseback is a finance/sales -type lease \nAssume the same facts as in Scenario 1, except that the leaseback term is \nfour years. \nBecause the leaseback term is for the major part of the remaining economic life of the machine (four -year lease term compared to five- year remaining economic \nlife), the leaseba ck would be classified as a finance lease by Seller -Lessee SL, \nand as a sales- type lease by Buyer -Lessor BL. Therefore, the transaction does \nnot qualify for sale (from the perspective of SL) or purchase (from the \nperspective of BL) accounting. Instead, both parties will account for the \ntransaction as a financing arrangement (see section 9.3). \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 823}), Document(page\_content='Leases 823 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Question 9.1.80 \nSeller -lessee participation in buyer -lessor financing \nDoes seller -lessee participation in the financing of the buyer -\nlessor affect whether a sale- leaseback transaction qualifies for \nsale/purchase accounting? \nBackground: A buyer -lessor may obtain financing from a third party to purchase \nthe underlying asset from the seller -lessee, and the seller -lessee may \nparticipate in that financing. For example, the seller -lessee may provide a \nfinancial guarantee or indemnification to the financing party, establish the \ncreditworthiness of the buyer -lessor to the financing party, or furnish a letter of \ncredit to the financing party where the seller -lessee’s leaseback is an integral \npart of the financing party’s decision to provide financ ing to the buyer -lessor. \nInterpretive response: It depends. I n gen eral, the seller -lessee providing a \nguarantee of the buyer -lessor’s debt (or otherwise participating in the buyer -\nlessor’s financing), by itself, does not affect whether the buyer -lessor obtains \ncontrol of the underlying asset (see Question 9.1. 60). That i s, absent other \nprovisions, the guarantee alone would not prevent the buyer -lessor from having \nthe ability to direct the use of , and obtain substantially all of the remaini ng \nbenefits from , the asset in the same manner as any other lessor that acquires \nan asset to lease to a third party (see paragraphs 9.1.70 – 9.1.90) – e.g. the \nguarantee alone would not prohibit the buyer -lessor from selling the asset \n(subject to the leaseback), or entering into an arrangement such as a forward-\nstarting lease , and realizi ng the remaining benefits from the asset as a result. \nThis is true even if the effect of the guarantee is that the buyer -lessor has not \ntaken on the significant risks of ownership of the asset. \nThe parties would, however, need to consider whether other ter ms and \nconditions associated with inducing the seller -lessee to provide the guarantee \nor otherwise participate in the financing prevent the buyer -lessor from obtaining \ncontrol of the asset. For example, if, as a condition of providing a loan \nguarantee, the buyer -lessor is not permitted to sell the underlying asset (even \nsubject to the leaseback) during the leaseback period, that may suggest the buyer -lessor does not have the ability to direct the use of, or obtain substantially \nall the remaining benefits fr om, the asset until the leaseback expires. \nA guarantee of the buyer -lessor’s debt is generally excluded from the leaseback \npayments (unless the guarantee is in substance a residual value guarantee – \nsee Question 5.4. 100), but would still need to be considered under Topic 460. If \nthe guarantee is in the scope of Topic 460, the fair value of the guarantee will reduce the amount of the transaction price that is allocated to the sale of the \nasset – i.e. the fair value of the guarantee is carved out from the tra nsaction \nprice and allocated to the guarantee. \n[842- 10-30-6(b)] \nThe following are additional considerations related to a financial guarantee \nprovided by the seller -lessee. \n— If the financial guarantee is not in the scope of Topic 460 (and is not in \nsubstance a residual value guarantee of the transferred asset), the seller -\n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 824}), Document(page\_content='Leases 824 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . lessee may be induced to grant a concession to the buyer -lessor that might \nbe considered a reduction of the transaction price for the sale. For example, \nto avoid having to perform under the guarantee, the seller -lessee might \naccelerate or increase the leaseback payments. Such concessions, if reasonably possible when the asset is sold to the buyer -lessor, would \ngenerally create variable consideration in the transaction price for the s ale \n(which would need to be estimated up- front subject to the variable \nconsideration constraint – see paragraph 9.2.10). If concessions occur, but \nwere not expected at contract inception, significant judgment may be \nrequired to determine whether such actions affect the transaction price for the sale or, instead, modify the leaseback. \n— If the buyer -lessor is a vendor to the seller -lessee (or vice versa), the seller -\nlessee’s guarantee of the buyer -lessor’s debt may induce either party to \ngrant the other conces sions in a revenue transaction. For example, the \nbuyer -lessor may grant a concession if it is the vendor because of the \nguarantee and the seller -lessee may grant a concession if it is the vendor \nbecause it doesn’t want to risk having to perform under the guarantee. A reasonable expectation of any such concessions would be treated as variable consideration in the revenue contract(s) between the parties. \n \n Question 9.1.90 \nSeller -lessee’s ability to share in income or profits \nDo income - or profit -sharing provisions preclude accounting \nfor the transfer of an asset as a sale/purchase in a sale-\nleaseback transaction? \nInterpretive response: It depends. The right of the seller -lessee to share in \nfuture income (e.g. the profit from a follow- on sal e of the asset or income \nearned from developing previously undeveloped land) will generally not affect \nthe buyer -lessor’s ability to direct the use of the asset. For example, such a \nprovision will not, by itself, affect whether the buyer -lessor can exercise \nrights to direct the use of the asset consistent with those of any other lessor, \nsuch as being able to sell the asset (subject to the lease) (see paragraphs 9.1.70 – 9.1.90). \nHowever, depending on the terms and conditions, a profit -sharing provision \nmay preclude the buyer -lessor from obtaining substantially all the remaining \nbenefits from the asset. \nIn general, we believe a profit -sharing provision would not preclude the buyer -\nlessor from obtaining substantially all of the remaining benefits from the as set \nif it merely permits the seller -lessee (or a related party) to participate in the \nfuture income. \nFor example, if the seller -lessee is entitled to a percentage of any profit the \nbuyer -lessor earns from selling the asset to a third party or to a percent age of \nthe income earned from developed property, we believe the buyer -lessor still \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 825}), Document(page\_content='Leases 825 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . has the right to obtain substantially all of the remaining benefits from the asset, \nand the portion it must pay to the seller -lessee is similar to paying a percentage \nof a leased retail store’s sales to the lessor. In that case, the Board concluded that a requirement for the lessee to remit a portion of the economic benefits it \nobtains from use of the asset to the lessor does not mean that it does not \nobtain substantially al l the economic benefits from use of the asset. Similarly, \nthe requirement for a customer to pay a sales - or usage- based royalty to the \nseller of an asset does not, by itself, preclude a sale under Topic 606 or Topic 610 ( other income). \n[842- 10-15-19] \nIn contrast, if the income share in effect grants all or substantially all of the \nupside benefit to the seller -lessee (or a related party), that would indicate the \nbuyer -lessor does not have the right to substantially all the remaining benefits \nfrom the asset. The following are examples that we believe will typically \nindicate that the buyer -lessor has not obtained substantially all the economic \nbenefits from use of the asset (not exhaustive) . \n— The seller -lessee is entitled to all or substantially all of any profit from a \nsubsequent sale of the asset. \n— The seller -lessee is entitled to all or substantially all of any profit from a \nsubsequent sale of the asset that exceeds a specified amount where there \nis a reasonable likelihood that amount will be significant ly exceeded if a sale \noccurs . \n— The seller -lessee is entitled to receive the variable expected benefits from \ndevelopment of an undeveloped asset, while the buyer -lessor’s return is \nfixed – i.e. substantially in the manner of a service fee. \n \n Question 9.1.100 \nDifferent conclusions by the seller -lessee and buyer -\nlessor \nWill a seller -lessee and a buyer -lessor reach the same \nconclusions about whether a sale/purchase has occurred in \nthe context of a sale -leaseback transaction? \nInterpretive respons e: Not always. It is possible that a seller -lessee and a \nbuyer -lessor in a sale -leaseback transaction will not come to the same \nconclusions about whether a sale/purchase occurs . This could result for any of \nthe following reasons (not exhaustive). [606- 10-25-25, 25 -30] \n— Different judgments or estimates (e.g. discount rate for the lease) result in \nthe two entities reaching different conclusions about whether the \nleaseback would be classified as a finance lease (lessee) or a sales -type \nlease (lessor). \n— Different judgments about the nature of the asset (e.g. whether assets \nsubstantially the same as the transferred assets are readily available in the \nmarketplace) could result in different conclusions about the effect of a \nseller -lessee repurchase option with a fair value strike price . \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 826}), Document(page\_content='Leases 826 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . — Different evaluations of the control guidance – i.e. the indicators and the \ndefinition of control . \n— Effect of variable lease payments on buyer -lessor lease classification – i.e. \nvariable leaseback payments may require the buyer -lessor to classify the \nleaseback as an operating lease even though the lessee would classify it as \na finance lease (see paragrap h 7.2.30). \n \n Question 9.1.110 \nUnit of account for determining whether a sale/ \npurchase has occurred \nWhat is the unit of account for determining whether a \nsale/purchase has occurred in a sale- leaseback transaction? \nInterpretive response: Each transferred asset is its own unit of account for \npurposes of determining whether a sale/purchase has occurred. Only after it \nhas been determined that a sale/purchase has occurred, and therefore that \nthere is a leaseback, does the entity determine whether multiple transferred \nand leased back assets constitute a single separate lease component (see \nsection 4.1). [842- 40-25-1, 25- 4] \nThis means that if two assets (e.g. a building and land) are transferred in a sale-\nleaseback transaction, even if the two leases would be accounted for as a \nsingle separate lease component, sale/purchase determination occurs at the \nindividual asset level. Therefore, it is possible that one asset fails sale \naccounting (e.g. because it is subject to a non- exempt repurchase option – see \nparagraph 9.1.50) but the other does not, even though the two leasebacks \nwould have been accounted for as a single separate lease component if both had been successfully sold. \nConsistent with the discussion in Question 3.2.10 related to lease identification, \nan entity does not break apart a single, integrated asset (e.g. an airplane or a \nship) and evaluate wheth er a sale/purchase has occurred separately for the \nassets combined to create the single integrated asset. \n \n Comparison to legacy US GAAP \nNew control -based sale determination aligns with Topic 606 and differs \nsubstantially from Topic 840 \n9.1.180 The control -based model for determining whether a sale has occurred in \nthe context of a sale- leaseback transaction differ s from the risks and rewards -\nbased model applied to sale- leasebacks of equipment and the prescriptive, \ncontinuing involvement model applied to sale -leasebacks of real estate under \nTopic 840. Under Topic 842, risks and rewards of ownership is just one of \nfive indicators, applied together with the control principle, used in determining \nwhether control of an asset has transferred from the seller -lessee to the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 827}), Document(page\_content='Leases 827 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . buyer -lessor . In addition, t he continuing involvement guidance that existed in \nTopic 840 has been superseded. \n9.1.190 As outlined in Question 9.1. 70, it is important to evaluate the control \nprinciple, not solely the control indicators, and apply more weight to those \nindicators and other evidence that provide relevant information about whether \nthe buyer -lessor obtains control of the underlying asset. In particular, the \nTopic 840 guidance placed significant weight on which party had exposure t o \nvarious risks of ownership; and as discussed in Question 9.1. 60, risk exposure \nwill typically not affect whether ‘control’ of the asset transfers to the buyer -\nlessor . \nDifferent sale -leaseback accounting for real estate vs. other assets \neliminated \n9.1.200 Topic 840 had different guidance for sale -leaseback transactions of real \nestate versus other assets. Under Topic 842, the same guidance applies to all \nsale-leaseback t ransactions, regardless of whether the underlying asset is real \nestate. [840- 40-25-9 – 25-18] \nSale-leaseback accounting now easier to achieve for real estate; more \ndifficult for other assets \n9.1.210 Sale-leaseback transactions in the US involving equipment often contain \nan option for the seller -lessee to repurchase the equipment. Such options \ngenerally did not result in a failed sale under Topic 840 unless the repurchase \noption was a bargain repurchase option. Topic 842 ma kes it more difficult for \nmany equipment sale- leaseback transactions to qualify for sale -leaseback \naccounting. [840- 40-25-13(a) ] \n9.1.220 Conversely, Topic 840 result ed in a failed sale for real estate sale -\nleaseback transactions if the seller -lessee ha d continuing involvement (including \na repurchase option at any strike price) with the real estate other than a normal \nleaseback. Failed sales we re common in real estate sale- leaseback transactions \nas a result. Because Topic 842 supersedes the continuing involvement \nprovisions that existed in Topic 840, it is generally easier for real estate sale -\nleaseback transactions to qualify for sale -leaseback accounting under Topic 842 \nthan it was under Topic 840. However, a seller -lessee repurchase option still \nprecludes sale-leaseback accounting for a r eal estate sale -leaseback transaction \n(see Question 9.1.30). [840- 40-25-9 – 25-18] \nContinuing involvement questions under legacy US GAAP \n9.1.230 Over time, many questions (often highly specific) arose in practice about \nhow to apply the continuing involvement provisions in Topic 840. Most of those \nquestions are no longer relevant under Topic 842 as a result of eliminating the \ncontinuing involvement provisions and because determining whether a \nsale/purchase occurs is now subject to the new control principle that did not \npreviously exist for real estate or equipment sale- leaseback transactions. Most \nof the specific items that affected whether a sale occurred in the context of the continuing involvement guidance in Topic 840 no longer have a specific effect \non the sale/purchase accounting conclusion under Topic 842. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 828}), Document(page\_content='Leases 828 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . New ‘failed purchase’ accounting \n9.1.240 When the transfer of the asset does not qualify for sale/purchase \naccounting based on the relevant guidance in Topic 606, Topic 842 requir es the \nbuyer -lessor to account for a sale -leaseback transaction as a ‘failed purchase’ \n(see section 9.3). In contrast, Topic 840 never require d the buyer -lessor to \naccount for a failed purchase, even if the seller -lessee account ed for the \ntransaction as a failed sale. \nProhibition on s ale-leaseback accounting for capital (finance) leasebacks \n9.1.250 Topic 840 did not prohibit sale -leaseback accounting by a seller -lessee \nsolely because the seller -lessee classified the leaseback as a capital lease. \n[840- 40-25-2] \n \n9.2 Accounting for s ale-leaseback t ransaction s \n Excerpt from ASC 842 -40 \n25 Recognition \nGeneral \n> Transfer of the Asset Is a Sale \n25-4 If the transfer of the asset is a sale in accordance with paragraphs 842- 40-\n25-1 through 25 -3, both of the following apply: \na. The seller -lessee shall: \n1. Recognize the transaction price for the sale at the point in time the \nbuyer -lessor obtains control of the asset in accordance with \nparagraph 606-10-25-30 in accordance with the guidance on \ndetermining the transaction price in paragraphs 606- 10-32-2 through \n32-27 \n2. Derecognize the carrying amount of the underlying asset \n3. Account for the lease in accordance with Subtopic 842- 20. \nb. The buyer -lessor shall account for the purchase in accordance with other \nTopics and for the lease in accordance with Subtopic 842- 30. \n30 Initial Measurement \nGeneral \n> Transfer of the Asset Is a Sale \n30-1 An entity shall determine whether a sale and leaseback transaction is at \nfair value on the basis of the difference between either of the following, \nwhichever is more readily determ inable: \na. The sale price of the asset and the fair value of the asset \nb. The present value of the lease payments and the present value of market \nrental payments. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 829}), Document(page\_content='Leases 829 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . 30-2 If the sale and leaseback transaction is not at fair value, the entity shall \nadjust the sale price of the asset on the same basis the entity used to \ndetermine that the transaction was not at fair value in accordance with \nparagraph 842-40-30-1. The entity shall account for both of the following: \na. Any increase to the sale price of the asset as a prepayment of rent \nb. Any reduction of the sale price of the asset as additional financing provided \nby the buyer -lessor to the seller -lessee. The seller -lessee and the buyer -\nlessor shall account for the additi onal financing in accordance with other \nTopics. \n30-3 A sale and leaseback transaction is not off market solely because the sale \nprice or the lease payments include a variable component. In determining \nwhether the sale and leaseback transaction is at fair value, the entity should \nconsider those variable payments it reasonably expects to be entitled to (or to \nmake) on the basis of all of the information (historical, current, and forecast) \nthat is reasonably available to the entity. For a seller -lessee, this would include \nestimating any variable consideration to which it expects to be entitled in \naccordance with paragraphs 606- 10-32-5 through 32- 9. \n30-4 If the transaction is a related party lease, an entity shall not make the \nadjustments required in paragraph 842-40-30-2, but shall provide the required \ndisclosures as discussed in paragraphs 842- 20-50-7 and 842- 30-50-4. \n30-5 See Examples 1 and 2 (paragraphs 842- 40-55-22 through 55- 38) for \nillustrations of the requirements for a sale and leaseback transaction. \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance \n>> Sale Subject to a Preexisting Lease \n55-22 Examples 1 and 2 illustrate the accounting for s ale and leaseback \ntransactions. \n>>> Example 1— Sale and Leaseback Transaction \n55-23 An entity (Seller) sells a piece of land to an unrelated entity (Buyer) for \ncash of $2 million. Immediately before the transaction, the land has a carrying \namount of $1 million. At the same time, Seller enters into a contract with \nBuyer for the right to use the land for 10 years (the leaseback), with annual \npayments of $120,000 payable in arrears. This Example ignores any initial \ndirect costs associated with the transaction. The terms and conditions of the \ntransaction are such t hat Buyer obtains substantially all the remaining benefits \nof the land on the basis of the combination of the cash flows it will receive \nfrom Seller during the leaseback and the benefits that will be derived from the \nland at the end of the lease term. In d etermining that a sale occurs at \ncommencement of the leaseback, Seller considers that, at that date, all of the \nfollowing apply: \na. Seller has a present right to payment of the sales price of $2 million. \nb. Buyer obtains legal title to the land. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 830}), Document(page\_content='Leases 830 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . c. Buyer has the significant risks and rewards of ownership of the land \nbecause, for example, Buyer has the ability to sell the land if the property \nvalue increases and also must absorb any losses, realized or unrealized, if \nthe property value declines. \n55-24 The observable fair value of the land at the date of sale is $1.4 million. \nBecause the fair value of the land is observable, both Seller and Buyer utilize \nthat benchmark in evaluating whether the sale is at market term. Because the \nsale is not at fair value (that is, the sales price is significantly in excess of the \nfair value of the land), both Seller and Buyer adjust for the off -market terms \nin accounting for the transaction. Seller recognizes a gain of $400,000 \n($1.4 million – $1 million) on the sale of the land. The amount of the excess \nsale price of $600,000 ($2 million – $1.4 million) is recognized as additional \nfinancing from Buyer to Seller (that is, Seller is receiving the additional benefit \nof financing from Buyer). Seller’s incremental borrowing rate is 6 per cent. The \nleaseback is classified as an operating lease. \n55-25 At the commencement date, Seller derecognizes the land with a carrying \namount of $1 million. Seller recognizes the cash received of $2 million, a \nfinancial liability for the additional financing obtained from Buyer of $600,000, \nand a gain on sale of the land of $400,000. Seller also recognizes a lease \nliability for the leaseback at the present value of the portion of the 10 \ncontractual leaseback payments attributable to the lease of $38,479 ($120,000 \ncontractual lease payment – $81,521 of that lease payment that is attributable \nto the additional Buyer financing), discounted at the rate of 6 percent, which is \n$283,210, and a corresponding right -of-use asset of $283,210. The amount of \n$81,521 is t he amount of each $120,000 annual payment that must be \nattributed to repayment of the principal of the financial liability for that financial \nliability to reduce to zero by the end of the lease term. \n55-26 After initial recognition and measurement, at eac h period of the lease \nterm, Seller will do both of the following: \na. Decrease the financing obligation for the amount of each lease payment \nallocated to that obligation (that is, $81,521) and increase the carrying \namount of the obligation for interest accrued using Seller’s incremental \nborrowing rate of 6 percent. For example, at the end of Year 1, the balance \nof the financial obligation is $554,479 ($600,000 – $81,521 + $36,000). \nb. Recognize the interest expense on the financing obligation (for example, \n$36,000 in Year 1) and $38,479 in operating lease expense. \n55-27 At the end of the lease term, the financing obligation and the lease \nliability equal $0. \n55-28 Also, at the commencement date, Buyer recognizes the land at a cost of \n$1.4 million and a financial asset for the additional financing provided to Seller \nof $600,000. Because the lease is an operating lease, at the date of sale Buyer \ndoes not do any accounting for the lease. \n55-29 In accounting for the additional financing to Seller, Buyer uses 6 percent \nas the applicable discount rate, which it determined in accordance with \nparagraphs 835- 30-25-12 through 25- 13. Therefore, Buyer will allocate $81,521 \nof each lease payment to Buyer’s financial asset and allocate the remaining ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 831}), Document(page\_content='Leases 831 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . $38,479 to lease in come. After initial recognition and measurement at each \nperiod of the lease term, Buyer will do both of the following: \na. Decrease the financial asset for the amount of each lease payment \nreceived that is allocated to that obligation (that is, $81,521) and increase \nthe carrying amount of the obligation for interest accrued on the financial \nasset using Seller’s incremental borrowing rate of 6 percent. Consistent \nwith Seller’s accounting, at the end of Year 1, the carrying amount of the \nfinancial asset is $554,4 79 ($600,000 – $81,521 + $36,000). \nb. Recognize the interest income on the financing obligation (for example, \n$33,269 in Year 2) and $38,479 in operating lease income. \n55-30 At the end of the lease term, the carrying amount of the financial asset \nis $0, an d Buyer continues to recognize the land. \n \n9.2.10 When a sale/purchase occurs in the context of a sale- leaseback \ntransaction, at the point in time that the buyer -lessor obtains control of the \nasset (under Topic 606), the seller -lessee: [842- 40-25-4(a), 606- 10-25-30, 32- 2 – 32-27] \n— recognizes the transaction price (i.e. the sales price) based on the guidance \non determining the transaction price in Topic 606, adjusted for any off -\nmarket terms; and \n— derecognizes the carrying amount of the underlying asset. \n9.2.20 Subject to any adjustment for off -market terms, this results in recognition \nof the full amount of the gain or loss on the sale of the asset. \n9.2.30 A seller -lessee accounts for the leaseback under the lessee accounting \nmodel (see chapter 6). [842- 40-25-4(a)(3)] \n9.2.40 A buyer -lessor accounts for the: [842- 40-25-4(b)] \n— purchase of the underlying asset in a sale- leaseback transaction consistent \nwith the guidance that would apply to any other purchase of a nonfinancial \nasset (subject to any off -market adjustment) – i.e. without the presence of a \nleaseback; and \n— leaseback under the lessor accounting model (see chapter 7). \n \n Question 9.2.05 \nPresentation of a sale -leaseback in the income \nstatement \nHow does a seller -lessee present the sale of the asset in a \nsale-leaseback in the income statement if it sells similar \nassets as part of its ordinary activities? \nInterpretive response: If sales of similar assets to those sold in the sale -\nleaseback transaction are part of the seller -lessee’s ‘ordinary activities’, the \nbuyer -lessor is a customer of the seller -lessee. For a discussion of ordinary \nactivities, see section 2.2.10 of KPMG Handbook, Revenue recognition. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 832}), Document(page\_content='Leases 832 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . In that case, we believe the seller -lessee should account for the sale under \nTopic 606, and present the sale consistent with its other sales of similar assets. \nThis would likely result in accounting for the sale proceeds as revenue from \ncontracts with customers, and the cost basis of the transferred asset \nderecognized as cost of goods sold. See note at the end of Example 9.2.10 . \n \n9.2.1 Determining whether the sale s price is off -market \n9.2.50 Unless the sale- leaseback transaction is between related pa rties ( see \nparagraph 9.2.100), the sale/purchase is accounted for at fair value. Therefore, \nboth the seller -lessee and the buyer -lessor need to assess whether the \ntransaction is at fair value – i.e. at market terms. [842- 40-30-1] \n \n Observation \nGain recognition consistent with that for any \nnonfinancial asset \n9.2.60 The Board concluded that if the sale and the leaseback are at market \nterms, the transfer of control of the asset (i.e. the sale) to the buyer -lessor is \nseparate and distinct from the buyer -lessor’s transfer of a right to use that asset \nto the seller -lessee. Consequently, the presence of the leaseback should \nneither preclude the sale of the asset, nor alter the accounting for that sale \n(except as necessary to adjust for off -market terms). [ASU 2016- 02.BC359 –BC360] \n9.2.70 In assessing whether the transaction is at fair value, an entity uses the \nformula that is more readily determinable: [842- 40-30-1] \n— the sales price of the asset versus the fair value of the asset; or \n— the present value of the lease payments versus the present value of market \nrental payments. \n \n Question 9.2.10 \nWhich formula to apply \nWill the two permissible formulas for assessing whether a \nsale-leaseback transaction is at fair value yield the same \nresult, and if not, is the selection of which formula to use an \noption? \nInterpretive response: The two formulas for determining whether the \ntransaction is at fair value may yield different results. Despite that fact, the \nBoard decided that either comparison c ould be an acceptable way to identify \nwhether the accounting for the transaction needs to be adjusted for off -market \nterms. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 833}), Document(page\_content='Leases 833 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . The decision about which formula to use when evaluating a given transaction is \nneither a ‘free choice’ nor an accounting policy elec tion applied to all sale-\nleaseback transactions. Rather, for each sale-leaseback transaction, an entity is \nrequired to maximize the use of observable prices and information, which may \nmean an entity uses the first formula in paragraph 9.2.70 for some trans actions \nand the second formula in paragraph 9.2.70 for others. Maximizing the use of \nobservable prices and information is consistent with using the comparison that \nis more readily determinable. [ASU 2016- 02.BC363 –BC364] \n9.2.80 A sale -leaseback transaction is not off -market solely because the sales \nprice or the leaseback payments include a significant variable component. In determining whether the sales price is at fair value, the entity considers those \nvariable payments that it reasonably expects to receive (or make) on the basis \nof all reasonably available information (e.g. historical, current, and/or \nforecast ed). For the seller -lessee, this includes estimating variable \nconsideration to which it expects to be entitled under the guidance on \nestimating variable consideration ( excluding the constraint on variable \nconsideration) in Topic 606. \n[842- 40-30-3, 606- 10-32-5 – 32-9] \n9.2.90 Sale-leaseback transactions are generally interdependent and negotiated \nas a package. Consequently, the parties could negotiate off -market terms for \neither the sale or the leaseback, and recoup the difference through the other \npart of the transaction – i.e. through a negotiated sales price above fair value \nand lease payments above market rates, or vice versa. \n9.2.100 If the sale- leaseback transaction is between related parties, neither \nthe seller -lessee nor the buyer -lessor adjust s for off- market terms. I nstead, \nthe entity discloses the off -market nature of the transaction (see \nparagraph 12.2.20). [842- 40-30-4] \n \n Observation \nAccounting for r elated party transactions based on \ncontractual terms \n9.2.110 The Board decided that recognizing sale- leaseback transactions between \nrelated parties based on the enforceable terms and conditions is consistent \nwith its corresponding decision for related party leases in general . In both \ncases, the Board concluded that a n entity should not account for the transaction \nin accordance with a subjective determination of its economic substance. \n[ASU 2016- 02.BC362] \n \n9.2.2 Adjusting the gain or loss for off -market terms \n9.2.120 If, based on the evaluation in section 9.2.1, the sale- leaseback \ntransaction is not at fair value , the entity ( whether the seller -lessee or the buyer -\nlessor ) adjusts the sale s price so that the transaction is recognized at fair value: \n[842- 40-30-2] \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 834}), Document(page\_content='Leases 834 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . — Deficit. If the sale s price is less than fair value, an adjustment is made to \nincrease the sales price of the asset. The corresponding debit is recognized \nas a rent prepayment. \n— Excess. If the sales price is greater than fair value, an adjustment is made \nto decrease the sales price of the asset. The corresponding credit is \nrecognized as additional financing provided by the buyer -lessor to the seller -\nlessee. \n9.2.130 When the sales price exceeds fair value , and additional financing is \nrecognized, both the seller -lessee and the buyer -lessor allocate a portion of \neach contractual lease payment to both the lease and the additional financing. \n[842- 40-30-2, 55- 23 – 55-30] \n— The amount allocated to each by the seller -lessee is the amount necessary \nto ensure that the lease liability and the additional financial liability both \nequal zero at the end of the leaseback term. \n— The amount allocated to each by the buyer -lessor is the amount necessary \nto reduce its financial asset and net investment in a direct financing \nleaseback to zero at the end of the leaseback term. \n9.2.140 Operating lease cost (seller -lessee) or income (buyer -lessor) is \ndetermined based on the total amount of the contractual payments allocated to the lease. \n \n9.2.3 Accounting for the leaseback \n9.2.150 When a sale- leaseback transaction results in a sale/purchase, both the \nseller -lessee and the buyer -lessor account for the leaseback in the same \nmanner as any other lease – see chapter 6 (lessees) and chapter 7 (lessors). \n[842- 40-25-4] \n \n Example 9.2.10 \nGain recognized by seller -lessee in a sale- leaseb ack \ntransaction \nSeller -Lessee SL sells a building to Buyer -Lessor BL and leases it back. The \nfollowing facts are relevant at the point in time that BL takes control of the building: \nCarrying amount of building: $1.5 million \nSales price (and fair value1) of the building: $2.5 million \nLease term: 4 years \nLease payments: Fixed payments of $325,000 per year in arrears \nSL’s incremental borrowing rate2: 10% \nLease incentives/initial direct costs: None ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 835}), Document(page\_content='Leases 835 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Notes: \n1. Based on recent sales prices of comparable buildings in the area, which are more \nreadily determinable than market rentals for the four -year leaseback. \n2. The rate implicit in the lease is not readily determinable (see section 5.6). \nAs illustrated in the following journal entries, SL recognizes the full amount of \nthe gain on the sale of the building, consistent with how it would recognize the \ngain resulting from the sale of any other nonfinancial asset. \n Debit Credit \nCash 2,500,000 \nBuilding 1,500,000 \nGain on sale1 1,000,000 \nTo recognize sale in sale- leaseback transaction. \nROU asset2 1,030,206 \nLease liability3 1,030,206 \nTo recognize leaseback in sale -leaseback \ntransaction. \nNotes: \n1. Sales price ($2.5 million) – carrying amount of building ($1.5 million). \n2. Lease liability ($1,030,206) + prepaid rent (nil) + initial direct costs (nil) – lease \nincentives (nil). \n3. Four payments of $325,000 (paid in arrears), discounted at 10%. \nNote: If SL sells similar buildings as part of its ordinary activities, rath er than \nrecognizing a net ‘gain on sale’ of the building of $1,000,000, SL would \nrecognize $2,500,000 in revenue from contracts with customers and \n$1,500,000 as cost of good s sold. \n \n Example 9.2.20 \nAccounting for a sale -leaseback transaction with \noff-mark et terms \nAssume the same facts as Example 9.2.10, except for the following. \n— The building ’s observable fair value on the date of the sale is $2 million – \ni.e. the sales price exceeds the building’ s observable fair value by $500,000. \n— The market rental payments are $198,800 per year – i.e. the present value \nof the contractual lease payments exceeds the present value of market rental payments by $400,037. \n— Buyer -Lessor BL applies a discount rate of 10% to the additional financing \nprovided to Seller -Lessee SL, determined in accordance with Subtopic 835-\n30 (imputation of interest ). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 836}), Document(page\_content='Leases 836 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Because the terms of the transaction are not at market, both parties record an \nadjustment to recognize the transaction at fair value, as an initial step in accoun ting for the sale- leaseback transaction. \nSeller -lessee accounting \nSL uses the fair value of the asset to determine the extent to which the sale/ \npurchase is off -market (see section 9.2.1) because the fair value of the asset is \nmore readily determinable tha n market rentals for the leaseback. This means that: \n— the gain on sale is calculated by reference to the fair value of $2 million; and \n— the excess of $500,000 ($2.5 million – $2 million) is recognized as additional \nfinancing. \nSL records the following journal entry when BL obtains control of the building. \n Debit Credit \nCash 2,500,000 \nBuilding 1,500,000 \nFinancial liability1 500,000 \nGain on sale2 500,000 \nTo recognize sale in sale -leaseback transaction. \nROU asset3 530,206 \nLease liability4 530,206 \nTo recognize leaseback in sale -leaseback \ntransaction. \nNotes: \n1. Contractual sales price ($2.5 million) – fair value of building ($2 million). \n2. Adjusted sales price ($2 million) – carrying amount of building ($1.5 million). \n3. Lease liability ($530,206) + prepaid rent (nil) + initial direct costs (nil) – lease incentives \n(nil). \n4. $1,030,206 (see Example 9.2.10) – off-market adjustment ($500,000). \n \n \n Example 9.2.30 \nAccounting for a rent -free lease in a sale- leaseback \ntransaction \nSeller -Lessee SL sells equipment with a carrying amount of $7 million and a fair \nvalue of $10 million to Buyer -Lessor BL in exchange for cash of $8 million and a \nrent-free lease of the same equipment. \nThe $2 million difference between the fair value and t he sales price (the most \nreadily determinable measure of whether the sale- leaseback transaction is off -\nmarket) represents a prepayment of the lease by SL – i.e. economically, the \nlease is not rent -free. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 837}), Document(page\_content='Leases 837 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . The parties record the following journal entries at t he point in time BL obtains \ncontrol of the equipment. \nBL: Debit Credit \nPP&E, net 10,000,000 \nCash 8,000,000 \nDeferred rent 2,000,000 \nTo record purchase of equipment . \n \nSL: Debit Credit \nCash 8,000,000 \nROU asset (prepaid rent) 2,000,000 \nGain on sale 3,000,000 \nPP&E, net 7,000,000 \nTo record sale of equipment . \nSubsequent to the sale, BL and SL account for the leaseback in the same \nmanner as any other prepaid lease. \n \n Comparison to legacy US GAAP \nAccounting for a gain or loss on a sale- leaseback transaction \n9.2.160 The requirement to recognize a gain immediately on recognition of a \nsale-leaseback transaction under Topic 842 is a change from Topic 840. Under \nTopic 840, the recognition of gain or loss on the sale of the underlying as set \ndepended on the rights retained by the seller -lessee. These thresholds are \nillustrated by the following chart. [840- 40-25-3 – 25-4] \nMinor More than minor, but less than substantially all Substantially all\n0% 10% 90% 100% \n9.2.170 Under Topic 840, gains or losses realized by a seller -lessee were \naccounted for as follows. [840- 40-25-3 – 25-4] \n— Transactions resulting in a realized loss by the seller -lessee: \n— Fair value of underlying asset < Carrying amount of underlying asset = Recognized the loss immediately. \n— Fair value of underlying asset > Carrying amount of un derlying asset = \nAccounted for the loss as a prepayment of rent (i.e. deferred \nrecognition). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 838}), Document(page\_content='Leases 838 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . — Transactions resulting in a realized gain by the seller -lessee (i.e. fair value > \ncarrying amount): \n— When the seller -lessee retained only a minor portion of the rig ht to the \nremaining use of the asset sold (i.e. < 10%), recognized the full gain \nimmediately. \n— When the seller retained more than a minor, but less than substantially all, of the remaining use of the asset sold (i.e. between 10% and 90%): \n– Operating leasebac ks. Recognized the gain to the extent that it \nexceeded the present value of the minimum lease payments. Remainder of realized gain was deferred and recognized over the leaseback term. \n– Capital leasebacks . Recognized the gain to the extent that the \nprofit on the sale exceeded the carrying amount of the underlying \nasset on the date of sale. \n— When the seller -lessee retained substantially all of the risks and benefits \nincidental to the ownership of the underlying asset (i.e. > 90%), profit on the sale was deferr ed and recognized to income over the leaseback term. \nLeaseback classification \n9.2.180 Under Topic 842, a leaseback that would be classified as a finance lease \nby the seller -lessee or a sales -type lease ( by the buyer -lessor) precludes \nsale/purchase accounting for the transaction. Therefore, a ll leasebacks are \nclassified as an operating lease by the seller -lessee, and as an operating lease \nor a direct financing lease by the buyer -lessor. There were no similar \nprohibitions on s ale-leaseback accounting based on leaseback classification \nunder Topic 840. [840- 40-25-2, 25- 8] \nRelated party transactions \n9.2.190 Under Topic 840, entities recognize d the economic substance of a \nrelated party lease rather than its legal form, which included evaluating the \neconomic substance of sale- leaseback transactions. The requirement to \nevaluate related party sale -leaseback transactions solely based on their legal \nform is a difference between Topic 840 and Topic 842. [840- 10-25-26] \n \n9.3 Accounting for failed s ale-leaseback t ransaction s \n Excerpt from ASC 842 -40 \n25 Recognition \nGeneral \n> Transfer of the Asset Is Not a Sale \n25-5 If the transfer of the asset is not a sale in accordance with \nparagraphs 842-40-25-1 through 25- 3, both of the following apply: ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 839}), Document(page\_content='Leases 839 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . a. The seller -lessee shall not derecognize the transferred asset and shall \naccount for any amounts received as a financial liability in accordance with \nother Topics. \nb. The buyer -lessor shall not recognize the transferred asset and shall accoun t \nfor the amounts paid as a receivable in accordance with other Topics. \n30 Initial Measurement \nGeneral \n> Transfer of the Asset Is Not a Sale \n30-6 The guidance in paragraph 842- 40-25-5 notwithstanding, the seller -lessee \nshall adjust the interest rate on its financial liability as necessary to ensure that \nboth of the following apply: \na. Interest on the financial liability is not greater than the payments on the \nfinancial liability over the shorter of the lease term and the term of the \nfinancing. The term of the financing may be shorter than the lease term \nbecause the transfer of an asset that does not qualify as a sale initially may \nqualify as a sale at a point in time before the end of the lease term. \nb. The carrying amount of the asset does not exceed the carrying amount of \nthe financial liability at the earlier of the end of the lease term or the date at \nwhich control of the asset will transfer to the buyer -lessor (for example, \nthe date at which a repurchase option expires if that date is earlier than the \nend of the lease term). \n55 Implementation Guidance and Illustrations \nGeneral \n> Illustrations \n>> Illustration of Sale and Leaseback Transaction \n>>> Example 2— Accounting for a Failed Sale and Leaseback \nTransaction \n55-31 An entity (Seller) sells an asset to an unrelated entity (Buyer) for cash of \n$2 million. Immediately before the transaction, the asset has a carrying \namount of $1.8 million and has a remaining useful life of 21 years. At the same \ntime, Seller enters into a contract with Buyer for the right to use the asset for \n8 years with annual payments of $200,000 payable at the end of each year and \nno renewal options. Seller’s incremental borrowing rate at the date of the \ntransaction is 4 percent. The contract includes an option to repurchase the \nasset at the end of Year 5 for $800,000. \n55-32 The exercise price of the repurchase option is fixed and, therefore, is \nnot the fair value of the asset on the exercise date of the option. Consequently, \nthe repurchase option precludes accounting for the transfer of the asset as a \nsale. Absent the repurchase option, there are no other factors that would \npreclude accounting for the transfer of the asset as a sale. \n55-33 Therefore, at the commencement date, Seller accounts for the \nproceeds of $2 million as a financial liability and continues to account for the \nasset. Buyer accounts for the payment of $2 million as a financial asset and \ndoes not recognize the transferred asset. Seller accounts for its financing ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 840}), Document(page\_content='Leases 840 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . obligation, and Buyer accounts for its financial asset in accordance with other \nTopics, except that, in accordance with paragraph 842 -40-30-6, Seller imputes \nan interest rate (4.23 percent) to ensure that interest on the financial liability is \nnot greater than the payments on the financial liability over the shorter of the \nlease term and the term of the financing and that the carrying amount of the \nasset will not exceed the financial liability at the point in time the repurchase \noption expires (that is, at the point in time Buyer will obtain control of the asset \nin accordance with the guidance on satisfying performance obligations in \nTopic 606). Paragraph 842 -40-30-6 does not apply to the buyer -lessor; \ntherefore, Buyer recognizes interest income on its financial asset on the basis \nof the imputed interest rate determined in accordance with paragraphs 835-30-\n25-12 through 25- 13, which in this case Buyer determines to be 4 percent. \n55-34 During Year 1, Seller recognizes interest expense of $84,600 (4.23% × \n$2 million) and recognizes the payment of $200,000 as a reduction of the \nfinancial liability. Seller also recognizes depreciation expense of $85,714 \n($1.8 million ÷ 21 years). Buyer recognizes interest income of $80,000 (4% × \n$2 million) and recognizes the payment of $200,000 as a reduction of its \nfinancial asset. \n55-35 At the end of Year 1, the carrying amount of Seller’s financial liability is \n$1,884,600 ($2 million + $84,600 – $200,000), and the carrying amount of the \nunderlying asset is $1,714,286 ($1.8 million – $85,714). The carrying amount of \nBuyer’s financial asset is $1,880,000 ($2 million + $80,000 – $200,000). \n55-36 At the end of Year 5, the option to repurchase the asset expires, \nunexercised by Seller. The repurchase option was the only feature of the \narrangement that precluded accounting for the transfer of the asset as a sale. \nTherefore, upon expiration of the repurchase option, Seller recognizes the sale \nof the asset by derecognizing the carrying amount of the financial liability of \n$1,372,077, derecognizing the carry ing amount of the underlying asset of \n$1,371,429, and recognizing a gain of $648. Buyer recognizes the purchase of \nthe asset by derecognizing the carrying amount of its financial asset of \n$1,350,041 and recognizes the transferred asset at that same amount. The \ndate of sale also is the commencement date of the leaseback for accounting \npurposes. The lease term is 3 years (8 year contractual leaseback term – \n5 years already passed at the commencement date). Therefore, Seller \nrecognizes a lease liability at the present value of the 3 remaining contractual \nleaseback payments of $200,000, discounted at Seller’s incremental borrowing \nrate at the contractually stated commencement date of 4 percent, which is \n$555,018, and a corresponding right -of-use asset of $555,018. Seller uses the \nincremental borrowing rate as of the contractual commencement date because \nthat rate more closely reflects the interest rate that would have been \nconsidered by Buyer in pricing the lease. \n55-37 The lease is classified as an operating le ase by both Seller and Buyer. \nConsequently, in Year 6 and each year thereafter, Seller recognizes a single \nlease cost of $200,000, while Buyer recognizes lease income of $200,000 \nand depreciation expense of $84,378 on the underlying asset ($1,350,041 ÷ \n16 years remaining useful life). \n55-38 At the end of Year 6 and at each reporting date thereafter, Seller \ncalculates the lease liability at the present value of the remaining lease ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 841}), Document(page\_content='Leases 841 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . payments of $200,000, discounted at Seller’s incremental borrowing rate of \n4 percent. Because Seller does not incur any initial direct costs and there are \nno prepaid or accrued lease payments, Seller measures the right -of-use asset \nat an amount equal to the lease liability at each reporting date for the \nremainder of the lease term. \n \n9.3.10 A failed sale -leaseback transaction occurs when the transaction does not \nmeet the requirements for sale/purchase recognition (see section 9.1). Instead, \nthe transaction is accounted for as a financing transaction by both the seller -\nlessee and buyer -lessor. [842- 40-25-5, 55-34] \n— The seller -lessee recognizes proceeds received from the buyer -lessor as a \nfinancial liability (financing method) and does not derecognize the \ntransferred asset. The seller -lessee continues to depreciate the transferred \nasset. \n— The buyer -lessor does not recognize the transferred asset and accounts for \nproceeds paid to the seller -lessee as a receivable (financial asset). \n \n Question 9.3.10 \nUseful life of the underlying asset in a failed sale -\nleaseback transaction \nWhat is the remaining useful life of the underlying asset in a \nfailed sale -leaseback? \nBackground: In a failed sale -leaseback, the seller -lessee continues to recognize \nand depreciate the underlying asset (see paragraph 9.3.10). However, the \nquestion arises about what the remaining useful life is for the underlying asset \nafter the failed sale. \nInterpretive response: It depends. When a failed sale occurs, the underlying \nasset remains, for accounting purposes, owned PP&E of the seller -lessee and \nno lease exists yet. Therefore, the useful life guidance in Topic 360 applies, and \nthe same general considerations that apply to the seller -lessee’s legally owned \nPP&E apply to the underlying asset. \nConsidering that guidance, the failed sale- leaseback transaction may tri gger a \nchange to the underlying asset’s useful life – i.e. the period over which the \nasset is expected to contribute directly or indirectly to future cash flows. [ASC \nMaster Glossary] \nThe following are examples. \n— A seller -lessee may conclude that the asset will no longer contribute to its \nfuture cash flows after it will be sold. Assume a leaseback term of 10 years, \nbut a successful sale will occur at the end of Year 7 when the repurchase \noption causing the failed sale expires. While t he seller -lessee will continue \nto use the underlying asset after the end of Year 7, it will control an ROU \nasset instead of the underlying asset from that date. We believe it would be \nreasonable to conclude the useful life of the underlying asset to the seller -\nlessee is only seven years. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 842}), Document(page\_content='Leases 842 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . — If a successful sale will not occur until the lease ends, we believe it is \nreasonable to consider the expected duration of the lease when \ndetermining the remaining useful life of the asset. Assume a maximum \npossible leaseba ck term of 15 years (a 10- year noncancelable period plus \nfive one -year renewal options). The seller -lessee in this scenario may assign \na remaining useful life equal to the expected duration of the lease (i.e. \nwhen it expects the sale to occur), even if tha t differs from either the \nmaximum possible leaseback term or the Topic 842 ‘lease term’. \n— The availability of the sale proceeds for repairs of, or upgrades to, the \nunderlying asset or for acquiring other assets could affect the seller -\nlessee’s plans with respect to use of the asset as compared to its plans \npre-transaction . This may result in the useful life being shortened or \nlengthened. \nThe above notwithstanding, Example 2 in Subtopic 842 -40 illustrat es a failed \nsale-leaseback transaction. The seller -lessee’s post-failed sale useful life in the \nexample exceeds all of the following: [842- 40-55-31, 55- 34] \n— the maximum possible leaseback term ; \n— the leaseback term that would apply to a successful sale -leaseback \ntransaction ; and \n— if shorter, the period of time until the buyer -lessor will obtain control of the \nunderlying asset (see paragraph 9.3.50) – e.g. if a seller -lessee repurchase \noption that precludes sale accounting expires before the end of the leaseback term. \nBased on Example 2, we do not believe the remainin g useful life of the \nunderlying asset must be capped at any of the above . \nHowever, if the underlying asset is a property improvement (building or integral equipment) constructed or installed on land leased from the lessor, the useful \nlife of the property improvements cannot exceed the lease term for the land \nlease. As examples, this can arise (not exhaustive): \n[842- 20-35-12] \n— in a build -to-suit scenario (see section 9.4) where the lessor legally owns \nthe land and the building, but the lessee is deemed to own the building for \naccounting purposes and fails sale accounting at the end of the \nconstruction period; or \n— when land and a building are sold and leased back together, but only the land is successfully sold (see Question 9.1.110). \nSalvage value \nIn addition to determining an appropriate remaining useful life of the underlying \nasset , the seller -lessee needs to consider the asset’s salvage value at the end \nof that useful life. We believe the salvage value of the asset should usually \nequal the lesser of (1) its expected residual value and (2) the carrying amount of \nthe financial liabil ity the asset’s transfer will extinguish. \nThis is because, while it is the asset itself that is recognized instead of an ROU \nasset, it is the buyer -lessor (not the seller -lessee) that is entitled to any residual \nasset value in excess of the financial liab ility balance. For example, the seller -\nlessee cannot realize any additional salvage value by selling the asset to a third ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 843}), Document(page\_content='Leases 843 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . party because it is legally owned by the buyer -lessor. For this reason, if there is \nno financial liability, or its carrying amount wil l be zero at the sale date, the \nasset’s salvage value should generally also be $0. \nWe believe this approach has the practical effect of eliminating any remaining \nbuilt-in loss unresolved by making the interest rate adjustment in paragraph \n9.3.30. \n9.3.20 When a seller -lessee determines that control of the underlying asset has \nnot transferred to the buyer -lessor (i.e. there is a failed sale), the agreed- upon \nsales price may indicate that the carrying amount of the asset is not recoverable if the sales price is lower than the carrying amount. However, an off -market \nsales price that is below the fair value of the asset and less than its carrying amount does not automatically mean that the carrying amount of the underlying \nasset is not recoverable. \n[360- 10-35-21] \n9.3.30 In applying the financing method, the seller -lessee adjusts the interest \nrate on its financial liability to ensure that: [842- 40-30-6] \n— interest on the financial liability is not greater than the payments made on \nthe financial liability – i.e. there is not negative accretion on the liability – \nover the shorter of the lease term or the term of the financing; and \n— the carrying amount of the underlying asset will not exceed the financing \nobligation at the earlier of (1) the end of the lease term, and (2) when \ncontrol of the underlying asset transfers to the buyer -lessor (see \nparagraph 9.3.50) – i.e. the seller -lessee adjusts the interest rate t o \nensure there is not a built -in loss. \n \n Question 9.3.20 \nNegative accretion assessed in the aggregate \nIs the interest rate required to be adjusted if there will be \nnegative accretion of the financing liability in one or some periods, but positive accretion over the entirety of the shorter of the lease term or the financing term?\n \nInterpretive response: No. Negative accretion could occur in only one or some \nof the periods during the shorter of the lease term or the term of the financing \nbeca use, for example, there is a free- rent holiday at the beginning of, or at \nsome point during, the lease term or because the lease payments escalate during the lease term. \nWhen evaluating whether an interest rate adjustment is required in accordance with par agraph 9.3.30, the analysis is an aggregate one. It only considers \nwhether there will be negative accretion over the entirety of the ‘shorter of’ period. If the interest rate will only result in negative accretion during one or some periods within that per iod, the interest rate is not adjusted. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 844}), Document(page\_content='Leases 844 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Question 9.3.25 \nAdjusting the interest rate on a failed sale -\nleaseback transaction during the financing period \nShould the seller -lessee in a failed sale- leaseback transaction \nlower the interest rate on its financial liability if the \nunderlying asset is impaired or its useful life is shortened? \nBackground: As outlined in paragraph 9.3.30, the interest rate on the seller -\nlessee’s failed sale -leaseback financial liability is adjusted upward if necessary \nto ensure the carrying amount of the underlying asset will not exceed the \nfinancial liability at the earlier of (1) the end of the lease term, and (2) when control of the underlying asset transfers to the buyer -lessor (‘earlier of date’). \nThe ‘failed sale period’ is the period between the contractual sale date and \nwhen a sale occurs for accounting purposes under Subtopic 842- 40. During that \nperiod, the seller -lessee continues to recognize and depreciate the underlying \nasset (see paragraph 9.3.10 and Question 9.3.10), and to recognize any impairment losses under Topic 360. As a result of following these \nrequirements, the carrying amount may be adjusted in a way that was not \ncontemplated when the interest rate was determined. This could occur, for \nexample, if the und erlying asset is impaired under Topic 360 during the period \nor if the useful life of the asset is reduced (see Question 9.3.10). \nInterpretive response: No. While Topic 842 does not explicitly discuss \nsubsequent adjustments to the interest rate, we believe the subsequent accounting for the underlying asset and the financial liability are independent. \nThis means that the interest rate on the financial liability should not be adjusted \nduring the failed sale period as a result of changes in the seller -lessee’s \naccounting for the underlying asset, such as recognition of an impairment loss \nor a change in the asset’s useful life. \n9.3.40 Example 2 in Subtopic 842- 40 demonstrates the accounting for a failed \nsale-leaseback transaction. [842- 40-55-31 – 55-38] \n9.3.50 A failed sale -leaseback transaction may qualify for sale/purchase \naccounting at some point during the term of the leaseback. For example: \n[842- 40-55-31 – 55-38, ASU 2016- 02.BC369] \n— the buyer -lessor may obtain control of the asset (a nd therefore complete \nthe sale/ purchase) before the end of the leaseback term if a seller -lessee \nrepurchase option (or other specific feature) that precluded sale/purchase \naccounting expires; or \n— the control guidance in Topic 606 may suggest that the buyer -lessor has not \nobtained control of the asset at the leaseback commencement date, but \nmay suggest otherwise before the end of the leaseback term. \n9.3.60 If an initially failed sale -leaseback transaction qualifies for sale/purchase \naccounting before the end of the leaseback term: [842- 40-55-31 – 55-38] \n— the seller -lessee derecognizes the remaining financial liability and the \ncarrying amount of the asset, and recognizes a gain for the difference; and \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 845}), Document(page\_content='Leases 845 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . — the buyer -lessor derecognizes its remaining financial asset and recognizes \nthe transferred asset at that same amount. \n9.3.70 Both parties then account for the remaining leaseback in accordance with \nthe applicable lessee and lessor guidance from the date the sale/purchase is \ndeemed to occur for accounting purposes. However, they both use the \ndiscount rate for the lease that would have been established at the contractual \nlease commencement date. This only matters for the buyer -lessor if the \nleaseback is a direct financing lease because a buyer -lessor cannot have a \nsales- type leaseback and does not recognize lease assets to be discounted for \nan operating leaseback. [842- 40-55-31 – 55-38] \n9.3.80 Example 2 in Subtopic 842- 40 states that the seller -lessee uses the lease \ncommencement date discount rate because that rate more closely reflects the \ninterest rate that would have been considered by the buyer -lessor in pricing the \nlease. [842- 40-55-31 – 55-38] \n \n Question 9.3.30 \nReassessing lease classification in a failed sale -\nleaseback \nWhen s hould classification of a leaseback be reassessed in a \nfailed sale -leaseback transaction ? \nWe are aware that the FASB has received a request to add a project to its \ntechnical agenda that is relevant to this Question. Consequently, there may be \nfurther developments around this issue, in which case we will update this \ninterpretive response in a future edition. \nInterpretive response: In general, we believe leaseback classification should \nnot be reassessed in a failed sale- leaseback transaction unless a lease \nclassification reassessment event occurs after the contractual leaseback \ncommencement date. \nThose events are: [842- 10-25-1] \n— a modification of the lease that is not accounted for as a separate contract \n(all entities ); \n— a change in the lease term ( seller -lessee only ); or \n— a change in the assessment of a lessee option to repurchase the underlying \nasset ( seller -lessee only ). \nThose events do not include when one or more condition(s) previously \nprecluding sale/purchase accounting is (are) cured (e.g. expiration of a seller -\nlessee repurchase option), even if the curing of that ( those) condition( s) results \nin the transaction now qualifying for sale/purchase accounting. \nWhen a sale -leaseback transaction qualifies for sale/purchase accounting during \nthe contractual l easeback term (see paragraph 9.3.50), the incremental \nborrowing rate used by the seller -lessee to discount the lease liability when the \nsale and leaseback are recognized is the incremental borrowing rate as of the \ncontractual commencement date. This is because that rate more closely \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 846}), Document(page\_content='Leases 846 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . reflects the interest rate that would have been considered by the buyer -lessor \nin pricing the lease. [842- 40-55-36] \nFollowing that logic, it would be inconsistent to classify the lease as of the date \nthe sale/purchase is recognized because changes in circumstances since the \ncontractual commencement date (e.g. changes to the fair value of the \nunderlying asset) may similarly be unrelated to the economics of the negotiated \ntransaction. Those changes in circumstances could result in a conclusion that a \nleaseback that was negotiated and structured by the parties to be an operating \nlease would be classified as a finance/sales -type lease at this later date, which \nwould then continue to preclude sale and leaseback accounting even thoug h \nthe condition(s) that initially precluded the sale/purchase has (have) been cured. \nWe believe this t o be inconsistent with the FASB ’s intent. \nFailed sale/purchase resulting from finance/sales -type classification \nAbsent a lease classification reassessment event, a failed sale/purchase \nresulting solely or partially from finance/sales -type leaseback classification \nshould be accounted for by the parties as a financing until the leaseback \nexpires. We do not believe it was the FASB’s intent for transactions that result \nin a failed sale/purchase at contractual commencement based on lease \nclassification to potentially achieve sale/purchase accounting later solely from \nthe passage of time. \nConsider the following examples. \n— At the contractual leaseback commencement date, an 8- year leaseback of \nan asset with a 10- year remaining economic life would fail the ‘lease term \ntest’. However, at the end of Year 3 of the leaseback, the 5- year remaining \nleaseback term would no longer equal a major part of the 7- year remaining \neconomic life of the underlying asset. \n— If the leaseback is classified as a finance/sales- type lease at the contractual \ncommencement date because of failing the ‘present value test’, a \nsubsequent increase in the fair value of the underlying asset after that date \n(which could later reverse itself) might result in a different conclusion if the \ntest were re- performed. \n— An alternative use for the transferred asset to the buyer -lessor may arise \nafter the contractual commencement date. \nIn each of these examples, if the parties reassess classification of the leaseback – either continuously or when all other failure conditions, such as a repurchase \noption, have been cured – a sale and leaseback could result; for example, at the \nend of Year 3 in the first example. In contrast, if the parties do not do so, and no \nlease classification reassessment event occurs (see paragraph 6.2.40), all of these transactions will remain failed sales/purchases, accounted for as financing transaction s, until the contractual leaseback expires. \n[842- 10-25-1] \nWe believe it was the FASB’s intent to revisit the accounting for the transaction \nonly if a change occurs that affects the economics of the lease from those \ncontemplated in negotiating and pricing t he lease. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 847}), Document(page\_content='Leases 847 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Alternative approach \nAs an alternative, we believe Example 2 in Subtopic 842- 40 (accounting for a \nfailed sale and leaseback transaction) could support reassessing leaseback \nclassification when the condition(s) previously precluding a sale/purchas e is \n(are) cured if , and only if, leaseback classification – at the later of the contractual \ncommencement date and the most recent classification reassessment event – \nwould not have also precluded sale/purchase accounting. \nThis view is based on the follow ing. [842- 10-25-1, 842- 40-55-36] \n— Lease classification is assessed at lease commencement under Topic 842. \n— A sentence in Example 2 states that the date of sale (i.e. the date the \nrepurchase option that precluded a successful sale/purchase expires) is the ‘commencement date of the leaseback for accounting purposes’. \nWhile we believe the above sentence i n Example 2 was intended to refer solely \nto the date the accounting should commence (i.e. when the leaseback liability and ROU asset are recognized) – and not to suggest that lease classification \nshould be assessed (or reassessed) at that date – we acknowledge that this is \nunclear . We therefore would accept this alternative approach as an accounting \npolicy election. \nWe do not believe Example 2 supports requiring or permitting leaseback \nclassification reassessment when the failed sale/purchase results solely or \npartially from finance/sales -type classification. This is because that example \nstates explicitly that the sel ler-lessee repurchase option is the only factor that \nprecludes a successful sale/purchase at the asset transfer date – i.e. \nsale/purchase accounting was not also precluded because of lease classification. Therefore, any transaction where lease classificati on is an additional reason for \nthe failed sale/purchase differs from Example 2. \n[842- 40-55-32] \n \n Question 9.3.40 \nBuyer -lessor accounting for initial direct costs \nincurred in a failed sale -leaseback transaction \nWhat guidance should a buyer -lessor apply to determine the \ninitial direct costs in a failed sale -leaseback transaction? \nBackground: In a failed sale -leaseback transaction, the seller -lessee does not \nderecognize the underlying asset and reflects the proceeds from the transaction \nas a financial liability (i.e. borrowing). Conversely, the buyer -lessor does not \nrecognize the transferred asset and reflects the cash payment as a loan to the \nseller -lessee (i.e. lending activity). \nTopic 842 provides guidance on the accounting for initial direct costs from a \nlease transaction, while Subtopic 310- 20 (receivables – nonrefundable fees and \nother costs) provides guidance on capitalizing loan origination costs. Therefore, \nthe question arises as to which guidance governs origination costs in a fa iled \nsale-leaseback transaction. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 848}), Document(page\_content='Leases 848 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Interpretive response: Topic 842 is not clear as to whether those costs should \nbe accounted for under the leasing or financial instruments guidance. \nWe believe that because a failed sale -leaseback transaction initially fal ls within \nthe scope of Topic 842 and then subsequently is accounted for as a loan, either \nof the above alternatives are acceptable if applied consistently by the buyer -\nlessor. The guidance in Subtopic 310- 20 may result in capitalizing more initial \ndirect c osts than those capitalized under Topic 842 because the capitalizable \ncosts under that Subtopic include items that do not meet the definition of initial \ndirect costs under Topic 842. \nIf a buyer -lessor capitalizes origination costs in accordance with Subtopic 310 -\n20, at the point a successful sale- leaseback occurs, there may be unamortized \ncapitalized costs that do not meet the definition of initial direct costs in \nTopic 842. In that circumstance, neither Topic 842 nor other GAAP directly \naddresses how the buyer -lessor should account for those costs. Consequently, \nwe believe the following would be acceptable. \nThe leaseback is classified as a direct financing lease \nIf the leaseback is classified as a direct financing lease, either of the following \napproaches i s acceptable. \n— Expense. Write off the unamortized origination costs that do not meet the \ndefinition of initial direct costs under Topic 842 as an expense at the \nsuccessful sale date. Under this approach, the buyer -lessor recognizes the \nnet investment in the lease at an amount equal to its financing receivable \nimmediately before the sale’s successful completion less the unamortized \norigination costs written off. This results in a net investment in the lease \nthat is generally determined in the same manner as i t would be for a sale-\nleaseback transaction that is accounted for as a sale initially. The buyer -\nlessor also recomputes the rate implicit in the lease under this approach so \nthat the remaining leaseback payments plus the original estimated residual \nvalue equal the new balance of the net investment in the lease. \n— Capitalize. Measure the net investment in the lease at the carrying amount \nof the financing receivable (inclusive of all of the unamortized origination \ncosts). This approach is consistent with Exampl e 2 in Subtopic 842 -40, in \nwhich the underlying asset is recognized by the buyer -lessor at the \nsuccessful sale date at the carrying amount of the financing receivable, and \nwith the notion that the buyer -lessor is simply recharacterizing the financing \nrecei vable as a net investment in a lease. [842- 40-55-36] \nThe leaseback is classified as a n operating lease \nIf the leaseback is classified as an operating lease, either of the following \napproaches is acceptable. \n— Expense. Write off the unamortized costs included in the financing \nreceivable that do not meet the definition of initial direct costs under \nTopic 842 as an expense at the successful sale date, and reclassify the \nremaining unamortized costs as deferred initial direct costs to be \nrecognized as an expense over the remaining lease term in the same \npattern as lease income. Under this approach, the buyer -lessor recognizes \nthe underlying asset at an amount equal to its financing receivable \nimmediately before the sale’s successful completion less the unam ortized ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 849}), Document(page\_content='Leases 849 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . origination costs. This results in an amount capitalized as property, plant \nand equipment that is determined in the same manner as it would be for a \nsale-leaseback transaction that is accounted for as a sale initially. \n— Capitalize. Measure the newly recognized underlying asset at the carrying \namount of the financing receivable (inclusive of all of the unamortized \norigination costs). This approach is consistent with Example 2 in \nSubtopic 842-40, in which the underlying asset is recog nized by the buyer -\nlessor at the successful sale date at the carrying amount of the financing receivable, and with the notion that the buyer -lessor is simply recharacterizing \nthe financing receivable as property, plant and equipment. \n[842- 40-55-36] \n \n Exam ple 9.3.10 \nFailed sale -leaseback transaction – repurchase \noption not reasonably certain to be exercised \nSeller -Lessee SL enters into a contract (that meets the contract existence \ncriteria in Topic 606) with Buyer -Lessor BL for the sale -leaseback of equipm ent. \nSL has an option to repurchase the equipment at the end of the noncancelable leaseback term at a fixed price of $5 million (intended to approximate the fair \nvalue of the equipment at that date) . Because of this option, which does not \nmeet the criteri a in paragraph 9.1.50, control of the equipment does not transfer \nto BL until after the repurchase option expires. Therefore, SL accounts for the \ntransaction as a failed sale (see section 9.1). \nIn each of the scenarios below, the repurchase option is not reasonably certain \nto be exercised, which is relevant to determining the lease payments used to \nadjust the interest rate. \nThe following additional facts are relevant. \nEquipment remaining economic life: 12 years \nEquipment remaining useful life: 5 years \nNet carrying amount of equipment on contractual date of sale: $10 million \nExpected residual value at end of Year 5: $5 million \nAnnual depreciation: $1 million \nSales price: $12 million \nLeaseback term: 5 years \nLeaseback renewal options: One 5-year renewal option \nContractual lease payment: Fixed payments of $1.2 million \nper year (in arrears) \nInterest rate (determined in accordance with \nparagraph s 835-30-25-12 – 25-13): 5.80% ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 850}), Document(page\_content='Leases 850 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Scenario 1: No adjustment to interest rate required \nUsing the interest rate of 5.80%, SL calculates the amortization table for the \nfinancial liability as follows. \nPeriod Asset \ncarrying \namount Financial \nliability \nbalance Contractual \nlease \npayment Principal \nportion of \npayment Interest \nexpense \nCommencement $10,000,000 $12,000,000 $ - $ - $ - \nYear 1 9,000,000 11,496,0001 1,200,000 504,0002 696,0003 \nYear 2 8,000,000 10,962,768 1,200,000 533,232 666,768 \nYear 3 7,000,000 10,398,609 1,200,000 564,159 635,841 \nYear 4 6,000,000 9,801,728 1,200,000 596,881 603,119 \nYear 5 5,000,000 9,170,228 1,200,000 631,500 568,500 \nNext, SL applies the tests in paragraph 9.3.30 and confirms that the interest \nrate does not require adjustment: \n— over the five- year term, the interest on the financial liability ($3,170,228) \ndoes not exceed the contractual lease payments ($6,000,000); and \n— at the end of Y ear 5, the expected carrying amount of the underlying asset \n($5,000,000)4 does not exceed the carrying amount of the financial liability \n($9,170,228). \nWhen the sale occurs for accounting purposes at the end of Year 5, because \nthe repurchase option expires, SL recognizes a gain of $4,170,228 ($9,170,228 \n– $5,000,000). \nNotes: \n1. Financial liability of $11,496,000 is calculated as the financial liability at the beginning of \nthe period reduced by the principal portion of the Year 1 payment ($12,000,000 – \n$504,000). \n2. Reduction to principal of $504,000 is calculated as the contractual lease payment less \ninterest expense ($1,200,000 – $696,000). \n3. Interest expense of $696,000 is calculated as the financial liability at the beginning of the \nperiod multiplied by the interest rate ($12,000,000 × 5.80%). \n4. Carrying amount at the start of Year 1 ($10,000,000) less $1,000,000 depreciation per \nyear for five years. \nScenario 2: Interest rate adjusted to avoid negative accretion \nAssume the same facts as Scenario 1, except that the lease payments are fixed \nat $650,000 per year (paid in arrears). \nUsing the interest rate of 5.80%, SL calculates the amortization table for the \nfinancial liability as follows . \nPeriod PP&E net \ncarrying \namount Financial \nliability \nbalance Contractual \nlease \npayment Reduction/ \n(Increase) to \nprincipal Interest \nexpense \nCommence -\nment $10,000,000 $12,000,000 $ - $ - $ - \nYear 1 9,000,000 12,046,000 650,000 (46,000) 696,000 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 851}), Document(page\_content='Leases 851 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Period PP&E net \ncarrying \namount Financial \nliability \nbalance Contractual \nlease \npayment Reduction/ \n(Increase) to \nprincipal Interest \nexpense \nYear 2 8,000,000 12,094,668 650,000 (48,668) 698,668 \nYear 3 7,000,000 12,146,159 650,000 (51,491) 701,491 \nYear 4 6,000,000 12,200,636 650,000 (54,477) 704,477 \nYear 5 5,000,000 12,258,273 650,000 (57,637) 707,637 \nNext, SL applies the tests in paragraph 9.3.30 and determines that the interest \nrate requires adjustment: \n— at the end of the five years, the expected carrying amount of the underlying \nasset ($5,000,000) does not exceed the carrying amount of the financial liability ($12,258,27 3); but \n— over the five- year te rm, the interest on the financial liability ($3,508,273) \nexceeds the contractual lease payments ($3,250,000). \nTo avoid negative accretion on the financial liability over the five- year term, SL \nmakes interest expense equal the contractual lease payments, which requires an adjusted interest rate of 5.42% (rounded). \nPeriod PP&E net \ncarrying \namount Financial \nliability \nbalance Contractual \nlease \npayment Reduction/ \n(Increase) to \nprincipal Interest \nexpense \nCommence -\nment $10,000,000 $12,000,000 $ - $ - $ - \nYear 1 9,000,000 12,000,000 650,000 - 650,000 \nYear 2 8,000,000 12,000,000 650,000 - 650,000 \nYear 3 7,000,000 12,000,000 650,000 - 650,000 \nYear 4 6,000,000 12,000,000 650,000 - 650,000 \nYear 5 5,000,000 12,000,000 650,000 - 650,000 \nWhen the sale occurs for accounting purposes at the end of Year 5, because \nthe repurchase option expires, SL recognizes a gain of $7,000,000 ($12,000,000 \n– $5,000,000). \nScenario 3: Interest rate adjusted to avoid built -in loss on sale \nAssume the same fact s as Scenario 1, except that the lease payments are fixed \nat $2,000, 000 per year (paid in arrears). \nUsing the interest rate of 5.80%, SL calculates the amortization table for the financial liability as follows. \nPeriod PP&E net \ncarrying \namount Financial \nliability \nbalance Contractual \nlease \npayment Principal \nportion of \npayment Interest \nexpense \nCommence -\nment $10,000,000 $12,000,000 $ - $ - $ - \nYear 1 9,000,000 10,696,000 2,000,000 1,304,000 696,000 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 852}), Document(page\_content='Leases 852 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Period PP&E net \ncarrying \namount Financial \nliability \nbalance Contractual \nlease \npayment Principal \nportion of \npayment Interest \nexpense \nYear 2 8,000,000 9,316,368 2,000,000 1,379,632 620,368 \nYear 3 7,000,000 7,856,717 2,000,000 1,459,651 540,349 \nYear 4 6,000,000 6,312,407 2,000,000 1,544,310 455,690 \nYear 5 5,000,000 4,678,527 2,000,000 1,633,880 366,120 \nNext, SL applies the tests in paragraph 9.3.30 and identifies that the interest \nrate requires adjustment: \n— over the five- year term, the interest on the financial liability ($2,678,527) \ndoes not exceed the contractual lease payments ($10,000,000); but \n— at the end of the five years, the ex pected carrying amount of the underlying \nasset ($5,000,000) exceeds the carrying amount of the financial liability ($4,678,527). \nTo avoid a loss when the sale is recorded, SL adjusts the interest expense to \nensure that the carrying amount of the financial liability at the end of the \nfive years is $5,000,000, which requires an adjusted interest rate of 6.40% \n(rounded). \nPeriod PP&E net \ncarrying \namount Financial \nliability \nbalance Contractual \nlease \npayment Principal \nportion of \npayment Interest \nexpense \nCommence -\nment $10,000,000 $12,000,000 $ - $ - $ - \nYear 1 9,000,000 10,768,128 2,000,000 1,231,872 768,128 \nYear 2 8,000,000 9,457,403 2,000,000 1,310,725 689,275 \nYear 3 7,000,000 8,062,778 2,000,000 1,394,625 605,375 \nYear 4 6,000,000 6,578,882 2,000,000 1,483,896 516,104 \nYear 5 5,000,000 5,000,000 2,000,000 1,578,882 421,118 \nWhen the repurchase option expires , the carrying amount of the equipment and \nthe balance of the financial liability are the same, and therefore SL recognizes \nno gain or loss at the time of sa le. \n \n Example 9.3.20 \nFailed sale -leaseback transaction – repurchase \noption reasonably certain to be exercised \nAssume the same facts as Example 9.3.10 Scenario 1, except that the strike \nprice of the repurchase option is $8 million, and is reasonably certain to be \nexercised at the end of the leaseback term (see section 5.2). \nIn this example, the interest rate needs to be adjusted so the financial liability at \nthe end of Year 5 will equal the repurchase option price. Because it is ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 853}), Document(page\_content='Leases 853 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . reasonably certain that control will never transfer to Buyer -Lessor BL, the \ninterest rate is imputed so that no gain or loss will be recognized, consistent \nwith the guidance in s ection 835- 30-25. Accordingly, the interest rate is \nadjusted to 3.82% (subject to rounding). \nPeriod PP&E net \ncarrying \namount Financial \nliability \nbalance Contractual \nlease \npayment Principal \nportion of \npayment Interest \nexpense \nCommence -\nment $10,000,000 $12,000,000 $ - $ - $ - \nYear 1 9,000,000 11,258,891 1,200,000 741,109 458,8911 \nYear 2 8,000,000 10,489,441 1,200,000 769,450 430,550 \nYear 3 7,000,000 9,690,567 1,200,000 798,874 401,126 \nYear 4 6,000,000 8,861,143 1,200,000 829,424 370,576 \nYear 5 5,000,000 - 9,200,0002 8,861,143 338,857 \nNotes: \n1. Interest expense is calculated by multiplying the balance of the financial liability by the \nadjusted interest rate ($12,000,000 × 3.82%). \n2. Lease payment for Year 5 is calculated as the fixed annual lease payment plus \nrepurchase option strike price ($1,200,000 + $8,000,000). \n \n \n Example 9.3.30 \nFailed sale -leaseback transaction – lessor accounting \nAssume the same facts as Example 9.3.10 , Scenario 1. Buyer -Lessor BL \nconcludes that the contract is a failed sale -leaseback because the contract \noffers Seller -Lessee SL a fixed price repurchase option (see section 9.1). In this \nexample, this is the only pr ovision of the arrangement preventing the \ntransaction from qualifying for sale- leaseback accounting. This is the same \nconclusion independently reached by SL in Example 9.3.10. \nBL accounts for the transaction as follows. \n— BL recognizes the payment of $12 mil lion to SL as a financial asset and \ndoes not recognize the underlying asset. \n— Under paragraphs 835- 30-25-12 – 25-13, BL determines an appropriate \ninterest rate to be 6%. This is based on prevailing rates for similar \ninstruments, BL’s assessment of the creditworthiness of SL, and other \nfactors assumed in pricing the contractual leaseback. \nBL calculates the amortization table for the financial asset as follows. \nPeriod Contractual lease \npayment Interest income Financial asset \nending balance \nCommencement $ - $ - $12,000,000 \nYear 1 1,200,000 720,0001 11,520,000 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 854}), Document(page\_content='Leases 854 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Period Contractual lease \npayment Interest income Financial asset \nending balance \nYear 2 1,200,000 691,200 11,011,200 \nYear 3 1,200,000 660,672 10,471,872 \nYear 4 1,200,000 628,312 9,900,184 \nYear 5 1,200,000 594,011 9,294,195 \nNote: \n1. Interest income is calculated by multiplying the balance of the financial asset by the \nimputed interest rate ($12,000,000 × 6%). \nControl of the asset transfers to BL when the repurchase option expires at the \nend of Year 5, which in this case is at the end of the contractual leaseback \nterm. BL recognizes the purchase of the asset by derecognizing the carrying \namount of its financial asset ($9,294,195) and recognizing the transferred asset \nat the same amount. BL depreciates the asset from this date forwar d based on \nTopic 360. \nNote: If control of the asset transferred before the end of the contractual \nleaseback, BL would derecognize the financial asset and recognize the \ntransferred asset in the same amount as the financial asset , begin depreciation, \nand begin accounting for the lease based on the lease classification determined \nat the contractual commencement date (see Question 9.3.30). \n \n Comparison to legacy US GAAP \nSeller -lessee accounting for failed sale -leaseback transactions is generally \nconsistent with practice under Topic 840 \n9.3.90 Consistent with Topic 842, a failed sale -leaseback transaction under \nTopic 840 was generally accounted for as a financing transaction. However, \nunlike Topic 842, Topic 840 also perm itted use of the deposit method when the \nsales price of the underlying asset was paid to the seller -lessee over time. \nTherefore, the requirement to use the financing method in all failed sales \nrepresents a change from the legacy guidance in Topic 840. [840- 40-25-11] \nAdjusting the discount rate for failed sale -leaseback transactions \n9.3.100 While practice under Topic 840 developed in a manner similar to the \nguidance on adjusting the discount rate in a failed sale- leaseback transaction \nunder Topic 842 (see paragraph 9.3. 30), Topic 840 did not have explicit \nguidance of this nature. \nNew ‘failed purchase’ accounting \n9.3.110 When the transfer of the asset does not qualify for sale/purchase \naccounting based on the relevant guidance in Topic 606, Topic 842 requires the \nbuyer -lessor to account for the sale-leaseback transaction as a ‘failed purchase’. \nIn contrast, Topic 840 did not require the buyer -lessor to account for a failed \npurchase, even if the seller -lessee accounted for the transaction as a failed sale. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 855}), Document(page\_content='Leases 855 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . 9.4 Lessee c ontrol before lease commencement \n Excerpt from ASC 842 -40 \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance \n>> Control of the Underlying Asset before the Commencement Date \n55-1 A lessee may obtain legal title to the underlying asset before that legal \ntitle is transferred to the lessor and the asset is leased to the lessee. If the \nlessee controls the underl ying asset (that is, it can direct its use and obtain \nsubstantially all of its remaining benefits) before the asset is transferred to the \nlessor, the transaction is a sale and leaseback transaction that is accounted for \nin accordance with this Subtopic. \n55-2 If the lessee obtains legal title, but does not obtain control of the \nunderlying asset before the asset is transferred to the lessor, the transaction is \nnot a sale and leaseback transaction. For example, this may be the case if a \nmanufacturer, a lessor , and a lessee negotiate a transaction for the purchase of \nan asset from the manufacturer by the lessor, which in turn is leased to the \nlessee. For tax or other reasons, the lessee might obtain legal title to the \nunderlying asset momentarily before legal t itle transfers to the lessor. In this \ncase, if the lessee obtains legal title to the asset but does not control the asset \nbefore it is transferred to the lessor, the transaction is accounted for as a \npurchase of the asset by the lessor and a lease between the lessor and \nthe lessee. \n>> Costs of the Lessee Relating to the Construction or Design of an \nUnderlying Asset \n55-3 An entity may negotiate a lease before the underlying asset is available \nfor use by the lessee. For some leases, the underlying asset may need to be \nconstructed or redesigned for use by the lessee. Depending on the terms and \nconditions of the contract , a lessee may be required to make payments \nrelating to the construction or design of the asset. \n55-4 If a lessee incurs costs relating to the construction or design of an \nunderlying asset before the commencement date , the lessee should account \nfor those costs in accordance with other Topics, for example, Topic 330 on \ninventory or Topic 360 on property , plant, and equipment. Costs relating to the \nconstruction or design of an underlying asset do not include payments made \nby the lessee for the right to use the underlying asset. Payments for the right \nto use the underlying asset are lease payments , regardl ess of the timing of \nthose payments or the form of those payments (for example, a lessee might \ncontribute construction materials for the asset under construction). \n55-5 If the lessee controls the underlying asset being constructed before the \ncommencement date, the transaction is accounted for in accordance with this \nSubtopic. Any one (or more) of the following would demonstrate that the ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 856}), Document(page\_content='Leases 856 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . lessee controls an underlying asset that is under construction before the \ncommencement date: \na. The lessee has the right to obtain the partially constructed underlying asset \nat any point during the construction period (for example, by making a \npayment to the lessor ). \nb. The lessor has an enforceable right to payment for its performance to date, \nand the asset does not have an alt ernative use (see paragraph 842- 10-55-7) \nto the owner -lessor. In evaluating whether the asset has an alternative use \nto the owner -lessor, an entity should consider the characteristics of the \nasset that will ultimately be leased. \nc. The lessee legally owns ei ther: \n1. Both the land and the property improvements (for example, a \nbuilding) that are under construction \n2. The non- real-estate asset (for example, a ship or an airplane) that is \nunder construction. \nd. The lessee controls the land that property improvements wi ll be \nconstructed upon (this includes where the lessee enters into a transaction \nto transfer the land to the lessor, but the transfer does not qualify as a sale \nin accordance with paragraphs 842- 40-25-1 through 25- 3) and does not \nenter into a lease of the land before the beginning of construction that, \ntogether with renewal options, permits the lessor or another unrelated \nthird party to lease the land for substantially all of the economic life of the \nproperty improvements. \ne. The lessee is leasing the land that property improvements will be \nconstructed upon, the term of which, together with lessee renewal \noptions, is for substantially all of the economic life of the property \nimprovements, and does not enter into a sublease of the land before the \nbeginning of c onstruction that, together with renewal options, permits the \nlessor or another unrelated third party to sublease the land for substantially \nall of the economic life of the property improvements. \nThe list of circumstances above in which a lessee controls a n underlying asset \nthat is under construction before the commencement date is not all inclusive. \nThere may be other circumstances that individually or in combination \ndemonstrate that a lessee controls an underlying asset that is under \nconstruction before t he commencement date. \n55-6 See Example 3 (paragraphs 842- 40-55-39 through 55- 44) for an illustration \nof the scope of this Subtopic. \n>> Lessee Indemnification for Environmental Contamination \n55-7 A provision that requires lessee indemnifications for preexisting \nenvironmental contamination does not, on its own, mean that the lessee \ncontrolled the underlying asset before the lease commenced regardless of \nthe likelihood of loss resulting from the indemnity. Consequently, the presence \nof such a provision does not mean the transaction is in the scope of this \nSubtopic. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 857}), Document(page\_content='Leases 857 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . > Illustrations \n>> Illustration of Guidance on Application of Costs of the Lessee \nRelating to the Construction or Design of an Underlying Asset \n55-39 Example 3 illustrates the guidance on determining whether a lessee \ncontrols an underlying asset that is under construction before the \ncommencement date. \n>>> Example 3— Lessee Control over an Asset under Construction \n55-40 Lessee and Lessor enter into a contract whereby Lessor will construct \n(whether itself or using subcontractors) a building to Lessee’s specifications \nand lease that building to Lessee for a period of 20 years once construction is \ncompleted for an annual lease payment of $1,000,000, increasing by 5 percent \nper year, plus a percentage of any overruns above the budgeted cost to \nconstruct the building. The building is expected to have an economic life of \n50 years once it is constructed. Lessee does not legally own the building and \ndoes not have a right under the contract to obtain the building while it is under \nconstruction (for example, a right to purchase the construction in process from \nLessor). In addition, while the building is being developed to Lessee’s \nspecifications, those specifications are not so specialized that the asset does \nnot have an alternative use to Lessor. \n>>>> Case A —Lessee Does Not Control the Asset under Construction \n55-41 Assume Lessee controls (that is, Lessee is the owner for accounting \npurposes) the land upon which the building will be constructed and, as part of \nthe contract, Lessee agrees to lease the underlying land to Lessor for an initial \nperiod of 25 years. Les sor also is granted a series of six 5- year renewal options \nfor the land lease. \n55-42 None of the circumstances in paragraph 842- 40-55-5 exist. Even though \nLessee owns the land (whether legally or for accounting purposes only) upon \nwhich the building will be constructed, Lessor legally owns the property \nimprovements and has rights to use the underlying land for at least \nsubstantially all of the economic life of the building. Lessee does not own the \nbuilding and does not have a right under the contract to obtain the building (for \nexample, a right to purchase the building from Lessor). In addi tion, the building \nhas an alternative use to Lessor. Therefore, Lessee does not control the \nbuilding under construction. Consequently, the arrangement is not within the \nscope of this Subtopic. Lessee and Lessor will account for the lease of the \nbuilding in accordance with Subtopics 842- 20 and 842- 30, respectively. If \nLessee incurs costs related to the construction or design of the building (for \nexample, architectural services in developing the specifications of the building), \nit will account for those costs as lease payments unless the costs are for \ngoods or services provided to Lessee, in which case Lessee will account for \nthose costs in accordance with other Topics. \n>>>> Case B —Lessee Controls the Asset under Construction \n55-43 Assume Lessee leases, rather than owns, the land upon which the \nbuilding will be constructed. Lessee has a 20- year lease of the underlying land \nand five 10- year renewal options. Therefore, Lessee’s lease of the underlying \nland, together with the renewal options, is for at leas t substantially all of the ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 858}), Document(page\_content='Leases 858 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . economic life of the building under construction. Lessee enters into a sublease \nwith Lessor for the right to use the underlying land for 20 years that \ncommences upon completion of the building. The sublease has a single \n10-year r enewal option available to Lessor. \n55-44 Lessee controls the building during the construction period and, \ntherefore, the arrangement is within the scope of this Subtopic. Lessee and \nLessor will apply the guidance in this Subtopic to determine whether thi s \narrangement qualifies as a sale and a leaseback or whether this arrangement \nis, instead, a financing arrangement. Lessee controls the building during the \nconstruction period because, in accordance with paragraph 842- 40-55-5(e), \nLessee controls the use of the land upon which the building will be \nconstructed for a period that is at least substantially all of the economic life of \nthe building and the sublease entered into with Lessor does not both (a) grant \nLessor the right to use the land before the beginni ng of construction and (b) \npermit Lessor to use the land for substantially all the economic life of the \nbuilding (that is, the sublease, including Lessor renewal options, only is for \n30 years as compared with the 50 -year economic life of the building). \n \n9.4.10 If the lessee controls the underlying asset before the lease \ncommencement date, the transaction is in the scope of the sale-leaseback \nguidance and the accounting described in sections 9.2 and 9.3 applies. \nHowever, obtaining legal title alone, especially if title is obtained only \nmomentarily (flash title) , does not necessarily mean that the lessee controls the \nunderlying asset before the commencement date. [842- 40-55-1 – 55-2, 55 -5] \n \n Question 9.4.05 \nControl of an underlying as set pre-lease \ncommencement when multiple parties are involved \nHow does an entity determine if it obtains control of an \nunderlying asset before lease commencement when multiple parties are involved? \nBackground: This question does not address underlying assets under \nconstruction (see section 9.4.1). \nSome lease arrangements involve multiple parties; for example: \n— a supplier (original equipment manufacturer, or OEM) that manufactured \nthe underlying asset and delivers it for lease; \n— the entity that will lease the manufactured underlying asset; and \n— a financier (e.g. a bank) that will purchase the underlying asset with the \nexpress intent of leasing it to the entity. \nDepending on the facts and circumstances, the entity that will lease the underlying asset may obtain ‘ control’ (see paragraph 9.1.30) of it before control \ntransfers to the financier. In that case, the sale- leaseback guidance applies, with \nthe entity as seller -lessee and the financier as buyer -lessor. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 859}), Document(page\_content='Leases 859 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Alternatively, despite the entity’s involvement in the a rrangement before \ncommencement of its lease with the financier, the entity may not obtain control \nof the underlying asset before it is transferred to (and control obtained by) the \nfinancier. In that case, the sale- leaseback guidance does not apply to the l ease \nbetween financier (as lessor) and the entity (as lessee). \nThe effect of this determination can be significant. For example, if the lease \nbetween financier and the entity includes a fixed price purchase option for the \nunderlying asset, the transaction will fail sale -leaseback accounting (see \nparagraph 9.1.50); section 9.3 discusses the accounting for a failed sale-leaseback. By contrast, that same fixed price purchase option – whether \nreasonably certain of exercise or not (see section 5.2) – does not af fect that \nboth parties will apply lease accounting to the transaction when it is not a sale -\nleaseback. \nInterpretive response: While Topic 842 provides explicit guidance on \ndetermining whether a lessee controls an underlying asset under construction, it does not provide explicit guidance to determine whether a lessee obtains \ncontrol of an underlying asset in a multi -party transaction such as that described \nin the background. \nIn this type of transaction, we believe the principal versus agent guidance in \nTopic 606 (revenue from contracts with customers) provides an appropriate \nframework. \n— If the lessee is the principal to the sale (transfer) of the underlying asset to \nthe ultimate lessor (i.e. rather than another party, such as the supplier in the \nbackground exa mple), that means the lessee controlled the underlying \nasset before its sale (transfer) and the transaction is a sale -leaseback. \n— If the lessee is not the principal to that sale (transfer), th at means it did not \ncontrol the underlying asset beforehand. \nApplying the principal -agent guidance in Topic 606 frequently involves judgment \nand careful consideration of all relevant facts and circumstances. Chapter 9 of \nKPMG Handbook, Revenue recognition\n, provides interpretive guidance; \nQuestions 9.3.40, 9.3.50 and 9.3.55 may be particularly relevant to scenarios like those described in this question. \n9.4.20 The following diagram explains how the sale -leaseback guidance int eracts \nwith the accounting for lessees (see chapter 6) and lessors (see chapter 7) \nwhen the lessee controls the underlying asset before the commencement date. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 860}), Document(page\_content='Leases 860 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Account for PP &E and financial \nliability until lease \ncommencement dateApply sale -leaseback accounting\n(section 9.2)Lease commencement date\nJanuary 1, Year 3Lessee controls asset under \nconstruction\nJanuary 1, Year 1\nApply PP &E and \ndebt guidanceHas there been a sale of the \nunderlying asset ?\n(section 9.1)Continue to account for the PP &E \nand the financial liability \nconsistent with failed sale -\nleaseback accounting \n(section 9.3)Yes\nNo \n9.4.30 The guidance in Subtopic 842- 40 stipulates that having legal title to an \nasset, especially if that legal title is only obtained momentarily (often referred to \nas ‘flash title’) before it is transferred to another entity, does not mean a lessee \ncontrols the underlying asset before lease commencement. This is consistent \nwith the guidance in Topic 606, which treats legal title only as an indicator of control and also provides specific guidance that obtaining flash title to a good \ndoes not mean an entity controls that good. \n[606- 10-55-37] \n \n9.4.1 Lessee involvement in the construction or design of \nthe underlying asset \n9.4.40 A lessee may enter into a lease in which the underlying asset needs to be \nconstructed or redesigned for use by the lessee, sometimes referr ed to as a \nbuild- to-suit lease . Depending on the terms and conditions of the contract, the \nlessee may be required to make payments related to the construction or design \nof the asset. [842- 40-55-3] \n9.4.50 If a lessee incurs costs relating to the constructi on or design of an underlying \nasset before the commencement date, it applies other US GAAP (e.g. Topic 330 on \ninventory or Topic 360 on property, plant and equipment) to account for such costs. \nHowever, costs relating to the construction or design of the underlying asset do not \ninclude payments made for the right to use the underlying asset (i.e. lease \npayments), regardless of the timing of those payments or the form of the \nconsideration; for example, a lessee might contribute materials or labor for the \nconstruction or redesign of the underlying asset. [842- 40-55-4] \n9.4.60 If a lessee controls an underlying asset that is under construction (or \nredesign) before the commencement date – i.e. it is the ‘accounting owner’ of \nthe asset – the transaction is a sale -leaseback transaction when construction is \ncomplete and the asset is available for use ( usually at lease commencement), \nand the accounting described in sections 9.2 and 9.3 appli es. [842- 40-55-5] \n9.4.70 In evaluating whether a lessee is the accounting owner of an asset under \nconstruction, Topic 842 focuses on whether the lessee controls the underlying \nasset before the lease commencement date (see paragraph 9.1.30) . The \nguidance state s that any one of the following characteristics would ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 861}), Document(page\_content='Leases 861 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . demonstrate that the lessee controls the underlying asset before the lease \ncommencement date. [842- 40-55-5] \n— The lessee has the right to obtain the partially constructed underlying asset at any point during the construction period (e.g. by making a payment to the \nlessor). \n— The lessor has an enforceable right to payment for its performance to date, and the asset does not have an alternative use to the owner -lessor. \n— The lessee legally owns bo th the land and the property improvements that \nare under construction, or the non- real estate asset that is being \nconstructed (e.g. a ship or aircraft). \n— The lessee controls the land on which the property improvements will be constructed (which includes where the lessee transfers the land to the \nowner -lessor, but that transfer does not qualify as a sale – e.g. because of a \nlessee repurchase option) and does not enter into a lease of the land before the beginning of construction that, together with the renewal options\n1, \npermits the lessor or another related party to lease the land for substantially \nall of the economic life of the property improvements. \n— The lessee is leasing the land on which the property improvements will be \nconstructed, the term of which, to gether with lessee renewal options1, is \nfor substantially all of the economic life of the property improvements and does not enter into a sublease of the land before the beginning of \nconstruction that, together with renewal options, permits the lessor or another unrelated third party to sublease the land for substantially all of the \neconomic life of the property improvements.\n1 \nNote: \n1. ‘Options’ refers to all renewal options, regardless of whether it is reasonably certain \nthat those options will be exercised. Therefore, this criterion considers the maximum \npossible lease term, rather than the ‘lease term’ as defined in Topic 842 (see section 5.3). \n9.4.80 The list in paragraph 9.4.70 is not exhaustive . There may be other \nfacts or circumstances that demonstrate that a lessee controls an underlying \nasset that is under construction before the commencement date. See \nQuestion 9.4.50. [842- 40-55-5] \n \n Question 9.4.10 \nLessee call option – exercisable only on occurrence \nof a contingent event \nDoes a lessee call option that is contingent on a future event \naffect whether or when control of the underlying asset \ntransfers to the lessee? \nBackground: A lessee call option may not be exercisable at the beginning of \nthe construction period. The option’ s exercisability may depend on the \noccurrence of a contingent event. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 862}), Document(page\_content='Leases 862 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Question 9.4.11 addresses situations where only the passage of time is \nrequired for the option to become exercisable. \nInterpretive response: A call option does not have to be unconditional to \ntransfer control of the underlying asset to the lessee. Whether a contingency \nprecludes, or changes the timing of, lessee control of the underlying asset \ndepends on whether the contingency is within the lessee’s control – e.g. the \ncontingent event permitting exercise of the call option is a default on the construction timeline and the lessee is the construction manager. \nContingency within lessee’s control \nA contingency that is within the lessee’s control is effectively ignored when determining whether , or when, the lessee obtains control of the underlying \nasset. \nFor example, assume construction of an underlying asset begins on January 1, \n20X1. The lessee has an enforceable option to acquire that asset during the \nconstruction period that is exercisable only on the occurrence of a contingent \nevent within the lessee’s control. The lessee could cause that contingent event \nto occur any time from the beginning of the construction period. There are no \nother contingencies to the exercisability of the option. I n this example, we \nbelieve the lessee is the accounting owner of the underlying asset from \nJanuary 1, 20X1 (the date construction of that asset began). \nContingency not within lessee’s control \nIf a lessee call option becomes exercisable only on a future contingent event \nthat is not within the lessee’s control, the lessee becomes the accounting \nowner of the underlying asset when the option becomes exercisable – i.e. \nwhen the contingency is resolved and there are no further contingencies outside of t he lessee’s control that preclude the lessee’s exercise of the option. \n \n Question 9.4.11 \nLessee call option – exercisable only at a future date \nWhen does a lessee call option for which the only \ncontingency is the passage of time transfer control of the \nunderlying asset to the lessee? \nBackground: A lessee call option may not be exercisable at the beginning of \nthe construction period. However, unlike in Question 9.4.10, it may be that only \nthe passage of time is required for the option to become exerci sable. For \nexample, a lessee option to purchase the underlying asset may only become \nexercisable six months after construction has begun. \nInterpretative response: Control of the underlying asset transfers at the point \nin time that passage of time becomes t he only contingency preventing lessee \nexercisability of the option to acquire the underlying asset. \nFor example, assume construction of an underlying asset begins on January 1, \n20X1. The lessee has an enforceable option to acquire that asset during the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 863}), Document(page\_content='Leases 863 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . construction period that is exercisable beginning on July 1, 20X1. There are no \nother contingencies to the exercisability of the option either before or after \nJuly 1, 20X1. In this case, we believe the lessee is the accounting owner of the \nunderlying asset f rom January 1, 20X1. \n \n Question 9.4.12 \nLessee call option – expires before the end of the \nconstruction period \nDoes a lessee call option that expires before the end of the \nconstruction period affect whether or when control of the \nunderlying asset transfers to the lessee? \nBackground: A lessee call option that would transfer control of the underlying \nasset to the lessee may not be exercisable throughout the construction period; \nit may expire before construction is complete. For example, after a certa in point \nin the construction process, the lessor (and legal owner) may no longer be \nwilling to permit the lessee to acquire the underlying asset. \nInterpretive response: We do not believe expiration before the end of the \nconstruction period affects whether, or when, a call option conveys control of \nthe underlying asset to the lessee. Even if the call option was the only factor resulting in the conclusion that the lessee was the accounting owner of the \nunderlying asset, the lessee would still apply the sale- leaseback guidance to \ndetermine when it transfers control of the asset to the lessor. This means, consistent with Question 9.1.25, the lessee cannot derecognize the underlying \nasset once it has been deemed the accounting owner before commencement \nof the lea se. \n \n Question 9.4.15 \nMeaning of ‘at any point’ \nCan a lessee obtain control of an underlying asset under \nconstruction if it has a call option that is not exercisable at all times during the construction period? \nBackground: Topic 842 indicates that a lessee is the accounting owner of an \nasset under construction that it will lease if it has the right to obtain the partially \nconstructed underlying asset ‘at any point’ during the construction period. ‘At \nany point’ could be interpreted as the lessee having the right to obtain the \nunderlying asset ( 1) at all times during the construction period or ( 2) at some \npoint during the construction period. \nInterpretive response: Yes. It is not necessary for a call option to be exercisable \nat all times during the construction period, or even at all times after it first \nbecomes exercisable. Once a call option becomes exercisable during the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 864}), Document(page\_content='Leases 864 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . construction period (e.g. by resolution of a contingency or the occurrence of a \nstated event), the lessee is deemed to be the accounting owner of the asset. \nEven if the call option is not exercisable at all times from that point until \nconstruction is complete, the lessee remains the accounting owner until the \ntransaction qualifies as a sale under the sale -leaseback guidance (see section 9.1). \n \n Question 9.4.20 \nLess or put options \nDo lessor put options ever result in a conclusion that the \nlessee controls an asset under construction? \nInterpretive response: While the guidance in Subtopic 842 -40 only refers to \nlessee call options transferring control of the underlying asset to the lessee, we \nbelieve control would also be transferred if the lessor has a ‘significant \neconomic incentive’ to exercise a put option – i.e. an option t o force the lessee \nto purchase the underlying asset under construction. Our view is based on the \nrepurchase agreements guidance in Topic 606, which states t hat the seller of a \ngood control s that good if the customer has a significant economic incentive to \nexercise an option to put the good back to the seller. [606- 10-55-72] \n \n Question 9.4.30 \nLand lease (or sublease) at below -market rent \nDoes below -market rent charged by the lessee for a lease or \nsublease to the owner -lessor of the land on which property \nimprovements to be leased by the lessee are to be \nconstructed, affect whether the lessee controls those \nimprovements? \nInterpretive response: Nominal or below -market rent, by itself, would not \nresult in a conclusion that the lessee controls (i.e. is the accounting owner of) \nthe property improvements that are under construction on the leased (or \nsubleased) land. \nIf, irrespective of the below -market rent (even if the payments are only \nnominal), the lessor controls the use of the land for substantially all the \neconomic life of the property improvements, the fact that the rent is below \nmarket does not alone change the conclusion that would be reached if the land \nlease (or sublease) were at market terms. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 865}), Document(page\_content='Leases 865 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Question 9.4.40 \nLessee participation in construction period \nfinancing \nDoes lessee participation in the construction period financing \nof the lessor mean the lessee controls the underlying asset \nduring the construction period? \nBackground: The lessee in a build- to-suit arrangement may either (1) provide \nconstruction financing to the lessor or (2) merely participate in that financing in a \nmanner similar to that discussed in Question 9.1. 80. \nInterpretive response: By itself, no. In isolation, providing a loan to the lessor \nor partici pating in the lessor’s third- party financing does not cause the lessee to \nmeet any of the five conditions in paragraph 9.4.70 or otherwise indicate that \nthe lessee controls (see paragraph 9.1.30) the underlying asset during the \nconstruction period. \nHowever, as discussed in Question 9.1. 80, other terms and conditions \nassociated with providing the financing, or otherwise participating in third- party \nfinancing, may transfer control of the underlying asset to the lessee. For example, if the lessee provides a l oan to the lessor to fund construction, and \ncan take ownership of the underlying asset if the lessor defaults, consistent with the discussion in Question 9.4.10, the lessee would control the asset if it \ncan induce a loan default. Similarly, if, as a condit ion of its involvement in the \nlessor’s third- party financing, the lessee has the right to purchase the asset if \nthe lessor defaults, the lessee would control the asset if it can induce the loan \ndefault – e.g. if the lessee is the construction manager and c onstruction delays \ncan trigger a default by the lessor on its third- party financing. Even if the lessee \ncannot induce a default, a term that provides the lessee the right to purchase \nthe asset upon a lessor default would give control of the asset to the lessee at \nthe point in time the lessor actually defaults. \nA guarantee of the lessor’s debt is excluded from the lease payments \n(unless the guarantee is in substance a residual value guarantee – see \nQuestion 5.4.100), but would still need to be considered under Topic 460. \n[842- 10-30-6(b)] \n \n Question 9.4.50 \nOther considerations that demonstrate lessee \ncontrol of an asset under construction \nIn addition to the factors in paragraph 842 -40-55-5, what \nshould an entity consider in determining whether a lessee \ncontrols an underlying asset that is under construction before \nthe commencement date? \nBackground : In addition to the factors that are outlined in paragraph 9.4.70, \nparagraph 842- 40-55-5 states that there may be “other circumst ances that \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 866}), Document(page\_content='Leases 866 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . individually or in combination demonstrate that a lessee controls an underlying \nasset that is under construction before the commencement date.” However, \nTopic 842 does not provide examples of such circumstances. As a result, questions have arisen about what those other circumstances might be. \nInterpretive response: In addition to the factors outlined in paragraph 9.4.70, \nan entity should evaluate whether the entity’s performance creates or enhances \nan asset (e.g. work in process) that the customer (lessee) controls as the \nasset is created or enhanced. This is a control -based test that is different \nfrom the previous risk -based build- to-suit evaluation under Topic 840 (see \nparagraphs 9.4.90 – 9.4.12 0). \nThis evaluation, which is explained below, is c onsistent with one of the factors \nconsidered under Topic 606 in determining whether a performance obligation is satisfied, and revenue recognized, over time. [606- 10-25-27(b)] \nThe factors considered under Topic 606 \nThe Board observed that, in concept, the evaluation of whether a lessee \ncontrols an underlying asset that is under construction is similar to the \nevaluation undertaken in Topic 606 to determine whether a performance \nobligation to transfer a good is satisfi ed over time. \n[ASU 2016- 02.BC400(b)] \nUnder the guidance in Topic 606, a customer obtains control of a good as it is \nbeing produced (or modified), and therefore the entity satisfies its performance \nobligation to transfer that good and recognizes revenue over time, when the \nentity’s performance: [606- 10-25-27(b) – 25-27(c)] \n— creates or enhances an asset (e.g. work in process) that the customer \ncontrols as the asset is created or enhanced; and/or \n— does not crea te an asset with an alternative use to the entity, a nd the entity \nhas an enforceable right to payment for performance completed to date. \nThe second test is consistent with one of the factors listed in paragraph 9.4.70: \n‘The lessor has an enforceable right to payment for its performance to date, and \nthe asse t does not have an alternative use to the owner -lessor ’. Therefore, only \nthe first test is relevant to ‘other’ factors. \nIn the c ontext of leasing, the first tes t can be translated as a ssessing whether \nthe lessee controls the underlying asset as it is being constructed. \nAssessing whether the lessee controls the underlying asset as it is being \nconstructed \nControl indicators in 606 -10-25-30 \nTopic 606 does not provide substantial guidance relevant to applying the ‘first \ntest’. Topic 606 merely refers to the control principle and related control \nguidance in paragraphs 606 -10-25-23 – 25-26 and paragraph 606- 10-25-30; see \nsection 7.3.30 of KPMG Handbook, Revenue recognition. Because Topic 606 \nmakes such reference, entities should consider that guidance in this leasing context (e.g. consider releva nt evidence provided by the control indicators in \nparagraph 606-10-25-30). \n[606- 10-55-7] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 867}), Document(page\_content='Leases 867 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Owner -lessor control \nWe believe one way of approaching the analysis in the context of this question \nis to look at whether the owner -lessor controls the underlying asset during the \nconstruction period – i.e. rather than the lessee. This is on the basis of the \nBoard’s belief, expressed in the basis for conclusions to ASU 2016 -02, that it \nwould be incompatible with the conceptual definition of an asset for two \nentities to control the same asset at the same time. Taking this approach, a \nconclusion under Topic 606 that a third party (or the lessee) constructing the \nasset for the owner -lessor should recognize revenue for the construction over \ntime because the owner -lessor cont rols the construction in process means the \nlessee cannot also contemporaneously control the construction in process. \n[ASU 2016- 02.BC371] \nTaking this approach to circumstances when none of the factors in \nparagraph 9.4.70 are met may be easier, and provide m ore clear -cut evidence \nfor the evaluation, than trying to assess whether the lessee controls the construction in process. This is because it may be clear that the owner -lessor \ncontrols the construction in process, and therefore that the lessee does not. \nFor example, consistent with the discussion in the basis for conclusions to \nASU 2014- 09, in the case of a construction contract in which a building is being \nconstructed on the owner -lessor’s owned or leased land, and the owner -lessor \nhas not leased (or subleased) that land, it would generally be the case that the \nowner -lessor controls the construction in process. \n[ASU 2014- 09.BC129] \nFactors that are not relevant \nFactors not directly relevant to a ssessing whether the lessee controls – i.e. has \nthe ability to d irect the use of, and obtain substantially all the remaining benefits \nfrom – the underlying asset as it is being constructed should not be considered. \nThis includes factors that would have been considered under Topic 840 (see \nparagraphs 9.4. 90 – 9.4.12 0). \nFor example, the lessee performing the following would generally not indicate \nthat the lessee controls the construction in process: \n— acting as the construction agent or general contractor for the project; and/or \n— purchasing the construction materials and/or paying subcontractors – e.g. to \nleverage the lessee’s purchasing power with relevant vendors or contractors. \nThose activities, in isolatio n, would not, for example, permit the lessee either to \nsell the construction in process and realize its remaining benefits or prevent the lessor from doing so. Therefore, they do not of themselves suggest that the \nlessee controls the underlying asset. Such activities may accompany a \nconclusion that the lessee controls the construction in process, but would not \ndirectly lead to that conclusion. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 868}), Document(page\_content='Leases 868 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Example 9.4.10 \nDetermining whether a lessee controls the \nunderlying asset before the commencement date (1) \nLessee LE and Owner -Lessor LR enter into a contract whereby LR will \nconstruct (whether itself or using subcontractors) a building to LE’s \nspecifications and lease that building to LE once construction is completed. The \nfollowing facts are relevant. \nEconomi c life of building: 40 years \nLease term: 20 years \nLease payments: Fixed payments of $500,000 per year in arrears, \nwith a 3.5% increase each year after Year 1 \nCost overruns: Agreed percentage payable by LE \nIn addition: \n— LE does not legally own the building and does not have a right under the \ncontract to obtain control of the building while it is under construction. For \nexample, LE does not have the right to purchase the construction- in-\nprocess from LR. \n— Although the building is being developed to LE’ s specifications, it is not so \ncustomized to LE that the building does not have an alternative use to LR. \nScenario 1: Lessee controls the building as it is being constructed \nLE controls the land on which the building is to be constructed. As part of the \ncontract, LE agrees to lease the underlying land to LR for 25 years, beginning at \nthe end of the construction period. The contract does not permit LR to renew \nthe land lease. \nIn this scenario, LE controls (i.e. is the accounting owner of) the building as i t is \nbeing constructed, because: \n— LE controls the land on which the building will be constructed; and \n— the lease of the building does not both (1) grant LR the right to use the land before the beginning of the construction period, and (2) permit LR to use \nthe land for substantially all of the economic life of the building – it grants \nLR the right to use the land for only 25 years out of an estimated economic \nlife of 40 years. \nBecause LE controls the building before lease commencement, the \narrangement is accounted for as a sale -leaseback transaction (see sections 9.1 \n– 9.3). Starting from the beginning of construction, LE will therefore recognize \nthe building as a construction- in-process asset with a corresponding liability for \nconstruction costs funded by LR. LE will only derecognize that asset and liability \nwhen a successful sale is concluded under the sale -leaseback guidance. \nScenario 2: Lessee does not control the building as it is being constructed \nLE leases the land on which the building is to be construct ed. LE has a 20- year \nlease of the underlying land, and four seven- year renewal options – i.e. the ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 869}), Document(page\_content='Leases 869 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . lease has a maximum possible term of 48 years. Therefore, LE’s lease of the \nunderlying land, together with the renewal options, is for at least substantially all of the economic life of the building under construction. \nLE enters into a sublease that gives LR the right to use the underlying land for \n25 years, commencing immediately before the beginning of construction of the \nbuilding. The sublease has two 10 -year renewal options available to LR. \nNone of the circumstances outlined in paragraph 9.4.70 exists. \n— LE is neither the legal nor the accounting owner of the land, and will not legally own the building while it is being constructed. \n— LE does not have the right to obtain the building (e.g. by purchase) from LR during the construction period. \n— The building has an alternative use to LR. \n— While LE is leasing the land on which the building will be constructed, LE has subleased that land to LR before the start of constr uction for a term \nthat, together with renewal options available to LR, is at least substantially \nall of the 40 -year economic life of the building (45 years exceeds the \n40-year economic life of the building). \nIn this scenario, there are no other circumstanc es that, individually or in \ncombination, suggest that LE controls the building as it is being constructed. \nTherefore, the arrangement is not subject to the sale- leaseback guidance in \nSubtopic 842 -40. \n \n Example 9.4.20 \nDetermining whether a lessee controls the \nunderlying asset before the commencement date (2) \nLessee LE and Owner -Lessor LR enter into a contract whereby LR will \nconstruct a manufacturing facility that LE will lease from LR for 15 years once constructed. \nThe following are key facts about the transaction. \nLegal ownership of land and building: LR \nLessee options to purchase the CIP : None \nEconomic life of building: 40 years \nLease of land and building: 15 years \nLease renewal or purchase options : None \nAlternative use for the building : \nSee (4) below. Yes \nEnforceable right to payment for work to date: \nSee (5) below. No ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 870}), Document(page\_content='Leases 870 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . In addition: \n1. LE is serving as the general contractor for the project – i.e. LE will manage \nand direct the construction of the facility. LE is experienced in constructing \nsimilar manufacturing facilities. \n2. LE will procure materials and subcontractors for the construction and will \npay those vendors. LR will reimburse LE for 100% of those costs. The \narrangement is structured this way to take advantage of LE’s significant \npurchasing power with vendors. \n3. LE will specify the key aspects of the facility’s design, layout and other \npivotal specifications. \n4. The facility would be suitable for use by numerous manufacturers other than LE, and there are no contractual restrictions preventing such use if LE \nwere to terminate the arrangement . \n5. If LE were to terminate the agreement during construction, LE would not \nowe LR for the costs of construction to date; however, it may owe some \ndamages for breach of contract. \n6. LE is expected to install significant leasehold improvements, but is required to remove them at the end of the lease. Once LE installs its specialized \nleasehold improvements, there would be a significant cost to rework the \nfacility for another manufacturer. \nEvaluation \nLE does not control the construction in process and therefore this arrangement \nis not subject to the sale- leaseback guidance in Subtopic 842- 40. \nLE and LR each undertake the following evaluation in reaching this conclusion. \nStep 1: Evaluation of the factors in paragraph 9.4.70 \nLE and LR both conclude that none of the fac tors in paragraph 9.4.70 are \npresent. \n— LE does not have the option to acquire the underlying asset during the \nconstruction period. \n— As described in the fact pattern, the construction in process has an alternative \nuse to LR. Once LE installs its specialized l easehold improvements, there \nwould be a significant cost to rework the facility for another manufacturer. \nHowever, this does not influence the analysis of whether LE controls the \nunderlying asset during the construction period because: \n— once LE is permitted and able to begin installing its leasehold improvements, the lease has commenced (see section 5.1); and \n— LR would not incur the cost of the rework; LE is required to remove its leasehold improvements at the end of the lease. \n— LE does not own the land and the construction in process. LR owns both. \n— LE does not control the land on which the underlying asset is being constructed. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 871}), Document(page\_content='Leases 871 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . — LE’s lease of the underlying land does not commence at the start of \nconstruction; nor is it for a period (together with available re newal options, \nof which there are none) that is at least substantially all the economic life of \nthe building being constructed. \nStep 2: Consideration of ‘other factors’ besides those in paragraph 9.4.70 \nSubsequent to concluding that none of the factors in paragraph 9.4.70 are \npresent, LE and LR both conclude that LR controls the construction in process \nand, therefore, that LE does not. Their analysis in this regard considered all of \nthe following. \n— During the construction period, it is LR that would be permi tted to sell the \nconstruction in process (with the associated lease) and obtain any cash \nflows from that sale (e.g. if land values go up during the construction \nperiod), and potentially to use the land and the construction in process as \ncollateral. \n— None of the key facts of the transaction suggest that LE has the ability to \ndirect the use of and obtain substantially all the remaining benefits from the \nconstruction in process. LE has no similar rights to those of LR in the \npreceding bullet, nor can it obtain any of the economic benefits listed in \nparagraph 606- 10-25-25(a-f). \n— A contractor (whether LE or an unrelated third party) constructing this \nbuilding for LR as its customer would likely recognize revenue for the \nconstruction over time on the basis of the criterion in paragraph 606- 10-25-\n27(b). This is because the facility is being constructed on LR’s land and, as noted in Step 1, LE does not control, or control the use of, the land for at \nleast substantially all the economic life of the facility being constructed. And \nbecause LR controls the facility as it is being constructed, LE cannot also \ncontrol the facility contemporaneously. \n \n Question 9.4.60 \nLessor accounting when lessee controls the \nunderlying asset under construction \nWhen a lessee controls ( i.e. is the accounting owner of) an \nunderlying asset that is under construction before the lease \ncommencement date, does the lessor account for the arrangement as a sale- leaseback transaction? \nInterpretive response: Yes. T he lessor accounts for its costs t o construct the \nasset as a loan to the lessee to construct the lessee’s asset. At the end of the \nconstruction period, the lessor applies the sale- leaseback guidance to \ndetermine whether (and when) to recognize the underlying asset. \nThis conclusion, which was confirmed in discussions with the FASB staff, is \nbased on the following. \n— Because the transaction includes a lease, Topic 842 is the prevailing guidance. \nAnd under Topic 842, if the lessee controls the underlying asset before the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 872}), Document(page\_content='Leases 872 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . commencement date, the transaction is accounted for as a sale- leaseback \ntransaction. This guidance is not limited to the lessee. [842- 40-55-1, 55- 5] \n— Example 3 Case B in Topic 842 concludes that the lessee controls the \nunderlying asset that is under construction, and states that as a result, \n“Lessee and Lessor will apply the guidance in this Subtopic to determine \nwhether this arrangement qualifies as a sale and leaseback …” [emphasis \nadded] [842- 40-55-44] \n— It was the Board’s intent to apply symmetrical accounting in terms of \ncontrol of an asset within the context of the sale- leaseback guidance and \nthat an entity should not account for an asset it does not control in \naccordance with Concepts Statement 6 (elements of financial statements). \nThe clear implication is that two entities (in this case, the lessee and the \nlessor) cannot control the same asset (i.e. the asset under construction) \nconcurrently. This was decided upon by the Board in an August 2014 FASB \nmeeting, and confirmed by Board members as their intent in a preparer -\ngroup liaison meeting in 20 15 before the issuance of ASU 2016- 02. \n[ASU 2016- 02.BC371] \n— The build- to-suit guidance in Topic 842 is based on the over -time revenue \nrecognition guidance in Topic 606, and TRG discussions were clear that a \nseller should not recognize an asset for a good being transferred to the \ncustomer over time. Applying that same approach, if the lessee controls the \nasset as it is being constructed, the lessor should not recognize the \nunderlying asset. [606- 10-25-27, TRG 04- 16.53, ASU 2016- 02.BC400(b)] \n \n Question 9.4.70 \nAccounting for the transfer of construction -in-\nprogress in a build -to-suit scenario \nHow do the lessee and the lessor account for the transfer of \nexisting construction -in-progress from the lessor to the \nlessee? \nBackground: The underlying asset that needs to be constructed or redesigned \nin a build -to-suit lease (see paragraph 9.4.40) is frequently not a brand new \nasset. The lessor may have the underlying asset on its books already as construction- in-progress (CIP). \nFor example, Lessee LE and Lessor LR enter into an arrangement to lease a \nbuilding upon its completion. Based on the facts and circumstances, LE is \ndetermined to control (i.e. be the accounting owner of) the underlying asset \nduring the construction period (see paragraph 9.4.70 and Question 9.4.50). At \ncontract inception, LR has already incurred $20 million in construction costs, \nrecognized as CIP on it s books. The CIP has a fair value of $22 million. It is \nexpected that the completed building will cost a total of $50 million and have a \nfair value of $55 million. \nInterpretive response: We believe the lessee should recognize the existing \nasset as CIP at its then -current fair value with a corresponding financial liability. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 873}), Document(page\_content='Leases 873 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . In the background example, this means that at contract inception, LE should \nrecognize CIP and a financial liability, each of $22 million. \nAssuming the construction continues to be financed by the lessor, the lessee should increase the CIP and the financial liability as the construction occurs, just as it would if the underlying asset was new construction at contract inception. \nWe believe the lessor’s accounting depends on whether it has the obligation \n(as a principal) to complete the underlying asset’s construction, or instead is acting solely as a financing agent for the construction. In many cases, the lessor \nagrees , regardless of whether i t will engage one or more subcontractors to \nperform some or all of the construction work, to complete the construction as \npart of the contract with the lessee. By contrast, the lessor may solely have an \nobligation to finance the underlying asset’s completi on, while another party (or \nthe lessee itself) undertakes the obligation to complete the asset’s \nconstruction. We believe the principal -agent considerations guidance in Topic \n606 (revenue from contracts with customers) provides a relevant framework to \nmake this determination; see chapter 9 of KPMG Handbook, Revenue \nrecognition. \nLessor has obligation to complete the construction \nThe lessor should recognize a receivable equal to the sum of the (1) contract \ninception carrying amount of the existing asset and (2) proportionate gross \nprofit. \nProportionate gross profit equals the portion of the total gross profit earned to \ndate based on an appropriate Topic 606 measure of progress toward \nconstruction completion; see section 7.4 of KPMG Handbook, Revenue \nrecognition. \nWe believe total gross profit in these scenarios equals the diffe rence between \n(1) the expected fair value of the underlying asset upon completion; and (2) the \nexpected total costs of construction ($5 million in the background example) . \nTopic 606 control requirements vs. Topic 842 build -to-suit requirements \nWe acknowledge that if the lessee does not have an option to purchase the CIP \nor the completed underlying asset, or has a significant economic incentive not \nto exercise such an option (and therefore, in effect, put the asset back to the \nlessor), Topic 606 or Subtopic 610- 20 would conclude that the lessee does not \ncontrol the CIP as it is being constructed. \n[606- 10-55-68, 55- 72 – 55-73] \nHowever, Topic 842 expressly assigns control of the CIP to the lessee from \nboth the lessee and lessor perspective. We believe this overrides the \nrepurchase agreements guidance in Topic 606, resulting in the above \naccounting for the lessor that treats the C IP as transferring to the lessee over \ntime as construction progresses. [842-40-55-5, ASU 2016- 02.BC371] \nLessor does not have obligation to complete the construction \nThe lessor should derecognize the underlying asset and recognize a receivable \nequal to the contract inception date fair value of the asset. Any difference \nbetween the two should be recognized as a gain or loss on the asset’s sale. \nIn the background example, if LR determines that it does not have an obligation to complete the underlying asset’s construction, it should: ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 874}), Document(page\_content='Leases 874 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . — derecognize the $20 million CIP asset; \n— recognize a receivable of $22 million from LE; and \n— recognize a $2 million gain on sale of the CIP. \nIn this case, any further costs of construction the lessor finances should be \nrecognized as a dditions to the receivable. \n \n \nQuestion 9.4.80 \nBuild -to-suit applicability when an underlying asset \nis modified \nDoes the build- to-suit lease guidance apply when the \nunderlying asset is modified after the commencement date? \nBackground: To illustrate this question, consider the following example. \nLessee LE and Lessor LR have an existing manufacturing facility lease. At the end of lease Year 4, LR agrees to: \n— expand the facility’s footprint with the intent to increase the manufacturing \nfloor space; and \n— upgrade the facility’s HVAC and electrical infrastructure to accommodate \nnew equipment the lessee intends to install. \nInterpretive response: The build -to-suit guidance applies to ‘underlying assets \nbeing constructed before the commencement date’ (see paragraph 9.4.10). [842-\n40-55-5] \nTherefore, we do not believe it applies when an underlying asset is modified \nafter the commencement date unless the changes in effect create a new \ncommencement date because the lessee loses control over the use of the \nasset while it is being modified or enhanced. \nWhen making this evaluation, an entity should consider whether: \n— the lessee will continue to use the asset during the construction period and, if so, how; \n— the modifications to the asset are lessee- owned i mprovements (see \nQuestions 5.4.80 and 5.4.81); if so, the lessee controls the use of the underlying asset while those improvements are made even if it must cease \nits other use(s) of the asset during that time; and \n— the modifications are themselves one or more separate ‘underlying assets’; \nif so, see Question 9.4.85. [842 Glossary] \nIf the build- to-suit guidance applies, the parties need to determine if the lessee \nis the accounting owner of the underlying asset being modified during the \nconstruction period of the modifications (see paragraph 9.4.70 and Question 9.4.50). \nAnd regardless of whether the build- to-suit guidance applies, the lessee and the \nlessor need to consider whether the changes to the underlying asset and/or \nother changes t o the lease (e.g. a lease term extension agreed to in return for \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 875}), Document(page\_content='Leases 875 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . LR expanding the manufacturing facility in the background example) trigger a \nlease modification and, if so, account for that modification. See sections 6.7 and \n7.6 for the lessee and lessor m odification guidance, respectively. \n \n \nQuestion 9.4.85 \nIdentifying the underlying asset under construction \nWhat constitutes the underlying asset under construction \nwhen an existing underlying asset is modified? \nBackground: To illustrate this question, consider the following scenarios. \n\uf8e7 The contract for an existing warehouse lease is modified. The lessor agrees \nto double the size of the leased warehouse by building a separate space \ndirectly adjacent to the existing warehouse footprint and sharing the \nexisting exterior wall – i.e. the formerly exterior wall will now be an interior \nwall separating the existing warehouse space from the new warehouse \nspace. \n\uf8e7 The contract for an existing manufacturing facility lease is modified. The \nlessor agrees to increase the facility’s footprint to increase the \nmanufacturing floor space and upgrade the entire facility’s HVAC and \nelectrical infrastructure to accommodate new equipment the lessee intends \nto install. Unlike the warehouse scenario, t here will be no physical \nseparation of the pre- existing and new manufacturing floor space. \nIn these scenarios, the question arises about whether the entire building (i.e. \nthe warehouse, inclu ding the existing and the new space, and the \nmanufacturing facili ty) must be considered for lessee accounting ownership \n(see paragraph 9.4.70 and Question 9.4.50). \nInterpretive response: If the asset modification meets the definition of an \n‘underlying asset’ – i.e. the customer will obtain the right to use it once \ncomplete and it is physically distinct (see section 3.2.2) – we believe the build-\nto-suit guidance applies only to the modific ation, and not to the pre- existing \nasset (see Question 9.4.80). [842 Glossary] \nThis is because the build -to-suit guidance explicitly applies to an ‘underlying \nasset’ being constructed before the commencement date. Therefore, if there are multiple underlying assets, each is its own unit of account for applying the build- to-suit guidance. \n[842- 40-55-5] \nWhen an asset modification meets the definition of an underlying asset on its \nown, the lessee and lessor will not, even if the lessee is determined to be the \naccounting owner of the modification, recognize and derecognize the original \nunderlying asset, respectively. \nThis applies as follows to the two background scenarios. \n— Warehouse. By virtue of its physical separation from the pre- existing \nwarehouse space (via the formerly exterior wall), the new warehouse space \nis a physically distinct space over which the lessee will obtain a right of use \nunder the modified contract. Therefore, the new warehouse space is its \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 876}), Document(page\_content='Leases 876 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . own unit of account, separate from the pre- existing warehouse, for \npurposes of applying the build- to-suit guidance. The lessee does not \ncapitalize as its own asset, nor the lessor derecognize, the pre- existing \nwarehouse if the lessee is determined to be the accounting owner of the \nnew warehouse space. \nWe do not believe this conclusion changes if the construction activities also \ninclude significantly modifying or redesigning the pre- existing warehouse \nspace as long as the pre- existing warehouse space and the new warehouse \nspace both meet the definition of a n underlying asset. The lessee and the \nlessor would evaluate the build- to-suit guidance for the pre- existing \nwarehouse space (see Question 9.4.80) separately from their build- to-suit \nconsiderations for the new warehouse space. \n— Manufacturing facility. The changes to the manufacturing facility do not \nresult in an additional underlying asset. Therefore, there is only one unit of \naccount before and after the modification. The lessee and the lessor should \nconsider Question 9.4.80 when deciding whether the build- to-suit guidance \napplies to this scenario. \n \n Question 9. 4.90 \nLease of to -be-constructed property improvements \non land sold by the lessee to the lessor \nDoes a seller -lessee control property improvements under \nconstruction on land it has legally sold to the buyer -lessor if \nthe land sale does not occur for accounting purposes until \nlease commencement? \nBackground: Assume a seller -lessee legally sells a plot of land to a buyer -lessor \nat fair value ; legal transfer happens immediately and there is no repurchas e \noption. Under the land sale contract, the buyer -lessor will construct a building \n(with an expected economic life of 40 years) on the land that the s eller-lessee \nwill lease , when completed, for 1 5 years. Because the seller -lessee will lease \nthe entire building, there is an implied leaseback of the land (see paragraph \n4.1.130). The leases of the land and the building will commence at the \nconclusion of the building’s construction. \nIn Question 9.1.25, we discuss that we do not believe a sale (seller -lessee) or \npurchase (buyer -lessor) in a sale -leaseback can occur for accounting purposes \nunder Subtopic 842- 40 before the lease commencement date. Consistent with \nthat Question, in this scenario, the seller -lessee remains the accounting owner \nof – i.e. continues to control – the underlying land during the building \nconstruction period. Because of this, the question arises about whether the seller -lessee is the de facto accounting owner of the building during the \nconstruction per iod. \nInterpretive response: We do not believe the fact that the seller -lessee \nremains the accounting owner of the land during the building construction \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 877}), Document(page\_content='Leases 877 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . period (and therefore, does not derecognize it), in itself, means the seller -lessee \ncontrols the building being constructed on that land during that period. \nThis is because, despite the seller -lessee’s continued accounting ownership of \nthe land during the building construction period, legal ownership of the land has \ntransferred. In addition, the seller -lesse e has ceded control over the land’s use \nto the buyer -lessor, consistent with the second part of paragraph 842- 40-55-\n5(d), in perpetuity, beginning with the buyer -lessor’s right to use the land to \nconstruct the building. \n \n Comparison to legacy US GAAP \nLessee control over asset under construction guidance different from \nlegacy US GAAP \n9.4.90 Topic 842 and Topic 840 both treat the lessee as the accounting owner of \nan underlying asset that is under construction in some circumstances and, in \nthese situations, the transaction is subject to the sale- leaseback guidance. \nHowever, Topic 842 and Topic 840 determine whether the lessee is the accounting owner of an underlying asset that is under construction differently. \n[840- 40-15-5] \n9.4.100 Under Topic 840, the lessee was the accounting owner of the asset \nduring the construction period if the lessee either: \n— took on substantially all of the construction- period risks, determined \nthrough a ‘maximum guarantee test’; or \n— engaged in one or more activities specifically o utlined in the guidance as \nprohibited involvement. Such activities included, but were not limited to, indemnifying the owner -lessor or its lenders for preexisting environmental \nrisks (when the risk of loss was more than remote), taking title to the asset at any point during the construction period, being obligated to pay for \nconstruction cost overruns, and paying construction project costs directly \n(other than some limited exceptions). \n9.4.11 0 Topic 842 eliminates the build -to-suit guidance in Topic 840 about \ndetermining whether a lessee controls the underlying asset during the construction period. Instead, it requires an evaluation of whether a lessee is the \naccounting owner of an underlying a sset under construction based on whether \nit ‘controls’ that asset before the commencement date of the lease.\n [840- 40-55-2 – \n55-15] \nLessor accounting for build -to-suit lease arrangements different from \nlegacy US GAAP \n9.4.12 0 As outlined in Question 9.4. 60, in the absence of further guidance we \nbelieve the guidance in Subtopic 842- 40 on lessee control of an underlying \nasset that is under construction before the commencement date applies to \nlessors as well as lessees. In contrast, Topic 840 did not provide gu idance for \nlessors in build- to-suit lease arrangements. Under Topic 840, regardless of \nwhether the lessee was deemed the accounting owner of an asset under ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 878}), Document(page\_content='Leases 878 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . construction, the lessor would typically have the construction- in-progress on its \nbalance sheet and would not apply the sale- leaseback guidance to the \ntransaction after the co nstruction period was complete. \n \n9.5 Transfer of tax benefits \n Excerpt from ASC 842 -40 \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance \n>> Transfer of Tax Benefits \n55-11 A U.S. entity purchases an asset and enters into a contract with a \nforeign investor that provides that foreign investor with an ownership right in, \nbut not necessarily title to, the asset. That ownership right enables the foreign \ninvestor to claim certain benefits of ownership of the asset for tax purposes in \nthe foreign tax jurisdiction. \n55-12 The U.S. entity also enters into a contract in the form of a leaseback for \nthe ownership right with the foreign investor. The contract contains a purchase \noption for the U.S. entity to acquire the foreign investor’s ownership right in \nthe asset at the end of the lease term . \n55-13 The foreign investor pays the U.S. entity an amount of cash on the basis \nof an appraised value of th e asset. The U.S. entity immediately transfers a \nportion of that cash to a third party, and that third party assumes the U.S. \nentity’s obligation to make the future lease payments , including the purchase \noption payment. The cash retained by the U.S. entity is consideration for the \ntax benefits to be obtained by the foreign investor in the foreign tax \njurisdiction. The U.S. entity may agree to indemnify the foreign investor against \ncertain future events that would reduce the availability of tax benefits to t he \nforeign investor. The U.S. entity also may agree to indemnify the third- party \ntrustee against certain future events. \n55-14 The result of the transaction is that both the U.S. entity and the foreign \ninvestor have a tax basis in the same depreciable asset . \n55-15 An entity should determine whether the transfer of the ownership right \nis a sale based on the guidance in paragraphs 842- 40-25-1 through 25 -3. \nConsistent with paragraphs 842- 40-25-2 through 25- 3, if the leaseback for the \nownership right is a finance lease or if the U.S. entity has an option to \nrepurchase the ownership right at any exercise price other than the fair value \nof that right on the exercise date, there is no sale. If the transfer of the \nownership right is not a sale, consistent with the guidance in paragraph 842- 40-\n25-5, the entity should account for the cash received from the foreign investor \nas a financial liability in accordance with other Topics. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 879}), Document(page\_content='Leases 879 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . 55-16 If the transfer of the ownership right is a sale, income recognition for the \ncash received should be determined on the basis of individual facts and \ncircumstances. Immediate income recognition is not appropriate if there is \nmore than a remote possibility of loss of the cash consideration received \nbecause of indemnif ication or other contingencies. \n55-17 The total consideration received by the U.S. entity is compensation for \nboth the tax benefits and the indemnification of the foreign investor or other \nthird-party trustee. The recognition of a liability for the indemnification \nagreem ent at inception in accordance with the guidance in Topic 460 on \nguarantees would reduce the amount of income related to the tax benefits \nthat the seller -lessee would recognize immediately when the possibility of loss \nis remote. \n \n \n Question 9.5.10 \nSale of tax benefits \nWhen does the sale of an ownership interest in an asset \nresult in sale -leaseback accounting? \nBackground: A sale of tax benefits is often structured in a way that appears \nsimilar to a sale -leaseback transaction. The following is a summary . \n— The seller s ells an ownership interest (but not necessarily title) in the \nunderlying asset to the buyer, such that the buyer can claim a tax benefit in \nits jurisdiction. [842- 40-55-11] \n— The seller then leases back that ownership interest from the buyer. \n[842- 40-55-12] \n— The parties to this transaction determine whether the transfer of the \nownership interest is a sale based on the guidance in paragraphs 842- 40-25-\n1 – 25-3. If the transfer is not a sale, the seller accounts for the cash \nreceived for the ownership interest as a financial liability. [842- 40-55-15] \nInterpretive response: Because each party is attempting to determine whether \nthe transaction is a sale and a leaseback, we believe the pertinent question is \nwhether the buyer’s acquisition of the ownership interest conveys control of the underlying asset to the buyer. \nIn that regard, either of the following would preclude accounting for the transfer \nof the ownership interest as a sale and a leaseback of the underlying asset: \n[842- 40-25-2 – 25-3] \n— the leaseback would be classified as a finance lease; or \n— the seller has an option to repurchase the ownership interest that does not \nmeet the two criteria in paragraph 9.1.50. \nIf neither of those conditions are met, we believe whether or not there is a sale of the underlying asset depends on whether the buyer obtains rights with \nrespect to the underlying asset (through its owners hip interest) that are \nequivalent to those a typical buyer -lessor obtains in a successful sale -leaseback \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 880}), Document(page\_content='Leases 880 \n9. Sale leaseback accounting \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . transaction (see paragraphs 9.1.70 – 9.1.90). If so, then the parties will account \nfor the transfer of the ownership interest (and the seller’s retenti on of the right \nto use the underlying asset) as a sale- leaseback. If not, the cash payment for \nthe ownership interest should be accounted for as a financing by both parties. \nIn general, we expect that if there is a difference in the rights that the buyer \nactually obtains through its ownership interest compared to the rights that it \nwould obtain if title to the underlying asset were conveyed, that the rights \nconveyed to the buyer will not be equivalent to those a typical buyer -lessor \nobtains in a successful sale -leaseback transaction. \n \n Comparison to legacy US GAAP \nTransfer of tax benefits guidance is affected by the requirement to \nconsider control \n9.5.10 Under Topic 840, entities often considered the guidance in the 1981 \nFASB Exposure Draft, Accounting for the Sale or Purchase of Tax Benefits \nthrough Tax Leases , which stated that an entity should account for a transaction \nthat is a sale of tax benefits str uctured as a lease as the sale of a tax benefit \nonly if it does not include elements commonly found in leasing transactions \nother than the transfer of tax benefits. The ED stated that if the transaction \nincludes a financing element, or a transfer of an int erest in the residual value of \nthe asset, then the transaction was a lease rather than a sale of tax benefits. \n9.5.20 Under Topic 842, the parties must conclude that control of the underlying \nasset has transferred to the buyer to conclude there is a sale- leaseback; \notherwise, there is a financing transaction. The requirement to determine if \nthere is a sale/purchase based on the guidance in Subtopic 842- 40, and the \nrequirement to account for transfers of tax benefits that do not meet the sale requirements as financing transactions constitute significant changes from \nTopic 840. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 881}), Document(page\_content='Leases 881 \n10. Income taxes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 10. Income taxes \nDetailed contents \nItem significantly updated in this chapter : # \nHow the standard works \n10.1 Deferred taxes \n10.1.1 Lessee considerations – operating leases \n10.1.2 Lease origination costs \n10.1.3 Lessee considerations – finance leases \n10.1.4 Lessor considerations \n10.1.5 Sale-leaseback considerations \nObservation \nLeveraged leases exception no longer required \nQuestions \n10.1.05 Disclosure of lease- related deferred taxes \n10.1.10 Related party leases # \n10.1.15 Intercompany operating leases: REIT and taxable REIT \nsubsidiary \n10.1.20 Impact of foreign currency \nExamples \n10.1.10 Deferred tax measurement of operating leases under Topic 840 (lessee)\n \n10.1.20 Deferred tax measurement of operating leases under Topic 842 (lessee)\n \n10.1.30 Lessor – direct financing lease for book purposes treated as \nnon‑tax lease for tax purposes \n10.1.40 Sale‑leaseback transaction accounted for as a sale and a \nleaseback for book purposes and for tax purposes (seller -\nlessee) \n10.1.50 Failed equipment sal e‑leaseba ck transaction for book \npurposes; sale and true tax leaseback for tax purposes \nComparison to legacy US GAAP \n10.2 State and local income tax implications \n10.3 Change in US Federal Tax Accounting Method \n10.4 Transfer pricing \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 882}), Document(page\_content='Leases 882 \n10. Income taxes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. How the standard works \nTopic 842 does not contain tax accounting guidance, and only minor, \nconforming amendments to Topic 740 (income taxes) were made as part of \nASU 2016- 02. These amendments do not change the basic requirements of \nTopic 740. \nThe adoption of Topic 842 will likely affect an entity’s calculation of deferred tax \nassets and liabilities even though tax laws may not be directly affected . The \nfollowing changes will have the greatest effect on an entity’s accounting for \ndeferred taxes. \n— For lessees , the recognition of ROU assets and lease liabilities for operating \nleases will require entities to recognize new deferred tax assets and \ndeferred tax liabilities not previously recognized. \n— For lesso rs, the deferral of selling profit for some direct financing leases \ncould create new (or larger) deferred tax assets. \n— For seller -lessees and buyer -lessors in sale -leaseback transactions, a \nfailed sale or failed purchase (see section 9.3) could result in new deferred \ntax issues if the sale -leaseback transaction is accounted for as a sale and a \nleaseback for tax purposes. \nIn addition, Topic 842 may affect the computation of state and local income-\nbased taxes as a result of changes to the apportionment formula. \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 883}), Document(page\_content='Leases 883 \n10. Income taxes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 10.1 Deferred taxes \n10.1.10 A basic principle of Topic 740 is to recognize deferred taxes for the \nfuture tax consequences of events that are recognized in the financial \nstatements or tax returns, but not yet in both. Future tax consequences result \nfrom differences between the tax basis and the financial statement carrying \namounts of assets and liabilities. Basis differences that have future tax \nconsequences are either taxable temporary differences ( which will result in \nfuture taxable amounts) or deductible temporary differences ( which will result in \nfuture deductible amounts). Deferred tax liabilities are recognized for taxable \ntemporary differences and deferred tax assets are recognized for deductible \ntemporary differences. \n10.1.15 Topic 842 does not include presentation or disclosure requirements for \ndeferred tax assets and liabilities arising from leases. Topic 740 (income taxes) \ngoverns their presentation and disclosure. See chapter 9 of KPMG Handbook, \nAccounting for income taxes . \n \n Question 10.1.05 \nDisclosure of lease -related deferred taxes \nAre deferred tax assets and liabilities arising from ROU assets \nand lease liabilities disclosed o n a gross basis ? \nInterpretive response: Yes. See paragraph 9.082a of KPMG Handbook, \nAccounting for income taxes . \n \n Comparison to legacy US GAAP \nMechanics of income tax accounting remain unchanged \n10.1.20 Topic 842, consistent with Topic 840, will create book/tax differences. \nHowever, because Topic 842 results in the recognition of more assets and \nliabilities than Topic 840, the adoption of Topic 842 may require entities to \nrecord new, or adjust existing, deferred tax assets and liabilities. \n10.1.30 Under Topic 840 for operating leases, a lessee generally recorded a \ndeferred tax asset for the accrued rent liability that existed, which would equal \nthe difference between the cumulative rent deductible for income tax purposes, \nsometimes based on the cash paid, and the cumulative rent recognized for \nbook purposes (generally on a straight -line basis). Because neither the \nunderlying asset nor the ROU asset was recognized by the lessee for book purposes, the only temporary difference created was the difference between \nthe rent expense recognized for tax purposes and book purposes. However, \nbecause Topic 842 requires recognition of an ROU asset and a lease liability \nthat have no tax basis, deferred tax accounts will be established to recognize \nthese basis differences. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 884}), Document(page\_content='Leases 884 \n10. Income taxes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 10.1.40 Aside from this difference, while the amounts may change due to the \nnew requirements of Topic 842 in comparison to Topic 840, the mechanics of \naccounting for the income tax consequences of leas e agreements remain \nsubstantially unchanged. \n \n10.1.1 Lessee considerations – operating leases \n10.1. 50 Under Topic 842, a lessee in an operating lease records a lease \nliability and a n ROU asset (see section 6.3) on the commencement date (see \nsection 5.1). For tax purposes, the lease will generally be a true tax lease (the \nincome tax equivalent of an operating lease), in which a n ROU asset and a lease \nliability are not recognized on the tax ledger. As a result, the operating lease gives rise to two separate temporary differences: (1) a temporary difference \nrelated to the ROU asset, and (2) a temporary difference related to the lease \nliability. The measurement of the temporary difference resulting from the ROU \nasset will be affected by items such as uneven lease payments, initial direct costs and lease incentives, which each affect the measurement of the ROU \nasset throughout the lease term. \n10.1. 60 The following table highlights the effect of the guidance in Topic 842 on \nvarious combinations of book and tax lease classification for lessees. \nBook \nclassification Tax classification Primary impact of Topic 842 \nOperati ng True tax lease (tax \noperating lease) New deferred tax balances because lease \nassets and lease liabilities are created with \nno tax basis (see Example 10. 1.20). \nOperating Non -tax lease (tax \nsales- type lease) Smaller deferred tax balances because \nthere will be book and tax basis lease \nassets and lease liabilities going forward, \nrather than only tax basis assets and \nliabilities. \nFinance True tax lease No significant change; amounts may vary. \nFinance Non-tax lease No significant change; amounts may vary. \n \n10.1.2 Lease origination costs \n10.1. 70 Generally, for both lessees and lessors, costs incurred to originate a \nlease are capitalized for tax purposes unless they are de minimis (not exceeding \n$5,000 in the aggregate per lease for US federal purposes), in which case they \nmay be deductible. \n10.1. 80 Under Topic 842, many types of lease origination costs will not meet the \ndefinition of initial direct costs (see section 5.5), and therefore will be expensed as incurred for book purposes. \n10.1.90 Those lease origination costs that meet the definition of initial direct \ncosts are capitalized and recognized as an expense over the lease term . An \nexcept ion is sales- type leases for lessors in which the fair value of the ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 885}), Document(page\_content='Leases 885 \n10. Income taxes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. underlying asset differs from its c arrying amount at lease commencement. For \nthose leases, initial direct costs are expensed at lease commencement (see \nsection 7.3.1). \n10.1. 100 For lessees, initial direct costs are capitalized as a component of the \nROU asset (see section 6.3), and as a result affect the measurement of the \ndeferred tax liability associated with the ROU asset. \n \n Example 10.1.10 \nDeferred tax measurement of operating leases \nunder Topic 840 (lessee) \nLessee LE leases a building from Lessor LR. The lease is classified as an operating lease. LE has a tax rate of 30%. The following facts are also relevant. \n— The total rent payments are $166,535, which equals the sum of the lease \npayments for the term of the lease of $14,527 in Year 1, and escalating 3% \nper year thereafter for a lease term of 10 years, paid in arrears. \n— LE incurs $5,000 in lease origination costs that meet the Topic 840 \ndefinition of initial direct costs, which are capitalized for book and tax \npurposes. LE does not deduct the initial direct costs for tax purposes, even \nthough they would be considered de minim is. \n— The total cost of the lease is $171,535 ($166,535 total lease payments + \n$5,000 initial direct costs). Therefore, the annual lease expense recognized \nfor book purposes is $17,154 ($171,535 / 10 years). \n— The lease is a true tax lease for income tax purposes , and the rent is \ndeductible for tax purposes as paid. \nDuring the first year of the lease, LE recognizes lease expense as follows (for \nbook purposes). \n Debit Credit \nLease expense 17,154 \nAccrued rent liability 2,127 \nCapitalized initial direct costs 500 \nCash 14,527 \nAt the end of the first year of the lease, LE has : \n— deductible expenses of $15,027 for tax purposes (actual cash rent paid + \nYear 1 amortization of the initial direct costs [ $5,000 / 10 years ]); and \n— lease expense of $17,154 for book purposes (straight -line lease expense, \nwhich includes $500 in Year 1 amortization of the initial direct costs ). \nAs a resul t, LE recognizes a current tax benefit of $4,508 ($15,027 × 30%). \n Debit Credit \nIncome taxes payable 4,508 \nCurrent income tax expense (benefit ) 4,508 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 886}), Document(page\_content='Leases 886 \n10. Income taxes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The accrued rent liability of $2,127 is a temporary difference that is tax-effected \nto calculate the related deferred tax asset. LE records the following journal \nentry. \n Debit Credit \nDeferred tax asse t1 638 \nDeferred income tax expense (benefit ) 638 \nNote : \n1. $2,127 × 30%. \nThe total income tax benefit for Year 1 of the lease is therefore $5,146 ($4,508 \n+ $638), which equals 30% of the book lease expense for Year 1 of $17,154. \n \n Example 10.1.20 \nDeferred tax measurement of operating leases \nunder Topic 842 (lessee) \nAssume the same lease and the same facts as in Example 10. 1.10, except for \nthe following. \n— The $5,000 in lease origination costs do not meet the definition of initial \ndirect costs under Topic 842, and therefore are expensed as incurred for \nbook purposes. \n— The rate implicit in the lease is not readily determinable, so LE uses its \nincremental borrowing rate of 10% as the discount rate for the lease. \n— LE determines the cost of the lease to be $166,535 (sum of the lease \npayments for the term of the lease of $14,527 in Year 1 and escalating 3% \nper year thereafter for a lease te rm of 10 years). Therefore, the annual lease \nexpense to be recognized for book purposes is $16,654 ($166,535 / \n10 years). \nAt lease commencement \nLE recognizes a n ROU asset and lease liability. \n Debit Credit \nROU asset 100,000 \nLease liability1 100,000 \nNote: \n1. Present value of the lease payments, discounted at 10%. \nFor tax purposes, the ROU asset and the lease liability are not recognized, \nresulting in temporary differences, while the lease origination costs are deferred \nfor tax purposes. Therefore, LE recognizes a deferred tax asset associated with \nthe lease liability, a deferred tax liabil ity associated with the ROU asset, and \nanother deferred tax asset associated with the lease origination costs that are \ncapitalized for tax purposes, but not for book purposes. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 887}), Document(page\_content='Leases 887 \n10. Income taxes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Debit Credit \nDeferred tax asset1 30,000 \nDeferred income tax expense (benefit)1 30,000 \nDeferred income tax expense (benefit)2 30,000 \nDeferred tax liability2 30,000 \nDeferred tax asset3 1,500 \nDeferred income tax expense (benefit)3 1,500 \nNotes: \n1. $100,000 carrying amount of the lease liability × 30% . \n2. $100,000 carrying amount of the ROU asset × 30% . \n3. $5,000 lease origination costs deferred for tax purposes only × 30% . \nLastly, LE expenses the lease origination costs as incurred for book purposes. \n Debit Credit \nOperating expense 5,000 \nCash 5,000 \nDuring the first year of the lease \nLE recognizes lease expense along with the lease payment as follows (for book \npurposes). \n Debit Credit \nLease expense 16,654 \nROU asset amortization 6,654 \nLease liability (interest accretion) 10,000 \nLease liability 14,527 \nCash (Year 1 lease payment) 14,527 \nAt the end of the first year of the lease: \n— the carrying amount of the lease liability is $95,473 ( the present value of the \nnine future payments, discounted at 10% ); \n— the carrying amount of the ROU asset is $93,346 ( $95,473 carrying amount \nof the lease liability – $2,127 accrued rent [ Year 1 lease cost of $16,654 – \nYear 1 lease payment of $14,527]); and \n— the tax basis of the deferred lease origination costs is $4,500 ( $5,000 – \n[$5,000 initial balance / 10 years ]). \nTherefore: \n— the carrying amount of the deferred tax asset related to the lease liability is \n$28,642 ($95,473 × 30%); ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 888}), Document(page\_content='Leases 888 \n10. Income taxes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — the carrying amount of the deferred tax liability related to the ROU asset is \n$28,004 ($93,346 × 30%); and \n— the carrying amount of the deferred tax asset related to the tax -deferred \nlease origination costs is $1,350 ($4,500 × 30%). \nLE records the following for book purposes related to income taxes to adjust \nthe deferred tax asset and deferred tax lia bility for the changes in the carrying \namount of the lease liability and the ROU asset, respectively; as well as to \nrecognize the tax effect of the current year tax deductible payments. \n Debit Credit \nDeferred income tax expense (benefit)1 1,358 \nDeferred tax asset1 1,358 \nDeferred tax liability2 1,996 \nDeferred income tax expense (benefit)2 1,996 \nDeferred income tax expense (benefit)3 150 \nDeferred tax asset3 150 \nIncome taxes payable4 4,508 \nCurrent income tax expense (benefit)4 4,508 \nNotes: \n1. $30,000 initial deferred tax asset – $28,642 end of Year 1 deferred tax asset related to \nthe lease liability. \n2. $30,000 initial deferred tax liability – $28,004 end of Year 1 deferred tax liability related \nto the ROU asset. \n3. $1,500 initial deferred tax asset – $1,350 end of Year 1 deferred tax asset related to \nthe origination costs. \n4. Tax deductible lease expense of $15,027 (cash paid for Year 1 lease paymen t of \n$14,527 + Year 1 tax amortization of lease origination costs of $500) × 30%. \nThe total income tax benefit for Year 1 is therefore $6,496 ($4,508 current tax benefit + $1,988 [ $1,996 – $1,358 + ( $1,500 – $150) ] net deferred tax benefit), \nwhich equals 30% of the sum of (1) the book lease expense for Year 1 of \n$16,654 and (2) the expensed lease origination costs of $5,000. \n \n Question 10.1.10 # \nRelated party leases \nDo deferred tax assets or liabilities arise in related party \nleases under Topic 842? \nInterpretive response: Yes. Under Topic 842, a related party lease is \naccounted for based on its enforceable terms and conditions ( or its written \nterms and conditions if the practical expedient outlined in sectio n 3.1.2 is being \napplied) – see section 6.2.2. In contrast, the tax treatment of such leases \ngenerally looks to the economic substance of the arrangement (i.e. similar to \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 889}), Document(page\_content='Leases 889 \n10. Income taxes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. how such leases were accounted for under Topic 840) . This c an result in \ntemporary differences for entities that engage in leasing activities with related \nparties on other than arm’s -length terms. [842- 10-55-12, 740- 10-25-2(b)] \n \n Question 10.1.15 \nIntercompany operating leases: REIT and taxable \nREIT subsidiary \nMust a REIT retain its REIT subsidiary’s deferred taxes on \nconsolidation? \nBackground: In some REIT structures (e.g. hotel and some healthcare REITs), \nthe REIT (parent company) owns a building and leases it under an operating \nlease to a REIT subsidiary (TRS) that either operates the property or contracts \nwith a th ird party to operate the property. \nAs discussed in Question 10.1.10 and section 6.2.2, the TRS accounts for the \nintercompany lease in its stand- alone financial statements as if it were a lease \nbetween unrelated parties. Because the TRS is taxed like a cor porate entity, it \nprovides deferred taxes in its ledger for the book/tax basis differences related to \nits ROU asset and lease liability. The deferred taxes are based on the TRS’s \napplicable tax rate. [842- 10-55-12] \nLike the TRS, the REIT accounts for the i ntercompany lease in its stand- alone \nfinancial statements as if it were a lease between unrelated parties. However, because the REIT is effectively taxed at a zero rate, it does not provide deferred \ntaxes in its ledger for its book/tax basis differences related to the lease. \nThe operating lease is eliminated in consolidation. \nInterpretive response: No. We do not believe the REIT must retain (or provide) \ndeferred taxes in the consolidated financial statements for the intercompany \noperating lease because there are no book/tax basis differences associated with \nthe lease after the REIT makes its elimina tion entries. Basis differences are \nidentified based on the difference between the tax basis of an asset or liability \nand its reported amount in the consolidated statement of financial position. \n[740- 10-25-20] \n \n10.1.3 Lessee considerations – finance leases \n10.1. 110 For finance leases, a lessee recognizes the following (see sections 6.3 \nand 6.4.1 ): \n— ROU asset (on the commencement date); \n— lease liability (on the commencement date); \n— interest expense on the lease liability each period of the lease term; and \n— amor tization of the ROU asset each period of the lease term. \n10.1. 120 A lessee amortizes the ROU asset on a straight -line basis, unless \nanother systematic basis is more representative of the pattern in which the \nlessee expects to consume its economic benefits . Amortization is recognized \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 890}), Document(page\_content='Leases 890 \n10. Income taxes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. over the period from the commencement date to the earlier of the end of the \nuseful life of the ROU asset or the end of the lease term. If the lessee is \nreasonably certain to exercise a purchase option to acquire the underlying asset, the lessee amortizes the ROU asset over the period to the end of the \nunderlying asset ’s useful life. \n10.1. 130 For tax purposes, finance leases are often treated as either true tax \nleases or non- tax leases (the income tax equivalent of a sales- type lease). Under \na true tax lease, the lessor maintains ownership of the asset and the related \ndeductions for depreciati on, and the lessee is able to deduct rental payments \nfor use of the asset. Compare this with a non -tax lease: Although legal \nownership of the asset remains with the lessor in a non- tax lease, the lessor is \nnot considered to have substantial risks and rewar ds of ownership; the lease is \nmore akin to a financing transaction because the lessee has a nominal purchase \noption at the end of the lease. As a result, the lessee receives the tax benefits of ownership and: \n— is able to deduct (1) the related depreciation for the asset, and (2) the \nportion of the payments that are considered interest ; but \n— is not perm itted to deduct the total rental payments. The lessor recognizes \ninterest income. \n10.1. 140 It is possible for a finance lease to be classified as a true tax lease for \ntax purposes . In those situations, the lessee records an ROU asset and a lease \nliability at lease commencement, and subsequently will recognize interest expense and ROU asset amortization. For the tax provision, the lessee will have \ntemporary dif ferences related to the ROU asset and the lease liability because \nthose do not exist for tax purposes. \n \n10.1.4 Lessor considerations \n10.1. 150 A lessor classifies leases as operating, direct financing or sales -type \nleases for book purposes. For tax purposes, those leases are generally treated \nas true tax leases or as non -tax leases, which are similar to a sales transaction. \n10.1. 160 For direct financing and sales- type leases, the present value of the \nlease payments during the lease term plus the pr esent value of the expected \nresidual value of the underlying asset at the end of the lease term is recognized \nas the lessor’s net investment in the lease (see section 7.3. 1). The deferral of \nselling profit for some direct financing leases may create new (or larger) \ndeferred tax assets in that those leases will frequently be non- tax leases for tax \npurposes and the entire tax profit on the lease (sales price – tax basis of the \nasset) will be recognized for tax purposes at the time of sale. \n10.1. 170 In some j urisdictions and fact patterns, the lease may be considered a \ntrue tax lease, where the lessor will be considered to own the asset for tax \npurposes and will deduct the depreciation for the asset and recognize taxable \nincome for the rental income. In other jurisdictions and fact patterns, the lease \nmay be treated as a non- tax lease for tax purposes. In this situation, the lessor \nwill recognize a taxable gain or loss on the sale of the asset and will recognize \ninterest income over the lease term for the financing provided to the lessee that \nis repaid through the payments under the lease. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 891}), Document(page\_content='Leases 891 \n10. Income taxes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 10.1. 180 The deductible amount scheduled in each future year is based on the \ndepreciation to be recognized for tax purposes in those future years. The \ntaxable amount schedule d in each future year is generally based on the present \nvalue of amounts to be received in each future year or on the future principal reductions in the lease receivable. \n10.1. 190 The following table highlights the effect of the changes in Topic 842 on \nvarious combinations of book and tax lease classification for lessors. \nBook classification Tax \nclassification Primary impact of Topic 842 \nOperating True tax lease No significant change; amounts may vary \nOperating Non -tax lease No significant change; amounts may vary \nSales -type True tax lease No significant change; amounts may vary \nSales -type Non -tax lease No significant change; amounts may vary \nDirect financing True tax lease No significant change; amounts may vary \nDirect financing Non -tax lease No significant change; amounts may vary1 \nNote: \n1. More significant changes from Topic 840 may result if under Topic 842 a direct financing \nlease results in selling profit that is required to be deferred and recognized over the lease \nterm (see Example 10. 1.30). \n \n Example 10.1.30 \nLessor – direct financing lease for book purposes \ntreated as non ‑tax lease for tax purposes \nLessor LR leases a piece of equipment to Lessee LE. The following facts are \nrelevant at the commencement date. \nLease term: 3 years \nLease payments: Fixed payments of $10,500 per year (paid \nin arrears); no variable lease payments \nLease options: None \nExpected future residual value: $12,500 \nRVG: $9,200 (third party other than LE) \nInitial direct costs: None \nRate implicit in the lease: 4.29% \nFair value: $40,000 \nTax basis: $29,000 \nBook carrying amount: $36,000 \nRemaining economic life of equipment: 5 years \nLR’s tax rate: 30% ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 892}), Document(page\_content='Leases 892 \n10. Income taxes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. For book purposes, the lease is a direct financing lease. For tax purposes, the \nlease qualifies as a non- tax lease and therefore it is treated as a sale for income \ntax purposes. \nAt lease commencement, LR recognizes the following for book purposes \n(exclusive of income tax effects). \n Debit Credit \nLease receivable1 37,091 \nUnguaranteed residual asset2 2,909 \nPP&E 36,000 \nDeferred selling profit3 4,000 \nNotes: \n1. Present value of the $10,500 annual contractual lease payments and the $9,200 \nguaranteed residual value, discounted at 4.29%. \n2. Present value of the unguaranteed residual value ($12,500 – $9,200 guarantee), \ndiscounted at 4.29%. \n3. Deferred selling profit = fair value of the underlying asset ($40,000) less its carrying \namount ($36,000). This is the same as the difference between the lease receivable \n($37,091) and the carrying amount of the underlying asset, net of the unguaranteed residual value ($33,091). \nBecause the lease is treated as a sale for income tax purposes, LR records the \nfollowing journal entry to recognize the income tax effects of the lease on the \ncommencement date. \n Debit Credit \nCurrent income tax expense (benefit)1 3,300 \nIncome taxes payable 3,300 \nDeferred tax asset2 1,200 \nDeferred income tax expense (benefit) 1,200 \nDeferred tax liability3 2,100 \nDeferred income tax expense (benefit) 2,100 \nNotes: \n1. Tax gain of $11,000 ($40,000 tax sales price – $29,000 tax carrying amount) × 30%. \n2. Deferred profit of $4,000 ($40,000 fair value – $36,000 book carrying amount) × 30%. \n3. Previous book -tax basis difference of $7,000 ($36,000 book carrying amount – \n$29,000 tax carrying amount) × 30% – i.e. a reduction of the previous deferred tax \nliability t hat existed because of the greater book carrying amount of the equipment \ncompared to the tax basis in the equipment. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 893}), Document(page\_content='Leases 893 \n10. Income taxes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. At the end of Year 1, LR records the following journal entry. \n Debit Credit \nCash (lease payment received) 10,500 \nUnguaranteed residual asset1 125 \nDeferred profit2 1,637 \nLease receivable3 8,909 \nInterest income4 3,353 \nNotes: \n1. Discount rate of 4.29% × unguaranteed residual asset balance of $2,909. \n2. Total lease income of $3,353 (calculated as the initial net investment in the lease of \n$36,000 × 9.31%) – interest on lease receivable ($1,591 = 4.29% discount rate × \ncarrying amount of $37,091) – accretion of unguaranteed residual asset ($125 = \n4.29% discount rate × carrying amount of $2,909). \n3. 9.31% (rounded) is the discount rate that would have been required at lease \ncommencement for the lease receivable plus the unguaranteed residual asset to equal \nthe fair value of the underlying asset ($40,000) less the deferred selling profit ($4,000). \n4. Total contract ual payments of $10,500 – interest on lease receivable of $1,591. \n5. Accretion of unguaranteed residual asset ($125) plus interest income on lease receivable ($1,591) + release of deferred profit ($1,637). \nAt the end of Year 1, LR records the following journal entry to account for the \ntax effects of the lease. \n Debit Credit \nCurrent income tax expense (benefit)1 515 \nIncome tax payable 515 \nDeferred income tax expense (benefit)2 491 \nDeferred tax asset 491 \nNotes: \n1. $40,000 tax basis in the financing × 4.29% = $1,716 × 30%. This is also the 30% tax \neffect of Year 1 interest income on the lease receivable ($1,591) and the \nunguaranteed residual asset ($125). The interest on the deferred selling profit of \n$1,637 is not factored in because there is no deferred selling profit for tax purposes. \n2. Change in the deferred profit of $1,637 × 30%. \n \n \n Observation \nLeveraged leases exception no longer required \n10.1.200 Topic 740 includes an exception to its basic requirements related to \nleveraged leases. Topic 842 eliminates leveraged lease accounting \nprospectively – i.e. for all leases that commence on or after the effective date of \nTopic 842 (see section 13.6). Therefore, once Topic 842 becomes effective, and as the grandfathered leveraged leases gradually expire, this exception in \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 894}), Document(page\_content='Leases 894 \n10. Income taxes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Topic 740 will no longer be relevant. The Board retained this exception in \nASU 2016- 02 because of its decision to grandfather existing lev eraged leases. \n[740- 10-25-3(c)] \n \n10.1.5 Sale-leaseback considerations \n10.1. 210 As discussed in section 9.1, an entity entering into a sale- leaseback \ntransaction will apply the specific requirements of Topic 606 (and other sale-\nleaseback specific considerations, such as whether the leaseback would be \nclassified as a finance/sales -type lease) to determine whether the transfer of \nthe asset is a sale. \n10.1. 220 If the transfer of the asset is considered a sale, the seller -lessee \nrecognizes the transac tion price for the sale (determined in accordance with \nTopic 606 , adjusted for off -market terms ) when the buyer -lessor obtains control \nof the asset, derecognizes the carrying amount of the sold asset and accounts \nfor the lease in accordance with Topic 842. \n10.1. 230 Changes to the sale- leaseback guidance mean that many equipment \nsale-leaseback transactions accounted for as a sale and a leaseback under \nTopic 840 may be failed sales under Topic 842. This will create new deferred \ntax issues if the sale -leaseba ck transaction is accounted for as a sale and a \nleaseback for tax purposes. For example, while the seller -lessee may be \nconsidered to have sold the asset for tax purposes, it may still have the asset, as well as a financing liability, for book purposes. \n10.1. 240 If the form of the transaction is respected for tax purposes, a sale-\nleaseback transaction generally enables the seller -lessee to deduct the full \nrental payments that it makes to the buyer -lessor for tax purposes. In addition, \nthe entity typically recognizes a gain or loss related to the sale of the asset. The \ngain may qualify as capital gains and the loss may be deductible in full as an \nordinary loss for tax purposes depending on the specific situation. If the form of \nthe transaction is not respect ed for tax purposes, a sale- leaseback is generally \ntreated as a secured financing for tax purposes, in which case the seller -lessee \nis not treated as transferring tax ownership of the underlying asset and \ncontinues to take deductions for depreciation, as w ell as deductions for interest \non financing provided by the buyer -lessor. \n10.1. 250 The buyer -lessor recognizes the asset at its purchase price (adjusted for \noff-market terms) and accounts for the lease in accordance with Topic 842. If \nthe transfer of the asset is not deemed a sale (or purchase for the buyer -lessor), \nthe seller -lessee does not derecognize the asset, continues to depreciate the \nasset and accounts for any amounts received as a financ ing liability. The buyer -\nlessor does not recognize the asset – i.e. the transaction results in a ‘failed \npurchase’ – and accounts for any amounts paid as a receivable in accordance \nwith other Topics. This may result in new deferred tax issues if the sale-\nleaseback transaction is accounted for as a sale and a l easeback for tax \npurposes. The buyer -lessor might own the asset and be earning taxable lease \nincome from the seller -lessee from the leaseback for tax purposes, but have a \nfinancing receivable and be earning interest income for book purposes. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 895}), Document(page\_content='Leases 895 \n10. Income taxes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 10. 1.40 \nSale‑leaseback transaction accounted for as a sale \nand a leaseback for book purposes and for tax \npurposes (seller -lessee) \nSeller -Lessee SL sells a piece of land to unrelated Buyer -Lessor BL and at the \nsame time reaches an agreement to lease the land back for 10 years. The \nfollowing facts are relevant at the date of the transaction. \nContractual sales price: $3.5 million \nFair value of the land: $2.8 million \nCarrying amount of the land: $2 million \nTax basis in the land: $2 million \nLeaseback term: 10 years \nLeaseback payments: Fixed payment s of $200,000 per year (paid in \narrears) ; no variabl e lease payments \nLeaseback options: None \nInitial direct costs: None \nRate implicit in the lease: Not readily determinable \nSL’s incremental borrowing rate: 6% \nSL’s tax rate for ordinary income and \ncapital gains: 30% \nIn addition: \n— The transaction is accounted for as a sale and a leaseback (i.e. the \ntransaction is not a failed sale) for both book and tax purposes. \n— The leaseback is a true tax lease for tax purposes. \nAt the date that the sale is completed and the leaseback commences, SL \nrecognizes the following journal entry for book purposes (excluding income tax \neffects). \n Debit Credit \nCash (sales price of asset) 3,500,000 \nGain1 800,000 \nLand 2,000,000 \nFinancing liability2 700,000 \nROU asset3 772,017 \nLease liability 772,017 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 896}), Document(page\_content='Leases 896 \n10. Income taxes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Notes: \n1. $2.8 million fair value – $2 million carrying amount. \n2. $3.5 million sales price – $2.8 million fair value. \n3. Present value of 10 annual lease payments of $104,892, discounted at 6%; $104,892 \n= $200,000 contractual leaseback payment – $95,108 allocated to repayment of the \n$700,000 financing liability. \nFor tax purposes, SL recognizes the $1.5 million difference between the \ncontractual sales price of $3.5 million and the tax basis in the land of $2 million \nas a gain on the sale of the land. In addition, because the leaseback is a true tax \nlease, SL does not have any lease ass et or lease liability for tax purposes. \nConsequently, at the date the sale is completed and the leaseback commences, \nSL recognizes the following income tax effects for book purposes. \n Debit Credit \nCurrent income tax expense (benefit)1 450,000 \nCurrent tax payable 450,000 \nDeferred tax asset2 210,000 \nDeferred income tax expense (benefit) 210,000 \nDeferred tax asset3 231,605 \nDeferred income tax expense (benefit) 231,605 \nDeferred income tax expense (benefit)4 231,605 \nDeferred tax liability 231,605 \nNotes: \n1. 30% tax effect on taxable gain of $1.5 million ($3.5 million contractual purchase price \nless $2 million tax basis carrying amount). \n2. $700,000 carrying amount of the financing liability × 30%. \n3. $772,017 carrying amount of the lease liability × 30%. \n4. $772,017 carrying amount of the ROU asset × 30%. \nDuring the first year of the leaseback, for book purposes, SL recognizes the \nfollowing journal entry (excluding income tax effects). \n Debit Credit \nInterest expense1 42,000 \nOperating lease cost2 104,892 \nLease liability3 58,571 \nFinancing liability4 53,108 \nROU asset5 58,571 \nCash 200,000 \nNotes: \n1. 6% discount rate × $700,000 financ ing liability. \n2. Total lease payments of $1,048,920 / 10- year lease term. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 897}), Document(page\_content='Leases 897 \n10. Income taxes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 3. $104,892 (portion of $200,000 annual payment allocated to the lease) – $46,321 \naccretion of the lease liability ($772,017 × 6%). \n4. $95,108 (portion of $200,000 annual payment allocated to the financ ing liability) – \n$42,000 interest on the financ ing liability ($700,000 × 6%). \n5. Total lease cost of $104,892 less accretion on lease liability of $46,321. \nDuring the first year of the leaseback, for tax purposes, SL deducts the \n$200,000 rental payment from its taxable income and SL recognizes the \nfollowing income tax effects for book purposes. \n Debit Credit \nCurrent tax payable1 60,000 \nCurrent income tax expense (benefit) 60,000 \nDeferred tax liability2 17,571 \nDeferred income tax expense (benefit) 17,571 \nDeferred income tax expense (benefit)3 17,571 \nDeferred tax asset 17,571 \nDeferred income tax expense (benefit)4 15,932 \nDeferred tax asset 15,932 \nNotes: \n1. 30% tax effect of the $200,000 contractual lease payment, fully deductible in the year \npaid. \n2. 30% tax effect of the Year 1 change in the book carrying amount of the ROU asset of \n$58,571. \n3. 30% tax effect of the Year 1 change in the book carrying amount of the lease liability of $58,571. \n4. 30% tax effect of the Year 1 change in the book carrying amount of the financing \nliability of $53,108. \n \n \n Example 10.1.50 \nFailed equipment sale ‑leaseback transaction for \nbook purposes; sale and true tax leaseback for tax \npurposes \nOn January 1, 20X1, Seller -Lessee SL has a piece of equipment that it has \ndecided to sell to Buyer -Lessor BL and lease back for liquidity purposes. The \nfollowing facts are relevant at the date of the transaction. \nContractual sales price: $1 million \nFair value of the equipment: $1 million \nCarrying amount of the equipment: $900,000 \nTax basis in the equipment: $750,000 \nLeaseback term: 5 years ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 898}), Document(page\_content='Leases 898 \n10. Income taxes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Remaining economic life of the \nequipment: 10 years, which is also the remainin g useful \nlife of the equipment \nExpected future residual value: $450,000 \nLeaseback payments: Fixed payments of $170,000 per year (paid \nin arrears); no variable lease payments \nLeaseback renewal or termination options: None \nInitial direct costs: None \nRate implicit in the leaseback: Not readily determinable by SL; \n7.5381% for BL \nSL’s incremental borrowing rate: 7% \nSL’s tax rate for ordinary income and \ncapital gains: 30% \nThe following additional facts are relevant. \n— There is a fixed price repurchase option for SL to repurchase the equipment \nat any time during the fifth year of the leaseback; therefore, the transaction \nis a failed sale for book purposes. \n— The transaction is a sale and a leaseback for tax purposes; the leaseback is \na true tax lease for tax purposes. \nScenario 1: Seller -lessee accounting \nOn January 1, 20X1, SL records the following journal entry to account for the failed sa le (excluding income tax effects). \n Debit Credit \nCash 1,000,000 \nFinancing liability 1,000,000 \nOn January 1, 20X1, SL records the following journal entry to account for the sale-date income tax effects of the transaction. \n Debit Credit \nCurrent income tax expense (benefit)1 75,000 \nIncome taxes payable 75,000 \nDeferred tax liability2 45,000 \nDeferred income tax expense (benefit) 45,000 \nDeferred income tax expense (benefit)3 270,000 \nDeferred tax liability 270,000 \nDeferred tax asset4 300,000 \nDeferred income tax expense (benefit) 300,000 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 899}), Document(page\_content='Leases 899 \n10. Income taxes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Notes: \n1. 30% tax effect of sales price ($1,000,000) – tax basis carrying amount ($750,000). \n2. Reversal of existing deferred tax liability ($900,000 – $750,000) × 30%. \n3. 30% tax effect of the basis difference between the carrying amount of the equipment \nfor book purposes ($900,000) and the tax basis (nil). \n4. 30% tax effect of the financing liability ($1,000,000), which has no tax basis. \nOn December 31, 20X1, SL records the following journal entry to record the \npayment made to BL under the terms of the sale- leaseback agreement, and \ndepreciation on the equipment that continues to be recognized by SL due to the \nfailed sale (excluding income tax effects). \n Debit Credit \nInterest expense1 70,000 \nFinancing liability2 100,000 \nCash 170,000 \nDepreciation expense3 90,000 \nAccumulated depreciation 90,000 \nNotes: \n1. $1,000,000 principal balance × 7% (SL’s incremental borrowing rate). \n2. Payment of $170,000 – interest component of $70,000. \n3. $900,000 book carrying amount at beginning of the year / 10 years. \nAlso on December 31, 20X1, SL records the following journal entry for the income tax effects of the first year of the arrangement. \n Debit Credit \nIncome taxes payable1 51,000 \nCurrent income tax expense (benefit)1 51,000 \nDeferred tax liability2 27,000 \nDeferred income tax expense (benefit)2 27,000 \nDeferred income tax expense (benefit)3 30,000 \nDeferred tax asset3 30,000 \nNotes: \n1. 20X1 lease payment for tax purposes of $170,000 × 30%, which is fully deductible in \nthe year paid. \n2. 30% of the change in the book carrying amount of the equipment, which decreased \nfrom $900,000 to $810,000 as a result of depreciation ($90,000) during the year. \n3. 30% of the change in the book carrying amount of the financing liability, which \ndecreased from $1,000,000 to $900,000 during the year. \nScenario 2: Buyer -lessor accounting \nOn January 1, 20X1, BL records the following journal entry to account for the \nfailed sale (excluding income tax effects). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 900}), Document(page\_content='Leases 900 \n10. Income taxes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Debit Credit \nFinancing receivable 1,000,000 \nCash 1,000,000 \nOn January 1, 20X1, SL records the following journal entry to account for the \nsale-date income tax effects of the transaction. \n Debit Credit \nDeferred tax asset1 300,000 \nDeferred income tax expense (benefit) 300,000 \nDeferred income tax expense (benefit)2 300,000 \nDeferred tax liabilit y 300,000 \nNotes: \n1. 30% tax effect of $1,000,000 of equipment recognized as an asset for tax purposes, \nbut not recognized for book purposes (failed purchase). \n2. 30% tax effect of the financing receivable recognized for book purposes, but not for \ntax purposes. \nOn December 31, 20X1, BL records the following journal entry to record the \npayment from SL under the terms of the sale- leaseback agreement (excluding \nincome tax effects). \n Debit Credit \nCash 170,000 \nInterest income1 60,000 \nFinancing receivable2 110,000 \nNotes: \n1. $1,000,000 principal balance × 6%. Consistent with Example 2 in Subtopic 842 -40, BL \ndetermined this rate of interest based on the guidance in Subtopic 835 -30 (imputation \nof interest). \n2. Payment of $170,000 – interest component of $60,000. \nOn December 31, 20X1, BL records the following journal entry to account for \nthe first year income tax effects of the arrangement. \n Debit Credit \nDeferred income tax expense (benefit)1 60,000 \nDeferred tax asset1 60,000 \nDeferred tax liability2 33,000 \nDeferred income tax expense (benefit)2 33,000 \nIncome tax payable3 9,000 \nCurrent income tax expense (benefit)3 9,000 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 901}), Document(page\_content='Leases 901 \n10. Income taxes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Notes: \n1. 30% tax effect of decrease in the tax basis of the equipment resulting from MACRS \ndepreciation. MACRS depreciation for the year ended December 31, 20X9 is \n$200,000. \n2. 30% tax effect of the change in the book carrying amount of the financing receivable (30% × $110,000). \n3. 30% tax effect of the true tax lease income of $170,000 earned in the first year of the \nleaseback – 30% tax effect of MACR S tax depreciation of equipment of $200,000. \n \n \n Question 10.1.20 \nImpact of foreign currency \nWhat are the deferred tax consequences of a lease being \ndenominated in a foreign currency? \nInterpretive response: For leases denominated in a foreign currency, the ROU \nasset is a nonmonetary asset while the lease liability is a monetary liability. \nTherefore, when accounting for a lease that is denominated in a foreign \ncurrency, the lease liability is remeasured using the current exchange rate, \nwhile the ROU asset is remeasured using the exchange rate as of the lease \ncommencement date (see section 6.4.3 ). As a result, the exception on \nrecognizing a deferred tax asset or liability for differences related to assets and \nliabilities that are remeasured from t he local currency into the functional \ncurrency using historical exchange rates and that result from changes in exchange rates will apply to the ROU asset but will not apply to the lease \nliability under Topic 842. \n[842- 20-55-10, 740- 10-25-3(f)] \n \n10.2 State and l ocal i ncome t ax implications \n10.2.10 Although domestic tax laws may remain unchanged on the adoption of \nTopic 842, and most states that use a property factor already include the value \nof leased assets in the apportionment formula, the requirement to bring all \nleases (other than those qualifying for the short -term exemption – see \nsection 6.3.1) on the balance sheet may affect the apportionment of taxable \nincome in some states. Entities should consider the need to review both state \nand local income tax laws to determine the effect of Topic 842, if any. \n10.2.20 An entity will need to consider the effect of any changes, if applicable, \non its state apportionment factors in its assessment of any necessary valuation \nallowance. Most states that use a property factor already require leased assets \nto be included in the factor and provide a valuation method for including such \nassets. In general, the Uniform Division of Income for Tax Purposes Act, which \nhas been widely adopted by the states, provides that property rented by the \ntaxpayer is valued at eight times the net annual rental rate. Nevertheless, the effect of including leases on the balance sheet may change the apportionment \nof taxable income in some states. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 902}), Document(page\_content='Leases 902 \n10. Income taxes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 10.2.30 For measuring state deferred tax assets and liabilities, an entity should \nassume that temporary differences will reverse in the tax jurisdictions in which \nthe related assets or liabilities are expected to be realized or settled, and \ntherefore would apply the enacted tax rate for that par ticular state for \nmeasuring deferred taxes. Entities generally should not assume that taxable or deductible amounts related to temporary differences in a tax jurisdiction will be \nshifted to a different tax jurisdiction through future intercompany transacti ons. \n \n10.3 Change in US Federal Tax Accounting Method \n10.3.10 Generally, a change in book accounting method (e.g. in accounting for \nleases) will not be deemed to constitute a change in underlying facts for US \nfederal tax procedural purposes. If a new tax accounting method is required or \ndesirable because the book accounting method changes, an entity must obtain \npermission from the IRS in advance of the change. The filing procedures and \ntiming vary based on whether the change is automatic or requires advanc e \nconsent from the IRS. \n10.3.20 An entity that changes to a tax accounting method identified in \npublished IRS guidance (currently Rev. Proc. 2015- 14) is deemed to be \nautomatically approved by the IRS when the copy of Form 3115, Application for \nChange in A ccounting Method, is filed and, at the same time, generally receives \naudit protection for prior years. For book purposes, the timing of recognizing the \neffects of a change in tax accounting methods will depend on when the entity \ndetermines to make the change, when Form 3115 is filed, and whether the \nentity is changing from an impermissible method to a permissible method. \n10.3.30 When a tax accounting method change is outside the automatic \nprocedures, IRS approval of the change is not automatic. The entity will need to consider the requirements of Topic 740 on accounting for tax positions with \nuncertaint y to determine whether it is appropriate to account for the change \nbefore it receives approval (i.e. the consent letter). \n10.3.40 The adoption of Topic 842 may result in a change in the pattern of \nrecognizing income and expenses for financial reporting purposes for an entity. \nAn entity should consider whether a tax accounting method change is \nappropriate and the related tax adjustment. An unfavorable adjustment (i.e. the \nincome inclusion catch- up adjustment that is the difference between the tax \naccounting on the old method and new method as of the beginning of the year of change) would generally be spread over four years for US federal tax \npurposes. This woul d also create an additional temporary difference for the \nportion of the effect of the tax accounting method change that has not yet been recognized for tax purposes. \n \n10.4 Transfer p ricing \n10.4.10 The classification of leases may affect both the lessee and lessor from a \ntransfer pricing perspective. Changes to the amount and timing of lease income and lease expense as a result of adopting Topic 842 could have an effect on ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 903}), Document(page\_content='Leases 903 \n10. Income taxes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. transfer pricing, specific ally as it relates to using revenue or profit -based \nmethods for establishing the transfer pricing. \n10.4.20 Entities use transfer pricing to determine the appropriate amount to \ncharge for intercompany transactions. Intercompany transactions are eliminated \nfrom the consolidated results for book purposes, but are not eliminated in each \ntaxing jurisdiction for tax purposes. As a result, an entity uses transfer pricing to \nhelp determine each member of the group’s taxable income. \n10.4.30 While each taxing authority has different rules and thresholds, the \ntransactions must usually be priced at arm’s -length. Under the arm’s -length \nstandard, governments evaluate whether intercompany transactions are priced \nsimilar to arm’s length transactions. Arm’s -length transact ions help ensure that \nan entity is not inappropriately allocating income to any particular tax jurisdiction. \n10.4.40 Entities may lease assets to one another for various reasons. If a lease is \nobtained from a related party, the interest rate and related t erms generally \nshould be the same (or within a reasonable range) compared to what it would receive from an unrelated party in an arm’s -length transaction. For a true tax \nlease, an entity will need to determine that the rental rates are appropriate and are considered to be at arm’s length. Entities should carefully consider the \nclassification of the leases from both a lessor and lessee perspective. \n10.4.50 An entity may need to consider whether its transfer pricing studies and \nsupporting documentation shoul d be revised or updated once the standard has \nbeen adopted. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 904}), Document(page\_content='Leases 904 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 11. Leases acquired in a \nbusiness combination or \nasset acquisition \nDetailed contents \nItem significantly updated in this chapter : # \nHow the standard works \n11.1 Accounting for leases acquir ed in a business combination \n11.1.1 Lease identification \n11.1.2 Lease classification \n11.1.3 Acquisition date recognition and measurement \n11.1.4 Leveraged leases \n11.1.5 Post-acquisition accounting \nObservation \nMeasurement of lease assets and lease liabilities is not at fair value \nQuestions \n11.1.10 Reassessment of lease identification \n11.1.20 Acquiree assessment of lease classification or lease \nidentification is not known \n11.1.25 Reassessment of lease identification – acquiree’s \nassessment not made under US GAAP \n11.1.30 Reassessment of lease identification – acquirer and acquiree \nadopted Topic 842 at dif ferent dates \n11.1.40 Different acquirer and acquiree transition elections \n11.1.50 Reassessment of lease identification – only the acquirer has \nadopted Topic 842 \n11.1.60 Reassessment of lease classification – lease is modified in a \nbusiness combination \n11.1.70 Acquiree’s lease classification retained from Topic 840 \n11.1.75 Reassessment of lease classification – only the acquirer has \nadopted Topic 842 \n11.1.80 Reassessment of l ease classification – acquirer’s \nassessment of lease term or purchase opt ion is different \nfrom acquiree’s in a business combination ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 905}), Document(page\_content='Leases 905 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 11.1.90 Reassesment of l ease classification – lease is acquired in an \nasset acquisition \n11.1.95 Reassessment of lease classification – acquiree’s \nassessment not made under US GAAP \n11.1.100 Incremental borrowing rate to use when measuring an \nacquired lease – implicit rate not readily determinable \n11.1.110 In-place leases \n11.1.120 Subleases of an acquiree \n11.1. 130 Preexisting lease relationship \n11.1.140 Favorability or unfavorability associated with a renewal option \n11.1.150 Lease classification impact on the measurement of underlying assets \n11.1.160 How off -market lease terms affect the fair value of the \nunderlying asset in sales -type and direct financing leases – \nlessors \n11.1.170 Involvement of a third -party lessor in a business combination \n11.1. 180 Acquisition accounting for an acquiree failed sale/purchase \n11.1.190 Accounting for leases acquired in an asset acquisition \n11.1.200 Different acquirer/acquiree separation of lease and non -lease \ncomponent policy elections \n11.1.210 Measurement of acquired related party leases with off -\nmarket terms # \n11.1.220 Acquirer accounting for an operating lease when it is the lessee and is reasonably certain to exercise a lessee \npurchase option \n11.1.230 (Un)favorable contract (liabilities) assets for contracts not \naccounted for as leases before a modification \nExamples \n11.1.10 Reassessing lease identification \n \n11.1.20 Accounting for an acquired lease (operating lease) \n11.1.30 Accounting for an acquired lease (finance/sa les-type lease) \n11.1.40 Accounting for an acquired lease (operating lease) when the \nacquirer is reasonably certain to exercise a lessee purchase \noption \nComparison to legacy US GAAP \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 906}), Document(page\_content='Leases 906 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. How the standard works \nIn summary, the following are recognized as part of the acquisition accounting. \nAcquiree is lessee : Acquiree is lessor : \nOperating or finance \nlease Operating lease Sales -type or direct \nfinancing lease \n— ROU asset \n— Lease liability — Property, plant and \nequipment \n— Asset or liability (off-\nmarket lease terms) — Lease receivable \n— Unguaranteed residual \nasset1 \n— In all cases, any related intangible assets (e.g. a customer relationship) are \nrecognized. \n— The acquirer retains the acquiree’s lease classification unless the lease is modified \nas part of the acquisition, and that modification is not accounted for as a separate \ncontract under Topic 842 (see Question 11. 1.60). \n— In all cases, the lease assets and lease liabilities are measured as if the lease were \na new lease of the acquirer at the acquisition date. \nNote : \n1. The lease receivable and the unguaranteed residual asset are presented together as a \nsingle net investment in the lease (see section 7.3 .1). \nTopic 842 includes only limited guidance on accounting for leases acquired in a \nbusiness combination. Most of the guidance on this topic, including more \ndetailed guidance on the initial and subsequent measurement of assets and \nliabilities related to lease contracts acquired in a business combination, is \nincluded in Topic 805 ( business combinations ), which was amended by \nASU 2016- 02. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 907}), Document(page\_content='Leases 907 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 11.1 Accounting for leases acquired in a business \ncombination \n Excerpt from ASC 842 -10 \n15 Scope and Scope Exceptions \nGeneral \n> Identifying a Lease \n15-2 At inception of a contract , an entity shall determine whether that contract \nis or contains a lease. \n15-6 An entity shall reassess whether a contract is or contains a lease only if \nthe terms and conditions of the contract are changed. \n55 Implementation guidance and illustrations \nGeneral \n> Implementation Guidance \n>> Lease Classification \n>>> Lease of an Acquiree \n55-11 In a business combination or an acquisition by a not -for-profit entity, the \nacquiring entity should retain the previous lease classification in accordance \nwith this Subtopic unless there is a leas e modification and that modification is \nnot accounted for as a separate contract in accordance with paragraph 842- 10-\n25-8. \n \n Excerpt from ASC 842 -20 \n35 Subsequent Measurement \nGeneral \n> Amortization of Leasehold Improvements \n35-13 Leasehold improvements acquired in a business combination or an \nacquisition by a not -for-profit entity shall be amortized over the shorter of the \nuseful life of the assets and the remaining lease term at the date of acquisition. \n \n Excerpt from ASC 805 -20 \n25 Recognition \n>> Classifying or Designating Identifiable Assets Acquired and \nLiabilities Assumed in a Business Combination ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 908}), Document(page\_content='Leases 908 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 25-6 At the acquisition date, the acquirer shall classify or designate the \nidentifiable assets acquired and liabilities assumed as necessary to \nsubsequently apply other GAAP. The acquirer shall make those classifications \nor designations on the basis of the contractual terms, economic conditions, its \noperating or accounting policies, and other pertinent conditions as they exist at \nthe acquisition date. \n25-8 This Section provides the following two exceptions to the principle in \nparagraph 805- 20-25-6: \na. Classification of a lease of an acquiree shall be in accordance with the \nguidance in paragraph 842- 10-55-11 \nb. Classification of a contract written by an entity that is in the scope of \nSubtopic 944-10 as an insurance or reinsurance contract or a deposit \ncontract. The acquirer shall classify that contract on the basis of the \ncontractual terms and other factors at the inception of the contract (or, if \nthe terms of the contract have been modified in a manner that would \nchange its classification, at the date of that modifi cation, which might be \nthe acquisition date). \n> Recognizing Particular Assets Acquired and Liabilities Assumed \n25-9 Guidance on recognizing identifiable intangible assets, including operating \nleases and reacquired rights, follows. \n>> Identifiabl e Intangible Assets \n25-10 The acquirer shall recognize separately from goodwill the identifiable \nintangible assets acquired in a business combination. An intangible asset is \nidentifiable if it meets either the separability criterion or the contractual -legal \ncriterion described in the definition of identifiable. Additional guidance on \napplying that definition is provided in paragraphs 805 -20-25-14 through 25- 15, \n805-20-55-2 through 55 -45, and Example 1 (see paragraph 805- 20-55-52). For \nguidance on the recognition and subsequent measurement of a defensive \nintangible asset, see Subtopic 350- 30. \n25-10A An identifiable intangible asset may be associated with a lease, which \nmay be evidenced by market participants’ willingness to pay a price for the \nlease even if it is at market terms. For example, a lease of gates at an airport or \nof retail space in a prime shopping area might provide entry into a market or \nother future economic benefits that qualify as identifiable intangible assets, \nsuch as a customer relationship. In that situation, the acquirer shall \nrecognize the associated identifiable intangible asset(s) in accordance with \nparagraph 805-20-25-10. \n>> Operating Leases \n25-11 The acquirer shall recognize assets or liabilities related to an operating \nlease in which the acquiree is the lessee as required by paragraphs 805- 20-25-\n10A and 805- 20-25-28A. \n25-12 Regardless of whether the acquiree is the lessee or the lessor, the \nacquirer shall determine whether the terms of each of an acquiree’s operating \nleases are favorable or unfavorable compared with the market terms of leases \nof the same or similar items at the acquisition date. If the acquiree is a lessor, \nthe acquirer shall recognize an intangible asset if the terms of an operating \nlease are favorable relat ive to market terms and a liability if the terms are ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 909}), Document(page\_content='Leases 909 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. unfavorable relative to market terms. If the acquiree is a lessee, the acquirer \nshall adjust the measurement of the acquired right -of-use asset for any \nfavorable or unfavorable terms in accordance with paragraph 805- 20-30-24. \n25-13 An identifiable intangible asset may be associated with an operating \nlease, which may be evidenced by market participants’ willingness to pay a \nprice for the lease even if it is at market terms. For example, a lease of gates a t \nan airport or of retail space in a prime shopping area might provide entry into a \nmarket or other future economic benefits that qualify as identifiable intangible \nassets, such as a customer relationship. In that situation, the acquirer shall \nrecognize the associated identifiable intangible asset(s) in accordance with \nparagraph 805 -20-25-10. \n> Exceptions to the Recognition Principle \n>> Leases \n25-28A The acquirer shall recognize assets and liabilities arising from leases of \nan acquiree in accordance with Topic 842 on leases (taking into account the \nrequirements in paragraph 805- 20-25-8(a)). \n25-28B For leases for which the acquiree is a lessee, the ac quirer may elect, as \nan accounting policy election by class of underlying asset and applicable to all \nof the entity’s acquisitions, not to recognize assets or liabilities at the \nacquisition date for leases that, at the acquisition date, have a remaining lease \nterm of 12 months or less. This includes not recognizing an intangible asset if \nthe terms of an operating lease are favorable relative to market terms or a \nliability if the terms are unfavorable relative to market terms. \n30 Initial Measurement \nGeneral \n> Measurement Principle \n30-1 The acquirer shall measure the identifiable assets acquired, the liabilities \nassumed, and any noncontrolling interest in the acquiree at their acquisition-\ndate fair values. \n30-2 Exceptions to the measurement princ iple are identified and their \naccounting treatment is addressed in paragraphs 805- 20-30-10 through 30- 23. \n> Exceptions to the Measurement Principle \n>> Measurement of Lease Assets and Lease Liabilities Arising from \nLeases in Which the Acquiree Is the Lessee \n30-24 For leases in which the acquiree is a lessee, the acquirer shall measure \nthe lease liability at the present value of the remaining lease payments, as if \nthe acquired lease were a new lease of the acquirer at the acquisition date. \nThe acqu irer shall measure the right -of-use asset at the same amount as the \nlease liability as adjusted to reflect favorable or unfavorable terms of the lease \nwhen compared with market terms. \n>> Measurement of Assets and Liabilities Arising from Leases in Whi ch \nthe Acquiree Is the Lessor \n30-25 For leases in which the acquiree is a lessor of a sales -type lease or a \ndirect financing lease, the acquirer shall measure its net investment in the ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 910}), Document(page\_content='Leases 910 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. lease as the sum of both of the following (which will equal the fair value of the \nunderlying asset at the acquisition date): \na. The lease receivable at the present value, discounted using the rate implicit \nin the lease, of the following, as if the acquired lease were a new lease at \nthe acquisition date: \n1. The remaining lease payments \n2. The amount the lessor expect s to derive from the underlying asset \nfollowing the end of the lease term that is guaranteed by the lessee or \nany other third party unrelated to the lessor. \nb. The unguaranteed residual asset as the difference between the fair value \nof the underlying asset a t the acquisition date and the carrying amount of \nthe lease receivable, as determined in accordance with (a), at that date. \nThe acquirer shall take into account the terms and conditions of the lease in \ncalculating the acquisition- date fair value of an underlying asset that is subject \nto a sales -type lease or a direct financing lease by the acquiree -lessor. \n35 Subsequent Measurement \nGeneral \n> Additional Guidance on Subsequent Measurement of Assets \nAcquired, Liabilities Assumed or Incurred, and Any Noncontrolling \nInterests in a Business Combination \n35-6 Leasehold improvements acquired in a business combination shall be \namortized over the shorter of the useful life of the assets and the remaining \nlease term at the date of acquisition. However, if the lease transfers ownership \nof the underlying asset to the lessee, or the lessee is reasonably certain to \nexercise an option to purchase the und erlying asset, the lessee shall amortize \nthe leasehold improvements to the end of their useful life \n \n11.1.10 The following chart summarizes the acquirer’s initial accounting at the \nacquisition date. The chart highlights the following. [805- 20-25-10A, 25 -12, 25 -28A, \n30-24 – 30-25] \n— If the acquiree is a lessee, the same assets and liabilities are recognized \nregardless of whether th e lease is an operating lease or a finance lease. \n— If the acquiree is a lessor, the assets and liabilities recognized depend on \nwhether the lease is an operating lease, or a sales -type or direct financing \nlease. \n— In all cases, there may be one or more intangible assets related to the \nlease, such as a customer relationship , that must be recognized. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 911}), Document(page\_content='Leases 911 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Lease acquired in a business combination1\nAcquiree is lessee Acquiree is lessor\nOperating and finance leases Operating leasesSales -type and \ndirect financing \nleases\nLease liability2\nPresent value of \nthe remaining \nlease payments3 ROU asset\nEqual to the \nliability , adjusted \nfor any favorable /\nunfavorable terms4PP&E\nUnderlying asset at \nfair valueLease receivable\nPresent value of \nthe remaining \nlease payments \nand guaranteed \nresidual value5\nAsset or liability\nFavorable /\nunfavorable terms6Unguaranteed \nresidual asset\nDifference \nbetween fair value \nof underlying \nasset7 and lease \nreceivableIntangible assets\nAssociated with the lease8\nIntangible assets\nAssociated with the lease8\nNotes: \n1. The acquirer retains the acquiree’s lease classification unless the lease is modified as \npart of the business combination, and that modification is not accounted for as a separate \ncontract (see Question 11.1.60). [805- 20-25-8, 842- 10-55-11] \n2. The lease liability (lessee) or lease receivable (lessor in a sales -type or direct financing \nlease) is measured as if the lease were a new lease at that date – i.e. as if the acquisition \ndate were the lease commencement date. [805-20-30-24, 30- 25(a)] \n3. Discounted at the rate implicit in the lease if readily determinable, or otherwise using the \nacqu irer’s incremental borrowing rate (see Question 11.1.100) . [805- 20-30-24] \n4. Renewal and/or purchase options that are either (1) favorable to the acquiree -lessee or (2) \nunfavorable to the acquiree -lessee but for which exercise is outside of the control of the \nacquiree -lessee (e.g. within the control of the lessor or an unrelated third party) affect the \nmeasurement of the ROU asset (see Question 11.1. 140). \n5. Discounted at the rate implicit in the lease. [805- 20-30-25] \n6. If a renewal option or a purchase option is unfavorable to the acquiree- lessor, a liability is \nrecognized if exercise of the option is outside the lessor’s control (see Question \n11.1. 140). \n7. The terms and conditions of the lease are taken into account in determining the fair value of the underlying asset in a sales- type or direct financing lease (s ee Question s 11.1. 150 \nand 11.1. 160). \n8. Even if a lease is at market terms, there may be other iden tifiable intangible assets \nassociated with the lease, such as an in- place lease asset (see Question 11.1.110) or a \ncustomer relationship. For example, a lease of gates at an airport or of retail space in a \nprime shopping area might provide entry into a mar ket or other future economic benefits \nthat qualify as an identifiable intangible asset . Such identifiable intangible assets are \nrecognized at fair value in the acquisition accounting. \n[805- 20-25-10A] \n \n11.1.1 Lease identification \n11.1.20 Both parties to a contract (the customer and the supplier) evaluate at \ninception of the contract whether it is or contains a lease. An entity does not ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 912}), Document(page\_content='Leases 912 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. reassess whether a contract is or contains a lease unless the terms and \nconditions of the contract are changed. [842- 10-15-2, 15- 6 – 15-7] \n \n Question 11.1.10 \nReassessment of lease identification \nWhen should an acquirer reassess lease identification in a \nbusiness combination? \nBackground: Topic 842 provides specific guidance about when to reassess the \nclassification of a lease acquired in a business combination (see paragraph \n11.1.10 (Note 1 ) and Question 11.1.60), while Question 11.1.90 provides our \nview about when Topic 842 requires an acquirer to reassess the classification of \na lease acquired in an asset acquisition. \nUS GAAP does not provide explicit guidance about when, if ever, an acquirer \nshould reassess an acquiree’s conclusions about whether contracts acquired in a business combination are or contain a lease. \nIf reassessed as of the acquisition date, changed facts and circumstances since the acquiree’s assessment could lead to different conclusions about whether a \ncontract is or contains a lease. For example, changes in technology or other \nfactors since the acquiree’s assessment date could affect whether a \nsubstantive substitution right exists for the remainder of the ‘period of use’ from the acquisition date. \nIn addition , even if reassessed by the acquirer as of the acquiree’s assessment \ndate, different facts and circumstances and/or different j udgments may have \nled to a different lease identification conclusion. For example, because of its \noperations or other circumstances different from the acquiree, the acquirer \nmight have concluded that it could economically benefit from a substitution \nright that the acquiree concluded it could not benefit from . \nInterpretive response: We believe an acquirer should reassess the acquiree’s \nlease identification conclusions only for acquired contract s whose terms and \nconditions are changed in connection with the transaction. \n[842- 10-15-6] \nIf lease identification is reassessed because of changed contractual terms and \nconditions, it is reassessed as of the acquisition date based on the changed \nterms and conditions of the contract . \nAsset acquisitions \nWe believe the above applies equally to leases acquired in an asset acquisition. \nAcquiree assessments made in error \nThis interpretive response presumes that the acquiree’s lease identification \nconclusions were appropria te. Topic 842 and Topic 805 do not grandfather \naccounting conclusions reached in error ; therefore, an acquirer is required to \nconsider whether the acquiree’s lease identification assessments were \nappropriate. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 913}), Document(page\_content='Leases 913 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. If a reassessment is required because of an acq uiree error only, that \nreassessment is undertaken based on the acquiree’s business and the facts \nand circumstances as of the date the acquiree should have undertaken the \nassessment – i.e. the acquirer’s objective is solely to correct the acquiree’s \nerror . \n \n Question 11.1.20 \nAcquiree assessment of lease classification or lease \nidentification is not known \nWhat should an entity do if it does not know the acquiree’s \nlease classification or lease identification assessment? \nBackground: Acquirers in a business combination (or asset acquisition) will \nfrequently not reassess the acquiree’s classification of a lease (see section \n11.1.2) or its conclusions about lease identification (see Question 11.1.10) . \nThe pre-acquisition lease classification or lease i dentification assessment may \nnot be known by the acquirer , particularly in asset acquisitions. Therefore, the \nquestion arises about how the acquirer should determine the pre- acquisition \nlease classification or lease identification assessment. \nInterpretive response: We believe it is necessary for the acquirer to assess \nthe pre- acquisition lease classification or lease identification as if it was the \nacquiree – i.e. to determine what the acquiree’s classification or lease \nidentification assessment sh ould hav e been, based on the acquiree’s business \nand the facts and circumstances as of the date the acquiree should have \nundertaken that assessment. \nParagraphs 842- 10-55-11, 842- 10-25-1 and 842- 10-15-6, which we reference in \nour responses to Questions 11.1.60, 11.1.90 and 11.1.10, do not include \npracticability or other similar exceptions. Therefore, we do not believe an \nacquirer can avoid using the pre- acquisition lease classification or lease \nidentification assessment on the basis that either it does not know the pre-\nacquisition assessment s or that one or more of them would be difficult to \nrecreate. \nTo some extent, evaluating the pre- acquisition lease classification and lease \nidentification assessments is required in all business combinations (and asset \nacquisitio ns) because the guidance grandfathering pre- acquisition assessments \ndoes not grandfather assessments reached in error . Therefore, acquirers will \nhave to evaluate whether the pre- acquisition assessments were appropriate. \nLegacy US GAAP \nThis situation also a rose under legacy US GAAP (Topic 840), including under \nTopic 805 before the new definition of a business in ASU 2017- 01 was adopted, \nalbeit with lesser practical effect due to the off -balance sheet nature of \noperating leases for lessees. In those cases, we believe it was necessary for \nthe acquirer to effectively recreate the pre- acquisition lease classification and/ or \nlease identificat ion assessment. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 914}), Document(page\_content='Leases 914 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 11.1.25 \nReassessment of lease identification – acquiree’s \nassessment not made under US GAAP \nShould the acquirer reassess the acquiree’s lease \nidentification conclusions if they were not reached under US \nGAAP? \nBackground: Question 11.1.10 addresses when an acquirer should reassess \nlease identification in a business combination or an asset acquisition. That \nquestion assumes both the acquirer and the acquiree are US GAAP reporting \nentities. \nThis question addresses whether that same conclusion applies if the acquiree \nmade its lease identification assessment under other GAAP (e.g. IFRS Accounting Standards or GASB standards). \nInterpretive response: Yes. When an acquiree’s accounting pre- acquisition is \nnot under US GAAP, the acquirer must convert it to US GAAP. Regardless of \nwhether the transaction is a business combination or an asset acquisition, this \nincludes reassessing whether acquired contracts conta in a lease using the \nTopic 842 definition of a lease. \nWhen this occurs, the acquirer will need to determine what the acquiree’s lease \nidentification assessment would have been under Topic 842 based on the \nacquiree’s business and the facts and circumstance s as of the date the \nacquiree would have undertaken that assessment had it adopted Topic 842 at \nthe same date as the acquirer . \n \n Question 11.1.30 \nReassessment of lease identification – acquirer and \nacquiree adopted Topic 842 at different dates \nIf the acquiree’s lease identification conclusion was reached \nunder Topic 840, does the acquirer need to reassess that \nconclusion in a business combination or an asset acquisition? \nBackground: An acquirer and an acquiree may have adopted Topic 842 on \ndifferent da tes. For example, the acquirer adopted Topic 842 on January 1, \n20X1 and the acquiree on July 1, 20X1, while the business combination or asset \nacquisition occurs on October 1, 20X1. \nIn Question 11.1.10, we discuss our view that an acquirer should not reassess \nthe acquiree’s lease identification conclusions in a business combination or \nasset acquisition unless the terms and conditions of the contract are changed in \nconnection with the transaction. \nHowever, because of the different acquirer and acquiree adoption dates, the \nquestion arises about whether acquiree contracts that would have been \nassessed for lease identification under Topic 842 had the acquiree adopted \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 915}), Document(page\_content='Leases 915 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Topic 842 on the same date as the acquirer need to be reassessed for lease \nidentification under Topic 842. In this background example, the question would \napply to contracts entered into or modified from January 1, 20X1 through June \n30, 20X1 (assuming the acquirer elected the transition package of practical \nexpedients). \nInterpretive response: We are aware of multiple views about this question. In \nthe absence of additional guidance from the FASB or the SEC staff, we believe \nthe following views are acceptable. \nView 1: Do not reassess any contracts for which the terms and conditions \nare not changed in connection with the transaction \nUnder this view, the different adoption dates for the acquirer and the acquiree \nare ignored when considering which contracts , if any, to reassess for lease \nidentification. Consistent with our non -transition related response to Question \n11.1.10, the acquirer reassesses lease identification for existing acquiree \ncontracts only if the terms and conditions of the contract are changed in \nconnection with the transaction (assuming the acquiree’s lease identification conclusions were not reached in error). \nThe basis for this view is that there is no requirement for the acquirer to \nconform the two parties’ validly elected adopti on dates as part of its acquisition \naccounting. Therefore, the requirement to reassess lease identification should \nnot differ from th at outlined in Question 11.1.10 solely because of different \nTopic 842 adoption dates. By contrast , View 2 in effect treats adoption dates of \na new accounting standard (in this case, Topic 842) as an accounting policy that \nmust be conformed. \nView 2: Reassess those contracts that would have been assessed by the \nacquirer under Topic 842, but were assessed by the acquiree under To pic \n840 \nUnder this view, the acquirer reassesses any contracts assessed for lease identification by the acquiree using the Topic 840 definition of a lease that \nwould have been assessed by the acquiree using the Topic 842 definition of a \nlease if it had adopted Topic 842 on the same date as the acquirer. That \nreassessment is undertaken based on the acquiree’s business and the facts \nand circumstances as of the date the acquiree should have undertaken it. \nUsing the background example, because the acquirer adopted Topic 842 on \nJanuary 1, 20X1 applying the transition package of practical expedients, any \ncontracts it entered into or modified (and the modification not accounted for as a separate contract) on or after January 1, 20X1 would have been assessed by \nthe acquirer for lease identification using the Topic 842 definition of a lease. \nThose same contracts, if entered into or modified before the acquiree’s July 1, \n20X1 adoption date, and assuming the acquir ee also elected the transition \npackage of practical expedients, were assessed for lease identification by the \nacquiree using the Topic 840 definition of a lease. \nUnder View 2, assuming none of those contracts were reassessed by the \nacquiree on or after its own adoption date (e.g. because of a modification not \naccounted for as a separate contract), the acquirer reassesses whether they are \nor contain leases consistent with the preceding paragraphs . ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 916}), Document(page\_content='Leases 916 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The parties’ transition elections affect how this view is applied. \n— If the acquiree did not elect the transition package of practical expedients, \nregardless of the acquirer’s transition package election, the acquirer does \nnot reassess any of the acquiree’s existing contracts . This is because they \nall would have been assessed (or reassessed) b y the acquiree under the \nTopic 842 definition of a lease when it adopted Topic 842.1 \n— If only the acquiree elected the transition package of practical expedients, \nthe acquirer follows one of the following approaches . \n— If the acquirer does not treat the acquiree’s transition elections as accounting policies to conform (see Question 11.1.40) , the acquirer \nreassesses those acquiree contracts that would have been assessed by \nthe acquiree using the Topic 842 lease definition if it had adopted the \nstandard on the acquirer’s adoption date. These are the same contracts that would be reassessed if both parties had elected the package of \npractical expedients. \n— If the acquirer treats the acquiree’s transition elections as accounting \npolicies to conform (see Question 11.1.40 ), the acquirer reassess es all \nof the acquiree’s existing contracts entered into or last modified before \nthe acquiree’s adoption date, including those entered into or last \nmodified before the acquirer’s adoption da te. \nWhich party, the acquirer or the acquiree, adopted Topic 842 first can also \naffect how this view is applied. I nstead of the example presented, assume that \nthe acquiree adopted Topic 842 before the acquirer. \n— If both parties, neit her party or only the ac quirer elected the transition \npackage of practical expedients, the acquirer does not reassess any of the \nacquiree’s existing contracts.1 \n— If only the acquiree elected the transition package of practical expedients, \nthe acquirer follows one of the following approaches . \n— If the acquirer does not treat the acquiree’s transition elections as \naccounting policies to conform (see Question 11.1.40) , the acquirer \ndoes not reassess any of the acquiree’s existing contracts .1 \n— If the acquirer treats the acquiree’s transi tion elections as accounting \npolicies to conform (see Question 11.1.40 ), the acquirer reassess es any \nacquired contracts not assessed by the acquiree under the Topic 842 \ndefinition of a lease.1 This would be any contracts entered into or \nmodified ( and not meeting the Topic 842 criteria to be accounted for as \na separate contract ) before the acquiree’s Topic 842 adoption date. \nNote: \n1. All contracts for which the terms and conditions are changed in connection with \nthe business combination (or asset acquisition), or for which the acquiree’s \nassessment is reached in error, must be reassessed. See Question 11. 1.10. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 917}), Document(page\_content='Leases 917 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 11.1.40 \nDifferent acquirer and acquiree transition elections \nShould an acquirer conform the acquiree’s transition \nelections to its own in its business combination accounting? \nBackground: Assume an acquirer and acquiree made different transition \nelections when adopting Topic 842. For example, the acquiree elected the \ntransition package of practical expedients and the land easement practical \nexpedient (see section 13A.2 or section 13B.2), while the acquirer did not elect \neither . \nConsequently, the acquiree has: \n— leases classified as operating leases that would have been classified as \nfinance (lessee) or sales -type (lessor) leases had they been reassessed \nunder Topic 842; \n— contracts accounted for as leases that would not have met the Topic 842 \ndefinition of a lease, and vice versa; and \n— land easements not accounted for as leases that would have met the \ndefinition of a lease under Topic 842. \nIn this example, is the acquirer required to reassess: \n— what the lease classification of the acquiree would have been had the \nacquiree not elected the transition package of practical expedients to \nclassify the acquired leases post -acquisition? \n— whether contracts acquired from the acquiree would have met the Topic \n842 definition of a lease if they had been reassessed o n adoption by the \nacquiree? \n— whether land easements acquired from the acquiree would have met the \nTopic 842 definition of a lease if assessed as part of the acquiree’s \nadoption? \nInterpretive response: No. Accounting policies applicable to assets acquired \nand liabilities assumed from an acquiree generally should be conformed to \nthose of the acquirer after a business combination (see chapter 7 of KPMG \nHandbook, Business combinations ). However, we believe this applies only to \nongoing accounting policies, and that an acquiree’s valid, one- time transition \nelections when adopting Topic 842 are not accounti ng policies of the acquiree \nthat must be conformed to those of the acquirer. \nUnless the related contracts are modified in connection with the business \ncombination (and the modification is not accounted for as a separate contract) \nor the acquiree’s conclus ions were reached in error , in the background example \nthis means the acquirer retains : \n— the acquiree’s lease classification for identified leases; and \n— the acquiree’s lease identification conclusions, including those for its land \neasements. \nNotwithstanding this interpretive response, we do not believe there is guidance \nin Topic 842, Topic 805 or elsewhere in US GAAP that would prohibit an \nacquirer from treating the acquiree’s transition elections as accounting policies \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 918}), Document(page\_content='Leases 918 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. to conform to its own. An acquirer’s dec ision in this regard should be applied \nconsistently. \n \n Question 11.1.50 \nReassessment of lease identification – only the \nacquirer has adopted Topic 842 \nDoes the acquirer need to reassess the acquiree’s contracts \nfor lease identification if the acquirer ha s adopted Topic 842 \nbefore the acquisition date, but the acquiree has not? \nBackground: Assume an acquirer adopted Topic 842 on January 1, 20X1, while \nthe acquiree ha d not yet adopted Topic 842 on the October 1, 20X1 business \ncombination date – e.g. because the acquiree wa s a private company. \nTherefore, all of the acquiree’s pre- acquisition lease identification conclusions \nwere reached under Topic 840, which may differ from those that would have \nbeen reached under Topic 842. \nThe question arises about whether the acquirer must reassess the acquiree’s \nlease identification conclusions based on the Topic 842 definition of a lease. \nInterpretive response: We believe that the extent to which the acquirer needs \nto reassess the acquiree’s Topic 840 lease identification conclusions (assuming \nneither of the circumstances in Question 11.1.10 – changed terms and \nconditions or acquiree error – are present) depends on whether the acquiree \nearly adopts Topic 842 before the acquisition occurs. \nAcquiree does not early adopt Topic 842 \nIf the acquiree does not early adopt Topic 842 before the acquisition occurs, we believe the acquiree’s accounting under Topic 840 is akin to a situation where \nthe acquiree’s accounting is under IFRS Accounting Standards or other GAAP \nthat is not US GAAP (see Question 11.1.25). \nTherefore, under this view, which treats Topic 840 as akin to IFRS Accounting \nStandards or other local GAAP, the acquirer reassesses all of the acquiree’s \ncontracts for lease identification using the Topic 842 definition of a lease as of \nthe date that the acquiree would have undertaken that assessment had it \nadopted Topic 842 at the same date as the acquirer . \nAcquiree early adopts Topic 842 \nTopic 842 permits early adoption (see sections 13A.1 and 13B. 1). Therefore, the \nacquiree could have early adopted Topic 842 immediately before the acquisition \ncloses, with retrospective effect to the beginning of its current fiscal year . \nUsing the acquiree in the background example, and assuming the acquiree has \na calendar fiscal year, it could have early adopted Topic 842 immediately before \nthe acquisition closes on October 1, 20X1, effect ive to the beginning of its \ncurrent fiscal year (January 1, 20X1). \n[842- 10-65-1(b), 250- 10-45-14] \nThe acquiree’s transition elect ions, which we believe the acquiree can make \nindependent of what the acquirer chose for its own adoption (see Question \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 919}), Document(page\_content='Leases 919 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 11.1. 40), affect which contracts the acquirer must reassess for lease \nidentification. \n— If the transition package of practical expedients i s elected (and the land \neasements practical expedient, if applicable), acquiree contracts entered \ninto or modified (and not meeting the Topic 842 criteria to be accounted for \nas separate contract s) on or after January 1, 20X1 (acquiree’s early adoption \neffective date) would have been assessed for lease identification using the \nTopic 842 definition of a lease. Consequently, those contracts are \nreassessed in accounting for the acquisition because the acquiree had only \nassessed them under Topic 840. None of the other existing contracts of the \nacquiree need to be reassessed. \n— If neither the transition package of practical expedients nor the land \neasements practical expedient (if applicable ) is elected , all of the acquiree’s \ncontracts are subject to lease identifi cation reassessment using the Topic \n842 definition of a lease. This is because the acquiree would have been \nrequired to do so as part of its Topic 842 adoption. \nWe do not believe this approach is limited only to acquirees that made a formal \nelection to ea rly adopt before the acquisition date. Acquirees may have had no \ninterim financial reporting or other requirement to make such an election in that timeframe. Instead, we believe this approach can be elected after the \nacquisition date. However, regardless of when it is elected – i.e. before the \nacquisition date or after the acquisition has closed – the acquirer must follow \nthrough on all associated effects of the early adoption. This include s, but is not \nlimited to : \n— reflecting such adoption in any stand -alone acquiree financial statements \nissued on or after the acquisition date; and \n— making necessary disclosures about the acquiree’s election in the \nacquirer’s post -acquisition financial statements or other SEC filings. \n \n Example 11.1.10 \nReassessing l ease identification \nScenario 1: Acquirer and acquiree both adopted Topic 842 before the \nacquisition date (same adoption date) \nCompany AR acquires Lessee LE in a business combination. LE has eight \nexisting contracts (A –H). LE identified Contracts A –F as being leases, and \ncontracts G and H as not containing a lease. The following facts are relevant to \nAR’s evaluation about which contracts should be reassessed as to lease \nidentification . \n— The terms and conditions of Contracts A–E are not changed in connection \nwith the acquisition other than to change the named lessee from LE to AR. \n— The terms and conditions of Contracts F –H are changed in connection with \nthe acquisition. \n— AR determines that LE’s lease identification conclusions for contracts A –H \nare appropriate. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 920}), Document(page\_content='Leases 920 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. AR’s conclusions about which contracts need to be reassessed as to lease \nidentification are as follows. \nContract Reassessment evaluation \nA–E No reassessment of lease identification occurs. Changing the named \nlessee from LE to AR is not a change to the terms and conditions of the \ncontract. \nAdditionally, AR has determined that LE’s lease identification \nconclusions for these contracts a re appropriate. \nF–H AR reassesses whether these contracts are or contain a lease based on \n(1) the changed terms and conditions of the contracts, and (2) facts and \ncircumstances as of the acquisition date. \nScenario 2: Acquirer and acquiree both adopted Topic 842 before the \nacquisition date (different adoption dates) \nThe facts are the same as Scenario 1, except that Company AR and Lessee LE \nadopted Topic 842 on January 1, 20X1 and July 1, 20X1, respectively. Each \nelected the transition package of practical expedients. The acquisition closes on \nOctober 1, 20X1. In addition: \n— Contract s A and B were entered into in January 20X0. \n— Contracts C and D were entered into in February 20X1. \n— Contract E was entered into in May 20X0, and modified in April 20X1. The \nmodification did not add additional goods or services (including any rights to \nuse a dditional assets) to the contract, and therefore would not have \nqualified as a separate contract under Topic 842. \n— None of contracts A –H are reassessed by LE under Topic 842 between \nLE’s adoption date and the acquisition date. \nAR elects View 1 to Question 11.1.30 \nAR’s conclusions about which contracts should be reassessed as to lease \nidentification are the same as in Scenario 1. \nAR elects View 2 to Question 11.1.30 \nAR’s conclusions about which contracts need to be reassessed as to lease identification are as follows. \nContract Reassessment evaluation \nA–B No reassessment of lease identification occurs. Changing the named \nlessee from LE to AR is not a change to the terms and conditions of the \ncontract. \nAdditionally, AR has determined that LE’s lease identification \nconclusions for these contracts a re appropriate. \nC–D AR reassesses whether these contracts are or contain a lease using the \nTopic 842 definition of a lease and based on LE’s facts and circumstances as of their February 20X1 contract inception dates. \nAR does not reassess these contracts as of the acquisition date \nbecause their terms and conditions are not changed in connection with \nthe acquisition. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 921}), Document(page\_content='Leases 921 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Contract Reassessment evaluation \nE AR reassesses whether this contract is or contains a lease using the \nTopic 842 definition of a lease and based on LE’s facts and \ncircumstances as of the April 20X1 modification date at which AR would \nhave reassessed this contract using the Topic 842 lease definition. \nAR does not reassess this contract as of the acquisition date because its terms and conditions are not changed in connection with the \nacquisition. \nF–H AR reassesses whether these contracts are or contain a lease based on \n(1) the changed terms and conditions of the contracts, and (2) facts and circumstances as of the acquisition date. \nScenario 3: Acquirer adopted Topic 842 before the acquisition date, but \nAcquiree did not \nThe facts are the same as Scenario 2, except that LE would have adopted Topic \n842 (absent the acquisition) on January 1, 20X3. LE is a calendar year -end \nreporting company. \nLE does not early adopt Topic 842 before the acquisition occurs \nAR will reassess whether Contracts A –H are or contain leases in accounting for \nthe business combination. Because LE does not early adopt Topi c 842, AR \naccounts for the acquired contracts, including assessing whether those \ncontracts are or contain leases, in the same manner as it would if LE reported \nits financial statements pre -acquisition under a different basis of accounting \n(e.g. IFRS Accounting Standa rds). \nLE early adopts Topic 842 concurrent with the acquisition \nLE early adopts Topic 842 as of the October 1, 20X1 acquisition date, \nretroactive to the beginning of LE’s current fiscal year (January 1, 20X1). LE \nelects the transition package of practical expedients for its adoption. \nBased on this, and the facts and circumstances stipulated in the previous \nscenarios, AR’s conclusions about which contracts need to be reassessed as to \nlease identification are as follows. \nContract Reassessment evaluation \nA–B No reassessment of lease identification occurs for these contracts. \n— Changing the named lessee from LE to AR is not a change to the \nterms and conditions of the contract. Therefore, these contracts’ \nterms and conditions are not changed in connection wit h the \nacquisition. \n— LE elected the transition package of practical expedients, which means it does not need to reassess contracts entered into before, \nand not modified on or after, January 1, 20X1. \n— AR has determined that LE’s lease conclusions for these co ntracts \nare appropriate. \nC–D These contracts are reassessed as to whether they are or contain a \nlease using the Topic 842 definition of a lease and based on LE’s facts \nand circumstances as of their February 20X1 contract inception dates. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 922}), Document(page\_content='Leases 922 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Contract Reassessment evaluation \nThese contracts are not reassessed as of the acquisition date because \ntheir terms and conditions are not changed in connection with the \nacquisition. \nE This contract is reassessed as to whether it is or contains a lease using \nthe Topic 842 definition of a lease and based on LE’s facts and \ncircumstances as of the April 20X1 modification date. This is because \nLE’s early adoption, retroactive to January 1, 20X1, means LE should \nhave assessed this contract on that date using the Topic 842 lease \ndefinition. \nThis contr act is not reassessed as of the acquisition date because its \nterms and conditions are not changed in connection with the \nacquisition. \nF–H AR reassesses whether these contracts are or contain a lease based on \n(1) the changed terms and conditions of the contracts, and (2) facts and \ncircumstances as of the acquisition date. \n \n \n11.1.2 Lease classification \n \n Question 11.1. 60 \nReassessment of l ease classification – lease is \nmodified in a business combination \nIs the acquiree’s lease classification reassessed when there is \na lease modification in connection with a business \ncombination? \nBackground : A lease modification is a change to the terms and conditions of a \ncontract that results in a change in the scope of or the consideration for a lease. \n[842 Glossary] \nInterpretive response: Yes. The classification of an acquired lease is \nreassessed if there is a lease modification enacted as part of the business \ncombination (or acquisition of a not -for-profit entity) and that modification is not \naccounted for as a separate contract. [842- 10-55-11] \nChanges to a lease agreement t hat are not lease modifications \nA lease agreement may be modified to reflect a change in the identity of one of \nthe parties to the agreement (novat ion) as a result of the business combination. \nSuch amendments are not ‘lease modifications ’ (as defined in Topic 842) \nbecause they do not change the scope of, or consideration for, the lease. \nTherefore, lease classification is not reassessed. \nAnticipated lease modifications \nAn acquirer also does not reassess the classification of an acquired lease in \ncontemplation of a lease modification – i.e. even if the acquirer has a clear \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 923}), Document(page\_content='Leases 923 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. intent to modify the acquired lease, this does not alter its acquisi tion-date \nclassification. The acquirer will reassess the lease’s classification on the \neffective date of the modification. [842- 10-55-11] \n \n Question 11.1. 70 \nAcquiree’s lease classification retained from Topic \n840 \nDoes the acquirer retain the acquiree’s lease classification if it \nwas determined by the lessee under Topic 840 and retained via the transition package of practical expedients in adopting Topic 842? \nBackground: If an acquiree (lessee or lessor) elected the package of transition \npractical expedients in adopting Topic 842 (see sections 13A.2.3 and 13B.2.3), \nits classification for leases that commenced before the effective date of Topic \n842 will be based on the classification guidance in Topic 840 (unless the \nclassification has been reassessed in accordance with Topic 842 after the effective date). \nIf a business combination, acquisition of a not -for-profit entity or an asset \nacquisition occurs on or after the effective date, a question arises about whether lease classification should be reassessed under Topic 842. \nQuestion 11.1.75 addresses reassessing lease classification if the acquiree has not yet adopted Topic 842. \nInterpretive response: Yes, the acquiree’s lease classification should be \nretained, unless t he following applies. \n— It is a business combination or acquisition of a not -for-profit entity and the \nlease is modified as part of the acquisition (and that modification is not \naccounted for as a separate contract) ; see Question 11.1.60 . \n[842- 10-55-11] \n— It is an asset acquisition and one of the specific reassessment \ncircumstances outlined in Question 11.1.90 occurs in connection with the \nasset acquisition. \n \n \nQuestion 11.1.75 \nReassessment of lease classification – only the \nacquirer has adopted T opic 842 \nDoes the acquirer need to reassess the acquiree’s lease \nclassification if the acquirer has adopted Topic 842 before the acquisition date, but the acquiree has not? \nBackground: Assume an acquirer adopted Topic 842 on January 1, 20X1, while \nthe acquiree had not yet adopted Topic 842 on the October 1, 20X1 business \ncombination date – e.g. because it was a private company. Therefore, all of the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 924}), Document(page\_content='Leases 924 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. acquiree’s pre -acquisition lease classification conclusions were reached under \nTopic 840, which may differ from those that would have been reached under \nTopic 842. \nThe question arises about whether the acquirer must reassess the acquiree’s \nlease classification conclusions using the Topic 842 classification criteria. \nInterpretive response: \nAcquiree does not early adopt Topic 842 \nIf the acquiree does not early adopt Topic 842 before the acquisition occurs, we \nbelieve the acquiree’s accounting under Topic 840 is like a situation in which \nthe acquiree’s accounting is under IFRS Accounting Standards or other GAAP \nthat is not US GAAP (see Question 11.1.95). \nWe do not believe the business combination classification reassessment \nexemption in paragraph 842- 10-55-11 applies when the acquiree’s lease \nclassification was determined under Topic 840 (other than as described in \nQuestion 11.1.70). This is because that paragraph expressly refers to retaining \nthe previous lease classification ‘in accordance with this Subtopic’; lease \nclassification determined under Topic 840 is not in accordance with Subtopic \n842-10. \nUnder this view, which treats Topic 840 like IFRS Accounting Standards or \nother local GAAP, the acquirer reassesses all of the acquiree’s lease \nclassification conclusions using the Topic 842 classification criteria as of th e \ndate that the acquiree would have undertaken that assessment had it adopted \nTopic 842 at the same date as the acquirer. \nAcquiree early adopts Topic 842 \nTopic 842 permits early adoption (see sections 13A.1 and 13B.1). Therefore, the \nacquiree could have ea rly adopted Topic 842 immediately before the acquisition \ncloses, with retrospective effect to the beginning of its current fiscal year . \nUsing the acquiree in the background example, and assuming the acquiree has \na calendar fiscal year, it could have early adopted Topic 842 immediately before \nthe acquisition closes on October 1, 20X1, effective from the beginning of its \ncurrent fiscal year (January 1, 20X1). [842- 10-65-1(b), 250- 10-45-14] \nThe acquiree’s transition elections, which we believe the acquiree can make \nindependent of what the acquirer chose for its own adoption (see Question \n11.1.40), affect whether the acquirer must reassess the acquiree’s lease \nclassification conclusions. \n— If the transition package of practical expedients is elected by the acquiree, it \nwould have conducted a lease classification assessment of its leases \nentered into or modified (and not meeting the Topic 842 cri teria to be \naccounted for as separate contracts) on or after January 1, 20X1 (acquiree’s early adoption effective date) using the Topic 842 classification criteria. \nConsequently, those contracts are reassessed in accounting for the \nacquisition because the acquiree had assessed them only under Topic 840. \nThe acquirer does not need to reassess lease classification for leases that \ncommenced before January 1, 20X1. \n— If the transition package of practical expedients is not elected, all of the \nacquiree’s leases a re subject to classification reassessment using the Topic ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 925}), Document(page\_content='Leases 925 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 842 classification criteria. This is because the acquiree would have been \nrequired to do so as part of its Topic 842 adoption. \nWe do not believe this approach is limited only to acquirees that made a formal \nelection to early adopt before the acquisition date. Acquirees may have had no interim financial reporting or other requirement to make such an election in that \ntimeframe. Instead, we believe this approach can be elected after the \nacquisition dat e. However, regardless of when it is elected – i.e. before or after \nthe acquisition date – the acquirer must follow through on all associated effects \nof the early adoption. This includes, but is not limited to: \n— reflecting such adoption in any stand- alone a cquiree financial statements \nissued on or after the acquisition date; and \n— making necessary disclosures about the acquiree’s election in the \nacquirer’s post -acquisition financial statements or other SEC filings. \n \n \nQuestion 11.1. 80 \nReassessment of l ease classification – acquirer’s \nassessment of lease term or purchase option is \ndifferent from acquiree’s in a business combination \nIs the acquiree’s lease classification reassessed when the \nacquirer’s assessment of the lease term or a lessee purchase \noption is different from the acquiree’s pre -acquisition \nassessment in a business combination? \nInterpretive response: No. The fact that the acquirer’s assessment of the \nlease term or the likelihood of purchase option exercise by the lessee is \ndifferent from th e acquiree’s is not in itself a lease classification reassessment \nevent in a business combination. [842- 10-25-1, 55-11] \nIn contrast, in an asset acquisition, this would require reassessment of the \nlease classification if the acquiree was the lessee in the lease (see \nQuestion 11.1. 90). \n \n Question 11.1. 90 \nReassessment of lease classification – lease is \nacquired in an asset acquisition \nIs the classification of an existing lease reassessed when the \nlease is acquired in an asset acquisition? \nInterpretive response: It depends. This is because under Topic 842 the \nclassification of a lease is reassessed only in specific circumstances. These are \nwhen there is a: [842- 10-25-1] \n— lease modification not accounted for as a separate contract (all entitie s); \n— change in the lease term ( lessees only ); or \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 926}), Document(page\_content='Leases 926 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — change in the assessment of whether a lessee is reasonably certain to \nexercise a purchase option ( lessees only ). \nAbsent one of these, lease classification is not reassessed. Therefore, \nacquisition of the leas e alone would not result in reassessing lease \nclassification. One of the above would have to occur in connection with the \nasset acquisition for lease classification to be reassessed, such as if: \n— the lease were modified in connection with the acquisition; or \n— the acquiree was the lessee in the acquired lease, and the acquirer, in \nmeasuring the lease liability and ROU asset in accordance with \nparagraph 805-20-30-24, reaches a different assessment of the lease term \nthan that of the acquiree immediately before the acquisition date. \nThe definition of ‘lease modification’ should be considered when deciding \nwhether a lease is modified in connection with an acquisition. Topic 842 defines \na lease modification as “a change in the terms and conditions that results in a \nchange in the scope of or the consideration for a lease.” Therefore, if the only \nchange to the lease agreement involves replacing the name of one of the \nparties to the lease with the name of the acquirer, no lease modification has \noccurred. [842 Glossary ] \nQuestion 11.1.20 addresses situations where the acquiree’s lease classification \nis not known. \n \n Question 11.1.95 \nReassessment of lease classification – acquiree’s \nassessment not made under US GAAP \nShould the acquirer reassess the acquiree’s lease \nclassification conclusions if they were not reached under US GAAP? \nBackground: Paragraph 11.1.10 (Note 1) and Question 11.1.90 address when \nan acquirer should reassess the classification of an acquired lease in a business \ncombination and asset acquisition, respectively. \nThis question addresses whether those same conclusions apply if the acquiree \nclassified the lease on the basis of other GAAP (e.g. IFRS Accounting Standards \nor GASB standards). \nInterpretive response: Yes. When an acquiree’s accounting pre- acquisition is \nnot under US GAAP, the acquirer must convert it to US GAAP. Regardless of \nwhether the transaction is a business combination or an asset acquisition, this \nincludes reassessing, using the Topic 842 classifica tion criteria, lease \nclassification conclusions reached by the acquiree under other GAAP. \nWe do not believe paragraph 842- 10-55-11 applies when the acquiree’s lease \nclassification was determined under other GAAP. This is because that paragraph expressly r efers to retaining the previous lease classification ‘in \naccordance with this Subtopic’; lease classification determined under other GAAP is not in accordance with Subtopic 842- 10. In addition, retaining previous \nlease classification would be meaningless i f the other GAAP did not include a \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 927}), Document(page\_content='Leases 927 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. requirement to classify leases (e.g. IFRS 16 does not permit or require \nclassification of leases by lessees). \nWhen this occurs, the acquirer will need to determine what the acquiree’s pre-\nacquisition lease classification would have been under Topic 842 based on the \nacquiree’s business and the facts and circumstances as of the date the \nacquiree would have undertaken that assessment \n \n11.1.3 Acquisition date recognition and measurement \n \n Observation \nMeasurement of lease assets and lease liabilities is \nnot at fair value \n11.1. 30 The business combinations guidance generally requires all assets \nacquired and liabilities assumed to be measured at fair value as of the \nacquisition date. However, the Board concluded that r equiring acquirers to \nmeasure lease assets and lease liabilities at fair value was not justifiable from a \ncost-benefit perspective. This is because of the likely difficulties and cost of \nobtaining reliable fair value measurements for those items, particula rly ROU \nassets. [ASU 2016 -02.BC416 –BC417] \n11.1. 40 However, the Board believe d that the measurement requirements for \nacquired lease assets and lease liabilities will, at least in many cases, \nreasonably approximate fair value. For example, the Board observed that, for \nlessors, the acquisition -date net investment in the lease measured under \nTopic 805 (as amended) will generally equal the acquisition- date fair value of \nthe underlying asset; for lessees, the net carrying amount of the ROU asset and \nthe lease liability recognized by the acquirer will generally approximate the fair \nvalue of the lease. [ASU 2016- 02.BC416– BC417] \nPrepaid or accrued rent \n11.1.50 Prepaid or accrued rent (of lessees or lessors) is not recognized in the \nacquisition accounting because those amounts do not meet the definition of an \nasset or a liability. Instead, th e remaining lease payments affect whether the \nlease, as of the acquisition date, is at market terms. This means that if the lease payments are significantly front - or back -loaded, at the acquisition date this may \nresult in a conclusion that the terms and c onditions of the lease are off -market – \ne.g. because the remaining lease payments may be significantly less than or \ngreater than the lease payments would be for a new lease with a term equal to the remaining lease term at the acquisition date. \n[ASU 2016- 02.BC415] \nVariable lease payments \n11.1.60 Variable lease payments that do not depend on an index or rate (e.g. \nbased on a percentage of estimated future sales) are not recognized outside of \na business combination until the obligation for those payments is incurred \n(lessees , see paragraph 6.4.200) or the payments are earned (lessors) . \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 928}), Document(page\_content='Leases 928 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. However, the existence of variable lease payments for a lease may affect the \ndetermination of whether the terms of the lease are favorable or unfavorable. \n— For the lessee, the favorability or unfavorability arising from the variable \nlease payments will affect the measurement of the acquired ROU asset. \n— For the lessor, the favorability or unfavorability arising from the variable \nlease payments wil l affect the (1) measurement of the intangible favorable \nlease asset or unfavorable lease liability in an operating lease, or (2) fair \nvalue of the underlying asset in a sales -type or direct financing lease. \nShort -term leases – practical expedient for lessees \nonly \n11.1.70 An acquirer may elect, as an accounting policy (by class of underlying \nasset), not to recognize ROU assets or lease liabilities for leases that, at the \nacquisition date, have a remaining lease term of 12 months or less. In that case, \nthe acquirer does not recognize any asset or liability for favorable or unfavorable \nterms relative to market. [805- 20-25-28B] \n11.1.80 This election applies to all of an acquirer’s acquisitions – i.e. it cannot be \napplied to select leases that meet the criterion, or to select acquisitions. This \npolicy election is independent of the lessee’s election of the short -term lease \nrecognition and measurement exemption (see section 6.3.1). In other words, an \nentity can elect this practical expedient for all short -term leases acquired in \nacquisition s while not electing the lessee short -term lease exemption for its \nown leases , or vice v ersa. [805- 20-25-28B] \n \n Question 11.1.100 \nIncremental borrowing rate to use when measuring \nan acquired lease – implicit rate not readily \ndeterminable \nIs the discount rate for an acquired lease the incremental \nborrowing rate of the acquirer or of the acquiree when the \nimplicit rate is not readily determinable ? \nBackground: For leases in which the acquiree is a lessee, the acquirer \nmeasures the lease liability at the present value of the remaining lease \npayments, as if the acquired lease were a new lease of the acquirer at the \nacquisition date. [805- 20-30-24] \nBecause of the italicized language, the question has arisen about whether this \nmeans the acquirer should, when the rate implicit in the lease is not readily \ndeterminable, always use its incremental borrowing rate when measuring the \nacquired lease liability ; or whether, in some cases, the incremental borrowing \nrate should continue to be that of the acquiree – e.g. when the acquiree \nremains the legal counterparty to the lease. \nInterpretive response: We believe the key language in the measurement \nguidance outlined in the background is ‘as if the acquired lease were a new \nlease’. We believe this language makes it clear that the acquirer does not retain \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 929}), Document(page\_content='Leases 929 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the acquiree’s pre- acquisition discount rate for the lease because a new lease is \nmeasured using an updated discount rate (i.e. as of the commencement date) . \nHowever, we also do not believe this language, or the italicized language in the \nbackground, automatically means the acquirer will use its own, parent/group \nincremental borrowing rate as the discount rate for the acquired lease. \nInstead, we believe the facts and circumstances will determine whether the \ndiscount rate for the acquired lease should be either: \n— the acquirer’s incremental borrowing rate; or \n— the acquiree’s incremental borrowing rate, reassessed as of the acquisition \ndate and taking into account the acquiree’s current credit characteristics \nand credit standing as part of the acquirer ’s consolidated group. \nIf the acquirer becomes the legal counterparty to the lease (e.g. through a \ncontract modification or a permitted /required assignment of the lease to the \nacquirer), we believe it sh ould use its own incremental borrowing rate, just as it \nwould for a new lease to which it is the legal counterparty. \nIn contrast, if the acquiree remains the legal counterparty to the lease (e.g. a s a \nsubsidiary of the acquirer) , we believe the question about which of the above \nborrowing rates to use is fundamentally no different from the question about \nwhether to use the parent or the subsidiary’s incremental borrowing rate to \nmeasure a new lease e ntered into by a subsidiary. Consequently, we believe \nthe same considerations outlined in Question 5.6.50 generally apply. \n \n Question 11.1. 110 \nIn-place leases \nDoes an in- place lease at the acquisition date create an \nintangible asset for the acquirer? \nBackground : An acquirer may identify value associated with leases in place at \nthe acquisition date. Value related to in- place leases may reflect, for example, \nthe value associated with avoiding the costs of originating the acquired in- place \nleases, as well as the value associated with the avoidance of holding costs that \nwould be incurred if an asset intended to be leased was acquired without a lessee. Origination costs comprise the costs to execute similar leases, including \nmarketing costs, leasing commissions, legal and other related costs. \nInterpretive response: Neither Topic 842 nor Topic 805 (either before or as \namended by ASU 2016- 02) explicitly address the recognition of in- place lease \nintangible assets. And while we acknowledge that there is an alternat ive view \nthat a separate intangible asset for in- place leases should not be recognized \nby an acquirer i n a business combination, consistent with our view under \nTopic 840 and Topic 805 before ASU 2016- 02, we believe an acquirer should \nseparately measure an intangible asset for in- place leases on a lease -by-lease \nbasis; see chapter 7 of KPMG Handbook, Business combinations . \nThe intangible asset recognized in accordance with Topic 805 (as amended) for \nan in -place lease should be recognized and reported separately in the financial \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 930}), Document(page\_content='Leases 930 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. statements. We do not believe that i t should be combined with the acquired \nlease assets (i.e. lessee ROU assets, or lessor lease receivables and \nunguaranteed residual assets), or with other lease- related intangibles (e.g. \nfavorable lease assets or unfavorable lease liabilities of operating lessors). \n \n Question 11.1. 120 \nSubleases of an acquiree \nHow sh ould an acquirer consider favorable or unfavorable \nsublease terms of an acquired lease? \nInterpretive response: An acquiree may be party to a sublease agreement. \nFor example, a sublease exists when the acquiree, as the original lessee \nunder a lease, subleases some or all of its right to use the underlying asset to a \nthird party. \nFavorable or unfavorable terms of the head lease will affect the measurement \nof the head lease ROU asset just as they would if there were no sublease. \nMeanwhile, favorable or unfavorable terms of the sublease result in the acquirer \nseparately recognizing an intangible favorable sublease asset or unfavorable \nsublease liability. The acquirer does not net any off -market terms in the head \nlease against any off -market terms in the subleas e. \n \n Question 11.1. 130 \nPreexisting lease relationship \nHow should the acquirer account for a preexisting lease \nbetween the acquirer and the acquiree at the acquisition \ndate? \nInterpretive response: An acquirer may have a preexisting lease with the \nacquiree, either as the lessee in that arrangement or as the lessor. \nRegardless of whether there are noncontrolling interests after the acquisition, at \nthe acquisition date, the lease becomes an intercompany lease and is \neffectively settled. This means the acquirer will not recognize any lease assets \nor lease liabilities related to the preexisting lease. Instead, the acquirer accounts for the settlement separately from the business combination, recogniz ing a gain \nor loss on the settlement of the lease in an amount equal to the lesser of : \n[805- 10-55-21(b)] \n— the amount by which the lease is favorable or unfavorable from the perspective of the acquirer relative to market terms ; and\n \n— the amount of any stated sett lement provisions in the lease available to the \ncounterparty for whom the contract is unfavorable. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 931}), Document(page\_content='Leases 931 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. In addition, the acquirer derecognizes any previously recognized assets or \nliabilities related to the lease as part of the effective settlement of the \narrang ement. The carrying amounts of any recognized assets or liabilities adjust \nthe amount of the gain or loss recognized for the settlement of the preexisting relationship, as illustrated in Example 3 in Section 805 -10-55. See also \nparagraph 11.011 and Example 11.3 in KPMG Handbook, Business \ncombinations\n. [805- 10-55-33] \n \n Question 11.1. 140 \nFavorability or unfavorability associated with a \nrenewal option \nHow should an acquirer account for favorability or \nunfavorability associated with a renewal option in an acquired lease? \nInterpretive response: \nAcquiree is the lessee \nA renewal period that is part of the lease term factors into the assessment of \nwhether the acquired lease is at favorable or unfavorable terms. Therefore, the \nfavorability or unfavorability of a renewal option (including an option not to \nterminate the leas e) that is reasonably certain to be exercised by the lessee, or \nthat the lessor can require the lessee to exercise, is considered in measuring \nthe acquired ROU asset. \nWhen a renewal period is not part of the lease term , we believe the treatment \nof the renewal option generally depends on whether it is favorable or \nunfavorable to the lessee. \n— A favorable renewal option factor s into the measurement of the acquired \nROU asset. \n— An unfavorable renewal option does not affect the measurement of the \nROU asset unless an unrelated third party can force its exercise because a \nlessee would not be expected to exercise an unfavorable option. \nAcquiree is the lessor \nThe favorability or unfavorability of an option for a renewal period that is part of the lease term affects eit her: \n— the measurement of any favorable lease asset or unfavorable lease liability recognized by the acquirer if the acquired lease is an operating lease; or \n— the mea surement of the lease receivable and the unguaranteed residual \nasset (see Question 11.1.80) . \nWhen a renewal period is not part of the lease term , we believe the treatment \nof the renewal option depends on whether it is favorable or unfavorable to \nthe lessor. \n— A favorable renewal option (i.e. unfavorable to the lessee) is generally \nascribed no value in acquisition accounting, unless there are unusual \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 932}), Document(page\_content="Leases 932 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. circumstances that indicate the lessee is likely to exercise the option \nanyway, in which case the option would create an asset for the acquirer . \n— An unfavorable renewal option (i.e. favorable to the lessee) generally \ncreate s a liability for the acquirer. \n \n Question 11.1. 150 \nLease classification impact on the measurement of \nunderlying assets \nWhen the acquiree is the lessor, does the lease classification \naffect the measurement of the underlying asset's fair value in \nacquisition accounting? \nInterpretive response: Yes. When the acquiree is the lessor, the terms and \nconditions of the lease affect the acquisition accounting differently depending \non the lease classificati on. [805- 20-30-25] \nTerms and conditions of a lease (acquiree is the \nlessor )\nOperating leaseSales -type or direct \nfinancing lease\nOff-market terms and \nconditions result in a \nseparate asset or liabilityOff-market terms affect fair \nvalue of underlying asset \nin measuring the lease \nassets (components of the \nnet investment in the \nlease ) \nThis difference means that acquirers of lessors will measure the fair value of \nthe underlying asset differently depending on the classification of the lease to \nwhich the underlying asset relates. Question 11.1. 160 discusses how off -\nmarket terms affect lessors’ accounting for acquired sales -type and direct \nfinancing leases. \nWe believe t he Board’s decisions in this regard principally stem from its desire \nto retain Topic 840 lessor accounting in most respects. Under Topic 840, \nacquirers generally already consider lease terms and conditions in valuing lessor \nlease assets for acquired sales- type or direct financing leases and recognize \nfavorable (unfavorable) assets (liabilities) for acquired operating leases. \n \n", metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 933}), Document(page\_content='Leases 933 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 11.1. 160 \nHow off -market lease terms affect the fair value of \nthe underlying asset in sales -type and direct \nfinancing leases – lessors \nHow do off -market terms affect the fair value of the \nunderlying asset in lessors’ accounting for acquired sales -type \nand direct financing leases? \nBackground: At the acquisition date, an acquirer lessor recognizes a lease \nreceivable and an unguaranteed residual asset. Paragraph 11.1.10 outlines how \nthose amounts, totaling to the net investment in the a cquired lease, are \ncalculated, noting that: [805- 20-30-25] \n— the fair value of the underlying asset as of the acquisition date is a key input to \nthe measurement of the newly acquired net investment in the lease and its components, the lease receivable and the unguaranteed residual asset; and \n— the fair value of the underlying asset is affected by the terms and \nconditions of the acquired lease. \nNeither Topic 805 nor Topic 842 explain or illustrate how to factor the terms and \nconditions of the acquired lease into the fair value of the underlying asset. \nFor context, consider a scenario in which Company AR acquires Lessor LR. \nLR has an existing lease with a customer for a long- lived equipment asset. \nThe lease is classified as a sales- type lease by LR and lease classification is \nnot reassessed by AR; see Note 1 to the table in paragraph 11.1.10 and \nQuestion 11.1. 90. At the acquisition date, the lease pricing is above market (i.e. \nfavorable) or below market (i.e. unfavorable) to AR compared to market terms. \nInterpretiv e response: The favorability or unfavorability of an acquired sales -\ntype or direct financing lease results in an adjustment to the estimated fair \nvalue of the underlying asset, and consequently affects the measurement of \nthe net investment in the lease (and its components, the lease receivable and \nthe unguaranteed residual asset). This is in contrast to an operating lease, \nwhere off -market terms result in separate recognition of a favorable lease asset \nor unfavorable lease liability. \nThis approach for acqui red sales -type or direct financing leases means that the \nacquisition -date fair value of the acquired underlying asset will be higher or \nlower than the fair value of an equivalent asset sold in an orderly transaction \nbetween market participants; the differe nce is the amount by which the lease is \noff-market. The amount of that adjustment is calculated in the same manner as \nfavorability/unfavorability is calculated for an operating lease. \nAdjusting the fair value of the underlying asset affects the acquisition date \nmeasurement of the acquired lease receivable and acquired unguaranteed \nresidual asset. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 934}), Document(page\_content='Leases 934 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Measuring the net investment in the lease and its components \nLease receivable \nThe undiscounted lease payments and guaranteed residual value are measured \nat the acq uisition date in the same manner as if the acquired lease were a new \nlease. However, the adjustment to the fair value of the underlying asset (for the \noff-market terms) results in a rate implicit in the lease that differs from what it \nwould be if the lease were priced at market. This is because the implicit rate \ndepends on the fair value of the underlying asset (see section 5.6.1). \nConsequently, the measurement of the lease receivable, which is discounted at \nthe rate implicit in the lease, differs from wha t it would be if the lease were \npriced at market. \nUnguaranteed residual asset \nThe acquisition- date unguaranteed residual asset is affected by the fair value of \nthe underlying asset because, as outlined in the table in paragraph 11.1.10, it is \nmeasured as the difference between the fair value of the underlying asset and the lease receivable. \nNet investment in the lease \nThe acquisition date net investment in the lease equals the sum of the \nacquisition date: \n— lease receivable; and \n— unguaranteed resi dual asset. \nTherefore, because the measurement of those items is affected by the off -\nmarket adjustment to the fair value of the underlying asset, so is the \nmeasurement of the net investment in the lease. \nPutting it all together \nOff-market terms of an acqui red sales -type or direct financing lease will result in \nthe following acquisition -date accounting process for the acquirer related to that \nlease. \n— Step 1 : Determine the fair value of the underlying asset without \nconsideration of the off -market terms of the acquired lease. \n— Step 2 : Calculate the off -market adjustment. \n— Step 3 : Adjust the fair value determined in Step 1 by the off -market \nadjustment calculated in Step 2. \n— Step 4 : Measure the lease receivable, unguaranteed residual asset and net \ninvestment in the l ease as outlined above. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 935}), Document(page\_content='Leases 935 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 11.1. 170 \nInvolvement of a third -party lessor in a business \ncombination \nHow should an acquirer account for a lease when a third \nparty becomes a lessor as part of the acquisition? \nInterpretive response: In certain business combinations, an unrelated third \nparty may acquire an asset directly from the acquiree, and in turn lease that \nasset to the acquirer. \nAcquireeAcquirer\nUnrelated third \npartyAcquired as \npart of the business combination\nSells Asset A toLeases Asset A to\n \nIf the transaction between the acquiree and the unrelated third party is \ncontingent on the business combination between the acquirer and the acquiree, \nthe acquirer should account for the sale of the asset by the acquiree and the lease from the unrelated third party as a sale- leaseback transaction (see \nchapter 9). \nThe acquirer should also account for the sale of the asset by the acquiree and \nthe lease from the unrelated third party as a post -acquisition sale -leaseback \ntransaction if the transaction between the acquiree and the unrelated third party \nis entered into either ( 1) after or ( 2) at or near the same time as the business \ncombination is agreed to by the acquiree and the acquirer. In such cases, it should be presumed that the sale of the asset by the acquiree to the unrelated \nthird party contemplated the subsequent lease of that asset to the acquirer. \n \n Question 11.1. 180 \nAcquisition accounting for an acquiree failed \nsale/purchase \nHow should an acquirer account for the failed sale or failed \npurchase of an acquiree in a sale -leaseback transaction? \nInterpretive response: We believe the business combination does not \neliminate the failed sale (if the acquiree is the seller -lessee) or the failed \npurchase (if the acquiree is the buyer -lessor). \nThe acquirer sh ould continue with the failed sale/purchase accounting until the \ntransaction meets the requirements in Subtopic 842- 40 for a sale/purchase. The \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 936}), Document(page\_content='Leases 936 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. assets and liabilities of the acquiree related to the failed sale- leaseback \ntransaction (e.g. the underlying ass et and financial liability if the seller -lessee or \nthe financial receivable if the buyer -lessor) are still subject to any appropriate \nadjustments to those assets and liabilities as required by Topic 805. \n \n Question 11.1. 190 \nAccounting for leases acquired in an asset \nacquisition \nHow should lease assets and lease liabilities in an asset \nacquisition be accounted for? \nBackground: Topic 805 (pre- and post -ASU 2016- 02) does not contain guidance \non the accounting for leases acquired in an asset acquisit ion – i.e. from the \nacquisition of assets that have a lease (or leases) attached that do not \nconstitute a business. \nInterpretive response: In an asset acquisition, in general, we believe the \nacquired leases should be accounted for in the same manner as they would be \nif they were acquired in a business combination – i.e. measured as if the lease \nwere a new lease of the acquirer at the acquisition date. \nHowever, because an entity does not recognize goodwill or a bargain purchase \ngain in an asset acquisition, the amounts recognized for the lease may be \nadjusted to relative fair value from what would have been recognized in \naccordance with Topic 805. For example, an acquired ROU asset (lessee) \nmeasured in accordance with paragraph 805-20-30-24, or a favorable operating \nlease asset (lessor) recognized in accordance with paragraph 805- 20-25-12, may \nbe further adjusted to relative fair value if the purchase price of the acquired \nassets (including transaction costs) is different from their aggregate fair value. \n \n Question 11.1.200 \nDifferent acquirer/acquiree separation of lease and \nnon-lease component policy elections \nDoes an acquirer measure an acquired lease based on its \naccounting policy to separate or not separate lease and non-\nlease components if it differs from that of the acquiree? \nBackground: An acquirer’s accounting policy to separate lease from non- lease \ncomponents, or vice versa, may differ from the acquiree’s (see section 4.4.1 ). \nIn addition to the measurement difference that would result from the ac quirer \nremeasuring the lease at the acquisition date based on its own accounting \npolicy, the acquiree’s election, if a lessee, might have resulted in a different \nlease classification from what would have resulted from applying the acquirer’s \naccounting pol icy. For example, the acquiree’s election as a lessee to separate \nlease and non- lease components might have resulted in operating lease \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 937}), Document(page\_content='Leases 937 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. classification for an acquired lease, while a non -separation accounting policy \nelection would have resulted in finance l ease classification for the same lease. \nQuestions arising when this accounting policy difference exists include the \nfollowing. \n— Does the acquirer measure the acquired leases based on its separation or \nnon-separation accounting policy? \n— Should the acquirer re assess the classification of the acquired lease, \nbecause of the effect the different accounting policy might have had on the \nacquiree’s lease classification (if a lessee)? \nInterpretive response: As outlined in c hapter 7 of KPMG Handbook, Business \ncombinations , accounting policies that apply to assets acquired and liabilities \nassumed fr om an acquiree generally should be conformed to those of the \nacquirer after a business combination. Therefore, we believe the acquirer \nshould follow its own separation or non- separation accounting policy when \nmeasuring the acquired lease asset and/or liabi lity, regardless of whether the \nacquiree was the lessee or the lessor in the lease. \nHowever, an acquirer should not reassess the classification of the acquired \nlease in these circumstances, even though it might have differed had the \nacquiree been followin g the same separation or non- separation accounting \npolicy as the acquirer. This is because, as outlined in paragraph 11.1.10 (Note 1) \nand Question 1 1.1.60, Topic 842 does not permit an acquiree to reassess the \nclassification of an acquired lease unless the lease is modified in connection \nwith the business combination (and that modification is not accounted for as a \nseparate contract). [842-10-55-11] \n \n Question 11.1.210 # \nMeasurement of acquired related par ty leases with \noff-market terms \nAre off-market terms of an acquired related party lease \nreflected in the measurement of the post -acquisition ROU \nasset? \nBackground: An acquirer may acquire a lease in a business combination (or an \nasset acquisition) that either was pre- acquisition and remains, or becomes as a \nconsequence of the acquisition, a related party lease. \nUnder Topic 842, entities account for related party leases based on their enforceable (or written – see section 3.1.2) terms and conditions. That is, \nentities do not make adjustments to their related party lease accounting for off -\nmarket terms or conditions. \n[842- 10-55-12, ASU 2016- 02.BC374] \nHowever, as shown in paragraph 11.1.10 (table), the carrying amount of an ROU asset acquired in a business combination (or asset acquisition – see \nQuestion 11.1. 190) is adjusted from the carrying amount of the lease liability for \nany above - or below- market terms. \n[805- 20-30-24] \nThe related party lease discussion does not explicitly ref erence such leases \nacquired in a business combination (or asset acquisition), while the acquired \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 938}), Document(page\_content='Leases 938 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. lease measurement guidance in Topic 805 does not refer to related party \nleases. Therefore, the question arises about whether the Topic 805 requirement \nto adjus t the measurement of an acquired ROU asset for off -market lease \nterms applies to an acquired related party lease. \nInterpretive response: Yes. Despite the related party lease guidance, we \nbelieve the acquirer adjusts the carrying amount of the ROU asset for any \nabove- or below- market terms of the related party lease. This is because of the \nparticular wording in paragraph 805- 20-30-24. \nWe believe t hat wording requires: \n— the lease liability to be measured first on the same basis as any new lease, \nwhich for a r elated party lease means based on the legally enforceable \nterms and conditions of the lease; and \n— the ROU asset to be measured second, without any reference to \nmeasuring as if a new lease, based on the measurement of the lease \nliability as adjusted for any off-market terms. \nIn addition to the wording in Topic 805, we believe that to not adjust the acquired ROU asset for off -market terms would inappropriately record the off -\nmarket effects of the lease through goodwill ; more commonly, inflating it \nbecause of below -market terms. \n \nAcquisition date recognition and measurement \nexamples \n Example 11.1. 20 \nAccounting for an acquired lease (operating lease) \nScenario 1: Lease is at market terms at the acquisition date (acquiree is \nthe lessee) \nCompany AR acquires Lessee LE, which leases its main transportation hub \nfrom Lessor LR. The hub comprises a large building and surrounding land near a \nmajor airport that serves as a storage and processing facility. \nThe following facts about the underlying lease (an operating lease) are relevant. \nLease term: 25 years \nLease payments: Fixed payments of $1 million per year in arrears, \nwith a 3% increase each year after Year 1 \nRVG: None \nOptions: None \nAt lease commencement: \n— Fair value of building and surrounding land: $30 million \n— Remaining economic life of building: 45 years \n— LE’s incremental borrowing rate: 7% ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 939}), Document(page\_content='Leases 939 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The lease is not modified in connection with the business combination. The \nfollowing facts at the acquisition date are relevant. \nLease term remaining: 19 years \nLease terms: At market \nAccrued rent liability: $2,281,81 01 \nAR’s incremental borrowing rate: 8%2 \nAR recognizes a lease liability and an ROU asset. There are no other identifiable \nintangible assets associated with the lease (see paragraph 11.1.10). \nLease liability: $14,177,9683 \nROU asset: $14,177,9684 \nIntangible assets (associated with the lease): None \nAR does not reassess LE’s conclusion that the arrangement is a lease, and AR \nretains LE’s classification of the lease . AR accounts for the remainder of the \nlease as if it is a new operating lease for the same facility commencing on the \nacquisition date. \nNotes: \n1. The difference between the lease payments made through the end of Year 6 of \n$6,468,410 and the straight -line lease cost recognized of $8,750,220 (($36,459,250 total \nlease payments / 25) × 6). \n2. AR cannot readily determine LR’s implicit rate for the lease. AR legally assumes the lease \nfrom LE in connection with the acquisition. \n3. The present value of the remaining lease payments due under the lease. \n4. Equal to the lease liability. No adjustment is required to the ROU asset because the \nterms of the lease a re at market at the acquisition date. The ROU asset is also not \nadjusted for LE’s pre -acquisition accrued rent liability, which is not carried forward in the \nacquisition accounting. \nScenario 2: Lease is at market terms at the acquisition date (acquiree is \nthe lessor) \nAssume the same facts as in Scenario 1 except for the following. \n— Company AR is acquiring Lessor LR, rather than Lessee LE. \n— The building and the land (i.e. the assets subject to the lease with LE) have \nfair values of $16 million and $12 million, respectively. \nBecause the acquiree is the lessor in the operating lease and the lease is at \nmarket terms at the acquisition date, AR recognizes the land and building, but no other assets or liabilities . \nLand: $12 million1 \nBuilding: $16 million2 \nAsset or liability (off- market lease terms): N/A \nIntangibl e asset s (associate d with the lease): None ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 940}), Document(page\_content='Leases 940 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Notes: \n1. AR recognizes the land at its fair value. AR will not depreciate the land subsequently. \n2. AR recognizes the building at its fair value. AR will depreciate the building over its \nremaining useful life, which is not necessarily the same as its remaining economic life \n(see section 5.7 ). \nAR does not recognize an accrued rent asset for the difference between the \nincome recognized by LR on a straight -line basis before the acquisition date and \nthe lease payments made through the acquisition date by LE – i.e. the \n$2,281,810 calculated in Scena rio 1. \nScenario 3: Lease is at below -market rates at the acquisition date \n(acquiree is the lessee) \nAssume the same facts as in Scenario 1 except that, at the acquisition date, the terms of the lease to Lessee LE are considered favorable compared to market \nterms. Although the Year 7 lease payment is reasonable compared to market \nrental terms, lease payments in this market should be increasing by 4% per \nyear thereafter. \nContractual payments in Years 7 \n– 25 (undiscounted): $29,990,840 $1,194,052 in Year 7, inc reasing by \n3% each of the 18 years thereafter \nMarket -based payments in \nYears 7 – 25 (undiscounted): $33,040,903 $1,194,052 in Year 7, increasing by \n4% each of the 18 years thereafter \nCompany AR recognizes a lease liability and a n ROU asset. Consistent with \nScenario 1, there are no other identifiable intangible assets associated with the \nlease (see paragraph 11.1.10). \nLease liability: $14,177,968 \nROU asset: $15,278,4271 \nIntangible assets (associated with the lease): None \nNote: \n1. While the lease liability at the acquisition date is the same as in Scenario 1 (based on \ncontractual lease payments), the ROU asset is $15,278,427. This is because the asset \nis based on the present value of the market -based rental payments. \nThe difference between the ROU asset and the lease liability of $1,100,459 reduces \nthe goodwill recognized in AR’s acquisition accounting, and will be recognized as \nadditional operating lease cost over the 19- year remaining lease term. \nScenario 4: Lease is at below -market rates at the acquisition date \n(acquiree is the lessor) \nAssume the same facts as in Scenario 3 except that Company AR is acquiring \nLessor LR, rather than Lessee LE. In addition, assume AR’s rate implicit in the \nlease at the acquisition date is 7.85%. \nBecause the acquiree is the lessor in the operating lease, AR recognizes the \nfollowing. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 941}), Document(page\_content='Leases 941 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Land: $12 million \nBuilding: $16 million \nLiability (off -market lease terms): $1,119,7541 \nIntangible assets (associated with the lease): None \nNote : \n1. The difference between the present value (using the implicit rate of 7.85%) of the \nremaining lease payments ($14,348,787) and the present value (using the implicit rate \nof 7.85%) of the remaining market -based rental payments ($15,468,541) is recognized \nas an unfavorable lease liability in AR’s acquisition accounting. This liability increases \nthe goodwill recognized by AR in the acquisition accounting, and will be recognized as \nadditional lease income over the 19- year remaining lease term (dr. unfavorable lease \nliability, cr. lease income) . \n \n \n Example 11.1. 30 \nAccounting for an acquired lease (finance/sales -type \nlease) \nScenario 1: Acquiree is the lessor \nCompany AR acquires Lessor LR, which leases manufacturing equipment to its \ncustomers. The following facts about one of those leases (a sales -type lease, \nproperly classified) to Lessee LE are relevant. \nLease term: 5 years \nLease payments: Fixed payments of $165,000 per year in arrears, \nwith a 4% increase each year after Year 1 \nEnd of lease: Ownership transfers to LE for no additional \nconsideration \nAt lease commencement: \n— Fair value of the equipment: $700,000 \n— Rate implicit in the lease: 8.49% \nThe following facts at the acquisition date are relevant. \nLease term remaining: 4 years \nLease terms: At market \nFair value of the equipment: $600,000 \nRate implicit in the lease: 8.08% \nThe underlying asset is not recognized in AR’s acquisition accounting. Instead , \nAR recognizes a lease receivable of $600,000, which equals the remaining lease \npayments of $728,694 discounted at the acquisition date implicit rate of 8.08%. \nThere is no unguaranteed residual asset to recognize because LE obtains \nownership of the equipment at the end of the lease term ; therefore, the net ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 942}), Document(page\_content='Leases 942 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. investment i n the lease is also $600,000, equal to the lease receivable. \nSubsequent to the acquisition date until the end of the lease term, AR accounts \nfor the acquired lease in the same manner as it would any other sales -type \nlease. \nScenario 2: Acquiree is the lessee \nAssume the same facts as in Scenario 1, except that Company AR is acquiring Lessee LE, rather than Lessor LR. In connection with the acquisition, the lease \nis legally assigned to AR. The rate implicit in the lease is not readily \ndeterminable because AR a nd LE do not know LR’s estimated residual value or \nLR’s initial direct costs. AR’s incremental borrowing rate is 7% at the \nacquisition date. \nAs part of its acquisition accounting, AR recognizes a lease liability of $615,018 \n(the remaining lease payments of $728,694 discounted at AR’s incremental \nborrowing rate of 7%) and a n ROU asset for the same amount. Because the \nlease is at market terms, there is no adjustment to the ROU asset from the \namount of the lease liability. Subsequent to the acquisition date, AR accounts for the lease in the same manner as it would any other finance lease (see \nsection 6.4.1) . \n \n11.1.4 Leverage d leases \n11.1. 90 Guidance for leveraged leases acquired in a business combination is \nincluded in section 7.8. \n \n11.1.5 Post -acquisition accounting \n11.1.100 Subsequent to the acquisition date, the acquirer applies the subsequent \nmeasurement guidance in Topic 842 to leases acquired in a business combination. The acquirer accounts for any intangible assets associated with \nthe lease in accordance with Topic 350 (goodwill and o ther intangibles ). \n11.1.110 Leasehold (or tenant ) improvements acquired in a business combination \nare recognized at fair value and are amortized from the acquisition date over \nthe shorter of the useful life of the leasehold improvements and the remaining \n‘lease term ’ (see section 5.3) at the date of acqui sition. This includes leasehold \nimprovements that were placed in service by the acquiree after lease \ncommencement (including significantly after lease commencement) . However, \nif the lease transfers ownership of the underlying asset to the lessee, or the \nlessee is reasonably certain to exercise an option to purchase the underlying \nasset (see section 5.2) , the lessee amortizes the leasehold improvements to \nthe end of their useful life. [805- 20-35-6] \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 943}), Document(page\_content='Leases 943 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 11.1. 220 \nAcquirer accounting for an operating le ase when it \nis the lessee and is reasonably certain to exercise a \nlessee purchase option \nHow should an acquirer account for a lease that was \nclassified as an operating lease by the acquiree when the \nacquirer is reasonably certain to exercise a lessee purchase option? \nBackground: Consider a scenario in which Company AR acquires Lessee LE, \nwhich has a lease of equipment from Lessor LR that it appropriately classified \npre-acquisition as an operating lease. The acquisition is accounted for as a \nbusiness combination (rather than an asset acquisition), and the lease is not \nmodified in connection with the acquisition. \nThe lease includes a lessee purchase option that, before the acquisition, LE \nconcluded it was not reas onably certain to exercise. However, AR remeasures \nthe lease as if it is a new lease at the acquisition date, and determines it is \nreasonably certain to exercise the purchase option. At the acquisition date, the \nremaining term of the lease is 6 years and the remaining useful life of the \nequipment is 11 years. [805- 20-30-24] \nDespite AR’s assessment of the purchase option, AR must retain LE’s pre-\nacquisition operating lease classification because the lease is not modified in \nconnection with the business combination; see Note 1 to the table in \nparagraph 11.1.10. \nIn this scenari o of an acquired operating lease in which the acquirer is \nreasonably certain to exercise an option to purchase the underlying asset, \ntwo questions arise. \n— Over what period should the cost of the remaining lease payments (6 years’ rentals plus purchase optio n exercise price) be recognized? \n— If the cost of the remaining lease payments should be recognized over the remaining useful life of the equipment (11 years), how much (1) lease cost \nand (2) depreciation of the equipment post -exercise of the purchase option \nshould be recognized? \nInterpretive response: In the background example, we believe AR should \nrecognize both: \n— lease cost over the remaining lease term; and \n— depreciation of the owned equipment from the date the equipment is \nacquired to the end of its useful life. \nWe do not believe that it would be appropriate to recognize the cost of the \nremaining lease payments over the remaining lease term only, such that no \ndepreciation is recognized on the owned equipment after the purchase option is \nexercised. \nWith resp ect to recognizing lease cost and depreciation, we are aware of two \napproaches being applied in practice. Because US GAAP does not provide \nspecific guidance in this regard, in the absence of additional guidance from the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 944}), Document(page\_content='Leases 944 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. FASB or the SEC staff, we will accept either approach, applied consistently to \nsimilar circumstances. \nExample 11.1. 40 illustrates both approaches. Under either approach: \n— the acquisition date measurement of the ROU asset and the lease liability is \nthe same; and \n— the lease liability equals $0 after the purchase option is exercised (and \npurchase price paid) at the end of Year 6. \nApproach 1: Straight -line basis \nUnder this approach, the acquirer recognizes the cost of the remaining lease \npayments, including the purchase option exercise price, on a straight -line basis \nover the remaining useful life of the underlying asset. Using the background example, this means that the acquirer will recognize annual lease cost until the \nend of Year 6 equal to the remaining lease payments divided by 11 years. \nAt the end of the lease term (end of Year 6), the remaining carrying amount of \nthe ROU asset will be reclassified to property, plant and equipment. The asset \nwill then be depreciat ed following the acquirer’s normal depreciation policy \nunder Topic 360 (typicall y, straight -line). \nThis approach consider s the following: \n— A straight -line pattern of cost recognition over the entire remaining useful \nlife of the underlying asset (regardless of the fact that for a portion of that \nperiod the asset will be leased, and for the remainder it will be owned) is \nmost representative of the pattern in which the acquirer will derive benefit \nfrom use of the asset; and \n— This cost recognition pattern (straight -line over 11 years) is consistent with \nthe lease’s continued classification post -acquisition as an operating lease, \nfor which the total lease cost (the sum of the rental payments and the \npurchase option exercise price) is generally recognized on a straight -line \nbasis. \nApproach 2: As -if finance lease \nUnder this approach, the acquir er allocates the remaining lease payments as of \nthe acquisition date between (1) lease cost and (2) depreciation as follows. \n— Depreciation is calculated based on what the carrying amount of the ROU \nasset would be at the purchase option exercise date if the lease were \nreclassified as a finance lease from the acquisition date; and \n— The lease cost is the difference between the remaining lease payments and \ndepreciation. \nAs in Approach 1, the carrying amount of the ROU asset at the end of the lease \nterm will be reclassified to property, plant and equipment when the purchase \noption is exercised. The asset will then be depreciated following the acquirer’s \nnormal depreciation policy under Topic 360 (typically, straight -line). \nThe lease cost is recognized on a straight -line basis over the remaining lease \nterm from the acquisition date (6 years in the background example). \nThis approach considers that there are economic differences between the \nperiods subject to lease and the periods after the lease term when the acquirer ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 945}), Document(page\_content='Leases 945 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. owns the asset, so that equal, straight -line cost each period throughout both \nmay not be appropriate. Total lease cost and depreciation calculated based on \nwhat would result from the ‘financed purchase’ (i.e. finance lease) model in a \nnon-business combination scenario more appropriately reflects those economic \ndifferences. Periodic lease cost during the lease term generally should exceed \nperiodic depreciation onc e the asset is owned because of the interest cost \nelement of the lease. \nComparing the two approaches \nThe following are the key practical differences between the approaches. \n— Approach 2 will generally result in greater lease cost (cost recognized over the remaining lease term), and less depreciation (after the purchase option \nis exercised) than Approach 1. The greater ROU asset and property, plant \nand equipment carrying amounts throughout the remaining useful life of the \nasset under Approach 1 may result in a greater likelihood of impairment \nunder Topic 360. \n— Approach 2 may be more complex to apply than Approach 1. This is because it requires consideration of the accounting that would result from \nfinance lease classification, even though the lease will not be accounted for \nas a finance lease. \n \n Example 11.1. 40 \nAccounting for an acquired lease (operating lease) \nwhen the acquirer is reasonably certain to exercise a \nlessee purchase option \nCompany AR acquires Lessee LE , which leases equipment from Lessor LR. The \nacquisition is accounted for as a business combination. LE appropriately \nidentified the lease and classified it as an operating lease before the acquisition \ndate, and the lease is not modified in connection with the business combination \nother than AR becoming the legal counterparty to the lease. The terms of the \nlease are considered at market as of the acquisition date. \nAt the acquisition date, AR remeasures the lease as if it is a new lease from the \nacquisition d ate. AR concludes that it is reasonably certain to exercise the \nlessee option to purchase the underlying asset at the end of the non- cancellable \nlease term. \nThe following additional facts about the underlying lease at the acquisition date \nare relevant. \nRem aining contractual lease term: 6 years \nRemaining useful life of equipment: 11 years \nRemaining rent payments: Fixed payments of $50,000 per year in arrears \nRenewal options: None \nLessee purchase option: $140,000 at the end of the contractual lease term \nAR’s incremental borrowing rate: 5% (the rate implicit in the lease cannot be readily \ndetermined) ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 946}), Document(page\_content='Leases 946 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Initial measurement \nBecause the lease was not modified in connection with the business \ncombination, AR does not reassess whether the arrangement is a l ease, and \nretains LE’s operating lease classification even though AR is reasonably certain to exercise the lessee option to purchase the equipment at the end of the \nlease. \nAt the acquisition date, the remaining lease payments are $440,000: remaining \nrent payments ($50,000 × 6), plus purchase option exercise price ($140,000). \nThe remaining lease payments are discounted at AR’s incremental borrowing \nrate of 5% to measure the acquisition date lease liability. Because the lease is \nat market, the ROU asset equal s the lease liability at the acquisition date. \nLease liability: $358,254 \nROU asset: $358,254 \nIntangible assets (associated with the lease): None \nSubsequent accounting \nApproach 1: Straight -line basis \nThe following table shows AR ’s accounting for the lease through the end of the \nlease term (i.e. through the end of Year 6 post -acquisition). \nYear ROU asset amortization ROU asset carrying amount \nLease \nliab. \nending \nbalance3 Single \nlease \ncost1 Lease \nliab. \naccret. ROU \nasset \namort.2 Beg. \nbalance ROU \nasset \namort. End. \nbalance \n1 $40,000 $17,913 $22,087 $358,254 $(22,087) $336,167 $326,167 \n2 40,000 16,308 23,692 336,167 (23,692) 312,475 292,475 \n3 40,000 14,624 25,376 312,475 (25,376) 287,099 257,099 \n4 40,000 12,855 27,145 287,099 (27,145) 259,954 219,954 \n5 40,000 10,998 29,002 259,954 (29,002) 230,952 180,952 \n6 40,000 9,048 30,952 230,952 (30,952) 200,000 - \nNotes: \n1. Lease payments of $ 440,000 / 11 years = $ 40,000. \n2. Single lease cost – lease liability accretion. \n3. Prior ending balance + lease liability accretion – $50,000 annual rent payment. In \nYear 6, the lease liability is also reduced by payment of the purchase option exercise \nprice of $140,000. \nAt the end of Year 6 when AR exercises the purchase option, AR reclassifies \nthe carrying amount of the ROU asset ($200,000) to property, plant and \nequipment. AR depreciates the owned equipment on a straight -line basis \n(consistent with its policy for other similar assets) over its 5 -year remaini ng \nuseful life. There is no lease liability from the end of Year 6 onward. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 947}), Document(page\_content='Leases 947 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The following table shows AR’s accounting for the equipment through the end \nof its useful life; there is no impairment or change in the equipment’s estimated \nuseful life. \nYear PP&E carrying amount \nDepn . expense Beg. balance PP&E depn . End. balance \n7 $40,000 $200,000 $(40,000) $160,000 \n8 40,000 160,000 (40,000) 120,000 \n9 40,000 120,000 (40,000) 80,000 \n10 40,000 80,000 (40,000) 40,000 \n11 40,000 40,000 (40,000) - \nApproach 2: As -if finance lease \nIn the following steps, AR calculates the end of Year 6 carrying amount of the ROU asset as if the lease were accounted for as a new finance lease from the \nacquisition date. \n1. Calculate th e annual finance lease \nROU amortization. $358,254 acquisition date ROU asset / \n11-year remaining useful life of \nequipment = $32,568.541 \n2. Multiply that amount by the 5 -year \nuseful life that will remain after the \nend of the 6- year contractual lease \nterm. $32,568.54 × 5 years = $162,843 \n3. Subtract Step 2 amount from the \nremaining lease payments to arrive \nat the lease cost to be recognized in \nYears 1 –6 post -acquisition. $440,000 – $162,843 = $277,157 \nNote: \n1. This result is shown in greater precision so t hat subsequent calculations and tables \nare mathematically accurate. \nThe following table shows AR ’s accounting for the lease through the end of the \nlease term (i.e. through the end of Year 6 post -acquisition). \nYear ROU asset amortization ROU asset carrying amount Lease \nliab. \nending \nbalance3 Single \nlease \ncost1 Lease \nliab. \naccret. ROU \nasset \namort.2 Beg. \nbalance ROU asset \namort. End. \nbalance \n1 $46,193 $17,913 $28,280 $358,254 $(28,280) $329,974 $326,167 \n2 46,193 16,308 29,885 329,974 (29,885 ) 300,089 292,475 \n3 46,193 14,624 31,569 300,089 (31,569 ) 268,520 257,099 \n4 46,193 12,855 33,338 268,520 (33,338 ) 235,182 219,954 \n5 46,193 10,998 35,195 235,182 (35,195 ) 199,987 180,952 \n6 46,192 9,048 37,144 199,987 (37,144 ) 162,843 - ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 948}), Document(page\_content='Leases 948 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Notes: \n1. $277,157 / 6-year contractual term . \n2. Single lease cost – lease liability accretion. \n3. Prior ending balance + lease liability accretion – $50,000 annual rent payment. In \nYear 6, the lease liability is also reduced by payment of the purchase option exercise \nprice of $140,000. \nAt the end of Year 6 when AR exercises the purchase option, AR reclassifies \nthe carrying amount of the ROU asset ($162,843) to property, plant and \nequipment. AR depreciates the owned equipment on a straight -line basis \n(consistent with its policy for other similar assets) over its 5 -year remaining \nuseful life. There is no lease liability from the end of Year 6 onward. \nThe following table shows AR’s accounting for the equipment through the end of its useful life; there is no impairment or change in the equipment’s estimated \nuseful life. \nYear Depn. expense PP&E carrying amount \nBeg. balance PP&E depn. End. balance \n7 $32,569 $162,843 $(32,569) $130,274 \n8 32,569 130,274 (32,569 ) 97,705 \n9 32,569 97,705 (32,569 ) 65,136 \n10 32,568 65,136 (32,568 ) 32,568 \n11 32,568 32,568 (32,568 ) - \n \n \n Question 11.1.230 \n(Un)favorable contract (liabilities) assets for \ncontracts not accounted for as leases before a \nmodification \nHow should a lessee account for a favorable (unfavorable) \ncontract asset (liability) when a non- lease contract is \nreassessed as a lease ? \nBackground: Assume that Company AR acquired Company AE. As part of AR’s \nacquisition accounting, it recorded a favorable contract intangible asset or an \nunfavorable contract liability for an existing service contract for which AE was \nthe customer and had appropriately determined the contract was not a lease. \nAfter the acquisition, the term s and conditions of the acquired contract are \nmodified (and the modification does not qualify to be accounted for as a \nseparate contract). On reassessment, based on the changed terms and \nconditions of the contract, and the facts and circumstances as of the effective \ndate of the modification, the contract meets the definition of a lease. \nAt the reassessment date, the question arises about how to account for the \nremaining favorable contract intangible asset or unfavorable contract liability, \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 949}), Document(page\_content='Leases 949 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. given that lessees no longer recognize either for leases after the adoption of \nTopic 842 (see paragraph 11.1.10). \nInterpretive response: We believe the lessee should derecognize the existing \ncontract asset (liability) at the effective date of the modification with a corre sponding adjustment to the new ROU asset. \n \n Comparison to legacy US GAAP \nAcquired operating leases where the acquiree is a lessee \n11.1.120 Under Topic 805 (pre- amendment), an asset or a liability was \nrecognized in a business combination only to the extent that the operating lease was favorable or unfavorable to market terms. In contrast, under Topic 805 (as \namended), the acquirer recognizes a lease liability and an ROU asset for \nacquired operating leases. The ROU asset is adjusted for favorable or \nunfavorable terms at the acquisition date. \n[805- 20-25-12] \n11.1. 130 The acquirer’s measurement of any favorable/unfavorable adjustment \nto the ROU asset under Topic 805 (as amended) will likely be similar to an \nacquirer’s measurement of any favorable lease asset or unfavorable lease \nliability under Topic 805 (pre- amendment). Consequently, the net effect of this \nchange on the amount of goodwill (or bar gain purchase gain) resulting from an \nacquisition may not be significant. \nAcquired finance (capital) lease assets and lease liabilities no longer \nmeasured at fair value \n11.1. 140 Topic 805 (pre- amendment) generally required the recognition of lease \nassets and lease liabilities related to capital (sales- type/direct financing) leases \nat fair value, regardless of whether the acquiree was a lessee or a lessor. In \ncontrast, Topic 805 (as amended) prescribes the measurement of lease assets \nand lease liabilities o n a basis other than fair value. [805- 20-30-12(h), 30 -24 – 30-25] \n11.1. 150 It is unclear how significant the financial statement effect of this \ndifference in measurement will be; the basis for conclusions states that the \nprescribed measurement “will approximate fair value .” However, eliminating \nthe requirement to account for finance (sales -type/direct financing) lease assets \nand lease liabilities at fair value may simplify the acquisition accounting for such \nleases compared to Topic 805 (pre -amendment). [ASU 2016- 02.BC416– BC417] \nConsideration of lease terms and conditions in determining the fair value \nof lease assets in an acquired sales -type/direct financing lease \n11.1. 160 Topic 805 (pre- amendment), unlike Topic 805 (as amended), did not \nexplicitly requir e consideration of the terms and conditions of the lease when \nmeasuring the lessor’s lease receivable or unguaranteed residual asset. \nHowever, in practice before ASU 2016- 02, measurement of the lease receivable \nand the unguaranteed residual asset at fair v alue would usually take into \nconsideration the terms and conditions of the lease. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 950}), Document(page\_content='Leases 950 \n11. Leases acquired in a business combination or asset acquisition \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Acquired operating leases where the acquiree is a lessor \n11.1. 170 An acquirer’s accounting for an acquired operating lease as a lessor in \nacquisition accounting under Topic 805 (as amended) is substantially unchanged \nfrom Topic 805 (pre- amendment). \nAcquired leasehold improvements \n11.1. 180 An acquirer’s accounting for acquired leasehold improvements under \nTopic 805 (as amended) is substantially unchanged from Topic 805 (pre -\namendment). \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 951}), Document(page\_content='Leases 951 \n12. Disclosures \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 12. Disclosures \nDetailed contents \nHow the standard works \n12.1 General disclosure req uirements \nObservations \nOverall disclosure objective to guide preparers \nNo specific guidance on disaggregation \nQuestion s \n12.1.10 Interim disclosure requirements \n12.1.20 Annual disclosures in interim filings in the year of adoption \n12.2 Lessee disclosures \n12.2.1 Qualitative and quantitative information \nObservation \nQuantitative information in lieu of a lease liability rollforward \nQuestion s \n12.2.05 Incremental borrowing rate disclosures \n12.2.10 Supplemental disclosure of noncash leasing activities – \nlessees \n12.2. 20 MD&A disclosure of contractual obligations \nExamples \n12.2.10 Weighted- average remaining lease term disclosure \n12.2.20 Weighted- average discount rate disclosure \n12.2.30 Periodic short -term lease cost does not reasonably reflect \nlessee’s short -term lease commitments \nComparison to legacy US GAAP \n12.3 Lessor disclosures \nQuestion s \n12.3.10 Assets subject to operating leases as a separate major class \nof depreciable assets \n12.3.20 Separate disclosure of tenant reimbursements \nExample \n12.3.10 Chart of lease income for the repor ting period \nComparison to legacy US GAAP \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 952}), Document(page\_content='Leases 952 \n12. Disclosures \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. How the standard works \nThe disclosure objective in Topic 842 is to provide financial statement users \nsufficient information to assess the amount, timing and uncertainty of cash \nflows arising from leases. To achieve that objective, lessees and lessors \ndisclose qualitative and quantitative information about lease transactions. \n \n \nThis generally will result in increased information being disclosed as compared \nto Topic 840. Accordingly, entities will need to evaluate whether they have \nappropriate systems, processes and internal controls to capture the complete \nand accurate lease data necessary to prepare the financial statement notes. \nFor a discussion of transition disclosures, see section 13A .2.5 (if electing the \neffective date transition method) or 13B.2.5 (if electing the comparative transition method) . \n \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 953}), Document(page\_content='Leases 953 \n12. Disclosures \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 12.1 General disclosure r equirements \n Excerpt from ASC 842 -20 \n50 Disclosure \nGeneral \n50-1 The objective of the disclosure requirements is to enable users of \nfinancial statements to assess the amount, timing, and uncertainty of cash \nflows arising from leases . To achieve that objective, a lessee shall disclose \nqualitative and quantitative informa tion about all of the following: \na. Its leases (as described in paragraphs 842- 20-50-3(a) through (b) and 842-\n20-50-7 through 50- 10) \nb. The significant judgments made in applying the requirements in this Topic \nto those leases (as described in paragraph 842- 20-50-3(c)) \nc. The amounts recognized in the financial statements relating to those \nleases (as described in paragraphs 842- 20-50-4 and 84 2-20-50-6). \n50-2 A lessee shall consider the level of detail necessary to satisfy the \ndisclosure objective and how much emphasis to place on each of the various \nrequirements. A lessee shall aggregate or disaggregate disclosures so that \nuseful inform ation is not obscured by including a large amount of insignificant \ndetail or by aggregating items that have different characteristics. \n \n Excerpt from ASC 842 -30 \n50 Disclosure \nGeneral \n50-1 The objective of the disclosure requirements is to enable users of \nfinancial statements to assess the amount, timing, and uncertainty of cash \nflows arising from leases . To achieve that objective, a lessor shall disclose \nqualitative and quantitative informa tion about all of the following: \na. Its leases (as described in paragraphs 842- 30-50-3(a), 842- 30-50-4, and \n842-30-50-7) \nb. The significant judgments made in applying the requirements in this Topic \nto those leases (as described in paragraph 842- 30-50-3(b)) \nc. The amounts recognized in the financial statements relating to those \nleases (as described in paragraphs 842- 30-50-5 through 50- 6 and 842 -30-\n50-8 through 50 -13). \n50-2 A lessor shall consider the level of detail necessary to satisfy the \ndisclosure objective and how much emphasis to place on each of the various \nrequirements. A lessor shall aggregate or disaggregate disclosures so that \nuseful information is not obscured by including a large amount of insignificant \ndetail or by aggregating i tems that have different characteristics. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 954}), Document(page\_content='Leases 954 \n12. Disclosures \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Excerpt from ASC 842 -40 \n50 Disclosure \nGeneral \n50-1 If a seller -lessee or a buyer -lessor enters into a sale and leaseback \ntransaction that is accounted for in accordance with paragraphs 842- 40-25-4 \nand 842- 40-30-1 through 30- 3, it shall provide the disclosures required in \nparagraphs 842- 20-50-1 through 50- 10 for a seller -lessee or paragraphs 842- 30-\n50-1 through 50 -13 for a buyer -lessor. \n50-2 In addition to the disclosures required by paragraphs 842- 20-50-1 through \n50-10, a seller -lessee that enters into a sale and leaseback transaction shall \ndisclose both of the following: \na. The main terms and conditions of that transaction \nb. Any gains or losses arising from the transaction separately from gains or \nlosses on disposal of other assets. \n \n12.1. 10 Topic 842 is silent about whether ea ch disclosure requirement should be \nprovided in all circumstances. However, the basis for conclusions highlights that \nit is implicit to the overall disclosure objective that the level of detail used in the \nnotes should reflect the significance of the entity’s leasing activity. As an \nentity’s leasing activities become more signifi cant, the disclosures will be more \ncomprehensive. [ASU 2016- 02.BC272 –BC276] \n12.1. 20 In a sale -leaseback transaction for which the asset transfer qualifies as a \nsale (see chapter 9): [842- 40-50-1] \n— the seller -lessee provides all applicable disclosures required for a lessee \n(see section 12.2) ; and \n— the buyer -lessor provides all applicable disclosures required for a lessor (see \nsection 12.3) . \n12.1.25 Topic 842 does not include disclosure requirements for deferred tax \nassets and liabilities arising from leases. Topic 740 (income taxes) governs their \ndisclosure. See Question 10.1.05 and chapter 9 of KPMG Handbook, \nAccounting for income taxes . \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 955}), Document(page\_content='Leases 955 \n12. Disclosures \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 12.1.10 \nInterim disclosure requirements \nAre the Topic 842 lease disclosures required for both interim \nand annual financial reporting periods after the year of \nadoption? \nBackground: Paragraph 842- 20-50-4, which provides for a number of lessee \ndisclosure requirements, states that specified quantit ative disclosures should \nbe made for each period presented in the financial statements. \nInterpretive response: No. The only disclosure requirement that applies to all \ninterim periods is for lessors to disclose a table of lease income recognized \nduring the period (see section 12.3 and Example 12.3.10) . There are no lessee \ndisclosures that are required for interim periods under Topic 842. However, the \nneed for additional interim disclosures should be evaluated under the \nrequirements of Topic 270. [842- 30-50-5] \nSee Question 12.1.20 for additional disclosure guidance for SEC registrants in \nthe year of adoption. \n \n Question 12.1.20 \nAnnual disclosures in interim filings in the y ear of \nadoption \nAre registrants required to provide all annual lease \ndisclosure s for each interim period in the year of adoption? \nInterpretive response: Yes. While Topic 842 only requires certain lessor \ndisclosures be made in all interim financial statements (see Question 12.1.10) , \nArticle 10 of Regulation S -X requires SEC registrants to provide both the annual \nand interim disclosures in each quarterly report in the year of adoption of a new \naccounting standard – i.e. the first, second and third quarter Form 10- Q filings. \n[Reg S -X, Article 10, FRM 1500] \nSpecifically, Art icle 10 of Regulation S -X requires disclosures about material \nmatters that were not disclosed in the most recent annual financial statements. \nTherefore, when a registrant adopts a new accounting standard in an interim \nperiod (which includes the initial int erim period of a fiscal year – e.g. as of the \nbeginning of the first quarter of the fiscal year) , it is expected to provide both \nthe annual and the interim period financial statement disclosures prescribed by \nthe new accounting standard, to the extent they are not duplicative with other \ndisclosures . [Reg S -X, Article 10, FRM 1500] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 956}), Document(page\_content='Leases 956 \n12. Disclosures \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Observation \nOverall disclosure objective to guide preparers \n12.1.30 The Board included a disclosure objective in the standard so that \nentities understand the purpose of the disclosure requirements, and to assist \nentities in determining the extent of information to disclose about leases. \n[ASU 2016- 02.BC273] \n \n Observation \nNo specific guidance on disaggregation \n12.1.40 Topic 606 explicitly requires entities to disaggregate revenue recognized \nfrom contracts with customers into categories that depict how the nature, \namount, timing and uncertainty of revenue and cash flows are affected by \neconomic factors . It also provides implementation guidance to assist in \nselecting the categories for disaggregation. [606- 10-50-5, 55- 2 – 55-91] \n12.1.50 While Topic 842 requires entities to consider the appr opriate level of \ndetail and aggregation for its lease disclosures, the Board decided not to \nprovide specific quantitative or qualitative disaggregation requirements such as \nthose required of entities about their contracts with customers under Topic 606. \n12.1. 60 However, the FASB staff, during deliberations of the disclosure \nproposals, provided examples of possible categories they believe qualitative lease disclosure information could be disaggregated into to satisfy the \ndisclosure objective, includi ng the following (not exhaustive). \n— Class of underlying asset. \n— Business segment or unit in which the leased asset is used. \n— Lease term – e.g. 3– 5 year leases, 6 –9 year leases and leases longer than \n10 years. \n— Lease payment terms – e.g. those with solely or principally fixed lease \npayments versus those with significant variable lease payments, or those \nthat are prepaid. \n— Geographical region in which the lease was entered into and/or in which the \nleased asset will be used. \n \n12.2 Lessee disclosures \n Excerpt from ASC 842 -20 \n50 Disclosure \nGeneral \n50-3 A lessee shall disclose all of the following: \na. Information about the nature of its leases, including: \n1. A general description of those leases. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 957}), Document(page\_content='Leases 957 \n12. Disclosures \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 2. The basis and terms and conditions on which variable lease \npayments are determined. \n3. The existence and terms and conditions of options to extend or \nterminate the lease. A lessee should provide narrative disclosure about \nthe options that are recognized as part of its right -of-use assets and \nlease liabilities and those that are not. \n4. The existence and terms and conditions of residual value guarantees \nprovided by the lessee. \n5. The restrictions or covenants imposed by leases, for example, those \nrelating to divid ends or incurring additional financial obligations. \nA lessee should identify the information relating to subleases included in \nthe disclosures provided in (1) through (5), as applicable. \nb. Information about leases that have not yet commenced but that creat e \nsignificant rights and obligations for the lessee, including the nature of any \ninvolvement with the construction or design of the underlying asset . \nc. Information about significant assumptions and judgments made in applying \nthe requirements of this Topic, which may include the following: \n1. The determination of whether a contract contains a lease (as \ndescribed in paragraphs 842- 10-15-2 through 15- 27) \n2. The allocation of the consideration in a contract between lease and \nnonlease components (as described in para graphs 842- 10-15-28 \nthrough 15- 32) \n3. The determination of the discount rate for the lease (as described in \nparagraphs 842- 20-30-2 through 30- 4). \n50-4 For each period presented in the financial statements, a lessee shall \ndisclose the following amounts relating to a lessee’s total lease cost, which \nincludes both amounts recognized in profit or loss during the period and any \namounts capitalized as part of the cost of another asset in accordance with \nother Topics, and the cash flows arisi ng from lease transactions: \na. Finance lease cost, segregated between the amortization of the right -of-\nuse assets and interest on the lease liabilities. \nb. Operating lease cost determined in accordance with paragraphs 842- 20-\n25-6(a) and 842- 20-25-7. \nc. Short -term lease cost, excluding expenses relating to leases with a lease \nterm of one month or less, determined in accordance with paragraph 842-\n20-25-2. \nd. Variable lease cost d etermined in accordance with paragraphs 842- 20-25-\n5(b) and 842- 20-25-6(b). \ne. Sublease income, disclosed on a gross basis, separate from the finance or \noperating lease expense. \nf. Net gain or loss recognized from sale and leaseback transactions in \naccordance w ith paragraph 842- 40-25-4. \ng. Amounts segregated between those for finance and operating leases for \nthe following items: \n1. Cash paid for amounts included in the measurement of lease liabilities, \nsegregated between operating and financing cash flows \n2. Supplemental noncash information on lease liabilities arising from \nobtaining right -of-use assets \n3. Weighted -average remaining lease term ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 958}), Document(page\_content='Leases 958 \n12. Disclosures \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 4. Weighted -average discount rate. \n50-5 See paragraphs 842 -20-55-11 through 55- 12 for implementation guidance \non preparing t he weighted- average remaining lease term and the weighted-\naverage discount rate disclosures. See Example 6 (paragraphs 842- 20-55-52 \nthrough 55- 53) for an illustration of the lessee quantitative disclosure \nrequirements in paragraph 842- 20-50-4. \n50-6 A lessee shall disclose a maturity analysis of its finance lease liabilities \nand its operating lease liabilities separately, showing the undiscounted cash \nflows on an annual basis for a minimum of each of the first five years and a \ntotal of the amounts for the remaining years. A lessee shall disclose a \nreconciliation of the undiscounted cash flows to the finance lease liabilities and \noperating lease liabilities recognized in the statement of financial position. \n50-7 A lessee shall disclose lease transactions between related parties in \naccordance with paragraphs 850- 10-50-1 through 50- 6. \n50-7A\u202fWhen the useful life of leasehold improvements to the common control \ngroup determined in accordance with paragraph 842 -20-35-12A exceeds the \nrelated lease term, a lessee shall disclose the following information: \na. The unamortized balance of the leasehold improvements at the bal ance \nsheet date \nb. The remaining useful life of the leasehold improvements to the common \ncontrol group \nc. The remaining lease term. \n50-8 A lessee that accounts for short -term leases in accordance with \nparagraph 842-20-25-2 shall disclose that fact. If the short -term lease expense \nfor the period does not reasonably reflect the lessee’s short -term lease \ncommitments, a lessee shall disclose that fact and the amount of its short -\nterm lease commitments. \n50-9 A lessee that elects the practical expedient on not separating lease \ncomponents from nonlease components in paragraph 842- 10-15-37 shall \ndisclose its accounting policy election and whi ch class or classes of underlying \nassets it has elected to apply the practical expedient. \n50-10 A lessee that makes the accounting policy election in paragraph 842- 20-\n30-3 to use a risk -free rate as the discount rate shall disclose its election and \nthe cla ss or classes of underlying assets to which the election has been \napplied. \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance \n>> Weighted -Average Remaining Lease Term and Weighted -Average \nDiscount Rate Disclosures \n55-11 The lessee should calculate the weighted- average remaining lease term \non the basis of the remaining lease term and the lease liability balance for \neach lease as of the reporting date. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 959}), Document(page\_content='Leases 959 \n12. Disclosures \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 55-12 The lessee should calculate the weighted -average di scount rate on the \nbasis of both of the following: \na. The discount rate for the lease that was used to calculate the lease \nliability balance for each lease as of the reporting date \nb. The remaining balance of the lease payments for each lease as of the \nreporting date. \n> Illustrations \n>> Illustration of Lessee Quantitative Disclosure Requirements \n55-52 Example 6 illustrates how a lessee may meet the quantitative disclosure \nrequirements in paragraph 842- 20-50-4. \n>>> Example 6— Lessee Quantitative Disclosure Requirements in \nParagraph 842- 20-50-4 \n55-53 The following Example illustrates how a lessee may meet the \nquantitative disclosure requirements in paragraph 842- 20-50-4. \n Year Ending December 31, \n 20X2 20X1 \nLease cost \nFinance lease cost: $XXX $XXX \nAmortization of right -of-use assets XXX XXX \nInterest on lease liabilities XXX XXX \nOperating lease cost XXX XXX \nShort -term lease cost XXX XXX \nVariable lease cost XXX XXX \nSublease income (XXX) (XXX) \nTotal lease cost $XXX $XXX \n Year Ending December 31, \n 20X2 20X1 \nOther information \n(Gains) and losses on sale and leaseback \ntransactions, net $(XXX) $XXX \nCash paid for amounts included in the measurement \nof lease liabilities XXX XXX \nOperating cash flows from finance leases XXX XXX \nOperating cash flows from operating leases XXX XXX \nFinanc ing cash flows from finance leases XXX XXX \nRight -of-use assets obtained in exchange for new \nfinance lease liabilities XXX XXX \nRight -of-use assets obtained in exchange for new \noperating lease liabilities XXX XXX ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 960}), Document(page\_content='Leases 960 \n12. Disclosures \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Weighted- average remaining lease term—finance \nleases X.X years X.X years \nWeighted- average remaining lease term— operating \nleases X.X years X.X years \nWeighted- average discount rate—finance leases X.X% X.X% \nWeighted- average discount rate—operating leases X.X% X.X% \n \n \n12.2.1 Qualitative and quantitative information \n12.2. 10 Finance and operating lease liabilities are either presented separately o n \nthe balance sheet or disclosed separately in the notes to the financial \nstatements. [842- 20-45-1] \n12.2. 20 When making disclosures related to leases with related parties, lessees \nshould also comply with the relevant disclosure requirements in Topi c 850 \n(related party disclosures ). [850-10-50-1 – 50-6] \n12.2. 30 Although the Board provided a list of qualitative and quantitative \ndisclosures, a lessee may need to provide additional information about its \nleases to achieve the disclosure objective (see paragraph 12.1.30) . For example, \na lessee will need to consider whether to disclose information about reassessments or modifications that occurred during the reporting period, such \nas the following. \nDisclosure Required for: \nReassessments Modifications \nLessee action(s) that triggered a reassessment \nof the lease term or exercise of purchase \noption(s) . \uf0fc \nThe existence, and terms and conditions, of \ncontract modifications . \uf0fc \nWhether a contract modification was accounted for as a separate contract and any \nsignificant judgments made in that \ndetermination . \uf0fc \nReallocation of the remaining contract \nconsideration to the lease components and \nnon-lease components . \uf0fc \uf0fc (1)\n \nIf the lease classification changes, that fact and how it affects the comparative periods \npresented – e.g. amounts recognized in the \nincome statement , and in the statement of \ncash flows . \uf0fc \uf0fc (1)\n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 961}), Document(page\_content='Leases 961 \n12. Disclosures \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Disclosure Required for: \nReassessments Modifications \nThe effect on the measurement of the lease \nliability, ROU asset and any amounts \nrecognized in the income statement . \uf0fc \uf0fc (1)\n \nNote: \n1. When the lease modification is not accounted for as a separate contract. \n \n Observation \nQuantitative information in lieu of a lease liability \nrollforward \n12.2.40 Earlier drafts of the new leasing guidance proposed to require lessees to \nrollforward , using a tabular reconciliation, their lease liabilities each period. The \nBoard decided not to require a reconciliation of the opening and closing \nbalances of lease liabilities in Topic 842 due to preparers’ concerns about the \ncosts and complexity of implementation. \n12.2.50 Some preparers cited the need for more robust IT systems and/ or \nprocess capabilities to track and accumulate reconciling items that were not \nrequired under Topic 840. Instead, the Board decided to require lessees to \ndisclose those components of the reconciliation that they identify as most \nimportant to financial sta tement users, including total lease cost and cash paid \nfor amounts included in the measurement of lease liabilities. The Board decision \nnot to require a lease liability rollforward (or reconciliation) is consistent with \ncurrent US GAAP for other financial liabilities , which does not require a \nreconciliation. [ASU 2016- 02.BC284– BC286] \n \n Question 12.2.05 \nIncremental borrowing rate disclosures \nWhat should a lessee disclose about how it determines its \nincremental borrowing rate? \nBackground: Lessees are required to make disclosures about how they \ndetermine the discount rate for their leases, including the related assumptions \nand judgments, which will generally be the lessee’s incremental borrowing rate (see Question 5.6.20). \n[842- 20-50-3(c)(3)] \nInterpretive response: If lease discount rates are material to the lessee’s \nfinancial reporting, we believe the lessee should provide information relevant to how the rates reflected in the measurement of its leases were determined. We \ndo not believe generic disclosures that, in effect, merely repeat the Topic 842 \nincremental borrowing rate definition will satisfy the disclosure requirement. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 962}), Document(page\_content='Leases 962 \n12. Disclosures \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The lessee’s dis closure may include information about what inputs it used, and \nwhat adjustments it made to those inputs, in estimating the incremental \nborrowing rates. And if the lessee is using a portfolio approach in determining \nthose rates, or has a significant number of leases for which the rate reflects the \nincremental borrowing rate of the parent or group, rather than the legal entity \n(e.g. subsidiary) entering into the lease with the lessor, likely those facts should be disclosed as well. \n \n Question 12.2.10 \nSupplem ental disclosure of noncash leasing \nactivities – lessees \nAre lessees required to disclose all changes to ROU assets \nand lease liabilities that arise from noncash activities? \nBackground: The lessee disclosure requirements in Topic 842 only explicitly \nrequire lessees to disclose supplemental noncash information about ‘lease \nliabilities arising from obtaining ROU assets’. [842- 20-50-4(g)(2) , 55-53] \nSome stakeholders, in evaluating this question have asked whether: \n— the disclosure requirement in Topic 842 also applies to increases in the \nlessee’s ROU assets and lease liabilities resulting from remeasurements or \nmodifications that do not involve obtaining a new ROU asset – e.g. \nobtaining a new right to use an additional asset; and \n— supplemental noncash disclosures must be provided for activities that \ndecrease the lessee’s ROU assets and lease liabilities – e.g. \nremeasurements or modifications. \nThe follow ing table lists events whose occurrence could change the carrying \namount of recognized ROU assets and lease liabilities without an expenditure or \nreceipt of cash by the lessee (not exhaustive). \nEvent Increase to ROU asset \nand lease liability Decrease to RO U \nasset1 and lease \nliability \nModifications accounted for \nas a separate contract (see \nparagraphs 6.7.30 – 6.7.40) \uf0fc \nModifications granting the \nlessee an additional right of use, but not accounted for as \na separate contract \uf0fc \nModifications that change \nthe terms of an existing lease \n– e.g. change the lease term, \nadd/remove a lessee purchase option or change \nthe terms of a residual value \nguarantee \uf0fc \uf0fc \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 963}), Document(page\_content='Leases 963 \n12. Disclosures \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Event Increase to ROU asset \nand lease liability Decrease to RO U \nasset1 and lease \nliability \nModifications that change \nonly the price of an existing \nlease \uf0fc \uf0fc \nModificatio ns fully or partially \nterminating a lease – e.g. \nreducing the amount of \nspace being leased \uf0fc \nRemeasurement events (see \nsection 6.6) – e.g. changes to \nthe lease term, the \nassessment of a lessee \npurchase option or the \namount probable of being \nowed under a residual value \nguarantee \uf0fc \uf0fc \nNote: \n1. The ROU asset will not be decreased for one of these events if its pre- event carrying \namount is already $0. \nInterpretive response: To the extent material, yes. We believe the \nrequirements of Topic 842 and Topic 230 (statement of cash flows), taken \ntogether, effectively require supplemental disclosure of all material noncash \nchanges to ROU assets and lease liabilities. \nThere are differing views as to the extent of the specific Topic 842 requirement \nto disclose ‘supplemental noncash information on lease liabilities arising from \nobtaining right -of-use assets’. For example, when considering the background \nquestions, some believe the Topic 842 disclosure requirement applies only to \nevents that result from adding a new ROU asset, while others believe that the \ndisclosure was intended to capture either (1) any increases to ROU assets and \nlease liabilities or (2) all changes (increases and decr eases) in those asset or \nliability amounts. \nRegardless of one’s interpretation of Topic 842, we believe Topic 230, which \nwas not superseded or changed in any way by ASU 2016- 02, requires \ndisclosure of information about all investing and financing activities of an entity \nduring a period that affect recognized assets or liabilities but do not result in \ncash receipts or cash payments in the period. Topic 230 does not make a \ndistinction between noncash activities that result in increases or decreases to \nrecogni zed assets or liabilities. It therefore requires disclosure of any noncash \nchanges to ROU assets and lease liabilities that are not required to be disclosed \nor presented elsewhere in the financial statements by another Topic (e.g. \nTopic 842). [230- 10-50-3] \nConsequently, any material noncash leasing activities would need to be \ndisclosed under Topic 230 regardless of whether they are required to be \ndisclosed by Topic 842. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 964}), Document(page\_content='Leases 964 \n12. Disclosures \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Neither Topic 842 nor Topic 230 specify where in the financial statements the \nrequired s upplemental noncash disclosures must be made. \n \n Question 12.2.20 \nMD&A disclosure of contractual obligations \nShould an SEC registrant’s MD&A disclosures about \ncontractual obligations be consistent with the maturity analysis of lease liabilities under Topic 842? \nBackground: In November 2020, the SEC adopted amendments to Regulation \nS-K to simplify MD&A and other financial disclosures; see KPMG Hot Topic, \nSEC amends Regulation S -K to streamline disclosures . Among other changes, \nthe amendments to Item 303 eliminated the requirement to tabularly present a \nregistrant’s contractual obli gations. \nThe rule amendments became effective on February 10, 2021. Compliance with \nthe amended rules wa s required beginning with the fiscal year ending on or \nafter August 9, 2021 – e.g. year ending December 31, 2021 for calendar year -\nend registrants. Ea rly compliance with the Item 303 amendments, in filings \nmade after February 10, 2021, wa s allowed if a registrant complies with the \namended Item in its entirety. [Reg S -K Section II.F] \nInterpretive response: It depends. Although the amendments to Item 303 \neliminate the requirement to tabularly present a registrant’s contractual \nobligations, we believe that lease commitments may still need to be disclosed, \nif material, in MD&A. The disclosure would be part of t he ‘enhanced’ liquidity \nand capital resources disclosures called for by the amendments, which include \nrequired disclosures of material cash requirements from obligations. [Reg S -K Item \n303(b)(1) ] \nThe enhanced liquidity and capital resources disclosures als o appear to require \nsome measure of continued time- banding of material future lease obligations. \n[Reg S -K Item 303(b)(1)] \nAn entity’s facts and circumstances will dictate the extent of the lease- related \ndisclosures required. To the extent that contractual commitments related to \nleases continue to be disclosed, we believe the disclosure should be consistent \nwith the entity’s US GAAP footnotes. Th is comports with guidance in the SEC \nStaff Financial Reporting Manual related to the previously required contractual \nobligations table, which state d, when preparing that disclosure, “The \ninformation disclosed in the table in respect of long- term debt obligations, \ncapital (finance) leases and operating lease obligations should be consistent with the disclosures provided in the financial statements.” \n[FRM 9240.6(c)] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 965}), Document(page\_content='Leases 965 \n12. Disclosures \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 12.2.10 \nWeighted -average remaining lease term disclosure \nA lessee calculates the weighted- average remaining lease term based on the \nremaining lease term and the lease liability balance for each lease at the \nreporting date. [842- 20-55-11] \nFor the year ended December 31, 20X1, Lessee LE discloses a weighted-average remaining lease term of 4.96 years for its finance leases, and \n2.73 years for its operating leases. LE calculated the weighted- average \nremaining lease terms as follows. \nLease ID Lease liab . \n12/31/ 20X1 \n(A) Remain ing \nlease term at \n12/31/20X1 \n(B) (A × B) Weighted-\navg. lease \nterm at \n12/31/ 20X1 \nFinance leases \nFL1 $ 52,936 4.00 211,744 \nFL2 94,499 5.50 519,745 D/C \n C = $147,435 D = 731,489 4.96 \nOperating leases \nOL1 $ 14,104 2.00 28,208 \nOL2 21,654 2.25 48,722 \nOL3 33,570 2.54 85,268 \nOL4 24,365 4.00 97,460 \nOL5 12,847 2.42 31,090 F/E \n E = $106,540 F = 290,748 2.73 \n \n \n Example 12.2. 20 \nWeighted -average discount rate disclosure \nA lessee calculates the weighted- average discount rate based on: [842- 20-55-12] \n— the discount rate for the lease – i.e. used to calculate the lease liability \nbalance for each lease at the reporting date; and \n— the remaining balance of the lease payments for each lease at the reporting \ndate. \nFor the year ended December 31, 20X1, Lessee LE discloses a weighted-\naverage discount rate of 5.72% for its finance leases, and 4.29% f or its \noperating leases. The leases described are the same as in Example 12. 2.10. LE \ncalculated the weighted- average discount rates as follows. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 966}), Document(page\_content='Leases 966 \n12. Disclosures \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Lease ID Remain ing \npmts . \n12/31/ 20X1 \n(A) Rate to calc . \nliabs . (B) (A × B) Weighted-\navg. discount \nrate \n12/31/ 20X1 \nFinance leases \nFL1 $ 60,000 5.20% 3,120 \nFL2 112,500 6.00% 6,750 D/C \n C = $172,500 D = 9,870 5.72% \nOperating leases \nOL1 $ 15,000 4.20% 630 \nOL2 22,800 4.20% 958 \nOL3 36,000 4.70% 1,692 \nOL4 27,000 4.20% 1,134 \nOL5 13,500 3.60% 486 F/E \n E = $114,300 F = 4,900 4.29% \n \n \n Example 12.2. 30 \nPeriodic short -term lease cost does not reasonably \nreflect lessee’s short -term lease commitments \nLessee LE has elected to apply the short -term lease exemption to one of its \nclasses of underlying assets: office equipment (e.g. copiers and printers). In \n20X1, LE has only a small number of leases within this class of underlying asset \nthat qualify for the exemption. The short -term lease cost recognized and \ndisclosed for those leases in 20X1 is $200,000. The remaining lease payments \ndue in 20X2 are $40,000. \nOn December 31, 20X1 , LE enters into a master lease agreement for a \nnumber of new items of office equipment. The leases subject to that \nagreement qualify as short -term leases because the non- cancellable period of \nthe leases is one year, and LE is not reasonably certain to exercise its right to \nrenew those leases at the end of the non- cancellable period – i.e. the lease \nterm is one year or less. \nBecause LE has elected the short -term lease exemption for its leases of office \nequipment, the exemption applies to these new office equipment leases. The \ntotal lease payments that will be paid in 20X2 for the additional items of office \nequipment are $2,400,000. \nIn accordance with the lessee disclosure requirements in Topic 842, LE \ndiscloses the following in the notes to its 20X1 financial statements: \n— the fact that it elected to apply the short -term lease ex emption for its \nleases of office equipment; \n— short -term lease cost of $200,000 in 20X1; and ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 967}), Document(page\_content='Leases 967 \n12. Disclosures \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — because the periodic short -term lease cost of $200,000 disclosed does not \nreasonably reflect the lessee’s short -term lease commitments as of \nDecember 31, 20X1, that fact , and the amount of its short -term lease \ncommitments of $2,440,000 ($2,400,000 + $40,000). \n \n Comparison to legacy US GAAP \nIncreased qualitative and quantitative disclosures \n12.2. 60 Lessee disclosures under Topic 842 are more extensive than those \nunder Topic 840. [840- 10-50, 840- 20-50, 840 -30-50, 840- 40-50] \n— Examples of new qualitative disclosures include (1) information about \nleases that have not yet commenced at the reporting date that create \nsignificant rights and obligations to the lessee, and (2) significant judgments \nmade, such as determining whether a contract c ontains a lease, \ndetermining the discount rate for the lease, and allocating the consideration in the contract to lea se and non- lease components. \n— Examples of new quantitative disclosures include cash paid for amounts included in the measurement of lease liabilities, supplemental non- cash \ninformation on lease liabilities arising from obtaining ROU assets for \noperating lea ses, weighted -average remaining lease terms, and weighted-\naverage discount rate information. \n \n12.3 Lessor disclosures \n Excerpt from ASC 842 -30 \n50 Disclosure \nGeneral \n50-3 A lessor shall disclose both of the following: \na. Information about the nature of its leases, including: \n1. A general description of those leases \n2. The basis and terms and conditions on which variable lease \npayments are determined \n3. The existence and terms and c onditions of options to extend or \nterminate the lease \n4. The existence and terms and conditions of options for a lessee to \npurchase the underlying asset . \nb. Information about significant assumptions and judgments made in applying \nthe requirements of this Topic, which may include the following: \n1. The determination of whether a contract contains a lease (as \ndescribed in paragraphs 842 -10-15-2 through 15 -27) ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 968}), Document(page\_content='Leases 968 \n12. Disclosures \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 2. The allocation of the consideration in a contract between lease and \nnonlease components (as described in paragraphs 842- 10-15-28 \nthrough 15- 32), unless a lessor elects the practical expedient in \nparagraph 842-10-15-42A and all nonlease components in the contra ct \nqualify for that practical expedient. \n3. The determination of the amount the lessor expects to derive from the \nunderlying asset following the end of the lease term . \n50-3A An entity that elects the practical expedient in paragraph 842- 10-15-42A \non not separating nonlease components from associated lease components \n(including an entity that accounts for the combined component entirely in \nTopic 606 on revenue from contracts with customers) shall disclose the \nfollowing by class of underlying asset : \na. Its accounting policy election and the class or classes of underlying assets \nfor which it has elected to apply the practical expedient \nb. The nature of: \n1. The lease component s and nonlease components combined as a result \nof applying the practical expedient \n2. The nonl ease components, if any, that are accounted for separately \nfrom the combined component because they do not qualify for the \npractical expedient. \nc. The Topic the entity applies to the combined component (this Topic or \nTopic 606). \n50-4 A lessor shall disclose any lease transactions between related parties (see \nTopic 850 on related party disclosures). \n50-5 A lessor shall disclose lease income recognized in each annual and interim \nreporting period, in a tabular format, to include the following: \na. For sales -type leases and direct financing leases : \n1. Profit or loss recognized at the commencement date (disclosed on a \ngross basis or a net basis consistent with paragraph 842- 30-45-4) \n2. Interest income either in aggregate or separated by components of the \nnet investment in the lease. \nb. For operating leases , lease income relating to lease payments . \nc. Lease income relating to variable lease payments not included in the \nmeasurement of the lease receivable. \n50-6 A lessor shall disclose in the notes the components of its aggregate net \ninvestment in sales -type and direct financing leases (that is, the carrying \namount of its lease receivables, its unguaranteed residual assets , and any \ndeferred selling profit on direct financing leases). \n50-7 A lessor shall disclose information about how it manages its risk \nassociated with the residual value of its leased assets. In particular, a lessor \nshould disclose all of the following: \na. Its risk management strategy for residual assets \nb. The carrying amount of residual ass ets covered by residual value \nguarantees (excluding guarantees considered to be lease payments for \nthe lessor, as described in paragraph 842 -30-30-1(a)(2)) ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 969}), Document(page\_content='Leases 969 \n12. Disclosures \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. c. Any other means by which the lessor reduces its residual asset risk (for \nexample, buyback agreement s or variable lease payments for use in \nexcess of specified limits). \n> Sales -Type and Direct Financing Leases \n50-8 In addition to the disclosures required by paragraphs 842- 30-50-3 through \n50-7, a lessor also shall provide the disclosures in pa ragraphs 842- 30-50-9 \nthrough 50- 10 for sales -type leases and direct financing leases . \n50-9 A lessor shall explain significant changes in the balance of its \nunguaranteed residual assets and deferred selling profit on direct financing \nleases. \n50-10 A lessor shall disclose a maturity analysis of its lease receivables , \nshowing the undiscounted cash flows to be received on an annual basis for a \nminimum of each of the first five years and a total of the amounts for the \nremaining years. A lessor shall disclose a reconciliation of the undiscounted \ncash flows to the lease receivables recognized in the statement of financial \nposition (or disclosed separately in the notes). \n> Operating Leases \n50-11 In addition to the disclosures required by paragraphs 842- 30-50-3 \nthrough 50- 7, a lessor also shall provide the disclosures in paragraphs 842- 30-\n50-12 through 50- 13 for operating leases . \n50-12 A lessor shall disclose a maturity analysis of lease payments , showing \nthe undiscounted cash flows to be received on an annual basis for a minimum \nof each of the first five years and a total of the amounts for the remaining \nyears. A lessor shall present that maturity analysis separately from the maturity \nanalysis re quired by paragraph 842- 30-50-10 for sales -type leases and direct \nfinancing leases . \n50-13 A lessor shall provide disclosures required by Topic 360 on property, \nplant, and equipment separately for underlying assets under operating leases \nfrom owned as sets. \n> Separating Components of a Contract \n50-14 A lessor that makes the accounting policy election in paragraph 842- 10-\n15-39A shall disclose its accounting policy election and comply with the \ndisclosure req uirements in paragraphs 235 -10-50-1 through 50 -6. \n12.3.10 Lessor disclosure requirements for grandfathered leveraged leases are \ndiscussed in s ection 7. 8. \n \n Example 12.3.10 \nChart of lease income for the reporting period \nThe following chart is an example of the lease income disclosure by Lessor LR, \nwhich is required to be in tabular format and is required to be provided in both \nannual and interim periods (see Question 12.1.10) . ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 970}), Document(page\_content='Leases 970 \n12. Disclosures \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. For the years ended December 31 (in thousands) 20X9 20X8 \nLease income – sales -type and direct financing leases \nProfit at lease commencement1 $ 17 $ 5 \nInterest income on lease receivables2 345 320 \nInterest income from accretion of unguaranteed \nresidual assets2 105 97 \nSubtotal 467 422 \nLease income – operating leases 510 495 \nVariable lease income 25 22 \nTotal lease income $1,002 $939 \nNotes: \n1. Presentation is based on LR’s business model in accordance with paragraph 842- 30-45-\n4. In this example, LR uses leases for the purpose of providing finance and therefore \nprofit is presented net. \n2. Interest income on LR’s net investment in leases may be disclosed either in aggregate \nor separately (as shown) for each component of the net investment in the lease. \n \n \n Question 12.3. 10 \nAssets subject to operating leases as a separate \nmajor class of depreciable assets \nAre assets subject to operating leases a separate major class \nof depreciable assets? \nInterpretive response: Yes. A lessor should treat assets subject to operating \nleases as a separate major class of depreciable assets, which should be \nfurther disaggregated by significant class of underlying assets (e.g. airplanes \nversus buildings) . \nIn the Board’s view, leased assets are often subject to risks different from \nowned a ssets that are held and used by the entity, and providing separate \ndisclosures related to those assets benefits users. In addition, the risks related \nto one class of leased asset may be very different from another such that \nadditional disaggregation by class of underlying asset is appropriate. \n[ASU 2016- 02.BC341] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 971}), Document(page\_content='Leases 971 \n12. Disclosures \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 12.3.20 \nSeparate disclosure of tenant reimbursements \nIs a lessor that elected the lessor non- separation practical \nexpedient permitted to separately disclose tenant \nreimbursements? \nBackground : Under Topic 840, lessors (particularly real estate lessors) \nfrequently adopted a practice for net leases (see paragraph 7.3.170) of \npresenting separately: \n— revenue from the base rental paym ents due under a lease; and \n— tenant reimbursements of lessor executory costs such as property taxes, \ninsurance and maintenance (including common area maintenance). \nAs explained in Question 7.7.30, it is not acceptable for a lessor that has \nelected the non- separation practical expedient for lease and non- lease \ncomponents (see paragraphs 4.4.51 – 4.4.57) to present these tenant \nreimbursements separately from base rental revenue in its income statement. \nConsequently, the question arises as to whether it is acc eptable for the lessor \nto disclose the amount of tenant reimbursements it has included within lease \nrevenue. For example, if a lessor recognizes lease revenue of $100 for the \nperiod, is it permitted to disclose that $16 of the $100 is related to tenant \nreimbursements? \nInterpretive response: In general, yes – provided that the lessor does not \ncharacterize the tenant reimbursements as a revenue measure, or present \nthem in a manner that suggests they reflect payments for something other \nthan, or in addition to, the right to use the underlying asset. \nTherefore, in general, we believe separate presentation of such amounts should \nbe labeled factually (e.g. as ‘tenant reimbursements’), and shown and/or \ndiscussed as a component of the single income statement line item (i.e. lease \nrevenue) – i.e. as an item that totals to lease revenue. Further , discussion of \ntenant reimbursements should be limited to disclosing facts, such as the dollar \namount of property tax and/or insurance r eimbursements billed to lessees that \nis included in the applicable income statement line item (e.g. l ease revenue) for \nthe period. \nIt would not be appropriate to characterize those amounts as anything other than a component of the single income statement line item. For example, we \ndo not beli eve tenant reimbursements should be presented in manner that \nsuggests lease revenue or rental revenue includes only the base rent payments. \nDoing so might inappropriately suggest a differentiation between the tenant \nreimbursements and base rent that is inc onsistent with the fact that both \namounts (the tenant reimbursements and the base rent) reflect payments for \nthe right to use the underlying asset. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 972}), Document(page\_content='Leases 972 \n12. Disclosures \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Comparison to legacy US GAAP \nMore information on risks to which a lessor is exposed and lease income \n12.3.20 Although the Board decided not to substantially change lessor \naccounting and to retain most of the existing disclosure requirements, its \ndecision to expand the lessor disclosure requirements is intended to provide \nfinancial statement users (e.g. investors and analysts) with: [840- 10-50, 840- 20-50, \n840-30-50, 840 -40-50] \n— more information about the risks to which a lessor is exposed; for example, \ncollectibility of lease receivables (i.e. credit risk), and risks related to the \nlessor’s re sidual interest in its leased assets; and \n— additional information about a lessor’s lease income ( see Example 12.3.10). \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 973}), Document(page\_content='Leases 973 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13A. Effective dates and \ntransition : effective date \nmethod \nDetailed contents \nItem significantly updated in this chapter: # \nNew item added to this chapter: \*\* \nStructure of transition chapters \nHow the standard wo rks \n13A.1 Effective dates # \nQuestions \n13A.1.10 Early adoption considerations \n13A.1.20 [Not used] \n13A.1.30 Issuance of a registration statement on Form S -3 after the \neffective date \n13A.1.40 [Not used] \n13A.1.50 Effective date for certain public business entities \n13A.1.60 Effective date for an entity in the process of an initial public \noffering (IPO) \*\* \n13A.2 Transition principles – lessees and lessors \n13A.2.1 Transition approach – general \n13A.2.2 Transition approach – modifications \n13A.2.3 Practical expedients \n13A.2.4 Land easements \n13A.2.5 Disclosures \nObservation s \nAdditional transition method offers relief to preparers \nImpact on initial direct costs for entities not electing the package of practical expedients\n \nPrior land easem ent accounting is grandfathered \nEffect of adoption on the financial statements \nQuestions \n13A.2.10 [Not used] \n13A.2.20 Date of lease classification reassessment ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 974}), Document(page\_content='Leases 974 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13A.2.30 Hindsight practical expedient – effect on lease classification \nif package of practical expedients elected \n13A.2.40 Hindsight practical expedient – lessee options \n13A.2.50 Hindsight practical expedient – existing capital (sales-\ntype/direct financing) leases \n13A.2.60 Hindsight practical expedient – short -term leases \n13A.2.70 Hindsight practical expedient – changes to straight -line \noperating lease income (expense) \n13A.2.80 Hindsight practical expedient – remeasurement events \n13A.2.90 Hindsight practical expedient – changes to an index or rate \non which variable lease payments are based \n13A.2.100 Errors in applying Topic 840 \n13A.2.110 Grandfathering arrangements committed or agreed to \nbefore reporting periods beginning after May 28, 2003 \n13A.2.120 Land easements arising before the effective date \n13A.2.130 Disclosures in comparative periods \n13A.2.140 Loss of EGC status before nonpublic business entity effective date \nExample \n13A.2.10 Applying hindsight with lease remeasurements and modifications\n \n13A.3 Transition for lessees # \n13A.3.1 Lessee elects package of practical expedients \n13A.3.2 Lessee does not elect package of practical expedients \n13A.3.3 ASU 2021- 09, Discount Rate for Lessees That Are Not \nPublic Business Entities \n13A.3.4 ASU 2023- 01, Common C ontrol Arrangements \*\* \nObservations \nImplementation guidance and illustrations in Topic 842 not updated for \neffective date method \nChanges in lessee lease classification in tr ansition \nQuestions \n13A.3.10 Minimum rental payments \n13A.3.20 Excluding CAM costs \n13A.3.30 Measurement of lease payments that depend on an index or rate in determining the operating lease liability\n \n13A.3.40 Foreign exchange rate to use in transition when the lease is not denominated in the entity’s functional currency\n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 975}), Document(page\_content='Leases 975 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13A.3.50 Determining the incremental borrowing rate in transition \n13A.3.60 ROU asset abandoned before the effective date \n13A.3.70 Executory costs that are part of Topic 420 liabilities on \ntransition \n13A.3.80 Transition guidance for Topic 420 liabilities results in negative ROU asset carrying amount\n \n13A.3.90 Existing sublease liabilities under Topic 840 \n13A.3.100 [Not used] \n13A.3.110 Effects of Topic 360 impairments before the effective date \n13A.3.120 Transition impact on prior asset group impairments \n13A.3.130 Recognizing ‘hidden’ ROU asset impairments at the effective date\n \n13A.3.140 Amortization period for leasehold improvements previously \nacquired in a business combination \nExamples \n13A.3.10 Lessee transition for an existing operating lease with package of practical expedients elected – Approach A \nin Question 13A.3.10\n \n13A.3.20 Lessee transition for an existing operating lease \nwith package of practical expedients elected – Approach B \nin Question 13A.3.10 \n13A.3.30 Lessee transition for an existing capital lease with package \nof practical expedients elected \n13A.3.40 Lessee transition for operating lease under Topic 840 classified as a finance lease under Topic 842 – package of \npractical expedients not elected\n \n13A.4 Transition for lessors \n13A.4.1 Lessor elects package of practical expedients \n13A.4.2 Lessor does not elect package of practical expedients \n13A.4.3 ASU 2018- 20, Narrow- Scope Improvements for Lessors \n13A.4.4 ASU 2019- 01, Codification Improvements \n13A.4.5 ASU 2021- 05, Lessors —Certain Leases with Variable Lease \nPayments \n13A.4.6 ASU 2023- 01, Common C ontrol Arrangements \*\* \nObservations \nChan ges in lessor lease classification in transition \nInitial direct costs included in the net investment in a sales‑type or \ndirect financing lease ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 976}), Document(page\_content='Leases 976 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Questions \n13A.4.10 Offset to assets and liabilities written off on transition \n13A.4.20 Revenue recognition guidance for arrangements that no \nlonger meet the definition of a lease \n13A.4.30 Comparative periods \nExample \n13A.4.10 Lessor transition for an operating lease under Topic 840 \nclassified as a sales ‑type lease under Topic 842 \n13A.5 Applying the guidance on components of a contract in transition \n13A.5.1 Lessee guidance \n13A.5.2 Lessor guidance – practical expedient for separation of lease \nand non- lease components does not apply \n13A.5.3 Lessor guidance – practical expedient for separation of lease \nand non- lease components applies \nObservation \nLessor reallocation may be permissible in some cases \nQuestions \n13A.5.10 Not separating lease from non- lease components on \ntransition \n13A.5.20 Accounting policy implications of separating lease from non-lease components on transition \n13A.5.30 Topic 842 and Topic 606 interaction in accounting for CAM \n13A.5.40 Existing arrangements with lease and non -lease elements – \nsubstantial services \n13A.5.50 Combining lease and non- lease components in comparative \nperiods \n13A.6 Leveraged leases \nQuestion \n13A.6.10 Acquired leveraged leases\n \n13A.7 Sale-leaseback transactions \nQuestions \n13A.7.10 Leaseback accounting in transition for previously failed sales \n13A.7.20 Successful sale -leaseback transactions that include seller -\nlessee repurchase options on adoption of Topic 606 \nExamples \n13A.7.10 Sale-leaseback transaction previously accounted for as a \nsale and an operating leaseback under Topic 840 \n13A.7.20 Sale-leaseback deferred gains and losses in transition ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 977}), Document(page\_content='Leases 977 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13A.8 Build -to-suit lease arrangements \n13A.8.1 Derecognition of build -to-suit assets and liabilities \n13A.8.2 Evaluating previous build- to-suit conclusions \n13A.8.3 Build -to-suit arrangements accounted for as successful sale -\nleaseback transactions \n13A.8.4 Lessee was the accounting owner under Topic 840 \n13A.8.5 Lessee was not the accounting owner under Topic 840 \nObservations \nBuild -to-suit transition \nLessees with build- to-suit leases may early adopt \nSAB Topic 11.M disclosure of impact on future periods \nQuestions \n13A.8.10 Lease classification for build -to-suit leases in transition \n13A.8.20 Lessee- paid costs included in existing build -to-suit asset s \n13A.9 Previous business combinations \nObservation \nImpact of previously recognized favor able lease asset or unfavorable \nlease liability on lessee’s subsequent accounting \nQuestion \n13A.9.10 (Un)favorable contract (liabilities) assets for contracts not \naccounted for as leases under Topic 840 \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 978}), Document(page\_content='Leases 978 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Structure of transition chapters \nThe discussion of transition has been divided into two separate chapters. \n— This chapter discusses the ‘effective date method’ , which is the additional \ntransition method introduced in ASU 2018- 11. \n— Chapter 13B discusses the ‘comparative method’ , which is the original \ntransition method introduced in ASU 2016- 02. \nFor purposes of comparison, the Question numbers are the same in each \nchapter. If a question is not applicable to one chapter, that question is indicated \nas ‘Not used’ in the ‘ Detailed contents ’. \nThe guidance that follows in t his chapter should be used only by those who \nelect the effective date method. \n \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 979}), Document(page\_content='Leases 979 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. How the standard works \nTopic 842 requires entities to use a modified retrospective transition method. \nIn July 2018, the Board issued ASU 2018 -11, which provides an alternative \nmodified retrospective transition method . Under this new method, the \ncumulative -effect adjustment to the opening balance of retained earnings is \nrecognized on the date of adoption – e.g. January 1, 2019 for calendar year-end \npublic business entities , and January 1, 2022 for private companies, that do not \nearly adopt Topic 842. \nEffective date: Public business \nentities :1 \nAnnual and interim \nperiods in fiscal \nyears beginning \nafter December 15, \n2018. Public not -for-profit \nentitie s:2,3 \nAnnual and interim \nperiods in fiscal \nyears beginning \nafter December 15, \n2019. \n Other entities: \n— Annual periods in fiscal years \nbeginning after \nDecember 15, \n2021. \n— Interim periods in fiscal years \nbeginning after \nDecember 15, \n2022. \nDate of initial \napplication: The entity’s effective date – i.e. the beginning of the reporting \nperiod in which Topic 842 is first applied. For a public business \nentity with a calendar year -end that does not early adopt \nTopic 842, this date will be January 1, 201 9. For a private company \nwith a calendar year -end that does not early adopt Topic 842, this \ndate will be January 1, 2022. \nThe effective date and the date of initial application are the same \nunder the e ffective date method. \nEarly adoption: All entities can adopt Topic 842 immediately. \nTransition \nmethod: Modified retrospective, which requires a cumulative -effect \nadjustment to the opening balance of retained earnings on the \neffective date. \nPackage of \npractical \nexpedients (all \nor nothing): An entity may elect not to reassess: \n— whether expired or existing contracts contain leases under the \nnew definition of a lease; \n— lease classification for expired or existing leases; and \n— whether previously capitalized initial direct costs would qualify \nfor capitalization under Topic 842. \nUse of \nhindsight: — Hindsight allowed when considering the likelihood that lessee \noptions to extend or terminate a lease or purchase the \nunderlying asset will be exercised. \n— Elect on its own or with the package of practical expedients. \nLand \neasements: — An entity may elect not to assess at transition whether any \nexpired or existing land easements are, or contain, leases if \nthey were not previously accounted for as leases under \nTopic 840. \n— Elect on its own or with the package of practical expedients \nand/or hindsight. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 980}), Document(page\_content='Leases 980 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Note s: \n1. This includes (1) public business entities, (2) public not‑for‑profit entities not addressed \nby Note 3, and ( 3) employee benefit plans that file or furnish financial sta tements with or \nto the SEC. \n2. ‘Public’ not -for-profit entities are those that have issued or are conduit bond obligors for \nsecurities that are traded, listed or quoted on an exchange or an over -the-counter market. \n3. Public not -for-profit entities are eligible to elect this effective date i f they did not issue \nGAAP- compliant financial statements reflecting the adoption of Topic 842 before June 3, \n2020 (the issuance date of ASU 2020 -05). \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 981}), Document(page\_content='Leases 981 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13A.1 Effective dates # \n Excerp t from ASC 842-10 \nTransition and Open Effective Date Information \nGeneral \n> Transition Related to Accounting Standards Update s No. 2016- 02, \nLeases (Topic 842) , No. 2018- 01, Leases (Topic 842): Land Easement \nPractical Expedient for Transition to Topic 842 , No. 2018- 10, Codification \nImprovements to Topic 842, Leases , No. 2018- 11, Leases (Topic 842): \nTargeted Improvements , No. 2018- 20, Leases (Topic 842): Narrow -Scope \nImprovements for Lessors , No. 2019- 01, Leases (Topic 842): Codification \nImprovemen ts, No. 2019- 10, Financial Instruments —Credit Losses (Topic \n326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): \nEffective Dates , No. 2020- 05, Revenue from Contracts with Customers \n(Topic 606) and Leases (Topic 842): Effective Dates for Certa in Entities , \nNo. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with Variable \nLease Payments , No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entities , and No. 2023- 01, Leases \n(Topic 842): Common Control Arrange ments \n65-1 The following represents the transition and effective date information \nrelated to Accounting Standards Updates No. 2016- 02, Leases (Topic 842) , \nNo. 2018- 01, Leases (Topic 842): Land Easement Practical Expedient for \nTransition to Topic 842, No. 2018- 10, Codification Improvements to Topic 842, \nLeases , No. 2018- 11, Leases (Topic 842): Targeted Improvements , No. 2018-\n20, Leases (Topic 842): Narrow- Scope Improvements for Lessors , No. 2019- 01, \nLeases (Topic 842): Codification Improvements , No. 2 019-10, Financial \nInstruments —Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), \nand Leases (Topic 842): Effective Dates , No. 2020- 05, Revenue from Contracts \nwith Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain \nEntities , No. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with \nVariable Lease Payments , No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entities , and No. 2023- 01, Leases (Topic \n842): Common Control Arrangements : [Note : See paragraph 842-10-S65-1 for \nan SEC Staff Announcement on transition related to Update 2016- 02.] \na. A public business entity , a not-for-profit entity that has issued or is a \nconduit bond obligor for securities that are traded, listed, or quoted on an \nexchange or an over -the-counter market (with an exception for those \nentities that have not yet issued their financial statements or m ade \nfinancial statements available for issuance as described in the following \nsentence) , and an employee benefit plan that files or furnishes financial \nstatements with or to the U.S. Securities and Exchange Commission shall \napply the pending content that l inks to this paragraph for financial \nstatements issued for fiscal years beginning after December 15, 2018, and \ninterim periods within those fiscal years. A not -for-profit entity that has \nissued or is a conduit bond obligor for securities that are traded, l isted, or \nquoted on an exchange or an over -the-counter market that has not yet \nissued financial statements or made financial statements available for ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 982}), Document(page\_content='Leases 982 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. issuance as of June 3, 2020 shall apply the pending content that links to \nthis paragraph for fiscal years beginning after December 15, 2019, and \ninterim periods within those fiscal years. Earlier application is permitted. \nb. All other entities shall apply the pending content that links to this \nparagraph for financial statements issued for fiscal years beginning after \nDecember 15, 2021, and interim periods within fiscal years beginning after \nDecember 15, 2022. Earlier application is permitted. \n Transition Related to Accounting Standards Update No. 2018- 11, \nLeases (Topic 842): Targeted Improvements \n65-2 The following represents the transition and effective date information \nrelated to Accounting Standards Update No. 2018- 11, Leases (Topic 842) : \nTargeted Improvements : \na. An entity that has not yet adopted the pending content that links to \nparagraph 842-10-65-1 shall apply the pending content that links to \nparagraph 842- 10-65-2, by class of underlying asset, to all new and existing \nleases when the entity first applies the pending content that links to \nparagraph 842- 10-65-1 and shall apply the same tra nsition method elected \nfor the pending content that links to paragraph 842- 10-65-1. \nb. An entity that has adopted the pending content that links to paragraph 842-\n10-65-1 shall apply the pending content that links to this paragraph, by \nclass of underlying asse t, to all new and existing leases either: \n1. In the first reporting period following the issuance of the pending \ncontent that links to paragraph 842- 10-65-2 \n2. At the original effective date of this Topic for that entity as determined \nin paragraph 842-10-65-1(a) and (b). \nc. An entity that has adopted the pending content that links to paragraph 842-\n10-65-1 shall apply the pending content that links to this paragraph, by \nclass of underlying asset, to all new and existing leases either: \n1. Retrospectively to all prior periods beginning with the fiscal years in \nwhich the pending content that links to paragraph 842- 10-65-1 was \ninitially applied \n2. Prospectively. \n> Transition Related to Accounting Standards Update No. 2018- 20, \nLeases (Topic 842): Narrow -Scope Improvements for Lessors \n65-3 The following represents the transition and effective date information \nrelated to Accounting Standards Update No. 2018- 20, Leases (Topic 842): \nNarrow -Scope Improvements for Lessors : \na. An entity that has not yet adopted the pending content that links to \nparagraph 842- 10-65-1 shall apply the pending content that links to this \nparagraph to all new and existing leases when the entity first applies the \npending content that links to paragraph 842- 10-65-1 and shall apply the \nsame transition method elected for the pending content that links to \nparagraph 842- 10-65-1. \nb. An entity that has adopted the pending content that links to paragraph 842-\n10-65-1 before the issuance of the pending content that links to this \nparagraph shall adopt the pending content that links to this paragraph to all \nnew and existing leases at the original effective date of this Topic for that \nentity as determined in paragraph 842 -10-65-1(a) through (b). Alternatively, ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 983}), Document(page\_content='Leases 983 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. an entity that has adopted the pending content that links to paragraph 842 -\n10-65-1 may adopt the pending content that links to this paragraph to all \nnew and existing leases either: \n1. In the first reporting period ending after the issuance of the pending \ncontent that links to this paragraph \n2. In the first reporting period beginning after the issuance of the pending \ncontent that links to this paragraph. \nc. An entity that has adopted the pending content that links to paragraph 842-\n10-65-1 before the issuance of the pending content that links to this \nparagraph shall apply the pending content tha t links to this paragraph to all \nnew and existing leases either: \n1. Retrospectively to all prior periods beginning wit h the fiscal years in \nwhich the pending content that links to paragraph 842- 10-65-1 was \ninitially applied \n2. Prospectively. \n> Transition Related to Accounting Standards Update s No. 2019- 01, \nLeases (Topic 842): Codification Improvements , No. 2019- 10, Financial \nInstruments —Credit Losses (Topic 326), Derivatives and Hedging (Topic \n815), and Leases (Topic 842): Effective Dates , and N o. 2020- 05, Revenue \nfrom Contracts with Customers (Topic 606) and Leases (Topic 842): \nEffective Dates for Certain Entities \n65-4 The following represents the transition and effective date information \nrelated to Accounting Standards Updates No. 2019- 01, Leases (Topic 842) : \nCodification Improvements , No. 2019 -10, Financial Instruments —Credit Losses \n(Topic 326), Derivatives and Hedging (Topi c 815), and Leases (Topic 842): \nEffective Dates , and No. 2020- 05, Revenue from Contracts with Customers \n(Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities : \na. All entities within the scope of paragraph 842- 10-65-1(a) shall apply the \npending content that links to this paragraph for financial statements issued \nfor fiscal years beginning after December 15, 2019, and interim periods \nwithin those fiscal years (with an exception for those entities that have not \nyet issued their financial statements or made financial statements available \nfor issuance as described in the following sentence). A not -for-profit \nentity that has issued or is a conduit bond obligor for securities that are \ntraded, listed, or quoted on an exchange or an over -the-counter market that \nhas not yet issued financial statements or made financial statements \navailable for issuance as of June 3, 2020 shall apply the pending content \nthat links to this paragraph for fiscal years beginning after December 15, \n2019, and interim periods within those fiscal years . All other entities shall \napply the pending content that links to this paragraph for financial \nstatements issued for fiscal years beginning after December 15, 2021, and \ninterim periods within fiscal years beginning after December 15, 2022. \nEarly application is permitted. \nb. An entity shall apply the pending content that links to this par agraph as \nof the date that it first applied the pending content that links to \nparagraph 842-10-65-1 and shall apply the same transition method elected \nfor the pending content that links to paragraph 842- 10-65-1 in accordance \nwith paragraph 842- 10-65-1(c). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 984}), Document(page\_content='Leases 984 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. > Transition Related to Accounting Standards Update No. 2021 -05, \nLeases (Topic 842): Lessors —Certain Leases with Variable Lease \nPayments \n65-5 The following represents the transition and effective date information \nrelated to Accounting Standards Upda te No. 2021- 05, Leases (Topic 842): \nLessors —Certain Leases with Variable Lease Payments : \na. An entity that has not yet adopted the pending content that links to \nparagraph 842- 10-65-1 as of July 19, 2021, shall apply the pending content \nthat links to this par agraph when it first applies the pending content that \nlinks to paragraph 842- 10-65-1 and shall apply the same transition method \nelected for the pending content that links to paragraph 842- 10-65-1. \nb. An entity within the scope of paragraph 842- 10-65-1(a) that has adopted \nthe pending content that links to paragraph 842- 10-65-1 as of July 19, \n2021, shall apply the pending content that links to this paragraph for fiscal \nyears beginning after December 15, 2021, and interim periods within those \nfiscal years. Earlie r application is permitted. \nc. An entity within the scope of paragraph 842- 10-65-1(b) that has adopted \nthe pending content that links to paragraph 842- 10-65-1 as of July 19, \n2021, shall apply the pending content that links to this paragraph for fiscal \nyears beginning after December 15, 2021, and interim periods within fiscal \nyears beginning after December 15, 2022. Earlier application is permitted. \nd. An entity within the scope of (b) or (c) shall apply the pending content that \nlinks to this paragraph by using one of the following two methods: \n1. Retrospectively to the date in which the pending content that links to \nparagraph 842- 10-65-1 was adopted (the beginning of the period of \nadoption of Topic 842). Under this transition method, the entity shall \napply the pending content that links to this paragraph to leases that \ncommence or are modified on or after the beginning of the period of its \nadoption of Topic 842 and do not meet the conditions in paragraph 842-\n10-25-8. \n2. Prospectively to leases that commence or are mod ified on or after the \ndate that the entity first applies the pending content that links to this \nparagraph and do not meet the conditions in paragraphs 842- 10- 25-8. \ne. An entity within the scope of (b) or (c) that elects the transition method in \n(d)(1) shall provide the following transition disclosures: \n1. The applicable transition disclosures required by Topic 250 on \naccounting changes and error corrections, except for the requirements \nin paragraph 250- 10-50-1(b)(2) and paragraph 250 -10-50-3 \n2. The transition di sclosures in paragraph 250- 10-50-1(b)(3) as of the \nbeginning of the earliest period presented but not before the date in \nwhich the pending content that links to paragraph 842- 10-65-1 was \nadopted. \nf. An entity within the scope of (b) or (c) that elects the tr ansition method in \n(d)(2) shall provide the following transition disclosures: \n1. The nature of and reason for the change in accounting principle \n2. The transition method \n3. A qualitative description of the financial statement line items affected \nby the change. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 985}), Document(page\_content='Leases 985 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. > Transition Related to Accounting Standards Update No. 2021 -09, \nLeases (Topic 842): Discount Rate for Lessees That Are Not Public \nBusiness Entities \n65-6 The following represents the transition and effective date information \nrelated to Accounting Standards Update No. 2021- 09, Leases (Topic 842): \nDiscount Rate for Lessees That Are Not Public Business Entities : \na. An entity that has not yet adopted the pending content that links to \nparagraph 842- 10-65-1 as of 11/11/2021, shall appl y the pending content \nthat links to this paragraph to all new and existing leases when the entity \nfirst applies the pending content that links to paragraph 842- 10-65-1. That \nentity shall apply the same transition method elected for the pending \ncontent that links to paragraph 842- 10-65-1. \nb. An entity that has adopted the pending content that links to paragraph 842-\n10-65-1 as of 11/11/2021, shall: \n1. Apply the pending content that links to this paragraph for financial \nstatements issued for fiscal years beginning a fter December 15, 2021, \nand interim periods within fiscal years beginning after December 15, \n2022. Earlier application is permitted as of the beginning of the fiscal \nyear of adoption. \n2. Apply the pending content that links to this paragraph on a modified \nretrospective basis to leases affected by the amendments existing as \nof the beginning of the fiscal year of adoption by adjusting the lease \nliability, which shall be calculated based on the discount rate and \nremaining lease term at the beginning of the fiscal year of adoption. An \nentity shall recognize the amount of the change in the lease liability as \nan adjustment to the corresponding right -of-use asset, unless: \ni. The carrying amount of the right -of-use asset is reduced to zero, \nin which case the entity shall recognize any remaining amount of \nthe adjustment to opening retained earnings at the beginning of \nthe fiscal year of adoption. \nii. The adjustment would increase a right -of-use asset that was \npreviously impaired, in which case the entity shall record the \nadjust ment to opening retained earnings at the beginning of the \nfiscal year of adoption. \nc. An entity within the scope of (b) shall not treat the adoption of the pending \ncontent that links to this paragraph as an event that would require the \nentity to: \n1. Remeasure an d reallocate the consideration in the contract in \naccordance with paragraph 842- 10-15-36. \n2. Reassess the lease term or a lessee option to purchase the underlying \nasset in accordance with paragraph 842- 10-35-1. \n3. Remeasure the lease payments in accordance with paragraph 842- 10-\n35-4. \n4. Reassess lease classification in accordance with paragraph 842 -10-25-\n1. \nd. An entity within the scope of (b) that has adopted the pending content that \nlinks to this paragraph shall disclose the following as of the beginning of \nthe fiscal year of adoption (rather than at the beginning of the earliest \nperiod presented): \n1. The information required by paragraph 250- 10-50-1(a) and (b)(3), if \napplicable ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 986}), Document(page\_content='Leases 986 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 2. The recognized amount of changes in lease liabilities and \ncorresponding right -of-use assets resulting from the transition \nadjustment. \nFor an entity within the scope of (b), at the date of adoption of the pending \ncontent that links to this paragraph, the entity may choose to apply or \ndiscontinue using the risk -free rate for any clas s of underlying asset. \n> Transition Related to Accounting Standards Update No. 2023 -01, Leases \n(Topic 842): Common Control Arrangements \n65-7 The following represents the transition and effective date information \nrelated to the practical expedient in Accounting Standards Update No. 2023- 01, \nLeases (Topic 842): Common Control Arrangements : \na. The pending content that links to this paragraph shall be effective for fiscal \nyears, including interim periods within those fiscal years, beginning after \nDecember 15, 2023. Early adoption is permitted in any annual or interim \nperiod for which financia l statements have not yet been made available for \nissuance. If an entity adopts the pending content that links to this \nparagraph in an interim period, it shall adopt that pending content as of the \nbeginning of the fiscal year that includes that interim period. \nb. An entity that adopts the pending content that links to this paragraph \nconcurrently with adopting the pending content that links to paragraph 842-\n10-65-1 shall apply th e pending content that links to this paragraph using \nthe same transition method elected for the pending content that links to \nparagraph 842- 10-65-1. \nc. An entity that adopted the pending content that links to paragraph 842- 10-\n65-1 before adopting the pending content that links to this paragraph shall \napply the pending content that links to this paragraph using either of the \nfollowing two methods: \n1. Prospectively to arrangements that commence or are modified on or \nafter the date that the entity first applies the pending content that links \nto this paragraph. \n2. Retrospectively to the beginning of the period in which the pending \ncontent that links to paragraph 842- 10-65-1 was first applied. The \npending content that links to this paragraph shall not be applicable for \narrangements no longer in place at the date of adoption. Under this \ntransition method: \ni. If an arrangement previously considered to be a lease c ontinues to \nbe a lease after applying the pending content that links to this \nparagraph, an entity shall apply the requirements in paragraphs 842-\n10-25-9 through 25- 17 to any changes in the lease resulting from \napplication of the practical expedient in the pending content that \nlinks to this paragraph. Any amounts that otherwise would have \nbeen recognized in earnings shall be recognized as a cumulative-\neffect adjustment to opening retained earnings (or net assets of a \nnot-for-profit entity) at the beginning of the earliest period presented \nin accordance with the pending content that links to paragraph 842-\n10-65-1. \nii. If an arrangement previously not considered a lease becomes a \nlease after applying the pending content that links to this paragraph, \nan entity shall account for the arrangement as a new lease. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 987}), Document(page\_content='Leases 987 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. d. An entity may document any existing unwritten terms and conditions of an \narrangement between entities under common control before the date on \nwhich the entity’s first interim (if applicable) or annua l financial statements \nare available to be issued in accordance with the pending content that links \nto this paragraph. \ne. An entity within the scope of ( c) shall provide the applicable transition \ndisclosures required by Topic 250 on accounting changes and err or \ncorrections, except for the requirements in paragraphs 250- 10-50-1(b)(2) \nand 250- 10-50-3. An entity that elects the transition method in (c)(2) shall \nprovide the transition disclosures in paragraph 250- 10-50-1(b)(3) as of the \nbeginning of the earliest p eriod presented but not before the date on which \nthe pending content that links to paragraph 842- 10-65-1 was adopted. \nf. An entity that elects the practical expedient(s) in paragraph 842- 10-65-1(f) \nor (g) is not required to apply either of those practical expedients to \ncommon control arrangements for which the pending content that links to \nthis paragraph is being applied. \n65-8 The following represents the transition and effective date information \nrelated to the accounting for leasehold improvements associated with leases \nbetween entities under common control in Accounting Standards Update No. \n2023 -01, Leases (Topic 842): Common Control Arrangements : \na. The pending content that links to this paragraph shall be effective f or fiscal \nyears, including interim periods within those fiscal years, beginning after \nDecember 15, 2023. Early adoption is permitted in any annual or interim \nperiod for which financial statements have not yet been made available for \nissuance. If an entity adopts the pending content that links to thi s \nparagraph in an interim period, it shall adopt that pending content as of the \nbeginning of the fiscal year that includes that interim period. \nb. An entity that adopts the pending content that links to this paragraph \nconcurrently with adopting the pending co ntent that links to paragraph 842-\n10-65-1 may apply the pending content that links to this paragraph using \nthe same transition method elected for the pending content that links to \nparagraph 842- 10-65-1 or may apply the pending content that links to this \nparagraph using either of the prospective methods specified in (c)(1) and \n(c)(2) below. \nc. An entity that adopted the pending content that links to paragraph 842- 10-\n65-1 before adopting the pending content that links to this paragraph s hall \napply the pending content that links to this paragraph using one of t he \nfollowing methods: \n1. Prospectively to all new leasehold improvements recognized on or after \nthe date that the entity first applies the pending content that links to \nthis paragraph. \n2. Prospectively to all new and existing leasehold improvements \nrecognized on or after the date that the entity first applies the pending \ncontent that links to this paragraph. An entity that elects this transition \napproach shall amortize the remaining balance of leasehold \nimprovements existing at the date of adoption of the pending content \nthat links to this paragraph over the remaining useful life of those \nimprovements to the common control group determined at that date. \n3. Retrospectively to the beginning of th e period in which the pending \ncontent that links to paragraph 842- 10-65-1 was first applied. Any \nleasehold improvements previously amortized or impaired that ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 988}), Document(page\_content='Leases 988 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. otherwise would not have been amortized or impaired had the pending \ncontent that links to this par agraph been applicable shall be r ecognized \nthrough a cumulative- effect adjustment to the opening b alance of \nretained earnings (or net assets of a not -for-profit entity) at the \nbeginning of the earliest period p resented in accordance with the \npending content that links to p aragraph 842-10-65-1. \nd. An entity within the scope of (c) shall provide the applicable transition \ndisclosures required by Topic 250 on accounting changes and error \ncorrections, except for the requirements in paragraphs 250- 10-50-1(b)(2) \nand 250-10-50-3. An entity that elects the transition method in (c)(3) shall \nprovide the transition disclosures in paragraph 250- 10-50-1(b)(3) as of the \nbeginning of the earliest period presented but not before the date on which \nthe pending content that links to paragraph 842- 10-65-1 was adopted. \n> SEC Staff Guidance \n> > SEC Staff Announcement: Transition Related to Accounting \nStandards Updates No. 2014- 09 and 2016- 02 \nS65-1 Note: At the December 2019 AICPA National Conference on Current \nSEC and PCAOB Devel opments, the SEC staff announced that it would not \nobject to a public business entity that otherwise would not meet the definition \nof a public business entity except for a requirement to include or the inclusion \nof its financial statements or financial inf ormation in another entity’s filing with \nthe SEC adopting Topic 842, Leases, for fiscal years beginning after December \n15, 2020, and interim periods within fiscal years beginning after December 15, \n2021. Those dates are consistent with the effective dates for Topic 842 as \namended in Accounting Standards Update No. 2019- 10, Financial \nInstruments —Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), \nand Leases (Topic 842): Effective Dates . The following is the text of SEC Staff \nAnnouncement: Transit ion Related to Accounting Standards Updates No. 2014-\n09 and 2016- 02. \nFASB Accounting Standards Updates No. 2014 -09, Revenue from \nContracts with Customers (Topic 606) , issued in May 2014 and codified \nin ASC Topic 606, Revenue from Contracts with Customers, and No. \n2016 - 02, Leases (Topic 842) , issued in February 2016 and codified in \nASC Topic 842, Leases, provide effective dates that differ for (1) public \nbusiness entities and certain other specified entities and (2) all other \nentities. The SEC staff has rec eived inquiries from stakeholders regarding \nthe application of the effective dates of ASC Topic 606 and ASC Topic \n842 for a public business entityFN1 that otherwise would not meet the \ndefinition of a public business entity except for a requirement to include \nor the inclusion of its financial statements or financial information in \nanother entity’s filing with the SEC. \nThe transition provisions in ASC Topic 606 require that a public business \nentity and certain other specified entities adopt ASC Topic 606 for annual \nreporting periods beginning after December 15, 2017, including interim \nreporting periods within that reporting period.FN2 All other entities a re \nrequired to adopt ASC Topic 606 for annual reporting periods beginning \nafter December 15, 2018, and interim reporting periods within annual \nreporting periods beginning after December 15, 2019. \nThe transition provisions in ASC Topic 842 require that a pu blic business ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 989}), Document(page\_content='Leases 989 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. entity and certain other specified entities adopt ASC Topic 842 for fiscal \nyears beginning after December 15, 2018, and interim periods within \nthose fiscal years.FN3 All other entities are required to adopt ASC Topic \n842 for fiscal years begi nning after December 15, 2019, and interim \nperiods within fiscal years beginning after December 15, 2020. \nIn response to the stakeholder inquiries outlined above, the SEC staff \nwould not object to a public business entity that otherwise would not \nmeet the definition of a public business entity except for a requirement \nto include or the inclusion of its financial statements or financial \ninformation in another entity’s filing with the SEC adopting (1) ASC Topic \n606 for annual reporting periods beginning after December 15, 2018, and \ninterim reporting periods within annual reporting periods beginning after \nDecember 15, 2019, and (2) ASC Topic 842 for fiscal years beginning \nafter December 15, 2019, and interim periods within fiscal years \nbeginning after December 15, 2020. \nA public business entity that otherwise would not meet the definition of a \npublic business entity except for a requirement to include or the inclusion \nof its financial statements or financial information in another entity’s filing \nwith the SEC ma y still elect to adopt ASC Topic 606 and ASC Topic 842 \naccording to the public business entity effective dates outlined above. \nThis announcement is applicable only to public business entities that \notherwise would not meet the definition of a public busines s entity \nexcept for a requirement to include or the inclusion of its financial \nstatements or financial information in another entity’s filing with the SEC. \nThis announcement is not applicable to other public business entities. \nFN 1 The definition of Public Business Entity i n the FASB’s ASC Master \nGlossary states, in part, the following: \nA public business entity is a business entity meeting any one of the \ncriteria below . . . \na. It is required by the U.S. Securities and Exchange Commission \n(SEC) to fi le or furnish financial statements, or does file or furnish \nfinancial statements (including voluntary filers), with the SEC \n(including other entities whose financial statements or financial \ninformation are required to be or are included in a filing) . . . \nAn entity may meet the definition of a public business entity solely \nbecause its financial statements or financial information is included in \nanother entity’s filing with the SEC. In that case, the entity is only a \npublic business entity for purposes of fi nancial statements that are filed \nor furnished with the SEC. \nFN 2 Early adoption of ASC Topic 606 is permitted for public business \nentities and certain other specified entities only as of annual reporting \nperiods beginning after December 15, 2016, including i nterim reporting \nperiods within that reporting period. \nFN 3 Early adoption of ASC Topic 842 is permitted for public business \nentities and certain other specified entities, as well as for all other \nentities. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 990}), Document(page\_content='Leases 990 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13A.1.10 If a calendar year ‑end public business entity adopts Topic 842 in \naccordance with the mandatory effective date under the effective date method, \nit records a cumulative -effect adjustment on January 1, 2019. In the entity’s \nDecember 31, 2019 financial statements, comparative reporting periods are \npresented in accordance with Topic 840, while the current period (2019) is \npresented in accordance with Topic 842 and its transition provisions . \n[842- 10-65-1(a) – 65-1(d)] \nComparative period\nTopic 840Comparative period\nTopic 840Current period\nTopic 842December 31, 2019Effective date \n(date of adoption )\nJanuary 1, 2019 January 1, 2018Beginning of earliest \nperiod presented\nJanuary 1, 2017\n \n13A.1.20 The effective date method is available as a transition option for \nadoption at any time after issuance of ASU 2018- 11 – i.e. July 30, 2018. It can \nbe applied as of the beginning of any period for which financial statements have \nnot been issued or made available for issuance. [842- 10-65-1(a) – 65-1(b)] \n \n Question 13A.1.10 \nEarly adoption considerations \nWhat reasons might an entity have to early adopt Topic 842? \nInterpretive response: \nLessors may want to align implementation with Topic 606 \nMost of the changes applicable to lessors transitioning from Topic 840 to \nTopic 842 were designed to substantially align key aspects of the lessor \naccounting model with the new revenue recognition guidance in Topic 606. For \nexample, the guidance covering separation and allocation guidance for lease \nand non ‑lease components, the lease modifications guidance, and the contract \ncombinations guidance are aligned with Topic 606, and the guidance on initial direct costs is aligned with Subtopic 340 -40 (other assets and deferred costs \nrelated to contracts with customers). \n[ASU 2016 -02.BC8(d)] \nThose aspects of Topic 606 (and Subtopic 340-40) and Topic 842 that are \nsubstantially aligned are designed to work together. The Board’s decision to align these aspects of the guidance explicitly considered that many lessors \nhave contracts that contain lease and non- lease (e.g. services or suppl ies) \ncomponents and that those lessors in particular would benefit from the \nalignment. Consequently, many lessors may find it preferable to early adopt \nTopic 842 at the same time as they adopt Topic 606. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 991}), Document(page\_content='Leases 991 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Entities may want to minimize disruption \nMost entiti es will likely be affected by the implementation of both Topic 606 \nand Topic 842. Some entities might view it as advantageous to adopt both \nTopics concurrently, in a big bang approach, to minimize the extent of ongoing \nsystems and process changes, get past the disruption, and revert to a steady \nstate accounting environment more quickly. \nSeller ‑lessees in real estate sale‑ leaseback transactions may want to early \nadopt \nAs discussed in section 9.1, it will generally be easier to achieve sale \naccounting for rea l estate sale -leaseback transactions under Topic 842 than \nunder Topic 840. A seller -lessee that has, or is contemplating, a significant real \nestate sale -leaseback transaction that is, or is expected to be, a failed sale \nunder Topic 840 might want to early adopt Topic 842 if the transaction would \nbe accounted for as a sale and a leaseback. For further discussion, see \nsection 13A.7. \nLessees with existing build ‑to‑suit lease arrangements may want to early \nadopt \nBecause of the existing build- to-suit lease accounting guidance in Topic 840, \nthere are many lessees that have assets and liabilities recognized for assets \nthat they do not legally own but were deemed to own for accounting purposes \nduring the construction period. In some of those cases, the construction period ended many years ago but, because of the restrictive sale- leaseback \nrequirements applicable to real estate under Topic 840, the entity has been unable to derecognize those assets and liabilities. Beca use the transition \nprovisions in Topic 842 applicable to build- to-suit leases and sale ‑leaseback \ntransactions may permit the entity to derecognize those assets and liabilities \n(see section 13A.8), some entities in this situation may choose to early adopt \nTopic 842. \n \n Question 13A.1.30 \nIssuance of a registration statement on Form S -3 \nafter the effective date \nDoes the reissuance of a registrant’s financial statements in \nconjunction with filing a registration statement on Form S-3 \nchange the date of initial application ? \nBackground: A calendar year -end public entity adopts Topic 842 on January 1, \n2019 using the effective date method and does not restate its 2018 and 2017 \ncomparative periods . In May 2019, the registrant files its first quarter 2019 \nForm 10-Q, which reflects the adoption of Topic 842. Shortly after, the \nregistrant files a registration statement on Form S -3 that includes financial \nstatements for the years ending December 31, 2018, 2017 and 2016, as well as \nthe quarters ending March 31, 2019 and 2018. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 992}), Document(page\_content='Leases 992 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Item 11(b)(ii) of Form S -3 requires retrospective revision of the pre- event \naudited financial statements that were incorporated by reference in the \nForm S-3 to reflect a subsequent change in accounting principle. \nInterpretive response: No. The reissuance of the financial statements in the \nForm S-3 does not change the date of initial application from January 1, 2019 in \nthe background example. [FRM 11210.1] \n \n Question 13A.1.50 \nEffective date for certain public business entities \nDoes an entity that is considered a ‘public business entity’ \nsolely because its financial statements or summarized \nfinancial information are included in an SEC filing have to follow the mandatory effective date for public business entities? \nInterpretive re sponse: No. At the July 20, 2017 EITF meeting, the SEC \nObserver announced that the SEC staff will not object if certain public business \nentities (PBEs) use the adoption dates for ‘other entities’. The SEC \nannouncement was later codified in paragraph 842- 10-S65-1. [842-10-S65-1] \nThe SEC staff has confirmed its intent to continue to extend relief to those \nsame PBEs based on the principles in paragraph 842- 10-S65-1. This means that \nalthough paragraph 842- 10-S65-1 references the ‘other entities’ mandatory \neffec tive date enacted by ASU 2019- 10, PBEs eligible for the SEC staff relief \ncan avail themselves of the additional one- year extension of that date afforded \nby ASU 2020 -05. See ‘ How the standard works ’ in this chapter for effective \ndate information. [CAQ SEC R egs Comm 07/2020, 842 -10-S65-1] \nThe SEC staff’s effective date relief is narrow and applies to an entity that \notherwise would not meet the definition of a PBE, but does so only because its \nfinancial statements or summarized financial information is included in another \nentity’s SEC filing. \nSituations where the SEC staff’s relief may apply include, but are not limited to: \n— private company equity method investees; \n— private acquired businesses; \n— acquired real estate operations; \n— properties securing loans that represent an asset concentration; \n— significant lessees; and \n— affiliates whose securities constitute a substantial portion of the collateral \nof a security that is registered or being registered with the SEC. \nA private entity whose financial information is included in an SEC filing but also \nmeets the definition of a PBE for other reasons – e.g. the filing of financial \nstatements with a regulatory agency other than the SEC – is not eligible for the \nSEC’s relief. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 993}), Document(page\_content='Leases 993 \n13A. Effective dates and transition: effective date method \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 13A.1.60\*\* \nEffective date for an entity in the process of an \ninitial public offering (IPO) \nWhat i s a non- EGC’s Topic 8 42 adoption date when i ssuing \nfinancial st atements to be i ncluded in a n IPO r egistration \nstatement? \nInterpretive response: An entity t hat is not a n EGC us es the adoption da te that \nwould have applied to it ha d it b een a public b usiness ent ity (PBE) a ll along ( e.g. \nJanuary 1, 2019 if it is a c alendar year-e nd company ). This is regardless of \nwhether the entity has already or ha s not yet adopted Topic 842. [CAQ SEC Regs \nComm 07/2020.III.A] \nFor ex ample, ev en if c alend ar year-end non -EGC E ntity A ha s already a dopted \nTopic 842 a s of January 1, 2021 , its IPO registration statement f inancial \nstatements a re adjusted t o reflect a dopting Topic 842 as of J anuary 1, 2019. \nThe entity pr esents t he ef fects of Topi c 842 in all periods presented from t hat \ndate. \nBy contrast, dur ing and after t he IPO r egistration process, a n EGC i s permitted \nto use t he Topic 84 2 adoption dates for no n-PBEs ( i.e. January 1, 2022 for \nannual p eriods a nd January 1, 2 023 for interim per iods). Question 13A. 2.140 \naddresses adoption guidance for an entity when it loses its EGC st atus. \n13A.2 Transition principles – lessees and lessors \nExcerpt from ASC 842 -10 \nTransition and Open Effective Date Information \nGeneral \n>T ransition Related to Accounting Standards Update s No. 2016- 02,\nLeases (Topic 842) , No. 2018- 01, Leases (Topic 842): Land Easement\nPractical Expedient for Transition to Topic 842 , No. 2018- 10, Codification\nImprovements to Topic 842, Leases , No. 2018- 11, Leases (Topic 842):\nTarg eted Improvements , No. 2018- 20, Leases (Topic 842): Narrow -Scope\nImprovements for Lessors , No. 2019- 01, Leases (Topic 842): Codification\nImprovements , No. 2019- 10, Financial Instruments —Credit Losses (Topic\n326), Derivatives and Hedging (Topic 815), and Le ases (Topic 842):\nEffective Dates , No. 2020- 05, Revenue from Contracts with Customers\n(Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities ,\nNo. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with Variabl e\nLease Payments , No. 2021- 09, Leases (Topic 842): Discount Rate for\nLessees That Are Not Public Business Entities , and No. 2023- 01, Leases\n(Topic 842): Common Control Arrangements\n65-1 The following represents the transition and effective date informati on\nrelated to Accounting Standards Update s No. 2016 -02, Leases (Topic 842) ,\n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 994}), Document(page\_content='Leases 994 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. No. 2018 -01, Leases (Topic 842): Land Easement Practical Expedient for \nTransition to Topic 842, No. 2018- 10, Codification Improvements to Topic 842, \nLeases , No. 2018- 11, Leases (Topic 842): Targeted Improvements , No. 2018-\n20, Leases (Topic 842): Narrow- Scope Improvements for Lessors , No. 2019- 01, \nLeases (Topic 842): Codification Improvements , No. 2019- 10, Financial \nInstruments —Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), \nand Leases (Topic 842): Effective Dates , No. 2020- 05, Revenue from Contracts \nwith Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain \nEntities , No. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with \nVariable Lease Payments , No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entities , and No. 2023- 01, Leases (Topic \n842): Common Control Arrangements : [Note : See paragraph 842-10-S65-1 for \nan SEC Staff Announcement on transition related to Update 2016- 02.] \nc. In the financial statements in which an entity first applies the pending \ncontent that links to this paragraph, the entity shall recognize and measure \nleases within the scope of the pending content that links to this paragraph \nthat exist at the application date, as determined by the transition method \nthat the entity elects. An entity shall apply the pending content that links to \nthis paragraph using one of the following two methods: \n1. Retrospectively to each prior reporting period presented in the financial \nstatements with the cumulative effect of initially applying the pending \ncontent that links to this paragraph recognized at the beginning of the \nearliest comparative period presented, subject to the guidance in (d) \nthrough (gg). Under this transition method, the application date shall be \nthe later of the beginning of the earliest period presented in the \nfinancial statements and the commencement date of the lease. \n2. Retrospecti vely at the beginning of the period of adoption through a \ncumulative -effect adjustment, subject to the guidance in (d) through \n(gg). Under this transition method, the application date shall be the \nbeginning of the reporting period in which the entity first applies the \npending content that links to this paragraph. \nd. An entity shall adjust equity and, if the entity elects the transition method \nin (c)(1), the other comparative amounts disclosed for each prior period \npresented in the financial statements, as if t he pending content that links \nto this paragraph had always been applied, subject to the requirements in \n(e) through (gg). \ne. If a lessee elects not to apply the recognition and measurement \nrequirements in the pending content that links to this paragraph to s hort-\nterm leases , the lessee shall not apply the approach described in (k) \nthrough (t) to short -term leases. \nSee Examples 28 through 29 (paragraphs 842- 10-55-243 through 55- 254) for \nillustrations of the transition requirements for an entity that applies t he pending \ncontent that links to this paragraph in accordance with (c)(1) . \nPractical expedients \nf. An entity may elect the following practical expedients, which must be \nelected as a package and applied consistently by an entity to all of its \nleases (including those for which the entity is a lessee or a lessor ), when \napplying the pending content that links to this paragraph to leases that \ncommenced before the effective date: \n1. An entity need not reassess whether any expired or existing contracts ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 995}), Document(page\_content='Leases 995 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. are or contain leases. \n2. An entity need not reassess the lease classification for any expired or \nexisting leases ( for example, all existing leases that were classified as \noperating leases in accordance with Topic 840 will be classified as \noperating leases, and all existing leases that were classified as capital \nleases in accordance with Topic 840 will be class ified as finance \nleases ). \n3. An entity need not reassess initial direct costs for any existing leases. \ng. An entity also may elect a practical expedient, which must be applied \nconsistently by an entity to all of its leases (including those for which the \nentity is a lessee or a lessor) to use hindsight in determining the lease \nterm (that is, when considering lessee options to extend or terminate the \nlease and to purchase the underlying asset ) and in assessing impairment \nof the entity’s right -of-use assets . This practical expedient may be elected \nseparately or in conjunction with either one or both of the practical \nexpedients in (f) and (gg). \ngg. An entity also may elect a practical expedient to not assess whether \nexisting or expired land easements that were not prev iously accounted for \nas leases under Topic 840 are or contain a lease under this Topic. For \npurposes of (gg), a land easement (also commonly referred to as a right of \nway) refers to a right to use, access, or cross another entity’s land for a \nspecified pur pose. This practical expedient shall be applied consistently by \nan entity to all its existing and expired land easements that were not \npreviously accounted for as leases under Topic 840. This practical \nexpedient may be elected separately or in conjunction with either one or \nboth of the practical expedients in (f) and (g). An entity that elects this \npractical expedient for existing or expired land easements shall apply the \npending content that links to this paragraph to land easements entered into \n(or modifi ed) on or after the date that the entity first applies the pending \ncontent that links to this paragraph as described in (a) and (b). An entity \nthat previously accounted for existing or expired land easements as leases \nunder Topic 840 shall not be eligible for this practical expedient for those \nland easements. \nDisclosure \ni. An entity shall provide the transition disclosures required by Topic 250 on \naccounting changes and error corrections, except for the requirements in \nparagraph 250-10-50-1(b)(2) and paragraph 250- 10-50-3. An entity that \nelects the transition method in (c)(2) shall provide the transition disclosures \nin paragraph 250- 10-50-1(b)(3) as of the beginning of the period of adoption \nrather than at the beginning of the ear liest period presented. \nNote : See paragraph 250- 10-S99-6 on disclosure of the impact that \nrecently issued accounting standards will have on the financial \nstatements of a registrant. \nj. If an entity uses one or more of the practical expedients in (f ), (g), and ( gg), \nit shall disclose that fact. \njj. An entity electing the transition method in (c)(2) shall provide the required \nTopic 840 disclosures for all periods that continue to be in accordance with \nTopic 840. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 996}), Document(page\_content='Leases 996 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13A.2.1 Transition approach – general \n13A.2.10 When an entity elects the effective date method, it recognizes and \nmeasures all leases that exist at the effective date using a modified \nretrospective transition approach. The entity records a cumulative- effect \nadjustment as of the effect ive date. Comparative periods are presented in \naccordance with Topic 840 and do not include any retrospective adjustments to \ncomparative periods to reflect the adoption of Topic 842. All leases that either \n(1) commence, or (2) are modified (where that modi fication is not accounted for \nas a separate contract) or remeasured on or after the effective date are \naccounted for under Topic 842. [842- 10-65-1(c) – 65-1(d), 65-1(q), 65 -1(t)] \n13A.2.20 As an exception, a lessee electing the recognition and measurement \nexemption for short ‑term leases (see section 6.3.1) does not apply the \ntransition requirements to short -term leases. For purposes of this exception, a \nshort -term lease is a lease with a to tal lease term of 12 months or less \n(including periods before the effective date) ; it is not a lease with a remaining \nlease term of 12 months or less at the effective date. See Question 13A.2.60 \nfor considerations about whether a lease is a short -term leas e in transition if \nelecting to use hindsight. [842- 10-65-1(e)] \n13A.2.30 Topic 842 does not specify what to do instead for unrecognized short -\nterm leases in transition. However, we believe the lessee should: \n— recognize the minimum rental payments (as define d in Topic 840 – see \nQuestion 13A.3.10) as lease cost, on a generally straight ‑line basis over the \nlease term, consistent with the lessee’s accounting for those leases under Topic 840; and \n— consistent with all other lessee leases that exist at the effective date, apply \nthe new requirements in Topic 842 to that lease if, on or after the effective date: \n— it is modified and that modification is not accounted for as a separate \ncontract (see section 6.7); or \n— there is an event that would require remeasurement of t he lease \nliability if it were recognized – e.g. a change in the lease term or in the \nassessment of a lessee purchase option (see section 6.6). \n13A.2.40 An entity adjusts equity at the effective date as if Topic 842 had always \nbeen applied, subject to the transition requirements described in this chapter. \n[842- 10-65-1(d)] \n13A.2.50 An entity applies the transition requirements to leases that commence \nbefore the effective date (or early adoption date) at that date. [842- 10-65-1(k), 65 -\n1(r), 65- 1(s), 65 -1(v), 65 -1(w), 65 -1(x), 65 -1(y)] \n Observation \nAdditional transition method offers relief to \npreparers \n13A.2.60 The effective date method provides significant relief to preparers that \nwere encountering unanticipated costs and complexities implementing Topic 842 using the comparative method. Election of the effective date method \nwill simplify transition for many of these entities. \n[ASU 2018- 11.BC7] \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 997}), Document(page\_content='Leases 997 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13A.2.70 A primary concern with allowing this optional transition method that \ndoes not restate comparative financial statements is the potential information \nloss to financial statement users. By removing the requirement to apply \nTopic 842 to comparative periods in transition, a lessee does not recognize \noperating lease assets and liabilities on the balance sheet for any comparative period. However, the Board noted in the basis for conclusions to ASU 2018- 11 \nthat the disclosures required under Topic 840 for the comparative periods, \nwhich are required under this transition method to be provided in the entity’s \nadoption- year financial statements, would still provide users with relevant \ninformation about the comparative periods. Ultimately, the election of this \ntransiti on method will only delay the availability of comparative financial \nstatement information on operating lease assets and liabilities by one year, \nsomewhat mitigating concerns about comparability of information in the \nfinancial statements.\n [ASU 2018- 11.BC8 –BC11] \n13A.2.80 Electing this new transition method only impacts when, but not how, \nan entity adopts Topic 842. This means that the recognition and measurement principles are the same under both the effective date and comparative \nmethods, but the timing of initial ROU asset and lease liability recognition for \nexisting operating leases, and first preparation of Topic 842 disclosures for all \nleases (see Chapter 12), will be different. \n[ASU 2018- 11.BC10] \n \n13A.2.2 Transition approach – modifications \n13A.2.90 There is no ‘transition period’ when an entity elects the effective date \nmethod. Therefore, there are no separate considerations for lease modifications \nthat occur during a transition period. Any modifications that occur before the \neffective date of Topic 842 are subject to the guidance in Topic 840. These \nleases are transitioned in the same manner as other leases that have \ncommenced before the effective date, which means the transition adjustment \nfor those leases considers the terms and conditions of the lease in effect as of \nthat date – i.e. subsequent to any modifications before that date. Modifications \nthat occur after the effective date are subject to the guidance in Topic 842. \n13A.2.100 Lessees will not reassess or remeasure leases before the effecti ve \ndate. Beginning on the effective date, the same reassessment and remeasurement requirements apply to leases that commenced before the \neffective date as apply to new leases that commence on or after the effective \ndate – i.e. Topic 842 applies in: \n[842- 10-65-1(q), 65- 1(t)] \n— determining when to reassess a lease and whether there is a resulting \nremeasurement (see section 6.6.1); \n— accounting for the remeasurement (see section 6.6.2); and \n— accounting for the lease after the remeasurement (see section 6.6.2). \n \n13A.2.3 Practical expedients \n13A.2.110 The following table summarizes the three transition practical \nexpedients in Topic 842. An entity electing the land easement practical \nexpedient only applies the transition guidance in Topic 842, including the ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 998}), Document(page\_content='Leases 998 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. following practical expedients, to land easements that were accounted for as \nleases under Topic 840. [842- 10-65-1(f) – 65-1(gg)] \nPackage of practical \nexpedients Use of hindsight Land easements \nOn transition, an entity may \nelect not to reassess: \n— whether expired or \nexisting contracts \ncontain a lease under \nthe new definition of a lease (see chapter 3); \n— lease classification for \nexpired or existing \nleases – see \nsections 6.2 (lessees) \nand 7.2 (lessors ); and \n— whether previously capitalized initial direct \ncosts would qualify for \ncapitalization under \nTopic 842 (see \nsection 5.5). \nAn entity electing this practical expedient must \nelect the entire package. An entity may use hindsight in \ndetermining the lease term, \nassessing the likelihood that a \nlessee renewal, termination or \npurchase option will be \nexercised (see section 5.3). An entity may elect not \nto reassess whether \nland easements meet \nthe definition of a lease \nif they were not \naccounted for as leases \nunder Topic 840. \nSection 13A.2. 4 \ndiscusses this practical \nexpedient in further \ndetail. \nEach of the three practical expedients may be elected separately from the other two. \nPractical expedient s are applied consistently to all leases – i.e. all leases for which the \nentity is a lessee or a lessor – that commence before the effective date. \n13A.2.120 An entity that elects to apply the package of practical expedients will, \nin effect, continue to account for existing leases (i.e. leases for which the \ncommencement date is before the effective date) in accordance with Topic 840 \nthroughout the entire lease term, including periods after the effective date. The \nfollowing are exceptions to this general principle. [ASU 2016‑ 02.BC390] \nLessees only Lessees and lessors \nRecognize an ROU asset and a lease \nliability for all operating leases at each \nreporting date after the effective date \n(see section 13A.3). \nApply the Topic 842 reassessment requirements (see s ection 6.6) beginning \non the effective date and, if the lease liability is remeasured on or after the \neffective date, account for the lease \nunder Topic 842 beginning on the \nremeasurement date (see paragraph 13A.2.90). If the lease is modified and not \naccounted for as a separate contract (see \nsections 6.7 and 7.6 for lessees and \nlessors , respectively) on or after the \neffective date, account for th e lease \nunder Topic 842 beginning on the \neffective date of the modification (see \nparagraph 13A.2.90). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 999}), Document(page\_content='Leases 999 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13A.2. 130 An entity that elects the land easements practical expedient continues \nto account for existing land easements (i.e. land easements that commenced \nbefore the effective date) consistent with its historical accounting practice \nbefore adopting Topic 842. An exception to this general principle arises if a land \neasement is modified on or after the effective date. [842- 10-65-1(gg), ASU 2018-\n01.BC17] \n \n Question 13A.2.20 \nDate of lease classification reassessment \nIf an entity does not elect the package of practical expedients, \nand is therefore required to reassess the classification of its \nexisting leases, as of what date does that reassessment \noccur? \nInterpretive response: An entity reassesses lease classification for each lease \nthat commences before the effective date of Topic 842 as of the later of: \n— the commencement date for the lease; or \n— the date of the last lease modification that, in accordance with Topic 840, \nrequired the entity to reassess the classification of the lease. \n \n Question 13A.2. 30 \nHindsight practical expedient – effect on lease \nclassification if package of practical expedients \nelected \nIf an entity elects both the package of practical expedients and the use of hindsight, is it required to reassess lease classification if hindsight results in a change to the lease term or the assessment of a lessee purchase option? \nInterpretive response: No. Topic 842 does not establish a hierarchy between \nthese two transition practical expedients such that hindsight overrides the \npackage of practical expedients. Therefore, even though changes to the lease \nterm or the assessment of a lessee purchase optio n resulting from the use of \nhindsight require, for example, the lessee to remeasure the minimum rental payments (existing operating leases) or the minimum lease payments (existing \ncapital leases – see Question 13A.2. 50), we do not believe an entity (lessee or \nlessor) is required to reassess lease classification if it has elected the package \nof practical expedients. \nHowever, we also do not believe that Topic 842 precludes reassessing lease \nclassification in such cases. This is on the basis that the hindsigh t practical \nexpedient was intended to permit entities to provide more accurate, updated \ninformation to financial statement users unhindered by their decisions with \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1000}), Document(page\_content='Leases 1000 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. respect to other transition practical expedients – e.g. the package of practical \nexpedients. [ASU 2016- 02.BC394] \n \n Question 13A.2. 40 \nHindsight practical expedient – lessee options \nDoes the hindsight practical expedient require an entity to \nreassess the lease term and any lessee purchase options? If \nyes, at what date does that reassessment occur and what \nfactors does it consider? \nInterpretive response: Yes, election of the hindsight practical expedient \nrequires an entity (lessee or lessor) to reevaluate the lease term and the entity’s \nassessment of any lessee purchase options on the effective date of Topic 842. \nThe reassessment takes into account all economic factors relevant to that \nassessment as of the effective date: contract -based, asset -based, market -\nbased and entity -based factors (see paragraph 5.2.60). That is, an entity \nassesses as of the effective date, with the benefit of hindsight, the same \nfactors it considers at lease commencement for new leases that commence on \nor after the effective date. The entity then uses that updated information to \nestablish the measurement of the lease at the effective date – i.e. rather than \nthe entity’s ‘reasonably assured’ assessment that it undertook under Topic 840. \nThis requirement, resulting from election of the hindsight practical expedient, is \nregardless of: \n— the fact that lessors do not reassess such items for leases that commence on or after the effective date of Topic 842 (unless the lease is modified and \nthat modification is not accounted for as a separate contract); and \n— whether or not any ‘triggering events’ (i.e. significant events or changes in \ncircumstances within the control of the lessee) have occurred before the \neffective date. \nThe following are examples (which would apply equally to the lessee or the \nlessor). \n— Example 1: Changes in market value \nA lessee concluded at lease inception under Topic 840 that exercise of a \nrenewal option was not reasonably assured and the lease term excluded \nthe optional renewal period. \nOn the effective date of Topic 842, it is clear that the renewal option will be \na significant bargain from fair market rent for the underlying asset at the \ntime of renewal such that it is reasonably certain (based on market factors) \nthat the lessee will exercise the renewal option. \nTherefore, when applying hindsight, the remaining lease term used to measure t he lease at the effective date will include the optional renewal \nperiod. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1001}), Document(page\_content='Leases 1001 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — Example 2: Impact of leasehold improvements \nA lessor concluded at lease inception under Topic 840 that exercise of a \nrenewal option by the lessee was not reasonably assured and exclud ed the \noptional renewal period from the lease term. \nBy the effective date of Topic 842, the lessee has constructed significant \nleasehold improvements that will have significant remaining economic \nvalue to the lessee after the optional renewal date such tha t the lessee is \nreasonably certain to exercise the renewal option. \nTherefore, when applying hindsight, the remaining lease term used to \nmeasure the lease at the effective date will include the optional renewal \nperiod. \nSubsequent to the effective date – i.e. after the entity undertakes the hindsight \nreassessment – leases that commenced before the effective date are \nreassessed on the same basis as new leases that commenced on or after the \neffective date. That is, lessors do not reassess the lease term or les see \npurchase options unless the lease is modified ( and that modification is not \naccounted for as a separate contract ) – see section 7.6, and lessees reassess \nthe lease term only as discussed in section 6.6 on reassessments and \nsection 6.7 on modifications. \n \n Question 13A.2. 50 \nHindsight practical expedient – existing capital \n(sales -type/direct financing) leases \nIf hindsight results in a change to the lease term or the \nassessment of a lessee purchase option, does an entity remeasure an existing capital (sales -type/direct financing) \nlease if its classification does not change on transition? \nBackground: Topic 842 s tates that: \n— The lease liability and ROU asset for an existing capital lease that remains \nclassified as a finance lease under Topic 842 are initially measured at the \neffective date as follows (see paragraph 1 3A.3.100). [842- 10-65-1(r)(1) – 65-1(r)(2)] \n— Lease liability: Carrying amount of capital lease obligation under Topic 840 immediately before the effective date. \n— ROU asset : Carrying amount of the capital lease asset under Topic 840 \nimmediately before the effective date, plus any unamortized initial \ndirect costs not included in the capital lease asset. \n— The net investment in the lease at the effective date for a sales -type or \ndirect financing lease that remains classified as a sales- type or direct \nfinancing lease under Topic 842 is measured a t the carrying amount of the \nnet investment immediately preceding the effective date under Topic 840 \n(see paragraph 13A.4.40 ). [842- 10-65-1(x)(1)] \nInterpretive response: Yes. If hindsight results in a change to the lease term \nor the assessment of a lessee purchase option, the lease assets and lease \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1002}), Document(page\_content='Leases 1002 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. liabilities should be remeasured. This is notwithstanding the Topic 842 \ntransition paragraphs referenced in the background. \nElection of the hindsight practical expedient is optional; therefore, the decision \nto apply this practical expedient includes acceptance of the remeasurement \nrequirements that accompany that decision. The hindsight practical expedient, if \nelected, is inten ded to provide more accurate, updated information to financial \nstatement users. It is unclear how that would be accomplished if the use of hindsight results in a changed lease term or changed assessment of a lessee \npurchase option but the entity does not r eflect that change in its measurement \nof lease assets and lease liabilities. \n[ASU 2016- 02.BC394] \n \n Question 13A.2. 60 \nHindsight practical expedient – short -term leases \nDoes the exercise of one or more renewal options that result \nin a cumulative lease term greater than 12 months preclude \naccounting for the lease as a short -term lease when applying \nthe hindsight practical expedient on transition? \nBackground: Consider an example whereby Lessee LE enters into a lease that \ncommences on January 1, 2017 that has a non- cancellable period of 12 months \nand three 12- month lessee renewal options. At January 1, 2017, it is not \nreasonably certain that LE will exercise any of the renewal options; therefore, \nthe lease term is 12 months. \nAs of the effective date (Janua ry 1, 2019 for LE), LE has exercised two of the \nrenewal options – i.e. as of the effective date, the current non- cancellable \nperiod of the lease extends to December 31, 2019. At no point in time before \nexercise was it ever ‘reasonably certain’ that LE woul d exercise one or more of \nthose options (see section 5.2), and it is not reasonably certain at the effective date that LE will exercise its one remaining option to extend the lease to December 31, 2020. \nLE has elected the hindsight transition practical expedient and is now \nconsidering whether this lease qualifies for the short -term lease recognition and \nmeasurement exemption given LE knows that the lease will have a total term, \nin hindsight, of at least three years. \nInterpretive response: It depends. If the initial lease term was 12 months or \nless and no single renewal option exercised by the lessee up to the effective date extended the lease term by more than 12 months from the end of the \npreviously determined lease term, the lease qualifies as a short -term lease on \ntransition; this is even if the lessee elected the hindsight practical expedient. \nTherefore, in the background example, the lease qualifies as a short -term lease, \ndespite LE’s use of the hindsight practical expedient. This is because the origina l lease term was 12 months or less and neither of the two renewal \noptions exercised by LE extended the lease term by more than 12 months from the end of the then -current lease term at the point in time the option was \nexercised. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1003}), Document(page\_content='Leases 1003 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. However, a lease such as tha t in the background example would not qualify, if \nusing hindsight, as a short -term lease at the effective date if any single renewal \noption was exercised that extended the lease term by more than 12 months \nfrom the end of the previously determined lease term or if LE had exercised \nmore than one of the available 12- month renewal options during the same then-\ncurrent 12- month lease term. For example, if the background lease had an initial \nterm of 12 months, but LE exercised a single 24- month renewal option, ra ther \nthan two 12- month renewal options, or had exercised both of the two 12- month \nrenewal options during the initial 12- month term of the lease, it would not be \nconsidered a short -term lease. \nWhile not explicit in the guidance, we believe this interpretati on of the \nTopic 842 transition guidance is consistent with the post -transition guidance \nthat says a lease does not lose its short -term categorization unless the lease \nterm changes such that, after the change, the remaining lease term extends \nmore than 12 m onths from the end of the previously determined lease term. \n[842- 20-25-3] \n \n Question 13A.2.70 \nHindsight practical expedient – changes to straight -\nline operating lease income (expense) \nIf the lease term changes as a result of applying the use -of-\nhindsight practical expedient, does the entity need to revise \nits straight- line income (expense) recognition? \nBackground: Lessor LR and Lessee LE are public business entities that \nentered into a five-year lease that commenced on January 1, 2014. The lease \nincluded a five -year lessee renewal option, which LR and LE both excluded \nfrom the lease term in their historical accounting. \nBoth LR and LE classified the lease as an operating lease under Top ic 840, and \nconcluded that income (expense) should be recognized on a straight -line basis. \nThe annual payments for the lease increase by 5 percent each year, including \nduring the optional renewal period. \nBy the effective date of Topic 842 (January 1, 2019) LE has exercised the \nrenewal option to extend the term of the lease. Both LR and LE elect the use-\nof-hindsight practical expedient. \nInterpretive response: Yes. If the lease term changes as a result of hindsight, \nthe entity is required to adjust all of it s related accounting correspondingly. \nIf the effect of applying hindsight means that the income (expense) recognized \nin prior periods would have been different from what was historically reported, \nthe entity recognizes any necessary adjustment to equity o n the effective date. \nUsing the background example, because of the annual 5% payment escalator, \nLR and LE would have recognized additional lease income (expense) in \nJanuary 1, 2014 to December 31, 2018 had they both estimated a lease term of \n10 years rath er than 5 years. The use of hindsight by LR and LE means they will \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1004}), Document(page\_content='Leases 1004 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. recognize less lease income (expense) after the effective date than they would \nhave had they not elected the use- of-hindsight practical expedient. \n \n Question 13A.2.80 \nHindsight practical expedient – remeasurement \nevents \nWhen applying hindsight, does a remeasurement arising from \nan event that occurs, or change in circumstances that arises, \non or after the effective date affect measurement of the lease \nat the effective date ? \nInterpretive response: No. As outlined in Question 13A .2.40, election of the \nhindsight practical expedient requires an entity (lessee or lessor) to reevaluate \nthe lease term and the entity’s assessment of any lessee purchase options as \nof the effective date. At that date, an entity considers all economic factors \nrelevant to that assessment for each of its leases : contract -based, asset -based, \nmarket -based and entity -based factors (see paragraph 5.2.60). \nAfter that effective date reassessment occurs, any changes t o the lease term or \nto the assessment of lessee purchase options that result from applying the \nguidance in Topic 842 (e.g. resulting from a ‘triggering event’ for lessees or \nfrom the reassessment of the lease upon a modification that is not accounted \nfor as a separate contract for lessees and lessors) are post -transition accounting \nevents – i.e. they are not ‘pushed back’ into the cumulative -effect adjustment at \nthe effective date. \n \n Question 13A.2.90 \nHindsight practical expedient – changes to an index \nor rate on which variable lease payments are based \nDoes using hindsight contemplate changes to a reference \nindex or rate on which variable lease payments are based at \nthe effective date? \nInterpretive response: No. We believe using hindsight is intended to apply to \nestimates and other matters of judgment, such as assessments the entity \nmade at lease inception under Topic 840 about the likelihood that the lessee \nwill exercise an option to renew (or terminate) the lease or exercise an option to \npurchase the underlying asset. \nWe do not believe the Board intended for entities to use the hindsight \npractical expedient to reflect changes in fact, such as actual changes in a \nreference index or rate upon which some or all of the variable lease payments \nin a lease depend. Therefore, when measuring the lease liability for a lease at \nthe effective date, an entity should use the index or rate as indicated in \nQuestion 13A.3. 30. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1005}), Document(page\_content='Leases 1005 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. \n Example 13A.2.10 \nApplying hindsight with lease remeasurements and \nmodifications \nThis example illustrates the interpretive guidance provided in Questions 13A.2.30 \n– 13A.2.90 about applying the hindsight practical expedient in evaluating lease \nremeasurements and modificati ons. \nThe following table summarizes relevant information about Lessee LE’s lease \nof a warehouse facility from Lessor LR. LE and LR have both elected to use the \npackage of transition practical expedients and the hindsight practical expedient. \nCommencement date of lease: January 1, 2004 \nLease term: 15 years \nTerms of renewal options: One 10- year option. LE must notify LR six months \nbefore the end of the term that LE will not exercise \nthe option or the option is deemed exercised. \nAt lease inception, exercise of the renewal option by \nLE is not reasonably assured. \nEffective date for LE: January 1, 2019 \nScenario 1: Lessee option exercised during comparative period \nLE did not notify LR of its intent to terminate the lease on or before July 1, \n2018. As a result, because July 1, 2018 represents six months before the end of the original lease term, the renewal option has been exercised in accordance with the terms of the contract. \nIn this scenario, the remaining lease term is 10 years for both LE and LR as of \nJanuary 1, 2019 (transition date for the lease under the effective date method). \nScenario 2: Lessee option exercised after the effective date \nAssume the same facts as in Scenario 1, except the commencement date of \nthe lease was January 1, 2005 and therefore the non- cancellable period of the \nlease ends December 31, 2019. This means that the date by which LE must notify LR of its intent not to exercise the extension option is July 1, 2019 (rather \nthan July 1, 2018). \nIn this scenario, if the entity (LE or LR) concludes, based on consideration of all \nrelevant economic factors as of the effective date (see Question 13A .2.40), that \nLE is reasonably certain to extend the lease beyond December 31, 2019, the remaining lease term will be 11 years (January 1, 2019 – December 31, 2029) at \nthe effective date. \nIf LE is not reasonably certain to exercise the option to extend the lease as of \nthe effective date, the remaining lease term is only one year (January 1, 2019 – \nDecember 31, 2019) at the effective date. If LE exercises the option on July 1, \n2019, that extension of the lease term does not affect the conclusion reached \non transition that the remaining lease term is one year at the effective date. The \nexercise of the option is solely a ‘post -transitio n’ accounting event for both LE \nand LR. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1006}), Document(page\_content='Leases 1006 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Scenario 3: Lease modification after the effective date \nAssume the same facts as Scenario 2, except that the lease does not include a \nrenewal option for LE. However, LE and LR agree on February 1, 2019 to \nmodify the lease to extend its term for 10 years following the end of the non -\ncancellable period of the lease ( which is December 31, 2019). \nDespite the fact that the modification occurred only one month after the \neffective date and before LE or LR have issued financ ial statements under \nTopic 842, the lease term extension resulting from the modification is not \nreflected in the remaining lease term at the transition date (i.e. the effective \ndate of January 1, 2019). Therefore, the remaining lease term at January 1, \n2019 is one year : January 1, 2019 – December 31, 2019. The change in the \nlease term resulting from the modification is not reflected in the financial \nstatements until the effective date of the modification. \n \n Question 13A.2.100 \nErrors in applying Topic 840 \nDoes election of the package of practical expedients require \nentities to correct errors in applying Topic 840 with respect to \nlease identification, lease classification and the accounting for \ninitial direct costs? \nInterpretive response: Yes. Election of the package of practical expedients \ndoes not grandfather errors in applying Topic 840; it only grandfathers the \nTopic 840 guidance. \nTherefore, if the package of practical expedients is elected, incorrect \nconclusions reached under Topic 840 about the following must be corrected, \nseparate from the transition accounting for those leases, in accordance with the guidance in Topic 840: \n— whether a contract is or contains a lease (including incorrect conclusions \nabout whether a contract or part of a contract was in the scope of \nTopic 840); \n— lease classification; and/or \n— the accounting for initial direct costs. \nThe effect of correcting an error in applying Topic 840 is excluded from the \ntransition effect of applying Topic 842. An entity corrects any error under \nTopic 840 before applying the transition guidance in Topic 842. For example, if \nan entity wrongly concluded that a contract did not contain a lease under Topic 840, the entity would recognize that lease in transition even if that \ncontract would not contain a lease under Topic 842. For the specific \nrequirements related to land easements, see Section 13A.2. 4. \n[ASU 2016-\n02.BC393(a)] \nIdentifying a lease may be the most likely area of error to which the package of \npractical expedients applies. Many contracts convey the right to use property, \nplant or equipment, but are not explicitly identified as ‘lease agreements’. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1007}), Document(page\_content='Leases 1007 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Examples include service contracts (including contracts for IT services), \ndedicated supply agreements, advertising and construction contracts. Under \nTopic 840, an entity may not have had a significantly different expense \nrecognition pattern or balance sheet treatment regardless of whether a \ntransaction was accounted for as an operating lease or as an executory or \nservice contract. Accordingly, entities may not have previously focused their \nefforts on identifying contracts that explicitly or implicitly contained operating leases. \nHowever, under Topic 842 identifying leases becomes much more important \nbecause entities recognize lease liabilities and ROU a ssets on the balance sheet \nfor each lease with a term that is longer than 12 months. Accordingly, the Board decided that the package of practical expedients should not provide an \nexemption for arrangements that were not accounted for as leases under \nTopic 840 even though they met the Topic 840 definition. \n \n Question 13A.2.110 \nGrandfathering arrangements committed or agreed \nto before reporting periods beginning after May 28, \n2003 \nAre arrangements that were grandfathered from application \nof the lease identification guidance in Topic 840 still \ngrandfathered on transition to Topic 84 2? \nBackground: Under Topic 840, arrangements not accounted for as leases that \nwere committed or agreed to before reporting periods beginning after May 28, \n2003 (and not subsequently modified or acquired in a business combination) \nwere grandfathered from determining whether the arrangement is or contains \na lease. \nInterpretive response: Yes, but only if the entity elects the package of \ntransition practical expedients. Topic 842 does not carry forward that \ngrandfathering provision, so unless the package of practical expedients is elected, the entity must reassess whether leases exist for all arrangements that \nhave not ended before the effective date. \nHowever, the package of prac tical expedients grandfathers the Topic 840 lease \nidentification guidance for all leases that commence before the effective date of \nTopic 842. We believe this includes the grandfathering provision in Topic 840. \nTherefore, if an entity elects the package of practical expedients, leases \npreviously eligible for this grandfathering provision would remain eligible for \nthat provision. \nBecause the grandfathering provision in Topic 840 does not apply to leases \nmodified after May 28, 2003, entities will need to have a process in place to \nensure that any modified contracts initially eligible for the grandfathering \nprovision were reassessed under Topic 840 upon modification, as well as a \nprocess in place to monitor any such contracts for modifications that oc cur on \nor after the effective date of Topic 842. If a contract previously eligible for the Topic 840 grandfathering provision is modified on or after the effective date, the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1008}), Document(page\_content='Leases 1008 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. entity will have to assess whether the contract is or contains a lease under \nTopic 842. \n \n Observation \nImpact on initial direct costs for entities not electing \nthe package of practical expedients \n13A.2. 140 An entity’s decision not to elect the package of practical expedients \nfor lease definition, lease classification and initial direct costs may not have a significant effect on the entity unless it has previously incurred a significant \namount of initial direct costs. This is because the new definition of a lease and \nthe new lease classification guidance will likely yield s imilar outcomes to the \nrelated guidance in Topic 840 in most cases (assuming no errors in applying \nTopic 840 – see Question 13A .2.10 0). However, because substantially fewer \ncosts qualify as initial direct costs under Topic 842 (see section 5.5), the effect \nof electing (or not electing) the package of practical expedients may be \nsignificant for entities that incur significant lease origination costs. \n[ASU 2016- 02.BC393(c)] \n \n13A.2.4 Land easements \n13A.2.150 A land easement is, in general, a right to use and/or enter (or cross) \nland owned by another party for a specific purpose, for which the rights vary \ndepending on the easement. Land easements may be perpetual or for a defined \nterm, may be prepaid or paid over tim e, and may provide for exclusive or \nnonexclusive (shared) use of the land. For a discussion of land easements and \nthe scope of Topic 842, see Question 2.3.10. \n13A.2.160 As some entities did not assess whether land easements met the \ndefinition of a lease under Topic 840, stakeholders expressed concern to the Board that it would be costly and complex to evaluate those land easements in \ntransition. As a result, the Board added a n optional transition practical expedient \nspecifically for land easements. It allows an entity to elect not to assess \nwhether any expired or existing land easements are, or contain, leases at \ntransition if they were not previously accounted for as leases under Topic 840. \nAn entity that elects this practical expedient should assess any new or modified \nland easements on or after the effective date under Topic 842. \n13A.2.170 This practical expedient does not apply to any land easements that \nwere previously accounted for as leases under Topic 840. Such land easements \nare subject to the same transition guidance as other identified leases. \n13A.2.180 This practical expedient is available separately, or in conjunction with \neither or both of the other practical expedients: the all -or-nothing package of \npractical expedients, and the ability to use hindsight (see section 13A.2.3). An \nentity that does not elect the land easements practical expedient must either: \n— If the package of practical expedients is not elected: reassess whether its \nland easements meet the Topic 842 definition of a lease; or \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1009}), Document(page\_content='Leases 1009 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — If the package of practical expedients is elected: ensure that its Topic 840 \nconclusions about whether its land easements were, or contained, leases \nwere correct (see Question 13A.2.100). \n \n Observation \nPrior land easement accounting is grandfathered \n13A.2.190 The Board specifically provided this transition practical expedient for \nland easements that were not accounted for as leases under Topic 84 0, rather \nthan land easements that were not assessed under Topic 840. In practical \nterms, this means that land easements that were accounted for under non-lease guidance do not need to be reassessed to determine if they met the \ndefinition of a lease either under Topic 840 (if the package of practical \nexpedients is elected) or Topic 842 (if the package of practical expedients is not elected) before transition. As a result, election of the practical expedient will \nessentially grandfather the legacy accounting for any land easements that exist at (i.e. have commenced before) the effective date of Topic 842, including any \nerroneously determined not to be a lease under Topic 840. \n13A.2.200 This differs from other transition guidance in Topic 842, which \nspecifies that errors in the application of Topic 840 are not grandfathered (see \nQuestion 13A.2.100) . If an entity does not elect this practical expedient, it \ncannot overlook land easements that were erroneously not accounted for as leases under Topic 840, even if the entity elects the package of practical \nexpedients.\n [ASU 2016- 02.BC393(a)] \n \n Question 13A.2.120 \nLand easements arising before the effective date \nCan an entity change its accounting policy for land easements \nbefore the effective date of Topic 842? \nInterpretive response: No. An entity that elects the optional transition practical \nexpedient for land easements is required to continue to apply consistent \naccounting policies to new or modified contracts entered into before the \neffective date of Topic 842. Therefore, an entity that previously accounted for \nland easements under Topic 840 should continue to apply Topic 840 to new \nland easements arising before the effective date. For example, a new ground lease agreement (which could be characterized as a land easement) \ncommencing before the effective date of T opic 842 is not eligible for the \npractical expedient because similar ground leases had previously been \naccounted for by the entity as leases under Topic 840. \n[ASU 2018- 01.BC17] \nAlternatively, if the entity has historically accounted for a population of land \neasements under other guidance (e.g. Topics 350 or 360), the entity should \ncontinue to apply that accounting policy to all similar land easements entered \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1010}), Document(page\_content='Leases 1010 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. into before the effective date of Topic 842. In this case, the entity is eligible to \napply the pract ical expedient to those land easements in transition. \n \n13A.2.5 Disclosures \n13A.2. 210 In addition to the ongoing disclosures required by Topic 842 for \nlessees and lessors, an entity generally provides the transition disclosures \nrequired for accounting cha nges and error corrections. As an exception, an \nentity is not required to disclose the effect of the change on income from \ncontinuing operations, net income and per ‑share amounts for the interim and \nannual period s post -adoption. [842- 10-65-1(i), 250- 10-50-1(b)(2) , 250 -10-50-3] \n13A.2. 220 If an entity elects the package of practical expedients , the practical \nexpedient to use hindsight and/or the land easements practical expedient , it \ndiscloses that fact. [842- 10-65-1(j)] \n13A.2. 230 Before the effective date, SEC registrants are required to evaluate \nnew accounting standards that they have not yet adopted and to disclose their \npotential material effects. These disclosures generally should include a \ndiscussion about the effect that adoption is expected to have on the financial \nstatements, unless this is not known or reasonably estimable. KPMG has \ndeveloped example disclosures that may be used as a starting point by lessees \nand lessors in drafting disclosures about the effects of adopting Topic 842: \nASC 842, Leases – Transition disclosures . [SAB Topic 11.M] \n13A.2. 240 While Topic 842 requires only certain lessor disclosures to be made in \nall interim financial statements, Article 10 of Regulation S -X requires SEC \nregistrants to provide both the applicable lessor and lessee annual and interim \ndisclosures in each interim period included in the entity’s quarterly reports on \nForm 10-Q in the year of adoption of a new accounting standard (see \nQuestion 12.1.20). \n13A.2. 250 Under the effective date method, an entity only presents disclosures \nfor periods subsequent to the effective date in accordance with Topic 842. The \nentity does not present Topic 842 disclosures for periods before the effective \ndate (see Question 13A.2. 130). However, the entity must carry forward all of \nthe disclosures that were required under Topic 840 for comparative periods \nbefore the effective date th at are presented in the entity’s post -adoption \nfinancial statements. This is different from the comparative method, which \nrequires that the Topic 842 disclosures – i.e. in lieu of the disclosures originally \nprovided for the applicable comparative period under Topic 840 – be prepared \nfor all periods presented (see Quest ion 13B.2. 120). [842- 10-65-1(jj)] \n13A.2. 260 The disclosures of future operating and capital lease commitments \nwas only required under T opic 840 for the last annual balance sheet date \npresented in the lessee’s financial statements (notwithstanding interim disclosure guidance under Topic 270 that could apply under some \ncircumstances). However, the transition provisions applicable to the eff ective \ndate method mandate that these lease commitments disclosures, as of the last balance sheet prepared under Topic 840, be carried forward and presented by \nthe entity in each set of interim and annual financial statements (e.g. in each \nQuarterly Report on Form 10-Q and Annual Report on Form 10 -K) issued for the \nyear of adoption. \n[842- 10-65-1(jj), ASU 2018 -11.BC14 ] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1011}), Document(page\_content='Leases 1011 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Observation \nEffect of adoption on the financial statements \n13A.2. 270 In various forums, including public meetings, that included members \nof the preparer and practitioner communities, members of the SEC staff have \nstated that an entity asserting in its financial statements that the effect of \nadoption of Topic 606 will not be material needs to consider the effect of the \nnew disclosure requirements. That is, even though the basic financial statements may not be materially affected, the information in the significant \nnew disclosures could be a material effect on the financial st atements, which \ninclude the notes. While this comment has most frequently been made in the context of comments about the adoption of Topic 606, we believe the SEC staff \nwould hold a similar view about an entity’s SAB 74 disclosures in relation to the \nnew l eases standard. \n13A.2. 280 We believe some entities, many lessors in particular, may conclude \nthat the effect of Topic 842 on their basic financial statements will not be \nmaterial but that they will have to make significant new disclosures. Those \nentities should be cognizant of this guidance from the SEC staff. Meanwhile, \nlessees and others that anticipate a material effect from adoption should \ndiscuss the substantial new Topic 842 disclosure requirements in their pre-\nadoption SAB 74 disclosures in additio n to the other anticipated effects on their \nfinancial statements. \n \n Question 13A.2. 130 \nDisclosures in comparative periods \nDo the lessee, lessor and sale- leaseback disclosure \nrequirements in Topic 842 apply to comparative periods \npresented in the post -adoption financial statements? \nInterpretive response: No, Topic 842 disclosures are not required for \ncomparative annual or interim periods ending before the effective date. \nHowever, previous disclosures required to be made under Topic 840 for those \nperiods are required to be included in the entity’s post -effective date financial \nstatements. \nIn all comparative periods presented af ter the effective date (i.e. annual and \ninterim periods that ended before the effective date) the entity should include \nthe following. [842- 10-65-1(jj), ASU 2018 -11.BC14 ] \n— Any disclosures previously required under Topic 840 for that comparative \nperiod. For example, in its first annual financial statements issued post -\nadoption of Topic 842, a lessee will include its Topic 840 operating lease rental expense disclosure for the comparative annual periods presented. \nAnd if a lessee was required to disclose operating lease rental expense in \nits 2018 first quarter 10- Q based on the requirements in Topic 270 (interim \nreporting) , it would include that disclosure in its 2019 first quar ter 10- Q. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1012}), Document(page\_content='Leases 1012 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — The prior year -end operating and capital lease commitment maturity tables \n(if a lessee) as required by paragraphs 840- 20-50-2 and 840- 30-50-1(b)-(c). \nThese tables would be unchanged from the prior year -end annual financial \nstatements. \n \n Questio n 13A.2.140 \nLoss of EGC status before nonpublic business entity \neffective date \nWhen does an EGC that has elected to use the ‘all other \nentities’ effective date but loses its EGC status before that date adopt Topic 842? \nBackground: Assume a calendar year -end entity begin s 2021 as an Emerging \nGrowth Company (EGC ) but loses EGC status on December 31, 20 21. This \ntiming is after the mandatory calendar year -end public business entity (PBE) \nadoption date for Topic 842 (January 1, 2019) , but before the mandatory \nadoption date for all other calendar year -end entities ( January 1, 2022) . The first \nperiodic financial statement filing the entity will make after it los es its EGC \nstatus will be its Annual Report on Form 10- K for 2021 . \nIn this situat ion, questions have arisen about transition to Topic 842, including: \n— Question 1: Upon the loss of EGC status, should the entity adopt Topic 842 \nwith an effective date of January 1, 2021 (beginning of its fiscal year), or is \nit instead required to adopt Topic 842 as of the date it would have been \nrequired to adopt Topic 842 as a PBE (i.e. January 1, 2019) and restate its \nprevious Forms 10- K and 10 -Q? \n— Question 2: Should the entity reflect adoption of Topic 842 in the \nsupplementary quarterly financial data table included in its 2021 Form 10- K? \n— Question 3: How should the comparative 2021 quarterly information be \npresented in the entity’s fiscal 2022 Form 10- Qs? \nInterpretive response: The responses to these questions are based on \ndiscussions with the SEC staff. \nQuestion 1 \nThe entity can adopt Topic 842 from January 1, 2021 – i.e. from the beginning \nof the entity’s fiscal year in which it lost EGC status. The entity is not required \nto adopt Topic 842 as of the date it would have been required to do so as a non-\nEGC PBE (January 1, 2019). The entity’s annual financial statements included in \nits 2021 Annual Report on Form 10 -K will therefore reflect the adoption of Topic \n842 from the beginning of its fiscal year. \nQuestion 2 \nIt depends. In November 2020, the SE C adopted amendments to Regulation S -\nK to modernize MD&A and other disclosures; see KPMG Hot Topic , SEC \namends Regulation S -K to streamline disclosures . \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1013}), Document(page\_content='Leases 1013 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The rule amendments became effective on February 10, 2021. Compliance with \nthe amended rules is required beginning with the fiscal year ending on or after \nAugust 9, 2021 – e.g. year ending December 31, 2021 for calendar year -end \nregistrants. [Reg S -K Section II.F] \nThe amendm ents to Item 302(a) clarify that an entity is only required to disclose \nselect quarterly financial data in annual filings if there are one or more material retrospective changes to the statements of comprehensive income for any \nquarters in the two most rec ent years. If the impacts of Topic 842 adoption \nwere material, the background entity would be required to disclose in its 2021 Form 10 -K, for each affected quarterly period and the fourth quarter of the \naffected year, summarized statement of comprehensive income and earnings \nper share financial information reflecting those changes. \nUnder Item 302(a), an entity that loses EGC status would have a retrospective \nquarterly change that requires materiality analysis. This is because the entity is \nrequired to adopt Topic 842 in the 2021 Form 10- K for the full fiscal year, \nincluding interim periods within that year. \n[Reg S -K Item 302(a)] \nIf the entity that loses EGC status determines that the retrospective changes \nare material, the affected quarters would include all four quarters because the \nmaterial retrospective change is as of January 1. [Reg S -K Item 302(a)] \nQuestion 3 \nFiscal 2021 com parative q uarterly financial information provided by the entity in \nits fiscal 2022 Form 10-Qs should be recast to reflect the entity’s adoption of \nTopic 842 as of January 1, 2021 . \nThe comparative 2021 quarterly information presented by the entity in its 2022 \nForm 10-Qs will not be the same as the information included in its filed 2021 \nForm 10-Qs, but it will be consistent with the supplementary quarterly financial \ndata included in the entity’s 2021 Form 10- K (if any, see Question 2) . \nNo reconciliation bet ween the filed 2021 Form 10- Qs and the 2021 comparative \ninformation presented in the 2022 Form 10 -Qs is required. However , the entity \nshould disclose its initial application of T opic 842 in Q4 of 2021 with an adoption \ndate of January 1, 202 1 in its 2022 Form 10 -Qs. \n \n13A.3 Transition for lessees # \n Excerpt from ASC 842 -10 \nTransition and Open Effective Date Information \nGeneral \n> Transition Related to Accounting Standards Update s No. 2016- 02, \nLeases (Topic 842) , No. 2018- 01, Leases (Topic 842): Land Easement \nPractical Expedient for Transition to Topic 842 , No. 2018- 10, Codification \nImprovements to Topic 842, Leases , No. 2018- 11, Leases (Topic 842): \nTargeted Improvements , No. 2018- 20, Leases (Topic 842): Narrow -Scope \nImprovements for Lessors , No. 2019 -01, Leases (Topic 842): Codification ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1014}), Document(page\_content='Leases 1014 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Improvements , No. 2019 -10, Financial Instruments —Credit Losses (Topic \n326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): \nEffective Dates , No. 2020- 05, Revenue from Contracts with Customers \n(Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities , \nNo. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with Variable \nLease Payments , No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entities , and N o. 2023- 01, Leases \n(Topic 842): Common Control Arrangements \n65-1 The following represents the transition and effective date information \nrelated to Accounting Standards Updates No. 2016- 02, Leases (Topic 842) , \nNo. 2018- 01, Leases (Topic 842): Land Easement Practical Expedient for \nTransition to Topic 842, No. 2018- 10, Codification Improvements to Topic 842, \nLeases , No. 2018- 11, Leases (Topic 842): Targeted Improvements , No. 2018-\n20, Leases (Topic 842): Narrow- Scope Improvements for Lessors , No. 2019- 01, \nLeases (Topic 842): Codification Improvements , No. 2019- 10, Financial \nInstruments —Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), \nand Leases ( Topic 842): Effective Dates , No. 2020- 05, Revenue from Contracts \nwith Customers (Topic 60 6) and Leases (Topic 842): Effective Dates for Certain \nEntities , No. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with \nVariable Lease Payments , No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entities , and No. 2023- 01, Leases (Topic \n842): Common Control Arrangements : [Note : See paragraph 842-10-S65-1 for \nan SEC Staff Announcement on transition related to Update 2016- 02.] \nLessees \nLeases previously classified as operating leases under Topic 840 \nk. A lessee shall initially recognize a right -of-use asset and a lease liability at \nthe application date as determined in (c). \nl. Unless, on or after the effective date, the lease is modified (and that \nmodification is not accounted for as a separate contract in accordance with \nparagraph 842- 10-25-8) or the lease liability is required to be remeasured in \naccordance with paragraph 842- 20-35-4, a lessee shall measure the lease \nliability at the present value of the sum of the following, using a discount \nrate for the lease (which, for entities that are not public business entities, \ncan be a risk- free rate determined in accordance with paragraph 842- 20-30-\n3) established at the application date as determi ned in (c): \n1. The remaining minimum rental payments (as defined under Topic 840). \n2. Any amounts probable of being owed by the lessee under a residual \nvalue guarantee. \nm. For each lease classified as an operating lease in accordance with \nparagraphs 842- 10-25-2 through 25- 3, a lessee shall initially measure the \nright-of-use asset at the initial measurement of the lease liability adjusted \nfor both of the following: \n1. The items in paragraph 842 -20-35-3(b), as applicable. \n2. The carrying amount of any liability recognized in accordance with \nTopic 420 on exit or disposal cost obligations for the lease. \nn. For each lease classified as an operating lease in accordance with \nparagraphs 842- 10-25-2 through 25- 3, a lessee shall subsequ ently measure \nthe right -of-use asset throughout the remaining lease term in accordance \nwith paragraph 842- 20-35-3(b). If the initial measurement of the right -of-use \nasset in (m) is adjusted for the carrying amount of a liability recognized in ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1015}), Document(page\_content='Leases 1015 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. accordance wi th Topic 420 on exit or disposal cost obligations for the \nlease, the lessee shall apply the recognition and subsequent measurement \nguidance in Sections 842 -20-25 and 842- 20-35, respectively, when the \nright-of-use asset has been impaired. \no. For each lease cl assified as a finance lease in accordance with \nparagraph 842-10-25-2, a lessee shall measure the right -of-use asset as \nthe applicable proportion of the lease liability at the commencement date, \nwhich can be imputed from the lease liability determined in ac cordance \nwith (l). The applicable proportion is the remaining lease term at the \napplication date as determined in (c) relative to the total lease term. A \nlessee shall adjust the right -of-use asset recognized by the carrying amount \nof any prepaid or accrued lease payments and the carrying amount of any \nliability recognized in accordance with Topic 420 for the lease. \np. If a lessee does not elect the practical expedients described in (f), any \nunamortized initial direct costs that do not meet the definition of i nitial \ndirect costs in this Topic shall be written off as an adjustment to equity \nunless the entity elects the transition method in (c)(1) and the costs were \nincurred after the beginning of the earliest period presented, in which case \nthose costs shall be written off as an adjustment to earnings in the period \nthe costs were incurred. \nq. If a modification to the contractual terms and conditions occurs on or \nafter the effective date, and the modification does not result in a \nseparate contract in accordance with paragraph 842 -10-25-8, or the \nlessee is required to remeasure the lease liability for any reason (see \nparagraphs 842-20-35-4 through 35- 5), the lessee shall follow the \nrequirements in this Topic from the effective date of the modification or \nthe remeasurement date. \nLeases previously classified as capital leases under Topic 840 \nr. For each lease classified as a finance lease in accordance with this Topic, a \nlessee shall do all of the following: \n1. Recognize a right -of-use asset and a lease liability at the car rying \namount of the lease asset and the capital lease obligation in \naccordance with Topic 840 at the application date as determined in (c). \n2. Include any unamortized initial direct costs that meet the definition of \ninitial direct costs in this Topic in the measurement of the right -of-use \nasset established in (r)(1). \n3. If a lessee does not elect the practical expedients described in (f), write \noff any unamortized initial direct costs that do not meet the definition of \ninitial direct costs in this Topic and tha t are not included in the \nmeasurement of the capital lease asset under Topic 840 as an \nadjustment to equity unless the entity elects the transition method in \n(c)(1) and the costs were incurred after the beginning of the earliest \nperiod presented, in which case those costs shall be written off as an \nadjustment to earnings in the period the costs were incurred. \n4. If an entity elects the transition method in (c)(1), subsequently measure \nthe right -of-use asset and the lease liability in accordance with \nSection 840-30-35 before the effective date. \n5. Regardless of the transition method selected in (c), apply the \nsubsequent measurement guidance in paragraphs 842 -20-35-4 through \n35-5 and 842- 20-35-8 after the effective date. However, when applying \nthe pending content in paragraph 842 -20-35-4, a lessee shall not ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1016}), Document(page\_content='Leases 1016 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. remeasure the lease payments for amounts probable of being owed \nunder residual value guarantees in accordance with paragraph 842-10-\n35-4(c)(3). \n6. Classify the assets and liabilities held under capital leases as r ight-of-\nuse assets and lease liabilities arising from finance leases for the \npurposes of presentation and disclosure. \ns. For each lease classified as an operating lease in accordance with this \nTopic, a lessee shall do the following: \n1. Derecognize the carrying amount of any capital lease asset and capital \nlease obligation in accordance with Topic 840 at the application date as \ndetermined in (c). Any difference between the carrying amount of the \ncapital lease asset and the capital lease obligation shall be accou nted \nfor in the same manner as prepaid or accrued rent. \n2. If an entity elects the transition method in (c)(1) and the lease \ncommenced before the beginning of the earliest period presented in \nthe financial statements or if the entity elects the transition method in \n(c)(2), recognize a right -of-use asset and a lease liability in accordance \nwith paragraph 842- 20-35-3 at the application date as determined in (c) . \n3. If an entity elects the transition method in (c)(1) and the lease \ncommenced after the beginning of the earliest period presented in the \nfinancial statements, recognize a right -of-use asset and a lease liability \nin accordance with paragraph 842- 20-30-1 at the commencement date \nof the lease. \n4. Account for the operating lease in accordance with the guidance in \nSubtopic 842-20 after initial recognition in accordance with (s)(2) or \n(s)(3). \n5. Write off any unamortized initial direct costs that do not meet the \ndefinition of initial direct costs in this Topic as an adjustment to equity \nunless the enti ty elects the transition method in (c)(1) and the costs \nwere incurred after the beginning of the earliest period presented, in \nwhich case those costs shall be written off as an adjustment to \nearnings in the period the costs were incurred. \nt. If a modificatio n to the contractual terms and conditions occurs on or after \nthe effective date, and the modification does not result in a separate \ncontract in accordance with paragraph 842- 10-25-8, or the lessee is \nrequired to remeasure the lease liability in accordance with paragraph 842-\n20-35-4, the lessee shall subsequently account for the lease in accordance \nwith the requirements in this Topic beginning on the effective date of the \nmodification or the remeasurement date. \n> Transition Related to Accounting Standar ds Update No. 2021- 09, \nLeases (Topic 842): Discount Rate for Lessees That Are Not Public \nBusiness Entities \n65-6 The following represents the transition and effective date information \nrelated to Accounting Standards Update No. 2021- 09, Leases (Topic 842): \nDiscount Rate for Lessees That Are Not Public Business Entities : \na. An entity that has not yet adopted the pending content that links to \nparagraph 842- 10-65-1 as of 11/11/2021 shall apply the pending content \nthat links to this paragraph to all new and existing leases when the entity \nfirst applies the pending content that links to paragraph 842- 10-65-1. That \nentity shal l apply the same transition method elected for the pending ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1017}), Document(page\_content='Leases 1017 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. content that links to paragraph 842 -10-65-1. \nb. An entity that has adopted the pending content that links to paragraph 842-\n10-65-1 (as of 11/11/2021) shall: \n1. Apply the pending content that links to this paragraph for financial \nstatements issued for fiscal years beginning after December 15, 2021, \nand interim periods within fiscal years beginning after December 15, \n2022. Earlier application is permitted as of the beginning of the fiscal \nyear of adoption. \n2. Apply the pending content that links to this paragraph on a modified \nretrospective basis to leases affected by the amendments existing as \nof the beginning of the fiscal year of adoption by adjusting the lease \nliability, which shall be calculated based on the discount rate and \nremaining lease term at the beginning of the fiscal year of adoption. An \nentity shall recognize the amount of the change in the lease liability as \nan adjustment to the corresponding right -of-use asset, unless: \ni. The carrying amount of the right -of-use asset is reduced to zero, \nin which case the entity shall recognize any remaining amount of \nthe adjustment to opening retained earnings at the beginning of \nthe fiscal year of adoption. \nii. The adjustment would increase a right -of-use asset that was \npreviously impaired, in which case the entity shall record the \nadjustment to opening retained earnings at the beginning of the \nfiscal year of adoption. \nc. An entity within the scope of (b) shall not treat the adoption of the pending \ncontent that links t o this paragraph as an event that would require the \nentity to: \n1. Remeasure and reallocate the consideration in the contract in \naccordance with paragraph 842- 10-15-36. \n2. Reassess the lease term or a lessee option to purchase the underlying \nasset in accordance w ith paragraph 842- 10-35-1. \n3. Remeasure the lease payments in accordance with paragraph 842- 10-\n35-4. \n4. Reassess lease classification in accordance with paragraph 842 -10-25-\n1. \nd. An entity within the scope of (b) that has adopted the pending content that \nlinks to t his paragraph shall disclose the following as of the beginning of \nthe fiscal year of adoption (rather than at the beginning of the earliest \nperiod presented): \n1. The information required by paragraph 250- 10-50-1(a) and (b)(3), if \napplicable \n2. The recognized amount of changes in lease liabilities and \ncorresponding right -of-use assets resulting from the transition \nadjustment. \nFor an entity within the scope of (b), at the date of adoption of the pending \ncontent that links to this paragraph, the entity may choose to apply or \ndiscontinue using the risk -free rate for any class of underlying asset. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1018}), Document(page\_content='Leases 1018 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. > Transition Related to Accounting Standards Update No. 2023 -01, Leases \n(Topic 842): Common Control Arrangements \n65-7 The following represents the transition a nd effective date information \nrelated to the practical expedient in Accounting Standards Update No. 2023- 01, \nLeases (Topic 842): Common Control Arrangements : \na. The pending content that links to this paragraph shall be effective for fiscal \nyears, including i nterim periods within those fiscal years, beginning after \nDecember 15, 2023. Early adoption is permitted in any annual or interim \nperiod for which financial statements have not yet been made available for \nissuance. If an entity adopts the pending content t hat links to this \nparagraph in an interim period, it shall adopt that pending content as of the \nbeginning of the fiscal year that includes that interim period. \nb. An entity that adopts the pending content that links to this paragraph \nconcurrently with adopting the pending content that links to paragraph 842-\n10-65-1 shall apply the pending content that links to this paragraph using \nthe same transition method elected for the pending content that links to \nparagraph 842- 10-65-1. \nc. An entity that adopted the pending content that links to paragraph 842- 10-\n65-1 before adopting the pending content that links to this paragraph shall \napply the pending content that links to this paragraph using either of the \nfollowing two methods: \n1. Prospectively to arrangements that commence or are modified on or \nafter the date that the entity first applies the pending content that links \nto this paragraph. \n2. Retrospectively to the beginning of the period in which the pending \ncontent that links to paragraph 842- 10-65-1 was first applied. The \npending content that links to this paragraph shall not be applicable for \narrangements no longer in place at the date of adoption. Under this \ntransition method: \ni. If an arrangement previously considered to be a lease continues to \nbe a lease after applying the pe nding content that links to this \nparagraph, an entity shall apply the requirements in paragraphs \n842-10-25-9 through 25 -17 to any changes in the lease resulting \nfrom application of the practical expedient in the pending content \nthat links to this paragraph. Any amounts that otherwise would \nhave been recognized in earnings shall be recognized as a \ncumulative -effect adjustment to opening retained earnings (or net \nassets of a not -for-profit entity) at the beginning of the earliest \nperiod presented in accordanc e with the pending content that links \nto paragraph 842- 10-65-1. \nii. If an arrangement previously not considered a lease becomes a \nlease after applying the pending content that links to this \nparagraph, an entity shall account for the arrangement as a new \nlease. \nd. An entity may document any existing unwritten terms and conditions of an \narrangement between entities under common control before the date on \nwhich the entity’s first interim (if applicable) or annual financial statements \nare available to be issued in accordance with the pending content that links \nto this paragraph. \ne. An entity within the scope of (c) shall provide the applicable transition \ndisclosures required by Topic 250 on accounting changes and error ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1019}), Document(page\_content='Leases 1019 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. corrections, except for the requirements in par agraphs 250 -10-50-1(b)(2) \nand 250- 10-50-3. An entity that elects the transition method in (c)(2) shall \nprovide the transition disclosures in paragraph 250- 10-50-1(b)(3) as of the \nbeginning of the earliest period presented but not before the date on which \nthe pending content that links to paragraph 842- 10-65-1 was adopted. \nf. An entity that elects the practical expedient(s) in paragraph 842- 10-65-1(f) \nor (g) is not required to apply either of those practical expedients to \ncommon control arrangements for which t he pending content that links to \nthis paragraph is being applied. \n65-8 The following represents the transition and effective date information \nrelated to the accounting for leasehold improvements associated with leases \nbetween entities under common control in Accounting Standards Update No. \n2023 -01, Leases (Topic 842): Common Control Arrangements : \na. The pending content that links to this paragraph shall be effective for fiscal \nyears, including interim periods within those fiscal years, beginning after \nDecember 15, 2023. Early adoption is permitted in any annual or interim \nperiod for which financial statements have not yet been made available for \nissuance. If an entity adopts the pending content that links to this \nparagraph in an interim period, it shall adopt t hat pending content as of the \nbeginning of the fiscal year that includes that interim period. \nb. An entity that adopts the pending content that links to this paragraph \nconcurrently with adopting the pending content that links to paragraph 842-\n10-65-1 may appl y the pending content that links to this paragraph using \nthe same transition method elected for the pending content that links to \nparagraph 842- 10-65-1 or may apply the pending content that links to this \nparagraph using either of the prospective methods specified in (c)(1) and \n(c)(2) below. \nc. An entity that adopted the pending content that links to paragraph 842- 10-\n65-1 before adopting the pending content that links to this paragraph shall \napply the pending content that links to this paragraph using one of the \nfollowing methods: \n1. Prospectively to all new leasehold improvements recognized on or \nafter the date that the entity first applies the pending content that links \nto this paragraph. \n2. Prospectively to all new and existing leasehold improvements \nrecognized on or after the date that the entity first applies the pending \ncontent that links to this paragraph. An entity that elects this transition \napproach shall amortize the remaining balance of leasehold \nimprovements existing at the date of adoption of the pending content \nthat links to this paragraph over the remaining useful life of those \nimprovements to the common control group determined at that date. \n3. Retrospectively to the beginning of the period in which the pending \ncontent that links to paragraph 842- 10-65-1 was first applied. Any \nleasehold improvements previously amortized or impaired that \notherwise would not have been amortized or impaired had the pending \ncontent that links to this paragraph been applicable shall be recognized \nthrough a cumulative- effect adjustment to the opening balance of \nretained earnings (or net assets of a not -for-profit entity) at the \nbeginning of the earliest period presented in accordance with the \npending content that links to paragraph 842 -10-65-1. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1020}), Document(page\_content='Leases 1020 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. d. An entity within the scope of (c) sh all provide the applicable transition \ndisclosures required by Topic 250 on accounting changes and error \ncorrections, except for the requirements in paragraphs 250- 10-50-1(b)(2) \nand 250- 10-50-3. An entity that elects the transition method in (c)(3) shall \nprovide the transition disclosures in paragraph 250- 10-50-1(b)(3) as of the \nbeginning of the earliest period presented but not before the date on which \nthe pending content that links to paragraph 842- 10-65-1 was adopted. \n55 Implementation Guidance and Illust rations \nGeneral \n> Implementation Guidance \n>> Illustrations of Transition \n>>> Illustration of Lessee Transition —Existing Capital Lease \n55-243 Example 28 illustrates lessee accounting for the transition of existing \ncapital leases when an entity elects the transition method in paragraph 842- 10-\n65-1(c)(1) . \n>>>> Example 28— Lessee Transition —Existing Capital Lease \n55-244 The effective date of the guidance in this Topic for Lessee is January 1, \n20X4. Lessee enters into a 7- year lease of an asset on January 1, 20X1, with \nannual lease payments of $25,000 payable at the end of each year. The lease \nincludes a residual value guarantee by Lessee of $8,190. Lessee’s incremental \nborrowing rate on the date of commencement was 6 percent. Lessee \naccounts for the lease as a capital lease. At lease commencement, Lessee \ndefers initial direct costs of $2,800, which will be amortized over the lease \nterm. On January 1, 20X2 (and before transition adjustments), Lessee has a \nlease liability of $128,707, a lease asset of $124,434, and unamortized initial \ndirect costs of $2,400. \n55-245 January 1, 20X2 is the beginning of the earliest comparative period \npresented in the financial statements in which Lessee first applies the \nguidance in this Topic. Lessee has elected the package of practical expedients \nin paragraph 842- 10-65-1(f). As such, Lessee accounts for the lease as a \nfinance lease, without reassessing whether the contract contains a lease or \nwhether classification of the lease would be different in accordance with this \nTopic. Lessee also does not reassess whether the unamortized initial direct \ncosts on January 1, 20X2, would have met the definition of initial direct costs in \nthis Topic at lease commencement. \n55-246 On January 1, 20X2, Lessee recognizes a lea se liability at the carrying \namount of the capital lease obligation on December 31, 20X1, of $128,707 and \na right -of-use asset at the carrying amount of the capital lease asset of \n$126,834 (which includes unamortized initial direct costs of $2,400 that wer e \nincluded in the capital lease asset). Lessee subsequently measures the lease \nliability and the right -of-use asset in accordance with Subtopic 840 -30 until the \neffective date. \n55-247 Beginning on the effective date, Lessee applies the subsequent \nmeasurement guidance in Section 842- 20-35, including the reassessment \nrequirements, except for the requirement to reassess amounts probable of ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1021}), Document(page\_content='Leases 1021 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. being owed under residual value guarantees. Such amounts will only be \nreassessed if there is a remeasurement of the lease liability for another reason, \nincluding as a result of a lease modification (that is, not accounted for as a \nseparate contract). \n>>> Illustration of Lessee Transition —Existing Operating Lease \n55-248 Example 29 illustrates lessee accounting for the tr ansition of existing \noperating leases when an entity elects the transition method in paragraph 842-\n10-65-1(c)(1) . \n>>>> Example 29— Lessee Transition —Existing Operating Lease \n55-249 The effective date of the guidance in this Topic for Lessee is January 1, \n20X4. Lessee enters into a five- year lease of an asset on January 1, 20X1, with \nannual lease payments payable at the end of each year. Lessee accounts for \nthe lease as an operating lease. At lease commencement, Lessee defers initial \ndirect costs of $500, which will be amortized over the lease term. On \nJanuary 1, 20X2 (and before transition adjustments), Lessee has an accrued \nrent liability of $1,200 for the lease, reflecting rent that was previously \nrecognized as an expense but was not yet paid a s of that date. Four lease \npayments (1 payment of $31,000 followed by 3 payments of $33,000) and \nunamortized initial direct costs of $400 remain. \n55-250 January 1, 20X2 is the beginning of the earliest comparative period \npresented in the financial statements in which Lessee first applies the \nguidance in this Topic. On January 1, 20X2, Lessee’s incremental borrowing \nrate is 6 percent. Lessee has elected the package of practical expedients in \nparagraph 842- 10-65-1(f). As such, Lessee accounts for the lease as an \noperating lease, without reassessing whether the contract contains a lease or \nwhether classification of the lease would be different in accordance with this \nTopic. Lessee also does not reassess whether the unamortized initial direct \ncosts on January 1, 20X2, would have met the definition of initial direct costs in \nthis Topic at lease commencement. \n55-251 On January 1, 20X2, Lessee measures the lease liability at $112,462, \nwhich is the present value of 1 payment of $31,000 and 3 payments of \n$33,000 discounted using the rate of 6 percent. The right -of-use asset is equal \nto the lease liability before adjustment for accrued rent and unamortized initial \ndirect costs, which were not reassessed because Lessee elected the practical \nexpedients in paragraph 842- 10-65-1(f). \n55-252 On January 1, 20X2, Lessee recognizes a lease liability of $112,462 and \na right -of-use asset of $111,662 ($112,462 – $1,200 + $400). \n55-253 From the transition date (January 1, 20X2) on, Lessee will continue to \nmeasure and recognize the lease liability at the present value of the sum of \nthe remaining minimum rental payments (as that term was applied under \nTopic 840) and the right -of-use asset in accordance with this Topic. \n55-254 Beginning on the effective date of January 1, 20X4, Lessee applies the \nsubsequent measurement guidance in Section 842- 20-35, including the \nreassessment requirements. \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1022}), Document(page\_content='Leases 1022 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Observation \nImplementation guidance and illustrations in \nTopic 842 not updated for effective date method \n13A.3.05 The implementation guidance and illustrations in Topic 842 were not \nupdated to reflect the effective date method. As a result, the illustrative \nexamples in section 842- 10-55 still only make reference to “the earliest \ncomparative period presented in the fi nancial statements.” \n \n13A.3.1 Lessee elects package of practical expedients \n13A.3.10 This section discusses the transition requirements for a lessee that \nelects the package of practical expedients (see section 13A .2.3). Because lease \nclassification is not reassessed in applying the package of practical expedients: \n[842- 10-65-1(f)(2)] \n— all existing leases classified as operating leases under Topic 840 will be \nclassified as operating leases under Topic 842; and \n— all existing leases classified as capital leases under Topic 840 will be \nclassified as finance leases under Topic 842. \nOperating leases under Topic 840 \n13A.3.20 The following diagram gives an overview of the transition requirements \nfor an operating lease, which are explained in this section, assuming a public \nbusiness entity with a calendar year -end. \nComparative periods\nTopic 840Current period\nTopic 842December 31, 2019Effective date \n(date of initial application )\nJanuary 1, 2019 January 1, 2017 January 1, 2018\nExisting leases commenced before Jan . 1, 2019 : \nApply Topic 840\nMeasurement at the effective date :\n— Lease liability = PV of remaining minimum rental \npayments , amount probable under RVG , using \ndiscount rate at transition date\n— ROU asset = lease liability +/(-) prepaid (accrued ) \nrent - remaining balance of lease incentives + \nunamortized IDCs Expired leases :\nDo nothingSubject to modifications and \nreassessments , pre-effective date \naccounting continues other than balance \nsheet recognition\n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1023}), Document(page\_content='Leases 1023 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Lease liability initial and subseq uent measurement \n13A.3.30 Absent lease modifications or remeasurements, the lease liability is \nmeasured as follows, both at the effective date and subsequently – i.e. for the \nremainder of the lease term. [842- 10-65-1(l)] \nPV of amount \nprobable of \nbeing owed \nunder RVGLease liabilityPV of unpaid \nminimum \nrental \npayments1\n \nNote: \n1. Minimum rental payments (as defined in Topic 840, see Question 13A.3.10) . \n13A.3.40 The discount rate for the lease is measured as follows at the effective \ndate. [842- 10-65-1(l), 842- 20-30-3] \n— For all entities, it is the rate implicit in the lease if that rate is readily \ndeterminable (see Question 5.6.20). \n— If the rate implicit in the lease is not readily determinable: \n— for public business ent ities, it is the lessee’s incremental borrowing rate \n(see Question 13A.3. 50); \n— for all other entities, a r isk‑free discount rate may be used instead of \nthe lessee’s incremental borrowing rate if the lessee elects to do so for the applicable class of underly ing asset (see paragraph 5.6.30). \n \n Question 13A.3.10 \nMinimum rental payments \nDo the ‘minimum rental payments’ in Topic 840 exclude the \nportion of fixed rental payments attributable to executory \ncosts such as taxes, insurance and maintenance (including CAM)?\n \nInterpretive response: Topic 840 is not clear in this respect. ‘Minimum rental \npayments’ is not a defined term in Topic 840 (or the ASC Master Glossary), and \nthere has been diversity in practice. \nSome entities accounted for executory cost s, when part of the fixed payments \nin the lease contract, as part of the minimum rental payments for a lease \n(Approach A), while other entities excluded such amounts from the minimum \nrental payments (Approach B). For example, in a gross real estate lease, entities \nfollowing Approach A treated the entire gross periodic payment as a minimum \nrental payment (and included that amount in their operating lease maturity \nanalysis disclosure), while those following Approach B excluded the portion of \nthe payment that represented executory costs for property taxes, insurance and \nmaintenance from the minimum rental payments for the lease (and excluded \nthat amount from their operating lease maturity analysis disclosure). \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1024}), Document(page\_content='Leases 1024 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. For any lease that includes fixed executory costs, the resulting lease liability and \nROU asset will be larger measured on the basis of Approach A than they would \nbe (i.e. assuming the same terms and conditions) measured on the basis of \nApproach B and will also be larger than they would be on the basis of t he ‘lease \npayments’ as defined in Topic 842 if there were non- lease components. \nThe SEC staff has observed “that the term ‘minimum rental payments’ is not \nexplicitly defined in ASC 840. As a result, the staff did not object to registrants \nconsistently appl ying their historical accounting policy conclusions regarding the \ncomposition of minimum lease payments when concluding whether executory costs should be included in remaining minimum rental payments for purposes \nof establishing the lease liability in transition.” Consequently, a lessee’s \napplication of Approach A or Approach B under Topic 840 may be retained \nby the lessee when measuring its existing operating leases on transition to \nTopic 842 in accordance with paragraph 842- 10-65-1(l). \n[2017 AICPA conf ] \nAn entity’s approach (A or B) should be disclosed and applied consistently to all of the entity’s existing leases that were operating leases under Topic 84 0. \nChanging from one approach to the other \nIn mid- 2018, t he SEC staff additionally communicated that changing one’s \napproach to inclu de or exclude executory costs from ‘minimum rental \npayments’ (e.g. changing from Approach A to Approach B) constitutes a change \nin accounting principle under Topic 250 (accounting changes and error corrections) that must be justified as preferable. \n[250- 10-20, 250- 10-45-1 – 45-2] \nHowever, we believe it may be acceptable to switch from Approach B to \nApproach A without establishing preferability if that change accompanies the lessee’s policy election not to separate lease and non- lease components in \ntransition to Topic 842 (see Question 13A.5.10). This is because, in that case, \nthe inclusion of executory costs in the measurement of the lease liability in \ntransition is the result of the lessee electing a new accounting principle created \nby the issuance of ASU 2016- 02, rather than changing an existing accounting \nprinciple ; this scenario was not considered by the SEC staff . \n[250- 10-45-2(a)] \n \n Question 13A.3. 20 \nExcluding CAM costs \nIs it acceptable to exclude only the CAM portion of the \n‘executory’ costs of a lease from the minimum rental payments in transition to Topic 842?\n \nBackground: As discussed in Question 13A.3.10, it is acceptable under \nTopic 840 to either include or exclude executory costs from ‘minimum rental \npayments’. Executory costs include costs of taxes, insurance and maintenance \n(including CAM). Topic 840 does n ot differentiate between these types of \nexecutory costs. [840- 10-25-1] \nInterpretive response: No. Based on discussions with the SEC staff, we do \nnot believe the transition guidance in Topic 842 permits an approach that would \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1025}), Document(page\_content='Leases 1025 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. solely exclude executory costs of maintenance from the minimum rental \npayments used to measure existing leases in transition. \n \n Question 13A.3. 30 \nMeasurement of lease pa yments that depend on an \nindex or rate in determining the operating lease \nliability \nFor existing operating leases with variable lease payments \nthat depend on an index or rate, what index or rate should \nthe lessee use to measure the effective date lease li ability? \nBackground: Topic 840 states , “lease payments that depend on an existing \nindex or rate, such as the consumer price index or the prime interest rate, shall \nbe included in minimum lease payments based on the index or rate existing at \nlease inception; any increases or decreases in lease payments that result from \nsubsequent changes in the index or rate are contingent rentals and therefore affect the determination of income as accruable.” \n[840- 10-25-4] \nIn practice, some entities followed this guidance w hen making their operating \nlease disclosures under Topic 840. That is, they continued to measure lease \npayments that depend on an index or rate (e.g. in disclosing remaining \nminimum rental payments in accordance with paragraph 840- 20-50-2) using the \nindex or rate at lease inception (or the date of the last lease modification that \nrequired the entity to reassess classification of the lease) throughout the lease \nterm. However, other entities followed a policy of updating the reference index \nor rate used to measure lease payments that depend on an index or rate in \nmaking their disclosure of future minimum rental payments for operating \nleases . \nInterpretive response: Based on discussions with the SEC staff, we \nunderstand that the staff would accept an entity continuing its historical accounting policy with respect to using (or not using) updated indices or rates in \ndisclosing its operating lease future minimum rental payments when measuring \nthe effective date lease liability. This would mean: \n— An entity that has historically not updated reference indices or rates when \nmeasuring lease payments that depend on an index or rate to include in the \nminimum rental payments would follow Approach A outlined below. \n— An entity that has historically updated reference indices or rates when \nmeasuring lease payments that depend on an index or rate to include in the \nminimum rental payments would follow Approach B outlined below. \nApproach A : Use index or rate indicated by paragraph 840- 10-25-4 \nUnder this approach, regardless of whether the existing operating lease is classified as an operating or a finance lease on transition, the lessee uses the \nindex or rate (e.g. CPI) as of lease inceptio n (or the date of the last lease \nmodification that required the entity to reassess the classification of the lease under Topic 840, if applicable) to determine the amount of variable lease \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1026}), Document(page\_content='Leases 1026 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. payments that depend on an index or rate to include in the effectiv e date lease \nliability. \nLeases acquired in a business combination \nAs an exception to the above, if an existing operating lease at the effective date \nwas acquired in a business combination, we believe a lessee should use the \nindex or rate as of the later of : \n— the acquisition date; or \n— the date of the last lease modification that, in accordance with Topic 840, \nrequired the lessee to account for the modified lease as a new lease . \nApproach B : Use index or rate as of the effective date \nUnder this approach, the le ssee uses the index or rate (e.g. CPI) as of the \neffective date to determine the amount of variable lease payments that depend \non an index or rate to include in the effective date lease liability. \nChanging approach \nAn entity that has historically not upda ted reference indices or rates used to \nmeasure lease payments that depend on an index or rate when preparing its \noperating lease future minimum rental payments disclosure may want to apply \nApproach B. \nThe SEC staff has communicated that this would constitute a change in \naccounting principle under Topic 250 (accounting changes and error corrections) \nthat must be justified as preferable, if material . [250- 10-20, 250- 10-45-1 – 45-2] \nNon-SEC registrants \nWe believe the above response applies equally to SEC registrants and entities \nthat are not SEC registrants. \n \n Question 13A.3.40 \nForeign exchange rate to use in transition when the \nlease is not denominated in the entity’s functional \ncurrency \nFor leases with payments that are not in the lessee’s \nfunctional currency that commenced before the effective \ndate, what exchange rate should be used to translate the ROU asset?\n \nBackground: The ROU asset for any lease (finance or operating) is a \nnonmonetar y asset while the lease liability is a monetary liability. Therefore, \nwhen accounting for a lease that is denominated in a foreign currency, if \nremeasurement into the lessee’s functional currency is required, the lease \nliability is remeasured using the cur rent exchange rate, while the ROU asset is \nremeasured using the exchange rate as of the lease commencement date. \n[842- 20-55-10] \nFor any capital lease under Topic 840 that commenced before the effective date, and that is classified as a finance lease under Topic 842, the lessee \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1027}), Document(page\_content='Leases 1027 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. recognizes at the effective date a finance lease ROU asset and a finance lease \nliability at the carrying amount of the capital lease asset and the capital lease \nobligation in accordance with Topic 840 immediately before the effective date. \n[842- 10-65-1(r)(1)] \nInterpretive response: For any lease liability (finance or operating), it is clear \nthe exchange rate that should be used to translate the lease liability at the \neffective date is the current rate at that date. This is because, as a monetary \nliability, a lease liability is always remeasured using the current exchange rate. \nFor a finance lease ROU asset arising from a capital lease under Topic 840, the \nlessee will remeasure the ROU asset at the effective date using the same \nexchange rate used immediately before the effective date (see background). \nThis is b ecause the lessee is required to recognize the finance lease ROU asset \nat the carrying amount of the capital lease asset and changing the exchange \nrate would change the carrying amount of the ROU asset in the entity’s \nreporting currency . \nWhile not explicit related to leases transition, we believe the ROU asset for a \nfinance or operating lease that was classified as an operating lease under \nTopic 840 shoul d be measured in the currency of the lease first. Then that \namount should be remeasured into the entity’s functional currency using the \nrate at the effective date. This is because there is guidance in Topic 830 \n(foreign currency matters) that requires an entity to use the exchange rate on the date that an asset or liability is initially recognized. And before the effective \ndate, no ROU asset was recognized. Initial recognition of ROU assets arising \nfrom existing operating leases occurs at the effective date. \n[830- 20-30-1] \nSee section 6.4.3 for discussion of the exchange rates to be used after initial \nmeasurement for an operating lease with payments denominated in a foreign \ncurrency. \n \n Question 13A.3.50 \nDetermining the incremental borrowing rate in \ntransiti on \nFor an existing operating lease, should the incremental \nborrowing rate for that lease consider (1) the remaining lease term and remaining minimum rental payments or (2) the total lease term and total minimum rental payments?\n \nBackground: Topic 842 specifies that the discount rate for each existing \noperating lease should be established at the effective date (if applying the \neffective date method), which means based on the facts and circumstances \n(e.g. economic environment and lessee credit standing) as of that date. \nHowever , it does not prescribe whether that rate should be based on the \nremaining lease term and remaining minimum rental payments or the total \nlease term and total minimum rental payments. \nInterpretive response: Because Topic 842 is not c lear on this question, we \nbelieve either approach is acceptable, as long as it is applied consistently as an \naccounting policy election to all of the lessee’s leases in transition and the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1028}), Document(page\_content='Leases 1028 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. policy disclosed. This position was affirmed by the FASB and SEC staffs, the \nlatter in a speech by Michael P. Berrigan, Professional Accounting Fellow, \nOffice of the Chief Accountant, at the 2017 AICPA Conference on Current SEC \nand PCAOB Developments. \nThat said, we believe use of the total lease term and total minimum r ental \npayments may be more consistent with the intent of the Board. This is because \nit is our understanding that the Board’s decision to permit lessees to determine \nthe incremental borrowing rate for an existing operating lease as of the \neffective date, ra ther than as of lease inception or lease commencement, was a \npractical accommodation intended to make it easier for lessees to make an \nestimate they generally did not have to make in accounting for those leases \nunder Topic 840. For example, the Board consi dered that it might be difficult for \na lessee to get third -party information about interest rates as of a date \nsignificantly in the past – e.g. obtain a bank quote for a rate the bank would \nhave charged 10 or 15 years ago. In contrast, it would generally be no more difficult to obtain the total lease term and total minimum rental payments than \nto obtain the remaining lease term and remaining minimum rental payments. \nFurther, we do not believe the transition provision was intended to substantially change the substance of the implied borrowing. A discount rate based on the \nremaining term of the lease and the remaining minimum rental payments may \ndiffer substantially from the rate that would be determined based on the total \nlease term and the total lease payments. A discount rate for the lease based on \nthe remaining payments and term may not reflect the economics of the lease \nand may be inconsistent with the Board’s intent that the incremental borrowing \nrate serve as a practical proxy for the interest rate in t he contract. For example, \nan entity would presumably pay a very different interest rate for a 15- year loan \nwith a principal balance of $15 million (i.e. assume a 15- year lease term with \n$15 million in gross minimum rental payments) than it would for a three -year \nloan with a beginning principal balance of $3 million (i.e. a three- year lease with \n$3 million in gross minimum rental payments). \nROU asset initial measurement \n13A.3.50 The ROU asset is measured as follows at the effective date. \nSection 13A.9 addresses additional considerations if the lease was acquired in a \nbusiness combination. [842- 10-65-1(m)] \nPrepaid /\n(accrued )\n lease \npaymentsLease \nliability Unamortized \nbalance of \nlease \nincentives \nreceivedUnamortized \nIDCsAny Topic \n420 lease \nliabilityor\n \n13A.3.60 Before the amendments in ASU 2016- 02, lessees were sometimes \nrequired to recognize a liability under Topic 420 (exit or disposal cost \nobligations) for (1) costs to terminate an operating lease before the end of its \nterm, and/or (2) other costs associated with the operating lease that will \ncontinue to be incurred without economic benefit to the entity. \n13A.3.70 At the effective date for a lease, any existing Topic 420 liability reduces \nthe initial measurement of the ROU asset recognized for the lease regardless of ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1029}), Document(page\_content='Leases 1029 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. whether the lease is classified as an operating lease or as a finance lease under \nTopic 842. If the lease is an operating lease, the accounting after the effective \ndate is different from other operating leases. The ROU asset is generally \namortized on a straight ‑line basis. The combined straight ‑line amortization of \nthe ROU asset and the accretion of the lease li ability on an effective interest \nbasis each period is recognized as a single operating lease cost for the lease. \n[842- 10-65-1(m) – 65-1(n)] \nROU asset subsequent measurement \n13A.3.80 After initial recognition, the ROU asset is measured using the same \nlesse e subsequent measurement guidance applicable to new operating leases \nthat commence on or after the effective date (see section 6.4.2). [842- 10-65-1(n)] \n \n Question 13A.3. 60 \nROU asset abandoned before the effective date \nShould a lessee recognize a n ROU asset in transition if it has \nalready abandoned the asset before the effective date? \nBackground: A lessee may have abandoned an ROU asset (see \nQuestion 6.5.50) arising from an existing operating lease before the effective \ndate of Topic 842. Despite this, following the transition requirements for the \ninitial measurement of the ROU asset could result in the lessee recognizing the \nabandoned ROU asset. This is because the transition guidance does not \naddress abandoned ROU asset scenarios and derives the RO U asset for \nexisting operating leases from the lease liability (which will not be zero, even in \nan abandonment scenario) . \nInterpretive response: No. An ROU asset should not be recognized on \ntransition if it was abandoned before the Topic 842 effective date. If an \nabandoned ROU asset is measured at an amount greater than zero after \napplying the transition guidance, a further adjustment should be recorded \nthrough equity to reduce the carrying amount of that ROU asset to zero as of \nthe effective date. \n \n Question 13A.3. 70 \nExecutory costs that are part of Topic 420 liabilities \non transition \nAre amounts for lessee executory costs (e.g. property taxes) \nin a Topic 420 liability netted against the ROU asset established on transition? \nBackground: Before transi tion to Topic 842, Lessee LE provided legal notice \nthat it will terminate its operating lease of a facility before the conclusion of the \ncontract term. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1030}), Document(page\_content='Leases 1030 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Based on the terms of the lease contract, in addition to making fixed rental \npayments, LE is required t o make variable property tax payments. Under \nTopic 420, at the cease- use date, LE recognized a liability for the remaining \nrental payments and the property tax payments it expected to make over the \nremaining term for which it will receive no economic benef it. \nInterpretive response: Yes. Paragraph 842- 10-65-1(m) does not envisage \nseparation of a Topic 420 operating lease liability into components – e.g. a \ncomponent associated with the contractual rental payments and a component related to one or more execut ory costs, such as an obligation to pay property \ntaxes on the underlying asset. Therefore, the entire Topic 420 liability is \nnetted against the effective date ROU asset, including any portion attributable \nto expected executory costs for which the lessee wi ll receive no \neconomic benefit , as long as the carrying amount of the ROU asset will not be \nreduced below zero subsequent to that action (see Question 13A.3. 80). \n \n Question 13A.3. 80 \nTransition guidance for Topic 420 liabilities results \nin negative ROU asset carrying amount \nIf netting the existing Topic 420 liability on transition would \nresult in a negative initial measurement of the ROU asset , \nhow is that excess credit accounted for ? \nBackground: The carrying amount of a lessee’s Topic 420 liability immediately \nbefore the Topic 842 effective date for an existing operating lease may exceed the amount that will be recognized for the lease liability at the effective date. \nConsequently, measuring the R OU asset in accordance with paragraph 842- 10-\n65-1(m) may result in a negative ROU asset carrying amount. \nFor example, the Topic 420 liability might include estimated executory costs \n(e.g. for property taxes or insurance) that the lessee expects to pay over the \nremaining lease term for which it will receive no economic benefit . However, \nthe lease liability does not include such amounts – either because the costs are \nvariable or because the lessee has historically followed Approach B in \nQuestion 13A.3.10. \nInterpretive response: If netting the Topic 420 liability would create a negative \nROU asset carrying amount , we believe the lessee should reduce the carrying \namount of the ROU asset to zero and then do one of the following with the \nremaining amount of the Topic 420 liability: \n— Derecognize the ‘ excess ’ Topic 420 liability . The corresponding entry is \nan adjustment to equity at the effective date. The costs underlying that \nexcess amount will be recognized through the income statement as they \nare incurred after th e effective date. \nUnder this approach, the lessee will recognize those costs through the \nincome statement twice: once when the Topic 420 liability was established \nbefore the effective date, and again when those costs are actually incurred after the effective date. Operating lease costs are no longer in the scope of \nTopic 420 from the effective date of Topic 842; therefore this approach \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1031}), Document(page\_content='Leases 1031 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. takes the perspective that there is no longer a basis in Topic 420 to \nrecognize the excess amounts. \nProponents of this approach believe that paragraph 842- 10-65-1(d) would \ninstruct the lessee to take the excess credit to equity on the effective date \nand account for the lease- related costs underlying that excess liability that \nwill be incurred after the effective date in the same manner as such costs \nwill be accounted for after the effective date for new leases. [842- 10-65-1(d)] \n— Continue to recognize the ‘ excess ’ Topic 420 liability . Under this \napproach, the excess credit is accounted for after the effective date in the \nsame manner as before the effective date. Proponents of this approach \nnote that the FASB stated its intent for lessees to be able to ‘run off’ \nexisting leases in accordance with the requirements in previous GAAP \n(other than recognizing new ROU assets and lease liabilities for existing \noperating leases) – see paragraph 13A.2.120. Therefore, it would be \ninconsistent with that intent to require a lessee to derecognize the excess \nTopic 420 liability and recognize those costs through the income statement \na second time. Proponents further note that it would appear to be \ninconsistent with the intent of the new standard to derecognize existing \nliabilities when its principal goal was the recognition of previously \nunrecognized leas e liabilities. [ASU 2016- 02.Summary , ASU 2016- 02.BC390] \nTopic 842 does not provide guidance on this type of scenario; therefore, in the \nabsence of additional guidance from the FASB or the SEC staff, we believe either of the above approaches is acceptable as an accounting policy election \napplied to all of the entity’s leases for which it is a lessee. \n \n Question 13A.3. 90 \nExisting sublease liabilities under Topic 840 \nHow should sublease liabilities recognized under Topic 840 \nfor existing leases be accounted for on initial application of \nTopic 842? \nBackground: Under Topic 840, if costs expected to be incurred under an \noperating sublease (e.g. executory costs and either amortization of the leased \nasset or rental payments on an operating lease) exceed anticipated revenue on \nthe operating sublease, a lo ss is recognized by the sublessor. [840- 20-25-15] \nThe transition guidance in Topic 842 provides explicit guidance on how to \naccount for existing Topic 420 liabilities in transition (see paragraph 13A.3.70 \nand Question 13A.3. 80), but does not address sublea se liabilities recognized in \naccordance with the Topic 840 guidance in the preceding paragraph. \nInterpretive response: \nExisting operating leases \nFor existing operating leases, regardless of how classified under Topic 842 (i.e. \nas operating or finance leas es), we believe any of the following approaches is \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1032}), Document(page\_content='Leases 1032 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. acceptable as an accounting policy election applied to all of an entity’s leases \nfor which it is the lessee. \n— By analogy to transition for Topic 420 liabilities (Topic 420 analogy \napproach). Net existing su blease liabilities against the ROU asset for \nexisting operating leases on initial application of Topic 842 by analogy to the \nguidance on Topic 420 liabilities in paragraph 842- 10-65-1(m). Proponents of \nthis approach believe these two types of liabilities a re similar in nature and \nnote that the FASB staff has, in discussions about impairment of ROU \nassets in transition (see Question 13A.3. 110, for example), also equated \nthese two types of liabilities. Therefore, because Topic 842 does not \nprovide any guidanc e on accounting for sublease liabilities recognized under \nparagraph 840-20-25-15 on initial a pplication of Topic 842, we believe \nanalogizing to the Topic 420 liability transition guidance is reasonable. \nA lessee applying this analogy will apply the guidance in both \nparagraphs 842-10-65-1(m) and 65- 1(n). See paragraph 13A.3.70 and \nQuestions 13A.3. 70 and 13A.3. 80. \n— Eliminate the sublease liability through equity (elimination approach). \nWrite off the existing sublease liability through equity as part of the \ncumulative effect transition adjustment at the effective date. Topic 842 \ndoes not have sublease loss guidance like what existed in Topic 840. \nTherefore, proponents of this approach believe there is no longer a basis in \nTopic 842 upon which to continue to recognize the sublease liability. \nProponents of this approach believe that paragraph 842- 10-65-1(d) would \ninstruct the lessee to write off the liability to equity at the effective date. \n[842- 10-65-1(d)] \nA lessee adopting this approach would consider whether the loss -making \nsublease means the newly recognized ROU asset is impaired (if the ROU \nasset is the only asset in its asset group) . We believe at the point in time \nthe sublease was entered into, the ROU asset may have become its own \nasset group (see Question 6.5.60); and if so, recognizing any impairment of the ROU asset that exists as a result of entering into the loss -making \nsublea se through effective date equity would not conflict with the \nresponses to Questions 13A.3. 110 and 13A.3. 120. However, if a Topic 360 \nimpairment is not taken on the effective date, the effect of this approach will be that the sublease loss is taken against current period earnings after \nthe effective date – i.e. the sublease loss recognized previously under Topic \n840 will be taken a second time through earnings in periods post -adoption. \nIn the case of an impairment resulting from this approach, we believe th e \nlessee’s accounting on and after the effective date may be very similar in \nresult to applying the Topic 420 analogy approach. If there is not an \nimpairment of the ROU asset, we believe it may be unlikely that a lessee \nwill elect this approach given the r equirement to effectively recognize the \nsublease loss twice. \n— Retain separate recognition of the sublease liability (separate \nrecognition approach). The lessee would : \n— continue to recognize the Topic 840 sublease liability separate from the \nnew lease liabil ity recognized in transition; and ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1033}), Document(page\_content='Leases 1033 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — reduce the liability over the shorter of (1) the remaining head lease term \nor (2) the remaining term of the loss -making sublease, in a pattern \nconsistent with the recognition of lease cost (operating leases) or amortizati on of the ROU asset (finance leases) over that same period of \ntime. \nIn contrast to the Topic 420 analogy approach, a lessee electing this \napproach will not recognize the effect of the sublease loss over the entire \nhead lease term if the sublease term is shorter than that of the head lease. \nAdditionally, head lease cost will continue to be recognized on a straight -\nline basis after the effective date, rather than on a front -loaded basis as \nwould occur if analogizing to the Topic 420 liability requirements. \nProponents of this approach note that the FASB stated its intent for lessees \nto be able to ‘run off’ existing leases in accordance with the requirements \nin previous GAAP (other than recognizing new ROU assets and lease \nliabilities for existing operating leases) – see paragraph 13A.2.120, and that \nthis approach would be most consistent with that intent. [ASU 2016-02.Summary , ASU 2016- 02.BC390] \nUnder this approach, if the lease is modified or remeasured on or after the \neffective date, we believe t he ‘run -off’ allowance would end. Therefore, the \nremaining carrying amount of the sublease liability would be written off. We believe the offsetting entry would be first to the modified or remeasured \nROU asset (dr. sublease liability, cr. ROU asset) ; and s econd to a gain. That \nis, a gain should only result if the adjustment would reduce the carrying \namount of the ROU asset below zero. This accounting would be the most \nconsistent with the generally prospective accounting under Topic 842 for lease modificatio ns and remeasurements . \nExisting capital leases classified as finance leases under Topic 842 \nThe transition guidance in Topic 842 for existing capital leases classified as finance leases under Topic 842 requires the new finance lease ROU asset and \nfinance lease liability to equal the carrying amount of the existing capital lease \nasset and capital lease obligation. We believe this explicit requirement \nprecludes reducing the carrying amount of the existing capital lease asset by \nthe amount of any Topic 840 sublease liability. \n[842- 10-65-1(r)] \nConsequently, we believe a lessee is required to adopt either the ‘separate recognition’ or ‘elimination’ approaches outlined for existing operating leases. \nIf applying the elimination approach, we believe the requirement to measure \nthe finance lease ROU asset at the carrying amount of the prior capital lease \nasset precludes recognizing an additional Topic 360 impairment as part of the transition date cumulative effect adjustment. \nIf applying the separate recognition approach, the lessee will: \n— continue to recognize the separate Topic 840 sublease liability; and \n— reduce the liabilit y over the shorter of the (1) remaining head lease term or \n(2) remaining term of the loss -making sublease, in a pattern consistent with \nthe pattern of amortization of the ROU asset over that same period of time. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1034}), Document(page\_content='Leases 1034 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Existing capital leases classified as operating leases under Topic 842 \nFor existing capital leases classified as operating leases under Topic 842, we \nbelieve the lessee should follow the ‘elimination approach’. This is because the \ngoal of the transition requirements for these leases is to effectively reset the \nlease so that the accounting at and after the effective date is consistent with \nthat for any new operating lease that commences on or after the effective date \n(see paragraphs 13A.3.200 – 13A.220). To that end, we believe any new \noperating lease subject to a loss -making sublease will be considered for \nimpairment under Topic 360 (see section 6.5.2); and if the ROU asset is not \nimpaired, the lessee will account for the sublease income deficits through \nearnings each period as incurred. \n \n Question 13A.3. 110 \nEffects of Topic 360 impairments before the \neffective date \nWhat effect do prior impairments under Topic 360 have on \nthe initial recognition of ROU assets for existing operating \nleases? \nInterpretive response: None, unless the circumstances discussed in \nQuestion 13A.3.130 exist. \nAt a November 2016 FASB meeting, the Board affirmed the view expressed by \nthe FASB staff that less ees should not begin applying the long -lived asset \nimpairment requirements in Topic 360 (property, plant, and equipment) to new ROU assets until the effective date of Topic 842. This includes ROU assets that \nare part of an asset group that was previously i mpaired, except as discussed in \nQuestions 13A.3. 90 and 13A.3. 130. \nThe FASB staff believes that it was the Board’s intent that, in general, lessees \nshould only adjust the carrying amount of operating lease ROU assets for the \nfollowing, both of which were a pplicable to operating leases under Topic 840: \n— any liabilitie s recognized in accordance with the contract termination costs \nguidance in Topic 420; or \n— the subleas e loss guidance in paragraph 840- 20-25-15. However, see \nQuestion 13A.3. 90 for sublease liabili ties recognized under paragraph 840-\n20-25-15; we do not believe offsetting of those liabilities against the ROU \nasset is required. \nThe Board did not intend for lessees to have to go back in time and evaluate \nwhat effect operating lease ROU assets would have had on Topic 360 \nimpairment assessments before the effective date (see Question 13A.3.120). \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1035}), Document(page\_content='Leases 1035 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 13A.3.120 \nTransition impact on prior asset group impairments \nShould a lessee’s prior accounting for a long- lived asset \nsubject to impairment under Topic 360 be changed as a result \nof the transition to Topic 842 ? \nBackground: The recognition of operating lease ROU as sets will increase the \nnumber and carrying amount of the long- lived assets in the asset group. \nFor example, an asset group with 50 long- lived assets that have an aggregate \ncarrying amount of $1 million at the date a previous asset group impairment \nwas rec orded may have had 65 long- lived assets with an aggregate carrying \namount of $1.2 million if the operating lease ROU assets had been recognized in the past . This may have affected either or both: \n— the amount of the impairment that was recorded – e.g. the am ount of the \nimpairment may have been limited to the amount that would reduce the \ncarrying amount of the long -lived assets in the group to zero; if additional \nlong-lived assets (ROU assets) were in the asset group, the impairment \ncharge may have been greater (see Question 13A.3. 130). \n— the allocation of the impairment to the long- lived assets in the asset group – \ni.e. even if the total amount of the impairment did not change, the amount \nof the impairment allocated to each asset in the group would differ if th ere \nwere additional assets in the group. \nInterpretive response: No. At a November 2016 FASB meeting, the Board \naffirmed the view expressed by the FASB staff that lessees should not alter their previous accounting for long- lived assets as a result of transi tioning to \nTopic 842. \nThis means that impairment amounts previously allocated to a long- lived asset \n(e.g. an item of property, plant or equipment or a finite -lived intangible asset), \nand subsequent accounting resulting from the amount of that impairment ( e.g. \ndepreciation or amortization of the long- lived asset), should not be changed as a \nresult of initially applying Topic 842. \n \n Question 13A.3. 130 \nRecognizing ‘hidden’ ROU asset impairments at the \neffective date \nCan a ‘hidden’ impairment of an ROU asset arising from a \nTopic 840 operating lease be recognized through equity at the \neffective date? \nBackground: A ‘hidden impairment’ refers to either: \n— where a Topic 360 asset group was fully impaired before the effective date \n(i.e. all of the long- lived as sets in the group were written down by the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1036}), Document(page\_content='Leases 1036 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. maximum allowable amount under Topic 360 at the time of the impairment) \nand an additional impairment charge would have been recorded on that \nasset group before the effective date had the operating lease ROU asset( s) \nbeen recognized at that date; or \n— where a Topic 360 asset group would have included only one or more \nROU assets that were not recognized under Topic 840, and an impairment \ncharge would have been recorded on that asset group before the effective date had the operating lease ROU asset(s) been recognized under \nTopic 840. \nInterpretive response: Based on the FASB staff views outlined in \nQuestions 13A.3. 110 and 13A.3. 120, we believe it would be acceptable for a \nlessee not to consider the impairment guidance in Topic 360 as it relates to newly recognized ROU assets until the effective date of Topic 842 and to \nrecognize any impairment that exists as of that date, including a ny ‘hidden \nimpairment’, and regardless of whether the condition or event giving rise to tha t \nimpairment occurred before the effective date, as a charge to adoption -year \nincome or loss. \nHowever, the FASB staff ha s expressed the view that it would be acceptable to \nrecognize a hidden impairment of an ROU asset arising from an existing operating lea se at the effective date. In that case, the amount of the additional \nimpairment (i.e. the hidden impairment plus any additional amount of \nimpairment that presently exists at the effective date) would be taken through \nan adjustment to equity at the effectiv e date, with a corresponding reduction to \nthe carrying amount(s) of the ROU asset(s). Note that no amount of past hidden \nimpairment should be taken at the effective date if the asset group to which the ROU asset belongs is not impaired at the effective dat e based on an effective \ndate Topic 360 analysis. \nWe believe this interpretation does not conflict with the responses to \nQuestions 13A.3. 110 and 13A.3. 120 because it (1) would not affect any prior \naccounting for other long- lived assets and (2) reflects a unique circumstance \nwhere this adjustment is effectively the result of a past impairment assessment \nand preexisting conditions of impairment , rather than one triggered primarily by \nthe recognition of new operating lease ROU assets. \n \n Question 13A.3.140 \nAmortization period for leasehold improvements \npreviously acquired in a business combination \nWhat amortization period should a lessee assign in transition \nto leasehold improvement s previously acquired in a business \ncombination? \nBackgrou nd: Topic 840 required the amortization period at the acquisition date \nto be the shorter of (1) the remaining useful life of the leasehold improvements \nand (2) a period equal to the sum of the non- cancellable period of the lease plus \nrenewal periods reasonably assured of exercise . [840- 10-35-9] \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1037}), Document(page\_content='Leases 1037 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. ASC 840 -10-35-9 \nParagraph 805 -20-35-6 requires that leasehold improvements acquired in a business \ncombination or an acquisition by a not -for-profit entity be amortized over the shorter \nof the useful life of the assets or a term that includes required lease periods and \nrenewals that are deemed to be reasonably assured (as used in the definition of lease \nterm) at the date of acquisition. \nTopic 842 requires the amortization period at the acquisition date to be the \nshorter of the (1) remaining useful life of the leasehold improvements and (2) \nremaining lease term . [842-20-35-13] \nAlthough Topic 842 and Topic 840 use different words, the amortization period \nfor acquired leasehold improvements that results from applying both Topics is \nthe same – i.e. one that is the shorter of (1) their remaining useful life and (2) a \nperiod that inc ludes the non- cancellable period of the lease plus renewal \nperiods the acquirer is reasonably certain to exercise. \n— Topic 840 used its particular italicized language because, before the \nadoption of Topic 842, an acquirer did not reassess the acquiree’s lea se \nterm as part of acquisition accounting. \n— In contrast, Topic 842 refers to the ‘remaining lease term’ because the \nacquirer does reassess the lease term of an acquired lease, as if it was a \nnew lease of the acquirer , at the acquisition date. [805-20-30-24] \nBecause Topic 840 did not reassess the lease term of an acquired lease, the \nremaining lease term at the acquisition date could be shorter than the \namortization period for the acquired leasehold improvements. This cannot occur \nunder Topic 842. \nBackground example \nCompany AR acquired Lessee LE in a business combination on January 1, 2018 \n– before AR’s adoption of Topic 842 on January 1, 2019 – with the following \nfacts. \n— LE is the lessee in a building lease with a remaining lease term of three \nyears immediately before the acquisition. The lease includes two five- year \nlessee renewal options that LE determined it was not reasonably assured to exercise; therefore, the options were excluded from LE’s determination \nof the lease term. The lease does not i nclude an option for LE to purchase \nthe building. \n— LE has constructed leasehold improvements, which it owns, that have a \n15-year remaining useful life at the acquisition date. \n— The following applied in AR’s acquisition accounting for the acquired lease \nwhen Topic 840 was in effect. \n— AR did not reassess the lease term determined by LE. \n— AR concluded that the leasehold improvements should be amortized \nover a period of eight years from the acquisition date. Eight years \nincludes the three- year remaining non- cance llable period of the lease \nplus the first of the five -year lessee renewal options, for which AR \nconcluded exercise was reasonably assured upon acquisition. Despite ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1038}), Document(page\_content='Leases 1038 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the longer useful life of the leasehold improvements, AR concluded that \nexercise of the seco nd five -year renewal option was not reasonably \nassured at the acquisition date. \n— At the effective date of January 1, 2019, AR concludes that it is reasonably \ncertain to exercise both five-year renewal options if it elects the use -of-\nhindsight practical expedient (see section 13A.2) . \nInterpretive response: We believe the response to this question differs \ndepending on whether the entity elects the use- of-hindsight practical expedient. \nEntity does not elect to use hindsight \nIn general, we believe transition pr ovisions are designed to migrate an entity’s \nlegacy accounting to that which would exist had the entity been applying the \nnew guidance all along. \nApplying this logic to the background example, had AR been applying \nTopic 842’s requirements at the acquisiti on date, it would have concluded, just \nas it did under Topic 840, that the amortization period for the acquired leasehold \nimprovements was eight years. This is because AR would have concluded that \nthe remaining lease term, assessed as if the acquired lease was a new lease on \nthe acquisition date, was eight years. Eight years is shorter than the 15- year \nremaining useful life of the leasehold improvements, so eight years would have been the amortization period. \nBecause Topic 842 and Topic 840 would result in the same amortization period, \nand AR did not elect to use hindsight in transition, AR simply retains the eight -\nyear amortization period in transition to Topic 842 (seven years remaining at the \neffective date). \nFurther, this approach also considers the Boa rd’s stated intent for lessees to, in \neffect, have the option to ‘run off’ existing leases in accordance with the \nrequirements of previous GAAP – other than recognizing new ROU assets and \nlease liabilities for existing operating leases ( see paragraph 13A.2 .120). This \napproach, which retains the entity’s amortization period for the leasehold \nimprovements at the effective date, is consistent with that intent. \n[ASU 2016-\n02.Summary, ASU 2016- 02.BC390] \nEntity elects to use hindsight \nAgain using the background example, if AR elected the use- of-hindsight \npractical expedient in transition, AR would account for the acquired lease in \ntransition as if it had always (since the acquisition date) assessed the lease \nterm as 13 years (rather than eight years). \nIn contrast to an entity that does not elect hindsight, we believe an entity \nelecting to use hindsight is also deciding to abandon ‘running off’ its old lease \naccounting. An entity electing hindsight is choosing to reassess, rather than \ncontinue to use, legacy account ing judgments such as the lease term. \nTherefore, we believe AR would also adjust the amortization period of the acquired leasehold improvements – i.e. AR would adjust its accounting for \nthose leasehold improvements as if it had originally assigned a 13- year \namortization period to those improvements (rather than eight years). This will \nresult in a cumulative -effect adjustment recognized through equity at the \neffective date. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1039}), Document(page\_content='Leases 1039 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Post -effective date accounting for acquired leasehold improvements \nRegardless of whether it elected the use- of-hindsight practical expedient in \ntransition, after transition an acquirer will change the amortization period for \nacquired leasehold improvements if either: \n— the lease term changes – through either reassessment or modification (not \naccounted for as a separate contract) – if the remaining lease term is the \namortization period under paragraph 842- 20-35-12; or \n— the useful life of the leasehold improvements changes and the remaining useful life is (or becomes, as a result of a decrease to the useful life) the amortization period under paragraph 842- 20-35-12. \nIn that case, the change in amortization period is accounted for prospectively in \naccordance with Topic 250 (accounting changes and error corrections). [250-10-\n45-17 – 45-20] \n \n Example 13A.3.10 \nLessee transition for an existing operating lease \nwith package of practical expedients elected – \nApproach A in Question 13A.3.10 \nScenario 1: Lease is not modified or remeasured on or after the effective \ndate \nThe following summarizes relevant information about Lessee LE’s lease of \noffice space. \nCommencement date of the lease: January 1, 2016 \nLease term: 5 years \nRental payments (annual, paid in arrears), which represent \nthe minimum rental payments under Topic 840:1 $28,000 first two years, \n$29,000 thereafter \nEstimated amount of annual payments related to \nreimbursing the lessor’s costs of property taxes, \ninsurance, and CAM that are included in the above \nminimum rental payments:1 $1,500 property taxes \n$1,000 insurance \n$1,000 CAM \nLease classification at inception under Topic 840: Operating lease \nInitial direct costs, amortized on a straight ‑line basis over \nthe lease term: $1,500 \nNote: \n1. In this example, LE has included fixed executory costs in the minimum rental \npayments when applying Topic 840 and is consistently applying this policy in transition \n– i.e. LE has applied Approach A discussed in Question 13A .3.10. \nBecause LE elected the package of practical expedients, it does not reassess \nwhether the contract is or contains a lease, whether classification of the lease \nwould be different under Topic 842, or whether the unamortized initial direct \ncosts at January 1, 2019 would meet the definition of initial direct costs under \nTopic 842. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1040}), Document(page\_content='Leases 1040 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Worksheet at January 1, 2019 (the effective date) \nAt January 1, 2019, LE’s incremental borrowing rate is 5.0% (see section 5.6 \nand Question 13A .3.50). \nStep Amounts \ndebit/(credit) Notes \nRecognize lease \nliability $(53,923) Remaining minimum rental payments \n($29,000 for each of 2019 and 2020) \ndiscounted at 5.0% \nRecognize ROU asset 53,723 Sum of lease liability recognized and $ 600 of \nunamortized IDCs, less $ 800 accrued rent \nliability \nDerecognize accrued \nrent 800 Balance at effective date under Topic 840 \nDerecognize \nunamortized IDCs (600) Balance at effective date under Topic 840 \nAdjustment to equity $ - N/A \nSubsequent accounting for the lease \nLE subsequently measures the lease liability and ROU asset through the end of \nthe lease term in a manner similar to how it determined the lease liability and \nROU asset at January 1, 2019; unless the lease is modified or there is a remeasurement of the leas e liability. \nLE does not modify the lease and does not have to remeasure the lease liability \non or after the effective date. There is also no impairment of the ROU asset \nthrough the remainder of the lease term. \nBalance sheet \nLE recognizes the following amounts in its balance sheet for its lease of office space through the end of the lease term. \nYear ended ROU asset arising \nfrom operating lease Lease liability arising \nfrom operating lease \nDec. 31, 20191 $27,519 $27,619 \nDec. 31, 2020 - - \nNote: \n1. Because LE elected the effective date method, no ROU asset or lease liability is \npresented in the comparative December 31, 2018 balance sheet. \nIncome statement1 \nLE recognizes the following amounts in its income statement for its lease of \noffice space through the end of the lease term. \nYear ended Operating lease cost \nDec. 31, 20192 $28,900 \nDec. 31, 2020 28,900 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1041}), Document(page\_content='Leases 1041 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Notes: \n1. A lessee continues to present lease cost in a manner consistent with its presentation \nunder Topic 840 (e.g. SG&A expenses). \n2. $28,600 (total minimum rental payments of $143,000 / 5 years) + $300 (amortization of \ninitial direct costs of $1,500 / 5 years). \nScenario 2: Lease is modified after the effective date \nChanging the facts of Scenario 1, on January 1, 2020 LE modifies the lease to \nextend the lease term for two additional years. The original lease agreement did \nnot include any renewal options. \nAs a resu lt, LE applies the lease accounting guidance under Topic 842 \nbeginning on the effective date of the modification (January 1, 2020). Because \nthe modification increases the lease term only, it does not grant LE an \nadditional right of use, and therefore the m odification cannot be accounted for \nas a separate contract. Accordingly, LE adjusts the original lease liability and records an equal and offsetting change to the existing ROU asset. The \nfollowing summarizes relevant information for the remeasurement of the lease \nliabilit y. \nExtension period: 2 years \nRemaining lease term, including the extension: 3 years \nAnnual, fixed payments during extension period of \n2 years (paid in arrears): $30,000 \nFixed payment for the remaining 1 year of the original lease term (paid in arrears): \n$29,000 \nEstimated amount of the remaining annual payments \nrelated to reimbursing the lessor’s costs of property \ntaxes, insurance and CAM: $1,750 property taxes \n$1,000 insurance \n$1,050 CAM \nAdditional initial direct costs associated with the lease \nmodification: None \nAt the effective date of the modification, $300 of the initial direct costs from the \ninitial lease remain unamortized. \nLease liability remeasurement \nIn this example, LE identifies only one difference between Topic 840 and \nTopic 842 that affects the remeasurement of the lease liability and the \nROU asset. \n— Under Topic 840 (if applying Approach A in Question 13A.3.10), the \nminimum rental payments (which are used to measure the lease liability \nand the ROU asset before the modification) included fixed amounts that \nwere intended to reimburse the lessor’s costs of property taxes, insurance \nand CAM. There were no non- lease components under Topic 840. \n— Under Topic 842, CAM is a non- lease component (a non- lease service \nprovided to LE by LR). Fixed pay ments required by the contract are \nallocated between the lease component (i.e. the right to use the asset) and \nthe non- lease component (CAM) on a relative stand- alone price basis. \nTherefore, a portion of what LE accounted for as the ‘minimum rental ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1042}), Document(page\_content='Leases 1042 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. payment s’ under Topic 840 (i.e. the fixed payments attributable to CAM) \nwill not be part of the ‘lease payments’ for the modified lease under \nTopic 842. Assume that this allocation is 95% to the lease component and \n5% to CAM. \nLE remeasures the lease liability bas ed on: \n— one rema ining lease payment of $27,550 (for the remainder of the original \nlease term), which is 95% of the total fixed payment; the remaining 5% ($1,450) is allocated to the CAM non- lease component; and \n— two additional lease payments of $28,500 for t he extension period, which is \n95% of the tot al fixed payment; the remaining 5% ($1,500) is allocated to \nthe CAM non- lease component. \nLE discounts the lease payments at its January 1, 2020 incremental borrowing rate of 5.5%. This results in a remeasured lea se liability of $75,991, or an \nincrease of $48,372 compared to the lease liability balance immediately before the effective date of the modification. \nJournal entry \nLE records the following journal entry at the effective date of the modification. \n Debit Credit \nROU asset 48,372 \nLease liability 48,372 \nTo remeasure ROU asset and lease liability \nfollowing lease modification. \nLease classification \nLE reassesses lease classification as of the effective date of the modification \nand determines that the modified lease is still classified as an operating lease. \nThis reassessment is based on facts and circumstances at that date – e.g. the \nremaining economic life and fair value of the underlying asset at that date. \nSubsequent accounting for the lease \nLE calculates the remaining lease cost for the lease as follows. \nTotal lease payments (including those paid and those not yet paid), reflecting the \nadjustment resulting from the lease modification \n12/31/16 12/31/17 12/31/18 12/31/19 12/31/20 12/31/21 12/31/22 \n$28,000 $28,000 $29,000 $29,000 $27,550 $28,500 $28,500 $198,550 \nPlus: Total initial direct costs attributable to the lease 1,500 \nLess: Periodic lease cost recognized in prior periods calculated as (straight -\nline rental expense of $28,600 × 4 periods) plus (amortization of initial \ndirect costs of $1,200) (115,600) \nRemaining lease cost for the lease $ 84,450 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1043}), Document(page\_content='Leases 1043 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. LE recognizes a single lease cost, calculated so that the remaining cost of the \nlease is allocated over the remaining lease term on a straight -line basis (i.e. \n$28,150 per year for the remaining three years). \nLE prospectively accounts for the lease liability and ROU asset from the \neffective date of the modification using the guidance in Topic 842 for an \noperating lease. \nBalance sheet \nLE recognizes the following amounts in its balance sheet for its lease of equipment through the end of the revised lease term. \nYear ended ROU asset arising \nfrom operating lease Lease liability arising \nfrom operating lease \nDec. 31, 2 020 $51,921 $52,620 \nDec. 31, 2021 26,665 27,014 \nDec. 31, 2022 - - \nIncome statement1 \nLE recognizes the following amounts in its income statement for its lease of \noffice space through the end of the lease term. \nYear ended Operating lease cost \nDec. 31, 2020 $28,150 \nDec. 31, 2021 28,150 \nDec. 31, 2022 28,150 \nNote: \n1. A lessee continues to present lease cost in a manner consistent with its presentation \nunder Topic 840 (e.g. SG&A expenses). \n \n Example 13A.3.20 \nLessee transition for an existing operating lease \nwith package of practical expedients elected – \nApproach B in Question 13A.3.10 \nScenario 1: Lease is not modified or remeasured on or after the effective \ndate \nThe following summarizes relevant information about Lessee LE’s lease of \noffice space. \nCommencement date of the lease: January 1, 2016 \nLease term: 5 years \nRental payments (annual, paid in arrears): $28,000 first two years, \n$29,000 thereafter ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1044}), Document(page\_content='Leases 1044 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Estimated amount of annual payments related to \nreimbursing the lessor’s costs of property taxes, \ninsurance, and CAM that are included in the above rental \npayments: $1,500 property taxes \n$1,000 insurance \n$1,000 CAM \nMinimum rental payments under Topic 840:1 $24,500 first two years, \n$25,500 t hereafter \nLease classification at inception under Topic 840: Operating lease \nInitial direct costs, amortized on a straight -line basis over \nthe lease term: $1,500 \nNote: \n1. In this example, LE has excluded fixed executory costs from the minimum rental \npayments when applying Topic 840 and is consistently applying this policy in transition \n– i.e. LE has applied Approach B discussed in Question 13A .3.10. \nBecause LE elected the package of practical expedients , it does not reassess \nwhether the contract is or contains a lease, whether classification of the lease \nwould be different under Topic 842, or whether the unamortized initial direct \ncosts at January 1, 2019 would meet the definition of initial direct costs under \nTopic 842. \nWorksheet at January 1, 2019 (the effective date) \nAt January 1, 2019, LE’s incremental borrowing rate is 5.0% (see section 5.6 \nand Question 13A.3.50). \nStep Amounts \ndebit/(credit) Notes \nRecognize lease liability $(47,414) Remaining minimum rental payments \n($25,500 for each of 2019 and 2020) \ndiscounted at 5.0% \nRecognize ROU asset 47,214 Sum of lease liability recognized and \n$600 of unamortized IDCs, less $800 \naccrued rent liability \nDerecognize accrued \nrent 800 Balance at transition under Topic 840 \nDerecognize \nunamortized IDCs (600) Balance at transition under Topic 840 \nAdjustment to equity $ - N/A \nSubsequent accounting for the lease \nLE subsequently measures the lease liability and ROU asset through the end of \nthe lease term in a manner similar to how it determined the lease liability and \nROU asset at January 1, 2019; unless the lease is modified or there is a \nremeasurement of the leas e liability. \nLE does not modify the lease and does not have to remeasure the lease liability on or after the effective date. There is also no impairment of the ROU asset \nthrough the remainder of the lease term. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1045}), Document(page\_content='Leases 1045 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Balance sheet \nLE recognizes the following amounts in its balance sheet for its lease of office \nspace through the end of the lease term. \nYear ended ROU asset arising \nfrom operating lease Lease liability arising \nfrom operating lease \nDec. 31, 20191 24,185 24,285 \nDec. 31, 2020 - - \nNote: \n1. Because LE elected the effective date method, no ROU asset or lease liability is \npresented in the comparative December 31, 2018 balance sheet. \nIncome statement1 \nLE recognizes the following amounts in its income statement for its lease of \noffice space through the end of the lease term. \nYear ended Operating lease cost \nDec. 31, 20192 25,400 \nDec. 31, 2020 25,400 \nNotes: \n1. A lessee continues to present lease cost in a manner consistent with its presentation \nunder Topic 840 (e.g. SG&A expenses). \n2. $25,100 (total minimum rental payments of $125,500 / 5 years) + $300 (amortization of \ninitial direct costs of $1,500 / 5 years). \nScenario 2: Lease is modified after the effective date \nChanging the facts of Scenario 1, on January 1, 2020 LE modifies the lease to \nextend the lease term for two additional years. The original lease agreement did \nnot include any renewal options. \nAs a result, LE applies the lease accounting guidance under Topic 842 beginning on the effective date of the modification (January 1, 2020). Because \nthe modification increases the lease term only, it does not grant LE an \nadditional right of use, and therefore the modification cannot be accounted for \nas a separate contract. Accordingly, LE adjusts the original lease liability and \nrecords an equal and offsetting change to the existing ROU asset. The \nfollowing summarizes relevant information for the remeasurement of t he lease \nliability. \nExtension period: 2 years \nRemaining lease term, including the extension: 3 years \nAnnual, fixed payments during extension period of 2 years (paid \nin arrears): $30,000 \nFixed payment for the remaining 1 year of the original lease \nterm (paid in arrears): $29,000 \nEstimated amount of the remaining annual payments related to \nreimbursing the lessor’s costs of property taxes, insurance and CAM: $1,750 property taxes \n$1,000 insurance \n$1,050 CAM \nAdditional initial direct costs associated with the lease modification: \nNone ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1046}), Document(page\_content='Leases 1046 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. At the effective date of the modification, $300 of the initial direct costs remain \nunamortized. \nLease liability remeasurement \nIn this example, LE identifies only one difference between Topic 840 and Topic 842 that affects the remeasurement of the lease liability and the \nROU asset: \n— Under Topic 840 (if applying Approach B in Question 13A.3.10), the \nminimum rental payments (which a re used to measure the lease liability \nand the ROU asset before the modification) excluded fixed amounts that were intended to reimburse the lessor’s costs of property taxes, insurance \nand CAM, while the ‘lease payments’ under Topic 842 generally include a t \nleast a portion of such amounts. There were no non- lease components of \nthis contract under Topic 840. \n— Under Topic 842, the CAM is a non- lease component (a non- lease service \nprovided to LE by LR). Fixed payments required by the contract are \nallocated between the lease component (i.e. the right to use the asset) and \nthe non- lease component (CAM) on a relative stand- alone price basis. \nTherefore, the portion of the consideration in the contract attributable to CAM will not be part of the ‘lease payments’ for the modified lease under \nTopic 842. Assume that this allocation is 95% to the lease component and \n5% to CAM. \nLE remeasures the lease liability based on: \n— one remaining lease payment of $27,550 (for the remainder of the original lease term), which is 95% of the total fixed payment; the remaining 5% \n($1,450) is allocated to the CAM non- lease component; and \n— two additional lease payments of $28,500 for the extension period, which is \n95% of the total fixed payment; the remaining 5% ($1,500) is allocated to \nthe CA M non- lease component. \nLE discounts the lease payments at its January 1, 2020 incremental borrowing \nrate of 5.5%. This results in a remeasured lease liability of $75,991, or an \nincrease of $51,706 compared to the lease liability balance immediately before \nthe effective date of the modification. \nJournal entry \nLE records the following journal entry at the effective date of the modification. \n Debit Credit \nROU asset 51,706 \nLease liability 51,706 \nTo remeasure ROU asset and lease liability \nfollowing lease modification. \nLease classification \nLE reassesses lease classification as of the effective date of the modification \nand determines that the modified lease is still classified as an operating lease. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1047}), Document(page\_content='Leases 1047 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Subsequent accounting for the lease \nLE calculates the remaining lease cost for the lease as follows. \nTotal lease payments (including those paid and those not yet paid), reflecting the \nadjustment resulting from the lease modification \n12/31/16 12/31/17 12/31/18 12/31/19 12/31/20 12/31/21 12/31/22 \n$24,500 $24,500 $25,500 $25,500 $27,550 $28,500 $28,500 $184,550 \nPlus: Total initial direct costs attributable to the lease 1,500 \nLess: Periodic lease cost recognized in prior periods calculated as (straight -\nline rental expense of $25,100 × 4 periods) plus (amortization of initial \ndirect costs of $1,200) (101,600) \nRemaining lease cost for the lease $ 84,450 \nLE recognizes a single lease cost, calculated so that the remaining cost of the \nlease is allocated over the remaining lease term on a straight -line basis (i.e. \n$28,150 per year for the remaining three years). \nLE prospectively accounts for the lease liability and ROU asset from the \neffective date of the modification using the guidance in Topic 842 for an \noperating lease. \nBalance sheet \nLE recognizes the following amounts in its balance sheet for its lease of equipment through the end of the revised lease term. \nYear ended ROU asset arising \nfrom operating lease Lease liability arising \nfrom operating lease \nDec. 31, 2020 $51,921 $52,620 \nDec. 31, 2021 26,665 27,014 \nDec. 31, 2022 - - \nIncome statement1 \nLE recognizes the following amounts in its income statement for its lease of \noffice space through the end of the lease term. \nYear ended Operating lease cost \nDec. 31, 2020 $28,150 \nDec. 31, 2021 28,150 \nDec. 31, 2022 28,150 \nNote: \n1. A lessee continues to present lease cost in a manner consistent with its presentation \nunder Topic 840 (e.g. SG&A expenses). \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1048}), Document(page\_content='Leases 1048 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Capital leases under Topic 840 \n13A.3.90 The following diagram gives an overview of the transition requirements \nfor a capital lease, which is explained in this section, assuming a public \nbusiness entity with a calendar year -end. \nComparative periods\nTopic 840Current period\nTopic 842December 31, 2019Effective date \n(date of initial application )\nJanuary 1, 2019 January 1, 2017 January 1, 2018\nExisting leases commenced before Jan . 1, 2019 : \nApply Topic 840\nMeasurement at the effective date :\n— Lease liability and ROU asset = carrying amount of \ncapital lease obligation and capital lease asset under \nTopic 840 \n— Include unamortized IDCs (not already included in \nmeasurement of capital lease asset ) in ROU assetExpired leases :\nDo nothing \nInitial recognition and measurement \n13A.3.100 The lease liability and ROU asset are initially measured as follows at \nthe effective date (subject to the considerations in Question 13A.2.50) . [842- 10-\n65-1(r)(1) – 65-1(r)(2)] \nTopic 842 item Measurement \nLease liability — Carrying amount of capital lease obligation under \nTopic 840 immediately before the effective date. \nROU asset — Carrying amount of the capital lease asset under Topic 840 immediately before the effective date. \n— Plus any unamortized initial direct costs not included in \nthe capital lease asset under Topic 840. \nSubsequent measurement beginning on the effective date \n13A.3.110 A lessee measures the ROU asset and the lease liability in accordance \nwith the subsequent measurement guidance applicable to new finance leases \nunder Topic 842. \n13A.3.120 As an exception, a lessee does not remeasure the lease payments for \nchanges in amounts probable of being owed under residual value guarantees \nunless the lease liability is remeasured for other reasons – e.g. because of a \nchange in the lease term or in the assessment of a lessee purchase option. \n[842- 10-65-1(r)(5)] \nPresentation an d disclosure \n13A.3.130 A lessee presents the assets and liabilities under capital leases as \nROU assets and lease liabilities arising from finance leases for presentation and disclosure purposes in all periods following the effective date. \n[842- 10-65-1(r)(6)] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1049}), Document(page\_content='Leases 1049 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 13A.3.30 \nLessee transition for an existing capital lease with \npackage of practical expedients elected \nScenario 1: Lease is not modified or remeasured on or after the effective \ndate \nAbout the lease \nThe following summarizes relevant information about Lessee LE’s lease of \nequipment. \nCommencement date of the lease: January 1, 2016 \nLease term: 7 years \nLease payments (annual, paid in arrears): $40,000 \nResidual value guarantee (lessee): $6,000 \nAmount probable of being owed under the residual value \nguarantee (no change throughout lease term): $2,000 \nLease classification at inception under Topic 840: Capital lease \nLE’s incremental borrowing rate at lease inception: 5.5% \nInitial direct costs, amortized on a straight ‑line basis over the \nlease term: $2,500 \nLE elects the package of practical expedients. Therefore, LE does not reassess \nwhether the contract is or contains a lease, whether classification of the lease \nwould be different under Topic 842, or whether the unamortized initial direct \ncosts at January 1 , 2019 would meet the definition of initial direct costs under \nTopic 842. \nWorksheet at January 1, 2019 (the effective date) \nStep Amounts \ndebit/(credit) Notes \nRecognize lease liability $(145,048 ) Equal to existing capital lease obligation \nRecognize ROU asset 135,396 Equal to existing capital lease asset \n($133,967 ) + existing unamortized IDCs \n($1,429) \nAdjustment to equity $ - N/A – replacing existing assets and \nliabilities at the same amounts \nSubsequent accounting for the lease \nLE will account for the lease liability and ROU asset in accordance with the \nsubsequent measurement guidance in Topic 842 from January 1, 2019 through \nthe end of the lease term . However , as an exception, because the entire \namount of the $6,000 residual value guarantee is already included in the lease liability, LE will not make any adjustments for changes in the amount that it is probable of owing under the residual value guarantee. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1050}), Document(page\_content='Leases 1050 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. LE does not modify the lease or have to remeasure the lease liability (e.g. for a \nchange in the lease term) subsequent to the effective date. The following \ntables show the effect of the lease accounting on the financial statements. \nBalance sheet \nLE recognizes the following amounts in its balance sheet through the end of the lease term. \nYear ended ROU asset arising \nfrom finance lease Lease liability arising \nfrom finance lease \nDec. 31, 20191 $102,547 $113,026 \nDec. 31, 2020 69,698 79,242 \nDec. 31, 2021 36,849 43,601 \nDec. 31, 2022 4,000 6,000 \nNote: \n1. Because LE elected the effective date method, no ROU asset or lease liability is \npresented in the comparative December 31, 2018 balance sheet. Instead, the amounts \nwill be presented as capital lease assets and capital lease obligations under Topic 840. \nWe expect that many lessees will present their finance lease ROU assets and finance \nlease liabilities in the same balance sheet line item as they presented capital lease assets and capital lease obligations under Topic 840. \nAt the end of the lease term, LE makes a paym ent under the residual value \nguarantee and credits c ash for $2,000, debits the lease liability for $6,000 and \ncredits the ROU asset for $4,000. \nIncome statement1 \nLE recognizes the following amounts in its income statement through the end \nof the lease term. \nYear ended Interest expense Amortization of ROU \nasset \nDec. 31, 2019 $7,978 $32,849 \nDec. 31, 2020 6,216 32,849 \nDec. 31, 2021 4,359 32,849 \nDec. 31, 2022 2,399 32,849 \nNote: \n1. The interest expense on the lease liability and amortization of the ROU asset are not \nrequired to be presented as separate line items; rather each is presented in a manner \nconsistent with how the entity presents other interest expense and depreciation or \namortization of similar assets (see section 6.9). \nScenario 2: Lease liabi lity is remeasured after the effective date \nChanging the facts of Scenario 1, on January 1, 2020, LE remeasures the lease \nliability. The lease included a renewal option and LE now determines that it is \nreasonably certain to exercise the option based on the occurrence of a \nsignificant event that is within its control (see section 6.6). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1051}), Document(page\_content='Leases 1051 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. As a result, LE applies the lease accounting guidance under Topic 842 \nbeginning on the remeasurement date (January 1, 2020). The following \nsummarizes relevant information for the remeasurement of the lease liability. \nRenewal period: 3 years \nRemaining lease term: 6 years \nLease payments for the renewal period (annual, paid in arrears): $43,000 \nLease payments for the remainder of the original lease term \n(annual, paid in arrears): $40,000 \nAmount probable of being owed under the residual value guarantee at the end of the revised lease term: \n$1,500 \nLE’s incremental borrowing rate at January 1, 2020: 6.0% \nLease liability remeasurement \nIn this example, LE identifies one difference between Topic 840 and Topic 842 \nthat affects the measurement of the lease liability and the ROU asset. Under \nTopic 840, minimum lease payments included the full amount of a lessee \nresidual value guarantee (and therefore the capita l lease obligation and the \ncapital lease asset reflect the full amount of such guarantee) while the \ndefinition of lease payments under Topic 842 includes only amounts probable of \nbeing owed by the lessee to satisfy the guarantee. \nLE remeasures the lease li ability based on: \n— three r emaining payments of $40,000 (the remainder of the original lease \nterm); \n— three additional payments of $43,000 to reflect the renewal period; and \n— a final payment of $1,500 to satisfy the residual value guarantee. \nLE discounts the st ream of lease payments at its incremental borrowing rate of \n6.0% at January 1, 2020. This results in a remeasured lease liability of $204,483, or an increase of $91,457 compared to the lease liability balance immediately before the remeasurement date. \nJournal entry \nLE records the following journal entry at January 1, 2020. \n Debit Credit \nROU asset 91,457 \nLease liability 91,457 \nTo remeasure ROU asset and lease liability \nfollowing reassessment of lease term. \nLease classification \nLE also reassesses lease classification, concurrent with the remeasurement of \nthe lease, based on the facts and circumstances at the remeasurement date \n(e.g. the fair value and remaining economic life of the underlying asset at that date) and determines that the l ease is still a finance lease. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1052}), Document(page\_content='Leases 1052 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Subsequent accounting for the lease \nLE prospectively accounts for the lease liability and the ROU asset using the \nguidance in Topic 842 for a finance lease (see section 6.4.1). \n— The lease li ability carrying amount is increased each period of the remaining \nlease term to reflect interest on the lease liability, and reduced to reflect the \nlease payments made during the period. \n— The ROU asset is measured at cost less any accumulated amortization (and \nany accumulat ed impairment losses). \nBalance sheet \nLE recognizes the following amounts in its balance sheet for its lease of \nequipment through the end of the revised lease term. \nYear ended ROU asset arising \nfrom finance lease Lease liability arising \nfrom finance lease \nDec. 31, 2020 $161,670 $176,752 \nDec. 31, 2021 129,336 147,357 \nDec. 31, 2022 97,002 116,198 \nDec. 31, 2023 64,668 80,170 \nDec. 31, 2024 32,334 41,980 \nDec. 31, 2025 - 1,500 \nAt the end of the lease term, LE makes a payment under the residual \nvalue guarantee, debits the lease liability for $1,500 and credits cash for $1,500. \nIncome statement1 \nLE recognizes the following amounts in its income statement for its lease of equipment through the end of the revised lease term. \nYear ended Interest expense Amortization of ROU \nasset \nDec. 31, 2020 $12,269 $32,334 \nDec. 31, 2021 10,605 32,334 \nDec. 31, 2022 8,841 32,334 \nDec. 31, 2023 6,972 32,334 \nDec. 31, 2024 4,810 32,334 \nDec. 31, 2025 2,520 32,334 \nNote: \n1. The interest expense on the lease liability and amortization of the ROU asset are not \nrequired to be presented as separate line items in the income statement; rather each is \npresented in a manner consistent with how the entity presents other interest expense \nand depreciation or amortization of similar assets (see section 6.9). \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1053}), Document(page\_content='Leases 1053 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13A.3.2 Lessee does not elect package of practical \nexpedients \n13A.3.140 Section 13A.3.1 discussed the lessee transition requirements when \nthe lessee elects the package of practical expedients and includes \nQuestions 13A.3.10 – 13A.3.130. Despite the inclusion of those questions in \nsection 13A.3.1, we believe the responses to those questions do not change if \nthe lessee does not elect the packa ge of practical expedients or the use of \nhindsight practical expedient. \nLeases previously classified as operating leases under \nTopic 840 \nLeases classified as operating leases under Topic 842 \n13A.3.150 In general, the recognition, initial measurement and s ubsequent \nmeasurement of the lease liability and ROU asset are the same as for a \nlessee that elects the package of practical expedients for its leases (see \nparagraphs 13A.3.30 – 13A.3.80). As an exception, at the effective date, a \nlessee writes off as an a djustment to equity any unamortized initial direct costs \nthat do not meet the definition of initial direct costs under Topic 842. This \nmeans that the initial and subsequent measurement of the lessee’s ROU asset , \nand periodic lease cost after the effective date, will differ between a lessee that \nelects the package of practical expedients and one that does not for the same \nlease for the effect of initial direct costs written off at the effective date. \n[842- 10-65-1(k), 65 -1(n), 65- 1(p)] \nLeases classified as fi nance leases under Topic 842 \nInitial recognition and measurement \n13A.3.160 The lease liability is recognized and measured the same as for an \nexisting operating lease that remains classified as an operating lease (see \nparagraph 13A.3.150). [842- 10-65-1(o)] \n13A.3.170 The ROU asset is recognized and measured using the formula in \nparagraph 13A.3.50, except that the starting point is a proportion of the original \nlease liability – i.e. the lease liability as of the original commencement date that \nis calculated as follows. \nRemaining lease term at transition \ndateProportion of \noriginal lease \nliabilityOriginal lease \nliability at \ncommencement \ndate1 Total lease term[] \nNote: \n1. Topic 842 states that this amount can be ‘imputed’ from the remaining lease liability, \nrather than directly calculated. Example 13A.3.40 demonstrates imputing the original \nlease liability and this is further discussed as part of the Example. [842- 10-65-1(o)] \nSubsequent measurement \n13A.3.180 Subsequent to initial recognition and measurement, there is no \ndifference in accounting for the finance lease solely because it was previously ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1054}), Document(page\_content='Leases 1054 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. classified as an operating lease under Topic 840 – i.e. compared with a finance \nlease previously classified as a capital lease under Topic 840. Example 13A.3.40 \nillustrates the accounting for an existi ng lease classified as an operating lease \nunder Topic 840 but classified as a finance lease under Topic 842. \nLeases previously classified as capital leases under Topic 840 \nLeases classified as finance leases under Topic 842 \n13A.3.190 In general, the recognition, initial measurement and subsequent \nmeasurement of the lease liability and ROU asset are the same as for a lessee \nthat elects the package of practical expedients for its leases. However, as an \nexception, at the effective date, a lessee writes off as an adjustment to equity \nany unamortized initial direct costs that do not meet the definition of initial direct costs under Topic 842 and that are not included in the measurement of \nthe capital lease asset under Topic 840. This means that the initial and \nsubsequent measurement of the lessee’s ROU assets , and amortization \nthereon, will differ between a lessee that elects the package of practical \nexpedients and one that does not for the same lease for the effect of initial direct costs written off at the effective date. \n[842- 10-65-1(r), 65- 1(t)] \nLeases classified as operating leases under Topic 842 \nTransition adjustments \n13A.3.200 At the effective date, a lessee: [842- 10-65-1(s)] \n— derecognizes the carrying amount of the capital lease asset and capital \nlease obligation determined under Topic 840; the difference is accounted \nfor as prepaid or accru ed rent; and \n— writes off as an ad justment to equity any unamortized initial direct costs \nthat do not meet the definition of initial direct costs under Topic 842. \nInitial recognition and measurement \n13A.3.210 The lessee initially measures the operating lea se liability and operating \nlease ROU asset as of the effective date using the subsequent measurement \nguidance in Subtopic 842-20. [842- 10-65-1(s)(2)] \nSubsequent recognition and measurement \n13A.3.220 Subsequent to the effective date, the lessee accounts for the \noperating lease in the same manner as it accounts for any other operating lease \nunder Topic 842. [842- 10-65-1(s)(4)] \n \n Observation \nChanges in lessee lease classification in transition \n13A.3.230 In general, we believe it will be relatively infrequent that a lease \nclassified as an operating lease under Topic 840 will be classified as a finance \nlease under Topic 842 or vice versa. However, here are a few examples of \nchanges in the lease classificat ion guidance that could result in different \noutcomes. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1055}), Document(page\_content='Leases 1055 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — Four of the five classification tests in Topic 842 for determining if a lease is \na finance lease are substantially similar to those in Topic 840 for \ndetermining if a lease is a capital lease. However, Topic 842 includes a fifth \ntest (the ‘alternative use’ test – see section 6.2) that has no equivalent in \nTopic 840. The introduction of this test could result in some Topic 840 \noperating leases being classified as finance leases if reassessed under \nTopic 842. \n— Lessees under Topic 840 do not consider either the lease term or present \nvalue classification tests (see section 6.2) when the lease term falls within \nthe last 25 percent of the total estimated economic life of the underlying \nasset. Topic 842 only inclu des a similar exemption for the lease term test \n(see section 6.2). Consequently, some leases for which the present value \ntest in Topic 840 was not even considered would have to consider the \nsimilar present value test in Topic 842 and some of those leases m ight \ntherefore be classified as finance leases. \n— While Topic 842 permits entities to continue to use 75 and 90 percent as \nbright -line thresholds when performing the lease term and present value \nlease classifi cation tests, respectively, it does not require use of those \nthresholds. Consequently, an entity not using those thresholds could reach a different conclusion about the classification of some of its existing leases \nif it reassesses lease classification under Topic 842 (see section 6.2). \n13A.3.240 In the first two examples mentioned above, the result of the changes \nto the lease classification guidance from Topic 840 to Topic 842 is that a \npreviously classified operating lease might be classified as a finance lease. In \nthe third example, in theory, the eff ect could be that a previously classified \noperating lease is classified as a finance lease or vice versa; however, it \nappears less likely that an entity could reasonably conclude that a lease term \ngreater than 75 percent is not a ‘major part’ of the remaining economic life of \nthe underlying asset or a present value of lease payments greater than 90 \npercent of the fair value of the underlying asset is not ‘substantially all’ of the \nfair value of the underlying asset than the opposite. For further discussion, see \nQuestions 6.2.10 and 6.2.20. \n13A.3.250 Based on our evaluation of the guidance, we believe, to the extent \nsome changes in lease classification would occur if a lessee were not to elect \nthe package of practical expedients, most of those differences wi ll be in the \ndirection of previously classified operating leases becoming finance leases, rather than vice versa. \n \n Example 13A.3.40 \nLessee transition for operating lease under Topic 840 \nclassified as a finance lease under Topic 842 – \npackage of practical expedients not elected \nThe following summarizes relevant information about Lessee LE’s lease of a machine. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1056}), Document(page\_content='Leases 1056 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Commencement date of the lease: January 1, 2015 \nLease term: 6 years \nMinimum rental payments determined under Topic 840 \n(annual, paid in arrears): $51,000 first 3 years \n$55,000 last 3 years \nLease classification at inception under Topic 840: Operating lease \nInitial direct costs: None \nLE does not elect the package of practical expedients available under Topic 842. \nAt January 1, 2019 (the effective date) \nAssume that the lease would have been classified as a finance lease under \nTopic 842 at lease commencement. At January 1, 2019, LE’s incremental \nborrowing rate is 6% (see section 5.6 and Question 13A .3.50). \nLease liab ility measurement \nOn January 1, 2019, LE measures the finance lease liability as $100,837 , which \nis the present value of two payments of $55,000, discounted at 6%. \nROU asset measurement \nLE determines the carrying amount of the ROU asset at January 1, 2019 using \nthe formula described in Topic 842 as follows. \nStep 1: Determine the minimum rental payments over the remaining lease term \nas of the effective date: ($55,000 × 2) = $110,000 \nStep 2: Determine the lease term at lease commencement: 6 years \nAssume LE does not elect the use- of-hindsight transition practical \nexpedient (see section 13A.2 ). Therefore, at the effective date, LE does \nnot revisit its previous conclusion about the lease term. If LE had elected to use hindsight, the total and remainin g lease term would reflect LE’s re-\nevaluation as of the effective date (see Question 13A.2. 40). \nStep 3: Determine the remaining lease term as of the effective date: 2 years \nStep 4: Divide the amount determined in Step 1 by the amount determined in \nStep 3: $110,000 / 2 years = $55,000 per year \nStep 5: Determine the present value of the periodic payment calculated in Step 4 over the lease term identified in Step 2 using the lessee’s incremental \nborrowing rate at the effective date: $55,000 per year in arrears for \n6 years discounted at 6% = $270,453 \nStep 6: Multiply the amount in Step 5 by the ratio of the remaining lease term \ncalculated in Step 3 divided by the lease term identified in Step 2: \n$270,453 × (2 / 6) = $90,151 \nStep 7: Add to the amount calculated in Step 6 the amount of any previously \nrecognized prepaid rental payments (and subtract from that amount any \naccrued rental payments): $90,151 - $4,000 = $86,151 \nJournal entry \nThe difference between the ROU asset and the lea se liability on January 1, \n2019, is an adjustment to opening retained earnings at that date. Lessee LE ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1057}), Document(page\_content='Leases 1057 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. recognizes the following journal entry to reflect the transition of the operating \nlease to a finance lease. \n Debit Credit \nROU asset 86,151 \nAccrued rent 4,000 \nRetained earnings 10,686 \nLease liability 100,837 \nTo recognize finance lease on transition. \nSubsequent accounting for the lease \nSubsequent to January 1, 2019, LE’s accounting is no different from that illustrated in Example 13A .3.30, Scenario 1. \nImputing the commencement date lease liability – alternative approach \nIn specifying measurement of the ROU asset as a proportion of the original \nlease liability (the lease liability at the commencement date), Topic 842 allows \nthe original lease liability to be imputed from the lease liability determined at the effective date. There is no additional guidance or an example of how to do this. \n[842- 10-65-1(o)] \nThe 2013 Exposure Draft included an illustrative example of how to impute the original lease liability from the effective date lease liability. The approach \nillustrated above imputes the original lease liability in the same manner as in the \n2013 Exposure Draft. However, because the example was not carried forward \nto Topic 842, there may be other ways an entity could meet the requirements. \nIn addition, in the Exposure Draft, the lease liability was not calculated based on the remaining minimum rental payments as is now required by paragraph 842-\n10-65-1(l). \nFor example, the guidance would not appear to prohibit the lessee in this \nexample from calculating the ‘original lease liability’ based on the actual \nminimum rental payments ($51,000 for the first three years; $55,000 for the \nfinal three years), rather than the derived lease payments of $55,000 illustrated. In that case: \n— The origina l lease liability, using the 6% discount rate for the lease, would \nbe $259,761 (rat her than $270,453). \n— The lessee would then multiply tha t amount ($259,761) by the ratio of the \nremaining lease term calculated in Step 3 divided by the lease term \nidentified in Step 2 ($259,751 × (2 / 6) = $86,587). \n— As with the other approach, the lessee would reduce this amount ($86,587) \nby the amount of the accrued rent ($86,587 - $4,000 = $82,587). \nUnder this approach, at January 1, 2019 LE would record a slightly different \njournal entry than that recorded using the preceding approach. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1058}), Document(page\_content='Leases 1058 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Debit Credit \nROU asset 82,587 \nAccrued rent 4,000 \nRetained earnings 14,250 \nLease liability 100,837 \nTo recogn ize finance lease on transition. \n \n \n13A.3.3 ASU 2021- 09, Discount Rate for Lessees That Are Not \nPublic Business Entities \n13A.3.260 ASU 2021 -09 (issued November 11, 2021) permits a lessee that is not \na public business entity to use a risk -free discount rate for the lease, instead of \nits incremental borrowing rate, as an accounting policy election by class of \nunderlying asset. The ASU also clarifies that a lessee must use the rate implicit \nin the le ase when it is readily determinable even if it has elected the risk -free \ndiscount rate expedient. [842- 20-30-3] \n13A.3.270 The effective dates of the amendments in ASU 2021- 09 are as follows. \n[842- 10-65-6] \nEffective date Entities that adopted \nTopic 842 before ASU \n2021- 09 was issued Entities that did not \nadopt Topic 842 before \nfinal ASU was issued \nAnnual periods – fiscal \nyears beginning after December 15, 2021 Adopt when the entity \nadopts Topic 842 \nInterim periods – in fiscal \nyears beginning after December 15, 2022 \nEarly adoption allowed? Yes, as of the beginning of \nfiscal year \n13A.3.280 The available transition approaches depend on the entity’s Topic 842 \nadoption status as of November 11, 2021 (i.e. the issuance date of ASU 2021-\n09). \n— Private entities that have not yet adopted Topic 842 will adopt the \namendments in ASU 2021- 09 at the same time and using the same \ntransition method they use to adopt Topic 842 – either the effective date \nmethod or the comparative method ( see chapters 13A and 13B , \nrespectively). \n— Private entities that have already adopted Topic 842 will apply ASU \n2021 -09 on a m odified retrospective basis to all leases that exist at the \nadoption date of the ASU’s amendments through a cumulative effect adjustment to retained earnings at the beginning of their fiscal year. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1059}), Document(page\_content='Leases 1059 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13A.3.4 ASU 2023 -01, Common C ontrol Arrangements \*\* \n13A.3.290\u202f ASU 2023- 01 (issued March 27, 2023) contains amendments to Topic \n842 around two issues that apply to arrangements between entities under \ncommon control. \n13A.3. 300 The effective dates of the amendments in ASU 2023- 01 are as follows. \nAn entity can select different adoption dates and transition methods for Issue 1 \nand Issue 2. For example, an entity can (1) early adopt only Issue 1 or Issue 2 \nand (2) elect a prospective transition method for one issue and a retrospective transition method for the other. \n[842- 10-65-7, 65 -8] \nEffective date Issue 1 (private entities \nonly) Issue 2 (all entities) \nAnnual periods – fiscal years \nbeginning after December 15, 2023 December 15, 2023 \nInterim periods – in fiscal \nyears beginning after December 15, 2023 December 15, 2023 \nEarly adoption allowed? Yes, in any annual or interim period, as of the \nbeginning of the fiscal year, for which financial \nstatements have not yet been made available for \nissua nce \nEntities that have not issued \n(or made available for \nissuance) financial statements \nunder Topic 842 before final \nASU was issued May adopt concurrent with Topic 842 \nIssue 1 \n13A.3.31 0 ASU 2023- 01 permits a private entity to elect a practical expedient to \nuse the written terms and conditions, as opposed to the legally enforceable \nterms and conditions, of a common control leasing arrangement to determine \nwhether a lease exists and, if so, to determi ne the classification of and \naccounting for that lease. See section 3.1.2. [842- 10-15-3A] \n13A.3. 320\u202f The available transition approaches depend on the entity’s Topic 842 \nadoption status as of March 27, 2023 (i.e. the issuance date of ASU 2023 -01). \n[842- 10-65-7] \n— Private entities that have not yet issued (or made available for \nissuance) financial statements under Topic 842 have the option to adopt \nthe Issue 1 amendments in their first Topic 842 compliant financial \nstatements and use the same transition method as they use to adopt the \nremainder of To pic 842 (i.e. the effective date method – for the comparative \nmethod, see chapter 13B) . \n— Private entities that have already applied Topic 842 in financial \nstatements that have been issued (or made available for issuance) \nhave the option to adopt the Issue 1 amendments: \n— prospectively to common control arrangements that commence or are modified on or after the entity ’s adoption date of the Issue 1 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1060}), Document(page\_content='Leases 1060 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. amendments (e.g. January 1, 2024 if a calendar year entity that does \nnot early adopt the amendments); or \n— on a mo dified retrospective basis to all common control arrangements \nthat still exist at the entity’s adoption date of the Issue 1 amendments. \nUnder the modified retrospective transition approach, the entity records the \neffect of adopting the Issue 1 amendments through a cumulative- effect \nadjustment to retained earnings at the beginning of the earliest period \npresented in the financial statements . \nFor example, assume that a calendar year private entity adopted Topic 842 on January 1, 2022; adopted the Issue 1 amendments on January 1, 2024; \nand is issuing financial statements that will present 2023 and 2024. Under \nthis transition approach, the entity would record the required cumulative-\neffect adjustment as of January 1, 2023 (beginning of earliest period \npresented), but based on an assumed retrospective application as of \nJanuary 1, 2022 (Topic 842 adoption date) to common control arrangements \nstill in place at January 1, 2024. \nIssue 2 \n13A.3.33 0 The Issue 2 amendments require that a lessee in a common control \nlease that is the accounting owner of related leasehold improvements generally \namortize the improvements over their estimated useful life to the common control group, regardless of the Topic 842 lease term, as long as it continues to \ncontrol the use of the underlying asset (see section 6.4) . \n[842- 20-35-12A] \n13A.3. 340\u202f The available transition approaches depend on the entity’s Topic 842 \nadoption status as of March 27, 2023 (i.e. the issuance date of ASU 2023 -01). \n[842- 10-65-8] \n— Entities that have not yet issued (or made available for issuance) \nfinancial statements under Topic 842 have the option to adopt the Issue \n2 amendments in their first Topic 842 compliant financial statements and \nuse the same transition method as they used to adopt the remainder of \nTopic 842 (i.e. the effective date method – for the comparative method, see \nchapter 13B) . Alternatively, these entities may use one of the two \nprospective methods outlined below for entities that have already adopted Topic 842. \n \n— Entities that have already applied Topic 842 in financial statements that have been issued (or made available for issuance) have the \nfollowing three options to adopt the Issue 2 amendment s. \n— Prospectively to all leasehold improvements that are recognized o n or \nafter the date the entity first applies the amendments (e.g. January 1, \n2024 for a calendar year entity that does not early adopt). \n— Prospectively to all new and existing leasehold improvements that are \nrecognized on or after the date the entity first applies the amendments, \nwith the remaining unamortized balance of existing leasehold \nimprovements amortized over their remaining useful life to the \ncommon control group (determined as of that same date). \n— On a modified retrospective basis (i.e. to the beginning of the period in \nwhich Topic 842 is first applied – e.g. January 1, 2022 for a calendar ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1061}), Document(page\_content='Leases 1061 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. year private entity that did not early adopt Topic 842) by apply ing the \namendments to existing leasehold improvements at the Issue 2 \nadoption date ( e.g. January 1, 2024 for a calendar year entity that does \nnot early adopt those amendments ), with a cumulative -effect \nadjustment to the opening balance of retained earnings at the beginning \nof the earliest period presented ( e.g. January 1, 2023 if the entity is \npresentin g 2023 and 2024 in its financial statements ) for any leasehold \nimprovements recognized as a result of adopting the ASU . \n \n13A.4 Transition for lessors \n Excerpt from ASC 842 -10 \nTransition and Open Effective Date Information \nGeneral \n> Transition Related to Accounting Standards Update s No. 2016- 02, \nLeases (Topic 842) , No. 2018- 01, Leases (Topic 842): Land Easement \nPractical Expedient for Transition to Topic 842 , No. 2018- 10, Codification \nImprovements to Topic 842, Leases , No. 2018- 11, Leases (Topic 842): \nTargeted Improvements , No. 2018- 20, Leases (Topic 842): Narrow -Scope \nImprovements for Lessors , No. 2019- 01, Leases (Topic 842): Codification \nImprovements , No. 2019- 10, Financial Instruments —Credit Losses (Topic \n326), Derivatives and Hedgi ng (Topic 815), and Leases (Topic 842): \nEffective Dates , No. 2020- 05, Revenue from Contracts with Customers \n(Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities , \nNo. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with Variable \nLease Payments , No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entities , and No. 2023- 01, Leases \n(Topic 842): Common Control Arrangements \n65-1 The following represents the transition and effective date information \nrelated to Accounting Standards Updates No. 2016- 02, Leases (Topic 842) , \nNo. 2018- 01, Leases (Topic 842): Land Easement Practical Expedient for \nTransition to Topic 842, No. 2018- 10, Codification Impr ovements to Topic 842, \nLeases , No. 2018- 11, Leases (Topic 842): Targeted Improvements , No. 2018-\n20, Leases (Topic 842): Narrow- Scope Improvements for Lessors , No. 2019-\n01, Leases (Topic 842): Codification Improvements , No. 2019- 10, Financial \nInstruments —Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), \nand Leases (Topic 842): Effective Dates , No. 2020- 05, Revenue from Contracts \nwith Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain \nEntities , No. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with \nVariable Lease Payments , No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entities , and No. 2023- 01, Leases (Topic \n842): Common Control Arrangements : [Note : See paragraph 842-10-S65-1 for \nan SEC Staff Announcement on transition related to Update 2016- 02.] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1062}), Document(page\_content='Leases 1062 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Lessors \nLeases previously classified as operating leases under Topic 840 \nv. For each lease classified as an operating lease in accordance with this \nTopic, a l essor shall do all of the following: \n1. Continue to recognize the carrying amount of the underlying asset and \nany lease assets or liabilities at the application date as determined in (c) \nas the same amounts recognized by the lessor immediately before that \ndate in accordance with Topic 840. \n2. Account for previously recognized securitized receivables as secured \nborrowings in accordance with other Topics. \n3. If a lessor does not elect the practical expedients described in (f), write \noff any unamortized initial direct costs that do not meet the definition \nof initial direct costs in this Topic as an adjustment to equity unless the \nentity elects the transition method in (c)(1) and the costs were incurred \nafter the beginning of the earli est period presented, in which case \nthose costs shall be written off as an adjustment to earnings in the \nperiod the costs were incurred. \nw. For each lease classified as a direct financing or a sales- type lease in \naccordance with this Topic, the objective is to account for the lease, \nbeginning on the application date as determined in (c), as if it had always \nbeen accounted for as a direct financing lease or a sales -type lease in \naccordance with this Topic. Consequently, a lessor shall do all of the \nfollowing: \n1. Derecognize the carrying amount of the underlying asset at the \napplication date as determined in (c). \n2. Recognize a net investment in the lease at the application date as \ndetermined in (c) as if the lease had been accounted for as a direct \nfinancing lease or a sales- type lease in accordance with Subtopic 842-\n30 since lease commencement. \n3. Record any difference between the amounts in (w)(1) and (w)(2) as \nfollows: \ni. If an entity elects the transition method in (c)(1), as an adjustment \nto equity (if the commence ment date of the lease was before the \nbeginning of the earliest period presented or if the lease was \nacquired as part of a business combination; see also (h)(3)) or \nearnings (if the commencement date of the lease was on or after \nthe beginning of the earliest period presented). \nii. If an entity elects the transition method in (c)(2), as an adjustment \nto equity . \n4. Account for the lease in accordance with this Topic after the application \ndate as determined in (c). \nLeases previously classified as direct financing or sales -type leases under \nTopic 840 \nx. For each lease classified as a direct financing lease or a sales -type lease in \naccordance with this Topic, do all of the following: \n1. Continue to recognize a net investment in the lease at the application \ndate as determined in (c) at the carrying amount of the net investment \nat that date. This would include any unamortized initial direct costs \ncapitalized as part of the lessor’s net investment in the lease in \naccordance with Topic 840. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1063}), Document(page\_content='Leases 1063 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 2. If an entity elects the transition method in (c)(1), before the effective \ndate, a lessor shall account for the lease in accordance with Topic 840. \n3. Regardless of the transition method selected in (c), beginning on the \neffective date, a lessor shall account for the lease in accordance with \nthe recognition, subsequent measurement, presentation, and \ndisclosure guidance in Subtopic 842- 30. \n4. Beginning on the effective date, if a lessor modifies the lease (and the \nmodification is not accounted for as a separate contract in accordance \nwith paragraph 842- 10-25-8), it shall account for the modified lease in \naccordance with paragraph 842- 10-25-16 if the lease is classified as a \ndirect financing lease before the modification or paragraph 842- 10-25-\n17 if the lease is classified as a sales- type lease before the \nmodification. A lessor shall not remeasure the net investment in the \nlease on or after the effective date unless the lease is modified (and \nthe modification is not accounted for as a separate contract in \naccordance with paragraph 842- 10-25-8). \ny. For each lease classified as an operating lease in accordance with this \nTopic, the objective is to account for the lease, beginning on the \napplication date as determined in (c), as if it had always been accounted for \nas an operating lease in accorda nce with this Topic. Consequently, a lessor \nshall do all of the following: \n1. Recognize the underlying asset at what the carrying amount would \nhave been had the lease been classified as an operating lease under \nTopic 840. \n2. Derecognize the carrying amount of the net investment in the lease. \n3. Record any difference between the amounts in (y)(1) and (y)(2) as \nfollows: \ni. If an entity elects the transition method in (c)(1), as an adjustment \nto equity (if the commencement date of the lease was before the \nbeginning of the earliest period presented or if the lease was \nacquired as part of a business combination) or earnings (if the \ncommencement date of the lease was on or after the beginning \nof the earliest period presented). \nii. If an entity elects the transitio n method in (c)(2), as an adjustment \nto equity . \n4. Subsequently account for the operating lease in accordance with this \nTopic and the underlying asset in accordance with other Topics. \n> Transition Related to Accounting Standards Update No. 2018 -11, \nLeas es (Topic 842): Targeted Improvements \n65-2 The following represents the transition and effective date information \nrelated to Accounting Standards Update No. 2018- 11, Leases (Topic 842) : \nTargeted Improvements : \na. An entity that has not yet adopted the pending content that links to \nparagraph 842- 10-65-1 shall apply the pending content that links to \nparagraph 842- 10-65-2, by class of underlying asset, to all new and existing \nleases when the entity first applies the pending content that links to \nparagraph 842-10-65-1 and shall apply the same transition method elected \nfor the pending content that links to paragraph 842 -10-65-1. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1064}), Document(page\_content='Leases 1064 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. b. An entity that has adopted the pending content that links to paragraph 842 -\n10-65-1 shall apply the pending content that links to thi s paragraph, by \nclass of underlying asset, to all new and existing leases either: \n1. In the first reporting period following the issuance of the pending \ncontent that links to paragraph 842- 10-65-2 \n2. At the original effective date of this Topic for that entity as determined \nin paragraph 842-10-65-1(a) and (b). \nc. An entity that has adopted the pending content that links to paragraph 842-\n10-65-1 shall apply the pending content that links to this paragraph, by \nclass of underlying asset, to all new and existing leases either: \n1. Retrospectively to all prior periods beginning with the fiscal years in \nwhich the pending content that links to paragraph 842- 10-65-1 was \ninitially applied \n2. Prospectively. \n> Transition Related to Accounting Standards Update No. 2018 -20, \nLeases (Topic 842): Narrow -Scope Improvements for Lessors \n65-3 The following represents the transition and effective date information \nrelated to Accounting Standards Update No. 2018- 20, Leases (Topic 842): \nNarrow -Scope Improvements for Lessors : \na. An entity that has not yet adopted the pending content that links to \nparagraph 842- 10-65-1 shall apply the pending content that links to this \nparagraph to all new and existing leases when the entity first applies the \npending content that links to paragraph 842- 10-65-1 and shall apply the \nsame transition method elected for the pending content that links to \nparagraph 842- 10-65-1. \nb. An entity that has adopted the pending content that links to paragraph 842-\n10-65-1 before the issuance of the pending content that links to this \nparagraph shall adopt the pending content that links to this paragraph to all \nnew and existing leases at the original effective date of this Topic for that \nentity as determined in paragraph 842- 10-65-1(a) through (b). Alternatively, \nan entity that has adopted the pending content that links to paragraph 842-\n10-65-1 may adopt the pending content that links to this paragraph to all \nnew and existing leases either: \n1. In the first reporting period ending after the issuance of the pending \ncontent that links to this paragraph \n2. In the first reporting period beginning after the issuance of the pending \ncontent that links to this paragraph. \nc. An entity that has adopted the pending content that links to paragraph 842-\n10-65-1 before the issuance of the pending content that links to this \nparagraph shall apply the pending content that links to this paragraph to all \nnew and existing leases either: \n1. Retrospectively to all prior periods beg inning with the fiscal years in \nwhich the pending content that links to paragraph 842- 10-65-1 was \ninitially applied \n2. Prospectively. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1065}), Document(page\_content='Leases 1065 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. > Transition Related to Accounting Standards Update s No. 2019- 01, \nLeases (Topic 842): Codification Improvements , No. 201 9-10, Financial \nInstruments —Credit Losses (Topic 326), Derivatives and Hedging (Topi c \n815), and Leases (Topic 842): Effective Dates , and No. 2020- 05, Revenue \nfrom Contracts with Customers (Topic 606) and Leases (Topic 842): \nEffective Dates for Certain Entities \n65-4 The following represents the transition and effective date information \nrelated to Accounting Standards Updates No. 2019- 01, Leases (Topic 842) : \nCodification Improvements , No. 2019 -10, Financial Instruments —Credit \nLosses (Topic 326), Derivatives and Hedging (Topi c 815), and Leases (Topic \n842): Effective Dates , and No. 2020- 05, Revenue from Contracts with \nCustomers (Topic 606) and Leases (Topic 842): Effective Dates for Certain \nEntities : \na. All entities within the scope of paragraph 842- 10-65-1(a) shall apply the \npending content that links to this paragraph for financial statements issued \nfor fiscal years beginning after December 15, 2019, and interim periods \nwithin those fiscal years (with an exception for those entities that have not \nyet issued their financial statements or made financial statements available \nfor issuance as described in the following sentence). A not -for-profit \nentity that has issued or is a conduit bond obligor for securities that are \ntraded, listed, or quoted on an exchange or an over -the-counter market \nthat has not yet issued financial statements or made financial statements \navailable for issuance as of June 3, 2020 shall apply the pending content \nthat links to this paragraph for fiscal years beginning after December 15, \n2019, and interim periods within those fiscal years. All other entities shall \napply the pending content that links to this paragraph for financial \nstatements issued for fi scal years beginning after December 15, 2021, and \ninterim periods within fiscal years beginning after December 15, 2022. \nEarly application is permitted. \nb. An entity shall apply the pending content that links to this paragraph as of \nthe date that it first ap plied the pending content that links to \nparagraph 842-10-65-1 and shall apply the same transition method elected \nfor the pending content that links to paragraph 842- 10-65-1 in accordance \nwith paragraph 842- 10-65-1(c). \n> Transition Related to Accountin g Standards Update No. 2021 -05, \nLeases (Topic 842): Lessors —Certain Leases with Variable Lease \nPayments \n65-5 The following represents the transition and effective date information \nrelated to Accounting Standards Update No. 2021- 05, Leases (Topic 842): \nLessors—Certain Leases with Variable Lease Payments : \na. An entity that has not yet adopted the pending content that links to \nparagraph 842- 10-65-1 as of July 19, 2021, shall apply the pending content \nthat links to this paragraph when it first applies the pendi ng content that \nlinks to paragraph 842- 10-65-1 and shall apply the same transition method \nelected for the pending content that links to paragraph 842- 10-65-1. \nb. An entity within the scope of paragraph 842- 10-65-1(a) that has adopted \nthe pending content that links to paragraph 842- 10-65-1 as of July 19, \n2021, shall apply the pending content that links to this paragraph for fiscal ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1066}), Document(page\_content='Leases 1066 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. years beginning after December 15, 2021, and interim periods within those \nfiscal years. Earlier application is permitted. \nc. An entity within the scope of paragraph 842- 10-65-1(b) that has adopted \nthe pending content that links to paragraph 842- 10-65-1 as of July 19, \n2021, shall apply the pending content that links to this paragraph for fiscal \nyears beginning after December 15, 2021, and interim periods within fiscal \nyears beginning after December 15, 2022. Earlier application is permitted. \nd. An entity within the scope of (b) or (c) shall apply the pending content that \nlinks to this paragraph by using one of the following two methods: \n1. Retrospectively to the date in which the pending content that links to \nparagraph 842- 10-65-1 was adopted (the beginning of the period of \nadoption of Topic 842). Under this transition method, the entity shall \napply the pending content that links to this paragra ph to leases that \ncommence or are modified on or after the beginning of the period of its \nadoption of Topic 842 and do not meet the conditions in paragraph \n842-10-25-8. \n2. Prospectively to leases that commence or are modified on or after the \ndate that the entity first applies the pending content that links to this \nparagraph and do not meet the conditions in paragraphs 842- 10- 25-8. \ne. An entity within the scope of (b) or (c) that elects the transition method in \n(d)(1) shall provide the following transition disc losures: \n1. The applicable transition disclosures required by Topic 250 on \naccounting changes and error corrections, except for the requirements \nin paragraph 250- 10-50-1(b)(2) and paragraph 250 -10-50-3 \n2. The transition disclosures in paragraph 250- 10-50-1(b)(3) as of the \nbeginning of the earliest period presented but not before the date in \nwhich the pending content that links to paragraph 842- 10-65-1 was \nadopted. \nf. An entity within the scope of (b) or (c) that elects the transition method in \n(d)(2) shall provide the following transition disclosures: \n1. The nature of and reason for the change in accounting principle \n2. The transition method \n3. A qualitative description of t he financial statement line items affected \nby the change. \n \n13A.4.1 Lessor elects package of practical expedients \n13A.4.10 The following are the transition requirements applicable to a lessor that \nelects the package of practical expedients. Because lease classification is not \nreassessed in applying the package of practical expedients: [842- 10-65-1(f)(2)] \n— all existing le ases classified as operating leases under Topic 840 will be \nclassified as operati ng leases under Topic 842; and \n— all existing leases classified as sales‑ type or direct financing leases under \nTopic 840 will be classified as sales ‑type or direct financing leases un der \nTopic 842. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1067}), Document(page\_content='Leases 1067 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Lease commencing on /after \nJan. 1, 2019 : Apply Topic 842Comparative periods\nTopic 840Current period\nTopic 842December 31, 2019Effective date \n(date of initial application )\nJanuary 1, 2019 January 1, 2017 January 1, 2018\nMeasurement at the effective date :\nOperating leases :\n— No change to measurement of underlying asset\n— Measure any lease assets or liabilities (e.g. IDCs , accrued or \ndeferred rent ) at carrying amount under Topic 840\nSales -type and direct financing leases :\n— Initially measure net investment in the lease (and its \ncomponents ) at carrying amounts under Topic 840\n— Do not reassess whether selling profit recognized under \nTopic 840 would be recognized under Topic 842Expired leases :\nDo nothing \n \nLeases previously classified as operating leases under \nTopic 840 \n13A.4.20 At the effective date, a lessor: [842- 10-65-1(v)] \n— continues to recognize the underlying asset and any lease assets or \nliabilities (e.g. accrued or deferred rent income) at their carrying amounts \nrecognized in accordance with Topic 840 immediately before the effective \ndate; and \n— accounts for previously recognized securitized receivables as secured \nborrowings in accordance with other GAAP, i f applicable. \n13A.4.30 After the effective date, the lessor accounts for the operating lease in \naccordance with the operating lease guidance in Topic 842. \nLeases previously classified as sales ‑type or direct financing \nleases under Topic 840 \n13A.4.40 At the effective date, the lessor continues to recognize a net \ninvestment in the lease equal to the carrying amount of the net investment \nimmediately preceding that date; this includes any unamortized initial direct \ncosts capitalized as part of t he net investment in the lease in accordance with \nTopic 840. An exception arises if election of the hindsight practical expedient results in a change to the lease term or the assessment of a lessee purchase \noption (see Question 13A.2.50). \n[842- 10-65-1(x)(1 ) – 65-1(x)(2)] \n13A.4.50 After the effective date, the lessor accounts for the net investment in \nthe lease under the Topic 842 recognition, subsequent measurement, \npresentation and disclosure guidance. [842- 10-65-1(x)(3)] \n13A.4. 60 If the lease is modified (and that modification is not accounted for as a \nseparate contract) on or after the effective date, a lessor applies Topic 842 beginning at the modification date and accounts for the modification under the \nlessor modifications guidance in Topic 842. A lessor does not remeasure the \nnet investment in the lease after the effective date unless the lease is modified ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1068}), Document(page\_content='Leases 1068 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. (and that modification is not accounted for as a separate contract). \n[842- 10-65-1(x)(4)] \n \n13A.4.2 Lessor does not elect package of practical exped ients \nLeases previously classified as operating leases under \nTopic 840 \nLeases classified as operating leases under Topic 842 \n13A.4. 70 The accounting at and subsequent to the effective date is the same as \nit is for a lessor that elects the package of practical expedients for its leases. As \nan exception, at the effective date, any unamortized initial direct costs that do \nnot meet the definition of initial direct costs under Topic 842 are written off as \nan adjustment to equity. [842- 10-65-1(v)(3)] \nLeases classified as direct financing or sales ‑type leases under Topic 842 \n13A.4. 80 The objective is to account for the lease, beginning on the effective \ndate, as if it had always been accounted for as a direct financing lease or a \nsales- type lease in accordance with Topic 842. Therefore, at the effective date a \nlessor: [842- 10-65-1(w)] \n— derecognizes the carrying amount of the underlying asset; \n— recognizes a net investment in the lease as if the lease had been accounted \nfor as a direct financing lease or a sales -type lease under Topic 842 since \nlease commencement; and \n— records the difference between the carrying amount of the underlying asset \nderecognized and the net investment in the lease recognized as an adjustment to equity. \n13A.4.90 After the effective date, the lessor accounts for the lease in accordance \nwith Topic 842. [842- 10-65-1(w)(4)] \nLeases previously classified as direct financing or sales ‑type \nleases under Topic 840 \nLeases classified as direct financing or sales -type leases under Topic 842 \n13A.4. 100 The accounting at, and subsequent to, the effective date is the same \nas it is for a lessor that elects the package of practical expedients for its leases \n(see section 13A.4.1). [842- 10-65-1(x)] \n13A.4. 110 Initial direct costs included in the measurement of the net investment \nin the lease are not written off even if they do not meet the definition of initial \ndirect costs under Topic 842. [842- 10-65-1(x)(1)] \nLeases classified as op erating leases under Topic 842 \n13A.4. 120 The objective is to account for the lease, beginning at the effective date, \nas if it had always been accounted for as an operating lease in accordance with \nTopic 842. Therefore, at the effective date, a lessor: [842- 10-65-1(y)(1) – 65-1(y)(3)] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1069}), Document(page\_content='Leases 1069 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — derecognizes the carrying amount of the net investment in the lease; \n— recognizes the underlying asset at the carrying amount that would have \nbeen recognized had the lease been classified as an operating lease under Topic 840; and \n— records any difference between the carrying amount of the underlying \nasset recognized and the net investment in the lease derecognized as an \nadjustment to equity. \n13A.4. 130 A lessor subsequently accounts for the operating lease in accordance \nwith Topic 842 and the underlying asset in accordance with other GAAP. \n[842- 10-65-1(y)(4)] \n \n Question 13A.4.10 \nOffset to assets and liabilities written off on \ntransition \nIf the classification of a lease changes on transition, is the \ndifference between those assets and liabilities derecognized \nand those recognized by the lessor taken as an adjustment to \nequity if the lease commenced during one of the comparative \nperiods presented in the financial statements ? \nInterpretive response: Yes. This is because, u nder the effective date method, \nthe comparative periods presented in the lessor’s interim and annual adoption-\nyear financial statements are not revised from what was previously issued. \nTherefore, any adjustments resulting from changes in lease cl assification \nnecessarily flow through equity at the effective date. [842-10-65-1(c)(2), ASU 2018 -\n11.BC7] \n \n Example 13A.4.10 \nLessor transition for an operating lease under \nTopic 840 classified as a sales ‑type lease under \nTopic 842 \nThe following summarizes relevant information about Lessor LR’s lease of \nequipment. In this example, LR does not elect the package of practical \nexpedients. \nCommencement date of the lease: January 1, 2016 \nLease term: 5 years \nRenewal, termination or purchase options: None \nLease payments (annual, paid in arrears): $17,000 \nEstimated residual value of the equipment at the end of the lease term: $18,000 \nResidual value guarantee (provided by either lessee or third party): None \nFair value at January 1, 2016: $77,000 \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1070}), Document(page\_content='Leases 1070 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Carrying amount at January 1, 2016: $77,000 \nRemaining (and original) economic life of the equipment: 7 years \nUseful life of the equipment: 7 years \nInitial direct costs incurred by lessor under Topic 840 (only $800 \nwould meet the definition of initial direct costs under Topic 842): $2,000 \nRate implicit in the lease under Topic 840, which does not factor in \ninitial direct costs: 9.368% \nRate implicit in the lease under Topic 842 (see section 5.6): 9.01% \nLease classification at inception under Topic 840: Operating lease \nThe lease is not modified on or after the effective date. \nLR does not elect the package of practical expedients. Therefore, it reassesses \nwhether the arrangement is or contains a lease, whether classification of the \nlease would be different under Topic 842, and whether the unamortized initial direct costs of $800 at January 1, 2019 would have qualified for capitalization \nunder Topic 842. \nLR determines that the arrangement is still a lease. However, the lease is \nclassified as a sales ‑type lease under Topic 842. Only $800 of the $2,000 in \ninitial direct costs under Topic 840 meet the definition of initial direct costs \nunder Topic 842, but that $800 would also have been capitalized because the \nfair value of the underlying asset equaled its carrying amount at lease commencement. \nWorksheet at January 1, 2019 (the effective date) \nThe objective of the transition guidance in this case is to account for the lease, \nbeginning on January 1, 2019 (i.e. the effective date), as if it had always been a \nsales- type lease accounted for in accordance with Topic 842. \nStep Amounts \ndebit/(credit) Notes \nDerecognize the \ncarrying amount of the \nunderlying asset $(44,000) $77,000 original carrying amount – \n3 years of depreciation ($77,000 / 7- year \nuseful life = $11,000) \nDerecognize entire \nunamortized portion of \noriginally capitalized \nIDCs (800) $2,000 original amount of IDCs \ncapitalized – 3 years of IDCs amortization \n($2,000 / 5-year lease term = $400) \nThe portion capitalizable under Topic 842 \nwill be included in the net investment in the sales -type lease \nRecognize a net \ninvestment in the lease \nas if the lease had \nbeen accounted for as a \nsales- type lease under \nTopic 842 since lease \ncommencement 45,049 Commencement date net investment in \nthe lease of $77,800 ($77,000 fair value \nof the underlying asset + $800 in \ncapitalizable IDCs) – three lease \npayments of $17,000 + 9.01% interest \non the net investment in the lease of \n$7,010, $6,110, and $5,129 for 2016, \n2017 and 2018, respectively \nAdjustment to equity $ (249) ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1071}), Document(page\_content='Leases 1071 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Accordingly, LR records the following journal entry. \n Debit Credit \nNet investment in equipment lease 45,049 \nEquipment 44,000 \nUnamortized initial direct costs 800 \nRetained earnings 249 \nTo recognize sales -type lease on transition. \nAfter January 1, 2019, LR accounts for the lease in accordance with Topic 842. \n \n Observation \nChanges in lessor lease classification in transition \n13A.4. 140 Consistent with the Observation at paragraph 13A .3.230, we believe it \nwill be relatively infrequent that a lease classified as an operating lease under \nTopic 840 would be classified as a sales -type or direct financing lease under \nTopic 842 or vice versa. The same examples outlined in that observation could \nresult in a different classification of an existing lease for lessors if reassessed \nunder the classification criteria in Topic 842, most likely from classification as an \noperating lease under Topic 840 to classification as a sales- type lease (or, less \nfrequently, to a direct financing lease). \n13A.4. 150 In addition to those examples, a lease classified as an operating lease \nunder Topic 840 solely because either (1) collectibility of the minimum lease payme nts was not reasonably predictable, or (2) there were important \nuncertainties surrounding the amount of unreimbursable costs yet to be incurred by the lessor under the lease would be classified as a sales ‑type lease \nunder Topic 842. Topic 842 does not prec lude sales -type lease classification \nwhen there are collectibility uncertainties or when there are uncertainties \nsurrounding unreimbursable costs. \n13A.4. 160 Consistent with our earlier lessee observations, it appears to us that, \nwhere lease classification might change for lessors if reassessed under \nTopic 842, it is most likely to involve operating leases being reassessed as \nsales- type or direct financing leases rather than the opposite. \n \n Observation \nInitial direct costs included in the net investment in \na sales‑type or direct financing lease \n13A.4. 170 If a lessor does not elect the package of practical expedients, it is \nrequired to reassess only whether those unamortized initial direct costs at the \neffective date capitalized in connection with an operating lease under Topic 840 \nwould meet the definition of initial direct costs under Topic 842. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1072}), Document(page\_content='Leases 1072 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13A.4. 180 Initial direct costs capitalized in connection with a direct financing \nlease under Topic 8401 are included in the lessor’s net investment in the lease. \nUnamortized amounts are not reassessed even if the lessor does not elect the \npackage of practical expedients. Those amounts are not reassessed because \nthe Board decided that sales -type/direct financing lessors should carry forward \nthe same net investment in the lease they had under Topic 840 to Topic 842 at the effective date. Reassessing unamortized initial direct costs for those leases \nwould have rendered that impossible in most cases given the substantially different definitions of initial direct costs between Topic 840 and Topic 842. \n[842- 10-65-1(x)(1)] \nNote: \n1. Initial direct costs are not capitalized in connection with a sales- type lease under \nTopic 840. \n \n Question 13A.4.20 \nRevenue recognition gu idance for arrangements \nthat no longer meet the definition of a lease \nWhat revenue recognition guidance does a lessor apply to \ncontracts that no longer meet the definition of a lease on adoption of Topic 842 if it uses the cumulative -effect method \nto transition to Topic 606? \nBackground: ABC Corp. adopts Topic 606 on January 1, 2018, using the \ncumulative -effect method (i.e. rather than the full retrospective method). ABC \napplies the guidance in Topic 606 to all contracts in 2018 and recognizes the \ncumulative effect of initial adoption of Topic 606 in the opening balance of \nretained earnings on January 1, 2018. The adoption of Topic 606 does not affect \nABC’s accounting for lease arrangements in the scope of Topic 840. \nABC adopts Topic 842 on January 1, 2019, and does not elect the package of \npractical expedients. On adoption of Topic 842, ABC concludes that an \narrangement previously accounted for as a lease under Topic 840 does not \nmeet the definition of a lease under Topic 842. Instead, ABC concludes the \narrangement provides a service in the scope of Topic 606. This arrangement \ncommenced in 2017. \nInterpretive response: On adoption of Topic 842, ABC should apply the \nguidance in Topic 606 to the arrangement that is no longer a lease, beginning at \nthe effective date. ABC should not restate the comparative periods (i.e. as if the \narrangement had been subject to the guidance in Topic 606 for all periods \npresented). \nBecause ABC elected the effective date method when adopting Topic 842, the \ncomparative periods continue to be presented in accordance with Topic 840, under which the arrangement in the background was appropriately accounted \nfor as a lease. The effect of adopting Topic 842 (i.e. no longer identifying the \narrangement as a lease, and instead accounting for the arrangement as a \nservice contract under Topic 606) should not be reflected in the comparative \nperiods. Any cumulative effect resulting from the change should be reflected in \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1073}), Document(page\_content='Leases 1073 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the Topic 842 cumulative effect transition adjustment recorded at the effective \ndate (i.e. January 1, 2019). \n \n13A.4.3 ASU 2018- 20, Narrow -Scope Improvements for \nLessors \n13A.4.190 ASU 2018 -20 (issued December 10, 2018) enacted the following \namendments to Topic 842: \n— created a lessor -only practical expedient for sales and other similar taxes \n(see paragraphs 7.3.210 – 7.3.240) ; \n— created accounting for lessor costs and lessee payments thereof that \ndiffers based on which party ( lessee or lessor ) remits payment for the cost \nto the relevant third party – e.g. the taxing authority or insur er. \nParagraphs 7.3.160 – 7.3.200 discuss these requirements ; and \n— clarified that a lessor should recognize variable payments not included in \nthe consideration in the contract as follows (see section 4.4.3): \n— the portion allocated to the separate lease component , in the period in \nwhich the changes in facts and circumstances on which the payment is \nbased occur ; and \n— the portion allocated to the non- lease component(s) , as revenue when \nthe requirements of the applicable Topic (e.g. Topic 606) are met . \nEntities that did not adopt Topic 842 before issuance of \nASU 2018- 20 \n13A.4. 200 Lessors that did not adopt Topic 842 before ASU 2018- 20 was issued \nwill adopt the amendments in paragraph 13A.4.190 when they adopt Topic 842. \nThe amendments will apply to all new and existing leases from the date of \nadoption – e.g. January 1, 2019 for a c alendar year-end public business entity. \n[842- 10-65-3(a)] \n13A.4.210 A lessor applying the effective date method is not required to recast \nits income statement presentation for periods before its adoption date (see \nQuestion 13A.4.30). Therefore, items may be presented differently in the \nadoption year than in comparative periods. The following are examples. \n— A lessor may have historically presented sales tax collections from lessees on a gross basis in the income statement – i.e. separately from the \nassociated tax cost. If the lessor elects the sales tax practical expedient on adopting Topic 842, it will present all sales tax collections on new and \nexisting leases net of the related tax cost from the date of adoption. \n— A lessor may have historically presented lessee reimbursements of \nproperty taxes or insurance net of the related costs. From the adoption date \nof Topic 842, for new and existing leases, it will present all property tax and \ninsurance costs and lessee reimbursements thereof on a gross basis. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1074}), Document(page\_content='Leases 1074 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 13A.4 .30 \nComparative periods \nIs a lessor permitted to recast comparative periods to \nconform to it s Topic 842 gross vs. net presentation ? \nBackground: As outlined in paragraph 13A.4.200, some lessors may be \nrequired to change their presentation of lessor costs (e.g. property taxes) and \nlessee payments thereof on adoption of Topic 842 from how they prese nted \nthose items historically under Topic 840. This may create noticeable differences \nbetween a lessor’s adoption y ear and comparative period financial statements . \nTopic 840 and SEC guidance \nTopic 840 does not prescribe gross or net presentation for lessor costs such as property taxes or insurance or lessee payments thereof , and there is no \nrelevant SEC guidance. \nInterpretive response: It depends. While Topic 842 would generally not permit \nrecasting the comparative periods, Topi c 250 ( accounting changes and error \ncorrections ) may provide an avenue to do so. \nTopic 842 does not permit recasting the comparative periods because, under \nthe effective date method, Topic 842 does not apply before the effective date – \ni.e. it does not apply to the comparative periods presented. Recasting the \ncomparative periods to, for example, separately present previously netted \nincome statement amounts would, in effect, be selectively applying t he \ncomparative period method (see c hapter 13B) to adopt the amendments in \nASU 2018- 20, while using the effective date method to adopt the remainder of \nTopic 842. \n[842- 10-65-1(c)] \nAlthough Topic 842 does not apply to the comparative periods presented when \nusing the effective date transition method, Topic 250 may be considered. A \nchange in gross versus net income statement presentation is a change in \naccounting principle under Topic 250. And because Topic 840 does not \nprescribe gross or net income statement presentation for lessor costs and \nlessee payments thereof , a lessor may be able to justify a change to its \ncomparative periods’ gross versus net income statement presentation to conform to its post -effective date presentation as preferable. An entity’s fact s \nand circumstances will affect whether or not such a change is preferable, and \nwhether a preferability determination is required for the change. \n[250- 10-45-2 – 45-8] \n \nEntities that early adopted Topic 842 before issuance of \nASU 2018- 20 \n13A.4.220 Lessor s that early adopted Topic 842 will adopt the amendments in \nASU 2018- 20 as of their mandatory Topic 842 adoption date – e.g. January 1, \n2019 for a calendar year -end public business entity. [842- 10-65-3(b)] \n13A.4.230 Alternatively , lessor s can elect t o apply the amendments to all new \nand existing leases in either: [842- 10-65-3(b)] \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1075}), Document(page\_content='Leases 1075 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — the first reporting period ending after the issuance of ASU 2018- 20 – e.g. \nthe quarter beginning October 1, 2018 for a calendar year -end public \nbusiness entity; or \n— the first reporting period beginning after the issuance of ASU 2018 -20 – e.g. \nthe quart er beginning January 1, 2019 for a calendar year -end public \nbusiness entity. \n13A.4.240 Lessors will apply the amendments either: [842- 10-65-3(c)] \n— retrosp ectively to all prior annual and interim periods after the entity’s \nTopic 842 adoption date; or \n— prospecti vely from the entity’s adoption date of the amendments. \n13A.4.25 0 An early adopting lessor applying the effective date method is not \nrequired to recast its income statement presentation for periods before its \nTopic 842 adoption date (see Question 13A.4.30). \n \n13A.4.4 ASU 2019- 01, Codification Improvements \n13A.4.260 ASU 2019 -01 (issued March 5, 2019 ) enacted the following \namendments to Topic 842: \n— reinstated guidance from Topic 840 requiring lessors that are not \nmanufacturers or dealers to measure the fair value of the underlying asset \nat its cost after reflecting any volume or trade discounts applied; cost \ninclud es acquisition costs such as sales taxes and delivery and installation \ncosts. An exception arises if there is a significant time lapse between asset \nacquisition and lease commencement. In those cases, the lessor determines the fair value of the underlying asset in accordance with \nTopic 820 (fair value measurements). Section 7.3.1 further discusses this \nguidance; and \n[842- 30-55-17A] \n— requires lessors that are depository or lending institutions in the scope of \nTopic 942 (financial services —depository and lending) to classify the \nprincipal portion of lease payments received under sales -type or direct \nfinancing leases as cash flows from i nvesting activities. The interest portion \nof those lease payments and all lease payments received under operating leases are classified as cash flows from operating activities. \n[842- 30-45-5, \n942-230-45-4] \n13A.4. 270 The effective date s of the amendments in ASU 2019- 01 are as \nfollows . [842- 10-65-4(a)] \nEffective date Public business entities All other entities \nAnnual periods – fiscal \nyears beginning after December 15, 2019 December 15, 2021 \nInterim periods – in fiscal \nyears beginning after December 15, 2019 December 15, 2022 \nEarly adoption allowed? Yes Yes \n13A.4. 280 A lessor that does not adopt these amendments as of its Topic 842 \nadoption date applies them retrospectively from that date . For example, a ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1076}), Document(page\_content='Leases 1076 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. calendar year -end public business entity lessor that adopts the amendments on \nJanuary 1, 2020 retrospectively applies the amendments from its Topic 842 \ndate of adoption of January 1, 2019. [842- 10-65-4(b)] \n \n13A.4.5 ASU 2021- 05, Lessors —Certain Leases with Variable \nLease Paym ents \n13A.4.290 ASU 2021 -05 (issued July 19, 2021) requires a lessor to classify a \nlease with variable lease payments that do not depend on an index or rate as an \noperating lease if: [842- 10-25-3A] \n— the lease would have been classified as a sales -type lease or a direct \nfinancing lease under the pre- ASU classificati on criteria; and \n— sales- type or direct financing classification would result in a \ncommencement date loss. \n13A.4. 300 The effective dates of the amendments in ASU 2021- 05 are as \nfollows. [842- 10-65-5] \nEffective date Public business entities Other entities \nAnnual periods – fiscal \nyears beginning after December 15, 2021 December 15, 2021 \nInterim periods – in fiscal \nyears beginning after December 15, 2021 December 15, 2022 \nEarly adoption allowed? Yes, but not before adopting ASC 842. \n13A.4. 310 The available transition approaches depend on the entity’s Topic 842 \nadoption status as of July 19, 2021 (i.e. the issuance date of ASU 2021 -05). \n— Lessors that have not yet adopted Topic 842 will adopt the amendments \nin ASU 2021- 05 at the same time and using the same transition method \nthey use to adopt Topic 842 – either the effective date method or the \ncomparative method ( see chapters 13A and 13B , respectively). \n— Lessors that have already ado pted Topic 842 will apply the amendments \nin ASU 2021- 05 either: \n— retrospectively to leases that commenced or were modified on or after \nthe entity’s adoption of Topic 842 (e.g. on January 1, 2019 for a \ncalendar -year public business entity); or \n— prospectivel y to leases that commence or are modified (and that \nmodification is not accounted for as a separate contract) after the entity \nadopts the ASU 2021- 05 amendments. \n \n13A.4.6 ASU 2023 -01, Common C ontrol Arrangements \*\* \n13A.4.320\u202f ASU 2023- 01 (issued March 27, 2023) contains amendments to Topic \n842 around two issues that appl y to arrangements between entities under ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1077}), Document(page\_content='Leases 1077 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. common control . Only the amendments related to the first of those two issues \n(Issue 1 ) applies to lessors. \n13A.4.330 The effective dates of the Issue 1 amendments in ASU 2023-01 are as \nfollows. [842- 10-65-7] \nEffective date All entities \nAnnual periods – fiscal \nyears beginning after December 15, 2023 \nInterim periods – in fiscal \nyears beginning after December 15, 2023 \nEarly adoption allowed? Yes, in any annual or interim period, as of the beginning \nof the fiscal year, for which financial statements have \nnot yet been made available for issuance \nEntities that have not \nissued (or made available \nfor issuance) financial \nstatements under Topic 842 before final ASU was \nissued May adopt concurrent with Topic 842 \n13A.4.34 0 The Issue 1 amendments permit a private entity (lessee or lessor) to \nelect a practical expedient to use the written terms and conditions, as opposed \nto the legally enforceable terms and conditions, of a common control leasing \narrangement to determine whether a lease exists and, if so, to determine the \nclassification of and accounting for that lease. See section 3.1.2. [842- 10-15-3A] \n13A.4.350\u202f The available transition approaches depend on the entity’s Topic 842 \nadoption status as of March 27, 2023 (i.e. the issuance date of ASU 2023- 01). \n[842- 10-65-7] \n— Private entities that have not yet issued (or made available for \nissuance) financial statements under Topic 842 have the option to adopt \nthe amendments in their first Topic 842 compliant financial statements and use the same transition method as they used to adopt the remainder of \nTopic 842 (i.e. the effective date method – for the comparative method, see \nchapter 13B) . \n \n— Private entities that have already applied Topic 842 in financial \nstatements that have been issued (or made available for issuance) \nhave t he option to adopt the amendments: \n— prospectively to common control arrangements that commence or are modified on or after the entity ’s adoption date of the ASU (e.g. January \n1, 2024 if a calendar year entity that does not early adopt the \namendments); or \n— on a modified retrospective basis to all leases that exist at the entity’s \nadoption of the ASU. \nUnder the modified retrospective transition approach, the entity records the \neffect of adopting the amendments through a cumulative- effect adjustment \nto retained earnings at the beginning of the earliest period presented in the \nfinancial statements . ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1078}), Document(page\_content='Leases 1078 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. For example, assume that a calendar year private entity adopted Topic 842 \non January 1, 2022; adopted the Issue 1 amendments on January 1, 2024; \nand is issuing financial statements that will present 2023 and 2024. Under \nthis transition approach, the entity would record the required cumulative-\neffect adjustment as of January 1, 2023 (beginning of earliest period \npresented), but based on an assumed retrospective application as of \nJanuary 1, 2022 (Topic 842 adoption date) to common control arrangements \nstill in place at January 1, 2024 . \n \n13A.5 Applying the guidance on components of a \ncontract in transition \n13A.5.10 Neither the transition guidance in Topic 842, nor the ASU 2016- 02 basis \nfor conclusions, explicitly discuss the effect of the new guidance on identifying, \nseparating and allocating the ‘consideration in the contract’ to components of a contract (see chapt er 4) on transition. \n13A.5.20 However, we believe the requirements with respect to the new \ncomponents guidance in transition can be derived from other requirements in \nthe transition guidance. Sections 13A .5.1 and 13A.5.2 describe what we believe \nthe effect (or non- effect) of this guidance is on the various transition scenarios \npresented, assuming the entity previously appropriately applied the guidance in \nTopic 840 with respect to (1) identifying lease and non -lease elements and (2) \nseparating elements and allocating contract consideration. As discussed in Question 13A.2.100, the transition guidance in Topic 842 does not grandfather \nprior errors in applying Topic 840. \n13A.5.30 Each of these scenarios assumes that the lease is not modified \n(lessees and lessors) or remeasured (lessees only) on or after the effective \ndate. If a lease is modified (and that modification is not accounted for as a \nseparate contract) or remeasured on or after the effective date, all of the \nrequirements of Topic 842 become applicable to that lease, including the \nguidance on accounting for components of a contract. \n13A.5.1 Lessee guidance \nOperating \uf0e0 Operating \n13A.5.40 Lessees will not reevaluate their previous allocations to lease and non-\nlease elements of a contract. This is because, absent a post -effective date \nmodification or remeasurement, the transition guidance requires lessees to use \nthe ‘minimum rental payments’ determined in accordance with Topic 840 to \naccount for the lease (see Question 13A.3.10) . Revising previous decisions with \nrespect to identification, separation and/or allocation of contract consideration would change the amounts used to account for the lease, directly contradicting \nthe explicit requirement to account for the lease based on t he minimum rental \npayments as determined under Topic 840. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1079}), Document(page\_content='Leases 1079 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Operating \uf0e0 Finance \n13A.5.50 The transition guidance applicable to this scenario requires the lessee \nto recognize and measure a new finance lease liability in the same way as for \nan operating lease that remains classified as an operating lease, and to derive \nthe new finance lease ROU asset from the finance lease liability at the \ncommencement date (see section 13A.3.2). \n13A.5.60 Measurement of the lease liability is based on the minimum rental \npaym ents (as defined in Topic 840). Revising previous decisions with respect to \nidentification, separation and/or allocation of contract consideration would \nchange the amounts used to account for the lease, contradicting the explicit \nrequirement to account for the lease based on the minimum rental payments as \ndetermined under Topic 840. \nFinance \uf0e0 Finance \n13A.5.70 Lessees will not reevaluate their previous allocations to lease and \nnon ‑lease elements of a contract. This is because the transition guidance \nrequires lessees to measure the initial finance lease ROU asset and initial finance lease liability at the same amounts recognized immediately before the \neffective date for the capital lease asset and the capital lease obligation, \nrespectively (except as noted in Question 13A.2. 50). \n13A.5.80 In addition, absent a post ‑effective date modification or \nremeasurement, lessees will not remeasure those amounts; they will simply complete the accounting for the lease based on those initially measured \namounts. Similar to the operating lease to operating lease scenario in \nparagraph 13A.5.40, revisions to decisions made about components of the \ncontract would require the lessee not to follow the explicit measurement \nrequirements for this scenario. \nFinance \uf0e0 Operating \n13A.5.90 The transition guidance applicable to this scenario requires the lessee \nto derecognize its existing capital lease asset and capital lease obligation and, at the effective date, recognize and measure a new operating lease liability in \naccordance with Topic 842 and derive the new operating lease ROU asset from \nthat lease liability (see paragraphs 13A. 3.210 – 13A.3.220). \n13A.5.100 Measurement of the lease liability in accordance with Topic 842 is \nbased on the lease payments. Because the lease payments are a function of \nthe separation and allocation guidance in Topic 842 if there are either (1) \nmultiple separate lease components or (2) lease and non- lease components of \nthe contract, lessees will need to apply the Topic 842 multiple -component \nseparation and allocation guidance (see section 4.4) to comply with the \ntransition measurement requirements. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1080}), Document(page\_content='Leases 1080 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 13A.5.10 \nNot separating lease from non -lease components \non transition \nIs the practical expedient for a lessee to not separate lease \nand non- lease components a policy election available to \nlessees for existing leases ? \nBackground: As a practical expedient, a lessee may elect not to separate non -\nlease components from the lease components to which they relate. A lessee \napplies this practical expedient as an accounting policy election by class of \nunderlying asset – e.g. office equipment, automobiles, office space. However, \nthere is no mention in Topic 842 as to whether a lessee could similarly apply \nthis expedient on transition. [842- 10-15-37] \nInterpretive response: Yes. While not explicitly provided for in the transition \nguidance, we believe lessees are permitted to make an accounting policy \nelection (by class of underlying asset) to not separate non- lease elements (e.g. \nsubstantial services such as those to operate the asset) from the lease elements to which they relate for existing leases . \nFor example, a lessor’s operation of the underlying asset (e.g. services to \noperate a ship or an airplane) is an example of a substantial service that is \naccounted for separate from the lease element. Therefore, in an operating \nlease, a lessee electing the non- separation practical expedient for existing \nleases on transition will account for fixed costs allocable to the operation \nservices as part of the minimum rental payments that are used to measure the \noperating lease liability. \nThe Board decided to per mit the non- separation practical expedient for leases \nthat commence on or after the effective date to ease the accounting for \nlessees, and many of the transition provisions were similarly intended. \nTherefore, we believe it is acceptable for lessees to appl y the expedient to \nexisting leases on transition. \n \n Question 13A.5.20 \nAccounting policy implications of separating lease \nfrom non -lease components on transition \nIf a lessee does not elect the lease/non -lease component \npractical expedient on transition, is this a binding accounting \npolicy election going forward for new leases that commence \nafter the effective date? \nInterpretive response: No. We do not believe there is a basis in Topic 842 for \nprohibiting a lessee from electing the practical expedient for new leases that \ncommence on or after the effective date solely because it did not elect to apply \nthe practical expedient on transition, application of which is not addressed in \nTopic 842 or ASU 2016- 02 (see Question 13A.5.10) . \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1081}), Document(page\_content='Leases 1081 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. However , based on related dis cussions with the SEC staff, we believe a lessee \nshould only apply the lease/non- lease practical expedient to existing leases on \ntransition if it will do so for new leases of underlying assets within the same \nclass commencing on or after the effective date of Topic 842 . \n \n13A.5.2 Lessor guidance – practical expedient for separation \nof lease and non -lease components does not apply \nOperating \uf0e0 Operating \n13A.5.110 The transition guidance requires lessors in this scenario to continue \nto recognize the underlying asset, as well as any other lease assets and \nliabilities (e.g. accrued rent assets or deferred rent liabilities), at the same amounts as immediately before t he effective date under Topic 840 (see \nparagraph 13A.4.20). If a contract that contains an operating lease includes \nmultiple lease components and/or lease and non- lease components, revising \nthe units of account and revising the allocation of the considerat ion in the \ncontract (which might be different from the total contract consideration under \nTopic 840 if there are variable payments that specifically relate to non- lease \ncomponents of the contract) would likely result in adjustments to any recognized lease assets or liabilities – i.e. a change would have resulted in a \nchange to the lease payments, and therefore the accrued/deferred rent amount would typically be measured differently from that which resulted under \nTopic 840. \nSales -type/direct financing \uf0e0 Sales-type/direct financing \n13A.5.120 Lessors will not reevaluate their previous allocations to lease and non-\nlease elements of a contract. This is because the transition guidance requires \nlessors to measure their initial lease assets under Topic 842 at the same \namount recognized immediately before the effective date under Topic 840 (see \nparagraph 13A.4.40). \n13A.5.130 In addition, absent a post ‑effective date modification not accounted for \nas a separate contract, lessors in this scenario will not remeasure their lease assets, they will simply complete the accounting for the lease based on the \ninitially measured amount for the net investment in th e lease. \nOperating \uf0e0 Sales -type/direct financing; or Sales -type/direct \nfinancing \uf0e0 Operating \n13A.5.140 The transition guidance states for either of these scenarios that “the \nobjective is to account for the lease, beginning on the application date … as if it \nhad always been accounted for as an operating [a sales -type or direct financing] \nlease in accordance with this Topic ” (see paragraphs 13A.4. 80 and 13A.4. 120). \nIt therefore seems clear that this would include reassessing the lessor’s \naccounting with res pect to the components of the contract. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1082}), Document(page\_content='Leases 1082 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 13A.5.30 \nTopic 842 and Topic 606 interaction in accounting \nfor CAM \nHow should a lessor account for CAM provided in a lease \nafter it adopts Topic 606 but before it adopts Topic 842? \nBackground: Topic 840 specifies that CAM is within its scope based on the \nfollowing. [840- 10-25-1(d), 15- 17, 15- 19(a)] \n— It describes maintenance as an executory cost. \n— It states that “if an arrangement contains a lease and related executory \ncosts, as well as other non- lease elements, the classification, recognition, \nmeasurement, and disclosure requirements of this Topic shall be applied by \nboth the purchaser and the supplier to the lease element of the \narrangement.” [emphasis added] \n— It chara cterizes related executory costs as part of ‘those for the lease’. \nInterpretive response: \nAccounting for existing leases before the effecti ve date of Topic 842 \nTopic 606 is a ‘residual standard’ in that it requires the application of other \nTopics first if those other Topics specify how to account for one or more parts \nof the contract. Topic 606 only applies to those parts of the contract tha t other \nTopics do not address. \nCAM expenditures are described as ‘executory costs’, and accounted for as part of the lease element under Topic 840. Therefore, CAM is not governed by \nTopic 606 for leases that commence before the effective date of Topic 842, and \nan entity may continue to account for CAM under its historical accounting policy. That said, on the adoption of Topic 606, based on discussions with the \nFASB and SEC staffs, we believe it would be acceptable for an entity to either \n(or both): \n[606- 10-15-4] \n— analogize to the guidance in Topic 606 in determining the measure of \nprogress to apply when recognizing CAM revenue – i.e. rather than follow \nits historical accounting policy for recognizing CAM; and/or \n— separately present CAM revenues as non -lease revenue. If a lessor decides \nto separately present CAM revenue as non- lease revenue, it is acceptable \nto allocate revenue between the lease and CAM using either: (1) the \nrequirements in Topic 840 or (2) the transaction price allocation guidance \nin Topic 6 06 (see paragraphs 13A.5.150 – 13A.5.160). On adoption of \nTopic 842, that separate presentation (if elected) should be reflected in the \ncomparative periods presented. \nAccounting for existing leases after the effective date of Topic 842 \nAssuming that lease classification is the same before and after adoption of \nTopic 842 (unless the lease is modified on or after the effective date and that \nmodification is not accounted for as a separate contract) , the lessor will not \nreevaluate the identification of and all ocation to lease and non- lease \ncomponents (see paragraphs 13A .5.110 – 13A.5.130). The lessor will continue \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1083}), Document(page\_content='Leases 1083 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. to account for CAM provided as part of the lease contract just as it did before \nthe effective date of Topic 842 (see above). \nAccounting for leases t hat commence or are modified on or after the \neffective date of Topic 842 \nFor all leases that commence or are modified on or after the effective date of Topic 842 (and that modification is not accounted for as a separate contract in \naccordance with paragra ph 842- 10-25-8), the lessor will identify CAM as a non -\nlease component and account for it under Topic 606. \n \n Observation \nLessor reallocation may be permissible in some \ncases \n13A.5.150 The discussion in paragraphs 13A .5.110 – 13A.5.130 notwithstanding, \nthe SEC staff has communicated that they may not object to a lessor beginning \nto account for maintenance services (including common area maintenance), \nwhich is a lease -related element under Topic 840, as a non- lease element \nbeginning with the lessor’s adoption of Topic 606 if the lessor adopts Topic 606 \nbefore it adopts Topic 842. Under this approach, we believe the lessor would \naccount for those services as within the scope of Topic 606 and would allocate \nthe contract consideration between the remaining lease elements and any non-\nlease elements (including maintenance services) in accordance with the \ntransaction price allocation guidance in paragraphs 606 -10-32-28 – 32-41. \n13A.5.160 The lessor’s accounting in this regard would follow the l essor’s \nTopic 606 transition approach (full retrospective approach or cumulative effect \napproach). \n13A.5.170 Taken as a whole, we believe entities will only be required to reassess \ntheir identification and accounting for components of a contract when the lease \nclassification changes as a result of applying Topic 842 to the lease. If lease \nclassification does not change or the entity elects the package of practical \nexpedients, which means the entity will not reassess classification of its leases \nunder Topic 842, entities will not be required to reassess their identification of \nor accounting for multiple components of a contract. Avoiding the effort to reassess the accounting for components of a contract and avoiding the \noperational complexities that could ar ise from that exercise if classification of a \nlease does change is another reason many entities will likely consider electing \nthe package of practical expedients. \n13A.5.180 However, consistent with the discussion in Question 13A.2. 100 about \nidentifying le ases, the ability to not reassess identification of or accounting for \nmultiple components of a contract presumes the entity applied the guidance in \nTopic 840 completely and accurately. For example, if an entity did not \nappropriately identify lease and non‑ lease elements, or did not appropriately \nseparate ‘minimum rental payments’ or ‘minimum lease payments’ from \npayments for non‑ lease elements (e.g. services), the transition guidance does \nnot excuse those errors. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1084}), Document(page\_content='Leases 1084 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 13A.5.40 \nExisting arrangements with lease and non- lease \nelements – substantial services \nWhat guidance applies to a lessor when accounting for \n‘substantial services’ provided to a lessee on transition? \nBackground: Topic 840 required a lessor to separate, at lease inception, \npayments and other consideration into those: [840- 10-15-19] \n— related to the lease, including the related executory costs; and \n— for other servi ces. \nUnder Topic 840, the term ‘executory costs’ referred to the normal expenses \nassociated with owning an asset, including insurance, maintenance and taxes. \nTherefore, activities identified as giving rise to executory costs, such as most \nmaintenance services, were not non- lease elements. ‘Substantial services’ \nwere accounted for separately from the lease (under Topi c 605 before the \nadoption of Topic 606). [840- 10-25-1(d), 840 -10-15-8 – 15-19] \nBefore the adoption of Topic 606, the components were required to be separated on a relative selling price basis. After the adoption of Topic 606, \nlessors separate lease from non -lease components (which includes substantial \nservice elements) using the transaction price allocation guidance in Topic 606. \n[840- 10-15-19] \nInterpretive response: Substantial services were non -lease elements under \nTopic 840. Therefore, before the lessor ’s adoption of Topic 606 they were \nrequired to be accounted for under Topic 605 (or other relevant pre- Topic 606 \nrevenue guidance). Consequently, substantial services become subject to \nTopic 606 for lessors on transition to Topic 606, and should be transit ioned \nusing the same guidance that applies to all other elements that were subject to the pre- Topic 606 revenue guidance. The consideration in the lease contract, \nhowever, is not reallocated between the lease and non -lease elements on \nadoption of Topic 606 and the lessor continues to use the consideration \nallocated to the non- lease component based on the Topic 840 allocation \nguidance (see also Question 13A.5. 30). \nIf substantial service elements were accounted for as being in the scope of Topic 840 (i.e. as part of a lease element), this is a non -GAAP accounting policy \nthat is subject to financial statement materiality considerations. There is no \npractical expedient in transition to Topic 606 that would permit a substantial \nservice element to be accounted for as part of a lease after the adoption of \nTopic 606. \nLessor practical expedient not to separate lease and non -lease \ncomponents \nAs discussed in section 13A.5.3, a lessor that elects the non- separation \npractical expedient for lease and non- lease components will combine lease and \nsubstantial service elements in existing leases that meet the specified criteria \n(see paragraph 13A.5.190) prospectively beginning: \n— For non- early adopters, on the effective date of Topic 842; and \n— For early adopters: \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1085}), Document(page\_content='Leases 1085 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — either (1) in the first reporting period following the issuance of \nASU 2018- 11 (e.g. the beginning of the fiscal quarter following the \nissuance date of the ASU) or (2) at the entity’s mandatory Topic 842 \nadoption date (e.g. January 1, 2019 for a calendar year -end public \nbusiness entity); and \n— retrospectively to all prior annual and interim periods after the entity’s \nTopic 842 adoption date. \nFor example, a lessor is not early adopting Topic 842 and will combine its ship \nlease and operations services elements for new leases under Topic 842 . In that \ncase, the lessor will also present ship lease and operations service (i.e. \nsubs tantial service) revenue for existing leases on a combined basis beginning \non the effective date of Topic 842. That same lessor, applying the effective date \nmethod, is not required to combine the lease and substantial operation service \nelements for presentation purposes in its comparative perio d financial \nstatements (see Question 13A.5. 50). \n \n13A.5.3 Lessor guidance – practical expedient for separation \nof lease and non -lease components applies \n13A.5.190 Topic 842 provides a lessor practical expedient whereby the lessor \ncan make an accounting pol icy election, by class of underlying asset, not to \nseparate lease and related non- lease components if both: [842- 10-15-42A] \n— the timi ng and pattern of transfer to the lessee of the lease component and \nthe non- lease component(s) associated with that lease component are the \nsame; and \n— the lease component, if accounted for separately, would be classified as an \noperating l ease. \n13A.5. 200 Paragraphs 4.4.51 – 4.4.56 discuss the lessor practical expedient in \ndetail. \nEntities that have not adopted Topic 842 on issuance of \nASU 2018- 11 \n13A.5. 210 Lessors that had not early adopted Topic 842 when ASU 2018- 11 \nwas issued may elect the practical expedient when they adopt Topic 842. \n13A.5. 220 For existing leases (i.e. those that commence before the adoption of \nTopic 842), lessors will apply the non -separation practical expedient from the \neffective date. That is, a lessor will combine lease and non- lease components \narising from an existing lease if they would also do so if the lease were a new \nlease that commence d on or after the entity’s adoption date. [842- 10-65-2(a)X)] \n13A.5. 230 A lessor applying the effective date method is not required to recast \nits income statement presentation for periods before its adoption date (see Question 13A.5. 50). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1086}), Document(page\_content='Leases 1086 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Entities that earl y adopted Topic 842 before the issuance of \nASU 2018- 11 \n13A.5. 240 Lessors can elect the practical expedient at either : \n— the beginning of the entity’s first reporting period following the issuance of \nASU 2018- 11 – e.g. the beginning of the fiscal quarter following the \nissuance date of the ASU ; or \n— at the entity’s mandatory Topic 842 adoption date – e.g. January 1, 2019 for \na calendar year -end public business entity. \n13A.5. 250 For existing leases (i.e. those that commence before the lessor’s \nadoption of the practical expedient), lessors will apply the non- separation \npractical expedient either : \n— retrospectively to all prior annual and interim periods after the entity’s Topic 842 adoption date; or \n— prospectively from the date of the entity’s adoption of the practical \nexpedient. \n13A.5. 260 An early adopting lessor applying the effective date method is not \nrequired to recast its income statement presentation for periods before its \nTopic 842 adoption date (see Question 13A.5. 50). \n \n Question 13A.5. 50 \nCombining lease and non -lease components in \ncomparative periods \nIs a lessor permitted to recast comparative periods to \nconform to its Topic 842 present ation of revenue from lease \nand qualifying non- lease components? \nBackground: Many lessors have presented lease and non- lease revenue \nseparately in their historical financial statements that they will account for as \npart of a combined component under Topic 842 beca use of the lessor non -\nseparation practical expedient (see paragraphs 13A.5.190 – 13A.5.200) . For \nexample, under Topic 840, a lessor may have presented lease revenue \nseparately from revenue from operating or other substantial services in the \nincome statement. \nAdditionally, under Topic 840, many lessors have presented base rent revenue separately from lease -related revenue arising from executory costs in the \nincome statement. For example, a real es tate lessor may have presented base \nrental revenue (i.e. from the minimum rental payments) separate from fixed \nCAM charges or variable tenant CAM reimbursements. \nBecause Topic 842 does not apply to periods before the date of adoption for \nlessors using the effective date method of transition (comparative periods \nremai n subject to Topic 840) , the question arises as to whether a lessor using \nthe effective date method is permitted to recast its income statement \npresentation for the comparative periods pre- Topic 842 adoption to conform to \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1087}), Document(page\_content='Leases 1087 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. its combined presentation post -adoption. We believe it is clear that a lessor is \nnot required to do so. [842- 10-65-1(c)] \nTopic 840 requires lease and non- lease (i.e. goods or s ubstantial service) \nelements to be accounted for separately and there is no practical expedient that \npermits lessors to account for them on a combined basis. Topic 840 does not, \nhowever, provide guidance on how such lease and non- lease revenue must be \npresented in the income statement . [840- 10-15-19] \nHowever, SEC guidance in Regulation S -X requires issuer entities to present \nincome from rentals (i.e. lease revenue) separately from sales and service \nrevenue in the income statement. [Reg S -X, Rule 5-03(b)] \nInterpretive response: Despite Topic 842 not applying to periods before the \ndate of adoption for lessors using the effective date method of transition, a \nlessor may still be permitted to do so. However, the specific lease and non-\nlease components for which it would be acceptable for a lessor to recast its \ncomparative period income statement presentation differ if the lessor is an \nSEC registrant. \nNon-SEC registrants \nTopic 842 does not apply to the comparative periods presented when using the effective date method. Therefore, Topic 250 (accounting changes and error \ncorrections) should be considered. \nWe do not believe a change in income statement aggregation or disaggregation \nis a change in accounting principle under Topic 250 if both the previous and the \nnew aggregations are a cceptable under the applicable US GAAP – i.e. Topic 840 \nin this instance. And because Topic 840 does not specify separate or combined \nincome statement presentation for the revenue items discussed in the \nbackground, we believe either was acceptable under Topic 840. \nIf a lessor changes its income statement aggregation for the comparative \nperiods, the notes to the financial statements should disclose the change. We \ndo not believe a preferability assessment under Topic 250 is required. \nSEC registrants \nWe believe our response for non- SEC registrants also applies to SEC registrants \nif, and only if, the item presented separately from lease revenue was an \nexecutory cost element (e.g. maintenance, including CAM), rather than a non-\nlease element ( i.e. goods or a substantial service), under Topic 840. \nHowever, because of the guidance in SEC Regulation S -X applicable to SEC \nregistrants, we do not believe income statement presentation of lease and non-\nlease goods or substantial service revenues on a c ombined basis was an \nacceptable accounting alternative for those lessors . Therefore, a lessor is not \npermitted to change its comparative period income statements to combine \nrevenues from leases and non- lease goods or substantial services . \nWe do not believe lessee payments of executory costs were required to be \npresented separately from lease revenue under Regulation S -X because \nTopic 840 characterizes those payments as part of ‘those for the lease’ (see \nQuestion 13A.5.30). \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1088}), Document(page\_content='Leases 1088 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13A.6 Leveraged leases \n Excerpt from ASC 842-10 \nTransition and Open Effective Date Information \nGeneral \n> Transition Related to Accounting Standards Update s No. 2016- 02, \nLeases (Topic 842) , No. 2018- 01, Leases (Topic 842): Land Easement \nPractical Expedient for Transition to Topic 842 , No. 2018- 10, Codification \nImprovements to Topic 842, Leases , No. 2018- 11, Leases (Topic 842): \nTargeted Improvements , No. 2018- 20, Leases (Topic 842): Narrow -Scope \nImprovements for Lessors , No. 2019- 01, Leases (Topic 842): Codification \nImprovemen ts, No. 2019- 10, Financial Instruments —Credit Losses (Topic \n326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): \nEffective Dates , No. 2020- 05, Revenue from Contracts with Customers \n(Topic 606) and Leases (Topic 842): Effective Dates for Certa in Entities , \nNo. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with Variable \nLease Payments, No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entities, and No. 2023- 01, Leases \n(Topic 842): Common Control Arrangements \n65-1 The following represents the transition and effective date information \nrelated to Accounting Standards Updates No. 2016- 02, Leases (Topic 842) , \nNo. 2018- 01, Leases (Topic 842): Land Easement Practical E xpedient for \nTransition to Topic 842, No. 2018- 10, Codification Improvements to Topic 842, \nLeases , No. 2018- 11, Leases (Topic 842): Targeted Improvements , No. 2018-\n20, Leases (Topic 842): Narrow- Scope Improvements for Lessors , No. 2019- 01, \nLeases (Topic 84 2): Codification Improvements , No. 2019- 10, Financial \nInstruments —Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), \nand Leases (Topic 842): Effective Dates , No. 2020- 05, Revenue from Contracts \nwith Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain \nEntities , No. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with \nVariable Lease Payments, No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entities, and No. 2023- 01, Leas es (Topic \n842): Common Control Arrangements : [Note : See paragraph 842-10-S65-1 for \nan SEC Staff Announcement on transition related to Update 2016- 02.] \nLeases previously classified as leveraged leases under Topic 840 \nz. For leases that were classified as leveraged leases in accordance with \nTopic 840, and for which the commencement date is before the effective \ndate, a lessor shall apply the requirements in Subtopic 842- 50. If a \nleveraged lease is modified on or after the effective date, it shall be \naccounted for as a new lease as of the effective date of the modification in \naccordance with the guidance in Subtopics 842- 10 and 842- 30. \n1. A lessor shall apply the pending content that links to this paragraph to a \nleveraged lease that meets the criteria in (z) that is acquired in a \nbusiness combination or an acquisition by a not -for-profit entity on \nor after the effective date. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1089}), Document(page\_content='Leases 1089 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13A.6.10 For leases classified as leveraged leases under Topic 840 and for which \nthe commencement date is before the effective date, a lessor continues its \nexisting leveraged lease accounting, even if the lessor does not elect the \npackage of transition pr actical expedients. However, if a leveraged lease is \nmodified on or after the effective date, it is accounted for as a new lease at the \nmodification date in accordance with Topic 842. [842- 10-65-1(z)] \n13A.6.20 If a lessee exercises an option to extend a l everaged lease that \ncommenced before the effective date of Topic 842 for which exercise was not \npreviously considered reasonably assured, the exercise of that option is \nconsidered a lease modification. [842- 50-15-1] \n13A.6.30 For further discussion of leveraged leases, see section 7.8. \n \n Question 13A.6.10 \nAcquired leveraged leases \nIf a leveraged lease is acquired, does the lessor continue to \napply leveraged lease accounting? \nBackground: The lease could be acquired separately, or as part of a business \ncombination (or an acquisition by a not -for-profit entity). \nInterpretive response: Yes, provided that the lease is not modified as part of \nthe acquisition. The lessor will continue to apply the leveraged lease guidance in \nSubtopic 842-50 (leveraged lease arrangements) (see section 7.8). \n \n13A.7 Sale-leaseback transactions \n Excerpt from ASC 842 -10 \nTransition and Open Effective Date Information \nGeneral \n> Transition Related to Accounting Standards Update s No. 2016- 02, \nLeases (Topic 842) , No. 2018- 01, Leases (Topic 842): Land Easement \nPractical Expedient for Transition to Topic 842 , No. 2018- 10, Codification \nImprovements to Topic 842, Leases , No. 2018- 11, Leases (Topic 842): \nTargeted Improvements , No. 2018- 20, Leases (Topic 842): Narrow -Scope \nImprovements for Lessors , No. 2019- 01, Leases (Topic 842): Codification \nImprovements , No. 2019- 10, Financial Instruments —Credit Losses (Topic \n326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): \nEffective Dates , No. 2020- 05, Revenue from C ontracts with Customers \n(Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities , \nNo. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with Variable \nLease Payments, No. 2021 -09, Leases (Topic 842): Discount Rate for \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1090}), Document(page\_content='Leases 1090 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Lessees That Are Not Public Business Entities, and No. 2023 -01, Leases \n(Topic 842): Common Control Arrangements \n65-1 The following represents the transition and effective date information \nrelated to Accounting Standards Updates No. 2016- 02, Leases (Topic 842) , \nNo. 2018- 01, Leases (Topic 842): Land Easement Practical Expedient for \nTransition to Topic 842, No. 2018- 10, Codification Impr ovements to Topic 842, \nLeases , No. 2018- 11, Leases (Topic 842): Targeted Improvements , No. 2018-\n20, Leases (Topic 842): Narrow- Scope Improvements for Lessors , No. 2019- 01, \nLeases (Topic 842): Codification Improvements , No. 2019- 10, Financial \nInstruments —Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), \nand Leases (Topic 842): Effective Dates , No. 2020- 05, Revenue from Contracts \nwith Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain \nEntities , No. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with \nVariable Lease Payments, No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entities, and No. 2023- 01, Leases (Topic \n842): Common Control Arrangements : [Note : See paragraph 842-10-S65-1 for \nan SEC Staff Announcement on transition related to Update 2016- 02.] \nSale and leaseback transactions before the effective date \naa. If a previous sale and leaseback transaction was accounted for as a sale \nand a leaseback in accordance with Topic 840, an entity shall not reassess \nthe transaction to determine whether the transfer of the asset would have \nbeen a sale in accordance with par agraphs 842- 40-25-1 through 25- 3. \nbb. If a previous sale and leaseback transaction was accounted for as a failed \nsale and leaseback transaction in accordance with Topic 840 and remains a \nfailed sale at the effective date: \n1. If an entity elects the transition method in (c)(1), the entity shall \nreassess whether a sale would have occurred at any point on or after \nthe beginning of the earliest period presented in the financial \nstatements in accordance with paragraphs 842-40-25-1 through 25- 3. \nThe sale and leaseback transaction shall be accounted for on a \nmodified retrospective basis from the date a sale is determined to have \noccurred. \n2. If an entity elects the transition method in (c)(2), the entity shall \nreassess whether a sale would have occurred at the beginning of the \nreporting period in which the entity first applies the pending content \nthat links to this paragraph in accordance with paragraphs 842- 40-25-1 \nthrough 25- 3 and recognize the sale as an adjustment to equity. The \nentity shall then account for the leaseback in accordance with the \nguidance in Subtopic 842- 20 after the beginning of the reporting period \nin which the entity first applies the pending content that links to this \nparagraph. \ncc. An entity shall account for the leaseback in accordance with the lessee and \nlessor transition requirements in (k) through (y). \ndd. If a previous sale and leaseback transaction was accounted for as a sale \nand capital leaseback in accordance with Topic 840, the transferor shall \ncontinue to recognize any deferred gain or loss that exists at the later of \nthe beginning of the earliest comparative period presented in the financial \nstatements and the date of the sale of the underlying asset (if an entity \nelects the transition method in (c)(1)) or that exists at the beginning of the \nreporting period in which the entity first applies the pendin g content that ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1091}), Document(page\_content='Leases 1091 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. links to this paragraph (if an entity elects the transition method in (c)(2)), as \nfollows: \n1. If the underlying asset is land only, straight line over the remaining \nlease term. \n2. If the underlying asset is not land only and the leaseback is a f inance \nlease, in proportion to the amortization of the right -of-use asset. \n3. If the underlying asset is not land only and the leaseback is an \noperating lease, in proportion to the recognition in profit or loss of the \ntotal lease cost. \nee. If a previous sale an d leaseback transaction was accounted for as a sale \nand operating leaseback in accordance with Topic 840, the transferor shall \ndo the following: \n1. Recognize any deferred gain or loss not resulting from off -market terms \n(that is, where the consideration for the sale of the asset is not at fair \nvalue or the lease payments are not at market rates) as a cumulative -\neffect adjustment to equity unless the entity elects the transition \nmethod in (c)(1) and the date of sale is after the beginning of the \nearliest period presented, in which case any deferred gain or loss not \nresulting from off -market terms shall be recognized in earnings in the \nperiod the sale occurred. \n2. Recognize any deferred loss resulting from the consideration for the \nsale of the asset not being at f air value or the lease payments not being \nat market rates as an adjustment to the leaseback right -of-use asset at \nthe later of the beginning of the earliest comparative period presented \nin the financial statements and the date of the sale of the underlying \nasset (if an entity elects the transition method in (c)(1)), or at the \nbeginning of the reporting period in which the entity first applies the \npending content that links to this paragraph (if an entity elects the \ntransition method in (c)(2)). \n3. Recognize a ny deferred gain resulting from the consideration for the \nsale of the asset not being at fair value or the lease payments not being \nat market rates as a financial liability at the later of the beginning of the \nearliest comparative period presented in the f inancial statements and \nthe date of the sale of the underlying asset (if an entity elects the \ntransition method in (c)(1)), or at the beginning of the reporting period in \nwhich the entity first applies the pending content that links to this \nparagraph (if a n entity elects the transition method in (c)(2)). \n \n13A.7.10 If a sale -leaseback transaction was previously accounted for as a sale \nand a leaseback under Topic 840, an entity does not reassess whether the \ntransaction would have qualified as a sale (or purchase) under Topic 842. This \nmeans that buyer -lessors will not revisit whether a purchase of the underlying \nasset occurred for any sale -leaseback transactions for which the sale/purchase \noccurred before the effective date. [842- 10-65-1(aa)] \n13A.7.20 An entity accounts for the leaseback in accordance with the lessee and \nlessor transition requirements outlined in sections 13A .2 – 13A.5. [842- 10-65-1(cc)] \n13A.7.30 If a transaction was previously accounted for as a sale and capital \n(finance) leaseback under Topic 840, a seller ‑lessee continues to amortize any \ndeferred gain or loss existing at the effective date as follows. [842- 10-65-1(dd)] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1092}), Document(page\_content='Leases 1092 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — If the asset is land only, over the remaining lease term on a straight ‑line \nbasis. \n— If the asset is not land only: \n— in proportion to the amortization of the ROU asset if the leaseback is a \nfinance lease; and \n— in proportion to total lease cost recognized in profit or loss if the \nleaseback is an operating lease. \n13A.7.40 If a tra nsaction was previously accounted for as a sale and operating \nleaseback under Topic 840, a seller -lessee (see Example 13A.7.20) : \n[842- 10-65-1(ee)] \n— recognizes the portion of any deferred gain or loss not resulting from off ‑\nmarket terms as a cumulative -effect adjustment to equity at the effective \ndate; and \n— recognizes the portion of any deferred gain or loss that resulted from \noff‑market terms as an adjustment to the leaseback ROU asset (if the sales \nprice was below market) or as a remaining financial liability (if the sales \nprice was above market) at the effective date. \n13A.7.50 Consistent with the transition requirements for lessees and l essors, \nthe sale- leaseback transition requirements generally limit the implementation \ncost and complexity for preparers. A seller -lessee will recognize an adjustment \nto equity on transition only for sale and operating leasebacks for which there is \na deferr ed gain or loss not resulting from off -market terms. \n13A.7.60 If a previous sale ‑leaseback transaction was, and continues to be at the \neffective date, accounted for as a failed sale under Topic 840, the entity \nreassesses whether a sale has occurred as of the effective date in accordance \nwith Topic 842. If so, the seller -lessee recognizes the sale as an adjustment to \nequity at that date. The leaseback is subsequently accounted for in the same \nmanner as any other seller -lessee leaseback (see section 9.2.3) from the \neffective date. [842- 10-65-1(bb)(2)] \n \n Question 13A.7.10 \nLeaseback accounting in transition for previously \nfailed sales \nWhat is the seller -lessee’s accounting for a sale -leaseback \ntransaction that remains a failed sale under Topic 840 at the \neffective date? \nInterpretive response: \nAccounting for the sale \nIf the sale criteria in Subtopic 842 -40 (see section 9.1) are met as of the \neffective date (because as of that point in time there are no conditions \nprecluding a sale under Subtopic 842- 40), the gain or loss on the sale of the \nunderlying asset should be recognized as an adjustment to equity as of that \ndate. [842- 10-65-1(bb)(2)] \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1093}), Document(page\_content='Leases 1093 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The guidance in section 9.2 applies if the sale criteria in Subtopic 842- 40 are \nmet after the effective date of Topic 842. \nAccounting for the leaseback \nIf the sale criteria in Subtopic 842 -40 are met as of the effective date of \nTopic 842, the accounting for the leaseback should follow the transition \nprovisions discussed in sections 13A.2 and 13A.3. \nIf the entity ha s elected the package of transition practical expedients (see \nsection 13A.2.3), we believe t he preceding paragraph means the following. \n— Because this was previously determined to be a failed sale- leaseback \ntransaction, there would be no additional considera tion as to whether the \nleaseback meets the definition of a lease under Topic 842. \n— Because there was no lease accounted for under Topic 840 ( i.e. because \nthe transaction was accounted for as a failed sale -leaseback ) the lessee had \nnot clas sified the lease under Topic 840. In the absence of specific \nguidance in Topic 842, we believe it is acceptable for the lessee to assess \nclassification of the lease as of either: \n— the lease commencement date, using the lease classification guidance \nin Topic 842; or \n— the lease inception date, using the lease classification guidance in \nTopic 840. \nWe believe the first approach is acceptable, even though the package of practical expedients has been elected, because there was no ‘existing \nlease’ that had previously been classified under Topic 840. However, we \nbelieve that to apply this approach, the entity must determine the commencement date of the leaseback (i.e. when a sale would have \nsuccessfully occurred) under Topic 842. \nAlternatively, we believe the second approach is acceptable because \nelection of the package of transition practical expedients effectively \ngrandfathers the legacy Topic 840 classification guidance, which required lease classification to be assessed as of lease inception. \nWe believe an entity’s chosen approac h should be applied consistently to \nall similar circumstances. \n— Any unamortized initial direct costs capitalized because the transaction was \naccounted for as a failed sale will not be reassessed, despite the fact that \nthose costs may have been expensed as transaction costs of the sale had \nthe transaction been a successful sale and leaseback under Topic 840. \nThose costs will be accounted for by the lessee in the same manner as any \nother unamortized initial direct costs are accounted for by lessees that elect \nthe package of transition practical expedients. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1094}), Document(page\_content='Leases 1094 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 13A.7.20 \nSuccessful sale -leaseback transactions that include \nseller -lessee repurchase options on adoption of \nTopic 606 \nIs a transaction accounted for as a sale and a leaseback under \nTopic 840 that includes a seller -lessee repurchase option \nreassessed as a financing arrangement because of the \nrepurchase agreements guidance in Topic 606? \nBackground: This question arises because Topic 606 states that if an entity has \nan obligation (a forward) or a right (a call option) to repurchase an asset, then \nthe customer does not obtain control of the asset – i.e. no sale occurs for \nrevenue recognition purposes. An entity accounts for the contract as a lease or \na financing arrangement depending on the relationship between the repurchase \namount and the original selling price. Further, if the contract is part of a sale-\nleaseback transaction, the entity should account for the contract as a financing \narrangement. [606- 10-55-68, ASU 2014- 09.BC426] \nIn contrast, the transition guidance in Topic 842 states that if a previous sale -\nleaseback transaction was accounted for as a sale and a leaseback in \naccordance with Topic 840, an entity does not reassess the transaction to \ndetermine whether the transfer of the asset would have been a sale. In \naddition, the sale- leaseback guidance in Subtopic 840- 40 was not amended by \nASU 2014- 09 (or any of the subsequent revenue ASUs) such that all sale-\nleaseback transactions remain within its scope until Topic 842 is adopted an d \nno guidance to refer to Topic 606 in the case of a seller -lessee repurchase \noption was added. [842- 10-65-1(aa), 840- 40-05-1] \nInterpretive response: No. We believe a successful sale- leaseback transaction \nunder Topic 840 should not be reassessed on transit ion to Topic 842. This is \nbecause of the combination of the transition guidance in Topic 842 (clearly \ndelineating the Board’s intent with respect to successful sale- leaseback \ntransactions) plus the fact that Subtopic 840- 40 was not amended by any of the \nrevenue ASUs. We believe this to be the case even if the transaction includes a \nseller -lessee repurchase option. [842- 10-65-1(aa), 840- 40-05-1] \nWe believe this conclusion is further supported for sale- leaseback transactions \nwith noncustomers by the fact that Subtopic 610- 20 on the derecognition of \nnonfinancial assets (as amended by ASU 2017- 05) specifically excludes from its \nscope any sale -leaseback transactions that were in the scope of Subtopic 840-\n40. [610- 20-15-4(c)] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1095}), Document(page\_content='Leases 1095 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 13A.7.10 \nSale-leaseback transaction previously accounted for \nas a sale and an operating leaseback under \nTopic 840 \nThe following summarizes relevant information about Seller -Lessee SL’s \nequipment sale- leaseback transaction with Buyer -Lessor BL. The transaction \nqualified as a sale and a leaseback – i.e. there was no failed sale. \nSale-leaseback transaction date: January 1, 2018 \nLeaseback term: 5 years \nLeaseback payments (annual, paid in arrears): $15,000 \nSales price and fair value of equipment at transaction date: $115,000 \nCarrying amount of equipment at transaction date: $80,000 \nRemaining economic life of the equipment at transaction date: 9 years \nLeaseback classification: Operating lease \nInitial direct costs: None \nLessee residual value guarantee: None \nThere is no automatic reversion of ownership to SL, nor does SL have an option \nto repurchase the equipment. SL retains more than a minor portion, but less \nthan substantially all, of the remaining use of the equipment. Therefore, \nbecause the profit on the sale does not exceed the present value of the \nminimum lease payments under Topic 840, the entire gain of $35,000 is \ndeferred and will be recognized over the five -year leaseback term. \nEffective date and transition \nSL and BL are calendar year -end public business entities that adopt Topic 842 \non January 1, 2019. \nSL and BL do not reassess whether the transaction would have qualified for \nsale/purchase accounting under Topic 842. BL does not adjust its previous \naccounting for the purchase of the a sset in any manner. On the Topic 842 \neffective date, SL will recognize the remaining amount of the deferred profit on \nthe sale- leaseback transaction to equity. \n Debit Credit \nDeferred profit on sale- leaseback transaction 28,000 \nRetained earnings 28,000 \nRecognize unamortized deferred gain on \ntransaction at effective date ( January 1, 2019). \nSubsequent accounting for the leaseback \nSL and BL account for the leaseback using the transition guidance discussed in \nsections 13A.2 – 13A.5. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1096}), Document(page\_content='Leases 1096 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 13A.7.20 \nSale-leaseback deferred gains and losses in \ntransition \nSeller -Lessee SL entered into a sale- leaseback transaction under Topic 840 that \nqualified as a sale and operating leaseback. The following scenarios illustrate \nSL’s treatment of the deferred gain or loss in transition under the requirements \ndescribed in pa ragraph 13A.7.40. \nThe sale occurred immediately before the effective date of Topic 842, so that \nany deferred gain or loss on the sale under Topic 840 has not been amortized \nwhen evaluating the transition adjustment. \nSale and operating leaseback \ntransactio n Deferred gain/loss transition adjustment \nDeferred gain scenarios \nFair value $100 Deferred gain recognized as a financial liability in \ntransition because the gain only arose as a result \nof the sale price exceeding fair value – i.e. if the \nsale price had not exceeded fair value, there \nwould not have been a gain (sale price would not \nhave exceeded carrying amount). Sale price $110 \nCarrying amount $105 \nDeferred gain $ 5 \n Debit Credit \n Deferred gain $5 \n Financial liability $5 \nFair value $100 Deferred gain written off to equity; no portion of \nthe gain is attributable to off -market terms \nbecause the sale price = fair value. Sale price $100 \nCarrying amount $ 95 Debit Credit \nDeferred gain $ 5 Deferred gain $5 \n Equity $5 \nFair value $100 $10 deferred gain is attributable to both (1) sale price exceeding carrying amount and (2) sale price \nexceeding fair value – i.e. there is a $5 effect to \neach. \nTherefore, the deferred gain is written off to both equity and to a new off -market financial liability. Sale price $105 \nCarrying amount $ 95 \nDeferred gain $ 10 \n Debit Credit \n Deferred gain $10 \n Equity $5 \n Financial liability $5 \nFair value $100 Deferred gain recognized as a financial liability in \ntransition because the gain only arose as a result \nof the sale price exceeding fair value – i.e. if the \nsale price had not exceeded fair value, there would not have been a gain (sale price would not \nhave exceeded carrying amount). Sale price $105 \nCarrying amount $100 \nDeferred gain $ 5 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1097}), Document(page\_content='Leases 1097 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Sale and operating leaseback \ntransactio n Deferred gain/loss transition adjustment \n Debit Credit \n Deferred gain $5 \n Financial liability $5 \nFair value $100 Deferred gain written off to equity; no portion of \nthe gain is attributable to off -market terms \nbecause the sale price < fair value. Sale price $ 95 \nCarrying amount $ 90 Debit Credit \nDeferred gain $ 5 Deferred gain $5 \n Equity $5 \nDeferred loss scenarios \nFair value $100 Deferred loss recognized as an adjustment to the new leaseback ROU asset because the sale price \n< fair value (i.e. loss is attributable to off -market \nsale price). Sale price $ 95 \nCarrying amount $100 \nDeferred loss $ 5 Debit Credit \n ROU asset $5 \n Deferred loss $5 \nFair value $100 Deferred loss recognized as an adjustment to the \nnew leaseback ROU asset because the sale price \n< fair value (i.e. loss is attributable to off -market \nsale price). Sale price $ 80 \nCarrying amount $ 95 \nDeferred loss $ 15 Debit Credit \n ROU asset $15 \n Deferred loss $15 \nFair value $100 Deferred loss recognized as an adjustment to the new leaseback ROU asset because the deferred \nloss is attributable to the sale price being less than \nfair value. $5 of the total loss was recognized on \nthe date of sale because the carrying amount > \nfair valu e by that amount. Sale price $ 80 \nCarrying amount $105 \nDeferred loss $ 20 \n Debit Credit \n ROU asset $20 \n Deferred loss $20 \nNo deferred gain/loss scenario \nFair value $100 N/A. There is no deferred gain or loss. The $5 \ndifference between carrying amount and sale \nprice was recognized at the date of sale under \nTopic 840 because the carrying amount of the \nasset > its fair value. Sale price $100 \nCarrying amount $105 \nDeferred gain/loss $ 0 \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1098}), Document(page\_content='Leases 1098 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13A.8 Build -to-suit lease arrangements \n Excerpt from ASC 842 -10 \nTransition and Open Effective Date Information \nGeneral \n> Transition Related to Accounting Standards Update s No. 2016- 02, \nLeases (Topic 842) , No. 2018- 01, Leases (Topic 842): Land Easement \nPractical Expedient for Transition to Topic 842 , No. 2018- 10, Codification \nImprovements to Topic 842, Leases , No. 2018- 11, Leases (Topic 842): \nTargeted Improvements , No. 2018- 20, Leases (Topic 842): Narrow -Scope \nImprovements for Lessors , No. 2019- 01, Leases (Topic 842): Codification \nImprovements , No. 2019- 10, Financial Instruments —Credit Losses (Topic \n326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): \nEffective Dates , No. 2020- 05, Revenue from Contracts with Customers \n(Topic 606) an d Leases (Topic 842): Effective Dates for Certain Entities , \nNo. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with Variable \nLease Payments, No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entities, and No. 2023- 01, Leases \n(Topic 842): Common Control Arrangements \n65-1 The following represents the transition and effective date information \nrelated to Accounting Standards Updates No. 2016- 02, Leases (Topic 842) , \nNo. 2018- 01, Leases (Topic 842): Land Easement Practical Expedient for \nTransition to Topic 842, No. 2018- 10, Codification Improvements to Topic 842, \nLeases , No. 2018- 11, Leases (Topic 842): Targeted Improvements , No. 2018-\n20, Leases (Topic 842): Narrow- Scope Improvements for Lessors , No. 2019- 01, \nLeases (Topic 842): Codification Improvements , No. 2019- 10, Financial \nInstruments —Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), \nand Leases (Topic 842): Effective Dates , No. 2020- 05, Revenue from Contracts \nwith Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain \nEntities , No. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with \nVariable Lease Payments, No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entities, and No. 2023- 01, Leases (Topic \n842): Common Control Arrangements : [Note : See paragraph 842-10-S65-1 for \nan SEC Staff Announcement on transition related to Update 2016- 02.] \nBuild -to-suit lease arrangements \nu. A lessee shall apply a modified retrospective transition approach for leases \naccounted for as build- to-suit arrangements under Topic 840 that are \nexisting at, or entered into after, the beginning of the earliest comparativ e \nperiod presented in the financial statements (if an entity elects the \ntransition method in (c)(1)) or that are existing at the beginning of the \nreporting period in which the entity first applies the pending content that \nlinks to this paragraph (if an ent ity elects the transition method in (c)(2)) as \nfollows: \n1. If an entity has recognized assets and liabilities solely as a result of a \ntransaction’s build -to-suit designation in accordance with Topic 840, the \nentity shall do the following: ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1099}), Document(page\_content='Leases 1099 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. i. If an entity elect s the transition method in (c)(1), the entity shall \nderecognize those assets and liabilities at the later of the beginning \nof the earliest comparative period presented in the financial \nstatements and the date that the lessee is determined to be the \naccount ing owner of the asset in accordance with Topic 840. \nii. If an entity elects the transition method in (c)(2), the entity shall \nderecognize those assets and liabilities at the beginning of the \nreporting period in which the entity first applies the pending cont ent \nthat links to this paragraph. \niii. Any difference in (i) or (ii) shall be recorded as an adjustment to \nequity at the date that those assets and liabilities were \nderecognized in accordance with (u)(1)(i) or (ii). \niv. The lessee shall apply the lessee transition requirements in (k) \nthrough (t) to the lease. \n2. If the construction period of the build- to-suit lease concluded before \nthe beginning of the earliest comparative period presented in the \nfinancial statements (if th e entity elects the transition method in (c)(1)) \nor if it concluded before the beginning of the reporting period in which \nthe entity first applies the pending content that links to this paragraph \n(if the entity elects the transition method in (c)(2)), and the transaction \nqualified as a sale and leaseback transaction in accordance with \nSubtopic 840 -40 before that date, the entity shall follow the general \nlessee transition requirements for the lease. \n \n13A.8.1 Derecognition of build -to-suit assets and liabilities \n13A.8.10 The transition guidance in Topic 842 requires lessees to derecognize \nany assets (e.g. property, plant and equipment or construction- in-progress) and \nliabilities recorded solely as a result of being the accounting owner of a \nconstructi on project under Topic 840 unless both: [842- 10-65-1(u)] \n— const ruction of the asset is in progress at the effective date of Topic 842; \nand \n— the lessee is the accounting owner of the underlying asset under constr uction based on Topic 842 (see section 9.4) . \n13A.8.20 A lessee derecognizes existing build -to-suit assets and liabilities that \nare recorded solely as a result of being the accounting owner of the \nconstruction project under Topic 840 at the effective date. Any difference \nbetween the assets and liabil ities derecognized is recorded in equity on that \ndate – subject to the discussion in Question 13A.8.20 for lessee- paid costs . \n[842- 10-65-1(u)(1)(ii), 65 -1(u)(1)(iii)] \n13A.8.30 [Not used] \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1100}), Document(page\_content='Leases 1100 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 13A.8.10 \nLease classification for build- to-suit leases in \ntransition \nOn transition, how is lease classification assessed when the \nlessee was considered the owner of the asset under \nconstruction under the Topic 840 build- to-suit requirement s? \nBackground: For the purpose of this question, Lessee LE was deemed the \naccounting owner of an asset under construction in a build- to-suit lease \narrangement under Topic 840. The lease inception date was January 1, 2016. \nThe lease commencement date (i.e. the end of the construction period) was \nJanuary 1, 2018. In accordance with paragraph 13A .8.20, the lessee \nderecognizes the underlying asset (see Question 13A.8.20) and related financial \nliability as of the effective date. \nTwo scenarios are discussed in this question. \n1. There was a successful sal e-leaseback under Topic 840 at January 1, 2018 \n(or any later date before January 1, 2019). \n2. The lessee had a failed sale -leaseback at January 1, 2018 and continues to \nrecognize the constructed asset and a financial liability at the effective date of Topic 842 (e.g. January 1, 2019). \nInterpretive response: If the package of transition practical expedients is not \nelected, classification of the lease in either background scenario will be \nassessed as of the lease commencement date (January 1, 2018). This is \nconsistent with the date any other lease is assessed f or classification when the \npackage of practical expedients is not elected (see Question 13A .2.20). \nIn contrast, if the package of transition practical expedients is elected, the \nanswer is more complex. \n— In Scenario 1, a lease exists under Topic 840 before t he effective date, the \nclassification of which would have been assessed as of lease inception \nunder Topic 840. Because the package of practical expedients was elected, \nwe do not believe the lessee should reassess the lease classification that \nwas determined at lease inception. \n— In Scenario 2, in the absence of specific guidance in Topic 842, we believe \nit would be acceptable for the lessee to assess classification of the lease as \nof either : \n— the commencement date of January 1, 2018, using the lease \nclassification guidance in Topic 842; or \n— the inception date of January 1, 2016, using the lease classification \nguidance in Topic 840. \n We belie ve the first approach is acceptable, even though the package of \npractical expedients has been elected, because there was no ‘existing lease’ that had previously been classified under Topic 840. We believe the \nsecond approach is acceptable because election of the package of \ntransition practical expedients effectively grandfathers the legacy Topic 840 \nclassification guidance, w hich required lease classification to be assessed \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1101}), Document(page\_content='Leases 1101 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. as of lease inception. We believe the chosen approach should be applied \nconsistent ly to all similar circumstances. \n \n Question 13A.8.20 \nLessee -paid costs included in existing build- to-suit \nasset s \nIf the carrying amount of a build- to-suit asset includes lessee -\npaid costs, should those amounts be written off at the \neffective date? \nBackground: For purposes of this question, the lessee wa s considered to be \nthe owner of the construction project under T opic 840; as a result, it has \nrecognized assets and liabilities associated with the construction. The transition \nprovisions of Topic 842 require the lessee to remove any assets and liabilities \nstill recorded at the effective date solely as a result of being the accounting \nowner of the construction project under Topic 840 – unless the asset remains \nunder construction at the effective date and the lessee is the accounting owner \nof the construction project under Topic 842 (see section 13A.8.4). \nAssume the les see paid the lessor or a third party amounts during the \nconstruction period that, apart from being considered the owner of the construction project, would have been recognized by the lessee as an asset. \nFor example, t he carrying amount of th e build- to-suit asset may include \namounts paid by the lessee for: \n— construction of the lessor’s owned asset or for lessor -owned leasehold \nimprovements; and/or \n— lessee- owned leasehold or property improvements. \nQuestion 5.4.80 addresses determining the accounting owner of l easehold \nimprovements. \nInterpretive response: It depends on what the accounting for the payments \nwould have been until the effective date absent the previous build- to-suit \nconclusion under Topic 840 that the lessee was the accounting owner of the \nconstruct ion project. \nThe lessee starts by determining the appropriate lease classification (see \nQuestion 13A.8.10) . Next , the lessee determines: \n— what the appropriate accounting treatment for those costs would have been at the time the costs were incurred; and \n— the subsequent accounting for those costs between the date they were incurred and the effective date. \nKey considerations generally include whether the amounts paid by the lessee \nare ‘lease payments ,’ or instead are payments for lessee- owned leasehold or \nproperty improvements . \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1102}), Document(page\_content='Leases 1102 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Operating lease classification \nLessor was accounting owner \nIf the lessor was the accounting owner of the underlying asset or of a leasehold \nor property improvement paid for by the lessee under an operating lease, \namounts paid by the lessee to construct the lessor -owned asset or lessor -\nowned improvement would have been accounted for as part of the ‘minimum \nlease payments’ under Topic 840 . \nFor example, if the lessee paid $100,000 of the costs to construct the lessor -\nowned underlying asset during the construction period, absent the build- to-suit \naccounting, that amount would have been accounted for as a lease \nprepayment. Therefore, when accounting for the lease in transition , the lessee \ndetermines how much of the prepayment that would have existed absent the \nbuild- to-suit accounting would be unamortized at the effective date. The lessee \nthen accounts for the unamortized prepayment based on the Topic 842 lessee \ntransition requirements (se e paragraph 13A.3.50). \nLessee was accounting owner \nIf the lessee was the accounting owner of leasehold or property improvements, \nabsent build- to-suit accounting, the lessee would have recognized the leasehold \nor property improvements as separate items of property, plant and equipment \nThe lessee would have amortized the cost of the improvements over the \nshorter of the (1) non- cancellable period of the lease plus renewal periods \nreasonably assured to be exercised or (2) useful life of the improvements. \nTheref ore, at the effective date, the lessee should continue to recognize PP&E \nwith a carrying amount equal to what the unamortized carrying amount of the \nimprovements would have been had Topic 840 build- to-suit accounting \nnever applied. \nFor example, assume the lessee paid $100,000 for leasehold improvements for \nwhich it was the accounting owner. The lessee recognized those costs as part \nof the cost of the building and was depreciating them over the 30- year useful \nlife of the building. Absent build- to-suit accou nting, the amortization period for \nthe leasehold improvements may have been considerably shorter – e.g. if the \nnon-cancellable period of the lease was 15 years and the lessee was not \nreasonably assured of exercising an option to extend the lease. In that \ncircumstance , the amount that should remain recognized at the effective date is \nthe amount that would be unamortized had the amortization period of the \nleasehold improvements always been 15 years . \nCapital/finance lease classification \nAbsent the build- to-suit accounting, payments to a third party for leasehold or \nproperty improvements, or to the lessor before lease commencement, including during the construction period, may have been capitalized as part of the cost of the capital lease asset. \nUnder Topic 842, the carrying amount of the capital lease asset immediately \nbefore the effective date becomes the carrying amount of the new finance \nlease ROU asset in transition (see paragraph 13A.3.100). Therefore, at the \nTopic 842 effective date, the lessee would capitalize the remaining unamortized \namount of these costs (previously included in property, plant and equipment \nunder Topic 840) into the new finance lease ROU asset. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1103}), Document(page\_content='Leases 1103 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13A.8.2 Evaluating previous build- to-suit conclusio ns \n13A.8. 40 A lessee is not required to reevaluate whether it would have been the \naccounting owner of an asset under construction in accordance with Topic 842 \nunless construction of the asset is in progress at the effective date. This is \nregardless of whether the lessee was the accounting owner of the asset under \nTopic 840. [842- 10-65-1(u)] \n13A.8. 50 If a lessee is determined to be the accounting owner of an asset under \nconstruction as of the effective date for which it was not the accounting owner \nunder Topic 840, it will recognize the assets and liabilities arising from being the \naccounting owner of an asset under construction at the effective date. The \nlessee will account for the assets after the effective date using the Topic 842 \nsale-leaseback guidance . \n \n Observation \nBuild -to-suit transition \nControl guidance applies only on or after the effective date \n13A.8. 60 The changes to the sale- leaseback guidance in Topic 842 will make it \neasier for a lessee that is the accounting owner of an asset under construction \nto derecognize the underlying asset at the end of the construction period. \n13A.8. 70 We believe the Board did not intend for a lessee to look back to periods \nbefore the effectiv e date of Topic 842 to determine whether it would have been \nthe accounting owner of an asset under construction. This intention would be \ninconsistent with much of the Board’s rati onale for its transition approach. It \nwould also appear to be at odds with the guidance on sale- leaseback \ntransactions that says the lessee does not reconsider whether a successful sale \nthat occurred before the effective date would have also been successful under Topic 842. \n13A.8. 80 Instead, Topic 842 requires that the lessee consider whether it is the \nowner of an asset under construction only if construction is ongoing at the \neffective date. \nTopic 842 does not appear to prohibit reevaluation of ownership if the \nlessee was not the accounting owner under Topic 840 \n13A.8. 90 The transition guidance for existing build -to-suit assets and liabilities \nappears to preclude continued recognition of build- to-suit assets and liabilities \non the balance sheet when cons truction is complete by the effective date, even \nif the lessee would have been the accounting owner of the underlying asset \nunder Topic 842. \n13A.8.10 0 However, because the transition guidance is silent, we believe it does \nnot prohibit a lessee from evalua ting under Topic 842 whether it was the \naccounting owner of an asset for which construction was complete by the effective date and for which it was not the accounting owner under Topic 840. \n13A.8.11 0 We expect it to be rare that a lessee would choose to v oluntarily \nmake this evaluation. However, if it does, it should recognize the assets and \nliabilities arising from being the accounting owner of an asset under \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1104}), Document(page\_content='Leases 1104 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. construction at the effective date if a sale would not have occurred before then \nunder the Topic 842 sale- leaseback guidance (Topic 842, rather than Topic 840, \nbecause the lessee is applying Topic 842 in concluding it was the accounting \nowner of the asset under construction) . In that case, the lessee will account for \nthe transaction from the effective date using the Topic 842 sale -leaseback \nguidance. In contrast, if a sale would have occurred under Topic 842 before the \neffective date, the lessee should only account for the lease from the \neffective date. \n \n13A.8.3 Build -to-suit arrangements accounted for as \nsuccessful sale -leaseback transactions \n13A.8.12 0 If the construction period ended before the effective date, and the \ntransaction qualified for sale- leaseback accounting under Topic 840 before that \ndate, the lessee only accounts for a leas e at the effective date because the \nbuild- to-suit assets and liabilities would already have been derecognized before \nthat date. The lessee applies the transition requirements in the same manner as \nit does for other sale- leaseback transactions on transition . For further discussion \nof the sale- leaseback transition provisions of Topic 842, see section 13A.7. \n[842- 10-65-1(u)(2)] \n \n13A.8.4 Lessee was the accounting owner under Topic 840 \n13A.8.13 0 The following diagram summarizes the transition requirements for a \nnumber of potential build- to-suit transition scenarios when the lessee was the \naccounting owner under Topic 840. \n Construction \ncompleted before the \neffective date\nScenario 1Construction is in \nprogress at the \neffective date\nScenario 2\nNot required to \nreevaluate under \nTopic 842 build -to-suit \nguidance\nWere sale criteria met \nunder Topic 840 sale-\nleaseback guidance ?Reevaluate under \nTopic 842 build -to-suit \nguidance\nIs the lessee the \naccounting owner \nunder Topic 842?\nContinue to account \nfor build -to-suit assets \nand liabilities until \nsale of the asset \noccurs based on \nTopic 842 sale-\nleaseback guidanceDerecognize the \nbuild -to-suit assets \nand liabilities as of the \neffective date and \napply the general \nlessee transition \nguidance to the lease1\nApply the general \nsale-leaseback \ntransition guidanceYes YesNo No', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1105}), Document(page\_content='Leases 1105 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Note: \n1. See section 13A.3 for discussion of the lessee transition provisions of Topic 842. \nScenario 1: Construction completed before the effective date \n13A.8.14 0 The lessee does not evaluate whether it would have been the \naccounting owner of the asset under Topic 842 because construction was \ncompleted before the effective date. The lessee’s tra nsition accounting will \ndepend on whether the Topic 840 sale criteria for a sale- leaseback transaction \nwere met. \n13A.8.15 0 When the Topic 840 sale criteria for a sale- leaseback transaction were \nmet before the effective date, the lessee does not reevaluate that conclusion, \nand applies the Topic 842 transition guidance to the sale- leaseback. \n13A.8.16 0 When the construction period ended before the effective date, but the \nTopic 840 sale criteria for a sale -leaseback transaction were not met, the lessee \nderecognizes the build- to-suit assets and liabilities that were recognized under \nTopic 840 as of the effective date. Any difference is recorded as an adjustment \nto equity at that date (after consideration of the guidance in Question 13A.8.20). \nThe lessee then applies the general lessee transition guidance to the lease. \nScenario 2: Construction is in progress at the effective date \n13A.8.17 0 The lessee reevaluates whether it is the accounting owner of the \nasset under Topic 842 at the effective date. If it is considered the accounting \nowner , the lessee continues to recognize the construction- in-progress assets \nand liabilities that arose because the lessee is the accounting owner until they \nqualify for derecognition under the sale -leaseback requirements of Topic 842. \n13A.8.18 0 If the lessee is not considered the accounting owner, it derecognizes \nthe build- to-suit assets and liabilities that it recognized under Topic 840 as of \nthe effective date. The lessee records the difference as an adjustment to equity \nat that date (after consideration of the guidance in Question 13A.8.20). The \nlessee then applies the general lessee transition guidance to the lease. \n \n13A.8.5 Lessee was not the accounting owner under \nTopic 840 \n13A.8. 190 The following diagram summarizes our u nderstanding of the transition \nrequirements for potential build- to-suit transition scenarios when the lessee \nwas not the accounting owner under Topic 840. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1106}), Document(page\_content='Leases 1106 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Construction completed \nbefore the effective date\nScenario 3\nNot required to \nreevaluate under \nTopic 842 build-to-suit \nguidance\nApply general lessee \ntransition guidance to \nthe leaseConstruction is in \nprogress at the effective \ndate\nScenario 4\nReevaluate under Topic 842 \nbuild-to-suit guidance\nIs the lessee the accounting \nowner under Topic 842?\nNo accounting \nuntil lease \ncommencementRecognize \nbuild-to-suit assets \nand liabilities at the \neffective dateYes No \nScenario 3: Construction completed before the effective date \n13A.8.20 0 The lessee is not required to evaluate whether it would have been the \naccounting owner of the asset while it was under construction in accordance \nwith Topic 842. However, we do not believe the transition guidance prohibits a \nlessee from making t his evaluation (see paragraph 13A.8.110). \n13A.8.21 0 If the lessee does not undertake this evaluation, it applies the general \nlessee transition requirements to the lease. \n13A.8.22 0 In the unlikely event that the lessee chooses to evaluate whether it \nwoul d have been the accounting owner under Topic 842, it should follow the \nguidance in paragraph 13A.8.110. \nScenario 4: Construction is in progress at the effective date \n13A.8.23 0 The lessee evaluates whether it controls, at the effective date of \nTopic 842, a n underlying asset a developer is presently constructing or \ndesigning that it will subsequently lease. If it controls the underlying asset, it \nwill be the accounting owner under Topic 842. \n13A.8.24 0 The lessee recognizes the assets and liabilities resulti ng from the \nconclusion that it is the accounting owner of the asset under construction at the \neffective date. The lessee will account for the transaction in accordance with \nthe sale- leaseback guidance in Topic 842 from the effective date. \n13A.8.25 0 If the lessee was not the accounting owner of the asset under either \nTopic 840 or Topic 842, then the lessee applies the requirements of Topic 842 \nat lease commencement. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1107}), Document(page\_content='Leases 1107 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Observation \nLessees with build -to-suit leases may early adopt \n13A.8.26 0 In many cases, the transition provisions in Topic 842 permit (or \nrequire) lessees to derecognize build -to-suit assets and liabilities that were \npreviously recognized under Topic 840, including such assets and liabilities that \nremained recognized because of the Topic 840 sale- leaseback requirements. \n13A.8.27 0 In addition, the changes to the sale- leaseback guidance in Topic 842 \nmake it easier for many lessees to derecognize build- to-suit assets and liabilities \nat the end of the construction period. Fewer build -to-suit arrangements for \nwhich a lessee is determined to be the accounting owner will result in failed sales. \n13A.8.28 0 Therefore, some lessees for which these factors are relevant may \nearly adopt Topic 842. \n \n Observation \nSAB Topic 11.M disclosure of impact on future \nperiods \n13A.8. 290 SEC registrants are required to evaluate new accounting standards \nthat they have not yet adopted and to disclose their potential material effects. These disclosures generally should include a discussion about the effect that \nadoption is expected to have on the financial statements, unless this is not \nknown or reasonably estimable. \n[SAB Topic 11.M] \n13A.8.30 0 As discussed in paragraph 13A .8.10, on transition a lessee may \nderecognize significant property, plant and equipment and debt obligations that \noriginally arose from build- to-suit lease arrangements. In their place, the lessee \nmay recognize ROU assets and lease liabilities for the l ease of the constructed \nassets. \n13A.8.31 0 If this is the case for a lessee, among other disclosures it should likely \nprovide in accordance with SAB Topic 11.M , it should disclose these facts and \nprovide a quantification of the related amounts. If precise quantification of the \namounts is not yet practicable, a range may be prov ided. We believe the SEC \ngenerally expects that a lessee will refine its estimates (i.e. narrow the ranges previously provided) as the effective date approaches, and that it will not be \nacceptable for an entity to provide ‘boilerplate’ disclosures while on ly stating \nthat it is continuing to evaluate the effect of Topic 842. KPMG has developed \nexample SAB 74 disclosures that may be used as a starting point by lessees \nand lessors in drafting disclosures about the effects of adopting Topic 842: \nASC 842, Leases – Transition disclosures\n. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1108}), Document(page\_content='Leases 1108 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13A.9 Previous business combinations \n Excerpt from ASC 842 -10 \nTransition and Open Effective Date Information \nGeneral \n> Transition Related to Accounting Standards Update s No. 2016- 02, \nLeases (Topic 842) , No. 2018- 01, Leases (Topic 842): Land Easement \nPractical Expedient for Transition to Topic 842 , No. 2018- 10, Codification \nImprovements to Topic 842, Leases , No. 2018- 11, Leases (Topic 842): \nTargeted Improvements , No. 2018- 20, Leases (Topic 842): Narrow -Scope \nImprovements for Lessors , No. 2019- 01, Leases (Topic 842): Codification \nImprovements , No. 2019- 10, Financial Instruments —Credit Losses (Topic \n326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): \nEffective Dates , No. 2020- 05, Revenue from Contracts with Customers \n(Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities , \nNo. 2021- 05, Leases (Topic 842): Lessors —Certain Le ases with Variable \nLease Payments, No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entities, and No. 2023- 01, Leases \n(Topic 842): Common Control Arrangements \n65-1 The following represents the transition and effective date information \nrelated to Accounting Standards Updates No. 2016- 02, Leases (Topic 842) , \nNo. 2018- 01, Leases (Topic 842): Land Easement Practical Expedient for \nTransition to Topic 842, No. 2018- 10, Codification Improvements to Topic 842, \nLeases , No. 2018- 11, Leases (Topic 842): Targeted Improvements , No. 2018-\n20, Leases (Topic 842): Narrow- Scope Improvements for Lessors , No. 2019- 01, \nLeases (Topic 842): Codification Improvements , No. 2019- 10, Financ ial \nInstruments —Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), \nand Leases (Topic 842): Effective Dates , No. 2020- 05, Revenue from Contracts \nwith Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain \nEntities , No. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with \nVariable Lease Payments, No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entities, and No. 2023- 01, Leases (Topic \n842): Common Control Arrangements : [Note : See paragraph 842-10-S65-1 for \nan SEC Staff Announcement on transition related to Update 2016- 02.] \nAmounts previously recognized in respect of business combinations \nh. If an entity has previously recognized an asset or a liability in accordance \nwith Topic 805 on business combinations relating to favorable or \nunfavorable terms of an operating lease acquired as part of a business \ncombination, the entity shall do all of the following: \n1. Derecognize that asset and liability (except for those arising from \nleases that are classified as operating leases in accordance with \nTopic 842 for which the entity is a lessor). \n2. Adjust the carrying amount of the right -of-use asset by a corr esponding \namount if the entity is a lessee. \n3. Make a corresponding adjustment to equity if assets or liabilities arise \nfrom leases that are classified as sales -type leases or direct financing ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1109}), Document(page\_content='Leases 1109 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. leases in accordance with Topic 842 for which the entity is a les sor. \nAlso see (w). \ne \n13A.9.10 If an entity previously recognized an asset (liability) relating to favorable \n(unfavorable) terms of an operating lease acquired as part of a business \ncombination: [842- 10-65-1(h)] \n— a lessee derecognizes that asset (liability), and adjusts the carrying amount \nof the ROU asset recognized on transition by a corresponding amount. \n— a lessor derecognizes that asset (liability) only if it arises from a sales‑ type \nor direct financing lease, and makes a corresponding adjustment to equity. \nThe lessor should also cons ider section 13 A.4.2 for transition guidance \nwhen the lease classification changes. \n13A.9.20 A favorable lease asset or unfavorable lease liability associated with an \noperating lease is not written off in transition by lessors. Lessors will continue \nto recognize such favorable lease assets or unfavorable lease liabilities even \nafter the adoption of the amendments to Topic 805 (business combinations) included in ASU 2016- 02; for a discussion about leases acquired in a business \ncombination or asset acquisit ion, see chapter 11. \n[842- 10-65-1(h)(1)] \n \n Observation \nImpact of previously recognized favorable lease \nasset or unfavorable lease liability on lessee’s \nsubsequent accounting \n13A.9.30 Topic 842 does not prescribe or illustrate the subsequent accounting \nfor a lease of a lessee that, at the effective date, is affected by a previously \nrecognized favorable lease asset or unfavorable lease liability, other than to say that the asset or liability is written off as an adjustment to the effective date \nROU asset. However, we believe that: \n— a favorable lease asset would affect the accounting for the lease on and \nafter the effective date in the same manner as initial direct costs – i.e. \nit would in crease the lessee’s ROU asset recognized at the effective date; \nand \n— an unfavorable lea se liability would affect the accounting for the lease after \nthe effective date in the same manner as a lease incentive – i.e. it would \ndecrease the lessee’s ROU asset recognized at the effective date. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1110}), Document(page\_content='Leases 1110 \n13A. Effective dates and transition: effective date method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 13A.9.10 \n(Un)favorable contract (liabilities) assets for \ncontracts not accounted for as leases under \nTopic 840 \nHow should a lessee account for a favorable (unfavorable) \ncontract asset (liability) when a non- lease contract is \nreassessed as a lease on transition to Topic 842? \nBackground: Assume that Company AR acquired Company AE before either \nentity adopted Topic 842. As part of AR’s acquisition accounting, it recorded \neither a favorable contract intangibl e asset or an unfavorable contract liability for \nan existing service contract for which AE was the customer and had \nappropriately determined the contract was not a lease under Topic 840. \nAt adoption, AR does not elect the transition package of practical ex pedients \n(see section 13A.2), and therefore reassesses the AE contract against the Topic \n842 lease definition. Based thereon, the AE contract meets the definition of a \nlease. \nIn this situation, the question arises about how to account for the remaining \nfavorable contract intangible asset or unfavorable contract liability at adoption, \nnoting that lessees no longer recognize either for leases after the adoption of \nTopic 842 (see paragraph 11.1.10), and at adoption derecognize any such assets \nor liabilities fo r existing operating leases as an adjustment to the new ROU \nasset. \nInterpretive response: We believe the lessee should derecognize the existing \ncontract asset (liability) at the adoption date, with a corresponding adjustment to the ROU asset. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1111}), Document(page\_content='Leases 1111 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13B. Effective dates and \ntransition : comparative \nmethod \nDetailed contents \nItem significantly updated in this chapter: # \nNew item added to this chapter: \*\* \nStructure of transition chapters \nHow the standard works \n13B.1 Effective dates # \nQuestions \n13B.1.10 Early adoption considerations \n13B.1.20 [Not used] \n13B.1.30 Issuance of a registration statement on Form S -3 after the \neffective date \n13B.1.40 Effects of adoption of Topic 842 by a succ essor entity on \npredecessor periods \n13B.1.50 Effective date for certain public business entities \n13B.1.60 Effective date for an entity in the process of an initial public \noffering (IPO) \*\* \n13B.2 Transition principles – lessees and lessors \n13B.2.1 Transition approach – general \n13B.2.2 Transition approach – modifications \n13B.2.3 Practical expedients \n13B.2.4 Land easements \n13B.2.5 Disclosures \nObservations \nImpact on initial direct costs f or entities not electing the package of \npractical expedients \nPrior land easement accounting is grandfathered \nEffect of adoption on the financial statements \nQuestions \n13B.2.10 Accounting for modifications that occur during the transition \nperiod ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1112}), Document(page\_content='Leases 1112 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13B.2.20 Date of lease classification reassessment \n13B.2.30 Hindsight practical expedient – effect on lease classification \nif package of practical expedients elected \n13B.2.40 Hindsight pra ctical expedient – lessee options \n13B.2.50 Hindsight practical expedient – existing capital (sales-\ntype/direct financing) leases \n13B.2.60 Hindsight practical expedient – short -term leases \n13B.2.70 Hindsight practical expedient – changes to straight -line \noperating lease income (expense) \n13B.2.80 Hindsight practical expedient – remeasurement events \n13B.2.90 Hindsight practical expedient – modifications and changes to \nan index or rate on which varia ble lease payments are based \n13B.2.100 Errors in applying Topic 840 \n13B.2.110 Grandfathering arrangements committed or agreed to \nbefore reporting periods beginning after May 28, 2003 \n13B.2.120 Land easements arising before the effective date \n13B.2.130 Disclosures in comparative periods \nExample \n13B.2.10 Applying hindsight with lease remeasurements and modifications\n \n13B.3 Transition for lessees # \n13B.3.1 Lessee elects package of practical expedients \n13B.3.2 Lessee does not elect package of practical expedients \n13B.3.3 ASU 2021- 09, Discount Rate for Lessees That Are Not \nPublic Business Entities \n13B.3.4 ASU 2023- 01, Common C ontrol Arrangements \*\* \nObservation \nChanges in lessee lease classification in transition \nQuestions \n13B.3.10 Minimum rental payments \n13B.3.20 Excluding CAM costs \n13B.3.30 Measurement of lease payments that depend on an index or \nrate in determining the operating lease liability \n13B.3.40 Foreign exchange rate to use in transition when the lease is not denominated in the entity’s functional currency\n \n13B.3.50 Determining the incremental borrowing rate in transition \n13B.3.60 ROU asset abandoned bef ore the date of initial application ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1113}), Document(page\_content='Leases 1113 \n13B. Effective dates and transition : comparative method \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13B.3.70 Executory costs that are part of Topic 420 liabilities on \ntransition \n13B.3.80 Transitio n guidance for Topic 420 liabilities results in \nnegative ROU asset carrying amount \n13B.3.90 Existing sublease liabilities under Topic 840 \n13B.3.100 Accounting for foreign currency gains/losses during transition\n \n13B.3.110 Effects of Topic 360 impairments before the effecti ve date \n13B.3.120 Transition impact on prior asset group impairments \n13B.3.130 Recognizing ‘hidden’ ROU asset impairments on transit ion \n13B.3.140 Amortization period for leasehold improvements previously acquired in a business combination\n \nExamples \n13B.3.10 Lessee transition for an existing operating lease with package of practical expedients elected – Approach A \nin Question 13B.3.10\n \n13B.3.20 Lessee transition for an existing operating lease \nwith package of practical expedients elected – Approach B \nin Question 13B.3.10 \n13B.3.30 Lessee transition for an existing capital lease with package \nof practical expedients elected \n13B.3.40 Lessee transition for operating lease under Topic 840 classified as a finance lease under Topic 842 – package of \npractical expedients not elected\n \n13B.4 Transition for lessors \n13B.4.1 Lessor elects package of practical expedients \n13B.4.2 Lessor does not elect package of practical expedients \n13B.4.3 ASU 2018- 20, Narr ow-Scope Improvements for Lessors \n13B.4.4 ASU 2019- 01 , Codification Improvements \n13B\n.4.5 ASU 2021- 05, Lessors —Certain Leases with Variable Lease \nPayments \n13B.4.6 ASU 2023- 01, Common C ontrol Arrangements \*\* \nObservations \nChanges in lessor lease classification in transition \nInitial direct costs included in the net investment in a sales ‑type or\ndirect financing lease \nQuestions \n13B.4.10 Offset to assets and liabilities written- off on transition ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1114}), Document(page\_content='Leases 1114 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13B.4.20 Revenue recognition guidance for arrangements that no \nlonger meet the definition of a lease \nExample \n13B.4.10 Lessor transition for an operating lease under Topic 840 \nclassified as a sales ‑type lease under Topic 842 \n13B.5 Applying the guidance on components of a contract in transition \n13B.5.1 Lessee guidance \n13B.5.2 Lessor guidance – practical expedient for separation of lease \nand non- lease components does not apply \n13B.5.3 Lessor guidance – practical expedient for separation of lease \nand non- lease components applies \nObservation \nLessor reallocation may be permissible in some cases \nQuestions \n13B.5.10 Not separating lease from non-lease components for \nexisting leases on transition \n13B.5.20 Accounting policy implications of separating lease from non-lease components for existing leases on transition\n \n13B.5.30 Topic 842 and Topic 606 interaction in accounting for CAM \n13B.5.40 Existing arrangements with lease and non -lease elements – \nsubstantial services \n13B.6 Leveraged leases \nQuestion \n13B.6.10 Acquired leveraged leases \n13B.7 Sale-leaseback transactions \nQuestions \n13B.7.10 Leaseback accounting on transition for previously failed \nsales \n13B.7.20 Successful sale -leaseback transactions that include seller -\nlessee repurchase options on adoption of Topic 606 \nExamples \n13B.7.10 Sale-leaseback transaction previously accounted for as a \nsale and an operating leaseback under Topic 840 \n13B.7.20 Sale-leaseback deferred gains and losses in transition \n13B.8 Build -to-suit lease arrangements \n13B.8.1 Derecognition of build- to-suit assets and liabilities \n13B.8.2 Evaluating previous build- to-suit conclusions ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1115}), Document(page\_content='Leases 1115 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13B.8.3 Build -to-suit arrangements accounted for as successful sale -\nleaseback transactions \n13B.8.4 Lessee was the accounting owner under Topic 840 \n13B.8.5 Lessee was not the accounting owner under Topic 840 \nObservations \nBuild -to-suit transition \nLessees with build- to-suit leases may early adopt \nSAB Topic 11.M disclosure of impact on future periods \nQuestions \n13B.8.10 Lease classificatio n for build- to-suit leases on transition \n13B.8.20 Lessee- paid costs included in existing build -to-suit assets \n13B.9 Previous business combinations \nObservation \nImpact of previously recognized favorable lease asset or unfavorable \nlease liability on lessee’s subsequent accounting \nQuestion \n13B.9.10 (Un)favorable contract (liabilities) assets for contracts not \naccounted for as leases under Topic 840 \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1116}), Document(page\_content='Leases 1116 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Structure of transition chapters \nThe discussion of transition has been divided into two separate chapters. \n— This cha pter discusses the ‘comparative method’, which is the original \ntransition method in ASU 2016- 02. \n— Chapter 1 3A discusses the ‘effective date method’, which is the additional \ntransition method introduced by ASU 2018- 11. \nFor purposes of comparison, the Quest ion numbers are the same in each of \nthese transition chapters. If a question is not applicable to one chapter, that \nquestion is indicated as ‘Not used’ in the ‘Detailed contents.’ \nThe guidance that follows in this chapter should be used only by those who \nelect the comparative method. \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1117}), Document(page\_content='Leases 1117 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. How the standard works \nTopic 842 requires entities to use a modified retrospective transition method. \nEntities that use the compar ative method record the cumulative -effect \nadjustment to the opening balance of retained earni ngs as of the beginning of \nthe earliest comparative period presented in the financial statements . From that \ndate to the effective date, an entity applies the Topic 842 transition guidance to \nnew and existing leases. \nEffective date: Public business \nentities:1 \nAnnual and interim \nperiods in fiscal \nyears beginning \nafter December 15, \n2018. Public not -for-profit \nentitie s:2,3 \nAnnual and interim \nperiods in fiscal \nyears beginning \nafter December 15, \n2019. \n Other entities: \n— Annual periods in fiscal years \nbeginning after December 15, \n2021. \n— Interim periods in fiscal years \nbeginning after \nDecember 15, 2022. \nDate of initial \napplication: The beginning of the earliest period presented in the entity’s first \nannual financial statements in which Topic 842 is applied. For a \npublic business entity with a calendar year -end that does not early \nadopt Topic 842, this date will be January 1, 2017. For a private \ncompany with a calendar year -end that does not early adopt Topic \n842 and presents one year of historical information, t his date will \nbe January 1, 2021. \nEarly adoption: All entities can adopt Topic 842 immediately. \nTransition \nmethod: Modified retrospective, with application of the new guidance to all \nperiods presented in the financial statements . \nTransition date: As referred to in this chapter, the date on which an entity applies \nthe transition requirements to a lease that commences before the \neffective date or early adoption date, which is the later of: (1) the \nbeginning of the earliest period presented in the financial \nstatements in which Topic 842 is initially applied, or (2) the \n‘commencement date’ for the lease (see section 5.1). \nPackage of \npractical \nexpedients (all \nor nothing): An entity may elect not to reassess: \n— whether expired or existing contracts contain leases under the \nnew definition of a lease; \n— lease classification for expired or existing leases; and \n— whether previously capitalized initial direct costs would qualify \nfor capitalization under Topic 842. \nUse of \nhindsight: — Hindsight allowed when considering the likelihood that lessee \noptions to extend or terminate a lease or purchase the \nunderlying asset will be exercised. \n— Elect on its own or with the package of practical expedients. \nLand \neasements: — May elect not to assess at transition whether any expired or \nexisting land easements are, or contain, leases if they were not \npreviously accounted for as leases under Topic 840. \n— Elect on its own or with the package of practical expedients \nand/or hindsight . ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1118}), Document(page\_content='Leases 1118 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Note s: \n1. This includes (1) public business entities, (2) public not‑for‑profit entities not addressed \nby Note 3, and ( 3) employee benefit plans that file or furnish financial statements with or \nto the SEC. \n2. ‘Public’ not -for-profit entities are those that have issued or are conduit bond obligors for \nsecurities that are traded, listed or quoted on an exchange or an over -the-counter market. \n3. Public not -for-profit entities are eligible to elect this effective dat e if they did not issue \nGAAP- compliant financial statements reflecting the adoption of Topic 842 before June 3, \n2020 (the issuance date of ASU 2020 -05). \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1119}), Document(page\_content='Leases 1119 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13B.1 Effective dates # \n Excerpt from ASC 842 -10 \nTransition and Open Effective Date Information \nGeneral \n> Transition Related to Accounting Standards Update s No. 2016- 02, \nLeases (Topic 842) , No. 2018- 01, Leases (Topic 842): Land Easement \nPractical Expedient for Transition to Topic 842 , No. 2018- 10, Codification \nImprovements to Topic 84 2, Leases , No. 2018- 11, Leases (Topic 842): \nTargeted Improvements , No. 2018- 20, Leases (Topic 842): Narrow -Scope \nImprovements for Lessors , No. 2019- 01, Leases (Topic 842): Codification \nImprovements , No. 2019- 10, Financial Instruments —Credit Losses (Topic \n326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): \nEffective Dates , No. 2020- 05, Revenue from Contracts with Customers \n(Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities , \nNo. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with Variable \nLease Payments , No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entities , and No. 2023- 01, Leases \n(Topic 842): Common Control Arrangements \n65-1 The following represents the transition and effective date information \nrelated to Accounting Standards Updates No. 2016- 02, Leases (Topic 842) , \nNo. 2018- 01, Leases (Topic 842): Land Easement Practical Expedient for \nTransition to Topic 842, No. 2018- 10, Codification Improvements to Topic 842, \nLeases , No. 2018- 11, Leases (Topic 842): Targeted Improvements , No. 2018-\n20, Leases (Topic 842): Narrow- Scope Improvements for Lessors , No. 2019- 01, \nLeases (Topic 842) : Codification Improvements , No. 2019- 10, Financial \nInstruments —Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), \nand Leases (Topic 842): Effective Dates , No. 2020- 05, Revenue from Contracts \nwith Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain \nEntities , No. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with \nVariable Lease Payments , No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entities , and No. 2023- 01, Leases (Topic \n842): Common Control Arrangements : [Note : See paragraph 842-10-S65-1 for \nan SEC Staff Announcement on transition related to Update 2016- 02.] \na. A public business entity , a not-for-profit entity that has issued or is a \nconduit bond obligor for securities that are traded, listed, or quoted on an \nexchange or an over -the-counter market (with an exception for those \nentities that have not yet issued their financial statements or made \nfinancial stateme nts available for issuance as described in the following \nsentence) , and an employee benefit plan that files or furnishes financial \nstatements with or to the U.S. Securities and Exchange Commission shall \napply the pending content that links to this paragraph for financial \nstatements issued for fiscal years beginning after December 15, 2018, and \ninterim periods within those fiscal years. A not -for-profit entity that has \nissued or is a conduit bond obligor for securities that are traded, listed, or \nquoted on a n exchange or an over -the-counter market that has not yet \nissued financial statements or made financial statements available for ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1120}), Document(page\_content='Leases 1120 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. issuance as of June 3, 2020 shall apply the pending content that links to \nthis paragraph for fiscal years beginning after Decem ber 15, 2019, and \ninterim periods within those fiscal years. Earlier application is permitted. \nb. All other entities shall apply the pending content that links to this \nparagraph for financial statements issued for fiscal years beginning after \nDecember 15, 2021 , and interim periods within fiscal years beginning after \nDecember 15, 20 22. Earlier application is permitted. \n> Transition Related to Accounting Standards Update No. 2018- 11, \nLeases (Topic 842): Targeted Improvements \n65-2 The following represent s the transition and effective date information \nrelated to Accounting Standards Update No. 2018- 11, Leases (Topic 842) : \nTargeted Improvements : \na. An entity that has not yet adopted the pending content that links to \nparagraph 842- 10-65-1 shall apply the pending content that links to \nparagraph 842- 10-65-2, by class of underlying asset, to all new and existing \nleases when the entity first applies the pending content that links to \nparagraph 842- 10-65-1 and shall apply the same transition method elected \nfor the pending content that links to paragraph 842- 10-65-1. \nb. An entity that has adopted the pending content that links to paragraph 842-\n10-65-1 shall apply the pending content that links to this paragraph, by \nclass of underlying asset, to all new a nd existing leases either: \n1. In the first reporting period following the issuance of the pending \ncontent that links to paragraph 842- 10-65-2 \n2. At the original effective date of this Topic for that entity as determined \nin paragraph 842-10-65-1(a) and (b). \nc. An en tity that has adopted the pending content that links to paragraph 842-\n10-65-1 shall apply the pending content that links to this paragraph, by \nclass of underlying asset, to all new and existing leases either: \n1. Retrospectively to all prior periods beginning with the fiscal years in \nwhich the pending content that links to paragraph 842- 10-65-1 was \ninitially applied \n2. Prospectively. \n> Transition Related to Accounting Standards Update No. 2018- 20, \nLeases (Topic 842): Narrow -Scope Improvements for Lessors \n65-3 The following represents the transition and effective date information \nrelated to Accounting Standards Update No. 2018- 20, Leases (Topic 842): \nNarrow -Scope Improvements for Lessors : \na. An entity that has not yet adopted the pending content that links to \nparagraph 842- 10-65-1 shall apply the pending content that links to this \nparagraph to all new and existing leases when the entity first applies the \npending content that links to paragraph 842- 10-65-1 and shall apply the \nsame transition method elec ted for the pending content that links to \nparagraph 842- 10-65-1. \nb. An entity that has adopted the pending content that links to paragraph 842-\n10-65-1 before the issuance of the pending content that links to this \nparagraph shall adopt the pending content that links to this paragraph to all \nnew and existing leases at the original effective date of this Topic for that \nentity as determined in paragraph 842- 10-65-1(a) through (b). Alternatively, \nan entity that has adopted the pending content that links to paragrap h 842 -', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1121}), Document(page\_content='Leases 1121 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 10-65-1 may adopt the pending content that links to this paragraph to all \nnew and existing leases either: \n1. In the first reporting period ending after the issuance of the pending \ncontent that links to this paragraph \n2. In the first reporting period beginn ing after the issuance of the pending \ncontent that links to this paragraph. \nc. An entity that has adopted the pending content that links to paragraph 842-\n10-65-1 before the issuance of the pending content that links to this \nparagraph shall apply the pending c ontent that links to this paragraph to all \nnew and existing leases either: \n1. Retrospectively to all prior periods beginning with the fiscal years in \nwhich the pending content that links to paragraph 842- 10-65-1 was \ninitially applied \n2. Prospectively. \n> Transition Related to Accounting Standards Update s No. 2019- 01, \nLeases (Topic 842): Codification Improvements , No. 2019- 10, Financial \nInstruments —Credit Losses (Topic 326), Derivatives and Hedging (Topi c \n815), and Leases (Topic 842): Effective Dates , and No. 2020- 05, Revenue \nfrom Contracts with Customers (Topic 606) and Leases (Topic 842): \nEffective Dates for Certain Entities \n65-4 The following represents the transition and effective date information \nrelated to Accounting Standards Updates No. 2019- 01, Leases (Topic 842) : \nCodification Improvements , No. 2019 -10, Financial Instruments —Credit Losses \n(Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): \nEffective Dates , and No. 2020- 05, Revenue from Contracts with Customers \n(Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities : \na. All entities within the scope of paragraph 842- 10-65-1(a) shall apply the \npending content that links to this paragraph for financial statements issued \nfor fiscal years beginning after December 15, 2019, and interim periods \nwithin those fiscal years (with an exception for those entities that have not \nyet issued their financial statements or made financial statements available \nfor issuance as descr ibed in the following sentence). A not-for-profit \nentity that has issued or is a conduit bond obligor for securities that are \ntraded, listed, or quoted on an exchange or an over -the-counter market that \nhas not yet issued financial statements or made financial statements \navailable for issuance as of June 3, 2020 shall apply the pending content \nthat links to this paragraph for fiscal years beginning after December 15, \n2019, and interim periods within those fiscal years . All other entities shall \napply the pending content that links to this paragraph for financial \nstatements issued for fiscal years beginning after December 15, 20 21, and \ninterim periods within fiscal years beginning after December 15, 20 22. \nEarly application is permitted. \nb. An entity shall apply the pending content that links to this paragraph as of \nthe date that it first applied the pending content that links to \nparagraph 842-10-65-1 and shall apply the same transition method elected \nfor the pending content that links to paragraph 842- 10-65-1 in accordance \nwith paragraph 842 -10-65-1(c). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1122}), Document(page\_content='Leases 1122 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. > Transitio n Related to Accounting Standards Update No. 2021 -05, \nLeases (Topic 842): Lessors —Certain Leases with Variable Lease \nPayments \n65-5 The following represents the transition and effective date information \nrelated to Accounting Standards Update No. 2021- 05, Leases (Topic 842): \nLessors —Certain Leases with Variable Lease Payments : \na. An entity that has not yet adopted the pending content that links to \nparagraph 842- 10-65-1 as of July 19, 2021, shall apply the pending content \nthat links to this paragraph when it first applies the pending content that \nlinks to paragraph 842- 10-65-1 and shall apply the same transition method \nelected for the pending content that links to paragraph 842- 10-65-1. \nb. An entity within the scope of paragraph 842- 10-65-1(a) that has adopted \nthe pending content that links to paragraph 842- 10-65-1 as of July 19, \n2021, shall apply the pending content that links to this paragraph for fiscal \nyears beginning after December 15, 2021, and interim periods within those \nfiscal years. Earlier application i s permitted. \nc. An entity within the scope of paragraph 842- 10-65-1(b) that has adopted \nthe pending content that links to paragraph 842- 10-65-1 as of July 19, \n2021, shall apply the pending content that links to this paragraph for fiscal \nyears beginning after December 15, 2021, and interim periods within fiscal \nyears beginning after December 15, 2022. Earlier application is permitted. \nd. An entity within the scope of (b) or (c) shall apply the pending content that \nlinks to this paragraph by using one of the foll owing two methods: \n1. Retrospectively to the date in which the pending content that links to \nparagraph 842- 10-65-1 was adopted (the beginning of the period of \nadoption of Topic 842). Under this transition method, the entity shall \napply the pending content tha t links to this paragraph to leases that \ncommence or are modified on or after the beginning of the period of its \nadoption of Topic 842 and do not meet the conditions in paragraph 842-\n10-25-8. \n2. Prospectively to leases that commence or are modified on or aft er the \ndate that the entity first applies the pending content that links to this \nparagraph and do not meet the conditions in paragraphs 842- 10- 25-8. \ne. An entity within the scope of (b) or (c) that elects the transition method in \n(d)(1) shall provide the fo llowing transition disclosures: \n1. The applicable transition disclosures required by Topic 250 on \naccounting changes and error corrections, except for the requirements \nin paragraph 250- 10-50-1(b)(2) and paragraph 250 -10-50-3 \n2. The transition disclosures in pa ragraph 250- 10-50-1(b)(3) as of the \nbeginning of the earliest period presented but not before the date in \nwhich the pending content that links to paragraph 842- 10-65-1 was \nadopted. \nf. An entity within the scope of (b) or (c) that elects the transition method in \n(d)(2) shall provide the following transition disclosures: \n1. The nature of and reason for the change in accounting principle \n2. The transition method \n3. A qualitative description of the financial statement line items affected \nby the change. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1123}), Document(page\_content='Leases 1123 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Transition Relat ed to Accounting Standards Update No. 2021 -09, Leases \n(Topic 842): Discount Rate for Lessees That Are Not Public Business \nEntities \n65-6 The following represents the transition and effective date information \nrelated to Accounting Standards Update No. 2021- 09, Leases (Topic 842): \nDiscount Rate for Lessees That Are Not Public Business Entities : \na. An entity that has not yet adopted the pending content that links to \nparagraph 842- 10-65-1 as of 11/11/2021 shall apply the pending content \nthat links to this paragraph to all new and existing leases when the entity \nfirst applies the pending content that l inks to paragraph 842- 10-65-1. That \nentity shall apply the same transition method elected for the pending \ncontent that links to paragraph 842- 10-65-1. \nb. An entity that has adopted the pending content that links to paragraph 842-\n10-65-1 (as of 11/ 11/2021) shall: \n1. Apply the pending content that links to this paragraph for financial \nstatements issued for fiscal years beginning after December 15, 2021, \nand interim periods within fiscal years beginning after December 15, \n2022. Earlier application is permitted as of the beginning of the fiscal \nyear of adoption. \n2. Apply the pending content that links to this paragraph on a modified \nretrospective basis to leases affected by the amendments existing as \nof the beginning of the fiscal year of adoption by adjusting the lease \nliability, which shall be calculated based on the discount rate and \nremaining lease term at the beginning of the fiscal year of adoption. An \nentity shall recognize the amount of the change in the lease liability as \nan adjustment to the corresponding right -of-use asset, unless: \ni. The carrying amount of the right -of-use asset is reduced to zero, \nin which case the entity shall recognize any remaining amount of \nthe adjustment to opening retained earnings at the beginning of \nthe fiscal year of adoption. \nii. The adjust ment would increase a right -of-use asset that was \npreviously impaired, in which case the entity shall record the \nadjustment to opening retained earnings at the beginning of the \nfiscal year of adoption. \nc. An entity within the scope of (b) shall not treat the adoption of the pending \ncontent that links to this paragraph as an event that would require the \nentity to: \n1. Remeasure and reallocate the consideration in the contract in \naccordance with paragraph 842- 10-15-36. \n2. Reassess the lease term or a lessee option to p urchase the underlying \nasset in accordance with paragraph 842- 10-35-1. \n3. Remeasure the lease payments in accordance with paragraph 842- 10-\n35-4. \n4. Reassess lease classification in accordance with paragraph 842 -10-25-\n1. \nd. An entity within the scope of (b) that has adopted the pending content that \nlinks to this paragraph shall disclose the following as of the beginning of \nthe fiscal year of adoption (rather than at the beginning of the earliest \nperiod presented): \n1. The information required by paragraph 250- 10-50-1(a) and (b)(3), if \napplicable ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1124}), Document(page\_content='Leases 1124 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 2. The recognized amount of changes in lease liabilities and \ncorresponding right -of-use assets resulting from the transition \nadjustment. \nFor an entity within the scope of (b), at the date of adoption of the pending \ncontent that links to this paragraph, the entity may choose to apply or \ndiscontinue using the risk -free rate for any class of underlying asset. \n> Transition Related to Accounting Standards Update No. 2023 -01, Leases \n(Topic 842): Common Control Arrangements \n65-7 The following represents the transition and effective date information \nrelated to the practical expedient in Accounting Standards Update No. 2023 -01, \nLeases (Topic 842): Common Control Arrangements : \na. The pending content that links to this paragraph shall be effective for fiscal \nyears, including interim periods within those fiscal years, beginning after \nDecember 15, 2023. Early adoption is permitted in any annual or interim \nperiod for which financial statements have not yet been made available for \nissuance. If an entity adopts the pending content that links to this \nparagraph in an interim period, it shall adopt that pending content as of the \nbeginning of the fiscal year that includes that interim period. \nb. An entity that adopts the pending content that links to this paragraph \nconcurrently with adopting the pending content that links to paragraph 842-\n10-65-1 shall apply the pending content that links to this paragraph using \nthe same transition method elected for the pending content that links to \nparagraph 842- 10-65-1. \nc. An entity that adopted the pending content that links to paragraph 842- 10-\n65-1 before adopting the pending content that links to this paragraph shall \napply the pending content that links to this paragraph using either of the \nfollowing two methods: \n1. Prospectively to arrangements that commence or are modified on or \nafter the date that the entity first applies the pending content that links \nto this paragraph. \n2. Retrospectively to the beginning of the period in which the pending \ncontent that links to paragraph 842- 10-65-1 was first applied. The \npending content that links to this paragraph shall not be applicable for \narrangements no longer in place at the date of adoption. Under this \ntransition method: \ni. If an arrangement previously considered to be a lease continues to \nbe a lease after applying the pending content that links to this \nparagraph, an entity shall apply the requirements in paragraphs \n842-10-25-9 through 25 -17 to any changes in the lease resulting \nfrom application of the practical expedient in the pending content \nthat links to this paragraph. Any amounts that otherwise would \nhave been recognized in earnings shall be recognized as a \ncumulative -effect adjustment to opening retained earnings (or net \nassets of a not -for-profit entity) at the beginn ing of the earliest \nperiod presented in accordance with the pending content that links \nto paragraph 842- 10-65-1. \nii. If an arrangement previously not considered a lease becomes a \nlease after applying the pending content that links to this \nparagraph, an entity shall account for the arrangement as a new \nlease. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1125}), Document(page\_content='Leases 1125 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. d. An entity may document any existing unwritten terms and conditions of an \narrangement between entities under common control before the date on \nwhich the entity’s first interim (if applicable) or annua l financial statements \nare available to be issued in accordance with the pending content that links \nto this paragraph. \ne. An entity within the scope of (c) shall provide the applicable transition \ndisclosures required by Topic 250 on accounting changes and err or \ncorrections, except for the requirements in paragraphs 250- 10-50-1(b)(2) \nand 250- 10-50-3. An entity that elects the transition method in (c)(2) shall \nprovide the transition disclosures in paragraph 250- 10-50-1(b)(3) as of the \nbeginning of the earliest p eriod presented but not before the date on which \nthe pending content that links to paragraph 842- 10-65-1 was adopted. \nf. An entity that elects the practical expedient(s) in paragraph 842- 10-65-1(f) \nor (g) is not required to apply either of those practical expedients to \ncommon control arrangements for which the pending content that links to \nthis paragraph is being applied. \n65-8 The following represents the transition and effective date information \nrelated to the accounting for leasehold improvements associated with leases \nbetween entities under common control in Accounting Standards Update No. \n2023 -01, Leases (Topic 842): Common Control Arrangements : \na. The pending content that links to this paragraph shall be effective for fiscal \nyears, including interim periods within those fiscal years, beginning after \nDecember 15, 2023. Early adoption is permitted in any annual or interim \nperiod for which financial statements have not yet been made available for \nissuance. If an entity adopts the pending content that links to thi s \nparagraph in an interim period, it shall adopt that pending content as of the \nbeginning of the fiscal year that includes that interim period. \nb. An entity that adopts the pending content that links to this paragraph \nconcurrently with adopting the pending co ntent that links to paragraph 842-\n10-65-1 may apply the pending content that links to this paragraph using \nthe same transition method elected for the pending content that links to \nparagraph 842- 10-65-1 or may apply the pending content that links to this \nparagraph using either of the prospective methods specified in (c)(1) and \n(c)(2) below. \nc. An entity that adopted the pending content that links to paragraph 842- 10-\n65-1 before adopting the pending content that links to this paragraph shall \napply the pending content that links to this paragraph using one of the \nfollowing methods: \n1. Prospectively to all new leasehold improvements recognized on or after \nthe date that the entity first applies the pending content that links to \nthis paragraph. \n2. Prospectively t o all new and existing leasehold improvements \nrecognized on or after the date that the entity first applies the pending \ncontent that links to this paragraph. An entity that elects this transition \napproach shall amortize the remaining balance of leasehold \nimprovements existing at the date of adoption of the pending content \nthat links to this paragraph over the remaining useful life of those \nimprovements to the common control group determined at that date. \n3. Retrospectively to the beginning of the period in whi ch the pending \ncontent that links to paragraph 842- 10-65-1 was first applied. Any \nleasehold improvements previously amortized or impaired that ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1126}), Document(page\_content='Leases 1126 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. otherwise would not have been amortized or impaired had the pending \ncontent that links to this paragraph been applicable shall be r ecognized \nthrough a cumulative- effect adjustment to the opening b alance of \nretained earnings (or net assets of a not -for-profit entity) at the \nbeginning of the earliest period p resented in accordance with the \npending content that links to p aragraph 842-10-65-1. \nd. An entity within the scope of (c) shall provide the applicable transition \ndisclosures required by Topic 250 on accounting changes and error \ncorrections, except for the requirements in paragraphs 250- 10-50-1(b)(2) \nand 250- 10-50-3. An entity that elects the transition method in (c)(3) shall \nprovide the transition disclosures in paragraph 250- 10-50-1(b)(3) as of the \nbeginning of the earliest period presented but not before the date on which \nthe pending content that links to paragraph 842- 10-65-1 was adopted. \n> SEC Staff Guidance \n> > SEC Staff Announcement: Transition Related to Accounting \nStandards Updates No. 2014- 09 and 2016- 02 \nS65-1 Note: At the December 2019 AICPA Nat ional Conference on Current \nSEC and PCAOB Developments, the SEC staff announced that it would not \nobject to a public business entity that otherwise would not meet the definition \nof a public business entity except for a requirement to include or the inclusi on \nof its financial statements or financial information in another entity’s filing with \nthe SEC adopting Topic 842, Leases, for fiscal years beginning after December \n15, 2020, and interim periods within fiscal years beginning after December 15, \n2021. Those dates are consistent with the effective dates for Topic 842 as \namended in Accounting Standards Update No. 2019- 10, Financial \nInstruments —Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), \nand Leases (Topic 842): Effective Dates . The following is the text of SEC Staff \nAnnouncement: Transition Related to Accounting Standards Updates No. 2014-\n09 and 2016- 02. \nFASB Accounting Standards Updates No. 2014 -09, Revenue from \nContracts with Customers (Topic 606) , issued in May 2014 and codified \nin ASC Topic 606, Revenue from Contracts with Customers, and No. \n2016 -02, Leases (Topic 842) , issued in February 2016 and codified in ASC \nTopic 842, Leases, provide effective dates that differ for (1) public \nbusiness entities and certain other specified entities and (2) all other \nentities. The SEC staff has received inquiries from stakeholders regarding \nthe application of the effective dates of ASC Topic 606 and ASC Topic \n842 for a public business entityFN1 that otherwise would not meet the \ndefinition of a public business entity except for a requirement to include \nor the inclusion of its financial statements or financial information in \nanother entity’s filing with the SEC. \nThe transition provisions in ASC Topic 606 require that a public business \nentity and certain other specified entities adopt ASC Topic 606 for annual \nreporting periods beginning after December 15, 2017, including interim \nreporting periods within that reporting period.FN2 All other entities are \nrequired to adopt ASC Topic 606 for annual reporting periods beginning \nafter December 15, 2018, and interim reporting periods within annual \nreporting periods beginning after December 15, 2019. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1127}), Document(page\_content='Leases 1127 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The transition provisions in ASC Topic 842 require that a public business \nentity and certain other specified entities adopt ASC Topic 842 for fiscal \nyears beginnin g after December 15, 2018, and interim periods within \nthose fiscal years.FN3 All other entities are required to adopt ASC Topic \n842 for fiscal years beginning after December 15, 2019, and interim \nperiods within fiscal years beginning after December 15, 2020. \nIn response to the stakeholder inquiries outlined above, the SEC staff \nwould not object to a public business entity that otherwise would not \nmeet the definition of a public business entity except for a requir ement \nto include or the inclusion of its financial statements or financial \ninformation in another entity’s filing with the SEC adopting (1) ASC Topic \n606 for annual reporting periods beginning after December 15, 2018, and \ninterim reporting periods within a nnual reporting periods beginning after \nDecember 15, 2019, and (2) ASC Topic 842 for fiscal years beginning \nafter December 15, 2019, and interim periods within fiscal years \nbeginning after December 15, 2020. \nA public business entity that otherwise would no t meet the definition of a \npublic business entity except for a requirement to include or the inclusion \nof its financial statements or financial information in another entity’s filing \nwith the SEC may still elect to adopt ASC Topic 606 and ASC Topic 842 \naccording to the public business entity effective dates outlined above. \nThis announcement is applicable only to public business entities that \notherwise would not meet the definition of a public business entity \nexcept for a requirement to include or the inclus ion of its financial \nstatements or financial information in another entity’s filing with the SEC. \nThis announcement is not applicable to other public business entities. \nFN 1 The definition of Public Business Entity in the FASB’s ASC Master \nGlossary state s, in part, the following: \nA public business entity is a business entity meeting any one of the \ncriteria below . . . \na. It is required by the U.S. Securities and Exchange Commission \n(SEC) to file or furnish financial statements, or does file or furnish \nfinan cial statements (including voluntary filers), with the SEC \n(including other entities whose financial statements or financial \ninformation are required to be or are included in a filing) . . . \nAn en tity may meet the definition of a public business entity sol ely \nbecause its financial statements or financial information is included in \nanother entity’s filing with the SEC. In that case, the entity is only a \npublic business entity for purposes of financial statements that are filed \nor furnished with the SEC. \nFN 2 Early adoption of ASC Topic 606 is permitted for public business \nentities and certain other specified entities only as of annual reporting \nperiods beginning after December 15, 2016, including interim reporting \nperiods within that reporting period. \nFN 3 Early adoption of ASC Topic 842 is permitted for public business \nentities and certain other specified entities, as well as for all other \nentitie s. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1128}), Document(page\_content='Leases 1128 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13B.1.10 If a calendar year ‑end public business entity adopts Topic 842 in \naccordance with the mandatory effective date, the following are the relevant \ndates. [842- 10-65-1(a) – 65-1(d)] \nComparative periods \n(Apply Topic 842 transition provisions )Current period\n(Apply Topic 842 )December 31, 2019Effective date \n(date of adoption )\nJanuary 1, 2019 January 1, 2018Beginning of earliest \nperiod presented \n(date of initial application )\nJanuary 1, 2017\n \n13B.1.20 An entity can early adopt Topic 842 at any time after issuance. \n[842- 10-65-1(a) – 65-1(b)] \n \n Question 13B.1.10 \nEarly adoption considerations \nWhat reasons might an entity have to early adopt Topic 842? \nInterpretive response: \nLessors may want to align implementation with Topic 606 \nMost of the changes applicable to lessors transitioning from Topic 840 to \nTopic 842 were designed to substantially align key aspects of the lessor \naccounting model with the new revenue recognition guidance in Topic 606. For \nexample, the guidance covering separation and allocation guidance for lease \nand non ‑lease components, the lease modifications guidance, and the contract \ncombinations guidance are aligned with Topic 606, and the guidance on initial \ndirect costs is aligned with Subtopic 340 -40 (other assets and d eferred costs \nrelated to contracts with customers) . [ASU 2016 -02.BC8(d)] \nThose aspects of Topic 606 (and Subtopic 340- 40) and Topic 842 that are \nsubstantially aligned are designed to work together. The Board’s decision to align these aspects of the guidance explicitly considered that many lessors have \ncontracts that contain lease and non-lease (e.g. services or supplies) \ncomponents and that those lessors in particular would benefit from the \nalignment. Consequently, many lessors may find it preferable to early adopt \nTopic 842 at the same time as they adopt Topic 606. \nEntities may want to minimize disruption \nMost entities will likely be affected by the implementation of both Topic 606 and Topic 842. Some entities might view it as advantageous to adopt both \nTopics concurrently, in a big bang approach, to minimize the extent of ongoing \nsystems and process changes, get past the disruption, and revert to a steady \nstate accounting environment more quickly. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1129}), Document(page\_content='Leases 1129 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Seller ‑lessees in real estate sale ‑leaseback transactions may want to early \nadopt \nAs discussed in section 9.1, it will generally be easier to achieve sale \naccounting for real estate sale- leaseback transactions under Topic 842 than \nunder Topic 840. A seller -lessee that has, or is contemplating, a significant real \nestate sale -leaseback transaction that is, or is expected to be, a failed sale \nunder Topic 840 might want to early adopt Topic 842 if the transaction would \nbe accounted for as a sale and a leaseback. For further discussion, see \nsection 13B.7. \nLessees with existing build ‑to‑suit lease arrangements may want to early \nadopt \nBecause of the existing build- to-suit lease accounting guidance in Topic 840, \nthere are many lessees that have assets and liabilities recognized for assets \nthat they do not legally own, but were deemed to own for accounting purposes \nduring the construction period. In some of those cases, the construction period \nended many years ago but, because of the restrictive sale- leaseback \nrequirements applicable to real estate under Topic 840 , the entity has been \nunable to derecognize those assets and liabilities. Bec ause the transition \nprovisions in Topic 842 applicable to build- to-suit leases and sale ‑leaseback \ntransactions may permit the entity to derecognize those assets and liabilities (see section 13 B.8), some entities in this situation may choose to early adopt \nTopic 842. \n \n Question 13B.1.30 \nIssuance of a registration statement on Form S -3 \nafter the effective date \nDoes the reissuance of a registrant’s financial statements in \nconjunction with filing a registration statement on Form S-3 \nchange the date of initial application to January 1, 2016 \nbecause it is the beginning of the earliest comparative period \npresented? \nBackground: A calendar year -end public entity adopts Topic 842 on January 1, \n2019. The beginning of the earliest comparative period presented is Janua ry 1, \n2017. In May 2019, the registrant files its first quarter 2019 Form 10- Q, which \nreflects the adoption of Topic 842. Shortly after, the registrant files a \nregistration statement on Form S -3 that includes financial statements for the \nyears ending Decem ber 31, 2018, 2017 and 2016, as well as the quarters \nending March 31, 2019 and 2018. \nItem 11(b)(ii) of Form S -3 requires retrospective revision of the pre- event \naudited financial statements that were incorporated by reference in the Form S-3 to reflect a subsequent change in accounting principle. \nInterpretive response: No. The reissuance of the financial statements in the \nForm S-3 accelerates the provision of the retroactively restated financial \nstatements for the years ended December 31, 2018 and 2017, but it does not \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1130}), Document(page\_content='Leases 1130 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. change the date of initial application from January 1, 2017 in the background \nexample. [FRM 11210.1] \n \n Question 13B.1.40 \nEffects of adoption of Topic 842 by a successor \nentity on predecessor periods \nDoes a successor entity have to retrospectively adjust \npredecessor period financial statements on adoption of \nTopic 842? \nBackground: Comparative financial statements may include periods related to \nboth a predecessor entity (‘predecessor periods’) and periods related to a \nsuccesso r entity (‘successor periods’) when there is change in the basis of \naccounting, such as resulting from a change in control, push- down accounting \nor fresh -start reporting. The successor entity’s financial statement presentation \noften includes a double black line separating the predecessor and successor \nperiods to communicate that the financial information between those periods is \nnot comparable due to the different bases of accounting. \nFor example, assume Registrant acquires all of the outstanding stock of \nSubsidiary on September 30, 2018. Registrant accounts for the acquisition as a \nbusiness combination under Topic 805 and Subsidiary applies push- down \naccounting so its separate financial statements reflect a change in accounting basis and are split between predecessor and successor periods. As a result, \nSubsidiary’s December 31, 2018 income statement includes a 3- month \nsuccessor period and a 9- month predecessor period separated by a black \nvertical line. \nInterpretive response: No. The SEC staff concluded there is no US GAAP or \nother regulatory requirement to retrospectively adjust predecessor periods for \naccounting changes by a successor entity . Therefore, entities that adopt a new \naccounting standard (e.g. Topic 842) in one period (e.g. calendar year 2019) are \nnot required to revise the predecessor period financial statements presented. \nThis applies to both voluntary and involuntary adoptions of new accounting \nstandards. \nContinuing the example in the background, Registrant and Subsidiary adopt \nTopic 842 on January 1, 2019 using the comparative period transition \napproach. Subsidiary reflect s the modified retro spective adoption of Topic 842 \nin the 3- month successor period ended December 31, 2018 but does not \nretro spectively adjust the 9 -month predecessor peri od for the adoption. The \nnotes to Subsidiary’s 2019 financial statements will include relevant information \nfor the predecessor and successor periods to explain the difference in basis as \nwell as the impact of adopting Topic 842. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1131}), Document(page\_content='Leases 1131 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 13B.1.50 \nEffective date for certain public business entities \nDoes an entity that is considered a ‘public business entity’ \nsolely because its financial statements or summarized \nfinancial information are included in an SEC filing have to follow the mandatory effective date for public business entities ? \nInterpretive response: No. At the July 20, 2017 EITF meeting, the SEC \nObserver to the EITF announced that the SEC staff will not object if certain \npublic business entities (PBEs) use the adoption dates for ‘other entities’. The \nSEC announcement was later codified in paragraph 842- 10-S65-1. [842-10-S65-1] \nThe SEC staff has confirmed its intent to continue to extend relief to those \nsame PBEs based on the principles in paragraph 842- 10-S65-1. This means that \nalthough paragraph 842- 10-S65-1 references the ‘other entities’ mandatory \neffective date enacted by ASU 2019- 10, PBEs eligible for the SEC staff relief \ncan avail themselves of the additional one- year extension of that date afforded \nby ASU 2020 -05. See ‘ How t he standard works ’ in this chapter for effective \ndate information. [CAQ SEC Reg s Comm 07/2020, 842 -10-S65-1] \nThe SEC staff’s effective date relief is narrow and applies to an entity that \notherwise would not meet the definition of a PBE, but does so only because its \nfinancial statements or summarized financial information is included in another \nentity’s SEC filing. \nSituations where the SEC staff’s relief may apply include, but are not limited to: \n— private company equity method investees; \n— private acquired businesses; \n— acquired real estate operations; \n— properties securing loans that represent an asset concentration; \n— significant lessees; and \n— affiliates whose securities constitute a substantial portion of the collateral \nof a security that is registered or being re gistered with the SEC. \nA private entity whose financial information is included in an SEC filing but also \nmeets the d efinition of a PBE for other reasons – e.g. the filing of financial \nstatements with a regulatory agency other than the SEC – is not eligible for the \nSEC’s relief. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1132}), Document(page\_content='Leases 1132 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 13B.1.60\*\* \nEffective date for an entity in the process of an \ninitial public offering (IPO) \nWhat is a non- EGC’s Topic 842 adoption date when issuing \nfinancial statements to be included in an IPO registration \nstatement? \nInterpretive response: An entity that is not an EGC uses the adoption date that \nwould have applied to it had it been a public business entity (PBE) all along (e.g. \nJanuary 1, 2019 if it is a calendar year -end company). This is regardless of \nwhet her the entity has already or has not yet adopted Topic 842. [CAQ SEC Regs \nComm 07/2020.III.A] \nFor example, eve n if calendar year -end non -EGC Entity A has already adopted \nTopic 842 as of January 1, 2021, its IPO registration statement financial \nstatements are adjusted to reflect adopting Topic 842 as of January 1, 2019. \nThe entity presents the effects of Topic 842 in all periods presented from that date. \nBy contrast, during and after the IPO registration process, an EGC is permitted \nto use the Topic 842 adoption dates for non-PBEs (i.e. January 1, 2022 for \nannual periods and January 1, 2023 for interim periods). Qu estion 13A.2.140 \naddresses adoption guidance for an entity when it loses its EGC status. \n \n13B.2 Transition principles – lessees and lessors \n Excerpt from ASC 842 -10 \nTransition and Open Effective Date Information \nGeneral \n> Transition Related to Accounting Standards Updates No. 2016 -02, \nLeases (Topic 842) , No. 2018- 01, Leases (Topic 842): Land Easement \nPractical Expedient for Transition to Topic 842 , No. 2018- 10, Codification \nImprovements to Topic 842, Leases , No. 2018- 11, Leases (Topic 842): \nTargeted Improvements , No. 2018- 20, Leases (Topic 842): Narrow -Scope \nImprovements for Lessors , No. 2019- 01, Leases (Topic 842): Codification \nImprovements , No. 2019- 10, Financial Instruments —Credit Losses (Topic \n326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): \nEffective Dates , No. 2020- 05, Revenue from Contracts with Customers \n(Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities , \nNo. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with Variabl e \nLease Payments , No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entities , and No. 2023- 01, Leases \n(Topic 842): Common Control Arrangements \n65-1 The following represents the transition and effective date information \nrelated to Accounting Standards Updates No. 2016 -02, Leases (Topic 842) , \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1133}), Document(page\_content='Leases 1133 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. No. 2018- 01, Leases (Topic 842): Land Easement Practical Expedient for \nTransition to Topic 842, No. 2018- 10, Codification Improvements to Topic 842, \nLeases , No. 2018- 11, Leases (Topic 842): Targeted Improvements , No. 2018-\n20, Leases (Topic 842): Narrow- Scope Improvements for Lessors , No. 2019- 01, \nLeases (Topic 842): Codification Improvements , No. 2019- 10, Financial \nInstruments —Credit Losses (Topic 326), Derivatives and Hedging (Topi c 815), \nand Leases (Topic 842): Effective Dates , No. 2020- 05, Revenue from Contracts \nwith Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain \nEntities , No. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with \nVariable Lease Payments , No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entitie s, and No. 2023- 01, Leases (Topic \n842): Common Control Arrangements : [Note : See paragra ph 842-10-S65-1 for \nan SEC Staff Announcement on transition related to Update 2016- 02.] \nc. In the financial statements in which an entity first applies the pending \ncontent that links to this paragraph, the entity shall recognize and measure \nleases within the scope of the pending content that links to this paragraph \nthat exist at the application date, as determined by the transition method \nthat the entity elects. An entity shall apply the pending content that links to \nthis paragraph using one of the following two methods: \n1. Retrospectively to each prior reporting period presented in the financial \nstatements with the cumulative effect of initially applying the pending \ncontent that links to this paragraph recognized at the beginning of the \nearliest comparative period presented, subject to the guidance in (d) \nthrough (gg). Under this transition method, the application date shall be \nthe later of the beginning of the earliest period presented in the \nfinancial statements and the commencement date of the lease. \n2. Retrospectively at th e beginning of the period of adoption through a \ncumulative -effect adjustment, subject to the guidance in (d) through \n(gg). Under this transition method, the application date shall be the \nbeginning of the reporting period in which the entity first applies t he \npending content that links to this paragraph. \nd. An entity shall adjust equity and, if the entity elects the transition method \nin (c)(1), the other comparative amounts disclosed for each prior period \npresented in the financial statements, as if the pending content that links \nto this paragraph had always been applied, subject to the requirements in \n(e) through (gg). \ne. If a lessee elects not to apply the recognition and measurement \nrequirements in the pending content that links to this paragraph to short -\nterm leases , the lessee shall not apply the approach described in (k) \nthrough (t) to short -term leases. \nSee Examples 28 through 29 (paragraphs 842- 10-55-243 through 55- 254) for \nillustrations of the transition requirements for an entity that applies the pending \ncontent that links to this paragraph in accordance with (c)(1). \nPractical expedients \nf. An entity may elect the following practical expedients, which must be \nelected as a package and applied consistently by an entity to all of its \nleases (including those for which the entity is a lessee or a lessor ), when \napplying the pending content that links to this paragraph to leases that \ncommenced before the effective date: ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1134}), Document(page\_content='Leases 1134 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 1. An entity need not reassess whether any expired or existing contracts \nare or contain leases. \n2. An entity need not reassess the lease classification for any expired or \nexisting leases (for example, all existing leases that were classified as \noperating leases in accordance with Topic 840 will be classified as \noperating leases, and all existing leases t hat were classified as capital \nleases in accordance with Topic 840 will be classified as finance \nleases ). \n3. An entity need not reassess initial direct costs for any existing leases. \ng. An entity also may elect a practical expedient, which must be applied \ncons istently by an entity to all of its leases (including those for which the \nentity is a lessee or a lessor) to use hindsight in determining the lease \nterm (that is, when considering lessee options to extend or terminate the \nlease and to purchase the underlyi ng asset ) and in assessing impairment \nof the entity’s right -of-use assets . This practical expedient may be elected \nseparately or in conjunction with either one or both of the practical \nexpedients in (f) and (gg). \ngg. An entity also may elect a practical expedient to not assess whether \nexisting or expired land easements that were not previously accounted for \nas leases under Topic 840 are or contain a lease under this Topic. For \npurposes of (gg), a land easement (also commonly referred to as a right of \nway) refers to a right to use, access, or cross another entity’s land for a \nspecified purpose. This practical expedient shall be applied consistently by \nan entity to all its existing and expired land easements that were not \npreviously accounted for a s leases under Topic 840. This practical \nexpedient may be elected separately or in conjunction with either one or \nboth of the practical expedients in (f) and (g). An entity that elects this \npractical expedient for existing or expired land easements shall a pply the \npending content that links to this paragraph to land easements entered into \n(or modified) on or after the date that the entity first applies the pending \ncontent that links to this paragraph as described in (a) and (b). An entity that \npreviously ac counted for existing or expired land easements under Topic \n840 shall not be eligible for this practical expedient for those land \neasements. \nDisclosure \ni. An entity shall provide the transition disclosures required by Topic 250 on \naccounting changes and error corrections, except for the requirements in \nparagraph 250- 10-50-1(b)(2) and paragraph 250- 10-50-3. An entity that \nelects the transition method in (c)(2) shall provide the transition disclosures \nin paragraph 250- 10-50-1(b)(3) as of the beginning of the period of adoption \nrather than at the beginning of the earliest period presented. \nNote : See paragraph 250- 10-S99-6 on disclosure of the impact that \nrecently issued accounting standards will have on the financial \nstatements of a registrant. \nj. If an entity uses one or more of the practical expedients in (f), (g), and (gg), \nit shall disclose that fact. \njj. An entity electing the transition method in (c)(2) shall provide the required \nTopic 840 disclosures for all periods that continue to be in accordance with \nTopic 840. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1135}), Document(page\_content='Leases 1135 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13B.2.1 Transition approach – general \n13B.2.10 When an entity elects the comparative method, it recognizes and \nmeasures all leases that exist at the beginning of the earliest comparative \nperiod presented using a modified retrospective transition approach. The entity \nrecords a cumulative -effect adjustment a t the date of initial application. \nComparative periods are presented in accordance with the transition period guidance in Topic 842 . All leases that either (1) commence, or (2) are modified \n(where that modification is not accounted for as a separate contra ct) or \nremeasured on or after the effective date are accounted for under Topic 842. \n[842- 10-65-1(c) – 65-1(d), 65- 1(q), 65- 1(t)] \n13B.2.20 As an exception, a lessee electing the recognition and measurement \nexemption for short ‑term leases (see section 6.3.1) does not apply the \ntransition requirements to short -term leases. For purposes of this exception, a \nshort -term lease is a lease with a total lease term of 12 months or less \n(including periods before the effective date); it is not a lease with a remaining \nlease term of 12 months or less at the effective date. See Question 13B.2.60 \nfor considerations about whether a lease is a short -term lease in transition if \nusing hindsight. [842-10-65-1(e)] \n13B.2.30 Topic 842 does not specify what to do instead for unrecognized short -\nterm leases in transition. However, we believe the lessee should: \n— recognize the minimum rental payments (as defined in Topic 840 – see \nQuestion 13B.3.10) as lease cost, on a generally str aight‑line basis over the \nlease term , consistent with the lessee’s accounting for those leases under \nTopic 840; and \n— consistent with all other lessee leases that exist at the effective date, apply \nthe new requirements in Topic 842 to that lease if, on or af ter the effective \ndate: \n— it is modified and that modification is not accounted for as a separate \ncontract (see section 6.7 ); or \n— there is an event that would require remeasurement of the lease liability if it were recognized – e.g. a change in the lease ter m or in the \nassessment of a lessee purchase option ( see section 6.6) . \n13B.2.40 An entity adjusts equity at the beginning of the earliest comparative \nperiod presented, and the other comparative amounts disclosed for each prior period presented, as if Topic 842 had always been applied, subject to the \ntransition requirements described i n this chapter. \n[842- 10-65-1(d)] \n13B.2.50 An entity applies the transition requirements to leases that commence \nbefore the effective date (or early adoption date) at the later of: (1) the \nbeginning of the earliest period presented in the financial statements, or (2) the \ncommencement date (see section 5.1). For ease of reference, this date is \nreferred to as the ‘transition date’ in this chapter. [842- 10-65-1(k), 65 -1(r), 65 -1(s), \n65-1(v), 65- 1(w), 65 -1(x), 65- 1(y)] \n13B.2.60 The following diagram is based on a calendar year ‑end public business \nentity that adopts Topic 842 on the mandatory effective date. The transition requirements apply to: \n— Lease A at the beginning of the earliest period presented – i.e. January 1, \n2017 is the transition date; and ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1136}), Document(page\_content='Leases 1136 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — Lease B at the commencement date of the lease – i.e. February 1, 2017 is \nthe transition date. \nComparative periods\n(Apply Topic 842 transition provisions )Current period\n(Apply Topic 842 )December 31, 2019Effective date \n(date of adoption )\nJanuary 1, 2019Beginning of earliest \nperiod presented \n(date of initial application )\nJanuary 1, 2017 January 1, 2018\nLease \nALease \nB\n(Feb. 1) \n \n13B.2.2 Transition approach – modifications \n13B.2.70 The following transition requirements apply to modifications that are \nnot accounted for as a separate contract, for both lessees and lessors. \n[842- 10-65-1(q), 65- 1(t), 65 -1(x)(4)] \nModification occurs … \nBefore beginning of \nearliest period presented: \n— Apply Topic 840. After beginning of \nearliest period \npresented but before \neffective date (i.e. \nduring the transition \nperiod): \n— Apply interpretive \nguidance in \nQuestion 13B .2.10. On or after effective date: \n— Apply the requirements of Topic 842 in accounting for \nthe modification and in \naccounting for the lease on \nand after the effective date of the modification. See \nsection 6.7 (lessees) and \nsection 7.6 (lessors). \n \n Question 13B.2.10 \nAccounting for modifications that occur during the \ntransition period \nWhich guidance, Topic 842 or Topic 840, applies to lease \nmodifications that occur during the transition period? \nBackground: The transition period is the period that falls between the date \nof initial application and the effective date. In the diagram under \nparagraph 13B.2.60, the transition period is from January 1, 2017 to \nDecember 31, 2018. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1137}), Document(page\_content='Leases 1137 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Interpretive response: It depends. Topic 842 is not explicit in this respect; \nhowever, we believe if the classification of the lease did not change as a result \nof the transition guidance, the entity should apply the Topic 840 guidance to any \nmodification that occurred before the effective date of Topic 842, which \nincludes the transition period. \nConsequently, if the entity elects the package of transition practical \nexpedients , and will not ther efore reassess lease classification in transition (see \nparagraph 13B.2.100), it will apply the Topic 840 guidance to all modifications \nthat occur before the effective date. \nIn contrast, if the entity does not elect the package of transition practical exped ients, the classification of some leases may change in transition (see \nQuestion 13B.2.20 ). For those leases only, in transition, the entity will apply the \nTopic 842 guidance to any modifications that occur during the transition period. \nThis guidance is fur ther illustrated in the following diagram . \nWas the package of \ntransition practical \nexpedients elected ? Apply Topic 840 \nmodifications guidance \nto any modifications that \noccur in the transition \nperiodYes\nDid classification of the \nlease change in transition ?No1\nApply Topic 842 \nmodifications guidance \nto any modifications that \noccur in the transition \nperiodNo\nYes \nNote: \n1. Classification of the lease is reassessed if the package of transition practical expedients \nis not elected. See paragraph 13 B.2.100. \nWe believe this approach is consistent with the transition guidance for lessees and lessors overall. In general, the transition guidance appears to have been \nwritten to minimize instances in which a lessee or lessor would have to revise \naccounting that occ urred under Topic 840 unless the classification of the lease \nchanged, in which case the entity would generally apply Topic 842 either from \nthe date of initial application forward (lessees) or as if the lease had always \nbeen accounted for based on its revis ed Topic 842 lease classification (lessor s).\n \n[842- 10-65-1(o), 65-1(s), 65-1(w), 65-1(y), ASU 2016- 02.BC390] \n13B.2.80 In the diagram in paragraph 13B.2.60: \n— If Lease B is modified on March 15, 2019 (i.e. after the effective date), the \nmodification will be accounted for under Topic 842. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1138}), Document(page\_content='Leases 1138 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — If Lease B is m odified on February 15, 2018 (i.e. during the transition \nperiod), the interpretive guidance in Question 13 B.2.10 applies. The entity \nwill account for the modification in accordance with Topic 840 if the \nclassification of the lease does not change in transition, and in accordance \nwith Topic 842 if the classification does change. \n13B.2.90 Lessees will not reassess or remeasure leases before the effective \ndate. Beginning on the effective date, t he same reassessment and \nremeasurement requirements apply to leases that commenced before the \neffective date as apply to new leases that commence on or after the effective \ndate – i.e. Topic 842 applies in: [842 ‑10-65-1(q), 65- 1(t)] \n— determining when to reassess a lease and whether there is a resulting \nremeasurement (see section 6.6.1); \n— accounting for the remeasurement (see section 6.6.2); and \n— accounting for the lease after the remeasurement (see section 6.6.2). \n \n13B.2.3 Practical expedients \n13B.2.100 The following table summarizes the three transition practical \nexpedients in Topic 842. An entity electing the land easement practical \nexpedient only applies the transition guidance in Topic 842, including the \nfollowing practical expedients, to land easements that were accounted for as \nleases under Topic 840. [842- 10-65-1(f) – 65-1(gg)] \nPackage of practical \nexpedients Use of hindsight Land easements \nOn transition, an entity may \nelect not to reassess: \n— whether expired or \nexisting contracts \ncontain a lease under \nthe new definition of a \nlease (see chapter 3); \n— lease classification for expired or existing \nleases – see \nsections 6.2 (lessees) \nand 7.2 (lessors ); and \n— whether previously capitalized initial direct \ncosts would qualify for \ncapitalization under \nTopic 842 (see \nsection 5.5). \nAn entity electing this \npractical expedient must \nelect the entire package. An entity may use hindsight in \ndetermining the lease term, \nassessing the likelihood that a \nlessee renewal, termination or \npurchase option will be \nexercised (see section 5.3). An entity may elect not \nto reassess whether \nland easements meet \nthe definition of a lease \nif they were not \naccounted for as leas es \nunder Topic 840. \nSection 13B.2.4 \ndiscusses this practical \nexpedient in further \ndetail. \nEach of the three practical expedients may be elected separately from the other two. \nPractical expedients are applied consistently to all leases – i.e. all leases for which the \nentity is a lessee or a lessor – that commence before the effective date. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1139}), Document(page\_content='Leases 1139 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13B.2.110 Lease modifications that occur before the effective date do not affect \nthe availability of the practical expedients. If an entity modifies its contracts that \nare leases under Topic 840 but would not be leases under Topic 842 during the \ntransition period ( between January 1, 2017 and December 31, 2018 in the \ndiagram in paragraph 13B.2.60) and has elected the package of practical \nexpedients, the entity would apply the Topic 840 definition of a lease to \nthe modified contract (s). In addition, unless there are a dditional modifications \non or after January 1, 2019 ( see the effective date in the diagram in \nparagraph 13B.2.60), the entity will not evaluate whether those contracts are \nleases under Topic 842. [842- 10-65-1(f)] \n13B.2.120 An entity that elects to apply a ll of the practical expedients will, in \neffect, continue to account for existing leases – i.e. leases for which the \ncommencement date is before the effective date – in accordance with \nTopic 840 throughout the entire lease term, including periods after the effective \ndate. The following are exceptions to this general principle . [ASU 2016 ‑02.BC390] \nLessees only Lessees and lessors \nRecognize an ROU asset and a lease \nliability for all operating leases at each \nreporting date (see section 13B.3). \nApply the Topic 842 reassessment \nrequirements (see section 6.6) beginning on \nthe effective date and, if the lease liability is \nremeasured on or after the effective date, \naccount for the lease under Topic 842 \nbeginning on the remeasurement date (see \nparagraph 13B.2.90 ). If the lease is modified and not accounted \nfor as a separate contract (see \nsections 6.7 and 7.6 for lessees and \nlessors , respectively) on or after the \neffective date, account for the lease \nunder Topic 842 beginning on the \neffective date of the modific ation (see \nparagraph 13B.2.70). \n13B.2. 130 An entity that elects the land easements practical expedient continues \nto account for existing land easements (i.e. land easements that commenced \nbefore the effective date) consistent with its historical accounting practice \nbefore adopting Topic 842. An exception to this general principle arises if a land \neasement is modified on or after the effective date. [842- 10-65-1(gg), ASU 2018-\n01.BC17] \n \n Question 13B.2.20 \nDate of lease classification reassessment \nIf an entity does not elect the package of practical expedients, \nand is therefore required to reassess the classification of its \nleases, as of what date does that reassessment occur? \nInterpretive response: An entity reassesses lease classification for each lease \nthat commences before the effective date of Topic 842 as of the later of : \n— the commencement date for the lease; or \n— the date of the last lease modification that occurr ed before the date of initial \napplication that, in accordance with Topic 840, required the entity to \nreassess the classification of the lease . \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1140}), Document(page\_content='Leases 1140 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Any lease modification that occurs after the transition date (i.e. during the \ntransition period ) for the lease should be accounted for as outlined in \nQuestion 13B.2.10. However, such modifications do not affect the date of the \nentity’s initial reassessment of lease classification under Topic 842 if the \npackage of practical expedients is not elected . \n \n Question 13 B.2.30 \nHindsight practical expedient – effect on lease \nclassification if package of practical expedients \nelected \nIf an entity elects both the package of practical expedients \nand the use of hindsight, is it required to reassess lease classification if hindsight results in a change to the lease term or the assessment of a lessee purchase option? \nInterpretive response: No. Topic 842 does not establish a hierarchy between \nthese two transition practical expedients such that hindsight overrides the \npackage of practical expedients. Therefore, even though changes to the lease \nterm or the assessment of a lessee purchase optio n resulting from the use of \nhindsight require, for example, the lessee to remeasure the minimum rental payments (existing operating leases) or the minimum lease payments (existing \ncapital leases – see Question 13B.2. 50), we do not believe an entity (lessee or \nlessor) is required to reassess lease classification if it has elected the package of practical expedients. \nHowever, we also do not believe that Topic 842 precludes reassessing lease \nclassification in such cases. This is on the basis that the hindsigh t practical \nexpedient was intended to permit entities to provide more accurate, updated \ninformation to financial statement users unhindered by their decisions with \nrespect to other transition practical expedients – e.g. the package of practical \nexpedients. [ASU 2016- 02.BC394] \n \n Question 13B.2.40 \nHindsight practical expedient – lessee options \nDoes the hindsight practical expedient require an entity to \nreassess the lease term and any lessee purchase options? I f \nyes, at what date does that reassessment occur and what \nfactors does it consider? \nInterpretive response: Yes, election of the hindsight practical expedient \nrequires an entity (lessee or lessor) to reevaluate the lease term and the entity’s \nassessment of any lessee purchase options on the effective date of Topic 842. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1141}), Document(page\_content='Leases 1141 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The reassessment takes into account all economic factors relevant to that \nassessment as of the effective date: contract -based, asset -based, market -based \nand entity -based factors ( see paragraph 5.2.60). That is, an entity assesses as of \nthe effective date, with the benefit of hindsight, the same factors it considers at \nlease commencement for new leases that commence on or after the effective \ndate. The entity then uses that updated information to establish the \nmeasurement of the lease at the transition date – i.e. rather than the entity’s \n‘reasonably assured’ assessment that it undertook under Topic 840. \nThis requirement, resulting from election of the hindsight practical expedient, is \nregardless of : \n— the fact that lessors do not reassess such items for leases that commence on or after the effective date of Topic 842 (unless the lease is modified and \nthat modification is not accounted for as a separate contract) ; and \n— whether or not any ‘triggering events’ (i.e. significant events or changes in \ncircumstances within the control of the lessee) hav e occurred before the \neffective date. \nThe following are examples (which would apply equally to the lessee or the \nlessor ). \n— Example 1: Changes in market value \nA lessee concluded at lease inception under Topic 840 that exercise of a renewal option was not rea sonably assured and the lease term excluded \nthe optional renewal period . \nOn the effective date of Topic 842, it is clear that the renewal option will be \na significant bargain from fair market rent for the underlying asset at the time of renewal such that i t is reasonably certain (based on market factors) \nthat the lessee will exercise the renewal option. \nTherefore, when applying hindsight, the remaining lease term used to \nmeasure the lease at the transition date will include the optional renewal \nperiod. \n— Example 2: Impact of leasehold improvements \nA lessor concluded at lease inception under Topic 840 that exercise of a \nrenewal option by the lessee was not reasonably assured and excluded the \noptional renewal period from the lease term. \nBy the effective date of Topic 842, the lessee has constructed significant \nleasehold improvements that will have significant remaining economic \nvalue to the lessee after the optional renewal date such that the lessee is \nreasonably certain to exercise the renewal option. \nTherefore, when applying hindsight, the remaining lease term used to measure the lease at the transition date will include the optional renewal period. \nSubsequent to the effective date – i.e. after the entity undertakes the hindsight \nreassessment – leases that commenced before the effective date are \nreassessed on the same basis as new leases that commenced on or after the \neffective date. That is, lessors do not reassess the lease term or lessee \npurchase options unless the lease is modified ( and that modific ation is not ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1142}), Document(page\_content='Leases 1142 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. accounted for as a separate contract ) – see section 7. 6, and lessees reassess \nthe lease term only as discussed in section 6.6 on reassessments and \nsection 6.7 on modifications . \n \n Question 13B.2. 50 \nHindsight practical expedient – existing capital \n(sales -type/direct financing) leases \nIf hindsight results in a change to the lease term or the \nassessment of a lessee purchase option, does an entity remeasure an existing capital (sales -type/direct financing) \nlease if its classification does not change on transition? \nBackground: Topic 842 states that: \n— The lease liability and ROU asset for an existing capital lease that remains \nclassified as a finance lease under Topic 842 are initially measured at the \ntransition date as follows (see para graph 13B.3.100). [842- 10-65-1(r)(1) – 65-\n1(r)(2)] \n— Lease liability: Carrying amount of capital lease obligation under Topic 840 immediately before the transition date. \n— ROU asset : Carrying amount of the capital lease asset under Topic 840 \nimmediately before the transition date, plus any unamortized initial \ndirect costs not included in the capital lease asset. \n— The net investment in the lease at the transition date for a sales -type or \ndirect financing lease that remains classified as a sales -type or direct \nfinancing lease under Topic 842 is measured at the carrying amount of the \nnet investment immediately preceding the transition date under Topic 840 \n(see paragraph 13 B.4.40). [842- 10-65-1(x)(1)] \nInterpretive response: Yes. If hindsight res ults in a change to the lease term or \nthe assessment of a lessee purchase option, the lease assets and lease liabilities should be remeasured. This is notwithstanding the Topic 842 transition \nparagraphs referenced in the background. \nElection of the hindsight practical expedient is optional; therefore, the decision \nto apply this practical expedient includes acceptance of the remeasurement \nrequirements that accompany that decision. The hindsight practical expedient, if \nelected, is intended to provide more accurate, updated information to financial statement users. It is unclear how that would be accomplished if the use of \nhindsight results in a changed lease term or changed assessment of a lessee \npurchase option but the entity does not reflect that change in its measurement \nof lease assets and lease liabilities. \n[ASU 2016- 02.BC394] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1143}), Document(page\_content='Leases 1143 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 13B.2.60 \nHindsight practical expedient – short -term leases \nDoes the exercise of one or more renewal opti ons that result \nin a cumul ative lease term greater than 12 months preclude \naccounting for the lease as a short -term lease when applying \nthe hindsight practical expedient on transition? \nBackground: Consider an example whereby Lessee LE enters into a lease t hat \ncommences on January 1, 2017 that has a non- cancellable period of 12 months \nand three 12- month lessee renewal options. At January 1, 2017, it is not \nreasonably certain that LE will exercise any of the renewal options; therefore, \nthe lease term is 12 months. \nAs of the effective date (January 1, 2019 for LE), LE has exercised two of the \nrenewal options – i.e. as of the effective date, the current non- cancellable \nperiod of the lease extends to December 31, 2019. At no point in time before exercise was it ever ‘reasonably certain’ that LE would exercise one or more of \nthose options (see section 5.2), and it is not reasonably certain at the effective \ndate that LE will exercise its one remaining option to extend the lease to \nDecember 31, 2020. \nLE has elected the hindsight transition practical expedient, and is now \nconsidering whether this lease qualifies for the short -term lease recognition and \nmeasurement exemption given LE knows that the lease will have a total term, \nin hindsight, of at least three years. \nInterpretive response: It depends. If the initial lease term was 12 months or \nless and no single renewal option exercised by the lessee up to the effective \ndate extended the lease term by more than 12 months from the end of the \npreviously determined lease term, the lease qualifies as a short -term lease on \ntransition; this is even if the lessee elected the hindsight practical expedient. \nTherefore, in the background example, the lease qualifies as a short -term lease, \ndespite LE’s use of the hindsight practic al expedient. This is because the \noriginal lease term was 12 months or less and neither of the two renewal \noptions exercised by LE extended the lease term by more than 12 months from \nthe end of the then -current lease term at the point in time the option wa s \nexercised. \nHowever, a lease such as that in the background example would not qualify, if \nusing hindsight, as a short -term lease for any portion of the transition period if \nany single renewal option was exercised that extended the lease term by more \nthan 12 months from the end of the previously determined lease term or if LE \nhad exercised more than one of the available 12 -month renewal options during \nthe same then- current 12- month lease term . For example, if the background \nlease had an initial term of 12 months, but LE exercised a single 24- month \nrenewal option, rather than two 12 -month renewal options, or had exercised \nboth of the two 12- month renewal options during the initial 12- month term of \nthe lease, it would not be considered a short -term lease. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1144}), Document(page\_content='Leases 1144 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. While not explicit in the guidance, we believe this interpretation of the \nTopic 842 transition guidance is consistent with the post -transition guidance \nthat says a lease does not lose its short -term categorization unless the lease \nterm changes such that, after the change, the remaining lease term extends \nmore than 12 months from the end of the previously determined lease term. \n[842- 20-25-3] \n \n Question 13B.2.70 \nHindsight practical expedient – changes to straight -\nline opera ting lease income (expense) \nIf the lease term changes as a result of applying the use -of-\nhindsight practical expedient, does the entity need to revise \nits straight- line income (expense) recognition? \nBackground: Lessor LR and Lessee LE are public busines s entities that \nentered into a five -year lease that commenced on January 1, 2014. The lease \ninclude d a five-year lessee renewal option, which LR and LE both excluded \nfrom the lease term in their historical accounting. \nBoth LR and LE classified the lease as an operating lease under Topic 840, and \nconcluded that income (expense) should be recognized on a straight -line basis . \nThe annual payments for the lease increase by 5 percent each year, including \nduring the optional renewal period. \nBy the effective date of Topic 842 ( January 1, 2019) LE has exercised the \nrenewal option to extend the term of the lease. Both LR and LE elect the use-\nof-hindsight practical expedient. \nInterpretive response: Yes. If the lease term changes as a result of hindsight, \nthe entity is required to adjust all of its related accounting correspondingly. \nThis means that if the income (expense) recognized in the comparative periods \npresented in the financial statements would have been different from what was \nhistorically reported, the entity must retrospectively adjust those amounts in its \npost-adoption financial statements. I n the case of the background example, the \nentity would recognize any necessary adjustment to equity for amounts of income (expense) that would have been recognized before LR and LE’s date of \ninitial application (January 1, 2017). \nUsing the background example, because of the annual 5% payment escalator, \nLR and LE would have recognized additional lease income (expense) in \nJanuary 1, 2014 to December 31, 2018 had they both estimated a lease term of \n10 years rather than 5 years. The use of hindsight by LR and LE means they will \nrecognize less lease income (expense) after the effective date than they would have had they not elected the use- of-hindsight practical expedient. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1145}), Document(page\_content='Leases 1145 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 13B.2.80 \nHindsight practical expedient – remeasurement \nevents \nWhen applying hindsight, does a remeasurement arising from \nan event that occurs, or change in circumstances that arises, \non or after the effective date affect measurement of the lease at the transition date? \nInterpretive response: No. As outlined in Q uestion 13B .2.40, election of the \nhindsight practical expedient requires an entity (lessee or lessor) to reevaluate \nthe lease term and the entity’s assessment of any lessee purchase options as \nof the later of the beginning of the earliest period presented and the lease \ncommencement date (i.e. the transition date) for each of its leases based on \nthe entity’s effective date consideration of all economic factors relevant to that \nassessment : contract -based, asset -based, market -based and entity -based \nfactors ( see paragraph 5.2.60). \nAfter that effective date reassessment occurs, any changes to the lease term or \nto the assessment of lessee purchase options that result from applying the \nguidance in Topic 842 (e.g. resulting from a ‘triggering event’ for lessees or \nfrom the reassessment of the lease upon a modification that is not accounted \nfor as a separate contract for lessees and lessors) are post -transition accounting \nevents that are not ‘ pushed back ’ to the transition date for that lease. \n \n Question 13B.2.90 \nHindsight practical expedient – modifications and \nchanges to an index or rate on which variable lease \npayments are based \nDoes using hindsight contemplate changes to the terms or \nconditions of the lease after the transition date, or changes to \na reference index or r ate? \nInterpretive response: No. We believe using hindsight is intended to apply to \nestimates and other matters of judgment, such as assessments the entity \nmade at lease inception under Topic 840 about the likelihood that the lessee \nwill exercise an option to renew (or terminate) the lease or exercise an option to purchase the underlying asset. \nWe do not believe the Board intended for entities to use the hindsight practical \nexpedient to reflect changes in fact, such as changes to contractual terms or \ncondit ions of the lease or factors that affect the amount of variable lease \npayments as though those changes occurred before they actually did. \nTherefore, an entity should not reflect, at the transition date, the effects of \neither: \n— changes to the actual terms or conditions of the lease contract that \noccurred after the transition date;\n1 or \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1146}), Document(page\_content='Leases 1146 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — a referenc e index or rate that exists in the future from the transition date – \ne.g. the entity does not use the CPI at the effective date when accounting \nfor the lease as of the transition date. When measuring the lease liability for \na lease at the transition date, an entity should use the index or rate as \nindicated in Question 13B.3.30. \nNote: \n1. Exercise of an option included in the contract is not a change to the terms or conditions \nthereof. Consequently, applying hindsight does contemplate options exercised or not \nexercised by an entity. \n \n Example 13B.2.10 \nApplying hindsight with lease remeasurements and \nmodi fications \nThis example illustrates the interpretive guidance provided in Questions 13B.2.30 \n– 13B.2.50 about applying the hindsight practical expedient in evaluating lease \nremeasurements and modifications. \nThe following table summarizes relevant information about Lessee LE’s lease of \na warehouse facility from Lessor LR. LE and LR have both elected to use the \npackage of transition practical expedients and the hindsight practical expedient. \nCommencement date of lease: January 1, 2004 \nLease term: 15 years \nTerms of renewal options: One 10- year option. LE must notify LR six months \nbefore the end of the term that LE will not exercise \nthe option or the option is deemed exercised. \nAt lease inception, exercise of the renewal option by \nLE is not r easonably assured. \nEffective date for LE: January 1, 2019 \nDate of initial application for LE: January 1, 2017 \nScenario 1: Lessee option exercised during transition period \nLE did not notify LR of its intent to terminate the lease on or before July 1, \n2018 . As a result, because July 1, 2018 represents six months before the end \nof the original lease term, the renewal option has been exercised in accordance with the terms of the contract . \nIn this scenario , the remaining lease term is 12 years for both LE and LR as of \nJanuary 1, 2017 (transition date for the lease) – i.e. two years remaining from \nthe original term plus the 10- year renewal period. T he lease term at January 1, \n2017 should include consideration of the event (exercise of the renewal option) \nthat occurred during the transition period and before the January 1, 2019 \neffective date. \nScenario 2: Lessee option exercised after the effective date \nAssume the same facts as in Scenario 1 , except the commencement date of \nthe lease was January 1, 2005 and therefore the non- cancellable period of the \nlease ends December 31, 2019. This means that the date by which LE must ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1147}), Document(page\_content='Leases 1147 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. notify LR of its intent not to exercise the extension option is July 1, 2019 (rather \nthan July 1, 2018). \nIn this scenario, if the entity (LE or LR) concludes, based on consideration of all \nrelevant economic factors as of the effective date (see Question 13 B.2.40), that \nLE is reasonably certain to extend the lease beyond December 31, 2019 , the \nremaining lease term will be 13 years (January 1, 2017 – December 31, 202 9) at \nthe transition date. \nIf LE is not reasonably certain to exercise the option to extend the lease as of \nthe effective date, the remaining lease term is only three years (January 1, 2017 \n– December 31, 2019) at the transition date. If lessee exercises the option on \nJuly 1, 2019, that extension of the lease term does not affect the conclusion \nreached that the remaining lease term at the transition date is three years. The \nexercise of the option is solely a ‘post -transition’ accounting event for both LE \nand LR. \nScenario 3: Lease modification during the transition period \nAssume the same facts as Scenario 2, except that the lease does not include a \nrenewal option for LE . However, LE and LR agree on February 1, 2018 to \nmodify the lease to extend its term for 10 years following the end of the non -\ncancellable period of the lease (December 31, 201 9). \nDespite the fact that the modification occurred during the transition period, the \nlease term extension resulting from the modification is not reflected in the \nremaining lease term at the transition date for the lease (i.e. January 1, 2017) . \nTherefore, the remaining lease term at January 1, 2017 is three years \n(January 1, 2017 – December 31, 2019) . The change in the lease term resulting \nfrom the modification is not reflected in the financial statements until the \nmodification date. \n \n Question 13B.2.100 \nErrors in applying Topic 840 \nDoes election of the package of practical expedients require \nentities to correct errors in applying Topic 840 with respect to lease identification, lease classification and the accounting for initial direct costs? \nInterpretive response: Yes. Election of the package of practical expedients \ndoes not grandfather errors in applying Topic 840; it only grandfathers the \nTopic 840 guidance. \nTherefore, if the package of practical expedients is elected, incorrect \nconclusions reached under Topic 840 about the following must be corrected, \nseparate from the transition accounting for those leases, in accordance with the guidance in Topic 840: \n— whether a contract is or contains a lease (including incorrect conclusions \nabout whether a contract or part of a contract was in the scope of \nTopic 840); \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1148}), Document(page\_content='Leases 1148 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — lease classification ; and/or \n— the accounting for initial direct costs. \nThe effect of correcting an error in applying Topic 840 is excluded from the \ntransition effect of applying Topic 842. A n entity corrects any error under \nTopic 840 before applying the transition guidance in Topic 842. For example, if \nan entity wrongly concluded that a contract did not contain a lease under \nTopic 840, the entity would recognize that lease in transition even if that \ncontract would not contain a lease under Topic 842. For the specific \nrequirements related to land easements, see s ection 13B .2.4 [ASU 2016-\n02.BC393(a)] \nIdentifying a l ease may be the most likely area of error to which the package of \npractical expedients applies. Many contracts convey the right to use property, \nplant or equipment, but are not explicitly identified as ‘lease agreements ’. \nExamples include service contracts (including contracts for IT services), dedicated supply agreement s, advertising and construction contracts. Under \nTopic 840, a n entity may not have had a significantly different expense \nrecognition pattern or balance sheet treatment regardless of whether a \ntransaction was accounted for as an operating lease or as an executory or \nservice contract. Accordingly, entities may not have previously focused their \nefforts on identifying contracts that explicitly or implicitly contained operating leases. \nHowever, under Topic 842 identifying leases becomes much more important \nbeca use entities recognize lease liabilities and ROU assets on the balance sheet \nfor each lease with a term that is longer than 12 months. Accordingly, the Board \ndecided that the package of practical expedients should not provide an \nexemption for arrangements that were not accounted for as leases under Topic 840 even though they met the Topic 840 definition. \n \n Question 13B.2.110 \nGrandfathering arrangements committed or agreed \nto before reporting periods beginning after May 28, \n2003 \nAre arrangements that were grandfathered from application \nof the lease identification guidance in Topic 840 still \ngrandfathered on transition to Topic 842? \nBackground: Under Topic 840, arrangements not accounted for as leases that \nwere committed or agreed to before reporting periods beginning after May 28, \n2003 (and not subsequently modified or acquired in a business combination) \nwere grandfathered from determining whether the arrangement is or contains \na lease. \nInterpretive response: Yes, but only if the enti ty elects the package of \ntransition practical expedients. Topic 842 does not carry forward that \ngrandfathering provision, so unless the package of practical expedients is \nelected, the entity must reassess whether leases exist for all arrangements that \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1149}), Document(page\_content='Leases 1149 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. have not ended before the date of initial application (i.e. the beginning of the \nearliest period presented). \nHowever, the package of practical expedients grandfathers the Topic 840 lease \nidentification guidance for all leases that commence before the effectiv e date of \nTopic 842. We believe this includes the grandfathering provision in Topic 840. \nTherefore, if an entity elects the package of practical expedients, leases \npreviously eligible for this grandfathering provision would remain eligible for \nthat provisi on. \nBecause the grandfathering provision in Topic 840 does not apply to leases \nmodified after May 28, 2003, entities will need to have a process in place to \nensure that any modified contracts initially eligible for the grandfathering provision were reasses sed under Topic 840 upon modification, as well as a \nprocess in place to monitor any such contracts for modifications that occur on \nor after the effective date of Topic 842. If a contract previously eligible for the \nTopic 840 grandfathering provision is modified on or after the effective date, the \nentity will have to assess whether the contract is or contains a lease under \nTopic 842. \n \n Observation \nImpact on initial direct costs for entities not electing \nthe package of practical expedients \n13B.2.140 An entity’s decision not to elect the package of practical expedients \nfor lease definition, lease classification and initial direct costs may not have a \nsignificant effect on the entity unless it has previously incurred a significant \namount of initial direct costs. This is because the new definition of a lease and \nthe new lease classification guidance will likely yield similar outcomes to the \nrelated guidance in Topic 840 in most cases (assuming no errors in applying \nTopic 840 – see Question 13B .2.100) . However, because substantially fewer \ncosts qualify as initial direct costs under Topic 842 (see section 5.5), the effect \nof electing (or not electing) the package of practical expedients may be \nsignificant for entities that incur significant lease origination costs. \n[ASU 2016- 02.BC393(c) ] \n \n13B.2. 4 Land easements \n13B.2. 150 A land easement is, in general, a right to use and/or enter (or cross) \nland owned by another party for a specific purpose, for which the rights vary \ndepending on the easement. Land easements may be perpetual or for a defined \nterm, may be prepaid or paid over tim e, and may provide for exclusive or \nnonexclusive (shared) use of the land. For a discussion of land easements and the scope of Topic 842, see Question 2.3.10. \n13B.2.160 As some entities did not assess whether land easements met the \ndefinition of a lease under Topic 840, stakeholders expressed concern to the \nBoard that it would be costly and complex to evaluate those land easements in \ntransition. As a result, the Board added a n optional transition practical expedient \nspecifically for land easements. It allows an entity to elect not to assess \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1150}), Document(page\_content='Leases 1150 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. whether any expired or existing land easements are, or contain, leases at \ntransition if they were not previously accounted for as leases under Topic 840. \nAn entity that elects this practical expedient should assess any new or modified \nland easements on or after the effective date under Topic 842. \n13B.2.170 This practical expedient does not apply to any land easements that \nwere previously accounted for as leases under Topic 840. Such land easements \nare subject to the same transition guidance as other identified leases. \n13B.2.180 This practical expedient is available separately, or in conjunction with \neither or both of the other practical expedients: the all -or-nothing package of \npractical expedients, and the ability to use hindsight (see section 13 B.2.3). An \nentity that does not elect the land easements practical expedient must either: \n— If the package of practical expedients is not elected: reassess whether its \nland easements meet the Topic 842 definition of a lease; or \n— If the package of practical expedients is elected: ensure that its Topic 840 \nconclusions about whether its land easements were, or contained, leases \nwere correct (see Question 13B .2.100). \n \n Observation \nPrior land easement accounting is grandfathered \n13B.2.190 The Board specifically provided this transition practical expedient for \nland easements that were not accounted for as leases under Topic 84 0, rather \nthan land easements that were not assessed under Topic 840. In practical \nterms, this means that land easements that were accounted for under non-\nlease guidance do not need to be reassessed to determine if they met the \ndefinition of a lease either under Topic 840 (if the package of practical \nexpedients is elected) or Topic 842 (if the package of practical expedients is not \nelected) before transition. As a result, election of the practical expedient will \nessentially grandfather the legacy accounting for any land easements that exist \nat (i.e. have commenced before) the effective date of Topic 842, including any \nerroneously determined not to be a lease under Topic 840. \n13B.2.200 This differs from other transition guidance in Topic 842, which \nspecifie s that errors in the application of Topic 840 are not grandfathered (see \nQuestion 13B.2.100) . If an entity does not elect this practical expedient, it \ncannot overlook land easements that were erroneously not accounted for as leases under Topic 840, even if the entity elects the package of practical \nexpedients.\n [ASU 2016- 02.BC393(a)] \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1151}), Document(page\_content='Leases 1151 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 13B.2.120 \nLand easements arising before the effective date \nCan an entity change its accounting policy for land easements \nbefore the effective date of Topic 842? \nInterpretive response: No. An entity that elects the optional transition practical \nexpedient for land easements is required to continue to apply consistent \naccounting policies to new or modified contracts entered into before the \neffective date of Topic 842. Therefore, an entity that previously accounted for \nland easements under Topic 840 should continue to apply Topic 840 to new \nland easements arising before the effective date. For example, a new ground \nlease agreement (which could be characterized as a land easement) \ncommencing before the effective date of Topic 842 is not eligible for the \npractical expedient because similar ground leases had previously been \naccounted for by the entity as leases under Topic 840. [ASU 2018- 01.BC17] \nAlternatively, if the enti ty has historically accounted for a population of land \neasements under other guidance (e.g. Topics 350 or 360), the entity should \ncontinue to apply that accounting policy to all similar land easements entered into before the effective date of Topic 842. In this case , the entity is eligible to \napply the practical expedient to those land easements in transition. \n \n13B.2.5 Disclosures \n13B.2.210 In addition to the ongoing disclosures required by Topic 842 for \nlessees and lessors, a n entity generally provides the transition disclosures \nrequired for accounting changes and error corrections. As an exception, an \nentity is not required to disclose the effect of the change on income from continuing operations, net income and per ‑share amounts for the (1) interim and \nannual period s post -adoption, or (2) prior periods retrospectively adjusted. \n[842-\n10-65-1(i), 250- 10-50-1(b)(2) , 250- 10-50-3] \n13B.2.220 If an entity elects the package of practical expedients , the practical \nexpedient to use hindsight and/or the land easements practical expedient, it \ndiscloses that fact. [842- 10-65-1(j)] \n13B.2.230 Before the effective date, SEC registrants are required to evaluate \nnew accounting standards that they have not yet adopted and to disclose their \npotential material effects. These disclosures generally should include a \ndiscussion about the effect that adoption is expected to have on the financial \nstatements, unless this is not known or reasonably estimable. KPMG has developed example disclosures that may be used as a starting point by lessees \nand lessors in drafting disclosures about the effects of adopting Topic 842: \nASC 842, Leases – Transition disclosures . \n[SAB Topic 11.M] \n13B.2.240 While Topic 842 requires only certain lessor disclosures to be made \nin all interim financial statements, Article 10 of Regulation S-X requires SEC \nregistrants to provide both the applicable lessor and lessee annual and interim \ndisclosures in each interim period included in the entity’s quarterly reports on \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1152}), Document(page\_content='Leases 1152 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Form 10-Q in the year of adoption of a new accounting standard (see \nQuestion 12.1.20). \n \n Observation \nEffect of adoption on the financial statements \n13B.2.250 In various forums, including public meetings, that included members \nof the preparer and practitioner communities , member s of the SEC staff have \nstated that an entity assert ing in its financial statements that the effect of \nadoption of Topic 606 will not be material needs to consider the effect of the \nnew disclosure requirements. That is, even though the basic financial \nstatements may not be materially affected, the information in the significant \nnew disclosures could be a material effect on the financial statements, which include the notes. While this comment has most frequently been made in the \ncontext of comments about the adoption of Topic 606, we believe the SEC staff \nwould hold a similar view about an entity’s SAB 74 disclosures in relation to the new leases standard. \n13B.2.260 We believe some entities, many lessors in particular, may conclude \nthat the effect of Topic 842 on their basic financial statements will not be material but that they will have to make significant new disclosures. Those \nentities should be cognizant of this guidance from th e SEC staff. Meanwhile, \nlessees and others that anticipate a material effect from adoption should discuss the substantial new Topic 842 disclosure requirements in their pre-\nadoption SAB 74 disclosures in addition to the other anticipated effects on their \nfinancial statements. \n \n Question 13B.2.130 \nDisclosures in comparative periods \nDo the lessee, lessor and sale- leaseback disclosure \nrequirements in Topic 842 apply to comparative periods \npresented in the post -adoption financial statements? \nInterpretive response: Yes. Under the comparative method, the disclosure \nrequirements apply to the comparative periods presented in the financial \nstatements. \nWhen meeting the disclosure requirements, an entity does so based on its \naccounting in accordance with the Topic 842 transition requirements that apply \nto the relevant leases . For example (not exhaustive): \n— variable lease cost disclosed in accordance with paragraph 842- 20-50-4(d) \nwill not include variable payments of executory costs that were not \nconsidered contingent rent under Topic 840; \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1153}), Document(page\_content='Leases 1153 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — the operating lease income disclosure required by paragraph 842- 30-50-5(b) \nwill disclose lease income relating to the minimum rental payments – i.e. \nrather than the ‘lease payments’; and \n— gains or losses arising from sale -leaseback transactions disclosed in \naccordance with paragraph 842- 40-50-2(b) will be based on the gain or loss \n(inclusive of any portion originally deferred under Topic 840) that was \ncalculated under Topic 840 – i.e. rather than the gain or loss that might have \nresulted from applying the guidance in Topic 842. \n \n13B.3 Transition for l essees # \n Excerpt from ASC 842 -10 \nTransition and Open Effective Date Information \nGeneral \n> Transition Related to Accounting Standards Update s No. 2016- 02, \nLeases (Topic 842) , No. 2018- 01, Leases (Topic 842): Land Easement \nPractical Expedient for Transition to Topic 842 , No. 2018- 10, Codification \nImprovements to Topic 842, Leases , No. 2018- 11, Leases (Topic 842): \nTargeted Improvements , No. 2018- 20, Leases (Topic 842): Narrow -Scope \nImprovements for Lessors , No. 2019- 01, Leases (Topic 842): Codification \nImprovements , No. 2019- 10, Financial Instruments —Credit Losses (Topic \n326), Derivatives and Hedging (Topi c 815), and Leases (Topic 842): \nEffective Dates , No. 2020- 05, Revenue from Contracts with Customers \n(Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities , \nNo. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with Variable \nLease Payments , and No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entitie s, and No. 2023- 01, Leases \n(Topic 842): Common Control Arrangements \n65-1 The following represents the transition and effective date information \nrelated to Accounting Standards Updates No. 2016- 02, Leases (Topic 842) , \nNo. 2018- 01, Leases (Topic 842): Land Easement Practical Expedient for \nTransition to Topic 842, No. 2018- 10, Codification Improvements to Topic 842, \nLeases , No. 2018- 11, Leases (Topic 842): Targeted Improvements , No. 2018-\n20, Leases (Topic 842): Narrow- Scope Improvements for Lessors , No. 2019- 01, \nLeases (Topic 842): Codification Improvements , No. 2019- 10, Financial \nInstruments —Credit Losses (Topic 326), Derivatives and Hedging (Topi c 815), \nand Leases (Topic 842): Effective Dates , No. 2020- 05, Revenue from Contracts \nwith Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain \nEntities , No. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with \nVariable Lease Paymen ts, No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entitie s, and No. 2023- 01, Leases (Topic \n842): Common Control Arrangements : [Note : See paragraph 842-10-S65-1 for \nan SEC Staff Announcement on transition related to Update 2016- 02.] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1154}), Document(page\_content='Leases 1154 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Lessees \nLeases previously classified as operating leases under Topic 840 \nk. A lessee shall initially recognize a right -of-use asset and a lease liability at \nthe application date as determined in (c). \nl. Unless, on or after the effective date, the lease is modified (and that \nmodification is not accounted for as a separate contract in accordance with \nparagraph 842- 10-25-8) or the lease liability is required to be remeasured in \naccordance with paragraph 842- 20-35-4, a lessee shall measure the lease \nliability at the present value of the sum of the following, using a discount \nrate for the lease (which, for entities that are not public business entities, \ncan be a r isk-free rate determined in accordance with paragraph 842- 20-30-\n3) established at the application date as determined in (c): \n1. The remaining minimum rental payments (as defined under Topic 840). \n2. Any amounts probable of being owed by the lessee under a resid ual \nvalue guarantee. \nm. For each lease classified as an operating lease in accordance with \nparagraphs 842- 10-25-2 through 25- 3, a lessee shall initially measure the \nright-of-use asset at the initial measurement of the lease liability adjusted \nfor both of the following: \n1. The items in paragraph 842 -20-35-3(b), as applicable. \n2. The carrying amount of any liability recognized in accordance with \nTopic 420 on exit or disposal cost obligations for the lease. \nn. For each lease classified as an operating lease in accorda nce with \nparagraphs 842- 10-25-2 through 25- 3, a lessee shall subsequently measure \nthe right -of-use asset throughout the remaining lease term in accordance \nwith paragraph 842- 20-35-3(b). If the initial measurement of the right -of-use \nasset in (m) is adjuste d for the carrying amount of a liability recognized in \naccordance with Topic 420 on exit or disposal cost obligations for the \nlease, the lessee shall apply the recognition and subsequent measurement \nguidance in Sections 842 -20-25 and 842- 20-35, respectivel y, when the \nright-of-use asset has been impaired. \no. For each lease classified as a finance lease in accordance with \nparagraph 842-10-25-2, a lessee shall measure the right -of-use asset as \nthe applicable proportion of the lease liability at the commencement date, \nwhich can be imputed from the lease liability determined in accordance \nwith (l). The applicable proportion is the remaining lease term at the \napplication date as determined in (c) relative to the total lease term. A \nlessee shall adjust the right -of-use asset recognized by the carrying amount \nof any prepaid or accrued lease payments and the carrying amount of any \nliability recognized in accordance with Topic 420 for the lease. \np. If a lessee does not elect the practical expedients described in (f), any \nunamortized initial direct costs that do not meet the definition of initial \ndirect costs in this Topic shall be written off as an adjustment to equity \nunless the entity elects the transition method in (c)(1) and the costs were \nincurred after the beginning of the earliest period presented, in which case \nthose costs shall be written off as an adjustment to earnings in the period \nthe costs were incurred. \nq. If a modification to the contractual terms and conditions occurs on or \nafter the effective date, and the modification does not result in a \nseparate contract in accordance with paragraph 842 -10-25-8, or the \nlessee is required to remeasure the lease liability for any reason (see ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1155}), Document(page\_content='Leases 1155 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. paragraphs 842- 20-35-4 through 35- 5), the lessee shall follow the \nrequirements in thi s Topic from the effective date of the modification or \nthe remeasurement date. \nLeases previously classified as capital leases under Topic 840 \nr. For each lease classified as a finance lease in accordance with this Topic, a \nlessee shall do all of the followi ng: \n1. Recognize a right -of-use asset and a lease liability at the carrying \namount of the lease asset and the capital lease obligation in \naccordance with Topic 840 at the application date as determined in (c). \n2. Include any unamortized initial direct costs that meet the definition of \ninitial direct costs in this Topic in the measurement of the right -of-use \nasset established in (r)(1). \n3. If a lessee does not elect the practical expedients described in (f), write \noff any unamortized initial direct costs that do not meet the definition \nof initial direct costs in this Topic and that are not included in the \nmeasurement of the capital lease asset under Topic 840 as an \nadjustment to equity unless the entity elects the transition method in \n(c)(1) and the costs were incurred after the beginning of the earliest \nperiod presented, in which case those costs shall be written off as an \nadjustment to earnings in the period the costs were incurred. \n4. If an entity elects the transition method in (c)(1), subsequently measure \nthe right -of-use asset and the lease liability in accordance with Section \n840-30-35 before the effective date. \n5. Regardless of the transition method selected in (c), apply the \nsubsequent measurement guidance in paragraphs 842 -20-35-4 through \n35-5 and 842- 20-35-8 after the effective date. However, when applying \nthe pending content in paragraph 842- 20-35-4, a lessee shall not \nremeasure the lease payments for amounts probable of being owed \nunder residual value guarantees in accordance with paragraph 842- 10-\n35-4(c)(3). \n6. Classify the assets and liabilities held under capital leases as right -of-\nuse assets and lease liabilities arising from finance leases for the \npurposes of presentation and disclosure. \ns. For each lease classified as an operating lease in accordance with this \nTopic, a lessee shall do the following: \n1. Derecognize the carrying amount of any capital lease asset and capital \nlease obligation in accordance with Topic 840 at the application date as \ndetermined in (c). Any difference between the carrying amount of the \ncapital lease asset and the capital lease obligation shall be accounted \nfor in the same manner as prepaid or accrued rent. \n2. If an entity elects the transition method in (c)(1) and the lease \ncommenced before the beginning of the earliest period presented in \nthe financial statements or if the entity elects the transition method in \n(c)(2), recognize a right -of-use asset and a lease liability in accordance \nwith paragraph 842- 20-35-3 at the application date as determined in (c). \n3. If an entity elects the transition m ethod in (c)(1) and the lease \ncommenced after the beginning of the earliest period presented in the \nfinancial statements, recognize a right -of-use asset and a lease liability \nin accordance with paragraph 842- 20-30-1 at the commencement date \nof the lease. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1156}), Document(page\_content='Leases 1156 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 4. Account for the operating lease in accordance with the guidance in \nSubtopic 842 -20 after initial recognition in accordance with (s)(2) or \n(s)(3). \n5. Write off any unamortized initial direct costs that do not meet the \ndefinition of initial direct costs in this Topic as an adjustment to equity \nunless the entity elects the transition method in (c)(1) and the costs \nwere incurred after the beginning of the earliest period presented, in \nwhich case those costs shall be written off as an adjustment to \nearnings in the period the costs were incurred. \nt. If a modification to the contractual terms and conditions occurs on or after \nthe effective date, and the modification does not result in a separate \ncontract in accordance with paragraph 842- 10-25-8, or the lessee is \nrequir ed to remeasure the lease liability in accordance with paragraph 842-\n20-35-4, the lessee shall subsequently account for the lease in accordance \nwith the requirements in this Topic beginning on the effective date of the \nmodification or the remeasurement dat e. \n> Transition Related to Accounting Standards Update No. 2021 -09, \nLeases (Topic 842): Discount Rate for Lessees That Are Not Public \nBusiness Entities \n65-6 The following represents the transition and effective date information \nrelated to Accounting Standards Update No. 2021- 09, Leases (Topic 842): \nDiscount Rate for Lessees That Are Not Public Business Entities : \na. An entity that has not yet adopted the pending content that links to \nparagraph 842- 10-65-1 as of 11/11/2021 shall apply the pending content \nthat links to this paragraph to all new and existing leases when the entity \nfirst applies the pending content that links to paragraph 842- 10-65-1. That \nentity shall apply the same transition method elected for the pending \ncontent that links to paragraph 842- 10-65-1. \nb. An entity that has adopted the pending content that links to paragraph 842-\n10-65-1 (as of 11/11/2021) shall: \n1. Apply the pending content that links to this paragraph for financial \nstatements issued for fiscal years beginning after December 15, 2021, \nand interim periods within fiscal years beginning after December 15, \n2022. Earlier application is permitted as of the beginning of the fiscal \nyear of adoption. \n2. Apply the pending content that links to this paragraph on a m odified \nretrospective basis to leases affected by the amendments existing as \nof the beginning of the fiscal year of adoption by adjusting the lease \nliability, which shall be calculated based on the discount rate and \nremaining lease term at the beginning of the fiscal year of adoption. An \nentity shall recognize the amount of the change in the lease liability as \nan adjustment to the corresponding right -of-use asset, unless: \ni. The carrying amount of the right -of-use asset is reduced to zero, \nin which case the entity shall recognize any remaining amount of \nthe adjustment to opening retained earnings at the beginning of \nthe fiscal year of adoption. \nii. The adjustment would increase a right -of-use asset that was \npreviously impaired, in which case the entity shall record the \nadjustment to opening retained earnings at the beginning of the \nfiscal year of adoption. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1157}), Document(page\_content='Leases 1157 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. c. An entity within the scope of (b) shall not treat the adoption of the pending \ncontent that links to this paragraph as an event that would require the \nentity to: \n1. Remeasure and reallocate the consideration in the contract in \naccordance with paragraph 842- 10-15-36. \n2. Reassess the lease term or a lessee option to purchase the underlying \nasset in accordance with paragraph 842- 10-35-1. \n3. Remeasure the lease payments in accor dance with paragraph 842- 10-\n35-4. \n4. Reassess lease classification in accordance with paragraph \n842-10-25-1. \nd. An entity within the scope of (b) that has adopted the pending content that \nlinks to this paragraph shall disclose the following as of the beginning of \nthe fiscal year of adoption (rather than at the beginning of the earliest \nperiod presented): \n1. The information required by paragraph 250- 10-50-1(a) and (b)(3), if \napplicable \n2. The recognized amount of changes in lease liabilities and \ncorresponding right -of-use assets resulting from the transition \nadjustment. \nFor an entity within the scope of (b), at the date of adoption of the pending \ncontent that links to this paragraph, the entity may choose to apply or \ndiscontinue using the risk -free rate for any class of underlying asset. \n> Transition Related to Accounting Standards Update No. 2023 -01, Leases \n(Topic 842): Common Control Arrangements \n65-7 The following represents the transition and effective date information \nrelated to the practical expedient in Accounting Standards Update No. 2023- 01, \nLeases (Topic 842): Common Control Arrangements : \na. The pending content that links to this paragraph shall be effective for fiscal \nyears, including interim periods within those fiscal years, beginning after \nDecember 15, 2023. Early adoption is permitted in any annual or interim \nperiod for which financial statements have not yet been made available for \nissuance. If an entity adopts the pending content that links to this \nparagraph in an interim period, it shall adopt that pending content as of the \nbeginning of the fiscal year that includes that interim period. \nb. An entity that adopts the pending content that links to this paragraph \nconcurrently with adopting the pending content that links to paragraph 842-\n10-65-1 shall apply the pending content that links to this paragraph using \nthe same transition method elected for the pending content that links to \nparagraph 842- 10-65-1. \nc. An entity that adopted the pending content that links to paragraph 842- 10-\n65-1 before adopting the pending content that links to this paragraph shall \napply the pending content that links to this paragraph using either of the \nfollowing two methods: \n1. Prospectively to arrangements that commence or are modified on or \nafter the date that the entity first applies the pending content that links \nto this paragraph. \n2. Retrospectively to the beginning of the period in which the pending \ncontent that links to paragraph 842- 10-65-1 was first applied. The \npending content that links to this paragraph shall not be applicable for ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1158}), Document(page\_content='Leases 1158 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. arrangements no longer in place at the date of a doption. Under this \ntransition method: \ni. If an arrangement previously considered to be a lease continues to \nbe a lease after applying the pending content that links to this \nparagraph, an entity shall apply the requirements in paragraphs \n842-10-25-9 through 25 -17 to any changes in the lease resulting \nfrom application of the practical expedient in the pending content \nthat links to this paragraph. Any amounts that otherwise would \nhave been recognized in earnings shall be recognized as a \ncumulative -effect adjust ment to opening retained earnings (or net \nassets of a not -for-profit entity) at the beginning of the earliest \nperiod presented in accordance with the pending content that links \nto paragraph 842- 10-65-1. \nii. If an arrangement previously not considered a lease becomes a \nlease after applying the pending content that links to this \nparagraph, an entity shall account for the arrangement as a new \nlease. \nd. An entity may document any existing unwritten terms and conditions of an \narran gement between ent ities under common control before the date on \nwhich the entity’s first interim (if applicable) or annual financial statements \nare available to be issued in accordance with the pending content that links \nto this paragraph. \ne. An entity within the scope of (c) shall provide the applicable transition \ndisclosures required by Topic 250 on accounting changes and error \ncorrections, except for the requirements in paragraphs 250- 10-50-1(b)(2) \nand 250- 10-50-3. An entity that elects the transition method in (c)(2) shall \nprovide the transition disclosures in paragraph 250- 10-50-1(b)(3) as of the \nbeginning of the earliest period presented but not before the date on which \nthe pending content that links to paragraph 842- 10-65-1 was adopted. \nf. An entity that elects the practical expedient(s) in paragraph 842- 10-65-1(f) \nor (g) is not required to apply either of those practical expedients to \ncommon contr ol arrangements for which the pending content that links to \nthis paragraph is being applied. \n65-8 The following represents the tra nsition and effective date information \nrelated to the accounting for leasehold improvements associated with leases \nbetween entities under common control in Accounting Standards Update No. \n2023 -01, Leases (Topic 842): Common Control Arrangements : \na. The pendin g content that links to this paragraph shall be effective for fiscal \nyears, including interim periods within those fiscal years, beginning after \nDecember 15, 2023. Early adoption is permitted in any annual or interim \nperiod for which financial statements have not yet been made available for \nissuance. If an entity adopts the pending content that links to this \nparagraph in an interim period, it shall adopt that pending content as of the \nbeginning of the fiscal year that includes that interim period. \nb. An entity that adopts the pending content that links to this paragraph \nconcurrently with adopting the pending content that links to paragraph 842-\n10-65-1 may apply the pending content that links to this paragraph using \nthe same transition method elected for the pen ding content that links to \nparagraph 842- 10-65-1 or may apply the pending content that links to this \nparagraph using either of the prospective methods specified in (c)(1) and \n(c)(2) below. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1159}), Document(page\_content='Leases 1159 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. c. An entity that adopted the pending content that links to paragraph 842- 10-\n65-1 before adopting the pending content that links to this paragraph shall \napply the pending content that links to this paragraph using one of the \nfollowing methods: \n1. Prospectively to all new leasehold improvements recognized on or after \nthe date that the entity first applies the pending content that links to \nthis paragraph. \n2. Prospectively to all new and existing leasehold improvements \nrecognized on or after the date that the entity first applies the pending \ncontent that links to this paragraph. An entity that elects this transition \napproach shall amortize the remaining balance of leasehold \nimprovements existing at the date of adoption of the pending content \nthat links to this paragraph over the remaining useful life of those \nimproveme nts to the common control group determined at that date. \n3. Retrospectively to the beginning of the period in which the pending \ncontent that links to paragraph 842- 10-65-1 was first applied. Any \nleasehold improvements previously amortized or impaired that \notherwise would not have been amortized or impaired had the pending \ncontent that links to this paragraph been applicable shall be r ecognized \nthrough a cumulative- effect adjustment to the opening b alance of \nretained earnings (or net assets of a not -for-profit entity) at the \nbeginning of the earliest period p resented in accordance with the \npending content that links to p aragraph 842-10-65-1. \nd. An entity within the scope of (c) shall provide the applicable transition \ndisclosures required by Topic 250 on accounting changes and error \ncorrections, except for the requirements in paragraphs 250- 10-50-1(b)(2) \nand 250- 10-50-3. An entity that elects the transition method in (c)(3) shall \nprovide the transition disclosures in paragraph 250- 10-50-1(b)(3) as of the \nbeginning of the earliest period presented but not before the date on which \nthe pending content that links to paragraph 842- 10-65-1 was adopted. \n55 Implementation Guidance and Illustrations \nGeneral \n> Implementation Guidance \n>> Illustrations of Transition \n>>> Illustration of Lessee Transition —Existing Capital Lease \n55-243 Example 28 illustrates lessee accounting for the transition of existing \ncapital leases when an entity elects the transition method in paragraph 842- 10-\n65-1(c)(1). \n>>>> Example 28— Lessee Transition —Existing Capital Lease \n55-244 The effective date of the guidance in this Topic for Lessee is January 1, \n20X4. Lessee enters into a 7- year lease of an asset on January 1, 20X1, with \nannual lease payments of $25,000 payable at the end of each year. The lease \nincludes a residual value guarantee by Lessee of $8,190. Lessee’s incremental \nborrowing rate on the date of commencement was 6 percent. Lessee \naccounts for the lease as a capital lease. At lease commencement, Lessee \ndefers initial direct costs of $2,800, which will be amortized over the lease \nterm. On January 1, 20X2 (and before transition adjustments), Lessee has a ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1160}), Document(page\_content='Leases 1160 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. lease liability of $128,707, a lease asset of $124,434, and unamortized initial \ndirect costs of $2,400. \n55-245 January 1 , 20X2 is the beginning of the earliest comparative period \npresented in the financial statements in which Lessee first applies the \nguidance in this Topic. Lessee has elected the package of practical expedients \nin paragraph 842- 10-65-1(f). As such, Lessee a ccounts for the lease as a \nfinance lease, without reassessing whether the contract contains a lease or \nwhether classification of the lease would be different in accordance with this \nTopic. Lessee also does not reassess whether the unamortized initial direc t \ncosts on January 1, 20X2, would have met the definition of initial direct costs in \nthis Topic at lease commencement. \n55-246 On January 1, 20X2, Lessee recognizes a lease liability at the carrying \namount of the capital lease obligation on December 31, 20X 1, of $128,707 and \na right -of-use asset at the carrying amount of the capital lease asset of \n$126,834 (which includes unamortized initial direct costs of $2,400 that were \nincluded in the capital lease asset). Lessee subsequently measures the lease \nliabilit y and the right -of-use asset in accordance with Subtopic 840 -30 until the \neffective date. \n55-247 Beginning on the effective date, Lessee applies the subsequent \nmeasurement guidance in Section 842- 20-35, including the reassessment \nrequirements, except for t he requirement to reassess amounts probable of \nbeing owed under residual value guarantees. Such amounts will only be \nreassessed if there is a remeasurement of the lease liability for another reason, \nincluding as a result of a lease modification (that is, not accounted for as a \nseparate contract). \n>>> Illustration of Lessee Transition —Existing Operating Lease \n55-248 Example 29 illustrates lessee accounting for the transition of existing \noperating leases when an entity elects the transition method in paragraph 842-\n10-65-1(c)(1). \n>>>> Example 29— Lessee Transition —Existing Operating Lease \n55-249 The effective date of the guidance in this Topic for Lessee is January 1, \n20X4. Lessee enters into a five- year lease of an asset on January 1, 20X1, with \nannual lease payments payable at the end of each year. Lessee accounts for \nthe lease as an operating lease. At lease commencement, Lessee defers initial \ndirect costs of $500, which will be amortized over the lease term. On \nJanuary 1, 20X2 (and before transition adjustments), Lessee has an accrued \nrent liability of $1,200 for the lease, reflecting rent that was previously \nrecognized as an expense but was not yet paid as of that date. Four lease \npayments (1 payment of $31,000 followed by 3 payments of $33,000) and \nunamortized initial direct costs of $400 remain. \n55-250 January 1, 20X2 is the beginning of the earliest comparative period \npresented in the financial statements in which Lessee first applies the \nguidance in this Topic. On January 1, 20X2, Lessee’s incremental borrowing \nrate is 6 percent. Lessee has elected the package of practical expedients in \nparagraph 842- 10-65-1(f). As such, Lessee accounts for the lease as an \noperating lease, without reassessing whether the contract contains a lease or \nwhet her classification of the lease would be different in accordance with this ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1161}), Document(page\_content='Leases 1161 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Topic. Lessee also does not reassess whether the unamortized initial direct \ncosts on January 1, 20X2, would have met the definition of initial direct costs in \nthis Topic at lease co mmencement. \n55-251 On January 1, 20X2, Lessee measures the lease liability at $112,462, \nwhich is the present value of 1 payment of $31,000 and 3 payments of \n$33,000 discounted using the rate of 6 percent. The right -of-use asset is equal \nto the lease liabil ity before adjustment for accrued rent and unamortized initial \ndirect costs, which were not reassessed because Lessee elected the practical \nexpedients in paragraph 842- 10-65-1(f). \n55-252 On January 1, 20X2, Lessee recognizes a lease liability of $112,462 and \na right -of-use asset of $111,662 ($112,462 – $1,200 + $400). \n55-253 From the transition date (January 1, 20X2) on, Lessee will continue to \nmeasure and recognize the lease liability at the present value of the sum of \nthe remaining minimum renta l payments (as that term was applied under \nTopic 840) and the right -of-use asset in accordance with this Topic. \n55-254 Beginning on the effective date of January 1, 20X4, Lessee applies the \nsubsequent measurement guidance in Section 842- 20-35, including t he \nreassessment requirements. \n \n \n13B.3.1 Lessee elects package of practical expedients \n13B.3.10 This section discusses the transition requirements for a lessee that \nelects the package of practical expedients (see section 13B .2.3). Because lease \nclassification is not reassessed in applying the package of practical expedients: \n[842- 10-65-1(f)(2)] \n— all existing leases classified as operating leases under Topic 840 will be \nclassified as operating leases under Topic 842; and \n— all existing leases classified as capital leases under Topic 840 will be \nclassified as finance leases under Topic 842. \nOperating leases under Topic 840 \n13B.3.20 The following diagram gives an overview of the transition requirements \nfor an operating lease, which are explained in this section, assuming a public \nbusiness entity with a calendar year -end. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1162}), Document(page\_content='Leases 1162 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Comparative period Comparative period Current periodDecember 31, 2019Effective date \n(date of adoption )\nJanuary 1, 2019Beginning of earliest \nperiod presented\nJanuary 1, 2017 January 1, 2018\nExisting leases commenced before Jan . 1, 2017\nDate of initial recognition and measurement (see \nparagraph 13B.2.50):\n— If lease commenced on /before Jan . 1, 2017 : at \nJan. 1, 2017\n— If lease commenced after Jan . 1, 2017 : at \ncommencement date \nMeasurement :\n— Lease liability = PV of remaining minimum rental \npayments , amount probable under RVG , using \ndiscount rate at transition date\n— ROU asset = lease liability +/(-) prepaid (accrued ) \nrent - remaining balance of lease incentives + \nunamortized IDCs\nExpired leases :\nDo nothing \nLease liability initial and subsequent measurement \n13B.3.30 Absent lease modifications or remeasurements, the lease liability is \nmeasured as follows, both at the transition date (see paragraph 13B.2.50) and \nsubsequently – i.e. for the remainder of the lease term. [842- 10-65-1(l)] \nPV of amount \nprobable of \nbeing owed \nunder RVGLease liabilityPV of unpaid \nminimum \nrental \npayments1\n \nNote: \n1. Minimum rental payments (as defined in Topic 840, see Question 13B .3.10 ). \n13B.3.40 The discount rate for the lease is measured as follows at the transition \ndate. [842- 10-65-1(l), 842- 20-30-3] \n— For all entities, it is the rate implicit in the lease if that rate is readily \ndeterminable (see Question 5.6.20). \n— If the rate implicit in the lea se is not readily determinable: \n— for public business entities, it is the lessee’s incremental borrowing rate \n(see Ques tion 13B.3.50); \n— for all other entities, a risk ‑free discount rate may be used instead of \nthe lessee’s incremental borrowing rate if the les see elects to do so for \nthe applicable class of underlying asset (see paragraph 5.6.30). \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1163}), Document(page\_content='Leases 1163 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 13B.3.10 \nMinimum rental payments \nDo the ‘minimum rental payments’ in Topic 840 exclude the \nportion of fixed rental payments attributable to executory \ncosts such as taxes, insurance and maintenance (including CAM )? \nInterpretive response: Topic 840 is not clear in this respect. ‘Minimum rental \npayments’ is not a defined term in Topic 840 (or the ASC Master Glossary), and \nthere has been diversity in practice. \nSome entities accounted for executory costs, when part of the fixed payments \nin the lease contract, as part of the minimum rental paym ents for a lease \n(Approach A), while other entities excluded such amounts from the minimum \nrental payments (Approach B). For example, in a gross real estate lease, entities \nfollowing Approach A treated the entire gross periodic payment as a minimum \nrental payment (and included that amount in their operating lease maturity \nanalysis disclosure) , while those following Approach B excluded the portion of \nthe payment that represented executory costs for property taxes, insurance and \nmaintenance from the minimum r ental payments for the lease (and excluded \nthat amount from their operating lease maturity analysis disclosure) . \nFor any lease that includes fixed executory costs , the resulting lease liability and \nROU asset will be larger measured on the basis of Approach A than they would \nbe (i.e. assuming the same terms and conditions) measured on the basis of \nApproach B, and will also be larger than they would be on the basis of the \n‘lease payments’ as defined in Topic 842 if there were non- lease components . \nThe SEC staff has observed “that the term ‘minimum rental payments’ is not \nexplicitly defined in ASC 840. As a result, the staff did not object to registrants \nconsistently applying their historical accounting policy conclusions regarding the \ncomposition of minimum lease payments when concluding whether executory \ncosts should be included in remaining minimum rental payments for purposes \nof establishing the lease liability in transition.” Consequently, a lessee’s \napplication of Approach A or Approach B under Topic 840 may be retained by \nthe lessee when measuring its existing operating leases o n transition to \nTopic 842 in accordance with paragraph 842-10-65-1(l). [2017 AICPA conf ] \nAn entity’s approach (A or B) should be disclosed and applied consistently to all \nof the entity’s existing leases that were operating leases under Topic 840. \nChanging from one approach to the other \nIn mid- 2018, t he SEC staff additionally communicated that changing one’s \napproach to include or exclude executory costs from ‘minimum rental \npayments’ (e.g. changing from Approach A to Approach B) constitutes a change \nin accounting principle under Topic 250 (accounting changes and error \ncorrections) that must be justified as preferable. [250- 10-20, 250- 10-45-1 – 45-2] \nHowever , we believe it may be acceptable to switch from Approach B to \nApproach A without establishing preferability if that change accompanies the lessee’s policy election not to separate lease and non- lease components in \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1164}), Document(page\_content='Leases 1164 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. transition to Topic 842 (see Question 13 B.5.10). This is because in that case, \nthe inclusion of executory costs in the measurement of the lease liability in \ntransition is the result of the lessee electing a new accounting principle created \nby the issuance of ASU 2016- 02, rather than changing an existing accounting \nprinciple ; this scenario was not considered by the SEC staff . [250- 10-45-2(a)] \n \n Question 13B.3. 20 \nExcluding CAM costs \nIs it acceptable to exclude only the CAM portion of the \n‘executory’ costs of a lease from the minimum rental payments in transition to Topic 842?\n \nBackground: As discussed in Question 13B.3.10, it is acceptable under \nTopic 840 to either include or exclude executory costs from ‘minimum rental \npayments’. Executory costs include costs of taxes, insurance and maintenance \n(including CAM). Topic 840 does not differentiate between these types of \nexecutory costs. [840- 10-25-1] \nInterpretive response: No. Based on discussions with the SEC staff, we do \nnot believe the transition guidance in Topic 842 permits an approach that would \nsolely exclude executory costs of maintenance from the minimum rental payments used to measure existing lea ses on transition. \n \n Question 13B.3.30 \nMeasurement of lease payments that depend on an \nindex or rate in determining the operating lease \nliability \nFor operating leases with variable lease payments that \ndepend on an index or rate and for which lease inception was \nbefore the date of initial application, what index or rate \nshould the lessee use to measure the transition date lease \nliability? \nBackground: Topic 840 states , “lease payments that depend on an existing \nindex or rate, such as the consumer price index or the prime interest rate, shall \nbe included in minimum lease payments based on the index or rate existing at \nlease inception; any increases or decreases in lease payments that result from subsequent changes in the index or rate are contingent rentals and therefore \naffect the determination of income as accruable.” \n[840- 10-25-4] \nIn practice, some entities followed this guidance when making their operating \nlease disclosures under Topic 840. That is, they continued to measure lease \npayments that depend on an index or rate (e.g. in disclosing remaining \nminimum rental payments in accordance with paragraph 840- 20-50-2) using the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1165}), Document(page\_content='Leases 1165 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. index or rate at lease inception (or the date of the last lease modification that \nrequired the entity to reassess classification of the lease) throughout the lease \nterm. However, other entities followed a policy of updating the reference index \nor rate used to measure lease payments that depend on an index or rat e in \nmaking their disclosure of future minimum rental payments for operating \nleases . \nInterpretive response: Based on discussions with the SEC staff, we \nunderstand that the staff would accept an entity continuing its historical \naccounting policy with respec t to using (or not using) updated indices or rates in \ndisclosing its operating lease future minimum rental payments when measuring \nthe transition date lease liability. This would mean: \n— An entity that has historically not updated reference indices or rates when \nmeasuring lease payments that depend on an index or rate to include in the \nminimum rental payments would follow Approach A outlined below. \n— An entity that has historically updated reference indices or rates when \nmeasuring lease payments that depend on an index or rate to include in the \nminimum rental payments would follow Approach B outlined below. \nApproach A : Use index or rate indicated by paragraph 840- 10-25-4 \nUnder this approach, regardless of whether the existing operating lease is classif ied as an operating or a finance lease on transition, the lessee uses the \nindex or rate (e.g. CPI) as of lease inception (or the date of the last lease modification that required the entity to reassess the classification of the lease \nunder Topic 840, if ap plicable) to determine the amount of variable lease \npayments that depend on an index or rate to include in the transition date lease \nliability. \nLeases acquired in a business combination \nAs an exception to the above, if an existing operating lease was acqui red in a \nbusiness combination, we believe a lessee should use the index or rate as of \nthe later of: \n— the a cquisition date; or \n— the date of the last lease modification that, in accordance with Topic 840, required the lessee to account for the modified lease as a new lease. \nApproach B : Use index or rate as of the transition date \nUnder this approach, the lessee uses the index or rate (e.g. CPI) as of the transition date to determine the amount of variable lease payments that depend \non an index or rate to include in the transition date lease liability. \nChanging approach \nAn entity that has historically not updated reference indices or rates used to \nmeasure lease payments that depend on an index or rate when preparing its \noperating lease future mini mum rental payments disclosure may want to apply \nApproach B. \nThe SEC staff has communicated that this would constitute a change in \naccounting principle under Topic 250 (accounting changes and error corrections) \nthat must be justified as preferable, if mate rial. \n[250- 10-20, 250- 10-45-1 – 45-2] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1166}), Document(page\_content='Leases 1166 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Non-SEC registrants \nWe believe the above response applies equally to SEC registrants and entities \nthat are not SEC registrants. \n \n Question 13B.3.40 \nForeign exchange rate to use in transition when the \nlease is not deno minated in the entity’s functional \ncurrency \nFor leases with payments that are not in the lessee’s \nfunctional currency that commenced before the date of initial \napplication, what exchange rate should be used to translate the ROU asset ? \nBackground: The ROU asset for any lease (finance or operating) is a \nnonmonetary asset while the lease liability is a monetary liability. Therefore, \nwhen accounting for a lease that is denominated in a foreign currency, if \nremeasurement into the lessee’s functional currency is required, the lease \nliability is remeasured using the current exchange rate, while the ROU asset is \nremeasured using the exchange rate as of the lease commencement date. \n[842- 20-55-10] \nFor any capital lease under Topic 840 that commenc ed before the date of initial \napplication, and that is classified as a finance lease under Topic 842, the lessee recognizes at the date of initial application a finance lease ROU asset and a \nfinance lease liability at the carrying amount of the capital lea se asset and the \ncapital lease obligation in accordance with Topic 840 immediately before the \ndate of initial application. \n[842- 10-65-1(r)(1)] \nInterpretive response: For any lease liability (finance or operating), it is clear \nthe exchange rate that should be used to translate the lease liability at the date \nof initial application is the current rate at that date. This is because, as a \nmonetary liability, a lease liability is always remeasured using the current \nexchange rate. \nFor a finance lease ROU asset ar ising from a capital lease under Topic 840, the \nlessee will remeasure the ROU asset at the date of initial application using the same exchange rate used immediately before that date (see background). This \nis because the lessee is required to recognize the finance lease ROU asset at \nthe carrying amount of the capital lease asset, and changing the exchange rate \nwould change the carrying amount of the ROU asset in the entity’s reporting \ncurrency . \nWhile not explicit related to leases transition, we believe the ROU asset for a \nfinance or operating lease that was classified as an operating lease under \nTopic 840 should be measured in the currency of the lease first. Then that \namount should be remeasured into the entity’s functional currency using the \nrate at the da te of initial application. This is because there is guidance in \nTopic 830 ( foreign currency matters ) that requires an entity to use the exchange \nrate on the date that an asset or liability is initially recognized. And before the \ndate of initial application , no ROU asset was recognized. Initial recognition of \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1167}), Document(page\_content='Leases 1167 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. ROU assets arising from existing operating leases occurs at the date of initial \napplication for a lease that commenced before that date. [830- 20-30-1] \nSee section 6.4.3 for discussion of the exchange ra tes to be used after initial \nmeasurement for an operating lease with payments denominated in a foreign currency. \n \n Question 13B.3.50 \nDetermining the incremental borrowing rate in \ntransition \nFor an existing operating lease that commenced before the \ndate of initial application, should the incremental borrowing rate for that lease consider (1) the remaining lease term and remaining minimum rental payments or (2) the total lease term and t otal minimum rental payments? \nBackground: Topic 842 specifies that the discount rate for each existing \noperating lease should be established at the transition date, which means \nbased on the facts and circumstances (e.g. economic environment and lessee \ncredit standing) as of that date. However , it does not prescribe whether that \nrate should be based on the remaining lease term and remaining minimum \nrental payments or the total lease term and total minimum rental payments. \nInterpretive response: Because T opic 842 is not clear on this question, we \nbelieve either approach is acceptable , as long as it is applied consistently as an \naccounting policy election to all of the lessee’s leases in transition and the \npolicy disclosed. This position was affirmed by the FASB and SEC staffs, the \nlatter in a speech by Michael P. Berrigan, Professional Accounting Fellow, \nOffice of the Chief Accountant , at the 2017 AICPA Conference on Current SEC \nand PCAOB Developments . \nThat said, we believe use of the total lease term and total minimum rental \npayments may be more consi stent with the intent of the Board. This is because \nit is our understanding that the Board’s decision to permit lessees to determine \nthe incremental borrowing rate for an existing operating lease as of the date of \ninitial application, rather than as of lea se inception or lease commencement, \nwas a practical accommodation intended to make it easier for lessees to make an estimate they generally did not have to make in accounting for those leases \nunder Topic 840. For example, the Board considered that it might be difficult for \na lessee to get third -party information about interest rates as of a date \nsignificantly in the past – e.g. obtain a bank quote for a rate the bank would \nhave charged 10 or 15 years ago. In contrast, it would generally be no more \ndifficult to obtain the total lease term and total minimum rental payments than \nto obtain the remaining lease term and remaining minimum rental payments. \nFurther, we do not believe the transition provision was intended to substantially \nchange the substance of the implied borrowing. A date of initial application \ndiscount rate based on the remaining term of the lease and the remaining \nminimum rental payments may differ substantially from the rate that would be \ndetermined based on the total lease term and the total lease payments . A \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1168}), Document(page\_content='Leases 1168 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. discount rate for the lease based on the remaining payments and term may not \nreflect the economics of the lease and may be inconsistent with the Board’s \nintent that the incremental borrowing rate serve as a practical proxy for the \ninterest rate in the contract. For example, an entity would presumably pay a \nvery different interest rate for a 15- year loan with a principal balance of \n$15 million (i.e. as sume a 15- year lease term with $15 million in gross minimum \nrental payments) than it would for a three- year loan with a beginning principal \nbalance of $3 million (i.e. a three- year lease with $3 million in gross minimum \nrental payments). \n \nROU asset initial measurement \n13B.3.50 The ROU asset is measured as follows at the transition date. \nSection 13B.9 addresses additional considerations if the lease was acquired in \na business combination. [842- 10-65-1(m)] \nPrepaid /\n(accrued )\n lease \npaymentsLease \nliability Unamortized \nbalance of \nlease \nincentives \nreceivedUnamortized \nIDCsAny Topic \n420 lease \nliabilityor\n \n13B.3.60 Before the amendments in ASU 2016- 02, lessees were sometimes \nrequired to recognize a liability under Topic 420 ( exit or d isposal cost \nobligations) for (1) costs to terminate an operating lease before the end of its \nterm, and/or (2) other costs associated with the operating lease that will \ncontinue to be incurred without economic benefit to the entity. \n13B.3.70 At the transition date for a lease , any existing Topic 420 liability reduces \nthe initial measurement of the ROU asset recognized for the lease regardless of \nwhether the lease is classified as an operating lease or as a finance lease under \nTopic 842. If the lease is an operating lease, the accounting after the transition \ndate is different from other operating leases. The ROU asset is generally \namortized on a straight ‑line basis. The combined straight ‑line amortization of \nthe ROU asset and the accretion of the lease liability on an effective interest \nbasis each period is recognized as a single operating lease cost for the lease. \n[842- 10-65-1(m) – 65-1(n)] \nROU asset subsequent measurement \n13B.3.80 After initial recognition, the ROU asset is measured using the same \nlessee subsequent measurement guidance applicable to new operating leases \nthat commence on or after the effective date (see section 6.4.2). [842- 10-65-1(n)] \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1169}), Document(page\_content='Leases 1169 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 13B.3. 60 \nROU asset abandoned before the date of initial \napplication \nShould a lessee recognize a right -of-use (ROU) asset o n \ntransition if it has already abandoned the asset before the \ndate of initial application ? \nBackground: A lessee may have abandoned an ROU asset (see \nQuestion 6.5.50) arising from an existing operating lease before the date of \ninitial application . Despite this, following the transition requirements for the \ninitial measurement of the ROU asset could result in the lessee recognizing the \nabandoned ROU asset. This is because the transition guidance does not \naddress abandoned ROU asset scenarios and derives the ROU asset for \nexisting operating leases from the lease liability (which will not be zero, ev en in \nan abandonment scenario). \nInterpretive response: No. An ROU asset should not be recognized on \ntransition if it was abandoned before the date of initial application . If an \nabandoned ROU asset is measured on transition at an amount greater than zero \nafter applying the transition guidance, a further adjustment should be recorded \nthrough equity to reduce the carrying amount of that ROU asset to zero as of \nthe transition date. \n \n Question 13B.3.70 \nExecutory costs that are part of Topic 420 liabilities \non transition \nAre amounts for lessee executory costs (e.g. property taxes) \nin a Topic 420 liability netted against the ROU asset established on transition? \nBackground: Before transition to Topic 842, Lessee LE provided legal notice \nthat it will terminate its operating lease of a facility before the conclusion of the \ncontract term . \nBased on the terms of the lease contract, in addition to making fixed rental \npayments, LE is required to make variable property tax payments. Under \nTopic 420, at the cease- use date, LE recognized a liability for the remaining \nrental payments and the property tax payments it expected to make over the remaining term for which it will receive no economic benefit . \nInterpretive response: Yes. Paragraph 842- 10-65-1(m) does not envisage \nseparation of a Topic 420 operating lease liability into components – e.g. a \ncomponent associated with the contractual rental payments and a component \nrelated to one or more executory costs, such as an obligation to pay property \ntaxes on the underlying asset . Therefore, the entire Topic 420 liability is \nnetted against the transition date R OU asset, including any portion attributable \nto expected executory costs for which the lessee will receive no \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1170}), Document(page\_content='Leases 1170 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. economic benefit , as long as the carrying amount of the ROU asset will not be \nreduced below zero subsequent to that action (see Question 13 B.3.80). \n \n Question 13 B.3.80 \nTransition guidance for Topic 420 liabilities results \nin negative ROU asset carrying amount \nIf netting the existing Topic 420 liability on transition would \nresult in a negative initial measurement of the ROU asset , \nhow is that excess credit accounted for ? \nBackground: The carrying amount of a lessee’s Topic 420 liability immediately \nbefore the Topic 842 transition date for an existing operating lease may exceed \nthe amount that will be recognized for the lease liability at that date. \nConsequently, measuring the ROU asset in accordance with paragraph 842- 10-\n65-1(m) may result in a negative amount. \nFor example, the Topic 420 liability might include estimated executory costs \n(e.g. for property taxes or insurance) that the lessee expects to pay over the \nremaining lease term for which it will receive no economic benefit . However, \nthe lease liability does not include such amounts – either because the costs are \nvariable or because the lessee has historically followed Approach B to \nQuestion 13B.3.10. \nInterpretive response: If netting the Topic 420 liability would create a negative \nROU asset carrying amount , we believe the lessee should reduce the carrying \namount of the ROU asset to zero and then do one of the following with the \nremaining amount of the Topic 420 liability . \n— Derecognize the ‘ excess ’ Topic 420 liability . The corresponding entry is \nan adjustment to equity at the transition date. The costs underlying that \nexcess amount will be recognized through the income statement as they \nare incurred after the transition date. \nUnder this approach, the lessee will recognize those costs through the \nincome statement twice : once when the Topic 420 liability was established \nbefore the transition date, and again when those costs are actually incurred after the transition date. Operating lease costs are no longer in the scope of \nTopic 420 from the effective date of Topic 842; therefore, this approach \ntakes the perspective that there is no longer a basis in Topic 420 to \nrecognize the excess amounts. \nProponents of this approach believe that paragraph 842- 10-65-1(d) would \ninstruct the les see to take the excess credit to equity on the transition date \nand account for the lease- related costs underlying that excess liability that \nwill be incurred after the transition date in the same manner as such costs \nwill be accounted for after the effective date for new leases. \n[842- 10-65-1(d)] \n— Continue to recognize the ‘ excess ’ Topic 420 liability . Under this \napproach, the excess credit is accounted for after the transition date in the \nsame manner as before the transition date. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1171}), Document(page\_content='Leases 1171 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Proponents of this approach note that the FASB stated i ts intent for lessees \nto be able to ‘run off’ existing leases in accordance with the requirements \nin previous GAAP (other than recognizing new ROU assets and lease \nliabilities for existing operating leases) – see paragraph 13B.2.120. \nTherefore, it would be inconsistent with that intent to require a lessee to \nderecognize the excess Topic 420 liability and recognize those costs \nthrough the income statement a second time. Proponents further note that \nit would appear to be inconsistent with the intent of the ne w standard to \nderecognize existing liabilities when its principal goal was the recognition of \npreviously unrecognized lease liabilities. [ASU 2016- 02.Summary , ASU 2016-\n02.BC390] \nTopic 842 does not provide guidance on this type of scenario; therefore, in th e \nabsence of additional guidance from the FASB or the SEC staff, we believe \neither of the above approaches is acceptable as an accounting policy election \napplied to all of the entity’s leases for which it is a lessee. \n \n Question 13B.3. 90 \nExisting sublease liabilities under Topic 840 \nHow should sublease liabilities recognized under Topic 840 \nfor existing leases be accounted for on initial application of Topic 842? \nBackground: Under Topic 840, if costs expected to be incurred under an \noperating subl ease (e.g. executory costs and either amortization of the leased \nasset or rental payments on an operating lease) exceed anticipated revenue on \nthe operating sublease, a loss is recognized by the sublessor. [840- 20-25-15] \nThe transition guidance in Topic 842 provides explicit guidance on how to \naccount for existing Topic 420 liabilities in transition (see paragraph 13B.3.70 \nand Question 13B.3.80), but does not address sublease liabilities recognized in \naccordance with the Topic 840 guidance in the preceding paragraph. \nInterpretive respons e: \nExisting operating leases \nFor existing operating leases, regardless of how classified under Topic 842 (i.e. as operating or finance leases), we believe any of the following approaches is \nacceptable as an accounting policy election applied to all of an entity’s leases \nfor which it is the lessee. \n— By analogy to transition for Topic 420 liabilities (Topic 420 analogy \napproach). Net existing sublease liabilities against the ROU asset for \nexisting operating leases on initial application of Topic 842 by analogy to the guidance on Topic 420 liabilities in paragraph 842- 10-65-1(m). \nProponents of this approach believe these two types of liabilities are similar in nature and note that the FASB staff has, in discussions about impairme nt \nof ROU assets in transition (see Question 13B .3.110, for example), also \nequated these two types of liabilities. Therefore, because Topic 842 does \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1172}), Document(page\_content='Leases 1172 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. not provide any guidance on accounting for sublease liabilities recognized \nunder paragraph 840- 20-25-15 on initial application of Topic 842, we believe \nanalogizing to the Topic 420 liability transition guidance is reasonable. \nA lessee applying this analogy will apply the guidance in both \nparagraphs 842-10-65-1(m) and 65- 1(n). See paragraph 13B .3.70 and \nQuestions 13B.3.70 and 13 B.3.80. \n— Eliminate the sublease liability through equity (elimination approach). \nWrite off the existing sublease liability through equity as part of the \ncumulative effect transition adjustment at the transition date. Topic 842 \ndoes not have sublease loss guidance like what existed in Topic 840. \nTherefore, proponents of this approach believe there is no longer a basis in Topic 842 upon which to continue to recognize the sublease liability. \nProponents of this approach believe that paragraph 842- 10-65-1(d) would \ninstruct the lessee to write off the liability to equity at the transition date. \n[842-10-65-1(d)] \nA lessee adopting this approach would consider whether the loss -making \nsublease means the newly recognized ROU asset is impaired (if the ROU \nasset is the only asset in its asset group) . We believe at the point in time \nthe sublease was entered into, the ROU asset may have become its own \nasset group (see Question 6.5.60); and if so, recognizing any impairment of \nthe ROU asset that exists as a result of entering into the loss -making \nsublease through transition date equity would not conflict with the \nresponses to Questions 13 B.3.110 and 13 B.3.120. However, if a Topic 360 \nimpairment is not taken on the effective date, the effect of this approach \nwill be that the sublease loss is taken against current period earni ngs after \nthe effective date – i.e. the sublease loss recognized previously under Topic \n840 will be taken a second time through earnings in periods post -adoption. \nIn the case of an impairment resulting from this approach, we believe the \nlessee’s accountin g on and after the transition date may be very similar in \nresult to applying the Topic 420 analogy approach. If there is not an \nimpairment of the ROU asset, we believe it may be unlikely that a lessee \nwill elect this approach given the requirement to effec tively recognize the \nsublease loss twice. \n— Retain separate recognition of the sublease liability (separate recognition approach). The lessee would: \n— continue to recognize the Topic 840 sublease liability separate from the new lease liability recognized in tr ansition; and \n— reduce the liability over the shorter of (1) the remaining head lease term \nor (2) the remaining term of the loss -making sublease, in a pattern \nconsistent with the recognition of lease cost (operating leases) or amortization of the ROU asset (finance leases) over that same period of \ntime. \nIn contrast to the Topic 420 analogy approach, a lessee electing this \napproach will not recognize the effect of the sublease loss over the entire \nhead lease term if the sublease term is shorter than that of t he head lease. \nAdditionally, head lease cost will continue to be recognized on a straight -\nline basis after the transition date, rather than on a front -loaded basis as \nwould occur if analogizing to the Topic 420 liability requirements. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1173}), Document(page\_content='Leases 1173 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Proponents of this approach note that the FASB stated its intent for lessees \nto be able to ‘run off’ existing leases in accordance with the requirements \nin previous GAAP (other than recognizing new ROU assets and lease liabilities for existing operating leases) – see paragraph 13B.2.120, and that \nthis approach would be consistent with that intent. \n[ASU 2016- 02.Summary , \nASU 2016- 02.BC390] \nUnder this approach, if the lease is modified or remeasured on or after the \neffective date, we believe the run- off allowance would end. Theref ore, the \nremaining carrying amount of the sublease liability would be written off. We \nbelieve the offsetting entry would be first to the modified or remeasured \nROU asset (dr. sublease liability, cr. ROU asset) ; and second to a gain. That \nis, a gain should only result if the adjustment would reduce the carrying \namount of the ROU asset below zero. This accounting would be the most \nconsistent with the generally prospective accounting under Topic 842 for \nlease modifications and remeasurements. \nExisting capital leases classified as finance leases under Topic 842 \nThe transition guidance in Topic 842 for existing capital leases classified as \nfinance leases under Topic 842 requires the new finance lease ROU asset and \nfinance lease liability to equal the carrying amount of the existing capital lease \nasset and capital lease obligation. We believe this explicit requirement \nprecludes reducing the carrying amount of the existing capital lease asset by \nthe amount of any Topic 840 sublease liability. [842- 10-65-1(r)] \nConsequently, we believe a lessee is required to adopt either the ‘separate \nrecognition’ or ‘elimination’ approaches outlined for existing operating leases. \nIf applying the elimination approach, we believe the requirement to measure \nthe finance lease ROU asset at the carrying amount of the prior capital lease \nasset precludes recognizing an additional Topic 360 impairment as part of the \ntransition date cumulative effect adjustment. \nIf applying the separate recognition approach, the lessee will: \n— continue to recog nize the separate Topic 840 sublease liability; and \n— reduce the liability over the shorter of the (1) remaining head lease term or \n(2) remaining term of the loss -making sublease, in a pattern consistent with \nthe pattern of amortization of the ROU asset ov er that same period of time. \nExisting capital leases classified as operating leases under Topic 842 \nFor existing capital leases classified as operating leases under Topic 842, we \nbelieve the lessee should follow the ‘elimination approach’. This is because the \ngoal of the transition requirements for these leases is to effectively reset the \nlease so that t he accounting at and after the transition date is consistent with \nthat for any new operating lease that commences on or after the effective date \n(see paragraphs 13 B.3.200 – 13B.3.230). To that end, we believe any new \noperating lease subject to a loss -makin g sublease will be considered for \nimpairment under Topic 360 (see section 6.5.2); and if the ROU asset is not \nimpaired, the lessee will account for the sublease income deficits through \nearnings each period as incurred. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1174}), Document(page\_content='Leases 1174 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 13B.3.100 \nAccounting for foreign currency gains/losses during \ntransition \nShould foreign currency gains and losses arising from the \nrecognition of new ROU assets and lease liabilities be \nrecognized in the income statement during the transition period or as a cumulat ive adjustment to equity ? \nBackground: Lessee LE is a public business entity in the United States and \nhas a calendar year -end. Functional and reporting currency is USD for LE. \nLE regularly leases equipment with payments in JPY. LE has analyzed the \ndocumentation and concluded there is not an embedded derivative in \nthe contract. \nLE adopts Topic 842 on January 1, 2019. As a part of the adoption, LE records \nan ROU asset and lease liability as of January 1, 2017 for its leases \ndenominated in JPY (see Question 13 B.3.40). There would be a foreign \ncurrency effect related to these leases during 2017 and 2018 because the \nleases are not denominated in LE’s functional/reporting currency. \nInterpretive response: Foreign currency gains and losses arising from the \nrecognition of new ROU assets and lease liabilities should be recognized in \nthe income statement during the transition period. There are no specific \ntransition provisions included in Topic 842 for the acc ounting for foreign \ncurrency gains and losses in the comparative periods under the modified retrospective approach. \nIn the absence of specific transition provisions, an entity should apply the general modified retrospective transition guidance in paragraph 842- 10-65-1(d), \n“An entity shall adjust equity at the beginning of the earliest comparative period \npresented, and the other comparative amounts disclosed for each prior period \npresented in the financial statements, as if the pending content that links to this \nparagraph had always been applied, subject to the requirements in (h) \nthrough (ee).” \nTherefore, LE (as an example) would: \n— adjust its 2017 and 2018 income statements to reflect the applicable \nforeign currency gains and losses; and \n— adjust equity as of the beginning of January 1, 2017 (i.e. the beginning of \nthe earliest comparative period presented) for foreign currency gains and \nlosses related to periods before that date. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1175}), Document(page\_content='Leases 1175 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 13B.3.110 \nEffects of Topic 360 impairment s before the \neffective date \nWhen does a lessee begin to apply the long- lived asset \nimpairment guidance in Topic 360 to its operating lease ROU \nassets? \nInterpretive response: On the effective date of Topic 842, unless the \ncircumstances discussed in Question 13 B.3.130 exist. \nAt a November 2016 FASB meeting, the Board affirmed the view expressed by \nthe FASB staff that lessees should not begin applying the long -lived asset \nimpairment requirements in Topic 360 (property, plant, and equipment) to new \nROU assets until the eff ective date of Topic 842. This includes ROU assets that \nare part of an asset group that was previously impaired, except as discussed in \nQuestions 13B.3. 90 and 13B.3. 130. Even though a new ROU asset may be \nrecognized as of the date of initial application, f rom that date until the effective \ndate, those ROU assets generally should not be subject to the Topic 360 \nimpairment guidance. \nThe FASB staff believes it was the Board ’s intent that , in general, lessees \nshould only adjust the carrying amount of operating l ease ROU assets for the \nfollowing, both of which were applicable to operating leases under Topic 840: \n— any liabil ities recognized in accordance with the contract termination costs \nguidance in Topic 420; or \n— the sublease guidance in paragraph 840- 20-25-15. However, see \nQuestion 13B.3. 90 for sublease liabilities recognized under paragraph 840-\n20-25-15; we do not believe offsetting of those liabilities against the ROU \nasset is required. \nThe Board did not intend for lessees to have to go back in time and evaluate \nwhat effect operating lease ROU assets would have had on Topic 360 \nimpairment assessments before or during the transition period (see \nQuestion 13B.3.120). \n \n Question 13B.3.120 \nTransition impact on prior asset group impairments \nShould a lessee’s prior accounting for a long- lived asset \nsubject to impairment under Topic 360 be changed as a result \nof the transition to Topic 842 ? \nBackground: The recognition of operating lease ROU assets will increase the \nnumber and carrying amount of the long- lived assets in the asset group. \nFor example, an asset group with 50 long -lived assets that have an aggregate \ncarrying amount of $1 million at the date a previous asset group impairment \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1176}), Document(page\_content='Leases 1176 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. was recorded may have had 65 long-lived assets with an aggregate car rying \namount of $1.2 million if the operating lease ROU assets had been recognized \nin the past . This may have affected either or both: \n— the amount of the impairment that was recorded – e.g. the amount of the \nimpairment m ay have been limited to the amount that would reduce the \ncarrying amount of the long -lived assets in the group to zero; if additional \nlong-lived assets (ROU assets) were in the asset group, the impairment \ncharge may have been greater (see Question 13B.3. 130). \n— the allocation of the impairment to the long- lived assets in the asset group – \ni.e. even if the total amount of the impairment did not change, the amount \nof impairment allocated to each asset in the group would differ if there \nwere additional assets in the group. \nInterpretive response: No. At a November 2016 FASB meeting, the Board \naffirmed the view expressed by the FASB staff that lessees should not alter \ntheir previous accounting for long- lived assets as a result of transitioning to \nTopic 842. \nThis means that impairment amounts previously allocated to a long- lived asset \n(e.g. an item of property, plant or equipment or a finite -lived intangible asset), \nand subsequent accounting resulting from the amount of that impairment (e.g. \ndepreciation or amortization of the long- lived asset) , should not be changed as a \nresult of initially applying Topic 842. \n \n Question 13B.3.130 \nRecognizing ‘hidden’ ROU asset impairments o n \ntransition \nCan a ‘hidden’ impairment of an ROU asset arising from a \nTopic 840 operating lease be recognized through equity at the \ndate of initial application (or in the comparative periods) ? \nBackgr ound: A ‘hidden impairment’ refer s to either: \n— where a Topic 360 asset group was fully impaired before the effective date \n(i.e. all of the long- lived assets in the group were written down by the \nmaximum allowable amount under Topic 360 at the time of the impairment ) \nand an additional impai rment charge would have been recorded on that \nasset group before the effective date had the operating lease ROU asset(s) \nbeen recognized at that date; or \n— where a Topic 360 asset group would have included only one or more ROU \nasset s that were not recognized under Topic 840, and an impairment \ncharge would have been recorded on that asset group before the effective \ndate had the operating lease ROU asset(s) been recognized under \nTopic 840. \nInterpretive response: Based on the FASB staff views outlined in \nQuestions 13B.3.110 and 13 B.3.120, we believe it would be acceptable for a \nlessee not to consider the impairment guidance in Topic 360 until the effective \ndate of Topic 842 and to recognize any impairment that exists as of that date, \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1177}), Document(page\_content='Leases 1177 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. including any ‘hidden impairment’, and regardless of whether the condition or \nevent giving rise to that impairment occurred before the effective date, as a \ncharge to adoption- year income or loss. \nHowever, the FASB staff has expressed the view that it would be acceptable to \nrecognize a hidden impairment of an ROU asset arising from an existing \noperating lease in transition. In that case, the amount of the additional \nimpairment would be taken as of the later of the date of initial application \n(through an adjustment to equity) a nd the impairment date (through a charge to \nincome of the comparative period the impairment was recorded), with a \ncorresponding reduction to the carrying amount(s) of the ROU asset(s). Note \nthat no amount of past hidden impairment should be taken at the da te of initial \napplication if the asset group to which the ROU asset belongs is not impaired \nbased on a Topic 360 analysis at the effective date. \nWe believe this interpretation does not conflict with the responses to \nQuestions 13B.3.110 and 13 B.3.120 because (1) it would not affect any prior \naccounting for other long- lived assets and (2) reflects a unique circumstance \nwhere this adjustment is effectively the result of a past impairment assessment \nand preexisting conditions of impairment , rather than one triggered primarily by \nthe recognition of new operating lease ROU assets. \n \n Question 13B.3.140 \nAmortization period for leasehold improvements \npreviously acquired in a business combination \nWhat amortization period should a lessee assign in transition \nto leasehold improvement s previously acquired in a business \ncombination? \nBackground: Topic 840 required the amortization period at the acquisition date \nto be the shorter of (1) the remaining useful life of the leasehold improvements \nand (2) a period equal to the sum of the non- cancellable period of the lease plus \nrenewal periods reasonably assured of exercise. [840- 10-35-9] \nASC 840 -10-35-9 \nParagraph 805 -20-35-6 requires that leasehold improvements acquired in a business \ncombination or an acquisition by a not -for-profit entity be amortized over the shorter \nof the useful life of the assets or a term that includes required lease periods and \nrenewals that are deemed to be reasonab ly assured (as used in the definition of lease \nterm) at the date of acquisition. \nTopic 842 requires the amortization period at the acquisition date to be the \nshorter of the (1) remaining useful life of the leasehold improvements and (2) \nremaining lease term . [842-20-35-13] \nAlthough Topic 842 and Topic 840 use different words, the amortization period for acquired leasehold improvements that results from applying both Topics is \nthe same – i.e. one that is the shorter of (1) their remaining useful lif e and (2) a \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1178}), Document(page\_content='Leases 1178 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. period that includes the non- cancellable period of the lease plus renewal \nperiods the acquirer is reasonably certain to exercise. \n— Topic 840 used its particular italicized language because, before the \nadoption of Topic 842, an acquirer did not r eassess the acquiree’s lease \nterm as part of acquisition accounting. \n— In contrast, Topic 842 refers to the ‘remaining lease term’ because the \nacquirer does reassess the lease term of an acquired lease, as if it was a \nnew lease of the acquirer , at the acquis ition date. [805-20-30-24] \nBecause Topic 840 did not reassess the lease term of an acquired lease, the \nremaining lease term at the acquisition date could be shorter than the \namortization period for the acquired leasehold improvements. This cannot occur under Topic 842. \nBackground example \nCompany AR acquired Lessee LE in a business combination on January 1, 2018 – before AR’s adoption of Topic 842 on January 1, 2019 – with the following \nfacts. \n— LE is the lessee in a building lease with a remaining lease term of three \nyears immediately before the acquisition. The lease include s two five -year \nlessee renewal options that LE determined it was not reasonably assured \nto exercise; therefore, the options were excluded from LE’s determination of the lease term. The lease does not include an option for LE to purchase the building. \n— LE has constructed leasehold improvements, which it owns, that have a 15-year remaining useful life at the acquisition date. \n— The following applied in AR’s acquisition accounting for the acqui red lease \nwhen Topic 840 was in effect. \n— AR did not reas sess the lease term determined by LE. \n— AR concluded that the leasehold improvements should be amortized over a period of eight years from the acquisition date. Eight years \nincludes the three- year remain ing non- cancellable period of the lease \nplus the first of the five -year lessee renewal options, for which AR \nconcluded exercise was reasonably assured upon acquisition. Despite \nthe longer useful life of the leasehold improvements, AR concluded that exercis e of the second five -year renewal option was not reasonably \nassured at the acquisition date. \n— At the effective date of January 1, 2019, AR concludes that it is reasonably \ncertain to exercise both five-year renewal options if it elects the use -of-\nhindsight practical expedient (see section 13B.2) . \nInterpretive response: We believe the response to this question differs \ndepending on whether the entity elects the use- of-hindsight practical expedient. \nEntity does not elect to use hindsight \nIn general, we believe transition provisions are designed to migrate an entity’s \nlegacy accounting to that which would exist had the entity been applying the \nnew guidance all along. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1179}), Document(page\_content='Leases 1179 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Applying this logic to the background example, had AR been applying \nTopic 842’s requirements at the acquisition date, it would have concluded, just \nas it did under Topic 840, that the amortization period for the acquired leasehold improvements was eight years. This is because AR would have concluded that \nthe remaining lease term, a ssessed as if the acquired lease was a new lease on \nthe acquisition date, was eight years. Eight years is shorter than the 15- year \nremaining useful life of the leasehold improvements, so eight years would have \nbeen the amortization period. \nBecause Topic 842 and Topic 840 would result in the same amortization period, \nand AR did not elect to use hindsight in transition, AR simply retains the eight -\nyear amortization period in transition to Topic 842 (seven years remaining at the \neffective date). \nFurther, this approach also considers the Board’s stated intent for lessees to, in \neffect, have the option to ‘run off’ existing leases in accordance with the \nrequirements of previous GAAP – other than recognizing new ROU assets and \nlease liabilities for existing opera ting leases (see paragraph 13B.2.120). This \napproach, which retains the entity’s amortization period for the leasehold \nimprovements in transition, is consistent with that intent. \n[ASU 2016- 02.Summary, \nASU 2016- 02.BC390] \nEntity elects to use hindsight \nAgain using the background example, if AR elected the use- of-hindsight \npractical expedient in transition, AR would account for the acquired lease in \ntransition as if it had always (since the acquisition date) assessed the lease term \nas 13 years (rather than ei ght years). \nIn contrast to an entity that does not elect hindsight, we believe an entity \nelecting to use hindsight is also deciding to abandon ‘running off’ its old lease \naccounting. An entity electing hindsight is choosing to reassess, rather than \ncontinu e to use, legacy accounting judgments such as the lease term. \nTherefore, we believe AR would also adjust the amortization period of the \nacquired leasehold improvements – i.e. AR would adjust its accounting for \nthose leasehold improvements, including in its comparative financial statements \nfor periods before its Topic 842 adoption, as if it had originally assigned a 13-\nyear amortization period to those improvements (rather than eight years). This \nwill result in a reduction to 2018 amortization expense, resul ting in an increased \ncarrying amount for the leasehold improvements as of the effective date. \nPost -transition accounting for acquired leasehold improvements \nRegardless of whether it elected the use- of-hindsight practical expedient in \ntransition, after tran sition an acquirer will change the amortization period for \nacquired leasehold improvements if either: \n— the lea se term changes – through either reassessment or modification (not \naccounted for as a separate contract) – if the remaining lease term is the \namort ization period under paragraph 842- 20-35-12; or \n— the useful life of the leasehold improvements changes and the remaining \nuseful life is (or becomes, as a result of a decrease to the useful life) the \namortization period under paragraph 842- 20-35-12. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1180}), Document(page\_content='Leases 1180 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. In that case, the change in amortization period is accounted for prospectively in \naccordance with Topic 250 (accounting changes and error corrections). [250- 10-\n45-17 – 45-20] \n \n Example 13B.3.10 \nLessee transition for an existing operating lease \nwith package of practical expedients elected – \nApproach A in Question 13B.3.10 \nScenario 1: Lease is not modified or remeasured on or after the effective \ndate \nThe following summarizes relevant information about Lessee LE’s lease of \noffice space. \nCommencement date of the lease: January 1, 2016 \nLease term: 5 years \nRental payments (annual, paid in arrears) , which \nrepresent the minimum rental payments under \nTopic 840:1 $28,000 first two years, \n$29,000 thereafter \nEstimated amount of annual payment s related to \nreimbursing the lessor’s costs of property taxes , \ninsuranc e, and CAM that are included in the above \nminimum rental payments:1 $1,500 property taxes \n$1,000 insurance \n$1,000 CAM \nLease classification at inception under Topic 840 : Operating lease \nInitial direct costs, amortized on a straight ‑line basis over \nthe lease term: $1,500 \nNote: \n1. In this example, LE has included fixed executory costs in the minimum rental \npayments when applying Topic 840 and is consistently applying this policy in transition \n– i.e. LE has applied Approach A discussed in Question 13B .3.10. \nEffective date and transition \nAccrued rent liability :\nUnamortized IDCs :$ 600\n 1,200Carrying amounts \n(before transition adjustments )Comparative period Comparative period Current periodDecember 31, 2019Effective date \n(date of adoption )\nJanuary 1, 2019 January 1, 2018Beginning of earliest \nperiod presented\nJanuary 1, 2017\n \nBecause LE elected the package of practical expedients, it does not reassess \nwhether the contract is or contains a lease, whether classification of the lease ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1181}), Document(page\_content='Leases 1181 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. would be different under Topic 842, or whether the unamortized initial direct \ncosts at January 1, 2017 would meet the definition of initial direct costs under \nTopic 842. \nWorksheet at January 1, 2017 (beginning of earliest period presented) \nAt January 1, 2017, LE’s incremental borrowing rate is 5.0% (see section 5.6 \nand Question 13 B.3.50). \nStep Amounts \ndebit/(credit) Notes \nRecognize lease liability $(101,880) Remaining minimum rental payments \n($28,000 for 201 7 and $29,000 for each \nof 2018–2020) discounted at 5.0% \nRecognize ROU asset 102,480 Sum of lease liability recognized and \n$1,200 of unamortized IDCs , less $600 \naccrued rent liability \nDerecognize accrued \nrent 600 Balance at transition under Topic 840 \nDerecognize unamortized IDCs (1,200) Balance at transition under Topic 840 \nAdjustment to equity $ - N/A \nSubsequent accounting for the lease \nLE subsequently measures the lease liability and ROU asset through the end of \nthe lease term in a manner similar to how it determined the lease liability and \nROU asset at January 1, 2017; unless the lease is modified or there is a \nremeasurement of the lease liability. \nLE does not modify the lease and does not have to remeasure the lease liability \non or after the effective date. There is also no impairment of the ROU asset \nthrough the remainder of the lease term. \nBalance s heet \nLE recognizes the following amounts in its balance sheet for its lease of office space through the end of the lease term. \nYear ended ROU asset arising \nfrom operating lease Lease liability arising \nfrom operating lease \nDec. 31, 20181 $53,723 $53,923 \nDec. 31, 2019 27,519 27,619 \nDec. 31, 2020 - - \nNote: \n1. The December 31, 2017 balance sheet is not shown because it is expected that LE will \npresent only one comparative balance sheet (i.e. as of December 31, 2018) in its first \nset of financial statements issued after the effective date of Topic 842. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1182}), Document(page\_content='Leases 1182 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Income statement1 \nLE recognizes the following amounts in its income statement for its lease of \noffice space through the end of the lease term. \nYear ended Operating lease cost \nDec. 31, 2017 $28,9002 \nDec. 31, 2018 28,900 \nDec. 31, 2019 28,900 \nDec. 31, 2020 28,900 \nNotes: \n1. A lessee continues to present lease cost in a manner consistent with its presentation \nunder Topic 840 (e.g. SG&A expenses). \n2. $28,600 (total minimum rental payments of $143,000 / 5 years) + $300 (amortization of initial direct costs of $1,500 / 5 years). \nScenario 2: Lease is modified after the effective date \nChanging the facts of Scenario 1, on January 1, 2020 LE modifies the lease to \nextend the lease term for two additional years. The original lease agreement did \nnot include any renewal options. \nAs a result, LE applies the lease accounting guidance under Topic 842 \nbeginning on the effective date of the modification (January 1, 2020). Because \nthe modification increases the lease term only, it does not grant LE an \nadditional right of use, and therefore the modification cannot be accounted for \nas a separate contract. Accordingly, LE adjusts the original lease liability and \nrecords an equal and offset ting change to the existing ROU asset. The following \nsummarizes relevant information for the remeasurement of the lease liability. \nExtension period: 2 years \nRemaining lease term, including the extension: 3 years \nAnnual, fixed payments during extension period of \n2 years (paid in arrears): $30,000 \nFixed payment for the remaining 1 year of the original \nlease term (paid in arrears): $29,000 \nEstimated amount of the remaining annual payments \nrelated to reimbursing the lessor’s costs of property \ntaxes, insurance and CAM : $1,750 property taxes \n$1,000 insurance \n$1,050 CAM \nAdditional initial direct costs associated with the lease \nmodification: None \nAt the effective date of the modification, $300 of the initial direct costs from the \ninitial lease remain unamortized. \nLease liability remeasurement \nIn this example, LE identifies only one difference between Topic 840 and \nTopic 842 that affects the remeasurement of the lease liability and the \nROU asset . ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1183}), Document(page\_content='Leases 1183 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — Under Topic 840 (if applying Approach A in Question 13B .3.10), the \nminimum rental payments (which are used to measure the lease liability \nand the ROU asset before the modification) included fixed amounts tha t \nwere intended to reimburse the lessor’s costs of property taxes, insurance \nand CAM . There were no non- lease components under Topic 840. \n— Under Topic 842, CAM is a non- lease component (a non- lease service \nprovided to LE by LR). Fixed payments required by t he contract are \nallocated between the lease component (i.e. the right to use the asset) and \nthe non- lease component (CAM) on a relative stand -alone price basis. \nTherefore, a portion of what LE accounted for as the ‘minimum rental \npayments’ under Topic 840 (i.e. the fixed payments attributable to CAM) \nwill not be part of the ‘lease payments’ for the modified lease under \nTopic 842. Assume that this allocation is 95% to the lease component and \n5% to CAM. \nLE remeasures the lease liability based on: \n— one remaining lease payment of $27,550 (for the remainder of the original \nlease term), which is 95% of the total fixed payment; the remaining 5% ($1,450) is allocated to the CAM non- lease component; and \n— two additional lease payments of $28,500 for the extension period, which is \n95% of the total fixed payment; the remaining 5% ($1,500) is allocated to \nthe CAM non- lease component. \nLE discounts the lease payments at its January 1, 2020 incremental borrowing \nrate of 5.5%. This results in a remeasured lease liabilit y of $75,991, or an \nincrease of $48,372 compared to the lease liability balance immediately before \nthe effective date of the modification. \nJournal entry \nLE records the following journal entry at the effective date of the modification. \n Debit Credit \nROU asset 48,372 \nLease liability 48,372 \nTo remeasure ROU asset and lease liability \nfollowing lease modification. \nLease classification \nLE reassesses lease classification as of the effective date of the modification \nand determines that the modified lease is still classified as an operating lease. \nThis reassessment is based on facts and circumstances at that date – e.g. the \nremaining economic life and fair value of the under lying asset at that date. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1184}), Document(page\_content='Leases 1184 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Subsequent accounting for the lease \nLE calculates the remaining lease cost for the lease as follows. \nTotal lease payments (including those paid and those not yet paid), reflecting the \nadjustment resulting from the lease modificati on \n12/31/16 12/31/17 12/31/18 12/31/19 12/31/20 12/31/21 12/31/22 \n$28,000 $28,000 $29,000 $29,000 $27,550 $28,500 $28,500 $198,550 \nPlus: Total initial direct costs attributable to the lease 1,500 \nLess: Periodic lease cost recognized in prior periods calculated as (straight -\nline rent al expense of $2 8,600 × 4 periods) plus (amortization of initial \ndirect costs of $1,200) (115,600) \nRemaining lease cost for the lease $ 84,450 \nLE recognizes a single lease cost, calculated so that the remaining cost of the \nlease is allocated over the remaining lease term on a straight -line basis (i.e. \n$28,150 per year for the remaining three years). \nLE prospectively accounts for the lease liability and ROU asset from the \neffective date of the modification using the guidance in Topic 842 for an \noperating lease. \nBalance sheet \nLE recognizes the following amounts in its balance sheet for its lease of equipment through the end of the revised lease term. \nYear ended ROU asset arising \nfrom operating lease Lease liability arising \nfrom operating lease \nDec. 31, 2020 $51,921 $52,620 \nDec. 31, 2021 26,665 27,014 \nDec. 31, 2022 - - \nIncome statement1 \nLE recognizes the following amounts in its income statement for its lease of \noffice space through the end of the lease term. \nYear ended Operating lease cost \nDec. 31, 2020 $28,150 \nDec. 31, 2021 28,150 \nDec. 31, 2022 28,150 \nNote: \n1. A lessee continues to present lease cost in a manner consistent with its presentation \nunder Topic 840 (e.g. SG&A expenses). \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1185}), Document(page\_content='Leases 1185 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Example 13B.3.20 \nLessee transition for an existing operating lease \nwith package of practical expedients elected – \nApproach B in Question 13B.3.10 \nScenario 1: Lease is not modified or remeasured on or after the effective \ndate \nThe following summarizes relevant information about Lessee LE’s lease of \noffice space. \nCommencement date of the lease: January 1, 2016 \nLease term: 5 years \nRental payments (annual, paid in arrears): $28,000 first two years, \n$29,000 thereafter \nEstimated amount of annual payments related to \nreimbursing the lessor’s costs of property taxes, \ninsurance, and CAM that are included in the above rental \npayments: $1,500 property taxes \n$1,000 insurance \n$1,000 CAM \nMinimum rental payments under Topic 840:1 $24,500 first two years, \n$25,500 thereafter \nLease classification at inception under Topic 840: Operating lease \nInitial direct costs, amortized on a straight -line basis over \nthe lease term: $1,500 \nNote: \n1. In this example, LE has excluded fixed executory costs from the minimum rental \npayments when applying Topic 840 and is consistently applying this policy in transition \n– i.e. LE has applied Approach B discussed in Question 13B .3.10. \nEffective date and transition \nAccrued rent liability :\nUnamortized IDCs :$ 600\n 1,200Carrying amounts \n(before transition adjustments )Comparative period Comparative period Current periodDecember 31, 2019Effective date \n(date of adoption )\nJanuary 1, 2019 January 1, 2018Beginning of earliest \nperiod presented\nJanuary 1, 2017\n \nBecause LE elected the package of practical expedients, it does not reassess \nwhether the contract is or contains a lease, whether classification of the lease \nwould be different under Topic 842, or whether the unamortized initial direct \ncosts at Januar y 1, 2017 would meet the definition of initial direct costs under \nTopic 842. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1186}), Document(page\_content='Leases 1186 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Worksheet at January 1, 2017 (beginning of earliest period presented) \nAt January 1, 2017, LE’s incremental borrowing rate is 5.0% (see section 5.6 \nand Question 13 B.3.50). \nStep Amounts \ndebit/(credit) Notes \nRecognize lease liability $(89,469) Remaining minimum rental payments \n($24,500 for 201 7 and $25,500 for each \nof 2018–2020) discounted at 5.0% \nRecognize ROU asset 90,069 Sum of lease liability recognized and \n$1,200 of unamortized IDCs , less $600 \naccrued rent liability \nDerecognize accrued rent 600 Balance at transition under Topic 840 \nDerecognize \nunamortized IDCs (1,200) Balance at transition under Topic 840 \nAdjustment to equity $ - N/A \nSubsequent accounting for the lease \nLE subsequently measures the lease liability and ROU asset through the end of \nthe lease term in a manner similar to how it determined the lease liability and \nROU asset at January 1, 2017; unless the lease is modified or there is a \nremeasurement of the lease liability. \nLE does not modify the lease and does not have to remeasure the lease liability on or after the effective date. There is also no impairment of the ROU asset through the remainder of the lease term. \nBalance sheet \nLE recognizes the f ollowing amounts in its balance sheet for its lease of office \nspace through the end of the lease term. \nYear ended ROU asset arising \nfrom operating lease Lease liability arising \nfrom operating lease \nDec. 31, 20181 $47,214 $47,414 \nDec. 31, 2019 24,185 24,285 \nDec. 31, 2020 - - \nNote: \n1. The December 31, 2017 balance sheet is not shown because it is expected that LE will \npresent only one comparative balance sheet (i.e. as of December 31, 2018) in its first \nset of financial statements issued after the effective date of Topic 842. \nIncome statement1 \nLE recognizes the following amounts in its income statement for its lease of \noffice space through the end of the lease term. \nYear ended Operating lease cost \nDec. 31, 2017 $25,4002 \nDec. 31, 2018 25,400 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1187}), Document(page\_content='Leases 1187 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Year ended Operating lease cost \nDec. 31, 2019 25,400 \nDec. 31, 2020 25,400 \nNotes: \n1. A lessee continues to present lease cost in a manner consistent with its presentation \nunder Topic 840 (e.g. SG&A expenses). \n2. $25,100 (total minimum rental payments of $125,500 / 5 years) + $300 (amortization of \ninitial direct costs of $1,500 / 5 years). \nScenario 2: Lease is modified after the effective date \nChanging the facts of Scenario 1, on January 1, 2020 LE modifies the lease to \nextend the lease term f or two additional years. The original lease agreement did \nnot include any renewal options. \nAs a result, LE applies the lease accounting guidance under Topic 842 \nbeginning on the effective date of the modification (January 1, 2020). Because \nthe modification increases the lease term only, it does not grant LE an \nadditional right of use, and therefore the modification cannot be accounted for as a separate contract. Accordingly, LE adjusts the original lease liability and \nrecords an equal and offsetting change to the existing ROU asset. The \nfollowing summarizes relevant information for the remeasurement of the lease \nliability. \nExtension period: 2 years \nRemaining lease term, including the extension: 3 years \nAnnual, fixed payments during extension period of \n2 years (paid in arrears): $30,000 \nFixed payment for the remaining 1 year of the original lease term (paid in arrears): \n$29,000 \nEstimated amount of the remaining annual payments \nrelated to reimbursing the lessor’s costs of property \ntaxes, insurance and CAM: $1,750 property taxes \n$1,000 insurance \n$1,050 CAM \nAdditional initial direct costs associated with the lease \nmodification: None \nAt the effective date of the modification, $300 of the initial direct costs remain \nunamortized. \nLease liability remeasurement \nIn this example, LE identifies only one difference between Topic 840 and Topic 842 that affects the remeasurement of the lease liability and the \nROU asset: \n— Under Topic 840 (if applying Approach B in Question 13B .3.10), the \nminimum rental payments (which are used to measure the lease liability and the ROU asset before the modification) excluded fixed amounts that \nwere intended to reimburse the lessor’s costs of property taxes, insurance \nand CAM, while the ‘lease payments’ under Topic 842 generally include at ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1188}), Document(page\_content='Leases 1188 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. least a portion of such amounts. There were no non- lease components of \nthis contract under Topic 8 40. \n— Under Topic 842, the CAM is a non- lease component (a non- lease service \nprovided to LE by LR). Fixed payments required by the contract are \nallocated between the lease component (i.e. the right to use the asset) and \nthe non- lease component (CAM) on a rel ative stand -alone price basis. \nTherefore, the portion of the consideration in the contract attributable to CAM will not be part of the ‘lease payments’ for the modified lease under \nTopic 842. Assume that this allocation is 95% to the lease component and \n5% to CAM. \nLE remeasures the lease liability based on: \n— one remaining lease payment of $27,550 (for the remainder of the original \nlease term), which is 95% of the total fixed payment; the remaining 5% \n($1,450) is allocated to the CAM non- lease component; and \n— two additional lease payments of $28,500 for the extension period, which is 95% of the total fixed payment; the remaining 5% ($1,500) is allocated to \nthe CAM non- lease component. \nLE discounts the lease payments at its January 1, 2020 incremental borrowing \nrate of 5.5%. This results in a remeasured lease liability of $75,991, or an \nincrease of $51,706 compared to the lease liability balance immediately before \nthe effective date of t he modification. \nJournal entry \nLE records the following journal entry at the effective date of the modification. \n Debit Credit \nROU asset 51,706 \nLease liability 51,706 \nTo remeasure ROU asset and lease liability \nfollowing lease modification. \nLease classification \nLE reassesses lease classification as of the effective date of the modification \nand determines that the modified lease is still classified as an operating lease. \nSubsequent accounting for the lease \nLE calculates the remaining lease cost for the lease as follows. \nTotal lease payments (including those paid and those not yet paid), reflecting the \nadjustment resulting from the lease modification \n12/31/16 12/31/17 12/31/18 12/31/19 12/31/20 12/31/21 12/31/22 \n$24,500 $24,500 $25,500 $25,500 $27,550 $28,500 $28,500 $184,550 \nPlus: Total initial direct costs attributable to the lease 1,500 \nLess: Periodic lease cost recognized in prior periods calculated as (straight -\nline rental expense of $25,100 × 4 periods) plus (amortization of initial \ndirect costs of $1,200) (101,600) \nRemaining lease cost for the lease $ 84,450 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1189}), Document(page\_content='Leases 1189 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. LE recognizes a single lease cost, calculated so that the remaining cost of the \nlease is allocated over the remaining lease term on a straight -line basis (i.e. \n$28,150 per year for the remaining three years). \nLE prospectively accounts for the lease liability and ROU asset from the \neffective date of the modification using the guidance in Topic 842 for an operating lease. \nBalance sheet \nLE recognizes the following amounts in its balance sheet for its lease of equipment through the end of the revised lease term. \nYear ended ROU asset arising \nfrom operating lease Lease liability arising \nfrom operating lease \nDec. 31, 2020 $51,921 $52,620 \nDec. 31, 2021 26,665 27,014 \nDec. 31, 2022 - - \nIncome statement1 \nLE recognizes the following amounts in its income statement for its lease of office space through the end of the lease term. \nYear ended Operating lease cost \nDec. 31, 2020 $28,150 \nDec. 31, 2021 28,150 \nDec. 31, 2022 28,150 \nNote: \n1. A lessee continues to present lease cost in a manner consistent with its presentation \nunder Topic 840 (e.g. SG&A expenses). \n \nCapital leases under Topic 840 \n13B.3.90 The following diagram gives an overview of the transition requirements \nfor a capital lease, which is explained in this section, assuming a public \nbusiness entity with a calendar year -end. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1190}), Document(page\_content='Leases 1190 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Comparative period Comparative period Current periodDecember 31, 2019Effective date \n(date of adoption )\nJanuary 1, 2019Beginning of earliest \nperiod presented\nJanuary 1, 2017 January 1, 2018\nExisting leases commenced before Jan . 1, 2017\nExisting leases commenced on /after \nJan. 1, 2017 , but before Jan . 1, 2019\nDate of initial recognition and measurement (see \nparagraph 13B.2.40 ):\n— If lease commenced on /before Jan . 1, 2017 : at Jan . 1, \n2017\n— If lease commenced after Jan . 1, 2017 : at \ncommencement date \nMeasurement :\n— Lease liability and ROU asset = carrying amount of \ncapital lease obligation and capital lease asset under \nTopic 840\n— Include unamortized IDCs (not already included in \nmeasurement of capital lease asset ) in ROU asset\nSubsequent measurement (until Dec . 31, 2018 ):\n— Apply guidance applicable to capital lease obligations \nand capital lease assets under Topic 840\nExpired leases :\nDo nothingLeases commencing on /after \nJan. 1, 2019 : Apply Topic 842 \nInitial recognition and measurement \n13B.3.100 The lease liability and ROU asset are initially measured as follows at \nthe transition date (see paragraph 13 B.2.50). [842- 10-65-1(r)(1) – 65-1(r)(2) ] \nTopic 842 item Measurement \nLease liability — Carrying amount of capital lease obligation under \nTopic 840 immediately before the transition date. \nROU asset — Carrying amount of the capital lease asset under \nTopic 840 immediately before the transition date. \n— Plus any unamortized initial direct costs not included in \nthe capital lease asset under Topic 840 . \nSubsequent measurement for periods before the effective date \n13B.3.110 A lessee subsequently measures the ROU asset and the lease liability \nin accordance with the subsequent measurement guidance in Topic 840. \n[842- 10-65-1(r)(4)] \nSubsequent measurement beginning on the effective date \n13B.3.120 A lessee measures the ROU asset and the lease liability in accordance \nwith the subsequent measurement guidance applicable to new finance leases \nunder Topic 842. \n13B.3.130 As an exception, a lessee does not remeasure the lease payments for \nchanges in amounts probable of being owed under residual value guarantees \nunless the lease liability is remeasured for other reasons – e.g. because of a \nchange in the lease term or in the assessment of a lessee purchase option. \n[842- 10-65-1(r)(5)] ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1191}), Document(page\_content='Leases 1191 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Presentation and disclosure \n13B.3.140 A lessee presents the assets and liabilities under capital leases as \nROU assets and lease liabilities arising from finance leases for presentation and \ndisclosure purposes in all periods presented in the financial statements. \n[842- 10-65-1(r)(6)] \n \n Example 13B.3.30 \nLessee transition for an existing capital lease with \npackage of practical expedients elected \nScenario 1: Lease is not modified or remeasured on or after the effective \ndate \nAbout the lease \nThe following summarizes relevant information about Lessee LE’s lease of \nequipment. \nCommencement date of the lease: January 1, 2016 \nLease term: 7 years \nLease payments (annual, paid in arrears): $40,000 \nResidual value guarantee (lessee): $6,000 \nAmount probable of being owed under the residual value \nguarantee (no change throughout lease term): $2,000 \nLease classification at inception under Topic 840 : Capital lease \nLE’s incremental borrowing rate at lease inception: 5.5% \nInitial direct costs, amortized on a straight ‑line basis over the lease \nterm: $2,500 \nEffective date and transition \nCapital lease obligation :\nCapital lease asset :\nUnamortized IDCs :$204,172\n 198,951\n 2,143Carrying amounts \n(before transition adjustments )Comparative period Comparative period Current periodDecember 31, 2019Effective date \n(date of adoption )\nJanuary 1, 2019 January 1, 2018Beginning of earliest \nperiod presented\nJanuary 1, 2017\n \nLE elects the package of practical expedients. Therefore, LE does not reassess \nwhether the contract is or contains a lease, whether classification of the lease \nwould be different under Topic 842, or whether the unamortized initial direct ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1192}), Document(page\_content='Leases 1192 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. costs at January 1, 2017 would meet the definition of initial direct costs under \nTopic 842. \nWorksheet at January 1, 2017 (beginning of earliest period presented) \nStep Amounts \ndebit/(credit) Notes \nRecognize lease liability $(204,172) Equal to existing capital lease obligation \nRecognize ROU asset 201,094 Equal to existing capital lease asset \n($198,951) + existing unamortized IDCs \n($2,143) \nAdjustment to equity $ - N/A – replacing existing assets and \nliabilities at the same amounts \nSubsequent accounting for the lease \nLE will account for the lease liability and ROU asset in accordance with the \nsubsequent measurement guidance: \n— in Topic 840 through December 31, 2018; and \n— in Topic 842 fr om January 1, 2019 through the end of the lease term . \nHowever, as an exception, because the entire amount of the $6,000 \nresidual value guarantee is already included in the lease liability, LE will not \nmake any adjustments for changes in the amount that it is probable of \nowing under the residual value guarantee. \nLE does not modify the lease or have to remeasure the lease liability (e.g. for a \nchange in the lease term) subsequent to the effective date. The following tables \nshow the ef fect of the lease accounting on the financial statements. \nBalance sheet \nLE recognizes the following amounts in its balance sheet through the end of the lease term. \nYear ended ROU asset arising \nfrom finance lease Lease liability arising \nfrom finance lease \nDec. 31, 20181 $135,396 $145,048 \nDec. 31, 2019 102,547 113,026 \nDec. 31, 2020 69,698 79,242 \nDec. 31, 2021 36,849 43,601 \nDec. 31, 2022 4,000 6,000 \nNote: \n1. The December 31, 2017 balance sheet is not shown because it is expected that LE will present only one \ncomparative balance sheet (i.e. as of December 31, 2018) in its first set of financial statements issued \nafter the effective date of Topic 842. We expect that many lessees will present their finance lease ROU \nassets and finance lease liabi lities in the same balance sheet line item as they presented capital lease \nassets and capital lease obligations under Topic 840. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1193}), Document(page\_content='Leases 1193 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. At the end of the lease term, LE makes a payment under the residual value \nguarantee and credits cash for $2,000, debits the lease liability for $6,000 and \ncredits the ROU asset for $4,000. \nIncome statement1 \nLE recognizes the following amounts in its income statement through the end \nof the lease term. \nYear ended Interest expense Amortization of ROU \nassets \nDec. 31, 2017 $11,229 $32,849 \nDec. 31, 2018 9,647 32,849 \nDec. 31, 2019 7,978 32,849 \nDec. 31, 2020 6,216 32,849 \nDec. 31, 2021 4,359 32,849 \nDec. 31, 2022 2,399 32,849 \nNote: \n1. The interest expense on the lease liability and amortization of the ROU asset are not \nrequired to be presented as separate line items; rather each is presented in a manner \nconsistent with how the entity presents other interest expense and depreciation or \namortization of similar assets (see section 6. 9). \nScenario 2: Lease liability is remeas ured after the effective date \nChanging the facts of Scenario 1, on January 1, 2020, LE remeasures the lease \nliability. The lease included a renewal option and LE now determines that it is \nreasonably certain to exercise the option based on the occurrence of a \nsignificant event that is within its control (see section 6.6). \nAs a result, LE applies the lease accounting guidance under Topic 842 \nbeginning on the remeasurement date (January 1, 2020). The following \nsummarizes relevant information for the remeasurem ent of the lease liability. \nRenewal period: 3 years \nRemaining lease term: 6 years \nLease payments for the renewal period (annual, paid in arrears): $43,000 \nLease payments for the remainder of the original lease term \n(annual, paid in arrears): $40,000 \nAmount probable of being owed under the residual value guarantee at the end of the revised lease term: $ 1,500 \nLE’s incremental borrowing rate at January 1, 2020: 6.0% \nLease liability remeasurement \nIn this example, LE identifies one difference between Topic 840 and Topic 842 \nthat affects the measurement of the lease liability and the ROU asset . Under \nTopic 840, minimum lease payments included the full amount of a lessee \nresidual value guarantee (and therefore the capital lease obligation and the \ncapital lease asset reflect the full amount of such guarantee) while the definition ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1194}), Document(page\_content='Leases 1194 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. of lease payments under Topic 842 includes only amounts probable of being \nowed by the lessee to satisfy the guarantee. \nLE rem easures the lease liability based on: \n— three remaining payments of $40,000 (the remainder of the original lease term); \n— three additional payments of $43,000 to reflect the renewal period; and \n— a final payment of $1,500 to satisfy the residual value guarantee. \nLE discounts the stream of lease payments at its incremental borrowing rate of \n6.0% at January 1, 2020. This results in a remeasured lease liability of \n$204,483, or an increase of $91,457 compared to the lease liability balance \nimmediately before the reme asurement date. \nJournal entry \nLE records the following journal entry at January 1, 2020. \n Debit Credit \nROU asset 91,457 \nLease liability 91,457 \nTo remeasure ROU asset and lease liability \nfollowing reassessment of lease term. \nLease classification \nLE also reassesses lease classification , concurrent with the remeasurement of \nthe lease, based on the facts and circumstances at the remeasurement date \n(e.g. the fair value and remaining economic life of the underlying asset at that \ndate) and determines that the lease is still a finance lease. \nSubsequent accounting for the lease \nLE prospectively accounts for the lease liability and the ROU asset using the \nguidance in Topic 842 for a finance lease (see section 6.4.1 ). \n— The lease liability carry ing amount is increased each period of the remaining \nlease term to reflect interest on the lease liability and reduced to reflect the \nlease payments made during the period. \n— The ROU asset is measured at cost less any accumulated amortization (and \nany accumu lated impairment losses). \nBalance sheet \nLE recognizes the following amounts in its balance sheet for its lease of equipment through the end of the revised lease term. \nYear ended ROU asset arising \nfrom finance lease Lease liability arising \nfrom finance lease \nDec. 31, 2020 $161,670 $176,752 \nDec. 31, 2021 129,336 147,357 \nDec. 31, 2022 97,002 116,198 \nDec. 31, 2023 64,668 80,170 \nDec. 31, 2024 32,334 41,980 \nDec. 31, 2025 - 1,500 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1195}), Document(page\_content='Leases 1195 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. At the end of the lease term, LE makes a payment under the residual \nvalue guarantee, debits the lease liability for $1,500 and credits cash for $1,500. \nIncome statement1 \nLE recognizes the following amounts in its income statement for its lease of equipment through the end of the revised lease ter m. \nYear ended Interest expense Amortization of ROU \nasset \nDec. 31, 2020 $12,269 $32,334 \nDec. 31, 2021 10,605 32,334 \nDec. 31, 2022 8,841 32,334 \nDec. 31, 2023 6,972 32,334 \nDec. 31, 2024 4,810 32,334 \nDec. 31, 2025 2,520 32,334 \nNote: \n1. The interest expense on the lease liability and amortization of the ROU asset are not \nrequired to be presented as separate line items in the income statement ; rather each is \npresented in a manner consistent with how the entity presents other interest expen se \nand depreciation or amortization of similar assets (see section 6. 9). \n \n13B.3.2 Lessee does not elect package of practical \nexpedients \n13B.3.150 Section 13 B.3.1 discussed the lessee transition requirements when \nthe lessee elects the package of practical expedients and includes \nQuestions 13B.3.10 – 13B.3.130. Despite the inclusion of those questions in \nsection 13B.3.1, we believe the responses to those questions do not change if \nthe lessee does not elect the package of practical expedients or the use of \nhindsight practical expedient. \nLeases previously classified as operating leases under \nTopic 840 \nLeases classified as operating leases under Topic 842 \n13B.3.160 In general, the recognition, initial measurement and subsequent \nmeasurement of the lease liability and ROU asset are the same as for a \nlessee that elects the package of practical expedients for its leases (see \nparagraphs 13B.3.30 – 13B.3.80). As an except ion, at the transition date, any \nunamortized initial direct costs that do not meet the definition of initial direct \ncosts under Topic 842 are written off as an adjustment to equity (if the costs \nwere incurred before the beginning of the earliest period presented in the financial statements) or to earnings of the comparative period presented (if \nincurred on or after the beginning of the earliest period presented) . This means \nthat the initial and subsequent measurement of the lessee’s ROU asset , and \nperiodic lease cost after the transition date, will differ between a lessee that \nelects the package of practical expedients and one that does not for the same ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1196}), Document(page\_content='Leases 1196 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. lease for the effect of initial direct costs written off in transition. [842- 10-65-1(k), \n65-1(n), 65- 1(p)] \nLeases classified as finance leases under Topic 842 \nInitial recognition and measurement \n13B.3.170 The lease liability is recognized and measured the same as for an \nexisting operating lease that remains classified as an operating lease (see \nparagraph 13B.3.160). [842- 10-65-1(o)] \n13B.3.180 The ROU asset is recognized and measured using the formula \nin paragraph 13B.3.50, except that the starting point is a proportion of the \noriginal lease liability – i.e. the lease liability as of the original commencement \ndate that is calculated as follows. \nRemaining lease term at transition \ndateProportion of \noriginal lease \nliabilityOriginal lease \nliability at \ncommencement \ndate1 Total lease term[] \nNote : \n1. Topic 842 states that this amount can be ‘imputed’ from the remaining lease liability, \nrather than directly calculated. Example 13B .3.40 demonstrates imputing the original \nlease liability and this is further discussed as part of the Example. [842- 10-65-1(o)] \nSubsequent measurement \n13B.3.190 Subsequent to initial recognition and measurement, there is no \ndifference in accounting for the finance lease in transition solely because it was \npreviously classified as an operating lease under Topic 840 – i.e. compared \nwith a finance lease pr eviously classified as a capital lease under Topic 840. \nExample 13B.3.40 illustrates the accounting for an existing lease classified as \nan operating lease under Topic 840 but classified as a finance lease under Topic 842. \nLeases previously classified as capital leases under Topic 840 \nLeases classified as finance leases under Topic 842 \n13B.3.200 In general, the recognition, initial measurement and subsequent \nmeasurement of the lease liability and ROU asset are the same as for a lessee \nthat elects the packag e of practical expedients for its leases. However, as an \nexception, at the transition date, any unamortized initial direct costs that do not meet the definition of initial direct costs under Topic 842 and that are not \nincluded in the measurement of the capital lease asset under Topic 840 are \nwritten off as an adjustment to equity (if incurred before the beginning of the earliest period presented in the financial statements) or t o earnings of the \ncomparative period presented (if incurred on or after the begi nning of the \nearliest period presented) . This means that the initial and subsequent \nmeasurement of the lessee’s ROU assets, and amortization thereon, will differ \nbetween a lessee that elects the package of practical expedients and one that ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1197}), Document(page\_content='Leases 1197 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. does not for the same lease for the effect of initial direct costs written off in \ntransition . [842- 10-65-1(r), 65- 1(t)] \nLeases classified as operating leases under Topic 842 \nTran sition adjustments \n13B.3.210 At the transition date, a lessee: [842- 10-65-1(s)] \n— derecognizes the carrying amount of the capital lease asset and capital \nlease obligation determined under Topic 840; the difference is accounted \nfor as prepaid or accrued rent ; and \n— writes off any unamortized initial direct costs that do not meet the definition of initial direct costs under Topic 842 as an adjustment to equity (if incurred \nbefore the beginning of the earliest period presented in the financial statements) or to earnings of the applicable comparative period presented \n(if incurred on or after the beginning of the earliest period presented) . \nInitial recognition and measurement \n13B.3.220 The lessee initially measures the operating lease liability and operating \nlease ROU asset as of the transition date, using the subsequent measurement \nguidance in Subtopic 842- 20 if the commencement date was before the date of \ninitial application, and the initial measurement guidance in Subtopic 842- 20 if \nthe commencement date is on or after the date of initial application . [842- 10-65-\n1(s)(2) – 65-1(s)(3)] \nSubsequent recognition and measurement \n13B.3.230 Subsequent to the transition date, the lessee accounts for the \noperating lease in the same manner as it accounts for any other operating lease \nunder Topic 842. [842- 10-65-1(s)(4)] \n \n Observation \nChanges in lessee lease classification in transition \n13B.3.240 In general, we believe it will be relatively infrequent that a lease \nclassified as an operating lease under Topic 840 will be classified as a finance \nlease under Topic 842 or vice versa. However, here are a few examples of \nchanges in the lease classificatio n guidance that could result in different \noutcomes. \n— Four of the five classification tests in Topic 842 for determining if a lease is a finance lease are substantially similar to those in Topic 840 for \ndetermining if a lease is a capital lease. However, Topic 842 includes a fifth \ntest (the ‘alternative use’ test – see section 6.2) that has no equivalent in \nTopic 840. The introduction of this test could result in some Topic 840 \noperating leases being classified as finance leases if reassessed under \nTopic 842. \n— Lessees under Topic 840 do not consider either the lease term or present \nvalue classification tests (see section 6.2) when the lease term falls within \nthe last 25 percent of the total estimated economic life of the underlying \nasset. Topic 842 only includes a similar exemption for the lease term test \n(see section 6.2). Consequently, some leases for which the present value \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1198}), Document(page\_content='Leases 1198 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. test in Topic 840 was not even considered would have to consider the \nsimilar present value test in Topic 842 and some of those leases mig ht \ntherefore be classified as finance leases. \n— While Topic 842 permits entities to continue to use 75 and 90 percent as \nbright -line thresholds when performing the lease term and present value \nlease classification tests, respectively, it does not require use of those \nthresholds. Consequently, an entity not using those thresholds could reach \na different conclusion about the classification of some of its existing leases if it reassesses lease classification under Topic 842 (see section 6.2). \n13B.3.250 In the f irst two examples mentioned above, the result of the changes \nto the lease classification guidance from Topic 840 to Topic 842 is that a \npreviously classified operating lease might be classified as a finance lease. In \nthe third example, in theory, the effec t could be that a previously classified \noperating lease is classified as a finance lease or vice versa; however, it appears \nless likely that an entity could reasonably conclude that a lease term greater \nthan 75 percent is not a ‘major part’ of the remaining economic life of the \nunderlying asset or a present value of lease payments greater than 90 percent \nof the fair value of the underlying asset is not ‘substantially all’ of the fair value \nof the underlying asset than the opposite. For further discussion, s ee \nQuestions 6.2.10 and 6.2.20. \n13B.3.260 Based on our evaluation of the guidance, we believe, to the extent \nsome changes in lease classification would occur if a lessee were not to elect \nthe package of practical expedients, most of those differences will be in the \ndirection of previously classifi ed operating leases becoming finance leases, \nrather than vice versa. \n \n Example 13B.3.40 \nLessee transition for operating lease under Topic 840 \nclassified as a finance lease under Topic 842 – \npackage of practical expedients not elected \nThe following summarizes relevant information about Lessee LE’s lease of a machine. \nCommencement date of the lease: January 1, 2015 \nLease term: 6 years \nMinimum rental payments determined under Topic 840 \n(annual, paid in arrears): $51,000 first 3 years \n$55,000 last 3 years \nLease classification at inception under Topic 840 : Operating lease \nInitial direct costs: None ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1199}), Document(page\_content='Leases 1199 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Effective date and transition \nAccrued rent liability : $4,000Carrying amounts \n(before transition adjustments )Comparative period Comparative period Current periodDecember 31, 2019Effective date \n(date of adoption )\nJanuary 1, 2019 January 1, 2018Beginning of earliest \nperiod presented\nJanuary 1, 2017\n \nLE does not elect the package of practical expedients available under Topic 842. \nAt January 1, 2017 (beginning of earliest period presented) \nAssume that the lease would have been classified as a finance lease under \nTopic 842 at lease commencement. At January 1, 2017, LE’s incremental \nborrowing rate is 6% (see section 5.6 and Question 13 B.3.50). \nLease liability measurement \nOn January 1, 2017, LE measures the finance lease liability as $186,807, which \nis the present value of one payment of $51,000, and three payments of \n$55,000, discounted at 6%. \nROU asset measurement \nLE determines the carrying amount of the ROU asset at January 1, 2017 using the formula described in Topic 842 as fol lows. \nStep 1: Determine the minimum rental payments over the remaining lease term \nas of the transition date: $51,000 + ($55,000 × 3) = $216,000 \nStep 2: Determine the lease term at lease commencement: 6 years \nAssume LE does not elect the use- of-hindsight practical expedient (see \nSection 13B.2). Therefore, at the effective date, LE does not revisit its \nprevious conclusion about the lease term. If LE had elected to use \nhindsight, the total and remaining lease term at the date of initial \napplication would reflect LE’s reevaluation as of the effective date (see \nQuestion 13B.2. 40) \nStep 3: Determine the remaining lease term as of the transition date: 4 years \nStep 4: Divide the amount determined in Step 1 by the amount determined in \nStep 3: $216,000 / 4 years = $54,000 per year \nStep 5: Determine the present value of the periodic payment calculated in Step 4 \nover the lease term identified in Step 2 using the lessee’s incremental \nborrowing rate at the transition date: $54,000 per year in arrears for \n6 years discounted at 6% = $265,536 \nStep 6: Multiply the amount in Step 5 by the ratio of the remaining lease term \ncalculated in Step 3 divided by the lease term identified in Step 2: \n$265,536 × (4 / 6) = $177,024 \nStep 7: Add to the amount calculated in Step 6 the amount of any previously \nrecognized prepaid rental payments (and subtract from that amount any \naccrued rental payments): $177,024 – $4,000 = $173,024 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1200}), Document(page\_content='Leases 1200 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Journal entry \nThe difference between the ROU asset and the lease liability on January 1, \n2017 is an adjustment to opening retained earnings at that date. Lessee LE \nrecognizes the following journal entry to r eflect the transition of the operating \nlease to a finance lease . \n Debit Credit \nROU asset 173,024 \nAccrued rent 4,000 \nRetained earnings 9,783 \nLease liability 186,807 \nTo recognize finance lease on transition. \nSubsequent accounting for the lease \nSubsequent to January 1, 2017, LE’s accounting is no different from that \nillustrated in Example 13B .3.30, Scenario 1. \nImputing the commencement date lease liability – alternative approach \nIn specifying measurement of the ROU asset as a proportion of the original \nlease liability (the lease liability at the co mmencement date), Topic 842 allows \nthe original lease liability to be imputed from the lease liability determined at the \ntransition date. There is no additional guidance or an example of how to do this. \n[842- 10-65-1(o)] \nThe 2013 Exposure Draft included an illustrative example of how to impute the \noriginal lease liability from the transition date lease liability. The approach \nillustrated above imputes the original lease liability in the same manner as in the \n2013 Exposure Draft. However, because the example was not carried forward \nto Topic 842, there may be other ways an entity could meet the requirements. \nIn addition, in the Exposure Draft, the lease liability was not calculated based on \nthe remaining minimum rental payments as is now required by paragraph 842-\n10-65-1(l). \nFor example, the guidance would not appear to prohibit the lessee in this \nexample from calculating the ‘original lease liability’ based on the actual \nminimum rental payments ($51,000 for the first three years; $55,000 for the \nfinal three y ears), rather than the derived lease payments of $54,000 illustrated. \nIn that case: \n— The original lease liability, using the 6% discount rate for the lease, would \nbe $259,761 (rather than $265,536). \n— The lessee would then multiply that amount ($259,761) by the ratio of the \nremaining lease term calculated in Step 3 divided by the lease term \nidentified in Step 2 ($259,751 × (4 / 6) = $173,174). \n— As with the other approach, the lessee would reduce this amount ($173,174) \nby the amount of the accrued rent ($173, 174 – $4,000 = $169,174). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1201}), Document(page\_content='Leases 1201 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Under this approach, at January 1, 2017 LE would record a slightly different \njournal entry than that recorded using the preceding approach. \n Debit Credit \nROU asset 169,174 \nAccrued rent 4,000 \nRetained earnings 13,633 \nLease liability 186,807 \nTo recognize finance lease on transition. \n \n \n13B.3.3 ASU 2021- 09, Discount Rate for Lessees That Are Not \nPublic Business Entities \n13A.3.270 ASU 2021 -09 (issued November 11, 2021) permits a lessee that is not \na public business entity to use a risk -free discount rate for the lease, instead of \nits incremental borrowing rate, as an accounting policy election by class of \nunderlying asset. The ASU also clarifies that a lessee must use the rate implicit \nin the lease when it is readily determinable even if it has elected the risk -free \ndiscount rate expedient. [842- 20-30-3] \n13A.4. 280 The effective dates of the amendments in ASU 2021- 09 are as \nfollows. [842- 10-65-6] \nEffective date Entities that adopted \nTopic 842 before ASU \n2021- 09 was issued Entities that did not \nadopt Topic 842 before \nfinal ASU was issued \nAnnual periods – fiscal \nyears beginning after December 15, 2021 Adopt when the entity \nadopts Topic 842 \nInterim periods – in fiscal \nyears beginning after December 15, 2022 \nEarly adoption allowed? Yes, as of the beginning of \nfiscal year \n13A.4. 290 The available transition approaches depend on the entity’s Topic 842 \nadoption status as of November 11, 2021 (i.e. the issuance date of ASU 2021-\n09). \n— Private entities that have not yet adopted Topic 842 will adopt the \namendments in ASU 2021- 09 at the same time and using the same \ntransition method they use to adopt Topic 842 – either the effective date \nmethod or the comparative method ( see chapters 13A and 13B , \nrespectively). \n— Private entities that have already adopted Topic 842 will apply ASU \n2021 -09 on a m odified retrospective basis to all leases that exist at the \nadoption date of the ASU’s amendments through a cumulative effect \nadjustment to retained earnings at the beginning of their fiscal year. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1202}), Document(page\_content='Leases 1202 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13B.3.4 ASU 2023 -01, Common C ontrol Arrangements \*\* \n13B.3.290\u202f ASU 2023 -01 (issued March 27, 2023) contains amendments to Topic \n842 around two issues that apply to arrangements between entities under \ncommon control . \n13B.3.300 The effective dates of the amendments in ASU 202 3-01 are as f ollows. \n[842- 10-65-7, 65- 8] \nEffective date Issue 1 (private entities \nonly) Issue 2 (all entities) \nAnnual periods – fiscal years \nbeginning after December 15, 2023 December 15, 2023 \nInterim periods – in fiscal \nyears beginning after December 15, 2023 December 15, 2023 \nEarly adoption allowed? Yes, in any annual or interim period, as of the \nbeginning of the fiscal year, for which financial \nstatements have not yet been made available for \nissuance \nEntities that have not issued \n(or made available for \nissuance) financial statements \nunder Topic 842 before final \nASU was issued May adopt concurrent with Topic 842 \nIssue 1 \n13B.3.31 0 ASU 2023- 01 permits a private entity to elect a practical expedient to \nuse the written terms and conditions, as opposed to the legally enforceable \nterms and conditions, of a common control leasing arrangement to determine \nwhether a lease exists and, if so, to determi ne the classification of and \naccounting for that lease. See section 3.1.2. [842- 10-15-3A] \n13B.3.3 20\u202f The available transition approaches depend on the entity’s Topic 842 \nadoption status as of March 27, 2023 (i.e. the issuance date of ASU 2023 -01). \n[842- 10-65-7] \n— Private entities that have not yet issued (or made available for \nissuance) financial statements under Topic 842 have the option to adopt \nthe Issue 1 amendments in their first Topic 842 compliant financial \nstatements and use the same transition method as they used to adopt the \nremainder of Topic 842 (i.e. the comparative method – for the effective date \nmethod, see chapter 13A) . \n— Private entities that have already applied Topic 842 in financial \nstatements that have been issued (or made available for issuance) \nhave the option to adopt the Issue 1 amendments: \n— prospectively to common control arrangements that commence or are modified on or after the entity ’s adoption date of the ASU (e.g. January \n1, 2024 if a calendar year end entity that does not early adopt the \namendments); or \n— on a modified retrospective basis to all common control arrangements \nthat still exist at the entity’s adoption date of the ASU. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1203}), Document(page\_content='Leases 1203 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Under the modified retrospective transition approach, the entity records the \neffect of adopting the Issue 1 amendments through a cumulative -effect \nadjustment to retained earnings at the beginning of the earliest period \npresented in the financial statements . \nFor example, assume that a calendar year private entity adopted Topic 842 \non January 1, 2022; adopted the Issue 1 amendments on January 1, 2024; \nand is issuing financial statements that will present 2023 and 2024. Under \nthis transition approach, the entity would record the required cumulative-\neffect adjustment as of January 1, 2023 (beginning of earliest period \npresented), but ba sed on an assumed retrospective application as of \nJanuary 1, 2022 (Topic 842 adoption date) to common control arrangements \nstill in place at January 1, 2024. \nIssue 2 \n13B.3.33 0 The Issue 2 amendments require that a lessee in a common control \nlease that is the accounting owner of related leasehold improvements generally \namortize the improvements over their estimated useful life to the common control group, regardless of the Topic 842 lease term, as long as it continues to control the use of the underlying asset (see section 6.4). \n[842- 20-35-12A] \n13B.3. 340\u202f The available transition approaches depend on the entity’s Topic 842 \nadoption status as of March 27, 2023 (i.e. the issuance date of ASU 202 3-01). \n[842- 10-65-8] \n— Entities that have not yet issued (or made available for issuance) \nfinancial statements under Topic 842 have the option to adopt the Issue \n2 amendments in their first Topic 842 compliant financial statements and \nuse the same transition method as they used to adopt the remainder of \nTopic 842 (i.e. the comparative method – for the effective date met hod, see \nchapter 13A) . Alternatively, these entities may use one of the two \nprospective methods outlined below for entities that have already adopted \nTopic 842. \n— Entities that have already applied Topic 842 in financial statements \nthat have been issued (o r made available for issuance) have the \nfollowing three options to adopt the Issue 2 amendments. \n— Prospectively to all leasehold improvements that are recognized on or \nafter the date the entity first applies the amendments (e.g. January 1, \n2024 for a calendar year entity that does not early adopt). \n— Prospectively to all new and existing leasehold improvements that are recognized on or after the date the entity first applies the amendments, \nwith the remaining unamortized balance of existing leasehold \nimprovements amortized over their remaining useful life to the \ncommon control group (determined as of that same date). \n— On a modified retrospective basis (i.e. to the beginning of the period in \nwhich Topic 842 is first applied – e.g. January 1, 2022 for a c alendar \nyear private entity that did not early adopt Topic 842) by apply ing the \namendments to existing leasehold improvements at the Issue 2 \nadoption date ( e.g. January 1, 2024 for a calendar year entity that does \nnot early adopt those amendments ), with a cumulative -effect \nadjustment to the opening balance of retained earnings at the beginning ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1204}), Document(page\_content='Leases 1204 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. of the earliest period presented ( e.g. January 1, 2023 if the entity is \npresenting 2023 and 2024 in its financial statements ) for any leasehold \nimprovements recognized as a result of adopting the ASU . \n \n13B.4 Transition for l essors \n Excerpt from ASC 842 -10 \nTransition and Open Effective Date Information \nGeneral \n> Transition Related to Accounting Standards Update s No. 2016- 02, \nLeases (Topic 842) , No. 2018- 01, Leases (Topic 842): Land Easement \nPractical Expedient for Transition to Topic 842 , No. 2018- 10, Codification \nImprovements to Topic 842, Leases , No. 2018- 11, Leases (Topic 842): \nTargeted Improvements , No. 2018- 20, Leases (Topic 842): Narrow -Scope \nImprovements for Lessors , No. 2019- 01, Leases (Topic 842): Codification \nImprovements , No. 2019- 10, Financial Instruments —Credit Losses (Topic \n326), Derivatives and Hedging (Topi c 815), and Leases (Topic 842): \nEffective Dates , No. 2020- 05, Revenue from Contracts with Customers \n(Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities , \nNo. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with Variable \nLease Payments , No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entitie s, and No. 2023- 01, Leases \n(Topic 842): Common Control Arrangements \n65-1 The following represents the transition and effective date information \nrelated to Accounting Standards Updates No. 2016- 02, Leases (Topic 842) , \nNo. 2018- 01, Leases (Topic 842): Land Easement Practical Expedient for \nTransition to Topic 842, No. 2018- 10, Codification Improvements to Topic 842, \nLeases , No. 2018- 11, Leases (Topic 842): Targeted Improvements , No. 2018-\n20, Leases (Topic 842): Narrow- Scope I mprovements for Lessors , No. 2019- 01, \nLeases (Topic 842): Codification Improvements , No. 2019- 10, Financial \nInstruments —Credit Losses (Topic 326), Derivatives and Hedging (Topi c 815), \nand Leases (Topic 842): Effective Dates , No. 2020- 05, Revenue from Contracts \nwith Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain \nEntities , No. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with \nVariable Lease Payments , No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entitie s, and No. 2023- 01, Leases (Topic \n842): Common Control Arrangements : [Note : See paragraph 842-10-S65-1 for \nan SEC Staff Announcement on transition related to Update 2016- 02.] \nLessors \nLeases previously classified as operating leases under Topic 840 \nv. For each lease classified as an operating lease in accordance with this \nTopic, a lessor shall do all of the following: \n1. Continue to recognize the carrying amount of the underlying asset and \nany lease assets or liabilities at the application date as determined in (c) ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1205}), Document(page\_content='Leases 1205 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. as the same amounts recognized by the lessor immediately before that \ndate in accordance with Topic 840. \n2. Account for previously recognized securitized receivables as secured \nborrowings in accordance with other Topics. \n3. If a lessor does not elect the practical expedients described in (f), write \noff any unamortized initial direct costs that do not meet the definition \nof initial direct costs in this Topic as an adjustment to equity unless the \nentity elects the transition method in (c)(1) and the costs were incurred \nafter the beginning of the earliest period presented, in which case \nthose costs shall be written off as an adjustment to earnings in the \nperiod the costs were incurred. \nw. For each lease classified as a direct financing or a sales- type lease in \naccordance with this Topic, the objective is to account for the lease, \nbeginning on the application date as determined in (c), as if it had always \nbeen accounted for as a direct financing lease or a sales- type lease in \naccordance with this Topic. Consequently, a lessor shall do all of the \nfollowing: \n1. Derecognize the carrying amount of the underlying asset at the \napplication date as determined in (c). \n2. Recognize a net investment in the lease at the application date as \ndetermined in (c) as if the lease had been accounted for as a direct \nfinancing lease or a sales -type lease in accordance with Subtopic 842-\n30 since lease commencement. \n3. Record any difference between the amounts in (w)(1) and (w)(2) as \nfollows: \ni. If an entity elects the transition method in (c)(1), as an adjustment \nto equity (if the commencement date of the lease was before the \nbeginning of the earliest period presented or if the lease was \nacquired as part of a business combination; see also (h)(3)) or \nearnings (if the commencement date of the lease was on or after \nthe beginning of the earliest period presented). \nii. If an entity elects the transition method in (c)(2), as an adjustment \nto equity . \n4. Account for the lease in accordanc e with this Topic after the application \ndate as determined in (c). \nLeases previously classified as direct financing or sales -type leases under \nTopic 840 \nx. For each lease classified as a direct financing lease or a sales -type lease in \naccordance with this Topic, do all of the following: \n1. Continue to recognize a net investment in the lease at the application \ndate as determined in (c) at the carrying amount of the net investment \nat that date. This would include any unamortized initial direct costs \ncapitalized as part of the lessor’s net investment in the lease in \naccordance with Topic 840. \n2. If an entity elects the transition method in (c)(1), before the effective \ndate, a lessor shall account for the lease in accordance with Topic 840. \n3. Regardless of the transit ion method selected in (c), beginning on the \neffective date, a lessor shall account for the lease in accordance with \nthe recognition, subsequent measurement, presentation, and \ndisclosure guidance in Subtopic 842 -30. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1206}), Document(page\_content='Leases 1206 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 4. Beginning on the effective date, if a l essor modifies the lease (and the \nmodification is not accounted for as a separate contract in accordance \nwith paragraph 842- 10-25-8), it shall account for the modified lease in \naccordance with paragraph 842- 10-25-16 if the lease is classified as a \ndirect f inancing lease before the modification or paragraph 842- 10-25-\n17 if the lease is classified as a sales- type lease before the \nmodification. A lessor shall not remeasure the net investment in the \nlease on or after the effective date unless the lease is modif ied (and \nthe modification is not accounted for as a separate contract in \naccordance with paragraph 842- 10-25-8). \ny. For each lease classified as an operating lease in accordance with this \nTopic, the objective is to account for the lease, beginning on the app lication \ndate as determined in (c), as if it had always been accounted for as an \noperating lease in accordance with this Topic. Consequently, a lessor shall \ndo all of the following: \n1. Recognize the underlying asset at what the carrying amount would \nhave bee n had the lease been classified as an operating lease under \nTopic 840. \n2. Derecognize the carrying amount of the net investment in the lease. \n3. Record any difference between the amounts in (y)(1) and (y)(2) as \nfollows: \ni. If an entity elects the transition method in (c)(1), as an adjustment \nto equity (if the commencement date of the lease was before the \nbeginning of the earliest period presented or if the lease was \nacquired as part of a business combination) or earnings (if the \ncommencement date of the lease was on or after the beginning of \nthe earliest period presented). \nii. If an entity elects the transition method in (c)(2), as an adjustment \nto equity . \n4. Subsequently account for the operating lease in accordance with this \nTopic and the underlying ass et in accordance with other Topics. \n> Transition Related to Accounting Standards Update No. 2018 -11, \nLeases (Topic 842): Targeted Improvements \n65-2 The following represents the transition and effective date information \nrelated to Accounting Standards Update No. 2018- 11, Leases (Topic 842) : \nTargeted Improvements : \na. An entity that has not yet adopted the pending content that links to \nparagraph 842- 10-65-1 shall apply the pending content that links to \nparagraph 842- 10-65-2, by class of underlying asset, to all new and existing \nleases when the entity first applies the pending content that links to \nparagraph 842- 10-65-1 and shall apply the same transition method elected \nfor the pending content that links to paragraph 842- 10-65-1. \nb. An entity that has adopted the pending content that links to paragraph 842-\n10-65-1 shall apply the pending content that links to this paragraph, by \nclass of underlying asset, to all new and existing leases either: \n1. In the first reporting period following the i ssuance of the pending \ncontent that links to paragraph 842- 10-65-2 \n2. At the original effective date of this Topic for that entity as determined \nin paragraph 842-10-65-1(a) and (b). ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1207}), Document(page\_content='Leases 1207 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. c. An entity that has adopted the pending content that links to paragraph 842-\n10-65-1 shall apply the pending content that links to this paragraph, by \nclass of underlying asset, to all new and existing leases either: \n1. Retrospectively to all prior periods beginning with the fiscal years in \nwhich the pending content that links to paragra ph 842- 10-65-1 was \ninitially applied \n2. Prospectively. \n> Transition Related to Accounting Standards Update No. 2018- 20, \nLeases (Topic 842): Narrow -Scope Improvements for Lessors \n65-3 The following represents the transition and effective date information \nrelated to Accounting Standards Update No. 2018- 20, Leases (Topic 842): \nNarrow -Scope Improvements for Lessors : \na. An entity that has not yet adopted the pending content that links to \nparagraph 842- 10-65-1 shall apply the pending content that links to this \nparagraph to all new and existing leases when the entity first applies the \npending content that links to paragraph 842- 10-65-1 and shall apply the \nsame transition method elected for t he pending content that links to \nparagraph 842- 10-65-1. \nb. An entity that has adopted the pending content that links to paragraph 842-\n10-65-1 before the issuance of the pending content that links to this \nparagraph shall adopt the pending content that links to this paragraph to all \nnew and existing leases at the original effective date of this Topic for that \nentity as determined in paragraph 842- 10-65-1(a) through (b). Alternatively, \nan entity that has adopted the pending content that links to paragraph 842-\n10-65-1 may adopt the pending content that links to this paragraph to all \nnew and existing leases either: \n1. In the first reporting period ending after the issuance of the pending \ncontent that links to this paragraph \n2. In the first reporting period beginning after the issuance of the pending \ncontent that links to this paragraph. \nc. An entity that has adopted the pending content that links to paragraph 842-\n10-65-1 before the issuance of the pending content that links to this \nparagraph shall apply the pending content that links to this paragraph to all \nnew and existing leases either: \n1. Retrospectively to all prior periods beginning with the fiscal years in \nwhich the pending content that links to paragraph 842- 10-65-1 was \ninitially applied \n2. Prospectively. \n> Transition Related to Accounting Standards Update s No. 2019- 01, \nLeases (Topic 842): Codification Improvements , No. 2019- 10, Financial \nInstruments —Credit Losses (Topic 326), Derivatives and Hedging (Topi c \n815), and Leases (Topic 842): Effective Dates , and No. 2020- 05, Revenue \nfrom Contracts with Customers (Topic 606) and Leases (Topic 842): \nEffective Dates for Certain Entities \n65-4 The following represents the transition and effective date information \nrelated to Accounting Standards Updates No. 2019- 01, Leases (Topic 842) : \nCodification Improvements , No. 2019 -10, Financial Instruments —Credit Losses \n(Topic 326), Derivatives and Hedging (Topi c 815), and Leases (Topic 842): \nEffective Dates , and No. 2020- 05, Revenue from Contracts with Customers \n(Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities : ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1208}), Document(page\_content='Leases 1208 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. a. All entities within the scope of paragraph 842- 10-65-1(a) shall apply the \npending content that links to this paragraph for financial statements issued \nfor fiscal years beginning after December 15, 2019, and interim periods \nwithin those fiscal years (with an exception for those entities that have not \nyet issued their financial statements or made financial statements available \nfor issuance as descr ibed in the following sentence). A not -for-profit \nentity that has issued or is a conduit bond obligor for securities that are \ntraded, listed, or quoted on an exchange or an over -the-counter market that \nhas not yet issued financial statements or made financial statements \navailable for issuance as of June 3, 2020 shall apply the pending content \nthat links to this paragraph for fiscal years beginning after December 15, \n2019, and interim periods within those fiscal years . All other entities shall \napply the pending content that links to this paragraph for financial \nstatements issued for fiscal years beginning after December 15, 20 21, and \ninterim periods within fiscal years beginning after December 15, 20 22. \nEarly application is permitted. \nb. An entity shall a pply the pending content that links to this paragraph as of \nthe date that it first applied the pending content that links to paragraph 842-\n10-65-1 and shall apply the same transition method elected for the pending \ncontent that links to paragraph 842- 10-65-1 in accordance with paragraph \n842-10-65-1(c). \n> Transition Related to Accounting Standards Update No. 2021 -05, \nLeases (Topic 842): Lessors —Certain Leases with Variable Lease \nPayments \n65-5 The following represents the transition and effective date information \nrelated to Accounting Standards Update No. 2021- 05, Leases (Topic 842): \nLessors —Certain Leases with Variable Lease Payments : \na. An entity that has not yet adopted the pending content that links to \nparagraph 842- 10-65-1 as of July 19, 2021, shall apply the pending content \nthat links to this paragraph when it first applies the pending content that \nlinks to paragraph 842- 10-65-1 and shall apply the same transition method \nelected for the pending content that links to paragraph 842- 10-65-1. \nb. An en tity within the scope of paragraph 842- 10-65-1(a) that has adopted \nthe pending content that links to paragraph 842- 10-65-1 as of July 19, \n2021, shall apply the pending content that links to this paragraph for fiscal \nyears beginning after December 15, 2021, and interim periods within those \nfiscal years. Earlier application is permitted. \nc. An entity within the scope of paragraph 842- 10-65-1(b) that has adopted \nthe pending content that links to paragraph 842- 10-65-1 as of July 19, \n2021, shall apply the pending content that links to this paragraph for fiscal \nyears beginning after December 15, 2021, and interim periods within fiscal \nyears beginning after December 15, 2022. Earlier application is permitted. \nd. An entity within the scope of (b) or (c) shall apply the pending content that \nlinks to this paragraph by using one of the following two methods: \n1. Retrospectively to the date in which the pending content that links to \nparagraph 842- 10-65-1 was adopted (the beginning of the period of \nadoption of Topic 842). Under t his transition method, the entity shall \napply the pending content that links to this paragraph to leases that \ncommence or are modified on or after the beginning of the period of its \nadoption of Topic 842 and do not meet the conditions in paragraph 842 -', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1209}), Document(page\_content='Leases 1209 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 10-25-8. \n2. Prospectively to leases that commence or are modified on or after the \ndate that the entity first applies the pending content that links to this \nparagraph and do not meet the conditions in paragraphs 842- 10- 25-8. \ne. An entity within the scope of (b) or (c) that elects the transition method in \n(d)(1) shall provide the following transition disclosures: \n1. The applicable transition disclosures required by Topic 250 on \naccounting changes and error corrections, except for the requirements \nin paragraph 250- 10-50-1(b)(2) and paragraph 250 -10-50-3 \n2. The transition disclosures in paragraph 250- 10-50-1(b)(3) as of the \nbeginning of the earliest period presented but not before the date in \nwhich the pending content that links to paragraph 842- 10-65-1 was \nadopted. \nf. An en tity within the scope of (b) or (c) that elects the transition method in \n(d)(2) shall provide the following transition disclosures: \n1. The nature of and reason for the change in accounting principle \n2. The transition method \n3. A qualitative description of the fi nancial statement line items affected \nby the change. \n \n13B.4.1 Lessor elects package of practical expedients \n13B.4.10 The following are the transition requirements applicable to a lessor that \nelects the package of practical expedients. Because lease classification is not \nreassessed in applying the package of practical expedients: [842- 10-65-1(f)(2)] \n— all existing leases classified as operating leases under Topic 840 will be \nclassifie d as operating leases under Topic 842; and \n— all existing leases classified as sales‑ type or direct financing leases under \nTopic 840 will be classified as sales ‑type or direct financing l eases under \nTopic 842. \nComparative period Comparative period Current periodDecember 31, 2019Effective date \n(date of adoption )\nJanuary 1, 2019Beginning of earliest \nperiod presented\nJanuary 1, 2017 January 1, 2018\nExisting leases commenced before Jan . 1, 2017\nOperating leases :\n— No change to measurement of underlying asset\n— Measure any lease assets or liabilities (e.g. IDCs , \naccrued or deferred rent ) at carrying amount under \nTopic 840 \n— Account for lease under Topic 840 until effective date\nSales -type and direct financing leases :\n— Initially measure investment in the lease (and its \ncomponents ) at carrying amounts under Topic 840\n— Do not reassess whether selling profit recognized \nunder Topic 840 would be recognized under Topic 842\n— Account for lease under Topic 840 until effective date\nExpired leases :\nDo nothingLeases commencing on /after \nJan. 1 2019 : Apply Topic 842 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1210}), Document(page\_content='Leases 1210 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Leases previously classified as operating leases under \nTopic 840 \n13B.4.20 At the transition date, a lessor: [842- 10-65-1(v)] \n— continues to recognize the underlying asset and any lease assets or \nliabilities (e.g. accrued or deferred rent income) at their carrying amounts \nrecognized in accordance with Topic 840 immediately before the transition \ndate; and \n— accounts fo r previously rec ognized securitized receivables as secured \nborrowings in accordance with other GAAP, if applicable. \n13B.4.30 After the transition date, the lessor accounts for the operating lease in \naccordance with Topic 840 for periods before the effective date; and st arting on \nthe effective date, in accordance with the operating lease guidance in Topic 842. \nLeases previously classified as sales ‑type or direc t financing \nleases under Topic 840 \n13B.4.40 At the transition date, a lessor continues to recognize a net invest ment \nin the lease equal to the carrying amount of the net investment immediately \npreceding that date; this includes any unamortized initial direct costs capitalized \nas part of the net investment in the lease in accordance with Topic 840. An \nexception arises if election of the hindsight practical expedient results in a \nchange to the lease term or the assessment of a lessee purchase option (see \nQuestion 13B.2. 50). [842- 10-65-1(x)(1) – 65-1(x)(2)] \n13B.4.50 After the transition date, the lessor accounts for the net investment in \nthe lease under Topic 840 for periods before the effective date; and starting on \nthe effective date, under the Topic 842 recognition, subsequent measurement, \npresentation and disclosure guidance. [842- 10-65-1(x)(3)] \n13B.4.60 If the lease is modified (and that modification is not accounted for as a \nseparate contract) on or after the effective date, a lessor applies Topic 842 beginning at the modification date and accounts for the modification under the \nlessor modifications guidance in Topic 842. A lessor does not remeasure the \nnet investment in the lease after the effective date unless the lease is modified (and that modification is not accounted for as a separate contract). \n[842- 10-65-1(x)(4)] \n \n13B.4.2 Lessor does not elec t package of practical expedients \nLeases previously classified as operating leases under \nTopic 840 \nLeases classified as operating leases under Topic 842 \n13B.4.70 The accounting at and subsequent to the transition date is the same as \nit is for a lessor that elects the package of practical expedients for its leases. As \nan exception, at the transition date, any unamortized initial direct costs that do \nnot meet the definition of initia l direct costs under Topic 842 are written off as \nan adjustment to equity (if incurred before the beginning of the earliest period \npresented in the financial statements) or to earnings of the comparative period ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1211}), Document(page\_content='Leases 1211 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. presented (if incurred on or after the beginn ing o f the earliest period presented) . \n[842- 10-65-1(v)] \nLeases classified as direct financing or sales ‑type leases under Topic 842 \n13B.4.80 The objective is to account for the lease, beginning on the transition \ndate, as if it had always been accounted for as a direct financing lease or a \nsales- type leas e in accordance with Topic 842. Therefore, at the transition date \na lessor: [842-10-65-1(w)] \n— derecognizes the carrying amount of the underlying asset; \n— recognizes a net investment in the lease as if the lease had been accounted \nfor as a direct financing lease or a sales -type lease under Topic 842 since \nlease commencement; and \n— records the difference between the carrying amount of the underlying asset \nderecognized and the net investment in the lease recogni zed as an \nadjustment to equity (if the commencement date of the lease was before \nthe beginning of the earliest period presented or if the lease was acquired \nas part of a business combination (see section 13 B.9)) or to comparative \nperiod earnings (if the commencement date of the lease was on or after the \nbeginning of the earliest period presented) . \n13B.4.90 After the transition date, the lessor accounts for the lease in \naccordance with Topic 842. [842- 10-65-1(w)(4)] \nLeases previously classified as direct f inancing or sales ‑type \nleases under Topic 840 \nLeases classified as direct financing or sales -type leases under Topic 842 \n13B.4.100 The accounting at, and subsequent to, the transition date is the same \nas it is for a lessor that elects the package of practical expedients for its leases \n(see section 13B.4.1). [842- 10-65-1(x)] \n13B.4.110 Initial direct costs included in the measurement of the net investment \nin the lease are not written off even if they do not meet the definition of initial \ndirect costs under Topic 842. [842- 10-65-1(x)(1)] \nLeases classified as operating leases under Topic 842 \n13B.4.120 The objective is to account for the lease, beginning at the transition date, \nas if it had always been accounted for as an operating lease in accordance with \nTopic 842. Therefore, at the transition date, a lessor: [842- 10-65-1(y)(1) – 65-1(y)(3)] \n— derecogniz es the carrying amount of the net investment in the lease; \n— recognizes the underlying asset at the carrying amount that would have \nbeen recognized had the lease been classified as an operating lease under \nTopic 840; and \n— records any difference between the ca rrying amount of the underlying \nasset recognized and the net investment in the lease derecognized as an adjustment to equity (if the commencement date of the lease was before \nthe beginning of the earliest period presented or if the lease was acquired as part of a business combination) or comparative period earnings (if the \ncommencement date of the lease was on or after the beginning of the \nearliest period presented) . ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1212}), Document(page\_content='Leases 1212 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13B.4.130 A lessor subsequently accounts for the operating lease in accordance \nwith Topic 842 and the underlying asset in accordance with other GAAP. \n[842- 10-65-1(y)(4)] \n \n Question 13B.4.10 \nOffset to assets and liabilities written -off on \ntransition \nIf the classification of a lease changes on transition, is the \ndifference between those assets and liabilities derecognized \nand those recognized by the lessor taken as an adjustment to \nequity if the lease commenced during the transition period? \nInterpretive response: No. A lessor should record thr ough its transition period \nincome statement , rather than equity, any amount(s) that would have been \nrecognized in its income statement for the comparative periods presented had \nthe lease always been accounted for under Topic 842. [842- 10-65-1(w)(3)(i), \n65-1(y)(3)(i)] \n \n Example 13B.4.10 \nLessor transition for an operating lease under \nTopic 840 classified as a sales ‑type lease under \nTopic 842 \nThe following summarizes relevant information about Lessor LR’s lease of \nequipment. In this example, LR does not elect the package of practical \nexpedients. \nCommencement date of the lease: January 1, 2016 \nLease term: 5 years \nRenewal, termination or purchase options: None \nLease payments (annual, paid in arrears): $17,000 \nEstimated residual value of the equipment at the end of the lease term: $18,000 \nResidual value guarantee (provided by either lessee or third party): None \nFair value at January 1, 2016: $77,000 \nCarrying amount at January 1, 2016: $77,000 \nRemaining (and original) economic life of the equipment: 7 years \nUseful life of the equipment: 7 years \nInitial direct costs incurred by lessor under Topic 840 (only $800 \nwould meet the definition of initial direct costs under Topic 842): $2,000 \nRate implicit in the lease under Topic 840, which does not factor in \ninitial direct costs: 9.368% \nRate implicit in the lease under Topic 842 (see section 5.6): 9.01% \nLease classification at inception under Topic 840: Operating lease \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1213}), Document(page\_content='Leases 1213 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The lease is not modified on or after the effective date. \nEffective date and transition \nUnderlying asset :\nUnamortized IDCs :$66,000\n 1,600Carrying amounts \n(before transition adjustments )Comparative period Comparative period Current periodDecember 31, 2019Effective date \n(date of adoption )\nJanuary 1, 2019 January 1, 2018Beginning of earliest \nperiod presented\nJanuary 1, 2017\n \nLR does not elect the package of practical expedients. Therefore , it reassesses \nwhether the arrangement is or contains a lease, whether classification of t he \nlease would be different under Topic 842, and whether the unam ortized initial \ndirect costs of $1,600 at January 1, 2017 would have qualified for capitalization \nunder Topic 842. \nLR determines that the arrangement is still a lease. However, the lease is \nclassified as a sales ‑type lease under Topic 842. Only $800 of the $2,000 in \ninitial direct costs under Topic 840 meet the definition of initial direct costs \nunder Topic 842, but that $800 would also have been capitalized because the \nfair value of the under lying asset equaled its carrying amount at lease \ncommencement. \nWorksheet at January 1, 2017 (beginning of earliest period presented) \nThe objective of the transition guidance in this case is to account for the lease, \nbeginning on January 1, 2017 (i.e. the transition date), as if it had always been a \nsales- type lease accounted for in accordance with Topic 842. \nStep Amounts \ndebit/(credit) Notes \nDerecognize the \ncarrying amount of the \nunderlying asset $(66,000) $77,000 original carrying amount – 1 year \nof depreciation ($77,000 / 7- year useful \nlife = $11,000) \nDerecognize entire \nunamortized portion of \noriginally capitalized \nIDCs (1,600) $2,000 original amount of IDCs \ncapitalized – 1 year of IDCs amortization \n($2,000 / 5 year lease term = $400) \nThe portion capitalizable under Topic 842 \nwill be included in the net investment in \nthe sales -type lease \nRecognize a net \ninvestment in the lease \nas if the lease had been \naccounted for as a \nsales- type lease under \nTopic 842 since lease \ncommencement 67,810 Commencement date net investment in \nthe lease of $77,800 ($77,000 fair value \nof the underlying asset + $800 in \ncapitalizable IDCs) – 2017 lease payment \nof $17,000 + 2017 interest on the net \ninvestment in the lease of $7,010 \n($77,800 × 9.01%) \nAdjustment to equity $ (210) ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1214}), Document(page\_content='Leases 1214 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Accordingly, LR records the following journal entry. \n Debit Credit \nNet investment in equipment lease 67,810 \nEquipment 66,000 \nUnamortized initial direct costs 1,600 \nRetained earnings 210 \nTo recognize sales -type lease on transition. \nAfter January 1, 2017, LR accounts for the lease in accordance with Topic 842. \n \n Observation \nChanges in less or lease classification in transition \n13B.4.140 Consistent with the O bservation at paragraph 13B.3.240, we believe it \nwill be relatively infrequent that a lease classified as an operating lease under \nTopic 840 would be classified as a sales -type or direct financing lease under \nTopic 842 or vice versa. The same examples outlined in that observation could \nresult in a different classification of an existing lease for lessors if reassessed \nunder the classification criteria in Topic 842, most likely from classification as an \noperating lease under Topic 840 to classification as a sales -type lease (or, less \nfrequently, to a direct financing lease). \n13B.4.150 In addition to those examples, a lease classified as an operating lease \nunder Topic 840 solely because either (1) collectibility of the minimum lease \npayments was not reasonably predictable, or (2) there were important \nuncertainties surrounding the amount of unreimbursable costs yet to be \nincurred by the lessor under the lease would be classified as a sa les ‑type lease \nunder Topic 842. Topic 842 does not preclude sales -type lease classification \nwhen there are collectibility uncertainties or when there are uncertainties \nsurrounding unreimbursable costs. \n13B.4.160 Consistent with our earlier lessee observat ions, it appears to us that, \nwhere lease classification might change for lessors if reassessed under \nTopic 842, it is most likely to involve operating leases being reassessed as \nsales- type or direct financing leases rather than the opposite. \n \n Observation \nInitial direct costs included in the net investment in \na sales ‑type or direct financing lease \n13B.4.170 If a lessor does not elect the package of practical expedients, it is \nrequired to reassess only whether those unamortized initial direct costs at the \ntransition date capitalized in connection with an operating lease under Topic 840 \nwould meet the definition of initial direct costs under Topic 842. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1215}), Document(page\_content='Leases 1215 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13B.4.180 Initial direct costs capitalized in connection with a direct financing \nlease under Topic 8401 are included in the lessor’s net investment in the lease. \nUnamortized amounts are not reassessed even if the lessor does not elect the \npackage of practical expedients. Those amounts are not reassessed because \nthe Board decided that sales -type/direct fina ncing lessors should carry forward \nthe same net investment in the lease they had under Topic 840 to Topic 842 at \nthe transition date. Reassessing unamortized initial direct costs for those leases \nwould have rendered that impossible in most cases given the substantially \ndifferent definitions of initial direct costs between Topic 840 and Topic 842. \n[842- 10-65-1(x)(1)] \nNote : \n1. Initial direct costs are not capitalized in connection with a sales- type lease under \nTopic 840. \n \n Question 13B.4.20 \nRevenue recognition guidance for arrangements \nthat no longer meet the definition of a lease \nWhat revenue recognition guidance does a lessor apply to \ncontracts that no longer meet the definition of a lease on adoption of Topic 842 if it uses the cumulative -effect method \nto transition to Topic 606 ? \nBackground: ABC Corp. adopts Topic 606 on January 1, 2018 using the \ncumulative -effect method (i.e. rather than the full retrospective method). ABC \napplies the guidance in Topic 606 to all contracts in 2018 and recognizes the \ncumulative effect of initial adoption of Topic 606 in the opening balance of \nretained earnings on January 1, 2018. The adoption of Topic 606 does not affect ABC’s accounting for lease arrangements in the scope of Topic 840. \nABC adopts Topic 842 on Ja nuary 1, 2019 and does not elect the package of \npractical expedients. On adoption of Topic 842, ABC concludes that an \narrangement previously accounted for as a lease under Topic 840 does not \nmeet the definition of a lease under Topic 842. Instead, ABC conc ludes the \narrangement provides a service in the scope of Topic 606. This arrangement \ncommenced in 2017. \nInterpretive response: On adoption of Topic 842, ABC should apply the \nguidance in Topic 606 to the arrangement that is no longer a lease, beginning \nwith the 2018 comparative period. ABC should also recognize the cumulative \neffect of initially applying Topic 606 to that arrangement in the January 1, 2018 \nopening retained earnings balance. \nABC should apply the guidance in Topic 605 to the arrangement for the 2017 comparative period, with the effect of applying Topic 605 for the first time \nrecognized as part of the Topic 842 transition adjustment on January 1, 2017 \n(the date of initial application of Topic 842). \nABC does not apply the guidance in Topic 606 when restating the 2017 \ncomparative period in its 2019 financial statements because ABC did not adopt \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1216}), Document(page\_content='Leases 1216 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Topic 606 until 2018 and elected the cumulative- effect transition method for the \nadoption of that standard. \n \n13B.4.3 ASU 2018- 20, Narrow -Scope Improvements for \nLessors \n13B.4.190 ASU 2018 -20 (issued December 10, 2018) enacted the following \namendments to Topic 842: \n— created a lessor -only practical expedient for sales and other similar taxes \n(see paragraphs 7.3.210 – 7.3.240) ; \n— created differential accounting for lessor costs and lessee payments \nthereof based on which party ( lessee or lessor ) remits payment for the \ncost to the relevant third party – e.g. the taxing authority or insur er. \nParagraphs 7.3.160 – 7.3.200 discuss these requirements ; and \n— clarified that a lessor should recognize variable payments not included in \nthe consideration in the contract as follows (see s ection 4.4.3): \n— the portion allocated to the separate lease component in the period in \nwhich the changes in facts and circumstances on which the payment is \nbased occur ; and \n— the portion allocated to the non- lease component(s) as revenue when \nthe requirements of the applicable Topic (e.g. Topic 606) are met. \nEntities that did not adopt Topic 842 before issuance of \nASU 2018- 20 \n13B.4.200 Lessors that did not early adopt Topic 842 before ASU 2018- 20 was \nissued will adopt the amendments in paragraph 13B.4.190 when they adopt \nTopic 842. The amendments will apply to all new and existing leases from the \ndate of initial application – e.g. January 1, 2017 for a calendar year -end public \nbusiness entity. [842- 10-65-3(a)] \nEntities that early adopted Topic 842 before issuance of ASU \n2018- 20 \n13B.4.210 Lessor s that early adopted Topic 842 will adopt the amendments in \nASU 2018- 20 as of their mandatory Topic 842 adoption date – e.g. January 1, \n2019 for a calendar year -end public business entity. [842- 10-65-3(b)] \n13B.4.220 Alternatively, l essor s can elect to apply the amendments to all new \nand existing leases in either: [842- 10-65-3(b)] \n— the first reporting period ending after the issuance of ASU 2018- 20 – e.g. \nthe quarter beginning October 1, 2018 for a calendar year -end public \nbusiness entity; or \n— the first reporting period beginning after the issuance of ASU 2018 -20 – e.g. \nthe quart er beginning January 1, 2019 for a calendar year -end public \nbusiness entity . ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1217}), Document(page\_content='Leases 1217 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13B.4.230 Lessors will apply the amendments either: [842- 10-65-3(c)] \n— retrospectively to all prior annual and interim periods after the entity’s \nTopic 842 date of initial application; or \n— prospectively from the entity’s adoption date of the amendments. \n \n13B.4.4 ASU 2019- 01, Codification Improvements \n13B.4.240 ASU 2 019-01 (issued March 5, 2019) enacted the following \namendments to Topic 842. \n— reinstated guidance from Topic 840 requiring lessors that are not \nmanufacturers or dealers to measure the fair value of the underlying asset \nat its cost after reflecting any volume or trade discounts applied; cost \ninclud es acquisition costs such as sales taxes and delivery and installation \ncosts. An exception arises if there is a significant time lapse between asset \nacquisition and lease commencement. In those cases, the lessor \ndetermines the fair value of the underlying asset in accordance with \nTopic 820 (fair value measurements). Section 7.3.1 further discusses this \nguidance; and [842- 30-55-17A] \n— requires lessors that are depository or lending institutions in the scope of \nTopic 942 (financial services —depository and lending) to classify the \nprincipal portion of lease payments received under sales -type or direct \nfinancing leases as cash flows from investing activities. The interest portion \nof those lease payments and all lease payments received under operating \nleases are classified as cash flows from operating activities. [842- 30-45-5, \n942-230-45-4] \n13B.4.250 The effective dates of the amendments in ASU 2019- 01 are as \nfollows . [842- 10-65-4(a)] \nEffective date Public business entities All other entities \nAnnual periods – fiscal \nyears beginning after December 15, 2019 December 15, 2021 \nInterim periods – in fiscal \nyears beginning after December 15, 2019 December 15, 2022 \nEarly adoption allowed? Yes Yes \n13B.4.260 On adoption, a lessor applies these amendments retrospectively from \nits date of initial application of Topic 842. For example, a calendar year -end \npublic business entity lessor that adopts the amendments on January 1, 2020 retrospectively applies the amendme nts from its Topic 842 date of initial \napplication of January 1, 2017. \n[842- 10-65-4(b)] \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1218}), Document(page\_content='Leases 1218 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13B.4.5 ASU 2021- 05, Lessors —Certain Leases with Variable \nLease Payments \n13B.4.270 ASU 2021 -05 (issued July 19, 2021) requires a lessor to classify a \nlease with variable lease payments that do not depend on an index or rate as an \noperating lease if: [842- 10-25-3A] \n— the lease would have been classified as a sales -type lease or a direct \nfinancing lease under the pre- ASU classification criteria; and \n— sales- type or direct financing classification would result in a \ncommencement date loss. \n13B.4.280 The effective dates o f the amendments in ASU 2021- 05 are as \nfollows. [842- 10-65-5] \nEffective date Public business entities Other entities \nAnnual periods – fiscal \nyears beginning after December 15, 2021 December 15, 2021 \nInterim periods – in fiscal \nyears beginning after December 15, 2021 December 15, 2022 \nEarly adoption allowed? Yes, but not before adopting ASC 842. \n13B.4.290 The available transition approaches depend on the entity’s Topic 842 \nadoption status as of July 19, 2021 (i.e. the issuance date of ASU 2021 -05). \n— Lessors that have not yet adopted Topic 842 will adopt the amendments \nin ASU 2021- 05 at the same time and using the same transition method \nthey use to adopt Topic 842 – either the effective date method or the \ncomparative method ( see chapters 13A and 13B , respectively). \n— Lessors that have already ado pted Topic 842 will apply the amendments \nin ASU 2021- 05 either: \n— retrospectively to leases that commenced or were modified on or after \nthe entity’s adoption of Topic 842 (e.g. on January 1, 2019 for a \ncalendar -year public business entity); or \n— prospectivel y to leases that commence or are modified (and that \nmodification is not accounted for as a separate contract) after the entity \nadopts the ASU 2021- 05 amendments. \n \n13B.4.6 ASU 2023 -01, Common C ontrol Arrangements \*\* \n13B.4 .320\u202f ASU 2023- 01 (issued March 27, 2023) contains amendments to Topic \n842 around two issues that appl y to arrangements between entities under \ncommon control . One the amendments related to the first of those two issues \n(Issue 1 ) applies to lessors. \nEffective date All entities \nAnnual periods – fiscal \nyears beginning after December 15, 2023 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1219}), Document(page\_content='Leases 1219 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Effective date All entities \nInterim periods – in fiscal \nyears beginning after December 15, 2023 \nEarly adoption allowed? Yes, in any annual or interim period, as of the beginning \nof the fiscal year, for which financi al statements have \nnot yet been made available for issuance \nEntities that have not \nissued (or made available \nfor issuance) financial \nstatements under Topic \n842 before final ASU was \nissued May adopt concurrent with Topic 842 \n13B.4.33 0 The Issue 1 amendments permit a private entity (lessee or lessor) to \nelect a practical expedient to use the written terms and conditions, as opposed \nto the legally enforceable terms and conditions, of a common control leasing \narrangement to determine whether a lease exists and, if so, to determine the \nclassification of and accounting for that lease. See section 3.1.2. [842- 10-15-3A] \n13B.4.340\u202f The available transition approaches depend on the entity’s Topic 842 \nadoption status as of March 27, 2023 (i.e. the issuance date of ASU 2023- 01). \n[842- 10-65-7] \n— Private entities that have not yet issued (or made available for \nissuance) financial statements under Topic 842 have the option to adopt \nthe amendments in their first Topic 842 compliant financial statements and use the same transition method as they used to adopt the remainder of \nTopic 842 (i.e. the comparative method – for the effective date method, see \nchapter 13A). \n— Private entities that have already applied Topic 842 in financial \nstatements that have been issued (or made available for issuance) \nhave the option to adopt the a mendments: \n— prospectively to common control arrangements that commence or are \nmodified on or after the entity’s adoption date of the ASU (e.g. January \n1, 2024 if a calendar year end entity that does not early adopt the amendments); or \n— on a modified retrospective basis to all leases that exist at the entity’s adoption date of the ASU. \nUnder the modified retrospective transition approach, the entity records the \neffect of adopting the amendments through a cumulative- effect adjustment \nto retained earnings at the beginning of the earliest period presented in the \nfinancial statements . \nFor example, assume that a calendar year private entity adopted Topic 842 on January 1, 2022; adopted the Issue 1 amendments on January 1, 2024; \nand is issuing financial statements that will present 2023 and 2024. Under \nthis transition approach, the entity would record the required cumulative-\neffect adjustment as of January 1, 2023 (beginning of earliest period presented), but based on an assumed retrospective application as of ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1220}), Document(page\_content='Leases 1220 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. January 1, 2022 (Topic 842 adoption date) to common control arrangements \nstill in place at January 1, 2024. \n \n13B.5 Applying the guidance on c omponents of a \ncontract in t ransition \n13B.5.10 Neither the transition guidance in Topic 842, nor the ASU 2016- 02 basis \nfor conclusions, explicitly discuss the effect of the new guidance on identifying, \nseparating and allocating the ‘consideration in the contract’ to components of a \ncontract (see chapter 4) on transition. \n13B.5.20 However, we believe the requirement s with respect to the new \ncomponents guidance in transition can be derived from other requirements in \nthe transition guidance. Sections 13 B.5.1 and 13 B.5.2 describe what we believe \nthe effect (or non- effect) of this guidance is on the various transition sc enarios \npresented, assuming the entity previously appropriately applied the guidance in \nTopic 840 with respect to (1) identifying lease and non -lease elements and (2 ) \nseparating elements and allocating contract consideration. As discussed in Question 13B.2.100, the transition guidance in Topic 842 does not grandfather \nprior errors in applying Topic 840. \n13B.5.30 Each of these scenarios assumes that the lease is not modified \n(lessees and lessors) or remeasured (lessees only) on or after the effective date. If a lease is modified (and that modification is not accounted for as a \nseparate contract) or remeasured on or after the effective date, all of the \nrequirements of Topic 842 become applicable to that lease, including the \nguidance on accounting for compon ents of a contract. \n \n13B.5.1 Less ee guidance \nOperating \uf0e0 Operating \n13B.5.40 Lessees will not reevaluate their previous allocations to lease and non-\nlease elements of a contract . This is because, absent a post -effective date \nmodification or remeasurement, the transition guidance requires lessees to use \nthe ‘minimum rental payments ’ determined in accordance with Topic 840 to \naccount for the lease (see Question 13B.3.10) . Revising previous decisions with \nrespect to identification, separation and/or allocation of contract consideration \nwould change the amounts used to account for the lease, directly contradicting the explicit requirement to account for the lease based on the minimum rental \npayments as determined under Topic 840. \nOperating \uf0e0 Finance \n13B.5.50 The transition guidance applicable to this scenario requires the lessee \nto recognize and measure a new finance lease liability in the same way as for \nan operating lease that remains classified as an operating lease, and to derive \nthe new finance l ease ROU asset from the finance lease liability at the \ncommencement date (see section 13B.3.2) . ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1221}), Document(page\_content='Leases 1221 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13B.5.60 Measurement of the lease liability is based on the minimum rental \npayments (as defined in Topic 840). Revising previous decisions with respect to \nidentification, separation and/or allocation of contract consideration would \nchange the amounts used to account for the lease, contradicting the explicit \nrequirement to account for the lease based on the minimum rental payments as \ndetermined under Topic 840 . \nFinance \uf0e0 Finance \n13B.5.70 Lessees will not reevaluate their previous allocations to lease and \nnon ‑lease elements of a contract . This is because the transition guidance \nrequires lessees to measure the initial finance lease ROU asset and initial \nfinance lease liability at the same amounts recognized immediately before the \ntransition date for the capital lease asset and the capital lease obligation, \nrespectively (except as noted in Question 13B.2. 50). \n13B.5.80 In addition, absent a post ‑effective date modification or \nremeasurement, lessees will not remeasure those amounts; they will simply complete the accounting for the lease based on those initially measured \namounts. Similar to the operating lease to operating lease scenario in \nparagraph 13B.5.40, revisions to decisions made about c omponents of the \ncontract would require the lessee not to follow the explicit measurement \nrequirements for this scenario. \nFinance \uf0e0 Operating \n13B.5.90 The transition guidance applicable to this scenario requires the lessee \nto derecognize its existing capital lease asset and capital lease obligation and, at \nthe transition date, recognize and measure a new operating lease liability in \naccordance with Topic 842 and derive the new operating lease ROU asset from \nthat lease liability. \n13B.5.100 Measurement of the lease liability in accordance with Topic 842 is \nbased on the lease payments. Because the lease payments are a function of the separation and allocation guidance in Topic 842 if there are either (1) \nmultiple separate lease components or (2) lease and non- lease components of \nthe contract, lessees will need to apply the Topic 842 multiple -component \nseparation and allocation guidance (see section 4.4) to comply with the \ntransition measurement requirements. \n \n Question 13B.5.10 \nNot separating l ease from non- lease components \nfor existing leases on transition \nIs the practical expedient for a lessee to not separate lease \nand non- lease components a policy election available to \nlessees for existing leases ? \nBackground: As a practical expedient, a lessee may elect not to separate non -\nlease components from the lease components to which they relate. A lessee \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1222}), Document(page\_content='Leases 1222 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. applies this practical expedient as an accounting policy election by class of \nunderlying asset – e.g. office equipment, automobiles, office space. H owever, \nthere is no mention in Topic 842 as to whether a lessee could similarly apply \nthis expedient to existing leases o n transition. [842- 10-15-37] \nInterpretive response: Yes. While not explicitly provided for in the transition \nguidance, we believe lessees are permitted to make an accounting policy \nelection (by class of underlying asset) to not separate non- lease elements (e.g. \nsubstantial services such as those to operate the asset) from the lease elements to which they relate for existing leases . \nFor example, a lessor’s operation of the underlying asset (e.g. services to \noperate a ship or an airplane) is an example of a substantial service that is \naccounted for separate from the lease element. T herefore, in an operating \nlease, a lessee electing the non- separat ion practical expedient for existing \nleases on transition will account for fixed costs allocable to the operation \nservices as part of the minimum rental payments that are used to measure the \noperating lease liability. \nThe Board decided to permit the non-separation practical expedient for leases \nthat commence on or after the effective date to ease the accounting for \nlessees, and many of the transition provisions were similarly intended. \nTherefore, we believe it is acceptable for lessees to apply the expedient to \nexisting leases on transition . \n \n Question 13B.5.20 \nAccounting policy implications of separating l ease \nfrom non -lease c omponents for existing leases o n \ntransition \nIf a lessee does not elect the lease/non -lease component \npractical expedient o n transition, is this a binding accounting \npolicy election going forward for new leases that commence \nafter the effective date? \nInterpretive response: No. We do not believe there is a basis in Topic 842 for \nprohibiting a lessee from electing the practical expedient for new leases that \ncommence on or after the effective date solely because it did not elect to apply \nthe practical expedient o n transition, application of which is not addressed in \nTopic 842 or ASU 2016- 02 (see Question 13B.5.10). \nHowever , based on related discussions with the SEC staff, we believe a lessee \nshould only apply the lease/non- lease practical expedient to existing leases on \ntransition if it will do so for new leases o f underlying assets within the same \nclass commencing on or after the effective date of Topic 842 . \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1223}), Document(page\_content='Leases 1223 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13B.5.2 Less or guidance – practical expedient for separation \nof lease and non -lease components does not apply \nOperating \uf0e0 Operating \n13B.5.110 The transition guidance requires lessors in this scenario to continue to \nrecognize the underlying asset, as well as any other lease assets and liabilities \n(e.g. accrued rent assets or deferred rent liabilit ies), at the same amounts as \nimmediately before the transition date under Topic 840 . If a contract that \ncontains an operating lease includes multiple lease components and/or lease \nand non- lease components, revising the units of account and revising the \nallocation of the consideration in the contract (which might be different from the \ntotal contract consideration under Topic 840 if there are variable payments that \nspecifically relate to non -lease components of the contract) would likely result in \nadjustments to any recognized lease assets or liabilities – i.e. a change would \nhave resulted in a change to the lease payments, and therefore the \naccrued/deferred rent amount would typically be meas ured differently from that \nwhich resulted under Topic 840. \nSales -type/direct financing \uf0e0 Sales -type/direct financing \n13B.5.120 Lessors will not reevaluate their previous allocations to lease and non-\nlease elements of a contract. This is because the trans ition guidance requires \nlessors to measure their initial lease assets under Topic 842 at the same \namount recognized immediately before the transition date under Topic 840. \n13B.5.130 In addition, absent a post ‑effective date modification not accounted for \nas a separate contract , lessors in this scenario will not remeasure their lease \nassets, they will simply complete the accounting for the lease based on the \ninitially measured amount for the net investment in the lease. \nOperating \uf0e0 Sales -type/direct financing; or Sales -type/direct \nfinancing \uf0e0 Operating \n13B.5.140 The transition guidance states for either of these scenarios that “the \nobjective is to account for the lease, beginning on the later of the beginning of \nthe earliest comparative period presented in the financial statements and the \ncommencement date of the lease, as if it had always been accounted for as an \noperating [a sales -type or direct financing] lease in accordance with this Topic. ” \nIt therefore seems clear that this would include r eassessing the lessor ’s \naccounting with respect to the components of the contract. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1224}), Document(page\_content='Leases 1224 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 13B.5.30 \nTopic 842 and Topic 606 interaction in accounting \nfor CAM \nHow should a lessor account for CAM provided in a lease \nafter it adopts Topic 606 but before it adopts Topic 842? \nBackground: Topic 840 specifies that CAM is within its scope based on the \nfollowing. [840- 10-25-1(d), 15- 17, 15- 19(a)] \n— It descr ibes maintena nce as an executory cost. \n— It states that “if an arrangement contains a lease and related executory \ncosts, as well as other non- lease elements, the classification, recognition, \nmeasurement, and disclosure requirements of this Topic shall be applied by both the purchaser and the supplier to the lease element of the \narrangement.” [emphasis added] \n— It charact erizes related executory costs as part of ‘those for the lease’. \nInterpretive response: \nAccounting for existing leases before the effective date of Topic 842 \nTopic 606 is a ‘residual standard’ in that it requires the application of other \nTopics first if those other Topics specify how to account for one or more parts \nof the contract. Topic 606 only applies to those parts of the contract that other Topics do not address. \nCAM expenditures are described as ‘executory costs’, and accounted for as part of the lease element under Topic 840. Therefore, CAM is not governed by \nTopic 606 for leases that commence before the effective date of Topic 842, and \nan entity may continue to account for CAM under its historical accounting policy. That said, on the adoption of Topic 606, based on discussions with the \nFASB and SEC staffs, we believe it would be acceptable for an entity to either \n(or both): \n[606- 10-15-4] \n— analogize to the guidance in Topic 606 in determining the measure of \nprogress to apply when recognizing CAM revenue – i.e. rather than follow \nits historical accounting policy for recognizing CAM; and/or \n— separately present CAM revenues as non -lease revenue. If a lessor decides \nto separately present CAM revenue as non- lease revenue, it is acceptable \nto allocate revenue between the lease and CAM using either: (1) the \nrequirements in Topic 840 or (2) the transaction price allocation guidance \nin Topic 606 (see paragraphs 13B.5.150 – 13B.5.160). On adoption of \nTopic 842, that separate presentation (if elected) should be reflected in the \ncomparative periods presented. \nAccounting for existing leases after the effective date of Topic 842 \nAssuming that lease classification is the same before and after adoption of Topic 842 (unless the lease is modified on or after the ef fective date and that \nmodification is not accounted for as a separate contract), the lessor will not reevaluate the identification of and allocation to lease and non- lease \ncomponents (see paragraphs 13B.5.110 – 13B.5.130). The lessor will continue \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1225}), Document(page\_content='Leases 1225 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. to accou nt for CAM provided as part of the lease contract just as it did before \nthe effective date of Topic 842 (see above). \nAccounting for leases that commence or are modified on or after the \neffective date of Topic 842 \nFor all leases that commence or are modif ied on or after the effective date of \nTopic 842 (and for which that modification is not accounted for as a separate \ncontract in accordance with paragraph 842- 10-25-8), the lessor will identify CAM \nas a non -lease component and account for it under Topic 606. \n \n Observation \nLessor reallocation may be permissible in some \ncases \n13B.5.150 The discussion in paragraphs 13B.5.110 – 13B.5.130 notwithstanding, \nthe SEC staff has communicated that they may not object to a lessor beginning \nto account for maintenance services (including common area maintenance), \nwhich is a lease -related element under Topic 840, as a non- lease element \nbeginning with the lessor’s adoption of Topic 606 if the lessor adopts Topic 606 \nbefore it adopts Topic 842. Under this approach, we believe the lessor would \naccount for those services as within the scope of Topic 606 and would allocate the contract consideration between the remaining lease elements and any non-\nlease elements (including maintenance services) in accordance with t he \ntransaction price allocation guidance in paragraphs 606 -10-32-28 – 32-41. \n13B.5.160 The lessor’s accounting in this regard would follow the lessor’s \nTopic 606 transition approach (full retrospective approach or cumulative effect \napproach). \n13B.5.170 Taken as a whole, we believe entities will only be required to reassess \ntheir identification and accounting for components of a contract when the lease classification changes as a result of applying Topic 842 to the lease. If lease \nclassification does not change or the entity elects the package of practical \nexpedients, which means the entity will not reassess classification of its leases \nunder Topic 842, entities will not be required to reassess their identification of \nor accounting for multiple components of a contract. Avoiding the effort to reassess the accounting for components of a contract and avoiding the \noperational complexities that could arise from that exercise if classification of a \nlease does change is another reason many entities will likely consider electing \nthe package of practical expedients. \n13B.5.180 However, consistent with the discussion in Question 13 B.2.100 about \nidentifying leases, the ability to not reassess identification of or accounting for \nmultiple components of a contract presumes the entity applied the guidance in \nTopic 840 completely and accurately. For example, if an entity did not \nappropriately ide ntify lease and non ‑lease elements , or did not appropriately \nseparate ‘minimum rental payments’ or ‘minimum lease payments’ from \npayments for non ‑lease elements (e.g. services), the transition guidance does \nnot excuse those errors. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1226}), Document(page\_content='Leases 1226 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 13B.5.40 \nExisting arrangements with lease and non -lease \nelements – substantial services \nWhat guidance applies to a lessor when accounting for \n‘substantial services’ provided to a lessee on transition? \nBackground: Topic 840 require d a lessor to separate , at lease i nception, \npayments and other consideration into those : [840- 10-15-19] \n— related to t he lease, including the related executory costs; and \n— for other services. \nUnder Topic 840, t he term ‘executory costs ’ refer red to the normal expenses \nassociated with owning a n asset, including insurance, maintenance and taxes. \nTherefore, activities identified as giving rise to executory costs, such as most \nmaintenance services, were not non- lease elements. ‘Substantial services’ \nwere accounted for separately from the lease (under Topic 605 before the \nadoption of Topic 606). [840- 10-25-1(d), 840 -10-15-8 – 15-19] \nBefore the adoption of Topic 606, the components were required to be \nseparated on a relative selling price basis . After the adoption of Topic 606, \nlessors separate lease from non- lease components (which includes substantial \nservice elements) using the transaction price allocation guidance in Topic 606. \n[840- 10-15-19] \nInterpretive response: Substantial services were non -lease elements under \nTopic 840. Therefore, before the lessor’s adoption of Topic 606 they were \nrequired to be accounted for under Topic 605 (or other relevant pre- Topic 606 \nrevenue guidance). Consequently, substantial services become subject to Topic 606 for lessors on transition to Topic 606, and should be transitioned \nusing the same guidance that applies to all other elements that were subject to the pre- Topic 606 revenue guidance. The consideration in the lease contract, \nhowever, is not reallocated between the lease and non -lease elements on \nadoption of Topic 606 and the lessor continues to use the consideration \nallocated to the non- lease component based on the Topic 840 allocation \nguidance (see also Question 13 B.5.30). \nIf substantial service elements were accounted for as being i n the scope of \nTopic 840 (i.e. as part of a lease element), this is a non -GAAP accounting policy \nthat is subject to financial statement materiality considerations. There is no \npractical expedient in transition to Topic 606 that would permit a substantial \nservice element to be accounted for as part of a lease after the adoption of \nTopic 606. \nLessor practical expedient not to separate lease and non -lease \ncomponents \nAs discussed in section 13 B.5.3, a lessor that elects the non- separation \npractical expedient f or lease and non- lease components will combine lease and \nsubstantial service elements in existing leases that meet the specified criteria \n(see paragraph 13 B.5.190) beginning: \n— For non- early adopters, on the date of initial application ; and \n— For early adopter s: \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1227}), Document(page\_content='Leases 1227 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — either (1) in the first reporting period following the issuance of \nASU 2018- 11 (e.g. the beginning of the fiscal quarter following the \nissuance date of the ASU) or (2) at the entity’s mandatory Topic 842 \nadoption date (e.g. January 1, 2019 for a calenda r year -end public \nbusiness entity); and \n— retrospectively to all reporting periods after the date of initial \napplication . \nFor example, a lessor is not early adopting Topic 842 and will combine its ship lease and operations service elements for new leases under Topic 842. In that \ncase, the lessor will also present ship lease and operations service (i.e. \nsubstantial service) revenue for existing leases on a combined basis beginning \non the date of initial application of Topic 842; this includ es combining the lease \nand substantial operation service elements for presentation purposes in the comparative periods . \n \n13B.5.3 Lessor guidance – practical expedient for separation \nof lease and non -lease components applies \n13B.5.190 Topic 842 provides a les sor practical expedient whereby the lessor \ncan make an accounting policy election, by class of underlying asset, not to separate lease and related non- lease components if both: \n[842- 10-15-42A] \n— the timing and pattern of transfer to the lessee of the lease c omponent and \nthe non- lease component(s) associated with that lease component are the \nsame; and \n— the lease component, if accounted for separately, would be classified as an \noperating lease. \nParagraphs 4.4.51 – 4.4.56 discuss the lessor practical expedient in detail. \nEntities that have not adopted Topic 842 on issuance of \nASU 2018- 11 \n13B.5.200 Lessors that had not early adopted Topic 842 when ASU 2018- 11 was \nissued may elect the practical expedient when they adopt Topic 842. \n13B.5.210 For existing leases (i. e. those that commence before the effective \ndate), lessors will apply the non- separation practical expedient from the date of \ninitial application . That is, a lessor will combine lease and non- lease components \narising from an existing lease if they would al so do so if the lease were a new \nlease that commenced on or after the entity’s adoption date. [842- 10-65-2(a)] \nEntities that early adopted Topic 842 before the issuance of \nASU 2018- 11 \n13B.5.220 Lessors can elect the practical expedient at either : \n— the beginning of the entity’s first reporting period following the issuance of \nASU 2018- 11 – e.g. the beginning of the fiscal quarter following the \nissuance date of the ASU ; or ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1228}), Document(page\_content='Leases 1228 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. — at the entity’s mandatory Topic 842 adoption date – e.g. January 1, 2019 for \na calendar year -end public business entity. \n13B.5.230 For existing leases (i.e. those that commence before the lessor’s \nadoption of the practical expedient), lessors will apply the non- separation \npract ical expedient retrospectively to all prior annual and interim periods after \nthe date of initial application. \n \n13B.6 Leveraged l eases \n Excerpt from ASC 842 -10 \nTransition and Open Effective Date Information \nGeneral \n> Transition Related to Accounting Standards Update s No. 2016- 02, \nLeases (Topic 842), No. 2018 -01, Leases (Topic 842): Land Easement \nPractical Expedient for Transition to Topic 842, No. 2018 -10, Codification \nImprovements to Topic 842, Leases, No. 2018 -11, Leases (Topic 842): \nTarg eted Improvements , No. 2018- 20, Leases (Topic 842): Narrow -Scope \nImprovements for Lessors, No. 2019 -01, Leases (Topic 842): Codification \nImprovements , No. 2019- 10, Financial Instruments —Credit Losses (Topic \n326), Derivatives and Hedging (Topic 815), and Le ases (Topic 842): \nEffective Dates , No. 2020- 05, Revenue from Contracts with Customers \n(Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities , No. \n2021 -05, Leases (Topic 842): Lessors —Certain Leases with Variable Lease \nPayments , No. 2021- 09, Leases (Topic 842): Discount Rate for Lessees \nThat Are Not Public Business Entities , and No. 2023 -01, Leases (Topic \n842): Common Control Arrangements \n65-1 The following represents the transition and effective date information \nrelated to Accounting Standards Updates No. 2016- 02, Leases (Topic 842) , \nNo. 2018- 01, Leases (Topic 842): Land Easement Practical Expedient for \nTransition to Topic 842, No. 2018- 10, Codification Improvements to Topic 842, \nLeases , No. 2018- 11, Leases (Topic 842): Targeted Improvements , No. 2018-\n20, Leases (Topic 842): Narrow- Scope Improvements for Lessors , No. 2019- 01, \nLeases (Topic 842): Codification Improvements , No. 2019- 10, Financ ial \nInstruments —Credit Losses (Topic 326), Derivatives and Hedging (Topi c 815), \nand Leases (Topic 842): Effective Dates , No. 2020- 05, Revenue from Contracts \nwith Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain \nEntities , No. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with \nVariable Lease Payments , No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entities , and No. 2023- 01, Leases (Topic \n842): Common Control Arrangements : [Note : See paragraph 842-10-S65-1 for \nan SEC Staff Announcement on transition related to Update 2016- 02.] \nLeases previously classified as leveraged leases under Topic 840 \nz. For leases that were classified as leveraged leases in accordance with \nTopic 840, and for which the commencement date is before the effective ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1229}), Document(page\_content='Leases 1229 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. date, a lessor shall apply the requirements in Subtopic 842- 50. If a \nleveraged lease is modified on or after the effective date, it shall be \naccounted for as a new l ease as of the effective date of the modification in \naccordance with the guidance in Subtopics 842- 10 and 842- 30. \n1. A lessor shall apply the pending content that links to this paragraph to a \nleveraged lease that meets the criteria in (z) that is acquired in a \nbusiness combination or an acquisition by a not -for-profit entity on \nor after the effective date. \n \n13B.6.10 For leases classified as leveraged leases under Topic 840 and for which \nthe commencement date is before the effective date, a lessor continues its \nexisting leveraged lease accounting, even if the lessor does not elect the \npackage of transition practical expedients (see paragraph 13B.2.100). However, \nif a leveraged lease is modified on or after the effective date, it is accounted for \nas a new lease at the modification date in accordance with Topic 842. [842- 10-\n65-1(z)] \n13B.6.20 If a lessee exercises an option to extend a leveraged lease that \ncommenced before the effective date of Topic 842 for which exercise was not previously considered reasonably assured, the exercise of that option is \nconsidered a lease modification. \n[842- 50-15-1] \n13B.6.30 For further discussion of leveraged leases, see section 7. 8. \n \n Question 13B.6.10 \nAcquired leveraged leases \nIf a leveraged lease is acquired, does the lessor continue to \napply leveraged lease accounting? \nBackground: The lease could be acquired separately, or as part of a business \ncombination ( or an acquisition by a not -for-profit entity ). \nInterpretive response: Yes, provided that the lease is not modified as part of \nthe acquisition. The lessor will continue to apply the leveraged lease guidance in \nSubtopic 842-50 (leveraged lease arrangements ) (see section 7.8). \n \n13B.7 Sale-leaseback t ransactions \n Excerpt from ASC 842 -10 \nTransition and Open Effective Date Information \nGeneral \n> Transition Related to Accounting Standards Update s No. 2016- 02, \nLeases (Topic 842), No. 2018 -01, Leases (Topic 842): Land Easement \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1230}), Document(page\_content='Leases 1230 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Practical Expedient for Transition to Topic 842, No. 2018 -10, Co dification \nImprovements to Topic 842, Leases, No. 2018 -11, Leases (Topic 842): \nTargeted Improvements , No. 2018- 20, Leases (Topic 842): Narrow -Scope \nImprovements for Lessors, No. 2019 -01, Leases (Topic 842): Codification \nImprovements , No. 2019- 10, Financial Instruments —Credit Losses (Topic \n326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): \nEffective Dates , No. 2020- 05, Revenue from Contracts with Customers \n(Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities , No. \n2021 -05, Leases (Topic 842): Lessors —Certain Leases with Variable Lease \nPayments , No. 2021- 09, Leases (Topic 842): Discount Rate for Lessees \nThat Are Not Public Business Entities , and No. 2023 -01, Leases (Topic \n842): Common Control Arrangements \n65-1 The following represents the transition and effective date information \nrelated to Accounting Standards Updates No. 2016- 02, Leases (Topic 842) , \nNo. 2018- 01, Leases (Topic 842): Land Easement Practical Expedient for \nTransition to Topic 842, No. 2018- 10, Codification Improvements to Topic 842, \nLeases , No. 2018- 11, Leases (Topic 842): Targeted Improvements , No. 2018-\n20, Leases (Topic 842): Narrow- Scope Improvements for Lessors , No. 2019- 01, \nLeases (Topic 842): Codification Improvements , No. 2019- 10, Financ ial \nInstruments —Credit Losses (Topic 326), Derivatives and Hedging (Topi c 815), \nand Leases (Topic 842): Effective Dates , No. 2020- 05, Revenue from Contracts \nwith Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain \nEntities , No. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with \nVariable Lease Payments, No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entities, and No. 2023- 01, Leases (Topic \n842): Common Control Arrangements : [Note : See paragraph 842-10-S65-1 for \nan SEC Staff Announcement on transition related to Update 2016- 02.] \nSale and leaseback transactions before the effective date \naa. If a previous sale and leaseback transaction was accounted for as a sale \nand a leaseback in accordance with Topic 840, an entity shall not reassess \nthe transaction to determine whether the transfer of the asset would have \nbeen a sale in accordance with paragraphs 842- 40-25-1 through 25- 3. \nbb. If a previous sale and leaseback transaction was accounted for as a failed \nsale and lease back transaction in accordance with Topic 840 and remains a \nfailed sale at the effective date: \n1. If an entity elects the transition method in (c)(1), the ent ity shall \nreassess whether a sale would have occurred at any point on or after \nthe beginning of the earliest period presented in the financial \nstatements in accordance with paragraphs 842-40-25-1 through 25- 3. \nThe sale and leaseback transaction shall be ac counted for on a \nmodified retrospective basis from the date a sale is determined to \nhave occurred. \n2. If an entity elects the transition method in (c)(2), the entity shall \nreassess whether a sale would have occurred at the beginning of the \nreporting period in which the entity first applies the pending content \nthat links to this paragraph in accordance with paragraphs 842- 40-25-1 \nthrough 25- 3 and recognize the sale as an adjustment to equity. The \nentity shall then account for the leaseback in accordance with th e \nguidance in Subtopic 842 -20 after the beginning of the reporting period ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1231}), Document(page\_content='Leases 1231 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. in which the entity first applies the pending content that links to this \nparagraph. \ncc. An entity shall account for the leaseback in accordance with the lessee and \nlessor transition requirements in (k) through (y). \ndd. If a previous sale and leaseback transaction was accounted for as a sale \nand capital leaseback in accordance with Topic 840, the transferor shall \ncontinue to recognize any deferred gain or loss that exists at the later of \nthe beginning of the earliest comparative period presented in the financial \nstatements and the date of the sale of the underlying asset (if an entity \nelects the transition method in (c)(1)) or that exists at the beginning of the \nreporting period in which the entity first applies the pending content that \nlinks to this paragraph (if an entity elects the transition method in (c)(2)), as \nfollows: \n1. If the underlying asset is land only, straight line over the remaining \nlease term. \n2. If the underlying asset is not land only and the leaseback is a finance \nlease, in proportion to the amortization of the right -of-use asset. \n3. If the underlying asset is not land only and the leaseback is an \noperating lease, in proportion to the recognition in profit or loss of the \ntotal lease cost. \nee. If a previous sale and leaseback transaction was accounted for as a sale \nand operating leaseback in accordance with Topic 840, the transferor shall \ndo the following: \n1. Recognize any deferred gain or loss not resulting from off -market \nterms (that is, where the consideration for the sale of the asset is not \nat fair value or the lease payments are not at market rates) as a \ncumulative -effect adjustment to equity unless the entity elects the \ntransition method in (c)(1) and the date of sale is after the beginning of \nthe earliest period presented, in which case any deferred gain or loss \nnot resulting from off -market terms shall be recognized in earnings in \nthe period the sale occurred. \n2. Recognize any deferred loss resulting from the consideration for the \nsale of the asset not being at fair value or the lease payments not being \nat market rates as an adjustment t o the leaseback right -of-use asset at \nthe later of the beginning of the earliest comparative period presented \nin the financial statements and the date of the sale of the underlying \nasset (if an entity elects the transition method in (c)(1)), or at the \nbeginning of the reporting period in which the entity first applies the \npending content that links to this paragraph (if an entity elects the \ntransition method in (c)(2)). \n3. Recognize any deferred gain resulting from the consideration for the \nsale of the asset not being at fair value or the lease payments not being \nat market rates as a financial liability at the later of the beginning of the \nearliest comparative period presented in the financial statements and \nthe date of the sale of the underlying asset (if an entity elects the \ntransition method in (c)(1)), or at the beginning of the reporting period in \nwhich the entity first applies the pending content that links to this \nparagraph (if an entity elects the transition method in (c)(2)). \n \n13B.7.10 If a sale -leaseback transaction was previously accounted for as a sale \nand a leaseback under Topic 840, an entity does not reassess whether the ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1232}), Document(page\_content='Leases 1232 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. transaction would have qualified as a sale (or purchase) under Topic 842. This \nmeans that buyer -lessors will not revisit w hether a purchase of the underlying \nasset occurred for any sale -leaseback transactions for which the sale/purchase \noccurred before the effective date. [842- 10-65-1(aa)] \n13B.7.20 An entity accounts for the leaseback in accordance with the lessee and \nlessor transition requirements outlined in sections 13 B.2 – 13B.5. [842- 10-65-1(cc)] \n13B.7.30 If a transaction was previously accounted for as a sale and capital \n(finance) leaseback under Topic 840, a seller ‑lessee continues to amortize any \ndeferred gain or loss existing at the later of the beginning of the earliest period \npresented or the date of sale of the underlying asset as follows. [842- 10-65-1(dd)] \n— If the asset is land only, over the remaining lease term on a straight ‑line \nbasis. \n— If the asset is not la nd only: \n— in proportion to the amortization of the ROU asset if the leaseback is a \nfinance lease; and \n— in proportion to total lease cost recognized in profit or loss if the \nleaseback is an operating lease. \n13B.7.40 If a transaction was previously accounted for as a sale and operating \nleaseback under Topic 840, a seller -lessee (see Example 13B.7.20): \n[842- 10-65-1(ee)] \n— recognizes the portion of any deferred gain or loss not resulting from off ‑\nmarket terms at the later of the beginning of the earliest period presented \n(as a cumulative -effect adjustment to equity) or the date of sale (in earnings \nof the comparative period presented) ; and \n— recognizes the portion of any deferred gain or loss that resulted from off‑market terms as an adjustment to the leaseback ROU asset (if the sale s \nprice was below market) or as a remaining financial liability (if the sale s \nprice was above market) at the transition date. \n13B.7.50 Consistent with the transition requirements for lessees and lessors, \nthe sale- leaseback transition requirements generally limit the implementation \ncost and complexity for preparers. A seller -lessee will recognize an adjustment \nto equity in transition only for sale and operating leasebacks for which there is a \ndeferred gain or loss not resulting from off -market terms. \n13B.7.60 If a previous sale ‑leaseback transaction was, and continues to be at the \neffective date, accounted for as a failed sale under Topic 840, the entity \nreassesses whether a sale would ha ve occurred at any point on or after the \nbeginning of the earliest period presented in the financial statements in \naccordance with Topic 842. If so, the sale -leaseback transaction is accounted \nfor on a modified retrospective basis – i.e. in accordance with the transition \nguidance applicable to sale and operating leasebacks – from the date a sale is \ndetermined to have occurred. [842- 10-65-1(bb)] \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1233}), Document(page\_content='Leases 1233 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Question 13B.7.10 \nLeaseback accounting on transition for previously \nfailed sales \nWhat is the seller -lessee’s accounting for a sale -leaseback \ntransaction that remains a failed sale under Topic 840 at the \neffective date? \nInterpretive response: \nAccounting for the sale \nIf the sale criteria in Subtopic 842 -40 (see section 9.1) are met as of the \nbeginning of the earliest period presented (because as of that point in time \nthere are no conditions precluding a sale under Subtopic 842- 40), we believe \nthe gain or loss on the sale of the underlying asset should be recognized as an \nadjustment to equity as of that date. [842- 10-65-1(bb)(1)] \nIn contrast, if the sale criteria in Subtopic 842- 40 are met during the transition \nperiod, we believe the gain or loss on the sale of the underlying asset should be \nrecognized in the period the sale criteria are m et. \nThe guidance in section 9.2 applies if the sale criteria in Subtopic 842- 40 are \nmet after the effective date of Topic 842. \nAccounting for the leaseback \nIf the sale criteria in Subtopic 842 -40 are met before the effective date of \nTopic 842, the accounting for the leaseback should follow the transition \nprovisions discussed in sections 13 B.2 and 13B .3 as if the lease \ncommencement date were the later of the date of initial application or the date that a sale is determined to occur under Subtopic 842- 40. \nIf the entity has elected the package of transition practical expedients (see section 13B.2.3), we believe the preceding paragraph means the following. \n— Because this was previously determined to be a failed sale- leaseback \ntransaction, there would be no additional consideration as to whether the \nleaseback meets the definition of a lease under Topic 842. \n— Because there was no lease accounted for under Topic 840 ( i.e. bec ause \nthe transactio n was accounted for as a failed sale -leaseback ) the lessee had \nnot classified the lease under Topic 840. In the absence of specific guidance in Topic 842, we believe it is acceptable for the lessee to assess \nclassification of the lease a s of either: \n— the lease commencement date, using the lease classification guidance \nin Topic 842; or \n— The lease inception date, using the lease classification guidance in \nTopic 840. \nWe believe the first approach is acceptable, even though the package of \npract ical expedients has been elected, because there was no ‘existing \nlease’ that had been previously classified under Topic 840. However, we believe that to apply this approach, the entity must determine the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1234}), Document(page\_content='Leases 1234 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. commencement date of the leaseback (i.e. when a sale would have \nsuccessf ully occurred) under Topic 842. \nAlternatively, we believe the second approach is acceptable because \nelection of the package of transition practical expedients effectively \ngrandfathers the legacy Topic 840 classification guidance, wh ich required \nlease classification to be assessed at lease inception. \nWe believe an entity’s chosen approach should be applied consistently to \nall similar circumstances. \n— Any unamortized initial direct costs capitalized because the transaction was \naccounted for as a failed sale will not be reassessed, despite the fact that \nthose costs may have been expensed as transaction costs of the sale had the transaction been a successful sale and leaseback under Topic 840. \nThose costs will be accounted for by the lessee in the same manner as any \nother unamortized initial direct costs are accounted for by lessees that elect \nthe package of transition practical expedients. \n \n Question 13B.7.20 \nSuccessful sale -leaseback transactions that include \nseller -lessee repurchase options on adoption of \nTopic 606 \nIs a transaction accounted for as a sale and a leaseback under \nTopic 840 that includes a seller -lessee repurchase option \nreassessed as a financing arrangement because of the \nrepurchase agreements guidance in Topic 606? \nBackground: This question arises because Topic 606 states that if an entity has \nan obligation (a forward) or a right (a call option) to repurchase an asset, then \nthe customer does not obtain control of the asset – i.e. no sale occurs for \nrevenue recognition purposes. An entity accounts for the contract as a lease or \na financing arrangement depending on the rel ationship between the repurchase \namount and the original selling price. Further, i f the contract is part of a sale -\nleaseback transaction, the entity should account for the contract as a financing arrangement . \n[606- 10-55-68, ASU 2014- 09.BC426] \nIn contrast, the transition guidance in Topic 842 states that if a previous sale -\nleaseback transaction was accounted for as a sale and a leaseback in accordance with Topic 840, an entity does not reassess the transaction to \ndetermine whether the transfer of the asset would have been a sale. In \naddition, the sale- leaseback guidance in Subtopic 840- 40 was not amended by \nASU 2014- 09 (or any of the subsequent revenue ASUs) such that all sale-\nleaseback transactions remain within its scope until Topic 842 is adopted and \nno guidance to refer to Topic 606 in the case of a seller -lessee repurchase \noption was added. \n[842- 10-65-1(aa) , 840-40-05-1] \nInterpretive response: No. We believe a successful sale- leaseback transaction \nunder Topic 840 should not be r eassessed on transition to Topic 842. This is \nbecause of the combination of the transition guidance in Topic 842 (clearly \ndelineating the Board’s intent with respect to successful sale- leaseback \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1235}), Document(page\_content='Leases 1235 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. transactions) plus the fact that Subtopic 840- 40 was not amended by any of the \nrevenue A SUs. We believe this to be the case even if the transaction includes a \nseller -lessee repurchase option. [842-10-65-1(aa), 840- 40-05-1] \nWe believe this conclusion is further supported for sale- leaseback transactions \nwith noncustomers by the fact that Subtopic 610- 20 on the derecognition of \nnonfinancial assets (as amended by ASU 2017- 05) specifically excludes from its \nscope any sale -leaseback transactions that were in the scope of Subtopic 840-\n40. [610-20-15-4(c)] \n \n Example 13B.7.10 \nSale-leaseback transaction previously accounted for \nas a sale and an operating leaseback under \nTopic 840 \nThe following summarizes relevant information about Seller -Lessee SL’s \nequipment sale- leaseback transaction with Buyer -Lessor BL. The transaction \nqualified as a sale and a leaseback – i.e. there was no failed sale. \nSale-leaseback transaction date: January 1, 2018 \nBeginning of earliest period presented: January 1, 2017 \nLeaseback term: 5 years \nLeaseback payments (annual, paid in arrears): $15,000 \nSales price and fair value of equipment at transaction date: $115,000 \nCarrying amount of equipment at transaction date: $80,000 \nRemaining economic life of the equipment at transaction date: 9 years \nLeaseback classification: Operating lease \nInitial direct costs: None \nLessee residual value guarantee: None \nThere is no automatic reversion of ownership to SL, nor does SL have an option \nto repurchase the equipment. SL retains more than a minor portion, but less \nthan substantially all, of the remaining use of the equipment. Therefore, \nbecause the profit on the sale does not exceed the present value of the \nminimum lease payments under Topic 840, the entire gain of $35,000 is \ndeferred and will be recognized over the five -year leaseback term. \nEffective date and transition \nSL and BL are calendar year -end public business entities that adopt Topic 842 \non January 1, 2019. \nSL and BL do not reassess whether the transaction would have qualified for \nsale/purchase accounting under Topic 842. BL does not adjust its previous \naccounting for the purchase of the asset in any manner. On adoption of \nTopic 842, S L will record the following journal entr ies to (1) recognize the full \namount of the profit on the sale-leaseback transaction as of the sale date ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1236}), Document(page\_content='Leases 1236 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. (January 1, 2018), which is later than the beginning of the earliest period \npresented, and (2) reverse the journal entry recorded under Topic 840 to \nrecognize one- fifth of the deferred gain during calendar 2018 (the first year of \nthe leaseback term) . \n Debit Credit \nDeferred profit on sale- leaseback transaction 35,000 \nGain on sale -leaseback transaction 35,000 \nRecognize gain on transaction at January 1, 2018 \nGain on sale -leaseback transaction 7,000 \nDeferred profit on sale- leaseback transaction 7,000 \nRecognize portion of deferred gain in 2018 \n($35,000 / 5) \nSubsequent accounting for the leaseback \nSL and BL account for the leaseback in the same manner as any other lease \nthat commenced during the transition period. \n \n Example 13B.7.20 \nSale-leaseback deferred gains and losses in \ntransition \nSeller -Lessee SL entered into a sale- leaseback transaction under Topic 840 that \nqualified as a sale and operating leaseback. The following scenarios illustrate SL’s treatment of the deferred gain or loss in transition under the requirements \ndescribed in pa ragraph 13B.7.40. \nThe sale occurred immediately before the transition date, so that any deferred \ngain or loss on the sale under Topic 840 has not been amortized when \nevaluating the transition adjustment. \nSale and operating lease back \ntransaction Deferred gain/loss transition adjustment \nDeferred gain scenarios \nFair value $100 Deferred gain recognized as a financial liability in \ntransition because the gain only arose as a result \nof the sale price exceeding fair value – i.e. if the \nsale price had not exceeded fair value, there \nwould not have been a gain (sale price would not \nhave exceeded carrying amount). Sale price $110 \nCarrying amount $105 \nDeferred gain $ 5 \n Debit Credit \n Deferred gain $5 \n Financial liability $5 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1237}), Document(page\_content='Leases 1237 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Sale and operating lease back \ntransaction Deferred gain/loss transition adjustment \nFair value $100 Deferred gain written off to equity; no portion of \nthe gain is attributable to off -market terms \nbecause the sale price = fair value. Sale price $100 \nCarrying amount $ 95 Debit Credit \nDeferred gain $ 5 Deferred gain $5 \n Equity $5 \nFair value $100 $10 deferred gain is attributable to both (1) sale price exceeding carrying amount and (2) the sale \nprice exceeding fair value – i.e. there is a $5 effect \nto each. \nTherefore, the deferred gain is written off to both equity and to a new off -mark et financial liability. Sale price $105 \nCarrying amount $ 95 \nDeferred gain $ 10 \n Debit Credit \n Deferred gain $10 \n Equity $5 \n Financial liability $5 \nFair value $100 Deferred gain recognized as a financial liability in \ntransition because the gain only arose as a result \nof the sale price exceeding fair value – i.e. if the \nsale price had not exceeded fair value, there \nwould not have been a gain (sale price would not \nhave exceeded carrying amount). Sale price $105 \nCarrying amount $100 \nDeferred gain $ 5 \n Debit Credit \n Deferred gain $5 \n Financial liability $5 \nFair value $100 Deferred gain written off to equity; no portion of \nthe gain is attributable to off -market terms \nbecause the sale price < fair value. Sale price $ 95 \nCarrying amount $ 90 Debit Credit \nDeferred gain $ 5 Deferred gain $5 \n Equity $5 \nDeferred loss scenarios \nFair value $100 Deferred loss recognized as an adjustment to the new leaseback ROU asset because the sale price \n< fair value (i.e. loss is attributable to off -market \nsale price). Sale price $ 95 \nCarrying amount $100 \nDeferred loss $ 5 Debit Credit \n ROU asset $5 \n Deferred loss $5 ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1238}), Document(page\_content='Leases 1238 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Sale and operating lease back \ntransaction Deferred gain/loss transition adjustment \nFair value $100 Deferred loss recognized as an adjustment to the \nnew leaseback ROU asset because the sale price \n< fair value (i.e. loss is attributable to off -market \nsale price). Sale price $ 80 \nCarrying amount $ 95 \nDeferred loss $ 15 Debit Credit \n ROU asset $15 \n Deferred loss $15 \nFair value $100 Deferred loss recognized as an adjustment to the \nnew leaseback ROU asset because the deferred \nloss is attributable to the sale price being less than \nfair value. $5 of the total loss was recognized on \nthe date of sale because the carrying amount > fair value. Sale price $ 80 \nCarrying amount $105 \nDeferred loss $ 20 \n Debit Credit \n ROU asset $20 \n Deferred loss $20 \nNo deferred gain/loss scenario \nFair value $100 N/A. There is no deferred gain or loss. The $5 \ndifference between carrying amount and sale \nprice was recognized at the date of sale under \nTopic 840 because the carrying amount of the \nasset > its fair value. Sale price $100 \nCarrying amount $105 \nDeferred gain/loss $ 0 \n \n \n13B.8 Build-to-suit l ease a rrangements \n Excerpt from ASC 842 -10 \nTransition and Open Effective Date Information \nGeneral \n> Transition Related to Accounting Standards Update s No. 2016- 02, \nLeases (Topic 842) , No. 2018- 01, Leases (Topic 842): Land Easement \nPractical Expedient for Transition to Topic 842 , No. 2018- 10, Codification \nImprovements to Topic 842, Leases , No. 2018- 11, Leases (Topic 842): \nTargeted Improvements , No. 2018- 20, Leases (Topic 842): Narrow -Scope \nImprovements for Lessors , No. 2019- 01, Leases (Topic 842): Codification \nImprovements , No. 2019- 10, Financial Instruments —Credit Losses (Topic \n326), Derivatives and Hedgi ng (Topi c 815), and Leases (Topic 842): \nEffective Dates , No. 2020- 05, Revenue from Contracts with Customers \n(Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities , ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1239}), Document(page\_content='Leases 1239 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. No. 2021 -05, Leases (Topic 842): Lessors —Certain Leases with Variable \nLease Payments, No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entities, and No. 2023- 01, Leases \n(Topic 842): Common Control Arrangements \n65-1 The following represents the transition and effective date information \nrelated to Accounting Standards Updates No. 2016- 02, Leases (Topic 842), \nNo. 2018- 01, Leases (Topic 842): Land Easement Practical Expedient for \nTransition to Topic 842, No. 2018- 10, Codification Im provements to Topic 842, \nLeases , No. 2018- 11, Leases (Topic 842): Targeted Improvements , No. 2018-\n20, Leases (Topic 842): Narrow- Scope Improvements for Lessors , No. 2019- 01, \nLeases (Topic 842): Codification Improvements , No. 2019- 10, Financial \nInstruments —Credit Losses (Topic 326), Derivatives and Hedging (Topi c 815), \nand Leases (Topic 842): Effective Dates , No. 2020- 05, Revenue from Contracts \nwith Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain \nEntities , No. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with \nVariable Lease Payments, No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entities, and No. 2023- 01, Leases (Topic \n842): Common Control Arrangements : [Note : See paragra ph 842-10-S65-1 for \nan SEC Staff Announcement on transition related to Update 2016 -02.] \nBuild -to-suit lease arrangements \nu. A lessee shall apply a modified retrospective transition approach for leases \naccounted for as build- to-suit arrangements under Topic 840 that are \nexisting at, or entered into after, the beginning of the earliest comparative \nperiod presented in the financia l statements (if an entity elects the \ntransition method in (c)(1)) or that are existing at the beginning of the \nreporting period in which the entity first applies the pending content that \nlinks to this paragraph (if an entity elects the transition method i n (c)(2)) as \nfollows: \n1. If an entity has recognized assets and liabilities solely as a result of a \ntransaction’s build -to-suit designation in accordance with Topic 840, the \nentity shall do the following: \ni. If an entity elects the transition method in (c)(1), the entity shall \nderecognize those assets and liabilities at the later of the beginning \nof the earliest comparative period presented in the financial \nstatements and the date that the lessee is determined to be the \naccounting owner of the asset in accordance with Topic 840. \nii. If an entity elects the transition method in (c)(2), the entity shall \nderecognize those assets and liabilities at the beginning of the \nreporting period in which the entity first applies the pending content \nthat links to this paragraph. \niii. Any difference in (i) or (ii) shall be recorded as an adjustment to \nequity at the date that those assets and liabilities were \nderecognized in accordance with (u)(1)(i) or (ii). \niv. The lessee shall apply the lessee transition requirements in (k) \nthrough (t) to the lease. \n2. If the construction period of the build- to-suit lease concluded before the \nbeginning of the earliest comparative period presented in the financial \nstatements (if the entity elects the transition method in (c)(1)) or if it \nconcluded before the beginning of the reporting period in which the \nentity first applies the pending content that links to this paragraph (if ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1240}), Document(page\_content='Leases 1240 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. the entity elects the transition method in (c)(2)), and the transaction \nqualified as a sale and leaseback transaction in accordance with \nSubtopic 840-40 before that date, the entity shall follow the general \nlessee transition requirements for the lease. \n \n13B.8.1 Derecognition of build -to-suit assets and liabilities \n13B.8.10 The transition guidance in Topic 842 requires lessees to derecognize \nany assets (e.g. property, plant and equipment or construction- in-progress) and \nliabilities recorded solely as a result of being the accounting owner of a \nconstruction project under Topic 840 unless both: [842- 10-65-1(u)] \n— construct ion of the asset is in progress at the effective date of Topic 842; \nand \n— the lessee is the accounting owner of the underlying asset under \nconstruction based on Topic 842 (see Section 9.4) . \n13B.8.20 A lessee derecognizes existing build -to-suit assets and liabilities that \nare recorded solely as a result of being the accounting owner of the \nconstruction project under Topic 840 a t the later of the: [842- 10-65-1(u)] \n— beginning of the earliest period presented – i.e. the date of initial \napplication; or \n— date the lessee was determined to be the accounting owner of the asset \nunder Topic 840. \n13B.8.30 Any difference between the assets and liabilities derecognized is \nrecorded in equity on that date – subject to the discussion in Question 13B.8.20 \nfor lessee- paid costs . [842-10-65-1(u)(1) ] \n13B.8.40 Derecognition of the existing build- to-suit assets and liabilities occur s \nregardless of whether the transaction qualified as a sale -leaseback transaction \nunder Topic 840. \n \n Question 13B.8.10 \nLease classification for build -to-suit leases o n \ntransition \nOn transition, how is lease classification assessed when the \nlessee was considered the owner of the asset under \nconstruction under the Topic 840 build- to-suit requirements? \nBackground: For the purpose of this question, L essee LE was deemed the \naccounting owner of an asset under construction in a build- to-suit lease \narrangement under Topic 840. The lease inception date was January 1, 2016. \nThe lease commencement date (i.e. the end of the construc tion period) was \nJanuary 1, 2018. In accordance with paragraph 13 B.8.20, the lessee \nderecognizes the underlying asset (see Question 13B. 8.20) and related financial \nliability as of the date of initial application. \nTwo scenarios are discussed in this questio n. \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1241}), Document(page\_content='Leases 1241 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 1. There was a successful sale -leaseback under Topic 840 at January 1, 2018 \n(or any later date before January 1, 2019) . \n2. The lessee had a failed sale -leaseback at January 1, 2018 and continues to \nrecognize the constructed asset and a financial liability at the effective date \nof Topic 842 (e.g. January 1, 2019) . \nInterpretive response: If the package of transition practical expedients is not \nelected, classification of the lease in either background scenario will be \nassessed as of the lease commencement date (J anuary 1, 2018). This is \nconsistent with the date any other lease is assessed for classification when the \npackage of practical expedients is not elected (see Question 13B.2.20). \nIn contrast, if the package of transition practical expedients is elected, the \nanswer is more complex . \n— In Scenario 1, a lease exists under Topic 840 before the effective date, the \nclassification of which would have been assessed as of lease inception \nunder Topic 840. Because the package of practical expedients was elected, \nwe do not believe the lessee sh ould reassess the lease classification that \nwas determined at lease inception. \n— In Scenario 2, in the absence of specific guidance in Topic 842, we believe \nit would be acceptable for the lessee to assess classification of the lease as \nof either : \n— the commencement date of January 1, 2018, using the lease \nclassification guidance in Topic 842; or \n— the inception date of January 1, 2016, using the lease classification \nguidance in Topic 840. \n We believe the first approach is acceptable , even though the package of \npractical expedients has been elected, because there was no ‘existing \nlease ’ that had previously been classified under Topic 840. We believe the \nsecond approach is acceptable because election of the package of \ntransition practical expedients effectively grandfathers the legacy Topic 840 \nclassification guidance, which required lease classification to be assessed \nas of lease inception. W e believe the chosen approach should be used \nconsistently in all similar circumstance s. \n \n Question 13 B.8.20 \nLessee -paid costs included in existing build- to-suit \nassets \nIf the carrying amount of a build- to-suit asset includes lessee -\npaid costs, should those amounts be written off at the ‘later \nof’ date? \nBackground : For purposes of this question, the lessee was considered to be \nthe owner of the construction project under Topic 840; as a result, it has \nrecognized assets and liabilities associated with the construction. The transition \nprovisions of Topic 842 require the lessee to remove any assets and liabilities \nstill recorded at the ‘later of’ date solely as a result of be ing the accounting \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1242}), Document(page\_content='Leases 1242 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. owner of the construction project under Topic 840 – unless the asset remains \nunder construction at the effective date and the lessee is the accounting owner \nof the construction project under Topic 842 (see section 13B.8.4). \nAssume the l essee paid the lessor or a third -party amounts during the \nconstruction period that, apart from being considered the owner of the \nconstruction project, would have been recognized by the lessee as an asset. \nFor example, t he carrying amount of th e build- to-suit asset may include \namounts paid by the lessee for: \n— construction of the lessor’s owned asset or for lessor -owned leasehold \nimprovements; and/or \n— lessee- owned leasehold or property improvements. \nQuestion 5.4.80 addresses determining the accounting owner of leasehold \nimprovements. \nInterpretive response: It depends on what the accounting for the payments \nwould have been until the transition date absent the previous build- to-suit \nconclusion under Topic 840 that the lessee was the accounting owner of the \nconstruction project. \nThe lessee starts by determining the appropriate lease classification (see \nQuestion 13B.8.10) . Next , the lessee determines: \n— what the appropriate accounting treatment for those costs would have \nbeen at the time the costs were incurred; and \n— the subsequent accounting for those costs between the date they were incurred and the transition date. \nKey considerations generally include whether the amounts paid by the lessee \nare ‘lease payments ,’ or instead are payments for lessee- owned leasehold or \nproperty improvements. \nOperating lease classification \nLessor was accounting owner \nIf the lessor was the accounting owner of the underlying asset or of a leasehold \nor property improvement paid for by the lessee under an operating lease, \namounts paid by the lessee to construct the lessor -owned asset or lessor -\nowned improvement would have been accounted for as part of the ‘minimum lease payments’ under Topic 840 . \nFor example, if the lessee paid $100,000 of the costs to construct the lessor -\nowned underlying asset during the construction period , absent the build- to-suit \naccounting, that amount would have been accounted for as a lease \nprepayment . Therefore, when accounting for the lease in transition, the lessee \ndetermines how much of the prepayment that would have existed absent the \nbuild- to-suit accounting would be unamortized at the transition date. The lessee \nthen accounts for the unamortized prepayment based on the Topic 842 lessee \ntransition requirements (see paragraph 13B.3.50) . \nLessee was accounting owner \nIf the lessee was the accounting owner of leasehold or property improvements, \nabsent build- to-suit accounting, the lessee would have recognized the leasehold \nor property improvements as separate items of property, plant and equipment. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1243}), Document(page\_content='Leases 1243 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The lessee would have amortized the cost of the improvements over the \nshorter of the (1) non- cancellable period of the lease plus renewal periods \nreasonably assured to be exercised or (2) useful life of the improvements. Therefore, in transition, the lessee should continue to recognize PP&E with a \ncarrying amount equal to what the unamortized carrying amount of the \nimprovements would have been had Topic 840 build- to-suit accounting never \napplied. \nFor exa mple, assume the lessee paid $100,000 for leasehold improvements for \nwhich it was the accounting owner. The lessee recognized those costs as part of the cost of the building and was depreciating them over the 30- year useful \nlife of the building. Absent bui ld-to-suit accounting, the amortization period for \nthe leasehold improvements may have been considerably shorter – e.g. if the \nnon-cancellable period of the lease was 15 years and the lessee was not \nreasonably assured of exercising an option to extend the lease . In that \ncircumstance , the amount that should remain recognized at the transition date \nis the amount that would be unamortized had the amortization period of the \nleasehold improvements always been 15 years. \nCapital/ finance lease classification \nAbsent the build- to-suit accounting, payments to a third party for leasehold or \nproperty improvements, or to the lessor before lease commencement, \nincluding during the construction period, may have been capitalized as part of the cost of the capital lease asset. \nUnder Topic 842, the carrying amount of the capital lease asset immediately \nbefore the transition date becomes the carrying amount of the new finance \nlease ROU asset in transition (see paragraph 13B.3.100). Therefore, at the \nTopic 842 transition date, the lessee would capitalize the remaining \nunamortized amount of these costs (previously included in property, plant and \nequipment under Topic 840) into the new finance lease ROU asset. \n \n13B.8.2 Evaluating previous build- to-suit conclusio ns \n13B.8.50 A lessee is not required to reevaluate whether it would have been the \naccounting owner of an asset under construction in accordance with Topic 842 \nunless construction of the asset is in progress at the effective date. This is \nregardless of whether the lessee was the accounting owner of the asset under \nTopic 840. [842-10-65-1(u)] \n13B.8.60 If a lessee is determined to be the accounting owner of an asset under \nconstruction as of the effective date for which it was not the accounting owner \nunder Topic 840, it will recognize the assets and liabilities arising from being the \naccounting owner of an asset under construction at the later of (1) the \nbeginning of the earliest period presented, or (2) the date it becomes t he \naccounting owner of the asset under construction based on the guidance in \nTopic 842. The lessee will account for the assets after the effective date using \nthe Topic 842 sale-leaseback guidance. \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1244}), Document(page\_content='Leases 1244 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Observation \nBuild -to-suit transition \nControl guidance applies only on or after the effective date \n13B.8.70 The changes to the sale- leaseback guidance in Topic 842 will make it \neasier for a lessee that is the accounting owner of an asset under construction \nto derecognize the underlying asset at the end of the construction period. \n13B.8.80 We believe the Board did not intend for a les see to look back to periods \nbefore the effective date of Topic 842 to determine whether it would have been \nthe accounting owner of an asset under construction. This intention would be \ninconsistent with much of the Board’s rationale for its transition approach. It \nwould also appear to be at odds with the guidance on sale- leaseback \ntransactions that says the lessee does not reconsider whether a successful sale that occurred before the effective date would have also been successful under \nTopic 842. \n13B.8.90 Instead, Topic 842 requires that the lessee consider whether it is the \nowner of an asset under construction only if construction is ongoing at the effective date. \nTopic 842 does not appear to prohibit reevaluation of ownership if the \nlessee was not the acc ounting owner under Topic 840 \n13B.8.100 The transition guidance for existing build- to-suit assets and liabilities \nappears to preclude continued recognition of build- to-suit assets and liabilities \non the balance sheet when construction is complete by the effective date , even \nif the lessee would have been t he accounting owner of the underlying asset \nunder Topic 842. \n13B.8.110 However, because the transition guidance is silent, we believe it does \nnot prohibit a lessee from evaluating under Topic 842 whether it was the \naccounting owner of an asset for which construction was complete by the \neffective date and for which it was not the accounting owner under Topic 840. \n13B.8.120 We expect it to be rare that a lessee would choose to voluntarily make \nthis evaluat ion. However, if it does, we believe it sh ould recognize the assets \nand liabilities arising from being the accounting owner of an asset under \nconstruction at the later of (1) the beginning of the earliest period pres ented, or \n(2) the date it becomes t he accounting owner of the asset under construction. \nThe lessee will account for the transaction from the recognition date using the \nTopic 842 sale-leaseback guidance. \n \n13B.8.3 Build -to-suit arrangements accounted for as \nsuccessful sale -leaseback transactions \n13B.8.130 If the construction period ended before the beginning of the earliest \nperiod presented, and the transaction qualified for sale -leaseback accounting \nunder Topic 840 before that date, the lessee only accounts for a lease because \nthe build- to-suit assets and liabilities would already have been derecognized. \nThe lessee appl ies the transition requirements in the same manner as it does \nfor other sale -leaseback transactions in transition . For further discussion of the \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1245}), Document(page\_content='Leases 1245 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. sale-leaseback transition provisions of Topic 842, see s ection 13B.7. \n[842-10-65-1(u)(2) ] \n \n13B.8.4 Lessee was the accounting owner under Topic 840 \n13B.8.140 The following diagram summarizes the transition requirements for a \nnumber of potential bui ld-to-suit transition scenarios when the lessee was the \naccounting owner under Topic 840. \nConstruction \ncompleted before the \nbeginning of the \nearliest comparative \nperiod presented\nScenario 1Construction \ncompleted during the \ncomparative periods\nScenario 2Construction is in \nprogress at the \neffective date\nScenario 3\nNot required to \nreevaluate under \nTopic 842 build -to-suit \nguidance\nWere sale criteria met \nunder Topic 840 sale-\nleaseback guidance ?Not required to \nreevaluate under \nTopic 842 build -to-suit \nguidanceReevaluate under \nTopic 842 build -to-suit \nguidance\nIs the lessee the \naccounting owner \nunder Topic 842?\nContinue to account \nfor build -to-suit assets \nand liabilities until \nsale of the asset \noccurs based on \nTopic 842 sale-\nleaseback guidanceDerecognize the \nbuild -to-suit assets \nand liabilities as of \nbeginning of earliest \ncomparative period \npresented (or date \nassets /liabilities first \nrecognized , if later ) \nand apply the general \nlessee transition \nguidance to the lease1Apply the general \nsale-leaseback \ntransition guidanceYes YesNo No\n \nNote: \n1. See section 13B .3 for discussion of the lessee transition provisions of Topic 842. \nScenario 1: Construction completed before the beginning of \nthe earliest comparative period presented \n13B.8.150 The lessee does not evaluate whether it would have been the \naccounting owner of the asset under Topic 842 because construction was \ncompleted before the effective date. The lessee’s transition accounting will \ndepend on whether the Topic 840 sale criteria for a sale -leaseback transaction \nwere met . \n13B.8.160 When the Topic 840 sale criteria for a sale -leaseback transaction were \nmet before the beginning of the earliest comparative period presented, the \nlessee does not reevaluate that concl usion, and applies the Topic 842 transition \nguidance to the sale- leaseback. \n13B.8.170 When the construction period ended before the beginning of the \nearliest comparative period presented, but the Topic 840 sale criteria for a sale -', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1246}), Document(page\_content='Leases 1246 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. leaseback transaction were not met , the lessee derecognizes the build- to-suit \nassets and liabilities that were recognized under Topic 840 as of the beginning \nof the earliest comparative period presented. Any difference is recorded as an \nadjustment to equity at that date (after consideration of the guidance in \nQuestion 13B.8.20) . The lessee then applies the general lessee transition \nguidance to the lease. \nScenario 2: Construction completed during the comparative \nperiods \n13B.8.180 The lessee does not evaluate whether it would have been the \naccounting owner of the asset under construction based on the new leases \nguidance because the construction was completed before the effective date. \n13B.8.190 Therefore, the lessee derecognizes the build- to-suit assets and \nliabilities that it recognized under Topic 840 as of the later of (a) the beginning of \nthe earliest comparative per iod presented, and (b) the date the lessee was \ndetermined to be the accounting owner of the underlying asset. Any difference is recorded as an adjustment to equity at that date. The lessee then applies the \ngeneral lessee transition guidance to the lease. \nScenario 3: Construction is in progress at the effective date \n13B.8.200 The lessee reevaluates whether it is the accounting owner of the \nasset under Topic 842 at the effective date. If it is considered the accounting \nowner, t he lessee continue s to recognize the construction- in-progress assets \nand liabilities that arose because the lessee is the accounting owner until they \nqualify for derecognition under the sale -leaseback requirements of Topic 842. \n13B.8.210 If the lessee is not considered the accounting owner, it derecognizes \nthe build- to-suit assets and liabilities that it recognized under Topic 840 as of the \nlater of (1) the beginning of the earliest comparative period presented, or (2) the \ndate the lessee was determined to be the accounting owner of the asset under \nTopic 840. The lessee records the difference as an adjustment to equity at that \ndate (after consideration of the guidance in Question 13B.8.20) . The lessee then \napplies the general lessee transition guidance to the lease. \n \n13B.8.5 Lessee was not the accounting owner under \nTopic 840 \n13B.8.220 The following diagram summarizes our understanding of the transition \nrequirements for potential build- to-suit transition scenarios when the lessee \nwas not the accounting owner under Topic 840. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1247}), Document(page\_content='Leases 1247 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Construction completed \nbefore the effective date\nScenario 4\nNot required to \nreevaluate under \nTopic 842 build-to-suit \nguidance\nApply general lessee \ntransition guidance to \nthe leaseConstruction is in progress \nat the effective date\nScenario 5\nReevaluate under Topic 842 \nbuild-to-suit guidance\nIs the lessee the accounting \nowner under Topic 842?\nNo accounting \nuntil lease \ncommencementRecognize \nbuild-to-suit assets \nand liabilities \nusing comparative \napproachYes No \nScenario 4: Construction completed before the effective date \n13B.8.230 The lessee is not required to evaluate whether it would have been the \naccounting owner of the asset while it was under construction in accordance \nwith Topic 842. However, we do not believe the transition guidance prohibits a \nlessee from making this evaluation (see paragraph 13B.8.110) . \n13B.8.240 If the lessee does not undertake this evaluation, it applies the general \nlessee transition requireme nts to the lease. \n13B.8.250 In the unlikely event that the lessee chooses to evaluate whether it \nwould have been the accounting owner under Topic 842, it should recognize \nthe assets and liabilities arising from being the accounting owner of the asset \nunder construction at the later of (1) the beginning of the earliest period \npresented, or (2) the date it was determined to be the accounting owner of the \nasset under construction under Topic 842. The lessee would account for the \ntransaction in accordance with the sale -leaseback guidance in Topic 842 from \nthe date of recognition. \nScenario 5: Construction is in progress at the effective date \n13B.8.260 The lessee evaluates whether it controls, at the effective date of \nTopic 842, an underlying asset a developer is presently constructing or \ndesigning that it will subsequently lease. If it controls the underlying asset, it \nwill be the accounting owner under Topic 842. \n13B.8.270 The lessee recognizes the assets and liabilities resulting from the \nconclusio n that it is the accounting owner of the asset under construction at the \nlater of (1) the beginning of the earliest comparative period presented, or (2) the \ndate the lessee was determined to be the accounting owner of the asset under \nconstruction under Topic 842. The lessee will account for the transaction in \naccordance with the sale- leaseback guidance in Topic 842 from the \neffective date. \n13B.8.280 If the lessee was not the accounting owner of the asset under either \nTopic 840 or Topic 842, then the lessee applies the requirements of Topic 842 \nat lease commencement. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1248}), Document(page\_content='Leases 1248 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Observation \nLessees with build -to-suit leases may early adopt \n13B.8.290 In many cases, the transition provisions in Topic 842 permit (or \nrequire) lessees to derecognize build -to-suit assets and liabilities that were \npreviously recognized under Topic 840, including such assets and liabilities that \nremained recognized because of the Topic 840 sale-leaseback requirements. \n13B.8.300 In addition, the changes to the sale- leaseback guidance in Topic 842 \nmake it easier for many lessees to derecognize build -to-suit assets and liabilities \nat the end of the construction period. Fewer build- to-suit arrangements for \nwhich a lessee is determined to be the accounting owner will result in failed \nsales. \n13B.8.310 Therefore, some lessees for which these factors are relevant may \nearly adopt Topic 842. \n \n Observation \nSAB Topic 11.M disclosure of impact on future \nperiods \n13B.8.320 SEC registrants are required to evaluate new accounting standards \nthat they have not yet adopted and to disclose their potential material effects. These disclosures generally should include a discussion about the effect that \nadoption is expected to have on the financial statements, unless this is not \nknown or reasonably estimable. \n[SAB Topic 11.M] \n13B.8.330 As discussed in paragraph 13B .8.10, on transition a lessee may \nderecognize si gnificant property, plant and equipment and debt obligations that \noriginally arose from build- to-suit lease arrangements. In their place, the lessee \nmay recognize ROU assets and lease liabilities for the lease of the constructed \nassets. \n13B.8.340 If this is the case for a lessee, among other disclosures it should likely \nprovide in accordance with SAB Topic 11.M , it should disclose these facts and \nprovide a quantification of the rela ted amounts. If precise quantification of the \namounts is not yet practicable, a range may be provided. We believe the SEC \ngenerally expects that a lessee will refine its estimates (i.e. narrow the ranges \npreviously provided) as the effective date approaches , and that it will not be \nacceptable for an entity to provide ‘boilerplate’ disclosures while only stating \nthat it is continuing to evaluate the effect of Topic 842. KPMG has developed \nexample SAB 74 disclosures that may be used as a starting point by les sees \nand lessors in drafting disclosures about the effects of adopting Topic 842: \nASC 842, Leases – Transition disclosures . \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1249}), Document(page\_content='Leases 1249 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13B.9 Previous business c ombinations \n Excerpt from ASC 842 -10 \nTransition and Open Effective Date Information \nGeneral \n> Transition Related to Accounting Standards Update s No. 2016- 02, \nLeases (Topic 842) , No. 2018- 01, Leases (Topic 842): Land Easement \nPractical Exped ient for Transition to Topic 842 , No. 2018- 10, Codification \nImprovements to Topic 842, Leases , No. 2018- 11, Leases (Topic 842): \nTargeted Improvements , No. 2018- 20, Leases (Topic 842): Narrow -Scope \nImprovements for Lessors , No. 2019- 01, Leases (Topic 842): Codification \nImprovements , No. 2019- 10, Financial Instruments —Credit Losses (Topic \n326), Derivatives and Hedging (Topi c 815), and Leases (Topic 842): \nEffective Dates , No. 2020- 05, Revenue from Contracts with Customers \n(Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities , \nNo. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with Variable \nLease Payments, No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entities, and No. 2023- 01, Leases \n(Top ic 842): Common Control Arrangements \n65-1 The following represents the transition and effective date information \nrelated to Accounting Standards Updates No. 2016- 02, Leases (Topic 842) , \nNo. 2018- 01, Leases (Topic 842): Land Easement Practical Expedient for \nTransition to Topic 842, No. 2018- 10, Codification Improvements to Topic 842, \nLeases , No. 2018- 11, Leases (Topic 842): Targeted Improvements , No. 2018-\n20, Leases (Topic 842): Narrow- Scope Improvements for Lessors , No. 2019- 01, \nLeases (Topic 842): Codification Improvements , No. 2019- 10, Financial \nInstruments —Credit Losses (Topic 326), Derivatives and Hedging (Topi c 815), \nand Leases (Topic 842): Effective Dates , No. 2020- 05, Revenue from Contracts \nwith Customers (Topic 606) and Leases (T opic 842): Effective Dates for Certain \nEntities , No. 2021- 05, Leases (Topic 842): Lessors —Certain Leases with \nVariable Lease Payments, No. 2021- 09, Leases (Topic 842): Discount Rate for \nLessees That Are Not Public Business Entities, and No. 2023- 01, Leases (Topic \n842): Common Control Arrangements : [Note : See paragraph 842-10-S65-1 for \nan SEC Staff Announcement on transition related to Update 2016- 02.] \nAmounts previously recognized in respect of business combinations \nh. If an entity has previously recognized an asset or a liability in accordance \nwith Topic 805 on business combinations relating to favorable or \nunfavorable terms of an operating lease acquired as part of a business \ncombination, the entity shall do all of the following: \n1. Derecognize that asset and liability (except for those arising from \nleases that are classified as operating leases in accordance with \nTopic 842 for which the entity is a lessor). \n2. Adjust the carrying amount of the right -of-use asset by a corre sponding \namount if the entity is a lessee. \n3. Make a corresponding adjustment to equity if assets or liabilities arise \nfrom leases that are classified as sales -type leases or direct financing \nleases in accordance with Topic 842 for which the entity is a less or. \nAlso see (w). \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1250}), Document(page\_content='Leases 1250 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. 13B.9.10 If an entity previously recognized an asset (liability) relating to favorable \n(unfavorable) terms of an operating lease acquired as part of a business \ncombination: [842- 10-65-1(h); 65-1(w)] \n— a lessee derecognizes that asset (liability), and adjusts the carrying amount \nof the ROU asset recognized on transition by a corresponding amount. \n— a lessor derecognizes that asset (liability) only if it arises from a sales‑ type \nor direct financing lease, and makes a corresponding adjustment in \naccordance with paragraph 842-10-65-1(w). \n13B.9.20 A favorable lease asset or unfavorable lease liability associated with an \noperating lease is not written off in transition by lessors. Lessors will continue \nto recognize such favorable lease assets or unfavorable lease liabilities even \nafter the adoption of the amendments to Topic 805 ( business combinations) \nincluded in ASU 2016- 02; for a discussion about leases acquired in a business \ncombination or asset acquisition , see chapter 11. [842- 10-65-1(h)(1)] \n \n Observation \nImpact of previously recognized favorable lease \nasset or unfavorable lease liability on lessee’s \nsubsequent accounting \n13B.9.30 Topic 842 does not prescribe or illustrate the subsequent accounting \nfor a lease of a lessee that, at the transition date, is affected by a previously \nrecognized favorable lease asset or unfavorable lease liability, other than to say \nthat the asset or liability is written off as an adjustment to the transition date \nROU asset. However, we believe that: \n— a favorable lease asset would affect the accounting for the lease on and \nafter the transition date in the same manner as initial direct costs – i.e. \nit would increase the lessee’s ROU asset recognized at the transition date; \nand \n— an unfavorable lease liability would affect the accounting for the lease after the transition date in the same manner as a lease incentive – i.e. it would \ndecrease the lessee’s R OU asset recognized at the transition date. \n \n Question 13B.9.10 \n(Un)favorable contract (liabilities) assets for \ncontracts not accounted for as leases under \nTopic 840 \nHow should a lessee account for a favorable (unfavorable) \ncontract asset (liability) when a non- lease contract is \nreassessed as a lease on transition to Topic 842? \nBackground: Assume that Company AR acquired Company AE before either \nentity adopted Topic 842. As part of AR’s acquisition accounting, it recorded \neither a favorable contract intangible asset or an unfavorable contract liability for \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1251}), Document(page\_content='Leases 1251 \n13B. Effective dates and transition : comparative method \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. an existing service contract for which AE was the customer and had \nappropriately determined the contract was not a lease under Topic 840. \nAR does not elect the transition package of practi cal expedients (see section \n13B.2) in transitioning to Topic 842, and therefore reassesses the AE contract \nagainst the Topic 842 lease definition. Based thereon, the AE contract meets \nthe definition of a lease. \nIn this situation, the question arises about how to account for the remaining \nfavorable contract intangible asset or unfavorable contract liability on transition, \nnoting that lessees no longer recognize either for leases after the adoption of \nTopic 842 (see paragraph 11.1.10), and in transition derec ognize any such \nassets or liabilities for existing operating leases as an adjustment to the new \nROU asset. \nInterpretive response: We believe the lessee should derecognize the existing \ncontract asset (liability) at the transition date – i.e. the later of (1) the beginning \nof the earliest period presented in the financial statements in which To pic 842 is \ninitially applied, and (2) the acquisition date, with a corresponding adjustment to \nthe ROU asset. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1252}), Document(page\_content='Leases 1252 \nTopic 842 Glossary \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Topic 842 Glossary \n Excerpts from ASC 842 \n20 Glossary \nAcquiree \nThe business or businesses that the acquirer obtains control of in a business \ncombination . This term also includes a nonprofit activity or business that a not \nfor-profit acquirer obtains control of in an acquisition by a not -for-profit \nentity . \nAcquirer \nThe entity that obtains control of the acquiree . However, in a business \ncombination in which a variable interest entity (VIE) is acquired, the primary \nbeneficiary of that entity always is the acquirer. \nAcquisition by a Not -for-Profit Entity \nA transaction or other event in which a not -for-profit acquirer obtains control of \none or more nonprofit ac tivities or businesses and initially recognizes their \nassets and liabilities in the acquirer’s financial statements. When applicable \nguidance in Topic 805 is applied by a not -for-profit entity , the term business \ncombination has the same meaning as this ter m has for a for -profit entity. \nLikewise, a reference to business combinations in guidance that links to \nTopic 805 has the same meaning as a reference to acquisitions by not -for-\nprofit entities. \nAdvance Refunding \nA transaction involving the issuance of new debt to replace existing debt with \nthe proceeds from the new debt placed in trust or otherwise restricted to retire \nthe existing debt at a determinable future date or dates. \nBusiness \nAn integrated set of activities and assets that is capable of being c onducted \nand managed for the purpose of providing a return in the form of dividends, \nlower costs, or other economic benefits directly to investors or other owners, \nmembers, or participants. Additional guidance on what a business consists of \nis presented in paragraphs 805- 10-55-4 through 55 -9. \nBusiness Combination \nA transaction or other event in which an acquirer obtains control of one or \nmore businesses. Transactions sometimes referred to as true mergers or \nmergers of equals also are business combinations. See also Acquisition by a \nNot-for-Profit Entity . \nCommencement Date of the Lease (Commencement Date) \nThe date on which a lessor makes an underlying asset available for use by a \nlessee. See paragraphs 842- 10-55-19 through 55- 21 for implementation \nguidance on the commencement date. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1253}), Document(page\_content="Leases 1253 \nTopic 842 Glossary \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Consideration in the Contract \nSee paragraph 842- 10-15-35 for what constitutes consideration in the contract \nfor lessees and para graph 842- 10-15-39 for what constitutes consideration in \nthe contract for lessors. \nContract \nAn agreement between two or more parties that creates enforceable rights \nand obligations. \nDelayed Equity Investment \nIn leveraged lease transactions that have been s tructured with terms such \nthat the lessee's rent payments begin one to two years after lease inception , \nequity contributions the lessor agrees to make (in the lease agreement or a \nseparate binding contract) that are used to service the nonrecourse debt \nduring this brief period. The total amount of the lessor's contributions is \nspecifically limited by the agreements. \nDirect Financing Lease \nFrom the perspective of a lessor , a lease that meets none of the criteria in \nparagraph 842- 10-25-2 but meets the criteria in paragraph 842- 10-25-3(b) and is \nnot an operating lease in accordance with paragraph 842- 10-25-3A. \nDiscount Rate for the Lease \nFor a lessee, the discount rate for the lease is the rate implicit in the lease \nunless that rate cannot be readily det ermined. In that case, the lessee is \nrequired to use its incremental borrowing rate . \nFor a lessor , the discount rate for the lease is the rate implicit in the lease. \nEconomic Life \nEither the period over which an asset is expected to be economically usable by \none or more users or the number of production or similar units expected to be \nobtained from an asset by one or more users. \nEffective Date of the Modification \nThe date that a lease modification is approved by both the lessee and the lessor . \nEstimated Res idual Value \nThe estimated fair value of the leased property at the end of the lease term . \nFair Value \nThe price that would be received to sell an asset or paid to transfer a liability in \nan orderly transaction between market participants at the measurement \ndate. \nFinance Lease \nFrom the perspective of a lessee, a lease that meets one or more of the \ncriteria in paragraph 842- 10-25-2. \nFiscal Funding Clause \nA provision by which the lease is cancelable if the legislature or other funding ", metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1254}), Document(page\_content='Leases 1254 \nTopic 842 Glossary \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. authority does not appropriate the funds necessary for the governmental unit \nto fulfill its obligations under the lease agreement. \nIncremental Borrowing Rate \nThe rate of inter est that a lessee would have to pay to borrow on a \ncollateralized basis over a similar term an amount equal to the lease payments \nin a similar economic environment. \nInitial Direct Costs \nIncremental costs of a lease that would not have been incurred if the lease had \nnot been obtained. \nInventory \nThe aggregate of those items of tangible personal property that have any of the \nfollowing characteristics: \na. Held for sale in the ordinary course of business \nb. In process of production for such sale \nc. To be currently consumed in the production of goods or services to be \navailable for sale. \nThe term inventory embraces goods awaiting sale (the merchandise of a \ntrading concern and the finished goods of a manufacturer), goods in the course \nof production (work in process), and goods to be consumed directly or \nindirectly in production (raw materials and supplies). This definition of \ninventories excludes long- term assets subject to depreciation accounting, or \ngoods which , when put into use, will be so classified. The fact that a \ndepreciable asset is retired from regular use and held for sale does not indicate \nthat the item should be classified as part of the inventory. Raw materials and \nsupplies purchased for production m ay be used or consumed for the \nconstruction of long -term assets or other purposes not related to production, \nbut the fact that inventory items representing a small portion of the total may \nnot be absorbed ultimately in the production process does not requi re separate \nclassification. By trade practice, operating materials and supplies of certain \ntypes of entities such as oil producers are usually treated as inventory. \nLease \nA contract , or part of a contract, that conveys the right to control the use of \nident ified property, plant, or equipment (an identified asset) for a period of time \nin exchange for consideration. \nLease Inception \nThe date of the lease agreement or commitment, if earlier. For purposes of this \ndefinition, a commitment shall be in writing, signed by the parties in interest to \nthe transaction, and shall specifically set forth the principal provisions of the \ntransaction. If any of the principal provisions are yet to be negotiated, such a \npreliminary agreement or commitment does not qualify for pur poses of this \ndefinition. \nLease Liability \nA lessee’s obligation to make the lease payments arising from a lease, \nmeasured on a discounted basis. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1255}), Document(page\_content='Leases 1255 \nTopic 842 Glossary \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Lease Modification \nA change to the terms and conditions of a contract that results in a change in \nthe scope of or the consideration for a lease (for example, a change to the \nterms and conditions of the contract that adds or terminates the right to use \none or more underlying assets or extends or shortens the contractual lease \nterm). \nLease Payments \nSee paragraph 842- 10-30-5 for what constitutes lease payments from the \nperspective of a lessee and a lessor . \nLease Receivable \nA lessor’s right to receive lease payments arising from a sales -type lease or \na direct financing lease plus any amount that a lessor expects to derive from \nthe underlying asset following the end of the lease term to the extent that it is \nguaranteed by the lessee or any other third party unrelated to the lessor, \nmeasured on a discounted basis. \nLease Term \nThe noncancellable period for which a lessee has the right to use an \nunderlying asset , together with all of the following: \na. Periods covered by an option to extend the lease if the lessee is \nreasonably certain to exercise that option \nb. Periods covered by an option to terminate the lease if the lessee is \nreasonably certain not to exercise that option \nc. Periods covered by an option to extend (or not to terminate) the lease in \nwhich exercise of the option is controlled by the lessor . \nLegal Entity \nAny legal structure used to conduct activities or to hold assets. Some \nexamples of such structures are corporations, partnerships, limited liability \ncompanies, grantor trusts, and other trus ts. \nLessee \nAn entity that enters into a contract to obtain the right to use an underlying \nasset for a period of time in exchange for consideration. \nLessor \nAn entity that enters into a contract to provide the right to use an underlying \nasset for a period of time in exchange for consideration. \nLeveraged Lease \nFrom the perspective of a lessor , a lease that was classified as a leveraged \nlease in accordance with the leases guidance in effect before the effective \ndate and for which the commencement date is before the effective date. \nMarket Participants \nBuyers and sellers in the principal (or most advantageous) market for the asset \nor liability that have all of the following characteristics: ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1256}), Document(page\_content='Leases 1256 \nTopic 842 Glossary \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. a. They are independent of each other, that is, they are not related parties , \nalthough the price in a related- party transaction may be used as an input to \na fair value measurement if the reporting entity has evidence that the \ntransaction was entered into at m arket terms \nb. They are knowledgeable, having a reasonable understanding about the \nasset or liability and the transaction using all available information, including \ninformation that might be obtained through due diligence efforts that are \nusual and customary \nc. They are able to enter into a transaction for the asset or liability \nd. They are willing to enter into a transaction for the asset or liability, that is, \nthey are motivated but not forced or otherwise compelled to do so. \nMonetary Liability \nAn obligation to pa y a sum of money the amount of which is fixed or \ndeterminable without reference to future prices of specific goods and services. \nNet Investment in the Lease \nFor a sales -type lease , the sum of the lease receivable and the \nunguaranteed residual asset . \nFor a direct financing lease , the sum of the lease receivable and the \nunguaranteed residual asset, net of any deferred selling profit. \nNot-for-Profit Entity \nAn entity that possesses the following characteristics, in varying degrees, that \ndistinguish it fr om a business entity: \na. Contributions of significant amounts of resources from resource providers \nwho do not expect commensurate or proportionate pecuniary return \nb. Operating purposes other than to provide goods or services at a profit \nc. Absence of ownership int erests like those of business entities. \nEntities that clearly fall outside this definition include the following: \na. All investor -owned entities \nb. Entities that provide dividends, lower costs, or other economic benefits \ndirectly and proportionately to their own ers, members, or participants, such \nas mutual insurance entities, credit unions, farm and rural electric \ncooperatives, and employee benefit plans. \nOperating Lease \nFrom the perspective of a lessee, any lease other than a finance lease . \nFrom the perspective of a lessor , any lease other than a sales -type lease or a \ndirect financing lease . \nOrderly Transaction \nA transaction that assumes exposure to the market for a period before the \nmeasurement date to allow for marketing activities that are usual and \ncustomary for transactions involving such assets or liabilities; it is not a forced \ntransaction (for example, a forced liquidation or distress sale). \nPenalty \n/Any requirement that is imposed or can be imposed on the lessee by the lease ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1257}), Document(page\_content="Leases 1257 \nTopic 842 Glossary \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. agreement or by factors outside the lease agreement to do any of the following: \na. Disburse cash \nb. Incur or assume a liability \nc. Perform services \nd. Surrender or transfer an asset or rig hts to an asset or otherwise forego an \neconomic benefit, or suffer an economic detriment. Factors to consider in \ndetermining whether an economic detriment may be incurred include, but \nare not limited to, all of the following: \n1. The uniqueness of purpose or location of the underlying asset \n2. The availability of a comparable replacement asset \n3. The relative importance or significance of the underlying asset to the \ncontinuation of the lessee's line of business or service to its custom ers \n4. The existence of leasehold improvements or other assets whose value \nwould be impaired by the lessee vacating or discontinuing use of the \nunderlying asset \n5. Adverse tax consequences \n6. The ability or willingness of the lessee to bear the cost associated with \nrelocation or replacement of the underlying asset at market rental rates \nor to tolerate other parti es using the underlying asset. \nPeriod of Use \nThe total period of time that an asset is used to fulfill a contract with a \ncustomer (including the sum of any nonconsecutive periods of time). \nProbable \nThe future event or events are likely to occur. \nPublic Business Entity \nA public business entity is a business entity meeting any one of the criteria \nbelow. Neither a not -for-profit entity nor an employee benefit plan is a \nbusiness entity. \na. It is required by the U.S. Securities and Exchange Commission (SEC) to file \nor furnish financial statements, or does fil e or furnish financial statements \n(including voluntary filers), with the SEC (including other entities whose \nfinancial statements or financial information are required to be or are \nincluded in a filing). \nb. It is required by the Securities Exchange Act of 1934 (the Act), as \namended, or rules or regulations promulgated under the Act, to file or \nfurnish financial statements with a regulatory agency other than the SEC. \nc. It is required to file or furnish financial statements with a foreign or \ndomestic regulatory agency in preparation for the sale of or for purposes of \nissuing securities that are not subject to contractual restrictions on transfer. \nd. It has issued, or is a conduit bond obligor for, securities that are traded, \nlisted, or quoted on an exchange or an over -the-counter market. \ne. It has one or more securities that are not subject to contractual restrictions \non transfer, and it is required by law, contract, or regulation to prepare \nU.S. GAAP financial statements (including notes) and make them publicly \navailable on a periodic basis (for example, interim or annual periods). An \nentity must meet both of these conditions to meet this criterion. ", metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1258}), Document(page\_content='Leases 1258 \nTopic 842 Glossary \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. An entity may meet the definition of a public business entity solely because its \nfinancial statements or financial information is included in another entity’s filing \nwith the SEC. In that case, the entity is only a public business entity for \npurposes of financial statements that are filed or furnished with the SEC. \nRate Implicit in the Lease \nThe rate of interest that, at a given date, causes the aggregate present value of \n(a) the lease payments and (b) the amount that a lessor expects to derive \nfrom the underlying asset following the end of the lease term to equal the \nsum of (1) the fair value of the underlying asset minus any related investment \ntax credit retained and expected to be realized by the lessor and (2) any \ndeferred initial direct costs of the lessor. However, if the rate determined in \naccordance with the preceding sentence is less t han zero, a rate implicit in the \nlease of zero shall be used. \nRelated Parties \nRelated parties include: \na. Affiliates of the entity \nb. Entities for which investments in their equity securities would be required, \nabsent the election of the fair value option under the Fair Value Option \nSubsection of Section 825 -10-15, to be accounted for by the equity \nmethod by the investing entity \nc. Trusts f or the benefit of employees, such as pension and profit -sharing \ntrusts that are managed by or under the trusteeship of management \nd. Principal owners of the entity and members of their immediate families \ne. Management of the entity and members of their immediate families \nf. Other parties with which the entity may deal if one party controls or can \nsignificantly influence the management or operating policies of the other to \nan extent that one of the transacting parties might be prevented from fully \npursuing its own separate interests \ng. Other parties that can significantly influence the management or operating \npolicies of the transacting parties or that have an ownership interest in one \nof the transacting parties and can significantly influence the other to an \nextent that one or more of the transacting parties might be prevented from \nfully pursuing its own separate interests. \nRemote \nThe chance of a future event or events occurring is slight. \nResidual Value Guarantee \nA guarantee made to a lessor that the value of an underly ing asset returned \nto the lessor at the end of a lease will be at least a specified amount. \nRight -of-Use Asset \nAn asset that represents a lessee’s right to use an underlying asset for the \nlease term . \nSales -Type Lease \nFrom the perspective of a lessor , a lease that meets one or more of the \ncriteria in paragraph 842- 10-25-2 and is not an operating lease in accordance \nwith paragraph 842- 10-25-3A. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1259}), Document(page\_content='Leases 1259 \nTopic 842 Glossary \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Security \nA share, participation, or other interest in property or in an entity of the issuer \nor an obligation of the issuer that has all of the following characteristics: \na. It is either represented by an instrument issued in bearer or registered \nform or, if not represented by an instrument, is registered in books \nmaintained to record transfers by or on behalf of the issuer. \nb. It is of a type commonly dealt in on securities exchanges or markets or, \nwhen represented by an instrument, is commonly recognized in any area in \nwhich it is issued or dealt in as a medium for investment. \nc. It either is one of a class or series or by its terms is divisible into a class or \nseries of shares, participations, interests, or obligations. \nSelling Profit or Selling Loss \nAt the commencement date , selling profit or selling loss equals: \na. The fair value of the underlying asset or the sum of (1) the lease \nreceivable and (2) any lease payments prepaid by the lessee, if lower; \nminus \nb. The carrying amount of the underlying asset net of any unguaranteed \nresidual asset ; minus \nc. Any deferred initial direct costs of the lessor. \nShort -Term Lease \nA lease that, at th e commencement date, has a lease term of 12 months or \nless and does not include an option to purchase the underlying asset that the \nlessee is reasonably certain to exercise. \nStandalone Price \nThe price at which a customer would purchase a component of a con tract \nseparately. \nSublease \nA transaction in which an underlying asset is re-leased by the lessee (or \nintermediate lessor ) to a third party (the sublessee) and the original (or head) \nlease between the lessor and the lessee remains in effect. \nUnderlying Asset \nAn asset that is the subject of a lease for which a right to use that asset has \nbeen conveyed to a lessee. The underlying asset could be a physically distinct \nportion of a single asset. \nUseful Life \nThe period over which an asset is expected to contribute directly or indirectly \nto future cash flows. \nUnguaranteed Residual Asset \nThe amount that a lessor expects to derive from the underlying asset \nfollowing the end of the lease term that is not guaranteed by the lessee or any \nother third party unrelated to the lessor, measured on a discounted basis. ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1260}), Document(page\_content='Leases 1260 \nTopic 842 Glossary \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Variable Interest Entity \nA legal entity subject to consolidation according to the provisions of the \nVariable Interest Entities Subsections of Subtopic 810 -10. \nVariable Lease Payments \nPayments made by a lessee to a lessor for the right to use an underlying \nasset that vary because of changes in facts or circumstances occurring after \nthe commencement date, other than the passage of time. \nWarranty \nA guarantee for which the underlying is related to the performance (regarding \nfunction, not price) of nonfinancial assets that are owned by the guaranteed \nparty. The obligation may be incurred in connection with the sale of goods or \nservices; if so, it may require further performance by the seller after the sale \nhas taken place. \n \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1261}), Document(page\_content='Leases 1261 \nIndex of changes \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved . Index of changes \nThis index lists the significant additions and changes made in this edition to \nassist you in locating recently added or updated content. 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Access our other US GAAP Handbooks \nAs part of Financial Reporting View, our library of in -depth guidance can be \naccessed here, including the following Handbooks as of May 2023. \n\uf0d8 Accounting changes and error corrections \n\uf0d8 Asset acquisitions \n\uf0d8 Bankruptcies \n\uf0d8 Business combinations \n\uf0d8 Climate risk in the financi al statements \n\uf0d8 Consolidation \n\uf0d8 Credit impairment \n\uf0d8 Debt and equity financing \n\uf0d8 Derivatives and hedging \n\uf0d8 Discontinued operations and held- for-sale disposal groups \n\uf0d8 Earnings per share \n\uf0d8 Employee benefits \n\uf0d8 Equity method of accounting \n\uf0d8 Fair value measurement \n\uf0d8 Financial statement presentation \n\uf0d8 Foreign currency \n\uf0d8 GHG emissions reporting \n\uf0d8 Going concern \n\uf0d8 IFRS compared to US GAAP \n\uf0d8 Impairment of nonfinancial assets \n\uf0d8 Income taxes \n\uf0d8 Investments \n\uf0d8 Leases \n\uf0d8 Leases: Real estate lessors \n\uf0d8 Long -duration contracts \n\uf0d8 Reference rate reform \n\uf0d8 Research and development \n\uf0d8 Revenue recognition \n\uf0d8 Revenue: Real estate \n\uf0d8 Revenue: Software and SaaS \n\uf0d8 Segment reporting \n\uf0d8 Service concession arrangements \n\uf0d8 Share -based payment \n\uf0d8 Software and website costs \n\uf0d8 Statement of cash flows \n\uf0d8 Transfers and servicing of financial assets ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1265}), Document(page\_content='Leases 1265 \n Acknowledgments \n \n \n \n© 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent \nmember firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. Acknowledgments \nThis Handbook has been produced by the Department of Professional Practice \nof KPMG LLP in the United States. \nWe would like to acknowledge the efforts of the main contributors to this \nHandbook : \nKimber Bascom \nScott Muir \nLandon Westerlund \nWe would also like to acknowledge the significant contributions of the following members of the Department to this edition of the Handbook: Hannah Conley , \nCorey Glidden, Robin Van Voorhies , Rob Werling, Dave Yates. \nLastly, we acknowledge the current and former members of the Department \nwho contributed significantly to earlier editions of this Handbook : Chris Bagwell, \nRichard Binderup, Richard Bird, Brian Byrd, Halie Creps, Matt Ericson, Teddy \nFabry, Mike Hall, Tim Hart, Dave Hermann, Jared Hirashima, Kevin Manson, \nErin McCloskey, Bob Mosier, Valarie Mosier, Mike Petry, Julie Santoro, Chase \nStobbe, Robin Van Voorhies, Patrick White, Ryan Withers , Agnes Yau- Chen, \nDaniel Zamora . \n ', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1266}), Document(page\_content=' \n \n \n \n \n \n \n \n \n \n \nAbout KPMG LLP \nKPMG LLP is the U.S. firm of the KPMG global organization of independent \nprofessional services firms providing Audit, Tax and Advisory services. 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Please contact the IFRS \nFoundation for details of countries where its Trade Marks are in use and/or have been registered. \n \n', metadata={'source': 'PDFs\_and\_TXT\\KPMG\_Leases\_Handbook\_05\_31\_2023.pdf', 'page': 1267}), Document(page\_content='www.pwc.com\nLeases \nPartially updated January 2024 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 0}), Document(page\_content='About the Leases guide \nPwC is pleased to offer our updated Leases guide . The FASB’s new standard on leases, ASC 842, is \neffective for all entities . This guide discusses lessee and lessor accounting under ASC 842. The first \nfour chapters provide an introduction and guidance on determining whether an arrangement is (or \ncontains) a lease and how to classify and account for lease and nonlease components . This guide also \ndiscusses the modification, remeasurement, and termination of a lease, sale and leaseback \ntransactions, leveraged lease transactions, as well as other topics. Chapter 9 address es the effective \ndate and transition. Presentation is addresse d in the Financial statement presentation guide. \nThis guide summarizes the applicable accounting literature, including relevant references to and \nexcerpts from the FASB’s Accounting Standards Codification (the Codification). It also provides our \ninsights a nd perspectives, interpretative and application guidance, illustrative examples, and \ndiscussion on emerging practice issues. \nThis guide should be used in combination with a thorough analysis of the relevant facts and \ncircumstances, review of the authorita tive accounting literature, and appropriate professional and \ntechnical advice. \nReferences to US GAAP \nDefinitions, full paragraphs, and excerpts from the FASB’s Accounting Standards Codification are \nclearly labelled. In some instances, guidance was cited with minor editorial modification to flow in the \ncontext of the PwC Guide. The remaining text is PwC’s original content. \nReferences to other PwC guidance \nThis guide provides general and specific references to chapters in other PwC guides to assist users i n \nfinding other relevant information. References to other guides are indicated by the applicable guide \nabbreviation followed by the specific section number. The other PwC guides referred to in this guide, \nincluding their abbreviations, are: \n□Business combin ations and noncontrolling interests (BCG)\n□Bankruptcies and liquidations (BLG)\n□Consolidation (CG)\n□Financial statement presentation (FSP)\n□Financing transactions (FG)\n□Income taxes (TX)\n□Loans and investments (LI)\n□Revenue from contracts with customers (RR)', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 1}), Document(page\_content='About the Leases guide \n□Transfers and servicing of financial assets (TS)\nSummary of significant changes \nFollowing is a summary of the noteworthy revisions . Additional updates may be made to keep pace \nwith significant developments . \nRevisions made in January 2024 \nLG 9, Presentatio n and disclosure \n□LG 9.2.3 was moved to FSP 6.8.16, LG 9.3.3 was moved to FSP 6.8.17, and the remaining \ncontent in LG 9 was moved to FSP 14 now that ASC 842 is effective for all entities .\nLG 10, Effective date and transition \nThe content in LG 10 was moved to LG 9. \nRevisions made in May 202 3 \nLG 3 , Classification \n□LG 3. 2.1.1 was added to reflect the issuance of ASU 2023 -01, Common Control Arrangement s.\n□Example LG 3-3 in LG 3.3.3.1 was updated to illustrate a lessee -sublessor ’s determination of the\nlease term of a sublease (as a sublessor) , and how that evaluation affects its consideration of the\nlease term of its head lease (as a lessee) .\nLG 8, Other topics \n□LG 8.11 was added to describe guidance on amortization of leasehold improvements, and for\nleases between entities under common control, how that guidance is affected by the issuance of\nASU 2023 -01, Common Control Arrangement s.', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 2}), Document(page\_content='About the Leases guide \nCopyrights \nThis publication has been prepared for general informational purposes, and does not constitute \nprofessional advice on facts and circumstances specific to any person or entity. 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'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 7}), Document(page\_content='Introduction \n1-21.1 Background \nFor many reporting entities, leasing is an important way to obtain access to property. It allows lessees \nto finance the use of necessary assets, often simplifies the disposal of used property, and reduces a \nlessee’s exposure to the risks inherent in asset ownership. \nThe FASB issued ASU 2016 -02 in February 2016 , which was amended in some respects by subsequent \nAccounting Standards Updates (collectively the “leases standard” or “ASC 842”) . Although the project \nbegan as a joint project with the IASB , the boards diverged in some key areas. Most significantly, the \nboards did not agree on whether all leases should be accounted for using the same model. After \nsignificant deliberation, the IASB decided that lessees sh ould apply a single model to all leases, which \nis reflected in IFRS 16, Leases , released in January 2016. The FASB decided that lessees should apply a \ndual model. Under the FASB model, lessees will classify a lease as either a finance lease or an \noperating lease, while a lessor will classify a lease as either a sales -type, direct financing, or operating \nlease. \nUnder the FASB model, a lessee should classify a lease based on whether the arrangement is effectively \na purchase of the underlying asset. Leases th at transfer control of the underlying asset to a lessee are \nclassified as finance leases (and as a sales -type lease for the lessor); lessees will classify all other leases \nas operating leases. In an operating lease, a lessee obtains control of only the use the underlying asset, \nbut not the underlying asset itself. \nA lease may meet the lessor finance lease criteria even when control of the underlying asset is not \ntransferred to the lessee (e.g., when the lessor obtains a residual value guarantee from a party other \nthan the lessee). Such leases should be classified as a direct finance lease by the lessor and as an \noperating lease by the lessee. See LG 3 for information on the dual model under US GAAP . \nThe dual model does not affect a lessee’ s initial recognition of assets and liabilities on its balance sheet, \nbut differentiates how a lessee should recognize lease expense in the income statement. The \naccounting for lessors is largely unchanged under the FASB and IASB models. \nFigure LG 1 -1 includes a description of some of the most significant differences between the guidance \nin ASC 842 and IFRS 16 . \nFigure LG 1-1 \nSummary of key differences between ASC 842 and IFRS 16 \nTopic Difference \nLessee accounting ASC 842 requires a lessee to classify a lease as either a finance or operating \nlease. Interest and amortization expense are recognized for finance leases \nwhile only a single lease expense is recognized for operating leases, typically \non a straight -line bas is. \nUnder IFRS 16, lessees will account for all leases in a manner similar to \nfinance leases. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 8}), Document(page\_content='Introduction \n1-3Topic Difference \nLessor accounting Under ASC 842, a sale and related profit are recognized upon the \ncommencement of a lease only when the arrangement transfers control of \nthe underlying asset to the lessee , i.e., in a sales -type lease, but not in a \ndirect financing lease. Also, lessors may elect to combine certain nonlease \ncomponents into the associated lease component. \nUnder IFRS 16, selling profit is recognized on direct financing leases when \nperformance obligations, defined in IFRS 15, Revenue from Contracts with \nCustomers , have been met . Under IFRS 16, generally lessors may not \ncombine lease and nonlease components. \nAdditionally, under ASC 842, a lessor must reassess lease classification \nwhen a lessee exercises a contractual extension or termination option not \npreviously included in the lease term. Under IFRS 16, a lessor may not \nreassess classification when the less ee exercises an existing contractual \noption to change the lease term. \nStatement of cash flows ASC 842 requires lessees to report the single expense associated with an \noperating lease as an operating activity. \nUnder IFRS 16, lessees account for all leases similar to a financed purchase , \nwith payments reported as a financ ing or operating activity in the \nstatement of cash flows , in accordance with IAS 7, Statement of Cash \nFlows . \nRemeasurement of \nvariable lease payments The ini tial measurement of lease -related assets and liabilities is similar \nunder ASC 842 and IFRS 16; h owever, subsequent changes in lease \npayments that vary with a rate or index (e.g., rents that increase for changes \nin an inflation index) are accounted for diff erently . \nUnder ASC 842 , such changes are recognized as variable payments , unless \nthe lessee is otherwise required to remeasur e the lease liability (e.g. , as a \nresult of reassessing the lease term). \nUnder IFRS 16 , lease assets and liabilities are remeasured when ever the \ncash flow change s. \nSale and leaseback \naccounting Under ASC 842, a seller -lessee would recognize the full gain from a sale and \nleaseback transaction that qualifies as a sale. \nIFRS 16 limits the recognition of gains from sale and leaseback \ntransactions . \nTransition ASC 842 require d a modified retrospective approach to each lease that \nexisted at the date of initial application as well as leases entered into after \nthat date. A reporting entity must have elect ed whether the date of initial \napplication is the beginning of the earliest c omparative period presented in \nthe financial statements, or the beginning of the period of adoption. In the \nlatter case, the reporting entity would not adjust the comparative periods. \nASC 842 did not permit a full retrospective approach. \nIFRS 16 allowed a reporting entity to elect a full retrospective approach, or \na simplified approach, but not the modified retrospective approach. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 9}), Document(page\_content='Introduction \n1-4Topic Difference \nOther □IFRS 16 has guidance excluding certain leases of low value assets from\nits recognition and measurement guidance\n□IFRS 16 has similar but not identical disclosure requirements\n□The a ccounting for subleases differs in some respects\n1.2 High -level overview \nThe FASB concluded that a lessee’s obligation to make lease payments meets the definition of a \nliability because it involves a present obligation that arises from a past event and the obligation is \nexpected to result in an outflow of economic benefits . The “pa st event” arises when the lessee signs the \nlease and the lessor makes the underlying leased asset available to the lessee. The “present obligation” \narises because the lessee cannot typically avoid making the contractual payments. \nThe boards also believe that a lessee’s right to use the underlying asset during the lease term meets the \ndefinition of an asset. Despite legally owning the asset, the lessor typically cannot use the underlying \nasset or even access the underlying asset without the lessee’s c onsent. \nThese two conclusions form the core principles of ASC 842. \nExcerpt from the Summary of ASU 2016 -02 \nThe core principle of Topic 842 is that a lessee should recognize the assets and liabilities that arise \nfrom leases . All leases create an asset and a liability for the lessee in accordance with FASB Concepts \nStatement No. 6, Elements of Financial Statements , and, therefore, recognition of those lease assets \nand lease liabilities represents an improvement over previous GAAP , which did not require leas e assets \nand lease liabilities to be recognized for most leases . \n1.2.1 Definition and scope \nA lease conveys the right to use an underlying asset for a period of time in exchange for consideration. \nAt the inception of a n arrangement, the parties should determine whether the contract is or contains a \nlease by assessing both of the following: \n□Whether there is an identified asset\n□Whether the contract conveys the right to control the use of the identified asset in exchange for\nconsiderat ion for a period of time\nOften, it may be easy to determine that an arrangement contains a lease. Other times, it may be \ndifficult to distinguish between a lease and an arrangement to buy or sell goods or services. See LG 2 \nfor information on evaluating wh ether an arrangement is a lease or contains a lease . \nThe leases standard does not require lessees to reflect lease assets and liabilities on the balance sheet \nfor arrangements with a lease term of 12 months or less. See LG 2.2.1 for additional information on \nthis short -term lease measurement and recognition exemption . In addition, certain arrangements are \noutside the scope of the leases standard, including: ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 10}), Document(page\_content='Introduction \n1-5□Leases of inventory or of construction in progress\n□Leases of intangible assets, including licenses of internal -use software\n□Leases to explore for or use natural resources\n□Leases of biological assets\n□Service concession arrangements within the scope of ASC 853 , Service Concession Arrangements\nAs discussed in LG 7, ASC 842 does not recognize a leveraged lease. However, lessors should continue \nto account for leveraged leases existing at the application date of the leases standard using the \nguidance in ASC 840, Leases , provided such leases are not modified on or after the application date of \nASC 842. \n1.2.2 Lessee classification \nUnder ASC 842, lease s are subject to a dual accounting model, under which different types of leases \nhave different accounting treatment subsequent to the initial recognition of lease assets and liabilities. \nThe principal distinction between the two types of leases is in the resulting income statement \nrecogniti on. As discussed in LG 4, a lessee with a finance lease is required to apply a financing model \nin which the expense resulting from the lease declines during the lease term. Operating leases, on the \nother hand, result in lease expense typically recognized o n a straight -line basis, by amortizing the \nlease d asset more slowly than a finance leased asset. \n1.2.3 Lessor classification \nLessors are also required to classify leases. Sales -type and direct financing leases are recognized by a \nlessor as leas e receivables, with interest income that is typically front -loaded (i.e., income per period \ndeclines during the lease term). The distinction between a sales -type and a direct financing lease is \nthat in a sales -type lease, the lessee obtains control of the underlying asset and the lessor recognizes \nselling profit and sales revenue upon lease commencement. In order to align lessor accounting with \nthe principles in the revenue recognition guidance in ASC 606, a lessor is precluded from recognizing \nselling prof it or sales revenue at lease commencement for a lease that does not transfer control of the \nunderlying asset to the lessee. \nAn operating lease results in the recognition of lease income on a straight -line basis, while the \nunderlying leased asset remains on the lessor’s balance sheet and continues to depreciate. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 11}), Document(page\_content='Introduction \n1-61.3 Comparison of ASC 842 and ASC 840 \nFigure LG 1 -2 summarizes the significant differences between ASC 842 and the previous guidance in \nASC 840. \nFigure LG 1 -2 \nChanges to lease accounting under ASC 842 \nTopic ASC 842 guidance Observations \nDefinition of a \nlease An arrangement is a lease or \ncontains a lease only when such \narrangement conveys the right to \n“control” the use of an “identified \nasset ” to a customer and the \ncustomer obtains substantially all \nits economic benefits Under ASC 840 , an arrangement can \ncontain a lease even without control of the \nuse of the asset if the customer takes \nsubstantially all of the output over the \nterm of the arrang ement. \nDetermining whether an arrangement \ncontains a lease is likely to be more \nimportant since virtually all leases will \nrequire recognition of an asset and liability \nby a lessee . It will also make the allocation \nof contractual consideration between lease \nand nonlease components a critical \nelement of the accounting analysis for \nmany reporting entities . \nLessee accounting There are no bright lines and there \nis one additional criterion \nregarding the specialized nature of \nthe underlying asset for lease \nclassi fication The lack of explicit bright lines will \nincrease the level of judgment required \nwhen classifying a lease – particularly for \ncertain highly structured transactions. \nDespite the removal of the bright lines, the \nguidance in ASC 842 -10-55-2 \nacknowledge s that one reasonable \napproach to determining whether the lease \nis for a major portion of the asset’s \nremaining economic life and whether lease \npayments represent substantially all of the \nasset’s fair value is the 75% and 90% \nthresholds , respectively, applicable in ASC \n840. \nLessees will recognize a right -of-\nuse asset and a lease liability for \nvirtually all leases Reflecting nearly all leases on the balance \nsheet is the biggest change, and one of the \nkey objectives of the guidance in ASC 842. \nExpense will be recognized on a \nstraight -line basis for an operating \nlease . This is accomplished by \nincreasing the amortization of the \nright -of-use asset as the imputed \ninterest on the liability declines \nover the lease term. Recognition of \nexpense for a finance lease will be \nsimilar to capital leases in ASC \n840. Under ASC 840, operating leases are off -\nbalance sheet. Under ASC 842, the \naccounting for an operating lease will \nbackload amortization of the right -of-use \nasset, potentially increasing the risk of an \nimpairment. Once impaired, the right -of-\nuse asset in an operating lease will be \namortized on a straight -line basis , which \nwill resul t in an expense recognition \npattern similar to a finance lease. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 12}), Document(page\_content='Introduction \n1-7Topic ASC 842 guidance Observations \nLessor accounting The classification c riteria are \nsimilar to that for lessees, with an \nadditional requirement to assess \ncollectibility to support \nclassification as a direct financing \nlease. Also , in order to derecogni ze \nthe asset and record revenue, \ncollection of payments due must \nbe probable for sales -type leases. \nTo recognize upfront revenue and \nprofit in a sales -type lease, the \nlessee will need to obtain control \nover the leased asset. \nLeases otherwise classified as a \nsales -type or direct financing lease \nmust be accounted for as an \noperating lease if they contain \nvariable lease payments that don’t \nrelate to a rate or index and would \nresult in recognition of a day -one \nloss. This accounting model is \nsimilar to ASC 840. Under ASC 840, to achieve sales -type \nlease accounting for real estate, title must \nautomatically transfer to the lessee by the \nend of the lease term. This condition has \nbeen removed from the guidance in ASC \n842. \nIn ASC 840, the difference between a \nsales -type lease and a direct finance lease \nis the presence of upfront profit. When \npresent, the arrangement is a sales -type \nlease. \nUnder ASC 842, the key distinction is \nbased on control. As a practical matter, \nthis will likely depend on whether the lease \npayment s criterion has been met in part \ndue to a third -party residual value \nguarantee. When this is the case, assuming \npayments are collectible, the lease is \nclassified as a direct financing lease. \nLease versus \nnonlease \ncomponents A contract may contain lease a nd \nnonlease components. Under ASC \n842, c omponents include only \nthose items or activities that \ntransfer a good or service to the \nlessee. \nA lessee may choose not to \nseparate nonlease components \nfrom their associated lease \ncomponents. If this election is \nmade, all cash flows associated \nwith the nonlease component \nwould be allocated to the \nassociated lease component. A \nlessor may elect to combine \nnonlease and associated lease \ncomponents when the timing and \npattern of transfer of the \ncomponents are identical, and the \nlease classification would have \nbeen an operating lease absent the \ncombination. If elected, the \ncombined components would be \naccounted for under ASC 842 only \nif the nonlease component is not \npredominant. \nThe right to use land is considered \na separate lease component unless \nthe accounting effect of accounting \nfor it separately would be \nimmateria l. Under ASC 840, property taxes and \ninsurance are considered executory costs. \nUnder ASC 842, property taxes and \ninsurance are not considered as \ncomponents of a contract as they are not \nfor a service provided by the lessor to the \nlessee , and are therefore a part of contract \npayments if the contract requires the \nlessee to reimburse the lessor for those \ncosts. \nUnder ASC 840, land is separately \nclassified when the fair value of the land is \n25% or more of the combined fair value of \nthe land a nd building. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 13}), Document(page\_content='Introduction \n1-8Topic ASC 842 guidance Observations \nInception date \nversus \ncommencement \ndate Under ASC 842, the determination \nof whether or not a contract is a \nlease or contains a lease is done at \nthe inception date. Lease \nclassification is determined , and \nthe lease is recognized and \nmeasured , at the lease \ncommencement date. Under ASC 840, assumptions relevant to \nclassification and measurement ar e \ndetermined at lease inception. Recognition \nof rent expense or capital lease assets and \nliabilities begin at the commencement \ndate. \nInitial direct costs Under ASC 842, initial direct c osts \nare defined as incremental costs of \na lease that would not have b een \nincurred if the lease had not been \nobtained. Under ASC 840, incremental direct costs \ncan include internal costs as well as \nexternal costs such as legal fees, even if \nincurred before the lease was obtained . \nTherefore, c ertain incremental costs \npreviousl y eligible for capitalization will be \nexpensed under ASC 842. \nBuild -to-suit \narrangements Ownership during construction \nperiod is based on a control model . ASC 840 guidance is based on a risks and \nrewards model, but contains several \ncomplex prescriptive provisions designed \nto assess lessee ownership during \nconstruction. The ASC 842 model has \neliminated these prescriptive rules and \nreplaced them with a model b ased on \ncontrol. \nUnder ASC 840, build -to-suit accounting \napplies only to lessees. Under ASC 842, \nbuild -to-suit accounting also applies to \nlessors. \nSale and leaseback \ntransactions Under ASC 842 , a sale and \nleaseback transaction will qualify \nas a sale only if: \n□it meets the sale guidance in\nthe revenue standard,\n□the leaseback is not a finance\nlease for a lessee or a sales -\ntype lease for a lessor , and\n□if there is a repurchase option,\nothe repurchase price is at\nthe underlying asset’s fair\nvalue at the time of\nexercise and\noalternative assets that are\nsubstantially the same as\nthe transferred asset are\nreadil y available in the\nmarketplace.Under ASC 840, sale and leaseback \naccounting is applicable only to lessees. \nThis includes detailed and specialized \nguidance applicable to sale and leasebacks \ninvolving real estate. \nUnder ASC 842, sale and leaseback \naccounting will apply to lessees and \nlessors. A “failed” sale is treated as a \nfinancing by both the lessee and lessor \n(i.e., the seller has not sold the asset but \nhas essentially mortgaged it). There is no \nspecialized guidance for sale and \nleasebacks of real estate. However, a sale \nand leaseback for real estate that includes \na repurchase opt ion will likely fail sale \naccounting (as it did before ASC 842) \nbecause all real estate is unique and no \nother asset would be substantially the \nsame. \nSale and leaseback transactions involving \nequipment frequently have fixed price \nrepurchase options – often at the request \nof the seller -lessee for commercial \nreasons. Such transactions will not qualify ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 14}), Document(page\_content='Introduction \n1-9Topic ASC 842 guidance Observations \nas a sale under the new standard. \nHowever , sale and leaseback accounting \napplied for transactions executed prior to \nthe application date of ASC 842 will not \nneed to be reevaluated. Existing “failed” \nsale and leaseback transaction s will be \nevaluated under the new standard and \nmay qualify for sale and leaseback \naccounting on transition. \nLessee \nreassessment A lessee is required to reassess the \nlease term if a tri ggering event \noccurs that is under the lessee’s \ncontrol or an option is \nexercised/not exercised as planned \nor an event written in the contract \noccurs that obligates the lessee to \nexercise/not exercise an extension \nor termination option . A change to \nthe lea se term will lead to a \nreassessment of lease classification \nand remeasurement of the lease \nliability and right -of-use asset. \nAssumptions such as the discount \nrate, fair value of the underlying \nasset , and variable rents based on \na rate or index will be upda ted as \nof the remeasurement date. ASC 840 does not require a reassessment \nof lease classification unless the lease is \nmodified or an option is exercised. Under \nASC 842, a lessee will need to monitor for \ntriggering events on an ongoing basis . \nModification A lease modification is a change to \nthe contractual terms and \nconditions of a lease that was not \npart of the original lease. A \nmodification that grants the lessee \nan additional right of use priced at \nmarket is a separate lease that is \nthen cla ssified at the lease \nmodification date. For all other \nmodifications , entities may have to \nreassess whether the arrangement \ncontains a lease, reallocate \ncontract consideration between the \nlease and nonlease components , \nreassess lease classification , and \nremeasure the lease liability and \nright -of-use asset prospectively . \nAssumptions such as the discount \nrate, fair value of the underlying \nasset , and variable rents based on \na rate or index will be updated as \nof the modification date. Lease modification s under ASC 840 can be \ncomplex and difficult to differentiate from \na termination of a lease contract. A \nrenewal or extension is considered a new \nlease. All other changes are subject to a \ntwo-step evaluation of the lease. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 15}), Document(page\_content='Introduction \n1-101.4 Disclosures \nThe leases standard in cludes extensive disclosure requirements intended t o enable us ers of financial \nstatements to unde rstand the amount, timing, and judgments related to a reporting entity’s accounting \nfor leases and the related cash flows. The leases standard requires disclosure of both qualitative and \nquantitative information about leases. See FSP 14 for information on disclosures. \n1.5 Transition and effective date \nP Entities other than public business entities are required to adopt ASC 842 in annual reporting \nperiods beginning after December 15, 2021 and interim periods within annual reporting periods \nbeginning after December 15, 2022. Earlier application is permitted. \nThe leases standard is required to be applied to leases in existence as of the date o f initial application \nusing a modif ied retrospective transitio n appr oach; a full retrospective transitio n approach is not \npermitted. Reporting entities may elect to ap ply the transition approach eith er (a ) as of the beginning \nof the earliest period presented in the financial statemen ts – in which case it would adjust its \ncomparative periods or (b) as of the beginning of the period of ado ption – in which case it would not \nadjust its compara tive p eriods. \nThe transition guida nce i ncludes optional provis ions intended to reduce the bur den of th e \nimplementation of the leases stan dard. Most significant ly, the classification of existing l eases and \nwhethe r an arrangeme nt contains a leas e do not need to be reassessed. Howeve r, the relief provisions \ncan only be adopted as a packa ge. That is, a reportin g ent ity canno t ele ct to reassess whether an \nexisting arrangement contains a lease upon transitio n, but at the same tim e not reass ess classification \nof existing leases. Lessee s may also apply hindsight with respect t o judgments around lease renewal \noptions and purchase optio ns. \nAs a result, lessees and lessors may generally carryforward their existing accounting balances when \nadopting the new guidance. See LG 9 for additional information about transition and the effective date \nof the leases standard. \nFinally, transferors and transferees of easements and rights- of-way that had no t previously accounted \nfor such rights as leases (due, in part, to ambiguous accounting guidance) , may conti nue to account for \nthose exis ting ar rangeme nts as they h ad, until such arrangements are modified. T he easements \nentered int o or modified on or after the effective da te must be evaluated unde r ASC 842. See LG \n2.3.2.1 for additio nal information abou t evaluat ing easement s. \n1.6 Implementation guidance \nFigure LG 1 -3 includes t opics addressed in the implementation guidance and illustrative examples \naccompanying the leases standard. It also references the section in this guide where each topic is \ndiscussed i n more detail . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 16}), Document(page\_content='Introduction \n1-11Figure LG 1 -3 \nTopics addressed in the leases standard implementation guidance \nTopic Location of discussion in \nguide \nDefinition of a lease LG 2.3 \nLease classification LG 3 \nLease term, including options to renew or terminate the lease, or to \npurchase the leased asset LG 3.3.3 \nInitial recognition – lessee LG 4.2 \nInitial recognition – lessor LG 4.3 \nDiscount rates LG 3.3.4.6 \nInitial direct costs LG 4. 1 and LG 4 .2 \nSubsequent recognition and measurement – lessee LG 4.4 \nSubsequent recognition and measurement – lessor LG 4.5 \nModification, remeasurement, and termination of a lease LG 5 \nSubleases LG 8.2 \nSale and leaseback transactions (including build -to-suit \ntransactions) LG 6 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 17}), Document(page\_content='Chapter 2: \nScope —updated January 2023', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 18}), Document(page\_content='Scope \n2-22.1 Leases scope overview \nA leasing arrangement conveys the use of an asset from one party to another without transferring \nownership. The leasing arrangement may take various forms . Some arrangements are clearly within \nthe scope of lease accounting, for example, a legal form lease that provides an explicit contractual right \nto use a buildi ng for a specified period of time in exchange for consideration. However, the right to use \nan asset can also be conveyed through arrangements that are not leases in legal form. For example, a \nhospital may execute an arrangement to purchase consumables and services from a vendor through an \narrangement that entitles the hospital to receive free medical equipment for a period of time. Although \nnot a lease in legal form, the rights to the medical equipment may be within the scope of lease \naccounting. \nASC 842, Leases , identifies arrangements that are to be accounted for as leases . This chapter discusses \nhow to identify which arrangements, or components within an arrange ment, should be accounted for \nunder ASC 842 . ASC 842 specifically excludes arrangements for the right to use a natural resource and \narrangements that transfer the right to use certain assets other than property, plant, or equipment \nfrom its scope. See LG 2.2 for additional information on the scope of ASC 842. \nThis chapter also di scusses how to identify the components to be evaluated for lease accounting and \nhow to differentiate the lease and nonlease components. \nArrangements with a special purpose entity that contain a lease may require the lessee to consolidate \nthe special purpo se entity under the variable interest entity model. See CG 2 for additional \ninformation. \n2.2 Exceptions to applying lease accounting \nA reporting entity should consider the application of lease accounting in ASC 842 to all arrangements \nthat meet the definition of a lease, as discussed in LG 2.3 , with the exception of the following: \n□Leases of intangible assets subject to ASC 350\n□Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources\nsubject to the guidance contained in ASC 930 and ASC 932.\n□Leases of biological assets (such as bearer plants and animals)\n□Leases of inventory\n□Leases of assets u nder construction\nASC 350 defines intangible assets as “assets (not including financial assets) that lack physical \nsubstance.” ASC 805 -20-55-37 indicates that air use rights are an example of a contract -based \nintangible asset. Many arrangements that provid e subsurface rights (i.e., rights to use space below the \nearth’s surface) are similar to air use rights. We believe rights to any spaces that cannot be inhabited or \naccessed by human beings, such as air rights or rights to construct a pipeline underground, lack \nphysical substance and thus could be accounted for as intangible assets outside the scope of ASC 842. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 19}), Document(page\_content='Scope \n2-3 The ASC 842 Glossary discusses the items subject to the leases of inventory exclusion. \nPartial definition from ASC 842 Glossary \nThe term inventory embraces goods awaiting sale (the merchandise of a trading concern and the \nfinished goods of a manufacturer), goods in the course of production (work in process), and goods to \nbe consumed directly or indirectly in production (raw materials and supplies). T his definition of \ninventories excludes long -term assets subject to depreciation accounting, or goods which, when put \ninto use, will be so classified. \nWe believe the scope exclusion for leases related to exploration is limited , and should apply to \ncircumst ances in which the customer has the substantive ability to mine or explore the applicable area. \nThe customer ’s rights and substantive ability to explore and /or mine the site should be evaluated at \ncontract inception, and upon reassessment triggers (see LG 5.3.1). For example, a site that was \noriginally leased for mining purposes may “lose” its scope exclusion once mining on that site has \nceased, even if the lessee extends the lease and continues to use the site in order to stage mining \noperations at nearby sites. Similarly, an arrangement allowing a customer to use an adjacent parcel of \nland to access the mining site would not be subject to this scope exc eption, but should be evaluated to \ndetermine whether the arrangement is or contains a lease. \n2.2.1 Short -term lease exemption for lessees \nAs discussed in ASC 842 -20-25-2, a lessee may elect not to apply the recognition requirements of ASC \n842 to short -term lea ses. This election should be made by class of underlying asset. If a lessee chooses \nto elect this short -term lease measurement and recognition exemption, it should recognize the lease \npayments in net income on a straight -line basis over the lease term. Var iable lease payments should be \nrecorded in the period in which the obligation for th e payment is incurred . \nThe ASC 842 Glossary defines a short -term lease. \nDefinition from ASC 842 Glossary \nShort -Term Lease : A lease that, at the commencement date, has a le ase term of 12 months or less and \ndoes not include an option to purchase the underlying asset that the lessee is reasonably certain to \nexercise . \nLeases often include options to either extend the term of the lease (commonly referred to as a renewal \noption) or to terminate the lease prior to the contractually defined lease expiration date (commonly \nreferred to as a termination option). The existence of either a renewal or termination option requires \nlessees and lessors to determine, at lease commencement, th e length of the lease term. As discussed in \nLG 3.3.3.1 , renewal or termination options that are reasonably certain of exercise (or non -exercise) by \nthe lessee are included in the lease term. Therefore, a one-year lease with a renewal option that the \nlessee is reasonably certain to exercise is not a short -term lease. See LG 3.3.3.1 for information on \ndetermining the term of a lease. \nA lessee should reassess whether a short -term lease continues to qualify for the short -term lease \nmeasurement and recognition exemption when certain events occur. See LG 5.4 for more information. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 20}), Document(page\_content='Scope \n2-4 2.3 Definition of a lease \nIn a lease, one party obtains the right to use an asset legally owned by another party for a period of \ntime. It is this right of use that distinguishes a lease from other executory contracts. The rights of a \nlessee are different from those of an owner of an asset or a party to a service agreement that does not \ntransfer a right of use. Nonetheless, a lessee does have certain rights that receive accounting \nrecognition a s an asset (with a corresponding liability for the obligation to make payments for that \nright of use) because a lessee has control over an economic resource and is benefiting from the use of \nthe asset. \nASC 842 -10-15-3 defines a lease as follows. \nASC 842 -10-15-3 \nA contract is or contains a lease if the contract conveys the right to control the use of identified \nproperty , plant, or equipment (an identified asset) for a period of time in exchange for consideration. \nA period of time may be described in terms of the amount of use of an identified asset (for example, \nthe number of production units that an item of equipment wi ll be used to produce). \nA lease conveys the right to use an identified asset for a period of time. Arrangements that are truly \nperpetual in nature would not meet the definition of a lease because there is no defined period of use. \nThese arrangements are m ore akin to acquiring an asset, and therefore, would be outside the scope of \nASC 842. \nReporting entities may need to consider if certain arrangements are truly perpetual in nature. “Pay as \nyou go” arrangements may provide the right to use an asset indefin itely. However, if the arrangement \ncan be terminated by the customer at any time by merely stopping payment, the perpetual provision \nmay not be substantive, and entities would need to evaluate the lease term. See LG 3.3.3.1 for \ninformation on determining t he term of a lease. \nThe right to control the use of an asset may not necessarily be documented, in form, as a lease \nagreement. Often, the right to use an identified asset is embedded in an arrangement that may appear \nto be a supply arrangement or service contract. Therefore, a reporting entity should consider all of the \nterms of an arrangement to determine whether it contains a lease. \nWhen performing the analysis to determine if an arrangement contains an embedded lease, multiple \narrangements may be considered to be a single transaction. If two or more arrangements are entered \ninto at the same time, a reporting entity should consider wh ether the analysis should be performed on \neach contract or the combination of contracts. ASC 842 -10-25-19 specifies the criteria to consider in \nmaking this determination. \nASC 842 -10-25-19 \nAn entity shall combine two or more contracts, at least one of whi ch is or contains a lease, entered into \nat or near the same time with the same counterparty (or related parties) and consider the contracts as \na single transaction if any of the following criteria are met: \na. The contracts are negotiated as a package with th e same commercial objective(s). ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 21}), Document(page\_content='Scope \n2-5b.The amount of consideration to be paid in one contract depends on the price or performance of the\nother contract.\nc.The rights to use underlying assets conveyed in the contracts (or some of the rights of use\nconveyed in the contracts) are a single lease component in accordance with paragraph 842 -10-15-\n28.\nIf a combination of contracts is determined to contain a lease, the same combined transaction sh ould \nbe used for purposes of lease classification, recognition and measur emen t in accordance with the \nguidance in ASC 842. \nSee LG 2.6 for discussion on when to perform the determination as to whether an arrangement is a \nlease. \n2.3.1 Use of an identified asset \nTo meet the definition of a lease, an arrangement must require use of an exp licitly or implicitly \nidentified asset that is physically distinct. Figure LG 2-1 highlights key considerations in determining \nwhether there is an identified asset. Each consideration is disc ussed further in the sections that follow. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 22}), Document(page\_content='Scope \n2-6Figure LG 2-1 \nDetermining whether there is an identified asset \n2.3.1.1 Explicitly specified asset \nIf a contract explicitly specifies the asset to be used (e.g., by serial number or a specified floor of a \nbuilding), the contract contains an identified asset unless the supplier has substantive substitution \nrights. See LG 2.3.1.4 for discussion of substitution rights. \n2.3.1.2 Implicitly specified asset \nA contract that does not explicitly specify an asset to be used to fulfill the contract may implicitly \nspecify the asset, for example, w hen the asset is made available for use. When a supplier must use an \nasset (i.e., plant, property and equipment) in order to fulfill the obligations in the contract, then there \nmight be an implicitly specified asset (subject to determining whether there ar e substantive \nsubstitution rights). See LG 2.3.1.4. \n', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 23}), Document(page\_content='Scope \n2-7Example LG 2-1 and Example LG 2-2 illustrate the identification of implicitly specified assets . \nEXAMPLE LG 2-1 \nBank data center contract \nCommercial Bank enters into a lease for a portion of its data cent er with Supplier Corp. The lease \ncontract does not explicitly specify the equipment to be used to fulfill the contract; however, as a result \nof security measures in place for its customer data, Commercial Bank imposes specific restrictions on \nthe equipment to be used. Although Supplier Corp has multiple data centers that are interchangeable \nand can service multiple customers at one time, the arrangement with Commercial Bank specifies the \ntype of equipment to be used to fulfill its contract and imposes restr ictions on access and substitution \nfor the duration of the contract. \nDoes the contract specify an asset to be used to fulfill the contract? \nAnalysis \nYes. Although the assets used to fulfill the contract are not explicitly specified, the assets are implicitly \nspecified as a result of the contractual requirements and specifications mandated by Commercial \nBank. \nEXAMPLE LG 2-2 \nAutomobile hood ornament contract \nSupplier Corp enters into a contract to provide Automobile Manufacturer with hood ornaments f or its \ncars. The contract does not explicitly specify the equipment to be used to fulfill the contract. Supplier \nCorp designs and custom builds a die in the shape of Automobile Manufacturer’s logo specifically to \nproduce the hood ornaments. Automobile Manu facturer is involved in ensuring the machine meets \ntheir specific standards. \nDoes the contract specify an asset to be used to fulfill the contract? \nAnalysis \nAlthough the die is not explicitly specified in the arrangement, the contract is reliant on the d ie and \ntherefore it is implicitly specified. While Supplier Corp is not contractually required to use a specific \ndie, it is not feasible to utilize a different die. Therefore, the asset used to fulfill the contract would be \nthe specialized die. \n2.3.1.3 Physically distinct \nAn identified asset must be physically distinct. A physically distinct asset may be an entire asset or a \nportion of an asset. For example, a building is generally considered physically distinct. One floor \nwithin the building may also be considere d physically distinct if it can be used independent of the \nother floors (e.g., point of entry or exit, access to lavatories). Similarly, the use of a static or electronic \nbillboard on the facade of a stadium may be considered physically distinct from the u se of the stadium \nas a whole if the location of the billboard is specified as a condition of the contract. Naming rights to a \nsports stadium typically involve co -branding and shared promotion, along with the right for the ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 24}), Document(page\_content='Scope \n2-8sponsoring entity to place its log o on the stadium . These rights are generally considered intangible \nassets and are outside the scope of the leasing guidance. \nCertain assets may lend themselves to use by more than one party and need to be carefully evaluated \nto determine if they are physically distinct. For example, a contract providing the use of a portion that \nis less than substantially all of the capacity in a pipeline to transport natural gas is not physically \ndistinct because it cannot be distinguished from other con current users of the pipeline. A portion of an \nasset that is not physically distinct is not an identified asset unless it represents substantially all of the \ncapacity of the asset and thereby provides the customer with the right to obtain substantially all of the \neconomic benefits from use of the asset. See LG 2.3.2.1 for additional information on evaluating \nwhether the contract provides substantially all of the economic benefits from use of an asset. \nAnother example is a tenant that rents one floor in a mu lti-story office building. The floor of the \nbuilding to be used by the individual tenant may be physically distinct. However, the tenant would also \nneed to consider its right to use the land on which the building is located. While the land on which the \nentire building is located is physically distinct, the portion of the land that the tenant has the right to \nuse, is not physically distinct. A tenant’s right to use a non -physically distinct portion of the land \nwould be an identified asset only if such right is for substantially all of the capacity of the land. For \nexample, if the tenant had the right to use nine floors in a ten -story building, it would be reasonable to \nconclude that the land in the arrangement is also an identified asset. Provided the other c riteria for a \nlease were met, the tenant would have a lease of both the building and the land and would need to \nevaluate whether they represent separate lease components. In contrast, if the tenant had the right to \nuse only two floors of the ten story buil ding, it would only have a lease of the building and not of the \nunderlying land. See LG 2.5 for additional information on identifying components within a lease. \nA portion of a pipeline (such as a lateral pipeline) could be physically distinct if an entity can separate \n(e.g., through use of a valve) and use the portion of the asset independent of the mainline pipeline. \n“Last mile” assets (i.e., the end of a single, contiguous asset) would be evaluated in the same way. If the \nlast mile is mechanically separa ble from the remainder of the asset (e.g., there is a switch that permits \nan entity to shut off the flow of electricity or signal to a power or telephone line), the asset would be \nconsidered physically distinct. \nWhen thinking about whether an asset is phy sically distinct, entities may need to consider the nature \nof the asset and evaluate how the asset was designed to be used. This evaluation could include the type \nof functionality the asset will provide and to what parties it will be provided. For example, consider an \narrangement that conveys the right to use a specific space on a cell phone tower to a customer. The \nprimary use of the cell tower is to sell or rent space on the tower to cell phone carriers. As a result, the \nspecific hosting locations on the cell tower are physically distinct. \nIn contrast, arrangements that provide use of a specific spot on an electric utility pole to a third party \n(i.e., a cell phone carrier) generally would not be considered physically distinct. The portion of a utility \npole to be used by a third party generally cannot be physically or mechanically separated from the \nremainder of the pole. Further, the primary use of a utility pole is to support electrical wires and \ntransport electricity (i.e., to permit the utility company to provide its core service). As the primary \npurpose is not to serve as a hosting device for third -party assets, it may be reasonable to conclude that \nthe utility pole attachments would not be considered physically distinct. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 25}), Document(page\_content='Scope \n2-92.3.1.4 Substantive substitution right s \nThe existence of substitution rights may result in the determination that a specific asset has not been \nidentified. If an asset is implicitly specified because the supplier does not have any alternative assets \navailable to fulfill the contract, substitut ion rights do not exist. If, however, an asset is explicitly \nspecified in a contract, but the supplier has a contractual right to substitute that asset, the entities \nwould need to evaluate the criteria in ASC 842 -10-15-10 to determine if the substitution r ights are \nsubstantive. \nASC 842 -10-15-10 \nEven if an asset is specified, a customer does not have the right to use an identified asset if the supplier \nhas the substantive right to substitute the asset throughout the period of use. A supplier’s right to \nsubst itute an asset is substantive only if both of the following conditions exist: \na.The supplier h as the practical ability to substitute alternative assets throughout the period of use\n(for example, the customer cannot prevent the supplier from substituting an a sset, and alternative\nassets are readily available to the supplier or could be sourced by the supplier within a reasonable\nperiod of time).\nb.The supplier would benefit economically from the exercise of its right to substitut e the asset (that\nis, the econom ic benefits associated with substituting the asset are expected to exceed the costs\nassociated with substituting the asset).\nWhen both of these criteria are met, the asset is not an identified asset irrespective of whether it is \nspecified in the underlying contract . \nProvisions that permit an alternative means for fulfilling a contract under certain circumstances may \nindicate that the customer does not have the right to use an identified asset. For example, a large \nmanufacturing entity may enter into an agreement with a customer that specifies a particular model of \nequipment to be used to fulfill the contact. Although the model number is specified, if the \nmanufacturer has several interchangeable pieces of equipment and can use any one of them to satisfy \nits obligations under the contract, the arrangement may not include an identified asset. Similarly, a \ncontract that permits a supplier to outsource its obligation to deliver a product or service m ay not meet \nthe identified asset criterion. \nAs discussed in ASC 842 -10-15-14, a supplier’s right to replace a specified asset during the term of an \narrangement if it is not working properly or becomes defective is not considered a substantive \nsubstitution right (i.e., an identified asset would still exist) and would not by itself preclude the \narrangement from being considered a lease. Likewise, a provision that contractually permits or \nrequires a supplier to substitute other assets on or after a specified date does not preclude the \narrangement from being considered a lease prior to the substitution date. \nQuestion LG 2 -1 discusses how customer approval affects substitution rights. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 26}), Document(page\_content='Scope \n2-10Question LG 2-1 \nIs a substitution right that requires customer approval consi dered substantive? \nPwC response \nNo. A substitution right in a contract that allows substitution only with customer approval is not \nconsidered substantive. \nSupplier has practical ability to substitute the asset \nIn addition to having a substitution right, a supplier must have a replacement asset that can perform \nthe functions required under the arrangement. Contractual language is not sufficient alone; the parties \nto the contract should also consider the practical ability of the supplier to substitute the ass et and to \nexecute the substitution within a reasonable amount of time. This evaluation should be performed \nbased on information available at contract inception and should exclude consideration of future events \nthat are not considered likely to occur. \nTo e valuate whether the supplier has the practical ability to substitute the asset, all relevant factors, \nsuch as those discussed below, should be considered together. \n□Whether similar assets that can be used to satisfy the arrangement are readily available\n□Whether any obstacles to substitution, such as cost or physical feasibility exist (e.g., if the asset is\nlocated on the customer’s premises)\nSupplier can benefit from exercising substitution right \nIn addition to having the practical ability to substitute one asset for another , the supplier must also \nbenefit economic ally from the substitution (e.g., the benefit must exceed the cost of substitution) for it \nto be considered substantive. A supplier may be able to articulate the benefits of substitution and \nrelated costs, and it may even have a history of when substitutions have occurred to help guide its \nanalysis. The customer, on the other hand, is likely to find this assessment more challenging. \nFor a customer, this analysis is similar to how it might consider the economic factors when evaluating \nwhether purchase and renewal options are reasonably certain. See LG 3.3.3.1 for information on that \nanalysis. In the case of substitution rights, the analysis primarily considers factors from the supplier’s \nperspective. Examples of factors to consider include: \n□Transportation costs of relocating one asset to a location where it can be used to satisfy the\narrangement or to move the output from the production loca tion to the customer\n□Foregone production resulting from down time necessary to switch assets and other disruptions to\nthe supplier’s and/or customer’s business\n□Costs to convert an asset that may not have produced identical output\n□Reduced production costs o r increased production volume resulting from a more efficient version\nof an asset', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 27}), Document(page\_content='Scope \n2-11There is no specific measurement threshold to be met; judgment is required to determine how \nsignificant the supplier’s economic benefits should be for the substitution right to be substantive, \nthereby precluding lease accounting. \nGenerally, a supplier will be in a better position to determine whether it can benefit from exercising a \nsubstitution right, but it may be obvious to a customer that the substitution right benefits th e supplier \nwhen there is a clear economic incentive and the barriers to substitution are minimal. When the \ncustomer does not have adequate transparency to the practicality or economics of supplier \nsubsti tution rights, it should assume that the substitution right is not substantive and that the \narrangement contains an identified asset . When an asset resides on a customer ’s premises, a supplier \ngenerally does not have a substantive substitution right because the costs and potential disruption \nwould be signifi cant. \nAdditionally, the assessment as to whether a substitution right is substantive should be based on facts \nand circumstances that exist at the inception of the contract. Any circumstances that are not likely to \noccur during the period of use would be d isregarded in the analysis. While a supplier may use \nsubstitution rights to manage its assets, and histor ically substitut es assets across its portfolio, the \nparties should consider whether it is likely that a specific asset will be substituted while in use by a \ncustomer. For example, a car rental company that frequently substitutes cars while they are under \ncontract to customers may be unable to support an assertion that substitution of a particular car under \nrental is likely to occur, because a typical car rental period i s short. Thus, it may be difficult to apply an \nentity -wide assertion that substitution rights are substantive. \nConsideration should also be given to whether the future events that might occur are within the \nsupplier’s ability to influence. ASC 842-10-15-11 discusses future events that, at inception, are not \nconsidered likely to occur during the period of use . An example is a provision in a contract that allows \nthe supplier to substitute the asset for new technology when it is available, but the technology is not \nsubstantially developed at inception of the contract. This would not be considered a substantive \nsubstitution right. Similarly, rights to substitute the asset predicated on government approval, changes \nin regulations, or expected changes in customers’ usage may not be substantive substitution rights. \nThe analysis is performed at the inception of the arrangement and does not consider hypothetical or \ncontingent changes. Rights that allow for the replacement of certain parts, or the asset as a whole, as a \nresult of loss or wear and tear are not considered substantive substitution rights. \nExample LG 2-3 illustrate s a substitution rights that is substantive . \nEXAMPLE LG 2-3 \nSupplier with substantive substitution rights \nWarehousing Corp owns a la rge warehouse that can be subdivided into numerous subsections by \ninserting removable walls. It leases out different portions of storage space to its customers based on \ntheir respective needs . \nManufacturing Corp contracts with Warehousing Corp to reserve 1,000 square feet of space to store its \nexcess inventory for a three -year period. The contract states that Manufacturing Corp’s inventory will \nbe stored in a specified location in the warehouse. However, Warehousing Corp has the right to shift \nManufacturin g Corp’s inventory to another location within its warehouse at its discretion, subject to \nthe requirement to provide 1,000 square feet for the three -year period. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 28}), Document(page\_content='Scope \n2-12Warehousing Corp frequently reorganizes its space to meet the needs of new contracts. The cos t of \nreallocating space is low compared to the benefits of being able to accommodate as many customers as \npossible in the warehouse. \nDoes the contract contain an identified asset? \nAnalysis \nNo. While the contract explicitly specifies the location where Ma nufacturing Corp’s inventory will be \nstored, the asset is not identified because Warehousing Corp has a substantive substitution right. \nWarehousing Corp has agreed to provide a specific amount of storage space within its warehouse at a \nspecific location. H owever, Warehousing Corp has the unilateral right to relocate Manufacturing \nCorp’s inventory. It would benefit by relocating the customer’s inventory and can do so without \nsignificant cost. As such, Warehousing Corp’s substitution rights are considered sub stantive, and there \nis not an identified asset. \nExample LG 2-4 illustrate s a substitution right that is not substantive. \nEXAMPLE LG 2-4 \nSupplier without substantive substitution rights \nWarehousing Corp owns a large warehouse that can be subdivided into num erous subsections by \ninserting removable walls. It leases out different portions of storage space to its customers based on \ntheir respective needs . \nManufacturing Corp contracts with Warehousing Corp to reserve 1,000 square feet of space to store its \nexcess inventory for a three -year period. Warehousing Corp has the right to shift Manufacturing \nCorp’s inventory to another location within its warehouse at its discretion, subject to the requirement \nto provide 1,000 square feet for the three -year period. However, Manufacturing Corp specified in its \ncontract that its materials must be stored at a specific temperature. \nWarehousing Corp frequently reorganize s its space to meet the needs of new contracts ; however, \nWarehousing Corp only has one location in its warehouse with a cooling system capable of \nmaintaining the required temperatures based on the layout of its HVAC system. \nDoes the contract contain an ide ntified asset? \nAnalysis \nYes. The asset is identified because Warehousing Corp does not have a substantive substitution right. \nWarehousing Corp has agreed to provide a specific level of capacity within its warehouse at a specific \nlocation within the wareho use and does not have the unilateral right to relocate Manufacturing Corp’s \ninventory without significant cost of installing additional cooling systems or modifying its HVAC \nsystem. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 29}), Document(page\_content='Scope \n2-13Supplier with a substitute right after a particular date \nA supplier’s sub stitution right is not substantive (and, thus, there could be an identified asset) when a \nsubstitution right exists for only a portion of the contract term. ASC 842 -10-15-13 provides guidance \non this situation. \nASC 842 -10-15-13 \nIf the supplier has a right or an obligation to substitute the asset only on or after either a particular \ndate or the occurrence of a specified event, the supplier does not have the practical ability to substitute \nalternative assets throughout the period of use. \nExample LG 2 -5 analyzes a substantive substitution right only after a particular date. \nEXAMPLE LG 2 -5 \nSupplier with substitution right after a particular date \nWarehousing Corp owns a large warehouse that can be subdivided into numerous subsections by \ninserting removable walls. It leases different portions of storage space to its customers based on their \nrespective needs. \nManufacturing Corp contracts with Wareho using Corp to reserve 1,000 square feet of space to store its \nexcess inventory for a three -year period. The contract states that Manufacturing Corp’s inventory will \nbe stored in a specified location in the warehouse. Within the first year of the arrangemen t, \nWarehousing Corp has the right to move Manufacturing Corp’s inventory to a different 1,000 square \nfoot location within its warehouse at its discretion. \nDoes Warehousing Corp have a substantive substitution right? \nAnalysis \nThe substantive substitution r ight does not exist throughout the period of use. As such, Manufacturing \nCorp could have a lease of the warehouse space beginning in year two of the agreement, provided the \nother criteria are met. \nArrangement term that exceeds the economic life of the identified asset \nThe term of an arrangement may exceed the economic life of the identified asset. The accounting term \nof a lease cannot exceed the economic life of the underlying asset subject to the lease. When an \narrangement is longer than the economic l ife of the identified asset, the supplier may be required to \nuse a comparable asset at a future date that may be specified in the arrangement, or at the end of the \neconomic life of the original asset. Such arrangements could include a lease of the first id entified asset \nas well as a forward starting lease of a second asset when the first asset is replaced. \n2.3.2 Right to control the use of an identified asset \nOnce a reporting entity concludes that the asset to be used is identified , the parties to the transact ion \nmust then evaluate whether the customer controls the use of that asset throughout the period of use. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 30}), Document(page\_content='Scope \n2-14An arrangement is not a lease if it does not convey control over the use of an asset to the customer. A \ncontract that does not convey control to the cu stomer, even when the asset to be used to fulfill the \ncontract is explicitly identified, is subject to the guidance applicable to a service or supply \narrangement. \nASC 842-10-15-4 provides the requirements for a customer to have control over an asset. \nASC 842-10-15-4 \nTo determine whether a contract conveys the right to control the use of an identified asset (see \nparagraphs 842-10-15-17 through 15 -26) for a period of time , an entity shall assess whether, \nthroughout the period of use, the customer has both of the following: \na.The right to obtain substantially all of the economic benefits from use of the identified asset (see\nparagraphs 842 -10-15-17 through 15 -19)\nb.The right to direct the use of the identified asset (see paragraphs 842 -10-15-20 through 15 -26).\nIf the customer in the contract is a joint operation or a joint arrangement, an entity shall consider \nwhether the joint operation or joint arrangement has the right to control the use of an identified asset \nthroughout the period of use. \nUtilizing all of an ass et’s output may indicate that the customer is obtaining substantially all of the \neconomic benefit ; however, this alone is not enough to demonstrate control of the asset. The customer \nmust also have the right to direct the use of the asset. Both criteria mu st be met to qualify for lease \naccounting. \nThe assessment of whether a reporting entity has control over an asset should consider the period of \nuse of that asset. The period of use is defined in the ASC 842 Glossary as follows. \nDefinition from the ASC 842 Glossary \nPeriod of Use: The total period of time that an asset is used to fulfill a contract with a customer \n(including the sum of any nonconsecutive periods of time). \nControl over use of an asset can be for a consecutive period, nonconsecutive periods, or a portion of \nthe term of the contract. In Example LG 2-6, a facility is used for two months each year over a five-\nyear period; the period of use refers to those specified time periods within the year, not the entire year. \nASC 842-1 0-15-5 provides guidance on a customer obtaining control for a portion of the term of a \ncontract.\nASC 842 -10-15-5 \nIf the customer has the right to control the use of an identified asset for only a portion of the term of \nthe contract, the contract contains a lease for that portion of the term. \nExample LG 2 -6 illustrates an arrangement in which control is obtained in nonconsecutive periods. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 31}), Document(page\_content='Scope \n2-15EXAMPLE LG 2-6 \nContract for a nonconsecutive period of use \nCustomer Corp enters into a contract with Supplier Corp that grants Customer Corp exclusive rights to \nuse a specific grain storage facility over a five -year period in the months of September and October. \nDuring these months, Customer Corp has the right to decide which crops are placed in storage and \nwhen to remove them. Supplier Corp provides the loading and unloading services for the warehouse \nactivities. During the other ten months each year, Supplier Corp has the right to determine how the \nwarehouse will be used. \nWhich party has the right to control the use of the identified asset during the period of use? \nAnalysis \nCustomer Corp has the right to control the use of the identified asset during the period of use because \nit has the power to determine how the warehouse will be used during the contractually -defined usage \nperiods. The analysis should focus on the rights and economics of the use of the warehouse for the \nspecified usage periods (September and October). During the period of use, Customer Corp has t he \nrights to determine how much of a crop to place in storage, and the timing of placing and removing it \nfrom storage. These rights are more significant to the economics of the use of the asset than the \nloading and unloading services performed by Supplier Corp during the same period. Customer Corp \nreceives all of the economic benefit from use of the asset during those specified time periods. The total \nperiod of time that the warehouse will be used to fulfil the contract is 10 months (2 months per year \nover the five -year period). \n2.3.2.1 Right to obtain substantially all the economic benefits \nThe first criterion in the control assessment is the right to the economic benefits derived from the \nasset. To be a lease, the arrangement must convey the right to obtain subs tantially all of the potential \neconomic benefits that can be obtained from directing the use of the asset throughout the period of \nuse. As discussed in LG 2.3.2, the period of use could be consecutive or nonconsecutive periods of \ntime. A customer would not control an asset if another party has the right to more than an \ninsignificant portion of the potential economic benefits. This is not a probability analysis as to who is \nlikely to receive the benefits; the assessment should focus on the contractual rights of the respective \nparties. Specifically, the rights to the output and other economics derived from use of the asset should \nbe considered. If a customer does not have contractual rights to all of the existing capacity of the asset, \nand the arrangement does not grant the customer an option to acquire any additional capacity, the \narrangement is unlikely to be a lease. However, if the customer has the option to increase the volume \nof the output it consumes before it is given to additional customers (right of f irst refusal), the \narrangement likely meets this criterion. \nIf the asset produces more than one type of output or benefit, this assessment should be made based \non the fair value of the contractual rights . In other words, the assessment should be performed based \non the potenti al economic returns associated with those contractual rights. The assessment should be \nbased on the asset as it exists at the time of entering into the arrangement by considering the capacity \nlevel at which the asset is expect ed to operate, maintenance schedules , and type of physical asset. The \nstandard does not define “economic benefits” but it does provide examples of ways the benefits can be \nobtained. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 32}), Document(page\_content='Scope \n2-16Excerpt from ASC 842 -10-15-17 \nA customer can obtain economic benefits fro m use of an asset directly or indirectly in many ways, such \nas by using, holding, or subleasing the asset. \nA customer may derive economic benefits from its use of an asset by producing goods for its own use \nor resale, providing services, or enhancing the v alue of other assets. The parties to the contract should \nconsider the economic benefits that can be derived from the use of the asset but not benefits that are \nderived solely from ownership of the asset (e.g., proceeds from the sale of the asset). \nA custo mer that contracts for the right to use an asset generally has a specific purpose or use of the \nasset in mind. However, assets can often function and produce various outputs during their operation \nin addition to what was initially contracted. Economic bene fits should include cash flows derived from \nboth the primary outputs and by -products. For example, a supplier that owns equipment to produce \ncustomized parts for its customer (an automobile company) may simultaneously sell the scrap metal to \na third party. When evaluating whether it is obtaining substantially all of the economic benefits from \nuse of the underlying equipment, the customer should consider the economics of the supplier selling \nthe scrap metal in addition to the manufactured parts. \nIn some industries , there are unique attributes associated with an asset ’s operation that may or may \nnot be considered output of the asset but need to be considered for purposes of the economic benefit \ntest. For example, renewable energy credits (RECs) produced by a solar generation facility have \neconomic value and should be considered an economic output in the leasing analysis because they are \na benefit relating to the use of the asset. Since the RECs are dependent on the output of a specified \npower plant, they shoul d be factored into the benefits derived from operation of that asset. \nQuestion LG 2 -2 discusses the economic benefit of an asset when its output is sold to separate parties. \nQuestion LG 2-2 \nIf an owner of a solar facility sells its energy production and renewable energy credits to separate \nparties, which party has the right to obtain substantially all of the economic benefits of the solar \nfacility? \nPwC response \nIt depends. If both the energy production and the RECs are deemed to be more than insignificant to \nthe total economics , then neither party would have the right to obtain substantially all of the economic \nbenefits and lease accounting would not apply. \nSome arrangements require the customer to share a portion of the cash flows derived from the use of \nthe asset with the supplier or another party. These arrangements may not prevent the customer from \nhaving the right to the economic benefits derived from the asset; rather, they may contain additional \nconsideration for the use of the asset. A common examp le is a payment from the customer to the \nsupplier based on a percentage of the sales derived from use of the asset. \nAgreements for the use of assets for which a customer cannot derive economic benefits on its own \nwithout other resources may still meet the definition of a lease if the customer meets the criteria ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 33}), Document(page\_content='Scope \n2-17necessary to direct the use of the asset. For example, a contract for the use of an asset of such a \nspecialized nature that the supplier must operate it may still be deemed a lease if the customer h as the \nability to dictate when it runs, or has the ability to let it sit idle. In this case, the customer retains the \nright to direct the use of the asset during the term of the arrangement and can effectively prevent \nanother party from obtaining the econo mic benefits. \nUnit of account \nIn order to assess whether a customer obtains substantially all of the economic benefits from the use of \nan identified asset, the customer must first identify the parties that have the right to use the asset. As \ndiscussed in LG 2.3.2.1 , certain agreements provide the customer with exclusive use of the identified \nasset during the period of use, while other arrangements provide for use of the asset by multiple \nparties. Determining whether more than one party has the right to use an identified asset requires \nidentification of the unit of account. Identifying the unit of account may be straight forward for some \narrangements. However, for certain contracts, like land easements, this determination may be more \nchallenging. \nExample LG 2-7 illustrate s how to identify the unit of account in certain land easement agreements. \nEXAMPLE LG 2-7 \nEasements – unit of account \nOn January 1, T ower Company enters into an arrangement to obtain the right to access farm land \nowned by Landowner for 40 years . The contract provides the right for Tower Company to access a \nspecific plot of land measuring 10 acres. The contract also provides Tower Company with the right to \nconstruct a tower on an identifi ed subsection of the 10 -acre plot . \nIn accordance with the contract, Landowner has the ability to use the space not occupied by Tower \nCompany’s assets for its own purposes, as long as the activities of Land owner do not interfere with the \noperation of Tower Company’s tower. Landowner does not have the a bility to access the specified \nportion of the plot of land where the tower will be built. \nWhat is the unit of account for assessing whether the agreement is o r contains a lease? \nAnalysis \nIn this fact pattern, we believe there are two units of account. \nThe contract provides for surface land rights and conveys different rights between the site for the \ntower and the remainder of the acreage. Tower Company has exc lusive use of the parcel where the \ntower will be constructed and shared access to the remaining property. Therefore, the agreement \ncontains two units of account. \nTower Company would need to evaluate both the subsection of the land where the tower will be built \nand the remaining space not occupied by the tower to determine if either meets the definition of a \nlease. The agreement specifies the location of both units of account. As such, each is considered an \nidentified asset. Tower Company has exclusive use of the specified parcel where the tower will be built, \nand thus has the ability to both (1) direct how this identified asset is used and (2) obtain substantially \nall of the economic benefits from it. As such, Tower Company has the right to control the use of that ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 34}), Document(page\_content='Scope \n2-18parcel of land, and the agreement contains a lease. Use of the remaining portion of the 10 -acre land \nparcel is shared between Tower Company and Landowner. As such, Tower Company would need to \nevaluate whether it has the right to control the use of that portion of the land. \nTower Company would determine the stand alone selling prices for each unit of account at inception \nand would allocate consideration based on those amounts. Tower Company would recognize the \nconsideration allocated to the tower si te when the lease begins. \nIn some arrangement, assets that will be used to fulfill the contract may not be determined until a later \ndate. ASC 842 -10-15-9 addresses these arrangements (sometime referred to as “floating” leases) . \nASC 842 -10-15-9 \nAn asset ty pically is identified by being explicitly specified in a contract . However, an asset also can be \nidentified by being implicitly specified at the time that the asset is made available for use by the \ncustomer. \n2.3.2.2 If, for exam ple, the subsection of land on which the tower will be constructed is not determined until \nJune 30 (six mont hs after the January 1 ince ption), there would still be two u nits of account at \ninception, and consideration would be allocate d to each unit of account based on stand-alone selling \nprices at t hat date. However, because the lease wou ld not commence until June 30 when the \nsubsection is iden tified, any amounts allocated to th e lease component w ould not be recognized until \nJune 30. \nAccounting fo r arrangements that (1) involve the righ t to use an asset to be specified in the future and \n(2) contain more than one unit of account, can be challenging. T he application of the model depends \non the facts and circumstances of each arrangement , which sh ould be carefully evaluated.\nIn ASC 842- 10-65-1 (g g), the FASB provided guidance on an optional transition practical expedient to \nnot evaluate unde r ASC 842 existing or expired land easements that were not previously accounted for \nas leases under ASC 840. Instead, reportin g entities that elect this practical expedient would continue \ntheir curr ent accounting fo r land easements that existed pr ior to the entity’s adoption date. All land \neasements arr angements entered into or modified afte r a reporting en tity’s adoption date are required \nto be evaluated under ASC 842. This practical expedient can be elected independent of all other \npractical expedients. See LG 9 for further discussion of practical expedients and transition \nconsiderations. \nRight to direct the u se of the identified asset \nThe second criterion in th e control assessment is the right to direct the use of the identified asset. \nDecisions about how and fo r what purpose an asset will be used ar e the mos t relevant factors to \nconsider when assessin g which party directs the use o f the identified asset. A reporting e ntity should \ngive the most weight to t he factors that have the greatest impact on the economic benefit to b e derived \nfrom that asset. \nFigure LG 2-2 illustrates the analysis that should be used to determine which party has the right to \ndirect the use of an identified asset. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 35}), Document(page\_content='Scope \n2-19Figure LG 2-2 \nAnalysis of which party has the right to direct the use of an identified asset \nASC 842 includes guidance for determining which party has the right to direct the use of an identified \nasset under two broad scenarios: either all relevant decisions about ho w and for what purpose the \nasset is used during the period of use are predetermined, or they are not. \nUnder either scenario, the customer will generally be deemed to have the right to direct the use of the \nasset if, during the period of use, the customer m ay operate the asset, or may direct others do so \nwithout the supplier having the right to change that right. Operating an asset take s different forms \ndepending on the nature of the asset. Determining whether a customer operates an asset may be \nstraightforw ard when an asset require s active operations (e.g. , construction equipment) . Other assets \nrequire little active operation (e.g. , storage containers) or are completely automated (e.g. , a solar \npanel) ; and it may be more difficult to d etermin e whether a cust omer operates such asset . However, a \ncustomer’s right to turn an asset on or off , to disconnect an asset from other assets, or to “pull the \n', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 36}), Document(page\_content='Scope \n2-20plug” (other than solely for safety or protective concerns ) would generally be considered a right to \noperate the asset. \nThe next step is to identify all the “relevant ” decisions that could be made during the period of use that \ncan change how and for what purpose the asset is used. As described in ASC 842 -10-15-24, a decision \nis considered “relevant” when they affect the economic benefits that could be derived from using the \nasset. Examples of these rights are outlined in ASC 842 -10-15-25. \nASC 842 -10-15-24 \nA customer has the right to direct how and for what purpose an asset is use d throughout the period of \nuse if, within the scope of its right of use defined in the contract, it can change how and for what \npurpose the asset is used throughout that period. In making this assessment, an entity considers the \ndecision -making rights that are most relevant to changing how and for what purpose an asset is used \nthroughout the period of use. Decision -making rights are relevant when they affect the economic \nbenefits to be derived from use. The decision -making rights that are most relevant are likely to be \ndifferent for different contracts, depending on the nature of the asset and the terms and conditions of \nthe contract . \nASC 842 -10-15-25 \nExamples of decision -making rights that, depending on the circumstances, grant the right to direct \nhow and f or what purpose an asset is used, within the defined scope of the customer’s right of use, \ninclude the following: \na.The right to change the type of output that is produced by the asset (for example, deciding whether\nto use a shipping container to transport goods or for storage, or deciding on the mix of products\nsold from a retail unit)\nb.The right to change when the output is produced (for example, deciding when an item of\nmachinery or a power plant will be used)\nc.The right to change where the output is produc ed (for example, deciding on the destination of a\ntruck or a ship or deciding where a piece of equipment is used or deployed)\nd.The right to change whether the output is produced and the quantity of that output (for example,\ndeciding whether to produce energ y from a power plant and how much energy to produce from\nthat power plant).\nDirect operations during the period of use \nIn some arrangements, the decisions related to how and for what purpose an asset is used, as outlined \nin ASC 842 -10-15-25, are already sp ecified in the contract before the lease term commences. Since \nthese decisions are predetermined and are not made during the period of use, they are ignored as long \nas any relevant decisions could occur during the period of use. For example, the ability to change \n“where the output is produced,” as described in ASC 842 -10-15-25 (c) may not apply to assets that are \nnot portable. As such, that factor is ignored in this evaluation. Predetermined decisions are only \nconsidered when there are no relevant decision -making rights that could be made during the period of \nuse. This principle is supported by an IFRS Interpretations Committee (a committee of the \nInternational Accounting Standards Board ) decision published at its January 2020 meeting . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 37}), Document(page\_content='Scope \n2-21(Although the US and IFRS Leases standards are not converged, the guidance on the right to \ndetermine how and for what purpose an asset is used is identical, and as such we believe that the \nCommittee’s interpretation should be applied. ) \nThe Committee considered a submission describing a voyage charte r agreement in which the following \nconditions were predetermined in the contract: \n□A specified ship would be used to transport a specified quantity of a customer’s coal to a single\ndestination . Neither the quantity nor the cargo could be changed\n□The quantity equaled the ship’s capacity\n□The contract designated three load ports. There was a predetermined number of voyages from\neach of the three load ports to the single destination (e.g., 10 trips from port A, seven from port B,\nand three from port C) . The revenue per trip was fixed; accordingly, the total revenue to the lessor ,\nand cost to the lessee , was fixed per the contract\n□The total number of voyages was predetermined, and would fully consume the ship’s capacity\nduring the perio d of use\n□The supplier operated and maintained the ship\nDuring the period of use , the customer could only choose the order in which the trips from each load \nport would occur . The facts assume that the order of the trips affected the economics derived from the \nuse of the ship during the period of use. Since a relevant decision exists during the period of use, the \nCommittee noted that all the predetermined decisions (which appear to be more impactful on the \neconomics than the order in which the trips occur ) should be ignored. Similarly, the supplier’s \nobligation to operate and maintain the ship is not relevant to determining which party had the right to \ndirect the use of the asset during the period of use . Accordingly, in the fact pattern conside red, the \ncustomer was deemed to direct the use of the ship during the period of use. \nThe right to determine how and for what purpose an asset is used is different than how those decisions \nare implemented. For example, when a customer outsources operation of an asset to an outside service \nprovider, it may continue to direct how and for what purpose the asset is used; the outsourcing (i.e., \nphysically operating the asset subject to the customer’s direction ) does not typically influence the \neconomic benefits that can be derived from the asset. \nSimilarly, if a customer must either approve, or could veto, a supplier’s decision, the customer is the \ndecision maker, notwithstanding the supplier’s advice and know -how. That the supplier was hired for \nits expertise, and proposed the decision, is similar to the functions of a customers’ expert employee. \nIn evaluating the ability to change what an asset is used for during the period of use, or how, when, \nwhether, and where the asset is used, one might encounter some decisions that are : (1) predetermined, \nor (2) directed by the customer , or (3) directed by the supplier , or any combination thereof . When \nevaluating which party has the right to direct the use of the underl ying asset during the period of use, \npredetermined decisions are ignored (e.g., the site where an asset may be used ); rather, the entities \nmust consider whether the customer or the supplier directs the remaining relevant decisions that, in \ntotal, more sign ificantly affect the economic benefits derived from the asset during the period of use. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 38}), Document(page\_content='Scope \n2-22Predetermined operations \nIf the contract explicitly states how and for what purpose an asset will be used throughout the term of \nthe arrangement, and neither party can change how and for what purpose the asset is used during the \nperiod of use , then different factors should be considered to determine which party is directing the use \nof the asset as discussed in ASC 842 -10-15-20(b). \nExcerpt from ASC 842 -10-15-20 \nA customer has the right to direct the use of an identified asset throughout the period of use in either \nof the following situations: \na....\nb.The relevant decisions about how and for what purpose the asset is used are predetermined (see\nparagraph 842 -10-15-21) and at least one of the following conditions exists:\nc.The customer has the right to operate the asset (or to direct others to operate the asset in a\nmanner that it determines) throughout the period of use without the supplier having the right to\nchange those operating instructions.\nd.The customer designed the asset (or specific aspects of the asset) in a way that predetermines how\nand for what purpose the asset will be used throughout the period of use.\nA reporting entity should consid er whether any variability is created during the operation of the asset , \nin order to determine whether there are any relevant decisions that are made during the period of use. \nIf so, the design of the asset is not used to determine which party directs the right to use the asset \nduring the period of use. \nDesign of the asset \nFor certain types of assets, the ir design is the primary factor in determining the resulting economics. \nThis is especially true when the design establishes how and when an asset is to be used. For example, a \ncustomer that contracts to buy electricity from a supplier’s windfarm that is responsible for locating \nthe site and the number of turbines to be used to generate the electricity it purchases, may have the \nright to direct the use of th e asset because the re are no relevant decisions that could be made during \nthe period of use that can be derived from the asset (i.e., because the electrical output is dependent on \nhow often the wind blows in a location selected by the customer). How the as set is to be used and for \nwhat purpose has been predetermined through the selection of the site and design of the asset. \nIn certain cases, the level of a customer’s involvement in the design of the asset may be unclear. In that \ncase, whether the customer was the sole decision maker for the most significant design decisions \nshould be considered to determine whether the customer made the decisions that established the \ndesign of the asset. If the decisions were jointly made by the customer and the supplier, t hen it will be \npresumed that the customer did not make the decisions that pre -determined the design of the asset. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 39}), Document(page\_content='Scope \n2-23Other considerations \nAs discussed in ASC 842 -10-15-23, an owner/supplier’s protective right to inspect their asset to ensure \nit is being ope rated properly and maintained sufficiently should not be a factor in determining who \ncontrols the asset. These rights are not decision making rights. \n2.3.2.3 Examples — right to control the use of an identified asset \nExample LG 2-8, Example LG 2-9, Example LG 2-10, Example LG 2-11, Example LG 2-12, and, \nExample LG 2-13 illustrate the determination of which party has the right to control the use of an \nidentified asset. \nEXAMPLE LG 2-8 \nConsideration of dispatch rights \nCustomer Corp contracts with Supplier Corp to manufacture parts in a facility on Customer Corp’s \nproperty. Customer Corp designed the facility and stipulates its specifications. Supplier Corp owns the \nfacility and leases the land from Customer Corp. Custom er Corp specifies how many parts it needs and \nwhen it needs the parts to be available. Supplier Corp operates the machinery and makes all operating \ndecisions including how and when the parts are to be produced, as long as it meets the contractual \nrequireme nts to deliver the specified number on the specified date. \nWhich party has the right to control the use of the identified asset (i.e., building and equipment) \nduring the period of use? \nAnalysis \nCustomer Corp does not direct the use of the asset that most significantly drives the economic benefits \nbecause Supplier Corp determines how and when the building and equipment are operated once the \ncontract is signed. Therefore, Supplier Corp has the right to control the use of the identified asset \nduring the perio d of use. Although Customer Corp stipulates the product to be provided and has input \ninto the initial decisions regarding the use of the asset through its involvement in the design of the \nasset, Customer Corp does not have dispatch rights (i.e., the right to control the output at a given \ntime). As such, Customer Corp does not have decision making rights over the asset during the period \nof use. This arrangement would be a supply agreement , not a lease. \nDetermining whether a supplier or a customer has dispatc h rights in a supply arrangement can be \nchallenging. The evaluation should be based on the specific facts and circumstances of the \narrangement. In making this assessment, companies should consider the following factors: \n□Can the product be inventoried and stored by the supplier ? A supplier’s nominal ability to control\nthe production schedule may not be substantive when it is impractical to store the output.\n□What is the typical lead time on orders? A short lead time may be indistinguishable from a\ndispatch right.\n□How long is the interval between orders? Very short intervals may be indistinguishable from a\ndispatch right.', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 40}), Document(page\_content='Scope \n2-24□Does the customer provide sufficient notice for orders such that a supplier can decide when to\nproduce the required quantity or do custome r orders dictate timing and level of the supplier’s\nproduction?\nEXAMPLE LG 2-9 \nIllustration of dispatch rights \nCustomer Corp enters into contract to purchase energy from Supplier Corp; Supplier Corp owns a pre-\nconstructed natural gas -fired power generation facility. Customer Corp has contracted for power from \nthe asset on an as -needed basis to fulfil l its power needs during peak periods of demand, but not on a \nconstant basis. Customer Corp will notify Supplier Corp when to generate power to satisfy its need s. \nCustomer Corp contracts for the right to all of the plant ’s capacity (100% of the electricity that can be \ngenerated) and therefore is entitled to all of the output . Customer Corp may allow the plant to sit idle \nat times of low demand. \nSupplier Corp is responsible for operating and maintaining the asset throughout the term of the \ncontract. \nWhich party has the right to control the use of the identified asset during the period of use? \nAnalysis \nCustomer Corp directs the use of the asset du ring the term of the contract through its right to dictate \nwhen the asset should operate and produce energy; the economics are most significant when the plant \nis operating and generating electricity. Since Customer Corp controls the decision to operate the asset \n(even though Customer Corp does not physically operate the facility), it has the right to direct the use \nof the asset that most significantly affects the economic benefits derived from its use, and therefore \nCustomer Corp controls the identified ass et during the term of the contract. In contrast to Example LG \n2-8, Customer Corp is making decisions about the use of the asset during the period of use.\nEXAMPLE LG 2-10 \nIllustration of lack of dispatch rights \nCustomer Corp enters into contract to purchase energy from Supplier Corp; Supplier Corp owns a pre-\nconstructed natural gas -fired power generation facility. Customer Corp was not involved in the design \nof the facility. Customer Corp has contracted for power from the asset on a full -time basis. Customer \nCorp will purchase all of the plant ’s capacity (100% of the electricity that can be generated) and \ntherefore is entitled to all of the output . \nSupplier Corp is responsible for operating and maintaining the as set throughout the term of the \ncontract. \nWhich party has the right to control the use of the identified asset during the period of use? \nAnalysis \nIt depends. The contract is for full -time operation; therefore, Customer Corp does not have dispatch \nrights. T he parties must identify any relevant decisions that could be made during the period of use. In \nthis fact pattern, whether and where the output is produced is predetermined by the terms of the ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 41}), Document(page\_content='Scope \n2-25contract and the nature of the asset. The parties should evalua te whether either party can change how \nmuch output is generated , and when it is generated. If Customer Corp makes those decisions, then it \nhas the right to direct the use of the asset during the period of use. If Supplier Corp makes those \ndecisions, (or if those decisions are predetermined by the terms of the contract), then Customer Corp \ndoes not have the right to direct the use of the identified asset. \nEXAMPLE LG 2-11 \nContract for the use of gas pipelines \nCustomer Inc enters into a five -year agreement with Supplier LP for 100% of the capacity of a specified \nnatural gas pipeline. Supplier LP operates and maintains the pipeline. Customer Inc pays a fixed \ncapacity charge each month. When Customer Inc chooses t o use the capacity, it also pays a variable \namount for each unit of natural gas transported. Supplier LP cannot use the pipeline capacity to \ntransport natural gas for any other customer. \nWhich party has the right to control the use of the identified asset during the period of use? \nAnalysis \nCustomer Inc has the right to control the use of the identified pipeline during the period of use. \nCustomer Inc makes the relevant decisions about how and for what purpose the pipeline will be used \nby determining when and how much natural gas will be transported through the pipeline. Customer \nInc also has the right to obtain substantially all of the economic benefits from the transportation of \nnatural gas through the pipeline because no one else can use the pipeline during the period of use. \nEXAMPLE LG 2-12 \nContract for use of manufacturing lines \nManufacturing Co enters into an arrangement with Supplier Corp for use of Supplier Corp’s \nmanufacturing lines over a five -year period. Manufacturing Co notifies Supplier Corp when the lines \nare to be used based on Manufacturer Co’s production needs. Supplier Corp does not have substantive \nsubstitution rights and cannot use the manufacturing lines for any other purpose. \nWhich party has the right to control the use of the identified asset during the period of use? \nAnalysis \nIt depends. If the ordering process is in substance a dispatch right (e.g., the manufacturing lines are \nonly used to produce Manufacturing Co’s product on the basis of, and only to the extent of, purchased \norders i ssued by Manufacturing Co during the contract period), the arrangement would contain a lease \nsince Manufacturer Co is making the relevant decisions that impact how and for what purpose the \nmanufacturing lines are used. In this scenario, (a) Manufacturer Co would receive substantially all of \nthe economic benefit from the exclusive use of the identified manufacturing lines, and (b) \nManufacturer Co would have the ability to determine when, whether, and how often the lines would be \nused based on its purchase or ders. \nIf, however, the ordering process is not in substance a dispatch right (i.e., Supplier Corp has flexibility \nto determine the capacity at which to run the manufacturing lines when purchase orders are received), \nManufacturer Co may merely be ordering p roduct, and the arrangement would not contain a lease ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 42}), Document(page\_content='Scope \n2-26because Manufacturer Co would not be making relevant decisions that impact how and for what \npurpose the asset is used. \nEXAMPLE LG 2-13 \nContract for use of an airplane over a three -year period \nSports Fr anchise enters into a contract with Supplier Corp for airplane transportation on an identified \nasset for Sports Franchise’s players for a three -year period. Sports Franchise provides the dates of \ntravel and the arrival and departure locations at least one week in advance of each trip, which is not \npredetermined in the contract terms. Sports Franchise will pay Supplier Corp a fixed fee per month for \nuse of the airplane. \nSupplier Corp provides the airplane, crew, and pilot for each flight. \nWhich party has t he right to control the use of the identified asset during the period of use? \nAnalysis \nSports Franchise has the right to control the asset because it can decide how and when the plane will \nbe utilized during the period of use. Although Supplier Corp can make operational decisions about the \nflight plan , it is Sports Franchise who determines w hen the plane will fly. The frequency and distance \ntraveled are more relevant to the overall economic benefits to be derived from the airplane than the \nspecific routes of each individual trip. \nIn addition to the lease, the contract contains other nonlease components, such as the services \nprovided by the pilot and crew, fuel, maintenance, and parking the airplane when not in use. See LG \n2.4 for further information on lease and nonlease components. \nAdditionally, ASC 842 contains the following example of a co ntract for network services that is not a \nlease. \nExample 10—Contract for Network Services \nASC 842 -10-55-124 \nCustomer enters into a contract with a telecommunications company (Supplier) for network services \nfor two years. The contract requires Supplier to s upply network services that meet a specified quality \nlevel. To provide the services, Supplier installs and configures servers at Customer’s premises; \nSupplier determines the speed and quality of data transportation in the network using the servers. \nSupplie r can reconfigure or replace the servers when needed to continuously provide the quality of \nnetwork services defined in the contract. Customer does not operate the servers or make any \nsignificant decisions about their use. \nASC 842 -10-55-125 \nThe contract d oes not contain a lease. Instead, the contract is a service contract in which Supplier uses \nthe equipment to meet the level of network services determined by Customer. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 43}), Document(page\_content='Scope \n2-27ASC 842 -10-55-126 \nCustomer does not control the use of the servers because Customer’s on ly decision -making rights \nrelate to deciding on the level of network services (the output of the servers) before the period of use —\nthe level of network services cannot be changed during the period of use without modifying the \ncontract. For example, even th ough Customer produces the data to be transported, that activity does \nnot directly affect the configuration of the network services and, thus, it does not affect how and for \nwhat purpose the servers are used. Supplier is the only party that can make decisi ons about the use of \nthe servers during the period of use. Supplier has the right to decide how data are transported using \nthe servers, whether to reconfigure the servers, and whether to use the servers for another purpose. \nAccordingly, Supplier controls t he use of the servers in providing network services to Customer. There \nis no need to assess whether the servers are identified assets because Customer does not have the right \nto control the use of the servers. \nThis example describes how entities would asse ss which party has the right to control the use of an \nasset when it is evident that the customer has the right to obtain substantially all the output of the \nasset and the asset cannot be substituted. In this example, the assets are located on Customer’s \npremises, and Customer presumably has the right to substantially all the output. ASC 842 -10-55-126 \nconcludes that Supplier controls the assets, notwithstanding that Customer appears to have the right \nto direct the use of the assets. Like Example LG 2 -9, it a ppears that Customer has the ability to use the \nnetwork assets on demand (i.e., dispatch rights), because Customer’s usage pattern would determine \nthe timing and volume of the assets’ usage. For example, Customer determines when to transmit data \nand how mu ch data is stored or transmitted. \nThe analysis as to which party has the right to control the use of an asset requires judgment. It may be \nappropriate to follow the principle in this example when the following circumstances are present: \n□The supplier uses multiple assets to fulfill its obligations to the customer.\n□The assets have more than one capability (i.e., each asset can perform several tasks).\n□The assets’ capabilities overlap, such that the supplier can make genuine decisions about how t o\ndeploy the multiple assets to fulfill its overall obligations to the customer. For example,\nthroughout the usage period of the agreement, the supplier could decide whether and when to use\neither Server A or Server B to store data or to run network securi ty tests, and the supplier could\ndecide whether and when to reconfigure Servers A or B to enhance efficiency.\n□The supplier’s decisions are not subordinate to the customer’s explicit or implicit approval. For\nexample, if the customer’s usage pattern could i mpede the supplier from exercising its decisions\nabout which of the multiple assets could be used to perform a particular task, the supplier may not\nhave the substantive right to direct the use of that asset. Accordingly, this example would more\nlikely app ly when the supplier uses the assets to fulfill a broader promise to the customer (as\nopposed to when the customer is contracting for the direct output of the particular asset).\nWhen these circumstances do not exist, an entity should consider whether the a rrangement more \nclosely resembles the contract to purchase electricity on an on -demand basis in Example LG 2 -9. \nWe believe this example was written to demonstrate only the particular decision as to which party has \nthe right to direct the use of an asset; it does not address whether there are other components within \nan arrangement that should be accounted for as lease components. For example, the servers in the ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 44}), Document(page\_content='Scope \n2-28example may not be leased, but a different conclusion might be reached for the communication \nequi pment (e.g., modems, routers) within the arrangement. \n2.4 Separating lease and nonlease components \nLease contracts may contain nonlease components that should be accounted for using other accounting \nmodels (e.g., common area maintenance or services such as se curity). Only the components that are \nintegral to the right to use an underlying asset are considered lease components. ASC 842 requires a \nreporting entity to allocate the contractual consideration between components of the arrangement. \nDistinguishing betw een lease and nonlease components is also important because it is not always \nappropriate to record assets and liabilities associated with the nonlease components. \nLessors and lessees follow different allocation methods among the components. For example, b y \ngranting a customer the right to use an asset, a supplier is performing a revenue generating activity \nand the recognition should be consistent with the framework in ASC 606. A customer using that asset \nwould not follow revenue recognition guidance. \nThis section discusses: \n□How to identify separate lease and nonlease components\n□How to allocate consideration to the components for a lessor and a lessee\nIf two or more arrangements are entered into at the same time, ASC 842 -10-25-19 provides guidance \nregarding whether those contracts should be considered together. \nIf contracts are combined based on the criteria in ASC 842 -10-25-19, the conclusion regardin g \nwhether the arrangement is or contains a lease could be different than assessing each contract \nindividually. Any component considered to be a lease element, regardless of whether it is in an \nindividual or combined contract, should be classified, recogniz ed, and measured in accordance with \nthe guidance in ASC 842. \nWhen analyzing a contract that contains multiple pieces of equipment, a customer should consider \nwhether the arrangement contains one lease component or more than one. See LG 2.5 for information \nregarding the accounting for multiple units of account within a lease that are all deemed to be separate \nlease components. \n2.4.1 Identifying lease and nonlease components \nContracts may involve payments for lease components, nonlease components, and items that ar e not \nconsidered contract components. The identification of these elements is important because \nconsideration in the contract (as defined in ASC 842) is allocated only to the lease and nonlease \ncomponents. \nTo be considered a component, an activity must tra nsfer a good or service. The transfer of the right to \nuse an asset in a leasing arrangement is considered a component similar to the delivery of an asset or \nproviding services. \nLease components are elements of the arrangement that provide the customer wit h the right to use an \nidentified asset. The right to use an underlying asset is a separate lease component if (1) the lessee can ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 45}), Document(page\_content='Scope \n2-29benefit from the right to use the underlying asset either on its own or together with other resources \nthat are readily availabl e, and (2) the right to use the underlying asset is neither highly dependent on \nnor highly interrelated with other rights to use other underlying assets in the arrangement. \nNot all activities related to a lease are subject to the guidance in ASC 842. For example, a supplier may \nlease a truck and also operate the leased asset on behalf of a customer (i.e., provide a driver). The \nservice of providing a driver is not related to securing the use of the truck and is not a lease \ncomponent. Only items that contri bute to securing the output of the asset are lease components. In \nthis example, only the use of the truck is considered a lease component. Similarly, costs incurred by a \nsupplier to provide maintenance on an underlying asset, as well as the materials and s upplies \nconsumed as a result of the use of the asset, are not lease components. \nNonlease components are distinct elements of a contract that are not related to securing the use of the \nleased asset . Arrangements that include both lease and nonlease compone nts are common in real \nestate transactions. For example, if the landlord/lessor of a property provides common area \nmaintenance (CAM) of leased office space , such as cleaning and landscape services, the CAM involves \ndelivery of a separate service and is not considered a cost of securing the office building . As such, it is \nconsidered a nonlease component . \nNonlease services can be included in equipment leases as well. For example, as part of a lease of \nspecialized equipment to a hospital, a medical device sup plier may also provide operational or \nmaintenance services. Even if the equipment is considered a lease, the operational or maintenance \nservices are nonlease components presuming they are distinct (i.e., capable of generating an economic \nbenefit separate f rom the lease of the equipment). See RR 3.3 for additional information. \nExcerpt from ASC 842 -10-15-30 \nComponents of a contract include only those items or activities that transfer a good or service to the \nlessee. Consequently, the following are not compone nts of a contract and do not receive an allocation \nof the consideration in the contract: \na.Administrative tasks to set up a contract or initiate the lease that do not transfer a good or service\nto the lessee\nb.Reimbursement or payment of the lessor’s costs. For example, a lessor may incur various costs in\nits role as a lessor or as owner of the un derlying asset. A requirement for the lessee to pay those\ncosts, whether directly to a third party or as a reimbursement to the lessor, does not transfer a\ngood or service to the lessee separate from the right to use the underlying asset.\nCosts related to property taxes and insurance do not involve the transfer of a good or service and \naccordingly are not contract components. As such, these costs do not represent payments for goods \nand services and are simply part of total consideration. Payments for proper ty taxes that are levied \nbased on legal ownership (i.e., regardless of which party uses the asset) and insurance when a lessor is \nthe primary beneficiary of the insurance policy would be incurred by the lessor of the underlying asset \nwhether or not the und erlying asset is leased. Although these payments may be based on a specific \nunderlying (e.g., real estate taxes), they do not represent components and instead simply reflect \nanother form of consideration under the contract. Such amounts are allocated to th eir lease and \nnonlease components following the guidelines described in LG 2.4.2 and LG 2.4.3 . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 46}), Document(page\_content='Scope \n2-30ASC 842 requires lessors to record gross revenues and expenses associated with activities or costs that \ndo not transfer a good or service to t he lessee (e .g., real estate taxes, insurance) when such amounts \nare paid by th e lessor and subsequently reimbur sed by the lessee, because the costs are the lesso r’s \ncosts of owning the asset. This will result in many lessors recording higher gr oss revenues and \nexpenses than they did under the previous leasing guidance. \nSee FSP 14 for additional discussion of presentation requirements under ASC 842. \nASC 8 42-10-15-39A requires lessors to exclude l essor costs from variable payments (and, therefore, \nfrom variable lease revenue), when th e costs are required to be paid by a lessee directly to a third \nparty. \nThe guidance also permit lessors, as an accounting policy election, to not evaluate whethe r certain \nsales taxes and other simila r taxes are costs of the lessor or costs of the lessee. Instead, lessors should \naccount for those amounts as if they were costs of the lessee and sh ould exclude the amounts from \ncontract consideration. \nFigure LG 2-3 illustrates common examples of lease compo nents, nonlease components, and items \nthat would not be considered contract components. The nature of payment for each of the items may \nbe fixed, variabl e (e.g., based on a third-party invoic e), or a combination of fixed and variable (e.g., a \nfixed amoun t adjusted for future price changes). The n ature of the payment doe s not dictate the \ndetermination of whether the item is a component. \nFigu re LG 2-3 \nExamples of components and non-components \nExamples of lease \ncomponents □Building\*\n□Land\*\n□A piece of equipment\nExamples of nonlease \ncomponents □Operating the leased asse t on behalf of the lessee\n□Training lessee personnel to operate the asset\n□Repair or maintenance of the leased asset\n□Security services\n□Consumables/supplies\n□Management services\nExamples of non -\ncomponents □Administrative tasks to initiate the lease\n□Reimbursement of lessor’s costs (including property taxes,\ninterest , and insurance)\n\*See LG 2.5 for evaluation of contracts that relate to buildings and land.\n2.4.2 Determining contract consideration \nOnce lease and nonlease components have been identified, the next step is to determine contract \nconsideration to be allocated to the identified components. Not all payments will be included in ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 47}), Document(page\_content='Scope \n2-31contract consideration . ASC 842 -10-15 provides guidance for det ermining what to include in contract \nconsideration for both lessors and lessees. \nASC 842 -10-15-35 \nThe consideration in the contract for a lessee includes all of the payments described in paragraph 842 -\n10-30-5, as well as the following payments that will b e made during the lease term:\na.Any fixed payments (for example, monthly service charges) or in substance fixed payments, less\nany incentives paid or payable to the lessee, other than those included in paragraph 842 -10-30-5\nb.Any other variable payments that d epend on an index or a rate, initially measured using the index\nor rate at the commencement date.\nASC 842 -10-15-39 \nThe consideration in the contract for a lessor includes all of the amounts described in paragraph 842 -\n10-15-35 and any other variable payment amounts that would be included in the transaction price in\naccordance with the guidance on variable consideration in Topic 606 on revenue from contracts with\ncustomers that specifically relates to either of the following:\na.The lessor’s efforts to transfer one or more goods or services that are not leases\nb.An outcome from transferring one or more goods or services that are not leases .\n2.4.3 Allocatin g consideration to lease and nonlease components \nOnce contract consideration has been determined, it needs to be allo cated to the lease and nonlease \ncomponents. ASC 842 -10-15-28 through ASC 842 -10-15-42 provide guidance for lessees and lessors \non how to allocate contract consideration once all contract components have been identified. \nFigure LG 2 -4 and Figure LG 2-5 sum marize how certain payments are treated in determining \ncontract consideration and allocating it to lease and nonlease components for lessors and lessees. \nFigure LG 2-4 \nDetermining and allocating contract consideration - lessor \nPayment type Include in consideration Allocation to components \nFixed payment Yes Allocate to lease and nonlease \ncomponents, generally based \non relative standalone price \nVariable payment that depends \non a rate or index, based on the \nrate or index at commencement \ndate Yes Allocate to lease and nonlease \ncomponents, generally based \non relative standalone price ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 48}), Document(page\_content='Scope \n2-32Payment type Include in consideration Allocation to components \nVariable payment not based on \nrate or index that relates \nexclusively to nonlease \ncomponents (see LG 2.4.6.1 for \ndetails) Determine amount of variable \npayments to include using the \nguidance in ASC 606 Allocate to specific nonlease \ncomponents, if doing so results \nin an allocation that is \nconsistent with the allocation \nobjective in ASC 606. \nOtherwise, allocate to all \ncomponents based on relative \nstandalone price \nVariable payments not based \non rate or index that relate to \nlease component, either in part \nor in full (see LG 2.4.6.1 for \ndetails), and changes in \nvariable payments based on a \nrate or index , that occur after \nlease commencement Not include d in consideration \nat lease commencement for \ninitial measurement When variability is eliminated \n(i.e., payment amount is \nknown), allocate on the same \nbasis as the initial allocation of \nconsideration \nSee LG 2.4.4 and LG 2.4.6 .1 for further details on how lessors should apply this guidance. \nFigure LG 2-5 \nDetermining and allocating contract consideration - lessee \nPayment type Include in consideration Allocation to components \nFixed payments Yes Allocate to lease and nonlease \ncomponents, generally based \non relative standalone price \nVariable payments that depend \non an index or rate Yes, using the index or rate at \nthe inception date Allocate to lease and nonlease \ncomponents, generally based \non relative standalone price \nOther variable payments Not included in consideration \nat lease inception for initial \nmeasurement When variability is eliminated \n(i.e., payment amount is \nknown), allocate on the same \nbasis as the initial allocation of \nconsideration \nSee LG 2.4.5 and LG 2.4.6.2 for further details on how lessees should apply this guidance. \n2.4.4 Lessor allocation of contract consideration \nBy satisfying a contract that contains lease and nonlease components, lessors generate revenue. \nTherefore, once the contract c omponents have been identified, it is appropriate for lessors to follow \nthe relevant guidance in ASC 606 to determine how to allocate contractual consideration between the \ncomponents. See RR 5 for guidance on this allocation method. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 49}), Document(page\_content='Scope \n2-332.4.4.1 If an arrangement includes variable consideration, the amount of total consideration allocated to the \nlease and nonlease components may vary based on the nature of the variable payments and the \ncomponents to which they relate . See LG 2.4.6.1 for information. \nComponent practical expedient fo r lessors \nThe guidance in ASC 842-1 0-15-42A allows lessors to elect to aggregate nonlease components that \notherwise would have been accounted for under the revenue recognition standard with the \nassociated lease component, if the following conditions are met: \n□The timing and pattern of transfer for the nonlease component and the associated lease\ncomponent are the same\n□The stand -alone lease component would be classified as an operating lease if accounted for\nseparately\nA lessor reco gnizes revenues under an operating lease over the lease term, generally on a straight -line \nbasis. Therefore, the first condition noted above only appl ies when the performance obligation for the \nnonlease component is also satisfied over time. Refer to RR 6. 3 for more information on performance \nobligations satisfied over time. Also, that condition would only apply if the lease and nonlease \ncomponents would be recognized over identical time periods, i.e., the condition would not apply when \nproviding the compon ents begin s, or end s, at different dates . For example, we do not believe a lessor \ncan apply this expedient to a three -year lease of equipment which includes a one -year maintenance \ncomponent (whereas they may be able to apply this expedient if the maintenan ce contract was also for \nthree years) . \nIf this practical expedient is elected, and the nonlease component is aggregated with the associated \nlease component, the lessor would account for the combined component as follows: \n□If the nonlease components are the predominant characteristic, account for the combined\ncomponent under the revenue standard. In doing so, the lessor would (a) recognize revenue\nconsistent with the method assessed when applying the “timing and pattern of transfer” criterion\nto use the exped ient and (b) account for all variable payments, including those related to the lease,\nunder the revenue guidance.\n□If the nonlease components are not the predominant characteristic, account for the combined\ncomponent as an operating lease under the leases s tandard. All variable payments, including those\nrelated to any good or service , would be accounted for as variable lease payments.\nLessors will need to ap ply judgment to determine the predominant characteris tic of the com bined \ncompon ent. The lessor should conside r whethe r the lessee wou ld ascribe more value t o the non-lease \ncomponent in the arrangemen t. We believe that often, the predominant characteristic will be readily \ndiscernable and could be determined qualitatively. When that is not the case, a lessor may need to \nevaluate the arrangement quantitativel y to conclude that the nonlease component is predominant. \nIf elected, the practical expedient will need t o be applied to all contracts that qual ify for the practical \nexpedient as of the date of the election. \nSee LG 3.3.4 for considerations for applying this practical expedient when assessing lease \nclassification. See LG 9 for further discussion of applying this practical expedient during transition. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 50}), Document(page\_content='Scope \n2-342.4.5 Lessee allocation of contract consideration \nASC 8 42 provides guidance for lessees to allocate contractual consideration between multiple \ncomponents. Consistent with other allocation models, such as the revenue recognition model in ASC \n606, this guidance emphasizes maximizing the use of observable inputs. \nASC 842 -10-15-33 \nA lessee shall allocate (that is, unless the lessee makes the accounting policy election described in \nparagraph 842 -10-15-37) the consideration in the contract to the separate lease components \ndetermined in accordance with paragraphs ASC 842-10-15-28 through 15 -31 and the nonlease \ncomponents as follows: \na.The lessee shall determine the relative standalone price of the separate lease components and the\nnonlease components on the basis of their observable standalone prices. If observable stan dalone\nprices are not readily available, the lessee shall estimate the standalone prices, maximizing the use\nof observable information. A residual estimation approach may be appropriate if the standalone\nprice for a component is highly variable or uncertai n.\nb.The lessee shall allocate the consideration in the contract on a relative standalone price basis to\nthe separate lease components and the nonlease components of the contract.\nInitial direct costs should be allocated to the separate lease components on the same basis as the lease \npayments . \nEstimating standalone prices will require judgment when identical goods or services are not readily \navailable in the marketplace. Assets do not need to be identical for their inputs to be considered \nobservable. Inputs are not required to be supplier specific or identical; similar leased products in the \nmarket can be useful observable data points provided the information is both consistent and \ncomparable. For example, a lessee may be able to estimate market rents for a new lease from similar, \nthough not identical, lease arrangements , by estimating the impact of the differences between the two \narrangements. A good or service that is unique to a supplier may not have market comparisons. In this \ncircumstance, a lessee should gather as much information from the supplier regarding their basis for \nestablishing the price in the arrangement. While knowing an asset ’s sale price may provide the lessee \nhelpful information, the allocat ion of consideration should be based on the standalone price of the \nright -of-use asset, not the standalone price of the underlying asset . \nA lessee should maximize the use of observable data and utilize the best available information to \ndetermine its alloc ation. Estimates are permitted when necessary, but only if observable standalone \npricing or observable inputs are not available. Estimates must be applied consistently across similar \narrangements and like assets. If an arrangement includes variable conside ration, whether the variable \nconsideration is included in total contract consideration and allocated to the lease and nonlease \ncomponents depends on the nature of the variable payments. See LG 2.4. 6 for information. \nQuestion LG 2 -3 addresses how a lessee should allocate payments for property taxes and insurance. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 51}), Document(page\_content='Scope \n2-35Question LG 2-3 \nShould a lessee that pays property taxes and insurance for an underlying asset directly to the billing \nauthority include those payments in its computation of contract consideration to be allocated to \ncomponents of the contract? \n2.4.5.1 \n2.4.5.2 PwC response \nIncluding payments m ade by a lessee fo r property taxes and insurance in contract consideration will \ndepend on whet her the lessee is required to pay a fixed or variable amount. \nIf a lessee is required to pay a fixed amount of property taxes and insurance related to the leased asset, \nsuch payments should be included in contract consideration and allocated to the lease and nonlease \ncomponents. I f a lessee is required to pay the actual amounts f or property taxes and insurance (i.e., a \nvariable amount rather than fixed payments) such payments should be excluded from contract \nconsideration and instead recorded as incurred by th e lessee. Whe n recorded, the variable amounts \nwould be allocated to the lease and nonlease components on the same basis as the initial allocation of \ncontract consideration. \nIf a lessee is required to pay f or property taxes and insurance, it does not matte r whethe r the lessee \ndirectly pays a third party on the lessor’s behalf or reimb urses the lessor. Insurance and property taxes \non the underlying asset are not separate lease or non-lease componen ts. The lessee should account for \nsuch payments as additional consideration in the arrangement, subject to allocation, and not as \ninsurance or property tax expense. Se e LG 2.5 f or additional information. \nComponent practical expedient fo r lessees \nA lessee may elect an accounting policy, by asset class, to include both the l ease and nonlease \ncomponents as a single component and accoun t for it as a lease. Making t his election relieve s the \nlessee of the obligation to allocate contract consideration to the lease and nonlease components, \nalthough it may increase the total lease liability to be recorded on its balance sheet. Refer to LG 9 for \nfurthe r discussion of applying this practical expedi ent during transition. \nIn descri bing the rationale for this practical expedient, paragrap hs BC149 and BC 150 of the Basis for \nConclus ions to ASU 2016-02 indicate that the Board focused on whet her lesse es should separate \nservices fr om lease components. It is unclear whether the Boa rd intended to allow lessee s to combine \npurchases of other goods that are not services (e.g., inventory), with lease components. We believe a \nlessee applying t his practical expedien t should combine the nonlease component only when it would \notherwise recognize the cost associat ed with both the lease and nonlease components in a similar \nfashion (i. e., either when both are capitalized or when both are expensed). For example, in a contract \nmanufacturing arrangement, a lessee could combine the procurement of raw materials and the lease of \nproduction equipment when both components are included in the lessee’s inven tory costing system \nand capitalized int o the measurement of inventory costs. Howev er, we do not believe a lessee should \ncombine, f or example, chemicals purchased for resale into the lease of a pipeline from the chemical \nsupplier, as doing so would distort the lessee’s reporting of inventory and cost of sales. \nAccounting effec ts of a lessee elec ting the com ponent practical expedient \nElectin g the practical expedient to combine lease and associated nonlease components as a single lease \ncomponent has additio nal accounting effects f or the lessee . This election wil l increase payments ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 52}), Document(page\_content='Scope \n2-36allocated to the lease components but it does not change the fair value used for classifying the \nunderlying asset. As such , the election increases the possibility that the lease would be classified as a \nfinance lease under the lease payment s criterion. \nWith the adoption of ASC 842, the guidance in ASC 420 -10, Exit or Disposal Cost Obligations, was \nmodified to remove leases from its scope. While ASC 420 -10 continues to apply to costs to terminate a \ncontract that is not a lease, it would not apply to nonlease components that the lessee has elected to \ncombine with lease components under the lessor expedient . See PPE 6.4.3 and PPE6.4.3A for more \ninformation on the application of ASC 420 on contract termination costs related to leases. \n2.4.6 Allocation of variable consideration \nThe allocation models for variable considera tion are intended to incorporate the allocation concepts in \nASC 606 while preserving the accounting model applicable to variable lease payments in ASC 842. The \nkey difference between the two models is that variable payments, other than those that depend on an \nindex or rate, are recognized under ASC 842 only as they are earned. In contrast, variable \nconsideration under ASC 606 is estimated (subject to a constraint) and included in the initial \nallocation of consideration. The discussion below highlights how to deal with this difference when an \narrangement includes lease and nonlease components. \nAs discussed in LG 2.4.1, before determining how to allocate consideration, it is imp ortant for lessees \nand lessors to identify the contract components. Variable consideration for costs that are not contract \ncomponents (e.g., real estate taxes, insurance) are excluded from total consideration and would be \nrecorded as incurred by the lessee . ASC 842 -10-15-40A clarifies the accounting by lessors for variable \npayments that relate to both a lease and a nonlease component. The amendment require s lessors to \nallocate certain variable payments to the lease and nonlease components when the changes i n facts \nand circumstances on which the variable payment is based occur. After the allocation, the amount of \nvariable payments allocated to the lease component would be recognized in profit or loss in \naccordance with the leases guidance, and the amount of v ariable payments allocated to nonlease \ncomponents would be recognized in accordance with other guidance, such as the revenue recognition \nguidance. \n2.4.6.1 Allocating variable consideration for lessors \nFigure LG 2-4 summarizes the allocation of consideration for l essors . When determining contract \nconsideration for lease and nonlease components, variable payments not based on an index or a rate \nshould only be considered provided they relate solely to nonlease goods and services. If they do, the \nvariable payments sho uld be estimated and, provided they meet the transaction price allocation \nobjective specified in ASC 606, allocated to the nonlease components. \nIf, however, the variable payments relate even partially to the lease component, they are recognized \nwhen the un derlying variability is resolved and are allocated to the lease and nonlease components on \nthe same basis as the initial allocation of consideration. A lessor would recognize the amount allocated \nto lease components in accordance with the guidance in ASC 8 42, and the amount allocated to \nnonlease components in accordance with other applicable literature (typically ASC 606). ASC 842 -10-\n15-39 through ASC 842 -10-15-40A provide guidance on allocating variable payments to nonlease\ncomponents.', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 53}), Document(page\_content='Scope \n2-37ASC 842 -10-15-39 \nThe consideration in the contract for a lessor includes all of the amounts described in paragraph 842 -\n10-15-35 and any other variable payment amounts that would be included in the transaction price in\naccordance with the guidance on variable consideration in Topic 606 on revenue from contracts with\ncustomers that specifically relate s to either of the following:\na.The lessor’s efforts to transfer one or more goods or services that are not leases\nb.An outcome from transferring one or more goods or services that ar e not leases.\nAny variable payment amounts accounted for as consideration in the contract shall be allocated \nentirely to the nonlease component(s) to which the variable payment specifically relates if doing so \nwould be consistent with the transaction pric e allocation objective in paragraph ASC 606 -10-32-28. \nASC 842 -10-15-39A \nA lessor may make an accounting policy election to exclude from the consideration in the contract and \nfrom variable payments not included in the consideration in the contract all taxes assessed by a \ngovernmental authority that are both imposed on and concurrent with a specific lease revenue -\nproducing transaction and collected by the lessor from a lessee (for example, sales, use, value added, \nand some excise taxes). Taxes assessed o n a lessor’s total gross receipts or on the lessor as owner of the \nunderlying asset shall be excluded from the scope of this election. A lessor that makes this election \nshall exclude from the consideration in the contract and from variable payments not inc luded in the \nconsideration in the contract all taxes within the scope of the election and shall comply with the \ndisclosure requirements in paragraph 842 -30-50-14. \nASC 842 -10-15-40 \nIf the terms of a variable payment amount other than those in paragraph 842 -10-15-35 relate to a lease \ncomponent, even partially, the lessor shall not recognize those payments before the changes in facts \nand circumstances on which the variable payment is based occur (for example, when the lessee’s sales \non which the amount of the variable payment depends occur). When the changes in facts and \ncircumstances on which the variable payment is based occur, the lessor shall allocate those payments \nto the lease and nonlease components of the contract. The allocation shall be on the same ba sis as the \ninitial allocation of the consideration in the contract or the most recent modification not accounted for \nas a separate contract unless the variable payment meets the criteria in paragraph 606 -10-32-40 to be \nallocated only to the nonlease compon ent(s). Variable payment amounts allocated to the lease \ncomponent(s) shall be recognized as income in profit or loss in accordance with this Topic, while \nvariable payment amounts allocated to nonlease component(s) shall be recognized in accordance with \nother Topics (for example, Topic 606 on revenue from contracts with customers). \nASC 842 -10-15-40A \nThe guidance in paragraph 842 -10-15-40 notwithstanding, a lessor shall exclude from variable \npayments lessor costs paid by a lessee directly to a third party. H owever, costs excluded from the \nconsideration in the contract that are paid by a lessor directly to a third party and are reimbursed by a \nlessee are considered lessor costs that shall be accounted for by the lessor as variable payments (this \nrequirement do es not preclude a lessor from making the accounting policy election in paragraph 842 -\n10-15-39A).', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 54}), Document(page\_content='Scope \n2-38In light of the different models applicable to lease - and nonlease -related variable consideration, the \nfirst step in accounting for variable lease payments is to determine whether the payments relate, even \npartially, to a lease element. To do this, we believe it would be appropriate to analyze the factors that \ndrive the variability of the payments. To practically analyze this, the factors that determine the amou nt \nand whether the variable payment is made should be understood. These factors could be physical \nfactors, such as machine hours, equipment usage time, or number of items sold. They could also be \nbased on economic factors, such as sales revenues and profit s. \nIf it is determined the variable payments relate partially or fully to the lease component, the variable \npayments are excluded from the allocation for initial measurement. They are instead subsequently \nallocated between the lease and nonlease component s when the underlying event occurs and then \nrecognized in accordance with ASC 842 -10-15-40. Variable payments that are exclusively related to the \nnonlease component are included in the allocation for initial measurement. \nIf allocating the variable consideration entirely to the nonlease component is consistent with the \ntransaction price allocation objective in ASC 606, the variable payment should be allocated entirely to \nthe nonlease component. The transaction price allocation objective is explained in ASC 606 -10-32-28 \nthrough ASC 606 -10-32-29, and ASC 606 -10-32-40. \nASC 606 -10-32-28 \nThe objective when allocating the transaction price is for an entity to alloca te the transaction price to \neach performance obligation (or distinct good or service) in an amount that depicts the amount of \nconsideration to which the entity exp ects to be entitled in exchange for transferring the promised \ngoods or services to the customer . \nASC 606 -10-32-29 \nTo meet the allocation objective, an entity shall allocate the transaction price to each performance \nobligation identified in the contract on a relative standalone selling price basis in accordance with \nparagraphs 606-10-32-31 through 32 -35, except as specified in paragraphs 606-10-32-36 through 32 -\n38 (for allocating discounts ) and paragraphs 606-10-32-39 through 32 -41 (for allocating consideration \nthat includes variable amounts). \nASC 606 -10-32-40 \nAn entity shall allocate a variable amount (and subsequent changes to that amount) entirely to a \nperformance obligation or to a distinct good or service that forms part of a single performance \nobligation in accordance with paragraph 606-10-25-14(b) if both of the following criteria are met: \na.The terms of a variable payment relate specifically to the entity’s efforts to satisfy the performance\nobliga tion or transfer the distinct good or service (or to a specific outcome from satisfying the\nperformance obligation or transferring the distinct good or service).\nb.Allocating the variable amount of consideration entirely to the performance obligation or the\ndistinct good or service is consistent with the allocation objective in paragraph 606-10-32-\n28 when considering all of the performance obligations and payment terms in the contract.', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 55}), Document(page\_content='Scope \n2-39If the transa ction price allocation objective is not met, the variable payment should be included in the \ninitial contract consideration and allocated to the lease and nonlease components based on their \nrelative standalone selling prices. \nIt is commo n for suppliers in certai n industries to structure transactions with significant variable \npayments . Suppliers in these indus tries are willing to accept variability in payments because they \nbelieve such arr angements will be profitable overall, and variable payments can make an arrangement \nattra ctive to the custom er. In certain instances, transactions with significant variable payments may \nqualify as a transfer o f control unde r ASC 606 an d may also meet the classification criteria a s a sales-\ntype leas e in accordance with ASC 842- 10-25-2 throu gh ASC 842 -10-25-3 (see LG 3.3 for lease \nclassification criteria). In these instances, the leases stan dard should be applied. Under ASC 842, \nvariable payments that do not depend on an index or rate and are at least partially relate d to the lease \nasset, are no t considered unt il the contingency is resolved. T his may lead to the recognition o f an \ninitial loss by the lessor (even if the overall arrangement is expected to be profitable). The discount \nrate used to record a lease receivable cannot be less than zero. As such, a lessor would not be permitted \nto use a rate less than zero to avoid recognition of an initial loss. In response t o concerns raised in the \npost implementation review, the FASB publishe d ASU 2021- 05, which upon adoption requires a lessor \nto classify a lease with variabl e lease payments (that do not d epend on an inde x or a rate) as an \noperating lease at the lease commencement date if classifying the lease as a sales-type lease (or direct \nfinancing lease) would result in recognition of a selling loss. See LG 9.10 for the effective date and \ntransition requirements of ASU 2021-05. \nFigure LG 2-6 illustrates the decision process f or the allocation of variable consideration for lessors . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 56}), Document(page\_content='Scope \n2-40Figure LG 2-6 \nLessor allocation of variable consideration \nExample LG 2-14, Example LG 2-15 and Example LG 2-16 illustrate how to allocate variable \nconsideration between lease and nonlease components. Figure LG 2 -7 summarizes the key distinctions \nbetween the facts and conclusions in each example. \nEXAMPLE LG 2 -14 \nVariable consideration is excluded from allocation – contract for sale of medical equipment and \nconsulting services (sales -type lease) \nCustomer Co, a medical facility, contracts with Supplier Corp to lease specialized medical equipment \nover a five -year period. Prior to leasing the specialized medical equipment from Supplier Corp, \nCustom er Co treated 5,000 patients per year using an older version of the equipment. Supplier Corp \n', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 57}), Document(page\_content='Scope \n2-41asserts that the new medical equipment is more efficient than the older version and will allow \nCustome r Co to treat additional patients . \nSupplier Corp will also provide consulting services to assist Customer Co with optimizing operations \nand reduc ing inefficiencies at its medical facility. Supplier Corp believes that the consulting services \nwill both reduc e costs and further increase the number of patients Customer Co can treat using the \nnew equipment. The number of hours Supplier Corp will provide each year as part of these consulting \nservices is fixed at inception of the contract . \nThe parties agree that C ustomer Co will make fixed annual payments of $400,000 and will make an \nincremental payment based on the number of patients treated using the new equipment. Specifically, \nfor each patient treated in excess of an established threshold of 6,000 per year, Cus tomer Co will make \nan incremental payment to Supplier Corp of $100 per patient. \nSupplier Corp believes that Customer Co will treat 7,000 patients each year, and therefore will be \nrequired to make an incremental payment of $100,000 (1,000 patients in exces s of threshold × $100 \nper patient) per year. Total expected annual payments are $500,000 ($400,000 fixed + $100,000 \nvariable ). \nSupplier Corp expects that even without the consulting services, Customer Co would realize a \nsignificant increase in the number of patients it could treat as a result of the new, more efficient \nequipment and would be required to make at least part of the incremental payment. \nThe medical equipment has a useful life of five years and is not expected to have a residual value at the \nend of the lease term. The lease of the medical equipment has met the classification criteria as a sales -\ntype lease since the lease term is for a major part of the useful life of the asset. \nThe standalone selling price of the equipment is $2,000,000 (cost b asis of $1,900,000) and the \nstandalone selling price for the consulting services is estimated to be $26,000 per year. \nIn the first year of the arrangement, Customer Co treats 7,000 patients using the new equipment. \nSupplier Corp has adopted ASU 2021 -05. \nSupplier Corp has elected not to aggregate lease and nonlease components in accordance with ASC \n842-10-15-42A.\nHow should Supplier Corp account for this arrangement at lease commencement and in the first year? \nAnalysis \nThe equipment lease and consulting s ervices are separate lease and nonlease components, \nrespectively. The variable payments do not depend on an index or rate. In addition, Supplier Corp \nbelieves that it will be entitled to at least part of the variable payments regardless of whether the \ncons ulting services are provided. Therefore, the variable payments relate, at least partially, to the lease \ncomponent. Consequently, the variable consideration should be excluded from the allocation of \nconsideration used for initial measurement, and will be al located to both the lease and nonlease \ncomponents when the underlying event occurs. \nAn allocation of the fixed payment over the term of the lease would be made as follows: ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 58}), Document(page\_content='Scope \n2-42Standalone \nprice \n(A) Relative % \n(A/$2,130,000) \n(B) Fixed Payments \n($400,000 × 5 \nyears) (C) Allocated \npayment \n(B × C) \nMedical \nequipment $2,000,000 93.9% $2,000,000 $1,877,934 \nConsulting \nservices \n(5 years) 130,000 6.1% $2,000,000 122,066 \nTotal $2,130,000 100% $2,000,000 \nAt the lease commencement date , because the variable payments that do not depend on an index or \nrate should be excluded from the allocation of consideration used for initial measurement , Supplier \nCorp would incur a net loss since allocated payments are lower than the cost basis of the eq uipment \n(allocated payment of $1,877,934 is less than the cost basis of $1,900,000) . In light of the day -one \nloss, Supplier Corp would classify and account for the lease as an operating lease in accordance with \nASU 2021 -05. \nIn the first year of the arrangement, Supplier Corp would allocate the fixed and variable payments of \n$500,000 ($400,000 fixed and $100,000 variab le) based on the relative standalone selling price of \nthe lease and nonlease components at lease inception , as shown below. \nRelative % Fixed payment \nallocated Variable \npayment \nallocated Total allocated \npayment \nMedical equipment 93.9% $375,587 $93,897 $469,484 \nConsulting services \n(5 years) 6.1% 24,413 6,103 30,516 \nTotal $400,000 $100,000 $500,000 \nFixed payments allocated to the medical equipment lease would be recognized in accordance with ASC \n842, typically on a straight -line basis . Since the lease is classified as operating lease , the a nnual \nstraight -line lease income attributable to the medical equipment lease is $375,587 ($1,877,934 /5). \nFixed payments allocated to the consulting services would be recognized using the guidance in ASC \n606. Variable payments would be recognized pursuant to the guidance in ASC 842 -10-15-40 when the\nvariability is re solved .\nEXAMPLE LG 2-15 \nVariable consideration is included in the allocation – contract for sale of medical equipment and \nconsulting services (sales -type lease) \nCustomer Co, a medical facility, contracts with Supplier Corp to lease specialized medical equipment \nover a five -year period. Prior to leasing the specialized medical equipment from Supplier Corp, \nCustom er Co treated 5,000 patients per year using an older version of the equipment. Supplier Corp \nbelieves that the new equipment will provid e for better patient care, but it is not expected to \nsignificantly impact the number of patients that Customer Co can treat. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 59}), Document(page\_content='Scope \n2-43Supplier Corp will also provide consulting services to assist Customer Co with optimizing operations \nand reduc ing inefficiencies at its medical facility. Supplier Corp believes that the consulting services \nwill both reduce costs and further increase the number of patients Customer Co can treat using the \nnew equipment. The number of hours Supplier Corp will provide each year as part of these consulting \nservices is fixed at inception of the contract . \nThe parties agree that Customer Co will make fixed annual payments of $400,000 and will make an \nincremental payment based on the number of patients treated using the new equipment. Specifica lly, \nfor each patient treated in excess of an established threshold of 6,000 per year, Customer Co will make \nan incremental payment to Supplier Corp of $100 per patient. Increases in the number of patients \nCustomer Co can treat will result primarily from the optimization of processes as a result of the \nconsulting services. A bsent those services , it is unlikely that the 6,000 patient threshold would be met . \nSupplier Corp believes that Customer Co will treat 7,000 patients each year, and therefore will be \nrequired to make an incremental payment of $100,000 (1,000 patients in excess of threshold × $100 \nper patient) per year. Total expected annual payments are $500,000 ($400,000 fixed + $100,000 \nvariable ). \nThe medical equipment has a useful life of five years a nd is not expected to have a residual value at the \nend of the lease term. The lease of the medical equipment has met the classification criteria as a sales -\ntype lease since the lease term is for a major part of the useful life of the asset. \nThe standalone selling price of the equipment is $2,000,000 (cost basis of $1,900,000) and the \nstandalone selling price for the consulting services is estimated to be $26,000 per year. \nIn the first year of the arrangement, Customer Co treats 7,000 patients using the new equipment. \nThe Company has adopted ASU 2021 -05. \nHow should Supplier Corp account for this arrangement at lease commencement and in the first year? \nAnalysis \nThe equipment lease and consulting services are separate lease and nonlease components, \nrespectively. The variable payments relate exclusively to the nonlease component. \nIn this example, Supplier Corp concludes that the variable payments relate spe cifical ly to an outcome \nfrom Supplier Corp’s performance of its consulting services. Therefore, Supplier Corp evaluates the \npayments in accordance with ASC 606-10-32-5 through ASC 606-10-32-13. Supplier Corp estimates, \nusing the most likely amount method, that (a) it will be entitled to receive the $500,000 in variable \npayments and (b) it is probable that including this amount in the transaction price will not result in a \nsignificant revenue reversal , the $500,000 would be included in consideration in the contract . \nSupplier Corp allocates the variable payments to the lease and nonlease components based on relative \nstandalone selling price, as the transaction price allocation objective is not met (please refer to \nExample LG 2 -16 for an example of how to allocate con sideration when the transaction price allocation \nobject ive in ASC 606 -10-32-28 is met) . See RR 5 for information on allocating variable consideration. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 60}), Document(page\_content='Scope \n2-44Standalone \nprice \n(A) Relative % \n(A/$2,130,00\n0) \n(B) Fixed \nPayments \n($400,000 × 5 \nyears) \n(C) Variable \nPayments \n($100,000 × \n5 years) \n(D) Total \nAllocated \npayment \nB × (C + D) \nMedical \nequipment $2,000,000 93.9% $2,000,000 $500,000 $2,347,500 \nConsulting \nservices (5 \nyears) 130,000 6.1% $2,000,000 $500,000 $152,500 \nTotal $2,130,000 100% $2,500,000 \nThe total allocated lease payments are $2,347,500. The annual payments attributable to the lease \ncomponent are $469,500 ($2,347,500/5). For simplicity, it is presumed that all annual lease \npayments, including the expected variable consideration, are receiv ed at the beginning of each year of \nthe lease. The rate implicit in the lease was determined to be 8.72% and the lease receivable is \n$2,000,000 . \nSince the lease with variable payments meets the classification criteria as a sales -type lease and does \nnot re sult in day -one loss , Supplier Corp would classify and account for th is lease as a sales -type lease. \nThe adoption of ASU 2021 -05 does not impact the accounting model since the arrangement does not \ngive rise to a day -one loss. Supplier Corp would remove the asset from its balance sheet and record a \nreceivable equal to the present value of the lease payments calculated using the rate implicit in the \nlease . \nSupplier Corp would r ecord the following journal entry on the lease commencement date . \nDr. Lease receivable $2,000,000 \nDr. Cost of sales $1,900,000 \nCr. Revenue $2,000,000 \nCr. Medical equipment asset $1,900,000 \nIn the first year of the arrangement, Supplier Corp would allocate the total $500,000 payment based \non the relative standalone selling price of the lease and nonlease components at lease inception . \nRelative % \n(A) Payment \n(B) Allocated lease payment \n(A × B) \nMedical equipment 93.9% $500,000 $469,500 \nConsulting services \n(5 years) 6.1% $500,000 30,500 \nTotal 100% $500,000 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 61}), Document(page\_content='Scope \n2-45At the beginning of the first year of the arrangement, Supplier Corp would record the following entry \nto record receipt of the fixed medical equipment lease payment and variable incremental patient \npayment based on expected patient volume. \nDr. Cash $500,0 00 \nCr. Lease receivable $469,500 \nCr. Deferred service revenue $30,500 \nInterest paid to Supplier Corp at the beginning of year 2 would be accrued during year 1 (via a debit to \nthe lease receivable and credit to interest income). At the beginning of the second year of the \narrangement, Supplier Corp would record the following e ntry to record receipt of the fixed medical \nequipment lease payment, variable incremental patient payment based on expected patient volume, \nand interest on the lease receivable. \nDr. Cash $500,000 \nDr. Lease receivable $133,460 \nCr. Lease receivable $469,500 \nCr. Deferred service revenue $30,500 \nCr. Interest income $133,460 \nEXAMPLE LG 2-16 \nAllocating variable consideration – contract for sale of medical equipment and consulting services \n(sales -type lease) \nCustomer Co, a medical facility, contracts with Supplier Corp to lease specialized medical equipment \nover a five -year period. Prior to leasing the specialized medical equ ipment from Supplier Corp, \nCustom er Co treated 5,000 patients per year using an older version of the equipment. Supplier Corp \nbelieves that the new equipment will provide for better patient care, but it is not expected to \nsignificantly impact the number of patients that Customer Co can treat. \nSupplier Corp will also provide consulting services to assist Customer Co with optimizing operations \nand reduc ing inefficiencies at its medical facility. Supplier Corp believes that the consulting services \nwill both re duce costs and further increase the number of patients Customer Co can treat using the \nnew equipment. The number of hours Supplier Corp will provide each year as part of these consulting \nservices is fixed at inception of the contract . \nThe parties agree tha t Customer Co will make fixed annual payments of $400,000 and will make an \nincremental payment based on the number of patients treated using the new equipment. Specifically, \nfor each patient treated in excess of an established threshold of 6,000 per year, Customer Co will make \nan incremental payment to Supplier Corp of $100 per patient. Increases in the number of patients \nCustomer Co can treat will result primarily from the optimization of processes as a result of the \nconsulting services. A bsent those servi ces, it is unlikely that the 6,000 patient threshold would be met . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 62}), Document(page\_content='Scope \n2-46Supplier Corp believes that Customer Co will treat 7,000 patients each year, and therefore will be \nrequired to make an incremental payment of $100,000 (1,000 patients in excess of threshold × $100 \nper patient) per year. Total expected annual payments are $500,000 ($400,000 fixed + $100,000 \nvariable ). \nThe medical equipment has a useful life of five years and is not expected to have a residual value at the \nend of the lease term. The lease of the medical equipment has met the classification criteria as a sales -\ntype lease since the lease term is for a major part of the useful life of the asset. \nThe standalone selling price of the equipment is $2,000,000 (cost basis of $1,900,000) and the \nstandal one selling price for the consulting services is estimated to be $ 100,000 per year ($500,000 \nover the term of the contract) . \nIn the first year of the arrangement, Customer Co treats 7,000 patients using the new equipment. \nThe Company has adopted ASU 2021 -05. \nHow should Supplier Corp account for this arrangement at lease commencement and in the first year? \nAnalysis \nThe equipment lease and consulting services are separate lease and nonlease components, \nrespectively. The variable payments relate exclusively to the nonlease component (consulting \nservices). \nSupplier Corp determined that it should allocate the variable payments entir ely to the nonlease \ncomponent (consulting services) and the fixed payments entirely to lease component (the equipment \nlease) because doing so would be consistent with the transaction price allocation objective in ASC 606 -\n10-32-28.\nThe fixed payments of $2 ,000,000 ($400,000 × 5 years) would be allocated to the lease component. \nSince the lease meets the classification criteria as a sales -type lease , Supplier Corp would classify and \naccount for this lease as a sales -type lease. The adoption of ASU 2021 -05 doe s not impact the \naccounting model. Supplier Corp would remove the asset from its balance sheet and record a \nreceivable equal to the present value of th ose fixed lease payments. \nSupplier Corp would r ecord the following journal entry on the lease commenceme nt date . \nDr. Lease receivable $2,000,000 \nDr. Cost of sales $1,90 0,000 \nCr. Revenue $2,000,000 \nCr. Medical equipment asset $1,900,000 \nIn the first year of the arrangement, Supplier Corp would allocate the $400,000 fixed lease payment \nentirely to the medical equipment lease and the $100,000 variable payment to the consulting services; \nthe revenue from services provided would be recognized using the guidance in ASC 606. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 63}), Document(page\_content='Scope \n2-47In the first year of the arrangement, Supplier Corp would record the following entry to record receipt \nof the fixed medical equipment lease payment and variable incremental patient payment. \nDr. Cash $500,000 \nCr. Lease receivable $400,000 \nCr. Service revenue $100,000 \nTo record receipt of the fixed medical equipment lease payment and variable incremental patient \npayment \nThis example depicts one fact pattern when the transaction price allocation objective under ASC 606 \nwould be considered met (i.e., stand -alone selling price for the consulting services is equal to the \nexpected variable payment for the services provided under the contract). We believe there are other \nfact patterns when the objective would also be met. Consider a circumstance when the fixed payments \nare $2,250,000 and the expected variable payments are $250,000. Allocating 100% of the variable \npayments and $250,000 of the fixed payments to the consulting services would also meet the \nallocation objective under ASC 606 because the payments allocated to both components of the \ncontract would be consistent with their stand -alone selling prices. \nFigure LG 2-7 \nA comparison of examples LG 2-14 through LG 2-16 \nExample Variable \npayment \ndepend \non a rate \nor index? Variable \npayment \nrelate at least \npartially to \nlease \ncomponent? Allocation of \nfixed payment \nto lease \ncomponent \nand variable \npayment to \nnonlease \ncomponent \nmeet \ntransaction \nprice \nallo cation \nobjective? Fixed \npayment \nallocated to Variable \npayment \nallocated to \nExample \nLG 2 -14 No Yes N/A Both lease \nand nonlease Both lease and \nnonlease, but \nonly upon \noccurrence of \nthe underlying \nevent \nExample \nLG 2 -15 No No No Both lease \nand nonlease Both lease and \nnonlease, at \ncontract \ninception \nExample \nLG 2 -16 No No Yes Lease Nonlease ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 64}), Document(page\_content='Scope \n2-482.4.6.2 Allocating variable consideration for lessees \nA lessee allocates consideration in a contract to lease and nonlease components based on their relative \nstandalone prices. Only consideration that is discussed in ASC 842 -10-15-35 is included in the \nallocable consideration. \nASC 842 -10-15-35 \nThe consideration in t he contract for a lessee includes all of the lease payments described in paragraph \n842-10-30-5, as well as all of the following payments that will be made during the lease term:\na.Any fixed payments (for example, monthly service charges) or in substance fixe d payments, less\nany incentives paid or payable to the lessee, other than those included in paragraph 842 -10-30-5\nb.Any other variable payments that depend on an index or a rate, initially measured using the index\nor rate at the commencement date.\nVariable payments that do not depend on an index or rate should be excluded from lease payments at \nlease commencement for initial measurement. Subsequent to initial measurement, these variable \npayments are recognized when the event determining the amount of variable consideration to be paid \noccurs. However, variable payments that are based on achieving a specified target would be recognized \nat the time the achievement of the target is considered probable in accordance with ASC 842 -20-55-1. \nThese payments, when recogn ized, will be allocated to the lease and nonlease components based on \ntheir relative standalone prices at lease inception . This concept is illustrated in ASC 842 -10-55-140. \nVariable payments that depend on an index or a rate are included in the allocable c onsideration and \nallocated based on the relative standalone prices of the lease and nonlease components. \nThe lessor -specific guidance in ASC 842 -10-15-39, under which a lessor ascribes certain variable \npayments solely to a nonlease component, as illustrat ed in Example LG 2 -16, does not apply to lessees. \nA lessee must allocate all payments to all lease and nonlease components based on their relative \nstandalone prices unless they elect the lessee component practical expedient described in LG 2.4.5.1. \n2.4.7 Lessor accounting for an arrangement that includes a “free” lease \nSuppliers often sell goods to customers in arrangements that require payment only when items are \npurchased , for example, on a per unit basis. Those suppliers may also provide related equipme nt to the \ncustomer at no additional charge. Examples include the following : \n□A supplier of corn flour provides a tortilla maker to its customers for no contractual charge. The\ncustomer pays the supplier only for flour purchased without a minimum purchase o bligation, and\nthere are no other fees in the arrangement.\n□A medical device manufacturer supplies a hospital with medical equipment for no contractual\nconsideration. The equipment can only be used with disposables that the customer must purchase\nfrom the supplier, but the contract contains no minimum purchases.\nIn many such cases, the arrangement contains a lease of the free equipment as evaluated under the \nguidance in ASC 842-10-15. Nonetheless, suppliers have asked whether they are required to allocate ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 65}), Document(page\_content='Scope \n2-49consideration to the “free” lease component . Some have pointed to the definition of lease in the ASC \n842 glossary to support the notion that a “free” lease does not meet the definition of a lease as there is \nostensibly no consideration . \nASC 842 -10 Glossary \nLease \nA contract, or part of a contract, that conveys the right to control the use of identified property, plant, \nor equipment (an identified asset) for a period of time in exchange for consideration . [emphasis \nadded] \nWe believe that a supplier -lessor should generally allocate consideration to all lease and nonlease \ncomponents within an arrangement . The component practical expedient for lessors (refer to LG \n2.4.4.1) would typically not appl y since the pattern of transfer for the equipment would b e at a point in \ntime and the services are performed over time. Notwithstanding this view, we believe it may be \nacceptable to allocate consideration solely to the nonlease component when an arrangement meets all \nof the following conditions: \na.The contract onl y includes variable payments not based on an index or rate; that is, the contract\ncontains no fixed payments (including fixed payments for other services), and no in -substance\nfixed payments (e.g. , minimum purchase requirements, take -or-pay provisions)\nb.The consumables are priced at (or below) their stand -alone selling price\nc.The consumable price would be no different if the equipment were not provided\nd.The “free” equipment is insignificant\nDetermining whether “free” equipment is insignificant will require careful consideration of the rights \nand obligations in the arrangement . For example, a contract that permits the lessor to repossess the \nequipment ( e.g., if a customer default s or fail s to meet supplier purchase or usage expectations ) may \nbe in conflict with an assertion that the equipment is insignificant. If a supplier concludes that the \n“free” lease is insignificant , it would be accounted for as an abandoned asset and written off through \nearnings when control transfers to the customer. Deferri ng and amortizing the cost of the equipment \nover time would be inconsistent with the supplier ’s assertion that the equipment is insignificant. \n2.5 Components within a lease \nLease accounting should be applied at the lowest component. Therefore, after determini ng the lease \nand nonlease components, a reporting entity should consider whether the lease contains more than \none lease component . This is done by identifying the units of account. \nA reporting entity should identif y whether the customer is contracting for a number of separate \ndeliverables or contracting for one deliverable that may incorporat e a number of different assets. This \nanalysis is similar to the one used to determine a performance obligation in ASC 606 . Components of a \ncontract that could be utili zed exclusive of the remainder of the contract components should be \naccounted for separately, as discussed in ASC 842 -10-15-28. Both of the criteria discussed in this \nguidance must be met in order to separate lease components. Note that while these criteri a are ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 66}), Document(page\_content='Scope \n2-50considered when evaluating multiple lease components, they are not considered when determining \nwhether a lease exists. \nASC 842 -10-15-28 \nAfter determining that a contract contains a lease in accordance with paragraphs 842 -10-15-2 through \n15-27, an ent ity shall identify the separate lease components within the contract. A n entity shall\nconsider the right to use an underlying asset to be a separate lease component (that is, separate from\nany other lease components of the contract) if both of the followin g criteria are met:\na.The lessee can benefit from the right of use either on its own or together with other resources that\nare readily available to the lessee. Readily available resources are goods or services that are sold or\nleased separately (by the lessor or other suppliers) or resources that the lessee already has\nobtained (from the lessor or from other transactions or events).\nb.The right of use is neither highly dependent on nor highly interrelated with the other right(s) to\nuse underlying assets in the contract. A lessee’s right to use an underlying asset is highly\ndependent on or highly interrelated with another right to use an underlying asset if each right of\nuse significantly affects the other.\nThe separate lease components s hould be determined by considering the nature and interdependency \nof the individual assets covered by the arrangement. The legal form of the arrangement is generally not \nrelevant to this analysis; a master lease for multiple assets is no more likely to be a single lease \ncomponent than one with multiple leases. If the assets are functionally independent of one another, \nthe arrangement include s multiple units of account ; each should be evaluated individually to \ndetermine whether it is a lease. Conversely, if the assets covered by an arrangement are designed to \nfunction together , those assets represent a single component . For example, if a customer leases \ncomputers and monitors from a technology supplier and the monitors are not tailored to the computer \n(each c an operate without the other by connecting to a competitor supplier’s products) the \narrangement should be accounted for as two lease components. While a computer and a monitor do \nnot function without each other, they do not need to function with one specif ic counterpart; any \nreadily available competitor product can be used without impacting functionality. \nAnother factor to consider is how specialized the asset is. If use of the asset depends on additional \nassets tailored to facilitate its use, this indicat es that there is a single lease component made up of \nmultiple assets. If a technology supplier develops a monitor that can be inserted into a computer for \nstorage, portability, and to charge the battery, the computer and monitor are likely one lease \ncompon ent because they are dependent on each other for full functionality. \nIn many real -estate leases, the lessee leases the building and the land that the building sits on. In a \nsingle tenant building, determination of the lease components may be straight forw ard. However, \nlessees in a multi -tenant, multiple -story building will also need to evaluate whether there is a land \nlease in the agreement. This assessment will typically depend on the significance of the tenant’s rights \nunder the contract , as a tenant in a multi -tenant building has the right to use a non -physically distinct \nportion of the land on which the building is located. In this scenario, the tenant’s right to use a non -\nphysically distinct portion of the land would only be considered an identified as set if the tenant had \nthe rights to substantially all of the capacity of the land (as discussed in LG 2.3.2.1 ). For example, if the \ntenant was leasing nine floors of a ten -story building, it would be reasonable to conclude that the right ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 67}), Document(page\_content='Scope \n2-51to use the land in the arrangement is an identified asset. The arrangement would then contain a land \nlease component provided the other criteria for a lease were met. \nIn arrangements that contain a land lease component, both the lessor and the lessee should consider \nwhether the land should be viewed as a separate lease component from the building. In general, \nlessors and lessees should view the lease of land as a separate lease component unless the accounting \neffect of doing so would be insignificant. For example, if separat ing the land component would have no \nimpact on lease classification of any lease component or the amount recognized for the land lease \ncomponent would be insignificant, the land component would not need to be separated from the \nbuilding component. \nExample LG 2-17 illustrates how to evaluate components within an arrangement and whether those \ncomponents are lease or nonlease components. \nEXAMPLE LG 2-17 \nLease of a fully furnished office building \nCustomer Corp rents an office building from Landlord Corp for a term of 15 years. The rental contract \nstipulates that the office is fully furnished and has a newly installed and tailored HVAC system. It also \nrequires Landlord Corp to perform all property maintenan ce during the term of the arrangement. \nCustomer Corp makes one monthly rental payment and does not pay for the maintenance separately. \nThe office building has a useful life of 40 years and the HVAC system and office furniture each has a \nlife of 15 years. \nWhat are the units of account in the lease? \nAnalysis \nThere are at least three components in the arrangement – the building assets (office and HVAC), the \noffice furniture, and the maintenance agreement. \nThe office and HVAC system are one lease component b ecause they cannot function independently of \neach other. The HVAC system was designed and tailored specifically to be integrated into the office \nbuilding and cannot be removed and used in another building without incurring substantial costs. \nThese building assets are a lease component because they are identified assets for which Customer \nCorp directs the use. \nThe office furniture functions independently and can be used on its own. It is also a lease component \nbecause it is a group of distinct assets for wh ich Customer Corp directs the use. \nThe maintenance agreement is a nonlease component because it is a contract for service and not for \nthe use of a specified asset. \nCustomer Corp will also need to consider whether separating the land would have be en signi ficant. \nThis could be the case when, if evaluated separately, the building would be classified as a finance lease \nwhile the land would be classified as an operating lease. See LG 3 for additional information on lease \nclassification. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 68}), Document(page\_content='Scope \n2-52To properly account fo r the lease components, Customer Corp will need to determine the standalone \nselling price (i.e., market rents) of the use of the building assets , the use of the office furniture, and the \nmaintenance services. If the sum of the standalone selling prices exc eeds the monthly payment, the \nimplicit discount provided for bundling the three components should be allocated between the service \nand each of the lease elements based on their relative standalone selling prices. \nQuestion LG 2 -4 discusses whether a lease c ontains more than one lease component. \nQuestion LG 2 -4 \nShould a reporting entity account for each floor or suite of a building subject to a single lease \nagreement as a separate lease component? \nPwC response \nIt depends. A reporting entity should apply the guidance in ASC 842 -10-15-28. In many cases, \nindividual floors or suites in an office building could be used by unrelated tenants with no or little \nmodification to the building layout, and use of a floor or s uite by one tenant may not affect the use of \nan adjacent floor or suite by a different tenant. Generally, such a lease would meet the criteria to be \nseparated into discrete lease components for each individual floor or suite, effectively similar to a \nmaste r lease of separate assets . \nAssuming the leases commence at the same date, and are co -terminus, accounting for each floor or \nsuite as a separate lease at lease commencement may have no accounting consequence. However, if \nthe agreement is subsequently modif ied such that the leases of the individual spaces are no longer co -\nterminus, it may become necessary for the reporting entity to identify the lease payments that would \nhave been allocated to the respective spaces at the original commencement date of the le ase (or as of \nthe last remeasurement event, if later). See LG 5.5.1 for additional guidance on accounting for \nmodifications that partially terminate a lease. \n2.5.1 Portfolio exception \nA reporting entity may elect to utilize a portfolio approach, under which it d oes not have to consider \nthe lease components to apply lease accounting. Lessees and lessors may use the portfolio approach \nfor leases provided its application does not create a material difference when compared to accounting \nfor leases at the individual asset level. In addition to the materiality considerations, we would expect \nthat a reporting entity that applies the exception would be able to demonstrate that the leases being \ngrouped have similar characteristics. The leases should have comparable conditi ons regarding such \nclauses as default, extensions, purchase options, and lease term. Common examples of leases that may \nmeet this criteria are office equipment (copiers, computers, phone systems with multiple handsets, \netc.) or vehicle fleets that have sin gle start and end dates. \n2.5.2 Reallocation of consideration \nUnder specific circumstances a lessee should reallocate the consideration paid between components as \ndiscussed in ASC 842 -10-15-36. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 69}), Document(page\_content='Scope \n2-53ASC 842 -10-15-36 \nA lessee shall remeasure and reallocate the consid eration in the contract upon either of the following: \na.A remeasurement of the lease liability (for example, a remeasurement resulting from a change in\nthe lease term or a change in the assessment of whether a lessee is or is not reasonably certain to\nexerci se an option to purchase the underlying asset) (see paragraph 842 -20-35-4)\nb.The effective date of a contract modification that is not accounted for as a separate contract (see\nparagraph 842 -10-25-8).\nSee LG 5 for information on lease modifications and remea surement. A lessee should not reallocate \nconsideration simply as a result of changes in prices used to determine the proportionate allocations, \nunless there is an indication that the initial allocation was inaccurate based on information that was \navailable at the time . \n2.6 Reassessment of whether a contract contains a lease \nThe determination of whether an arrangement is, or contains, a lease is performed at the inception of \nthe arrangement, which is different from when the lease classification and me asurement is performed. \nSee LG 3.2.1 for information on the timing of performing the classification and measurement analysis. \nOnce it is determined that an arrangement is, or contains, a lease, that determination should only be \nreassessed if the legal arrangement is modified. Changes to assumptions such as m arket -based factors \ndo not trigger a reassessment. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 70}), Document(page\_content='Chapter 3: \nLease classification –updated \nMay 2023 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 71}), Document(page\_content='Lease classification \n3-23.1 Lease classification overview \nUnder ASC 842, virtually all leases will require balance sheet recognition as a right -of-use asset and \nlease liability. Howe ver, lease classification will impact the amount and timing of lease income and \nexpense. \nThis chapter discusses the different types of leases, lease classification criteria , and the effect of \nvarious features and te rms on lease classification under ASC 842 . The accounting for leases is \ndiscussed in LG 4. \n3.2 Overview of lease classification \nThe terms of a lease arrangement determine how a lease is classified and the resulting income \nstatement recognition. Whe n the terms of a lease effectively transfer control of the underlying asset , \nthe lease represent s an in substance financed purchase (sale) of an asset and the lease is classified as a \nfinance lease by the lessee and a sales -type lease by the lessor . When a lease does not effectively \ntransfer control of the underlying asset to the lessee , but the lessor obtains a guarantee for the value of \nthe asset from a third party , the lessor would classify a lease as a direct financing lease. All other leases \nare classified as operating lease s. See LG 7 for information on l everaged leases, a specific model \napplicable to certain direct financing lease s that were entered into before the adoption of ASC 842 . \nWhile l everaged leases were eliminated under ASC 842 , leveraged leases that exist ed at the adoption of \nASC 842 were grandfathered . \nFigure LG 3-1 summarizes the acco unting by lessees for the different types of lease s. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 72}), Document(page\_content='Lease classification \n3-3Figure LG 3-1 \nOverview of lease accounting by lessee s \nStatement Finance lease Operating lease \nBalance sheet □Record a right -of-use asset and a\nlease liability□Record a right -of-use asset and a\nlease liability\nIncome \nstatement □Interest expense is determined\nusing the effective interest\nmethod. A mortization is recorded\non the right -of-use asset (usually\non a straight -line basis ). The\nperiodic expense at the beginning\nof the lease term will generally be\ngreater than the corresponding\ncash payments, but will decline\nover the lease term as the lease\nliability is reduced\n□Interest and amortization expense\nshould generally be presented\nseparately in the income\nstatement\n□The right -of-use asset is tested for\nimpairment in accordance with\nASC 360□Lease expense is recorded on a\nstraight -line basis over the lease\nterm by adding interest expense\ndetermined using the effective\ninterest method to the\namortization of the right -of-use\nasset . Unlike a finance lease,\namortization of the right -of-use\nasset is calculated as the\ndifference between the straight -\nline expense and the i nterest\nexpense on the lease liability for a\ngiven period\n□Lease e xpense is presented as a\nsingle line item in operating\nexpense in the income statement\n□The right -of-use asset is tested for\nimpairment in accordance with\nASC 360\nStatement of \ncash flows □Repayments of principal should\nbe classified as financing activities\n□Interest on the lease liability\nshould be classified in accordance\nwith guidance related to interest\nin AS C 230\n□Variable lease payments should be\nclassified as operating activities□Opera ting lease payments should\nbe classified as operating activities\n□Operating lease payments that are\ncapitalized as a cost bringing\nanother asset to intended use\nshould be classified as investing\nactivities\nFigure LG 3-2 summarizes the accounting by lessors for the different lease types (excluding leveraged \nleases , which are discussed in LG 7) and Question LG 3 -1 discusses how leases between related parties \nshould be classified. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 73}), Document(page\_content='Lease classification \n3-4Figure LG 3-2 \nOverview of lease accounting by lessors \nStatement Sales -type lease Direct financing leas e Operating lease \nBalance \nsheet □The underlying asset\nis derecognized and\nthe net investment in\nthe lease (the sum of\nthe present value of\nthe future lease\npayments and\nunguaranteed\nresidual value ) is\nrecorded\n□The net investment in\nthe lease is increased\nby interest income\nand decreased by\npayments collected□The underlying asset\nis derecognized and\nthe net investment in\nthe lease ( the sum of\nthe present value of\nthe future lease\npayments and\nunguaranteed\nresidual value) is\nrecorded\n□The net investment in\nthe lease is increased\nby interest income\nand decreased by\npayments collected□The underlying asset\nremains on the\nbalance sheet\n□The underlying a sset\ncontinues to be\ndepreciated over its\nuseful life , which\ncould extend beyond\nthe lease term\nIncome \nstatement □Selling profit or loss\*\nis recorded at lease\ncommencement\n□Interest income is\nrecorded based on the\neffective rate of\ninterest in the lease□Selling profit is\ndeferred and selling\nloss\* is recorded at\nlease commencement\n□Interest income is\nrecorded based on the\neffective rate of\ninterest in the lease□Lease revenue and\ndepreciation expense\nare presented on a\ngross basis in the\nincome statement\nStatement \nof cash \nflows □Cash receipts from all leases should be classified as operating activities except\nfor entities within the scope of ASC 946 (see ASC 842 -30-45-5).\n\* Unde r the se lease classification crit eria, lease arrangements with variable lease paymen ts may be \nclassified by lessors as a sales-type or direct-financing lease. T his m ay lead to the recognition o f a \nselling loss (i.e., a day-one loss) by the less or eve n when the overall arrangeme nt is expected to be \nprofitable. In response t o concerns raised in the post implementation review, in order to avoid \nrecognition o f such day-one loss under ASC 842, the FASB issued ASU 2021- 05, Lessors —Certain \nLeases with Variable Lease Payments , which upon adoption requi res a lessor to classify a lease with \nvariable lease payments (that do not depend on an index or a rate) as an operating lease at the lease \ncommencement date if classifying the lease as a sales-type lease or direct financing lease would result \nin recognition of a day-one loss. See LG 9.10 for the effective date and transition requirements of ASU \n2021- 05. Se e Example LG 4-9 for an illustration of a lease with significant variable payments.', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 74}), Document(page\_content='Lease classification \n3-53.2.1 Leases between r elated parties \nQuestion LG 3-1 \nHow should leases between related parties be classified? \nPwC response \nLeases between related parties should be classified like all other leases , as discussed in ASC 842 -10-55-\n12.The classification should be based on the terms of the contra ct, without adjustment for provisions\nthat may have been impacted by the related party relationship.\nASC 842 -10-55-12 \nLeases between related parties should be classified in accordance with the lease classification criteria \napplicable to all other leases on the basis of the legally enforceable terms and conditions of the lease. \nIn the separate financial statements of the related parties, the classification and accounting for the \nleases should be the same as for leases between unrelated parties. \nThe lessee an d lessor should look only to legally enforceable rights when classifying the lease. In \nidentifying the leg ally enforceable rights , it would be reasonable to start with a review of the written \ncontract. However, due to the relationship between the two parties, the legal lease provisions in the \nwritten contract may be uneconomic or a detailed contract may not exist at all . If this is the case, it \nwould be helpful to involve legal counsel to understand if there are legal rights that exist outside of a \nwritten contract. For example, within office space leased from a related party under a nonrenewable, \none-year managed service arrangement, a lessee may install leasehold improvements with an \neconomic life of five years. This may indicate that the lessee expec ts to use the space longer than the \none-year lease term and therefore the written contract terms of the arrangement may be considered \nuneconomic . Furthermore, that may be a reasonable expectation given that management of the lessee \nand lessor often include the same decision makers. Therefore , in this case it could be helpful to involve \nlegal counsel. \nRelated party leases are often embedded within other arrangements (e.g., a managed service \narrangement ). In those cases, the arrangement may include multiple components , including both lease \nand non -lease components . Therefore, once total contract consideration has been determined based \non the legally enforceable rights in the arrangement, it must be allocated between the multiple \ncomponents in order to determi ne the appropriate lease payments to be used for lease classification . \nThe total contract consideration is allocated to each component based on relative standalone price for \neach component. See LG 2.4 for further details on components. \n3.2.1.1 New guidance - Leases between entities under common control \nIn March 2023, the FASB issued ASU 2023 -01, Common Control Arrangements . The guidance \nprovide s entities within the scope of ASC 842-10-65-1(b) (that is, entities that are not public business \nentities, not -for-profit bond obligors, or employee benefit plans that file or furnish financial \nstatements with or to the SEC) a practical expedient to use written terms and conditions for \ndetermining whether a lease exists and, if so, the classification and ac counting for that lease. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 75}), Document(page\_content='Lease classification \n3-6An entity applying the practical expedient would not be required to determine whether those written \nterms and conditions are legally enforceable. If no written terms and conditions exist, an entity would \napply ASC 842 based on the legal ly enforceable terms of an arrangement. If an entity determines that a \nlease does not exist, other GAAP would apply. The practical expedient may be applied on an \narrangement -by-arrangement basis . \nThe new guidance is effective for all entities in fiscal years beginning after December 15, 2023, \nincluding interim periods within those fiscal years. Early adoption is permitted for both interim and \nannual financial statements that have not yet been made available for issuance. If an entity adopts the \nnew guidance in an interim period, it should adopt the guidance as of the beginning of the fiscal year \nthat includes that interim period. \nEntities adopting the new guidance concurrently with adopti ng ASC 842 may follow the same \ntransition requirements used to apply ASC 842. All other entities are required to apply the new \nguidance using one of the following two methods: \n□Prospectively to arrangements that commence or are modified on or after the date that the e ntity\nfirst applies the new guidance , or\n□Retrospectively to the beginning of the period in which the entity first applied ASC 842 , but only\nfor arrangements still in place at the date of adoption.\nUnder either adoption method, an entity is permitted to document any existing unwritten terms and \nconditions of an arrangement between entities under common control before the first d ate interim or \nannual financial statements are issued in accordance with this guidance. \nWhen an arrangement previously considered to be a lease continues to be a lease after applying the \nguidance in this ASU, the entities should account for any changes in the lease resulting from \napplication of the practical expedient as a lease modification. Refer to LG 5 for additional information \non accounting for lease modifications. \nIf an arrangement previously not considered a lease becomes a lease after applying th is ASU , an entity \nshould account for the arrangement as a new lease. \nThe ASU also provides guidance related to accounting for leasehold improvements associated with \ncommon control leases. Refer to LG 8.11 for additional informat ion on amortization of leasehold \nimprovements. \n3.2.2 Lease commencement \nASC 842 requires the determination of whether an arrangement contains a lease at lease inception. \nClassification and initial measurement of right -of-use assets and lease liabilities are determined at the \nlease commencement date, which is defined in the ASC 842 Glossary . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 76}), Document(page\_content='Lease classification \n3-7Definition from ASC 842 Glossary \nCommencement Date of the Lease (Commencement Date) : The date on which a lessor makes an \nunderlying asset available for use by a lessee. See paragraphs 842 -10-55-19 through 55 -21 for \nimplementation guid ance on the commencement date. \nRight-of-use assets and lease liabilities are not recognized before lease commencement because prior \nto that date , the lessor has not yet performed under the arrangement. To illustrate, assume a lessee \nand lessor enter into a lease arrangement on January 1, but the lessor does not make the underlying \nasset available for use by the lessee until April 1 of the same year . At lease inception (January 1), the \narrangement would be assessed to confirm that it contains a lease, but the initial lease classification \nassessment and measurement of the right -of-use asset and lease liability would occur on April 1. \nAlthough the lease commencement date may be defined in a lease agreement, the accounting \nassessment should be made on the date that the lessor makes the underlying asset available for use to \nthe lessee. For example, in many real estate leases, a lessee may obtain control over the use of the \nunderlying asset well before it begins to use the leased asset to facilitate the completion of leasehold or \nother improvements. Determining when a lessor has made the underlying asset available for a lessee’s \nuse is the key to correctly determining the commencement date. Some factors to consider are whether \nthe asset is complete , whether a lessee has the unfettered right to enter the property and the nature of \nany significant improvement work being performed on the asset . The commencement date specified in \nthe lease contract or the date when lease payments begin are not typically strong indicators of when a \nlessee has obtained control of the leased asset. For example, if the commencement date per the legal \nterms of lease a greement for a single floor in an office building has occurred and the lessee has the \nability to access the floor , but does not yet control how, when , or whether the space may be used, the \nlease has not commenced. This could occur when a lessor permits the lessee early access to a property \n(e.g., to install lessee improvements ) while, simultaneously , the lessor continues its own work . The \nlease has not commenced because the lessor has not relinquished control of the underlying asset to the \nlessee. \nThere may be instances whe n control of the underlying asset has been obtained by a lessee prior to \nlease commencement (e.g., when a lessee is involved in the construction of the underlying asset). In \nsuch cases, the lessee may be required to reflect its co ntrol over the asset prior to construction \ncompletion. Once construction is completed the lessee should account for the transaction as a sale and \nleaseback. See LG 6.3.2.6 for additional information. \nAlthough lease classification is determine d at the lease commencement date , in certain circumstances \na reporting entity may need to reassess classification at a later date. See LG 5. 3. \n3.2.3 Lease components \nA reporting entity must identify whether an arrangement contains multiple lease and nonlease \ncomponents. See LG 2. 4 for information on identifying separate lease components in a contract. \nA reporting entity must individually assess the classification of each separate lease component. For \nexample, if a reporting entity determines that a contract includes two separate lease components, the \nreporting entity should assess the classification of each one separately . In some cases , the classification \nof separate components in a single lease arrangement could differ. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 77}), Document(page\_content='Lease classification \n3-8A single lease component may include the right to use multiple underlying assets. When classifying a \nlease component with multiple underlying assets, identifying the economic life and estimating the fair \nvalue of the lease component will require judgment. See LG 3.3.3.3 and LG 3. 3.4.5, respectively, for \nadditional information. \n3.2.4 Master l ease agreements \nA master lease agreement is a contractual arrangement that governs the terms and conditions of \nmultiple underlying assets. Accordingly, while the terms and conditions are contractual ly defined at \nlease inception, each underlying asset subject to the agreement should be evaluated individually at the \ncommencement of each individual lease (i.e., when the lessor makes the underlying asset available for \nuse by the lessee). Generally, a mas ter lease agreement will result in multiple lease commencement \ndates because the terms and conditions within the agreement apply to different underlying assets that \nare made available for use by the lessee on different dates . \n3.3 Lease classification criteri a \nLease classification is governed by five c riteria. Although the guidance considers whether a lease is \neconomica lly similar to th e purchase of a nonfinan cial asset from the perspecti ve of control, the \nclassification approach is substa ntially s imilar to prev ious guidance . If any of the five criteria in ASC \n842- 10-25-2 are met, a lessee should classify the lease as a finance lease an d the lessor would classify \nthe lease as a sales-type lease . If none of the criteria are met, a lesso r would classi fy a lease as a direct \nfinancing lease if the criteri a in ASC 842- 10-25-3b are met. All other leases should be classifi ed as an \noperating lease by both the lessee and lessor .\nAlthough lessors are gener ally subject to the same classification criteria as lessees , additional \nconsideration s relevant to any revenue generating acti vity – such as the collectibility of amounts due \nunde r the lease – may impact the timing and recognition of selling profit or loss, or incom e over the \nlease term. Furtherm ore, unde r the lease classification crit eria, lease arrangements with variabl e lease \npayment s ma y be classifi ed by lessors as a sales-type o r direct-financing lease. This m ay lead to the \nrecognition o f a selling loss (i.e., a day-one loss) by the lessor even when the overall arrangement is \nexpected to be profitable. In resp onse to concerns raised in the post implementation review, in order \nto avoid recognition of such day- one loss under ASC 842, the FASB issued ASU 2021-05 which upon \nadoption requires a lessor to classify a lease with variabl e lease payments (that do not d epend on an \nindex or a rate) as an operating lease at the lease commencement date if classifying the lease as a \nsales-type lease or direct financing lease would result in recognition of a day-one loss. See LG 9.1 0 for \nthe effective date and transition requirements of ASU 2021-05. See Example LG 4-9 for an illustration \nof a lease with significant variable payments. \nA reporting entity that elects the exception for short-t erm leases would not apply the lease \nclassification criteria. See LG 2.2.1 for infor mation on the short-term lease measurement and \nrecognition exemption. \nFigure LG 3- 3 provide s the le ase classification criteria contained in ASC 842- 10-25-2 and \nASC 842- 10-25-3. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 78}), Document(page\_content='Lease classification \n3-9Figure LG 3-3 \nLease classification criteria \n', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 79}), Document(page\_content='Lease classification \n3-10Each of these types of leases are discussed in the following sections . \nQuestion LG 3-2 \nIf a lessee classifies a lease as a finance lease , must the lessor do so as well? \nPwC response \nGenerally, yes . The lessee and the lesso r apply the same basic classification criteria; h owever, \ndifferences in assumption s used to classi fy the lease (e.g., discou nt rate and the impact of renewal or \npurchase options) could give rise to classification differenc es. Less or classification may also be \nimpacted by factors unrelated t o the lessee . For exam ple, a lessor may obtain residual value insurance \nfrom a third pa rty and incl ude that guarantee in i ts lease payments . This could result in the lessor \nclassifying the lease as a direct financing lease while the lessee classifies it as operating. \nFurthermore, unde r the lease classification crit eria, lease arrangements with variabl e lease payments \nmay be classified by lessor s as a sales-type or direct-financing leas e. This may lead to the recognition \nof a sellin g loss (i.e., a day-one loss) by the lessor eve n when the overall arrangement is expected to be \nprofitable. In response t o concerns raised in the post implementation review, in order to avoid \nrecognition o f such day-one loss under ASC 842, the FASB issued ASU 2021-05 which up on adoption \nrequires a lessor to classify a lease with variable l ease payment s (that do not depend on an index or a \nrate) as an operating lease at the lease commencement date if classifying the lease as a sales-type \nlease or direct financing lease would result in recognition of a day-one loss. See LG 9.10 for the \neffective date and transition requirements of ASU 2021-05. See Example LG 4-9 for an illustration of \na lease with significant variable payments. \nQuestion LG 3-3 \nCan the classification criteria be applied to a group of leased assets (i.e., a portfolio approach)? \nPwC response \nYes. However , the results must not be materially different than classifying the underlying assets on an \nasset by asset basis. As a result, this approach would likely only be permitted in situations where the \nlease applies to a group of homogenous assets that have identical or nearly identical lease terms. \nQuestion LG 3-4 \nDo the lease classification criteria in ASC 842 -10-25-2 and ASC 842 -10-25-3 apply to leases of land? \nPwC response \nYes. L eases of land should be classified like any other lease; that is, evaluated based on the lease \nclassification criteria in ASC 842 -10-25-2 and ASC 842 -10-25-3. Consequently, l ong-term leases of \nland may be classified as finance leases . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 80}), Document(page\_content='Lease classification \n3-113.3.1 Transfer of ownership \nA lease is classified as a finance lease by a l essee and as a sales -type lease by a lessor if ownership of \nthe underl ying asset transfers to the lessee by the end of the lease term . This criterion is also met if the \nlessee is require d to pay a nominal fee for the legal transfer of ownership . However, if a lessee can \nchoose not to pay the nominal fee (resulting in the lessee having the option not to purchase the \nunderlying asset ), the provision would not meet the transfer of ownership criterion because it would \nbe considered an option to purchase the underlying asset. See LG 3.3.2 for information on the \naccounting for options to purchase the underlying asset . \nIt may be difficult to distinguish between a finance lease (subject to the guidance in ASC 842) and a \nfinanced purchase (sale) of an asset (subject to the guidance of ASC 606). Under ASC 606, the t ransfer \nof legal title to a buyer is an important indicator when determining whether an entity has transferred \ncontrol of an asset to a customer, but that fact is not determinative in isolation . A question arises as to \nwhether an arrangement should first b e evaluated under ASC 606 or ASC 842. For example, since \ntransfer of title does not automatically govern whether an entity has transferred control of an asset to a \ncustomer, it is not clear which standard should govern the accounting when title is not tran sferred to \nthe customer at the beginning of the arrangement . Similarly, it is unclear which standard should \ngovern when an arrangement does transfer legal ti tle to the customer, but that transfer is not, in \nisolation, determinative as to whether a sale has occurred . \nWe believe that reporting entities should generally apply ASC 842 , except when legal title transfers at \nthe beginning of an arrangement. This may result in an entity classifying a lease as a sales -type \n(finance) lease, but, nevertheless, the transaction would be accounted for under ASC 842. Reporting \nentities should first apply the guidance in ASC 606 when legal title is transferred to the customer at \nthe beginning of an arrangement. However, per ASC 606, an entity that transfers a good and r etains a \nsubstantive forward repurchase obligations or call option (that is, a repurchase right) should not \nrecognize revenue when the good is initially transferred to the customer because the repurchase right \nlimits the customer’s ability to control the g ood. If the repurchase price is less than the original sales \nprice of the asset and the arrangement is not part of a sale -leaseback transaction, the arrangement \nwould be subject to the account ing and lease classification guidance under ASC 842 . \n3.3.2 Purchase o ption s \nIf a lease contains an option to purchase the underlying asset and the option is reasonably certain to be \nexercise d by the lessee, the lessee and lessor should classify the lease as a finance lease and a sales -\ntype lease, respectively. An option may be reasonably certain to be exercise d by the lessee when a \nsignificant economic incentive exists . For example, this may exist when the price of the option is \nfavorable relative to the expected fair value of the underlying asset at the date the option becomes \nexercisable or when certain economic penalties exist that compel the lessee to elect to exercise its \noption . See LG 3. 4 for additional information on the impact of economic factors on the application of \nthe reasonably certain threshold. \n3.3.2.1 Purchase option prices \nA purchase option, whether fixed price or formula driven, should be evaluated to determine if it \nrepresents a significant economic incentive such that the lessee is reasonably certain to exercise it. \nGenerally, an option to purchase a leased asset at a price greater than or equal to an asset’s fair value \nat lease commencement would not give rise to a significant economic incentive based on price . \nAdditional consideration is required when a fixed -price option allows the lessee to buy the asset at a ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 81}), Document(page\_content='Lease classification \n3-12price tha t is less than the fair value of the asset at the lease commencement date . Both the lessee and \nlessor should consider all relevant factors , including t he nature of the leased asset and the length of \ntime before the option becomes exercisable , which may imp act the likelihood that the lessee would \nexercise the option. For example, an option to purchase real estate at a price below the commencement \ndate fair value is more likely to be considered reasonably certain of exercise than a similar option on \nequipment since real estate is generally expected to appreciate in value over the lease term whereas \nequipment is more like ly to depreciate in value. \nSee LG 3.4 for additional information on the application of the reasonably certa in threshold. \n3.3.3 Lease term t est \nIf the lease term is for a major part of the remaining economic life of the underlying asset, the lessee \nhas effectively obtained control of the underlying asset and should classify the lease as a finance lease ; \nthe lessor sh ould classify the lease as a sales -type lease . While ASC 842 does not require the use of \nbright lines, one approach to applying this indicator is to consider a lease term to be for a major part if \nit is equal to or greater than 75% of the underlying asset’s remaining economic life. As land has an \nindefinite life, this criterion would not apply to leases of land. \nLeases that commence at or near the end of the underlying asset’ s economic life are exempt from \nappl ying this particular lease classification criterion. When determining if a lease has commenced at or \nnear the end of the underlying asset’ s economic life, use to date and the remaining economic life of the \nunderlying asset at lease commencement should be c onsidered. The FASB has indicated that one \nreasonable approach to determining the applicability of this exception is to conclude that a lease that \ncommences in the final 25 % of an asset’ s economic life is at or near the end of the underlying asset’ s \neconom ic life. While there may be differing views in practice, we believe this exception should apply \nwhen ever entities are required to classif y a lease , e.g., when a lease is modified and the modification is \nnot accounted for as a separate lease . We believe that , for classification purposes, the “commencement \ndate” for an existing lease that is modified is the date the modification is executed. \nSee LG 3.3.3.2 for additional information on determining the estimated economic life of a leased asset . \n3.3.3.1 Determining the term of the lease \nLeases often include options to either extend the term of the lease (commonly referred to as a “renewal \noption”) or to terminate the lease prior to the contractual lease expiration date (c ommonly referred to \nas a “termination option”). \nAs discussed in ASC 842 -10-30-1, a lessee or lessor should consider all relevant contractual provisions, \nincluding renewal and termination options , to determine the term of the lease. Only renewal or \ntermina tion options that are reasonably certain of exercise by the lessee should be included in the \nlease term. Additionally, if a renewal option is controlled by the lessor, the lessee and lessor must \ninclude that renewal period in determining the lease term. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 82}), Document(page\_content='Lease classification \n3-13ASC 842 -10-30-1 \nAn entity shall determine the lease term as the noncance llable period of the lease, together with all of \nthe following: \na.Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that\noption\nb.Periods covered by an option to terminate the lease if the lessee is reasonably certain not to\nexercise that option\nc.Periods covered by an option to extend (or not to terminate) the lease in which exercise of the\noption is controlled by the lessor.\nUnlike a renewal option controlled by the lessor, periods covered by a renewal option controlled or \neffectively controlled by a third party may or may not be included in the lease term. Judgment must be \napplied to determine whether an optio n controlled or effectively controlled by a third party should be \nreflected in the lease term. \nThe assessment of whether it is reasonably certain that a lessee will exercise an option should be based \non the facts and circumstances at lease commencement. T he assessment should not be based solely on \nthe lessee’s intentions, past practices , or estimates. It should focus on the factors that create an \neconomic incentive for the lessee , including contract -, asset -, entity -, or market -based factors. \nWe believe t hat a lease that is cancellable only upon the occurrence of a remote contingency should be \nconsidered noncancellable for lease classification purposes. \nIf significant enough, a penalty for cancellation may result in a conclusion that continuation of the \nlease appears, at lease commencement, to be reasonably certain. If so, it should be considered \nnoncancellable for any periods in which the penalty exists. \nQuestion LG 3-5 \nHow should a lessee consider its past practices in assessing whether it is reasonably certain to exercise \nan option to renew a lease or to purchase an underlying asset? \nPwC response \nA lessee should not rely solely on past practice, but should consider the economics underlying its \nnegotiated arrangement. The FASB acknowledged that optional terms may not meet the conceptual \ndefinition of a liab ility, and therefore, the measurement of a lease liability should include options only \nwhen the lessee has economically little choice but to exercise the option. However, a lessee’s past \npractices (e.g. , its history of retaining assets for a particular len gth of time before replacing them) may \nbe in response to factors that would commercially compel the lessee to renew the lease or to exercise a \npurchase option. \nTo determine whether a renewal option is reasonably certain of exercise, a lessee and lessor should \ncompare the renewal rents with the expected fair market rent s for equivalent property under similar \nterms and conditions. In general, a renewal option with renewal rents that are equal to or greater than ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 83}), Document(page\_content='Lease classification \n3-14the rents in the initial lease term is not consi dered to be reasonably certain of exercise ; however, this \npresumption could be overcome if the economic penalties the lessee would suffer by not exercising the \nrenewal option are significant. Any step -down in rent s in a renewal period should give rise to a \npresumption (which can be overcome ) that the renewal option is reasonably certain of exercise by the \nlessee . See LG 3.4 for factors to consider when determining whether renewal, termination, or purchase \noptions are reasonably certain of exercise. \nQuestion LG 3-6 \nHow should a lessee and lessor determine the lease term in an arrangement that has no explicit end \ndate? \nPwC response \nA lessee and lessor should evaluate the enforceable rights and obligations in the contract. Any period \nthat may not be cancelled by the lessee should be included. Additionally, any provisions that allow the \nlessee to extend the lease (i.e., renewa l options) should be evaluated to determine whether the lessee is \nreasonably certain to exercise the m. For example, a lease agreement may provide a lessee with the \nright to use an underlying asset on a daily basis (no stated end date) that the lessee may r eturn at any \npoint subsequent to the first day of use. The noncancellable period of th is type of lease would be a \nsingle day and each subsequent day would be considered a daily renewal option that should be \nincluded in the lease term if determined to be re asonably certain of exercise by the lessee after \nconsidering all relevant contract -, asset -, entity -, and market -based factors . \nQuestion LG 3-7 \nHow should a lessee and lessor determine the lease term in an arrangement that can be canceled by \neither party? \nPwC response \nA lessee and l essor should first evaluate whethe r both parties have the unilatera l right to terminat e the \narrangement (i.e., symmetrical termination righ ts). If termination rights ar e symmetrical, the lessee \nand less or should determine if terminating the lease would result in either party incurring more than \nan insignificant penalt y, as defined in ASC 842- 10-20. If the termi nation rights are symmetrical with \nno more than an insignificant penalt y, the lease term is limited t o the period u p to t he time those \nsymmetrical rights are exercisable. If termination rights are not symmetrical or either party would \nincur more than an insignificant economic penalty, the lessee and lessor should follow the framework \ndiscussed above.\nWhen evaluating whethe r the lessee or lessor would in cur more than an insignificant economic \npenalty, they should consider not only ca sh payment s required to be made upo n exercise of the \ntermination o ptions, but also othe r penalties, such as the cos t of abandonin g leasehold improvements \nor the disruption caused by relocating employees (see LG 3.4 for othe r examples of termina tion \npenalties). We believe arrangements such as these will be mos t prevalent in related party agreements. \nSee LG 3.2 for othe r related party leasing considerations. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 84}), Document(page\_content='Lease classification \n3-15Question LG 3-8 \nWould a lease with a nonconsecutive term totaling 365 days or less be considered a short -term lease if \nthe overall agreement spans a period more than 12 months? \nPwC response \nYes. We believe t he determination of short -term, as defined in ASC 842 -10-20, should be evaluated on \nthe basis of aggregate nonconsecutive periods. See LG 2.2.1 for information on the short -term lease \nmeasurement and recognition exemption. \nQuestion LG 3-9 \nIs a lease with a fiscal funding clause (a clause included in some leases with federal, state, and local \ngovernme nt that gives the lessee the right to cancel if funds are not appropriated in future years ) \nconsidered noncance llable? \nPwC response \nGenerally, yes. A fiscal funding clause should be evaluated to determine whether it is more than \nremote that a lessee will exercise the clause. If it is determined that a lessee’s exercise of a fiscal \nfunding clause is more than remote, only the periods for which exercise is remote should be included \nin the lease term . In evaluating these provisions, the factors to be consider ed may include (1) a lessor’s \nexperience relative to other similar leases with the same lessee and/or with similar lessees and \ngovernmental agencies , (2) technological obsolescence, and (3) whether the leased asset is essential to \ncontinued normal operation of the governmental unit . \nExample LG 3-1, Example LG 3-2, Example LG 3-3, and Example LG 3-4 illustrate the effect of \nrenewal options on the lease term. \nEXAMPLE LG 3-1 \nLease term – ground lease with a renewal option \nLessee Corp enter s into a 15-year ground lease agreement . The lease grants Lessee Corp an option to \nrenew the lease for an additional 15 years. The ground rents adjus t to current market rates for \nequivalent unimproved land upon exercise of the renewal option. \nLessee Corp plans to construct a building on the leased land . The cost of the building is significant and \nits estimated life is 30 years. \nWhat is the lease term ? \nAnalysis \nThe lease term is 30 years. The loss of the building after year 15 as a result of non -renewal of the \nground lease provides Lessee Corp a significant incentive to renew the ground lease for a nother 15 \nyears. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 85}), Document(page\_content='Lease classification \n3-16EXAMPLE LG 3-2 \nLease term – build ing lease with a renewal option \nLessee Corp enters into an agreement to lease an office building for 10 years. The lease grants Lessee \nCorp the option to renew the lease for an additional 10 years. The rental costs adjust to current market \nrents for equiva lent office space upon exercise of the renewal option. \nWhat is the lease term? \nAnalysis \nSince the rents at the beginning of the renewal period will adjust to market rents , the renewal option \ndoes not create an economic incentive for Lessee Corp to exercis e its option. Therefore, assuming the \nasset is neither unique nor specialized and no other economic incentives exist, Lessee Corp will likely \nconclude , at the lease commencement date, that the option is not reasonably certain of exercise . \nAccordingly, the lease term would be 10 years. \nEXAMPLE LG 3-3 \nLease term – third party is not reasonably certain to exercise a renewal option \nLessee Corp leases an asset for a 1 0-year noncancellable period wi th two 5 -year renewal options (the \n“head lease”) from Lessor Corp. Lessee Corp subleases the leased asset to Sublessee also for a \nnoncancellable period of 1 0 years with two 5 -year renewal options. Lessee Corp (as sublessor) \ndetermines Sublessee is not reas onably certain to exercise its options to extend the sublease. Lessee \nCorp also determines it is not reasonably certain that it will exercise any renewal options in the head \nlease. \nHow should Lessee Corp (as sublessor) determine the term of the head lease , considering the renewal \noptions held by Sublessee ? \nAnalysis \nIncluding optional renewal periods could impact both classification and measurement of Lessee Corp’s \nlease of the asset. The guidance in ASC 842 -10-30-1 (see LG 3.3.3.1 above ) states that the lease term \nincludes “ periods covered by an option to extend (or not to terminate) the lease in which exercise of \nthe option is controlled by the lessor. ” \nOne might infer that this guidance requires the lessee to include all optional periods it must exercise \ndue to circumstances outside the lessee’s control (e.g., a renewal right over the asset granted by the \nLessee to Sublessee ). However, Lessee Corp is not required to include the renewal periods in the lease \nterm merely because Sublessee holds renewal rights. Instead, Lessee Corp must assess whether non -\nrenewal by Sublessee impose s an economic penalty sufficient to provide a significant economic \nincentive for Sublessee to exercise its renewal options. If so, the optional renewal periods would be \nincluded in lease term by Lessee Corp in evaluating its lease and sublea se. If not, Lessee Corp would \nclassify and measure its lease based on the noncancellable lease term. \nIn this example, the t erm of the head lease would be 1 0 years because (1) Lessor Corp cannot control \nwhether Lessee Corp will exercise the extension option and (2) Lessee Corp concluded it is not \nreasonably certain that it will exercise any renewal options in the head lease. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 86}), Document(page\_content='Lease classification \n3-17Reassessing lease term \nSubsequent to lease commencement, Lessee Corp would follow reassessment guidance for lessors to \nevaluate changes occurring during the sublease term (see LG 5.7 ). In accordance with lessor guidance \non reassessment , Lessee Corp (as sublessor) would not reassess whether Sublessee is reasonably \ncertain to renew the sublease until Sublessee actually exercises a renewal option not already included \nin the lease term . Until then , Lessee Corp would also not reassess the te rm of the head lease for the \nactions o f Sublessee (e.g., if Sublessee began installing lea sehold improvements , indicat ing it is likely \nto exercise a renewal option) as those actions are outside of Lessee Corp’s control. Lessee Corp would \nfollow reassessment guidance applicable to lessees to evaluate changes , including those resulting from \ntriggering event s that are within its own control occurring during the head lease term (see LG 5.3.1). \nEXAMPLE LG 3-4 \nLease term –third party is reasonably certain to exercise a renewal option \nLessee Corp leases an asset for a 10 -year noncancellable period with two 5 -year renewal options (the \n“head lease”) from Lessor Corp. Lessee Corp subleases the leased asset to Sublessee also for a \nnoncancellable period of 10 years with two 5 -year renewal op tions. At lease commencement, Lessee \nCorp (as sublessor) determines Sublessee is reasonably certain to exercise its options to extend the \nsublease. \nHow should Lessee Corp (as sublessor) determine the term of the head lease? \nAnalysis \nThe term of the head lease woul d be 20 years because Lessee Corp (as sublessor) concluded Sublessee \nis reasonably certain to exercise its options to extend the sublease . Lessee Corp’s obligation to supply \nthe asset as sublessor results in Lessee Corp similarly concluding the renewal options in the head lease \nare reasonably certain of exercise. \nWe believe the same conclusion would be reached if the asset were specialized and , instead of \nsubleasing the asset, Lessee Corp intended to use the asset to fulfill a revenue contract with a third \nparty. That is, Lessee Corp must evaluate whether or not it is reasonably certain that it will use the \nasset to fulfill the revenue contract during the renewal periods . \nExample LG 3 -5 illustrates how to determine a lease term for lease portfolio s where a lessee can \nterminate a percentage of the individual leases early . \nEXAMPLE LG 3 -5 \nLease term –Lease portfolios where a lessee can terminate a percentage of the individual leases early \nLessee Corp . leases a portfolio of 100 automobiles from Lessor Corp. Each automobile can be used and \noperated independent of the other automobiles . Therefore, the arr angement is considered leases of \nmultiple assets. The lease term is three years; however, Lessee Corp has the option to return 4 0 of the \nautomobiles after 2 years . Lessee Corp. believes that it is reasonably certain that it will return 40 \nautomobiles after 2 years . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 87}), Document(page\_content='Lease classification \n3-18The automobiles are similar and there is no higher likelihood that any individual automobile will be \nreturned early. In other words, it is 60% likely that each automobile will be kept for the full lease term \nand conversely it is 40% likely that e ach automobile will be returned early. \nWhat lease term should be used for each automobile? \nAnalysis \nLessee Co. should use a three - year lease term for 60 of the automobiles and a two -year lease term for \n40 of the automobiles. Lessor Corp. should use the same lease terms. \n3.3.3.2 Determining the e stimated economic life \nThe ASC 842 Glossary provides the following definition of economic life . \nDefinition from ASC 842 Glossary \nEconomic Life: Either the period over which an asset is expected to be economically usable by one or \nmore users or the number of production or similar units expected to be obtained from an asset by one \nor more users. \nDetermining the estimated economic life of an underly ing asset may be similar to establishing the \ndepreciable life of an asset . Depreciable lives may therefore provide a starting point to estimate \neconomic lives for comparable assets. Whether an asset is owned or rented should not affect the length \nof its economic life . \nDetermining the estimated economic life of a new asset may be easier than determining the estimated \neconomic life of equipment that has previously been owned or leased. A lessor or lessee should \nconsider the remaining life of the underlying asset at lease commencement. \nExample LG 3-6 and Example LG 3-7 illustrate how to determine the estimated economic life. \nEXAMPLE LG 3-6 \nEstimated economic life – economic life of a new asset (manufacturing equipment ) \nLessee Corp is in the business of manufacturing electrical devices for sale in retail hardware stores. \nLessee Corp normally purchases equipment used in its manufacturing process from a third -party \noriginal equipment manufacturer (OEM) and assigns a 15 -year useful life to the manufacturing \nequipment . Similar equipment must be replaced after 15 to 20 years of use (assuming normal repairs \nand maintenance during the usage period ), after which it is typically scrapped . \nIn an effort to manage cash flows, Lessee Corp enter s into a 10-year arrangement with the OEM to \nlease a new piece of manufacturing equipment. The new equipment is similar in nature to the \nequipment Lessee Corp normally purchases ; if Lessee Corp were purchasing the equip ment outright, it \nwould assign a 15 -year useful life for depreciation purposes. \nWhat is the estimated economic life of the equipment for purposes of classifying the lease ? ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 88}), Document(page\_content='Lease classification \n3-19Analysis \nSince the manufacturing equipment needs to be replaced at some point betwe en 15 and 20 years, the \nestimated economic life should fall within that range. The midpoint of the range (i.e. , 17.5 years) may \nbe a reasonable estimate of the equipment’s economic life assuming a more precise method of \nestimating the underlying asset’s economic life does not exist . \nEXAMPLE LG 3-7 \nEstimated economic life – economic life of a used asset (real estate) \nLessee Corp enters into a 10-year lease with Lessor Corp for the use of a warehouse . The warehouse is \n40 years old at lease commencement . Lessee Corp has purchased other warehouses and typically \ndepreciates th em over 40 years. \nWhat is the estimated economic life for purposes of classifying the lease ? \nAnalysis \nIf Lessee Corp simply look s to the age of the warehouse , it may conclude that the building has no \nfurther economic life . However, this is not a reasonable assumption at lease commencement given \nLessee Corp ’s intent to lease the building for 10 years. \nThe remaining economic life of the building should be estimated based on its condition at lease \ncommencement and Lessee Corp ’s estimate of how long the building will be usable in the future \nassuming normal repairs and maintenance. The assessment should be based on the underlying asset , \nnot the lease term . Lessee Corp may conclude that the building has a future economic life in excess of \nthe 10-year lease term depending on the building ’s condition. \nWhen classifying a lease, a lessor similarly should consider the remaining e conomic life of the \nunderlying asset considering its condition , even if that life exceeds the useful life over which it \ndepreciates the asset . \n3.3.3.3 Economic life involving multiple assets \nAs discussed in ASC 842 -10-25-5, a reporting entity should determine which asset represents the \npredominant asset when a lease component contains multiple underlying assets . Only the remaining \nestimated economic life of the predominant asset should be considered when classifying the lease \ncomponent. \nExample 13 in ASC 842 -10-55-146 through ASC 842-10-55-149 illustrates the application of this \nguidance to a lease of a turbine plant. The leased turbine plant consists of the turbine, the building that \nhouses the turbine, and the land under the building . The example concludes that these assets \ncolle ctively repres ent a single lease component. Considering the lessee entered into the lease to obtain \nthe power -generation capabilities of the turbine, and the land and building would have little to no use \nor value to the lessee without the turbine, the turb ine represent s the predominant asset in the lease \ncomponent. Accordingly, the remaining economic life of the turbine should be used when evaluating \nthe classification of the lease component. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 89}), Document(page\_content='Lease classification \n3-203.3.4 Lease payment test s \nThis criterion (commonly referred to as the “lease payments criterion” ) is met if the present value of \nthe sum of lease payments and any residual value guarantee d by the lessee that has not already been \nincluded in lease payments in accordance with ASC 842 -10-30-5(f) equals or exceeds substantia lly all \nof the fair value of the underlying asset . Although the FASB did not include bright lines in ASC 842, it \nhas indicated that one approach to applying this indicator is to consider payments equal to or greater \nthan 90 % of the underlying asset’s fair value . \nASC 842 -10-30-5 lists the six types of lease payments to be included in the measurement of aggregate \nlease payments used for lease classification purposes. \nASC 842 -10-30-5 \nAt the commencement date, the lease payments shall consist of the following payments relating to the \nuse of the underlying asset during the lease term : \na.Fixed payments, including in substance fixed payments, less any lease incentives paid or payable\nto the lessee (see paragraphs 842 -10-55-30 through 55-31).\nb.Variable lease payments that depend on an index or a ra te (such as the Consumer Price I ndex or a\nmarket interest rate), initially measured using the index or rate at the commencement date.\nc.The exercise price of a n option to purchase the underlying asset if the lessee is reasonably certain\nto exercise th at option (assessed considering the factors in paragraph 842 -10-55-26).\nd.Payments for penalties for terminating the lease if the lease term (as determined in accordance\nwith paragraph 842 -10-30-1) refl ects the lessee exercising an option to terminate the lease.\ne.Fees paid by the lessee to the owners of a special -purpose entity fo r structuring the transaction.\nHowever, such fees shall not be included in the fair value of the u nderlying asset for purposes of\napplying paragraph 842 -10-25-2(d) .\nf.For a lessee only, amounts probable of being owed by the lessee under residual value guarantees\n(see paragraph s 842-10-55-34 through 55 -36).\nIf a lease includes nonlease components, their value s and associated payments should be separated \nand excluded for purposes of lease classification, unless a lessee makes an accounting policy election \nnot to separate nonlease components for the parti cular asset class. See LG 2.4 for information on \nmultiple element arrangements and the allocation of consideration to lease and nonlease components. \nQuestion LG 3-10 \nAre the costs associated with removing leasehold improvements installed by the lessee (i.e., a lessee’s \nobligation to return an underlying asset to its original condition ) considered lease payments ? ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 90}), Document(page\_content='Lease classification \n3-21PwC response \nNo. The costs associated with a lessee’s obligation to return an underlying asset to its original \ncondition generally would not meet the definition of a lease payment (defined in ASC 842 -10-30-5), \nand should not be included when assessing lease classification or in the measurement of the lessee’s \nlease liability . Since the costs are asso ciated with removing the lessee’ s owned assets, t hese costs \nshould be accounted for using the guidance in ASC 410, Asset Retirement and Envir onment al \nObligations. \nQuestion LG 3-11 \nAre the costs a lessee incurs to dismantle and remove the lessor’s underlying asset at the end of the \nlease term considered lease payments? \nPwC response \nThese payments are incurred by the lessee to remove the lessor’ s assets and consequently the y would \nbe subject to the guidance in ASC 842 (not ASC 410) . However, t hese costs meet the definition of \nvariable lease payment s under ASC 842 because the ultimate amount payable will vary based on \nchanges in factors aft er lease commencement. Because the payments are not based on an index or rate , \nthey should not be included as a lease payment when assessing classification or in the measurement of \nthe lessee’s lease liability . \nQuestion LG 3-12 \nShould lease payments include nonmonetary consideration (e.g. , common stock of a lessee) ? \nPwC response \nGenerally, yes. We believe noncash consideration should be included in lease payments, measured at \nfair value on the lease commencement date. However, there are certain forms of noncash \nconsideration that are explicitly excluded from lease payments, such as a lessee’s gu arantee of a \nlessor’s debt. \nQuestion LG 3-13 \nShould lease payments include deposits paid by a lessee to a lessor? \nPwC response \nIt depends. P rovisions in a lease agreement commonly require a lessee to pay a deposit to a lessor at or \nbefore the lease commencement date to financially protect the lessor in the event the lessee damages \nor does not properly maintain the underlying asset. If the asset i s not damaged and is properly \nmaintained, t he lessor is required to reimburse the lessee for the full amount of the deposit at the end \nof the lease . \nIf a deposit paid by a lessee to a lessor is refundable, we do not believe the deposit is a lease payment. \nRather, the payment should be accounted for as a deposit asset and liability by a lessee and lessor, \nrespectively. Deposits should be evaluated to determine whether it is probable all or a portion of the \ndeposit will be returned to the lessee at or before the end of the lease term. When an amount on ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 91}), Document(page\_content='Lease classification \n3-22deposit is less than probabl e of being returned to the lessee , it should be recognized in the same \nmanner as a variable lease payment (i.e., a period cost) . \nIf a deposit paid by a lessee to a lessor is nonrefundable, we believe the deposit is a lease payment. For \nexample, if a lessee is required to pay a lessor a deposit at or before the lease commencement date to \ndemonstrate its commitment to lease the underlying asset, the deposit should be accounted f or as a \nfixed lease payment . \nQuestion LG 3-14 \nShould a lessor account for sales tax and other similar taxes collected from a lessee as contract \nconsideration? \nPwC response \nIt depends. As an accounting policy election, a lessor may account for sales tax and other similar taxes \ncollected from a lessee as lessee costs. If this policy is elected, a lessor would exc lude these costs from \ncontract consideration and variable consideration and present revenue net of these costs. If elected, \nadequate disclosure of the policy election is required. This policy election cannot be applied to a \nlessor’s gross receipts taxes. \nQuestion LG 3-15 \nHow should a lessor account for costs that are explicitly required to be paid by a lessee on the lessors ’ \nbehalf? \nPwC response \nIt depends. A lessor should exclude from variable payments all lessor costs that are explicitly required \nto be paid directly b y a lessee on behalf of the lessor to a third party. Examples include property taxes \nand insurance. A lessor would report revenue net of these amounts. Costs that are not part of contract \nconsideration that are paid by a lesso r to a third party and reimbursed by the lessee are considered \nlessor costs and would be accounted for as variable payments by the less ee. The lessor would therefore \nreport these amounts gross on the income statement. ASC 842 -10-15-40A only relate to costs \nassociated with the lease , and not lease payments themselves . \nQuestion LG 3 -16 \nAre payments related to non -performance -related default covenants considered lease payments for \nlease classification purposes? \nPwC response \nNo, any payments that must be made as a result of non -performance are not considered when \nassessing lease classification. These payments are considered variable lease payments. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 92}), Document(page\_content='Lease classification \n3-233.3.4.1 Fixed lease payments \nFixed lease payments are payments required under the lease. They can be either a fixed amount paid \nat various intervals in a lease ( e.g., a five -year equipment lease with annual lease payments of $2,000) \nor they can be payments that change over time at known amounts (e.g., lease payments of $2,000 per \nmonth at lease commencement that increase annually by $250 per month). \nThe exercise price of a purchase option should be included in the calculation of lease payments for \npurposes of lease classification and measurement when exercise is reasonably certain . See LG 3.4 for \ninformation on the application of the reasonably certain threshold. \nASC 842 -10-30-5 requires lease incentives to be recorded as a reduction of fixed payments when \ndetermining lease payments . See LG 3.3.4.2 for information on lease incentives. \nExamp le LG 3-8 illustrates how to determine the fixed lease payments. \nEXAMPLE LG 3-8 \nLease payments – determining the fixed payments \nLessee Corp and Lessor Corp enter into a 10-year lease of an office building for fixed annual lease \npayments of $100,000. Per th e terms of the lease agreement, annual fixed lease payments to Lessor \nCorp comprise $85,000 for rent and $15,000 for real estate taxes. \nWhat are the fixed lease payments for purposes of classifying the lease? \nAnalysis \nThe f ixed lease payments are $100,000. Although real estate taxes are explicitly stated in the lease \ncontract, they do not represent a separate nonlease component as they do not provide a separate good \nor service . The right to use the office building is the onl y component . The annual lease payments of \n$100,000 represent payments related to that single lease component . \nSee Example LG 3-9 for information on variable payments for real estate taxes. See LG 2. 4 for \nadditional information on identifying lease and nonlease components in a contract . \nLeasehold improvements \nPayments made by lessees for improvements to the underlying asset (e.g., upgrades to lighting, \nflooring, pantries) should be recorded as prepaid rent and included in fixed lease payments if the \npayment relates to an asset of the lessor. Determining whether payments made by a lessee for \nimprovements to the underlying asset should be accounted for as lease payments to a lessor or as \nleasehold improvements of the lessee requires judg ment. There is diversity in practice and there are a \nnumber of models in use to make the determination. While other models may be acceptable, we \nbelieve the following model closely follows the economics. \nGenerally, if a lease does n ot specifically require a lessee to make an improvement, the improvement \nshould be considered an asset of the lessee . Payments for lessee assets should be excluded from lease \npayments when evaluating lease classification and measuring the right -of-use asse t and lease liability. \nHowever, if the lease requires the lessee to make an improvement, the uniqueness of the improvement ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 93}), Document(page\_content='Lease classification \n3-24to the lessee ’s intended use should be considered. Improvements that are not specialized and for \nwhich it is probable they could be utilize d by a subsequent tenant would likely be considered assets of \nthe lessor. Other factors to consider include whether the improvement increases the fair value of the \nunderlying asset from the standpoint of the lessor and the economic life of the improv ement relative to \nthe lease term . \nIf a lessee is required to complete a lessor asset improvement, but the improvement has not been \ncompleted as of the lease commencement date, an estimate of the costs to construct the asset, net of \nany funding to be provi ded by the lessor, should be included in lease payments for purposes of \nclassification and measurement. Any subsequent difference between the estimated and actual cost of \nthe improvement should be accounted for as variable lease payments. See LG 3.3.4.3. \nSee LG 3.3.4.2 for information on lessor reimbursement for leasehold improvements. \n3.3.4.2 Lease incentives \nAs discussed in ASC 842 -10-55-30, a lease agreement may include incentives to encourage a lessee to \nsign the lease, such as an up -front cash payment to a lessee, payment of lessee costs (such as moving \nexpenses), or the assumption by a lessor of a lessee ’s preexisting lease . When a lessor assume s a \nlessee’s preexisting lease with a third party, the lessee and lessor should independently estimate any \nloss ass ociated with the assumption as illustrated in ASC 842 -10-55-30(b). \nExcerpt from ASC 842 -10-55-30(b) \nFor example, the lessee ’s estimate of the lease incentive could be based on a comparison of the new \nlease with the market rental rate available for similar underlying assets or the market rental rate from \nthe same lessor without the le ase assumption. The lessor should estimate any loss on the basis of the \ntotal remaining costs reduced by the expected benefits from the sublease of use of the assumed \nunderlying asset. \nLike other amounts included in lease payments, lease incentives are included in the calculation of \nconsideration in the contract, which must be allocated when multiple components exist (e.g. , lease and \nnonlease components). However, irresp ective of the allocation, lease incentives always reduce the \nconsideration in the contract for a lessee and lessor. \nFor a lessee, the reduction to fixed lease payments will affect lease classification and the initial \nmeasurement of the right -of-use asset and lease l iability. For a lessor, the reduction will affect lease \nclassification and the measurement of lease income on a straight -line basis (if classified as an \noperating lease) or t he net investment in the lease (if classified as a sales -type or direct financ ing \nlease ). \nReimbursement for leasehold improvements \nLessor reimbursement for some (or all) of the costs a lessee incur s to complete leasehold \nimprovements is a common example of a lease incentive . These payments may be calculated as a \ncertain amou nt per square foot or a fixed amount regardless of the level of improvements undertaken \nby a lessee. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 94}), Document(page\_content='Lease classification \n3-25To determine whether a payment from the lessor to the lessee represents a lease incentive, a reporting \nentity must determine whether it represents a lesse e or a lessor asset. See LG 3.3.4.1 for additional \ninformation about making that deter mination . If an improvement represents a lessee asset, the lessor \npayment is a lease incentive that should be recorded as a reduction to fixed lease payments. On the \nother hand, when a lessee pays for an improvement that is a lessor asset , the expenditure is prepaid \nrent rather than a lease incentive; the reimbursement is a reduction to prepaid rent. If a lessee w as not \nfully reimbursed, the difference between the costs incurred and the reimbursements received would be \nincluded in lease payments. \nIf a lessor agrees to pay a fixed or formula -based amount to the lessee once the lessee provides \nevidence of the expenditures and the contract does not specify the nat ure of the improvements to be \ncompleted , it is reasonable to conclude that the improvements represent lessee assets. However, if the \namount a lessee will receive is based on the actual costs incurred on improvements that are specified \nin the contract , judg ment will be required to determine whether the improvement s represent lessee or \nlessor asset s. \nWhen lessor reimbursement for lessee assets (i.e., a lease incentive) occurs subsequent to lease \ncommencement, the lessee and lessor must determine whether the lease incentive is considered fixed \nor variable. If the incentive is subject to a cap and it is reasonably certain the lessee will use some or all \nof the amount available for reimburseme nt by the lessor , we believe the portion of the incentive that is \nreasonably certain of use should be treated as an in substance fixed lease payment (i.e. , reduction to \nlease payments). A leasehold improvement allowance that is negotiated between a lessee and lessor \ncreates an economic incentive for the lessee to use the full amount of the allowance. Therefore, \nnegotiated lease incentives are generally considered reasonably certain of use because a lessee is \neconomically incentivized to use the entire incen tive that it negotiated . \nFor lessees, a t lease commencement, if an allowance for lessee assets represents an in substance fixed \nlease payment, we believe a lessee should estimate the timing and amount of the payments not yet \nreceived and include them in l ease payments when classifying the lease and measuring the lease \nliability, which in turn would get reflected in the right -of-use asset. See LG 3.3.4.3 for further \ndiscussion on in substance fixed lease payments. \nSimilarly, a lessor should estimate the t iming and amount of the payments not yet paid when \nclassifying the le ase and measuring the net investment in the lease if classified as a sales -type or direct \nfinance lease. If classified as an operating lease, although there is no impact to any amounts recorded \nat lease commencement, the reduction to lease payments is included in the calculation of lease income \nthat will be recorded on a straight -line basis over the lease term. \nSee LG 5. 3.2 for information on the subsequent accounting for estimated lease incentives. \nIf an incentive is determined to be variable at lease co mmencement, we believe a lessee should account \nfor the lease incentive as variable rent when the contingency is resolved . Therefore, the incentive does \nnot impact lease classification or initial measurement of the lease liability. \nQuestion LG 3-17 \nHow should a lessee account for in substance fixed lease incentives that will be used to construct lessee \nassets when all other lease payments are entirely variable? ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 95}), Document(page\_content='Lease classification \n3-26PwC response \nWe believe that at lease commencement , the lessee must measure the lease liability and right -of-use \nasset in accordance with ASC 842 -20-30-1. Because the lease payments (other than the incentive) are \nentirely variable , this would result in the recognition of a receivable rather th an a liability. This would \nalso result in a negative right -of-use asset (prior to considering the impact of any prepaid rents or \ninitial direct costs), which would be classified as a liability. The liability would then be amortized on a \nstraight -line basis over the lease term as a reduction to rent expense. \n3.3.4.3 Variable lease payments \nVariable lease payments, or contingent payments, are defined in the ASC 842 Glossary and further \ndiscussed in the Basis for Conclusions in ASU 2016 -02. \nDefinition from ASC 842 G lossary \nVariable Lease Payments: Payments made by a lessee to a lessor for the right to use an underlying \nasset that vary because of changes in facts or circumstances occurring after the commencement date , \nother than the passage of time. \nASU 2016 -02 BC20 5 \nSome or all of the lease payments for the right to use an asset can be variable. That variability can arise \nbecause lease payments are linked to: \na.Price changes due to changes in an external market rate or the value of an index. For example,\nlease pa yments might be adjusted for changes in a benchmark interest rate or the Consumer Price\nIndex.\nb.The lessee’s performance derived from the underlying asset. For example, a lease of retail property\nmay specify that lease payments are based on a specified perc entage of sales made from that\nproperty.\nc.The use of the underlying asset. For example, a car lease may require the lessee to make additional\nlease payments if the lessee exceeds a specified mileage.\nVariable lease payments that depend on an index or a rate should be included in the calculation of \nlease payment s when classifying a lease and in the measurement of the lease liability . Variable lease \npayment s should be calculated a t lease commencement, using the index or rate at lease \ncommencement ; no increase s or decrease s to future lease payments during the lease term should be \nassumed . \nVariable lease payments other than those that depend on an index or a rate should not be included in \nlease payment s for purposes of classif ication and measurement of the lease , unless those payments are \nin substance fixed lease payments . \nIf a lease includes a renewal option that the lessee is reasonably certain to exercise and the payments \nduring the renewal period are based on the fair market rents at the beginning o f the renewal period, \nwe believe the renewal period rents should be treated similar to variable lease payments that depend \non an index or rate. This approach is consistent with IFRS 16.28 , which says that variable lease ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 96}), Document(page\_content='Lease classification \n3-27payments that depend on an index or rate include payments that vary to reflect changes in market \nrental rates. \nSubsequent to the lease commencement date, when the actual payments in the renewal period are \nknown, the lessee would not remeasure the lease payments. Rather, any changes would be a period \ncost during the period in which they are incurred. The lessor would record the changes as earned \nduring the period they occur. \nSee LG 5.3.1 for information on when to remeasure lease payments , including the impact of variable \nlease payments on r emeasurement . \nExample LG 3-9, Example LG 3-10, and Example LG 3-11 illustrate when to include variable lease \npayments in the calculation of lease payment s when classifying a lease . \nEXAMPLE LG 3-9 \nLease payments – variable lease payments tied to an index \nLessee Corp enters into a n agreement with Lessor Corp to lease office space for a term of 60 months. \nLease payments during year one of the lease are $10,000 per month . Each year, lease payments \nincrease by an amount equivalent to the percentage incre ase in the Consumer Price Index (CPI). For \nexample, if the CPI increases by 3 %, lease payments during year two of the lease would increase 3% to \n$10,300 per month. If the CPI decreases or remains consistent, lease payments remain at the rate in \neffect during the previous year . \nWhat are the lease payments for purposes of classifying the lease? \nAnalysis \nIncreases in lease payments are tied to the percentage change in the CPI and m ovements in the CPI \nsubsequent to lease commen cement are unknown. As such, only the initial lease payments of $10,000 \nper month would be included in the calculation of lease payments when classifying the lease. \nSee Example LG 4-6 for a n example of the initial measurement of a lease with a variable le ase payment \ntied to an index. \nEXAMPLE LG 3-10 \nLease payments – variable lease payments tied to real estate taxes \nLessee Corp and Lessor Corp enter into a 10-year lease of an office building for fixed annual lease \npayments of $85,000. Per the terms of the lease agreement, Lessee Corp is required to pay Lessor \nCorp an amount equal to all real estate taxes associated with the building during the lease term . Real \nestate taxes are expected to be $15,000 for the first ye ar of the lease . \nWhat are the lease payments for purposes of classifying the lease? ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 97}), Document(page\_content='Lease classification \n3-28Analysis \nThe lease payments are $85,000. A lthough the terms of the lease require Lessee Corp to pay Lessor \nCorp an amount equal to the real estate taxes, real estate taxes vary on an annual basis . As such, they \nwould be considered variable lease payments that are not dependent on an index or a rate . As a result, \nthey should be excluded from lease payments for purposes of classif ication and measurement . \nAs discussed in Example LG 3-8, real estate taxes do not represent a separate lease component. See LG \n2.4 for additional information on identifying lease and nonlease components. \nEXAMPLE LG 3-11 \nLease payments – variable lease payments tied to fair market value \nLessee Corp enters into a five -year noncancellable office lease with Lessor Corp . The lease contains a \n5-year renewal option that Lessee Corp is reasonably certain to exercise. The lease payments are fixed\nat $600 k annually for each of the first five years. The annual lease payments for the renewal option\nwill be set at the beginning of the renewal period based upon the fair market rent at the beginning of\nthe renewal period.\nShould the lease liability include amounts related to the renewal period ev en though the amount of the \nannual lease payments for that period is unknown at the lease commencement date? \nAnalysis \nYes. Similar to variable lease payments that depend on an index or rate, lease payments during the \nrenewal period should be included in l ease payments when classifying and measuring the lease at lease \ncommencement . The renewal period rents should be based on the market rental rate at lease \ncommencement (i.e., $600k per year), not the estimated market rental rate at the beginning of the \nrene wal period. \nIn substance fixed lease payments \nVariable lease payments that are considered in substance fixed lease payments should be included in \nthe calculation of lease paymen ts for classification and measurement . ASC 842 -10-55-31 provides \nguidance on in substance fixed lease payments. \nExcerpt from ASC 842 -10-55-31 \nIn substance fixed payments are payments that may, in form, appear to contain variability but are, in \neffect, unavoidable. In substance fixed paymen ts for a lessee or a lesso r may include, for example, any \nof the following: \na.Payments that do not create genuine variability (such as those that result from clauses that do not\nhave economic substance )\nb.The lower of the payments to be made when a lessee has a c hoice about which set of payments it\nmakes , although it must make at least one set of payments.', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 98}), Document(page\_content='Lease classification \n3-29Variable lease payments based on performance or use are excluded from the calculation of lease \npayments for classification and measurement. This is true even if there is a high probability of some \npayment for usage during the lease term . Accordingly, a reporting entity would not include payments \nthat vary solely on the basis of future use or performance in lease payments, regardless of the \nprobability of occurre nce (except in cases where the arrangement contains a guaranteed minimum \npayment or penalty that effectively a mount s to a floor for lease payments ). \nSome lease payments are contingent in form , but are in effect, unavoidable ; for example, p ayments \ndue to clauses that lack economic substance or that provide a choice of payment type, but no ability to \navoid a payment. \nFor example, consider a 10 -year lease that provides for an increase in rent beginning in year six, which \nis calculated as five times the change in the CPI over the prior five-year period, with any increase in \nrent capped at 5 %. It is reasonable to conclude a 5 % rent increase commenc ing in the sixth year of the \nlease term is unavoidable ; therefore, the 5 % rent increase should be included in lease payments by the \nlessee and lessor. \nThere is often some portion of a contingent lease payment that is highly probable of being paid (e.g., \nsome level of payment will generally be required in a lease that provides for percentage rent based on \nsales derived from the output of the leased asset ). However, because the payment provision creates \ngenuine variability, the total payment should be considered a variable lease payment and excluded \nfrom the lease payments. \nA lease may include protective rights that impact the amount of lease payments due. Protective rights \nare generally rights that protect a lessee from the requirement to make paymen ts during periods when \nthe underlying asset is not available for use. For example, lease payment s due may be substantially \nreduced during periods of excessive downtime for maintenance or inspection, when a lessor defaults \non its obligations , or when weathe r conditions render the underlying asset unavailable to the lessee . \nThe effect of protective rights should be disregarded when determining lease payments for purposes of \nclassification and measurement. \nExample LG 3-12, Example LG 3-13, Example LG 3-14, and Example LG 3-15 illustrate how to \ndetermine if variable lease payments are considered in substance fixed lease payments. \nEXAMPLE LG 3-12 \nLease payments – payments tied to sales \nLessee Corp enters into a 10 -year lease for retail office space with Lessor Corp . The annual lease \npayments are $20,000 plus an amount equal to 5 % of Lessee Corp ’s sales. Lessee Corp ’s annual sales \nhave exceeded $200,000 since it began operations and are projected to grow at a rate of 10 % annually . \nWhat ar e the lease payments for purposes of classifying the lease? \nAnalysis \nThe lease payments for purposes of classifying the lease are the fixed annual lease payments of \n$20,000. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 99}), Document(page\_content='Lease classification \n3-30Although there is a high probability of some variable lease payments being made in light of Lessee \nCorp ’s historical results and projections, the variable lease payments are based exclusively on, and \nvary with, the performance of the underlying asset and do not represent in substance fixed lease \npayments . \nEXAMPLE LG 3-13 \nLease payments – in substance fixed lease payments \nLessee Corp enters into a five-year lease for office space with Lessor Corp. The initial base rent is \n$10,000 per month. Rents increase by the greater of 1 % of Lessee Corp ’s generated sales or 3 % of the \nprevious rental rate on each anniversary of the lease commencement date. \nWhat are the lease payments for purposes of classifying the lease? \nAnalysis \nThe lease payments for purposes of classifying the lease are the fixed monthly payment s of $10,000 \nplus the minimum annual increase of 3 %. \nLessee Corp is required to pay no less than a 3% increase r egardless of the level of sales activity ; \ntherefore , this minimum level of increase is an in substance fixed lease payment . \nEXAMPLE LG 3-14 \nLease payments – payments tied to use of medical device consumables \nLessee Corp enters into a three -year lease for a medical device with Lessor Corp. Annual fixed lease \npayments are $100,000. Lessee Corp is also required to purchase at least $1 million of consumables to \nbe used in the operation of the medical device by the end of the lease term. If Lessee Corp does not \norder $1 million of consumables, it is required to make a shortfall payment equal to the difference \nbetween the total consumables purchased and $1 million. \nThe measurement and allocation of contract consideration are not addressed in this example. For \nsimplicity, assume all payments are allocated to the lease component (i.e. , the medical device). \nWhat are the lease payments for purposes of classifying the l ease? \nAnalysis \nThe lease payments for purposes of classifying the lease include both the $300,000 fixed lease \npayments (3 years × $100,000 per year) and the in substance fixed lease payment of $1 million for \nconsumables. \nAlthough the payment for consumables varies based on use, because Lessee Corp is required to make \npayments of at least $1.3 million regardless of its consumable use , the $1 million minimum payment is \nan in substance fixed lease payment. \nSee Question LG 3-18 for information on the differences between payments included in lease \npayments and payments included in contract consideration. See LG 2.4 for information on measuring \nand allocating contract consideration to identified lease and nonlease components. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 100}), Document(page\_content='Lease classification \n3-31EXAMPLE LG 3-15 \nLease payments – protective rights \nLessee Corp enters into a 5 -year lease for equipment with Lessor Corp. The arrangement provides that \nLessor Corp will maintain the equipment and operate it in accordance with instructions provided by \nLessee Corp . \nPayments due from Lessee Corp to Lessor Corp are based on the daily operation of the equipment (i.e. , \nperformance -based rates assigned to the nature of the activities performed each day throughout the \nterm of the contract) as follows: \n□Each day the equipment is available for use and operated by Lessor Corp , Lessee Corp must pay\n$1,000;\n□Each day the equipment is available for use and Lessor Corp is available to operate the equipment,\nbut the asset is not utilized as instructed by Lessee Corp , Lessee Corp must pay $750;\n□Each day the equipment is (a) unavailable for use at the request of Lessor Corp (e.g. , maintenance,\nrequired inspections), (b) unavailable for use due to events outside of both Lessee Corp and Lessor\nCorp ’s control (e.g. , weat her conditions), or (c) available for use, but Lessor Corp is not available\nto operate the equipment, Lessee Corp must pay $500. If the aggregate days the equipment is not\noperational due to (a), (b) , or (c) exceeds 15 in a year, no payment is due from Les see Corp for\nnon-operational days exceeding the 15 day maximum. Based on historical experience with similar\ncontracts, it is probable the total number of nonoperational days will exceed the 15 day maximum.\nWhat are the lease payments for purposes of class ifying the lease? \nAnalysis \nDaily fixed payments are $ 750. \nThe daily rate of $750 represents the lowest amount the lessee would pay the lessor when the \nunderlying asset is available for use. The additional $250 the lessee would pay when it uses the asset i s \na variable payment based on usage, and, therefore, is excluded from lease payments. The $500 \npayment level (and $0 payment) only apply when the lessor is unable to make the asset available for \nthe lessees use, i.e. , they result from a protective right. Payments (or payment reductions) resulting \nfrom a protective right are not considered in determining lease payments. Thus, any reductions in rent \nbelow $750 are (negative ) variable payments . Variable payments are excluded from lease payments \neven though Lessee Corp and Lessor Corp conclude d it is probable that the total number of \nnonoperational days will exceed the 15 day maximum, resulting in days whe n Lessee Corp is not \nrequired to make payments to Lessor Corp . \nThe daily rate of $ 750 represents the lowest contractual rate that is not the result of a protective right \n(i.e., it is the in substance daily fixed payment) . Accordingly, the total annual consideration in the \ncontract is $ 273,750 ($750 per day × 365 days ), which should be allo cated between the lease and \nnonlease components. Only the payments allocated to the lease should be considered for purposes of \nclassifying the lease. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 101}), Document(page\_content='Lease classification \n3-323.3.4.4 Residual value guarantees \nThe ASC 842 Glossary provides the following definition of a residual value guar antee . \nDefinition from ASC 842 Glossary \nResidual Value Guarantee : A guarantee made to a lessor that the value of an underlying asset returned \nto the lessor at the end of a lease will be at least a specified amount . \nA residual value guarantee provides a lessor with certainty (subject to credit risk) that the fair value of \nthe underlying asset subject to lease will not decline below a certain amount. Lessees may be \nmotivated to provide such guarantees in order to obtain a lease that may not otherwise be av ailable to \nthem or to obtain more favorable pricing for the leased asset. Lessors may also secure residual value \nguarantees from a third party to reduce or eliminate their risk in the residual value of the asset. \nResidual value guarantees provided by a le ssee \nIf the present value of the lease payments and any residual value guarantees provided by the lessee \nguarantees a lessor the recovery of substantially all of the fair value of its underlying asset, the \narrangement is a finance lease for the lessee and sales -type lease for the lessor . \nLessee s and lessors should include the full amount of the potential payment payable under a residual \nvalue guarantee in fixed lease payments when evaluating lease classification under ASC 842 -10-25-2 \n(d)(i.e., the lease p ayments criterion) . While the terms of certain residual value guarantees may\neliminate virtually all of the lessor’s risk in the underlying asset, the likelihood of loss by the lessor is\nnot a factor that should be considered when classifying a lease.\nThe requirement to include the full amount of the potential payment payable under a residual value \nguarantee differs from the measurement guidance , which requires that lessees and lessors consider \nonly the present value of any payment under a lessee residual value guarantee that is probable of being \nowed. \nA lessee may choose to obtain residual value insurance from an unrelated third party to protect against \nany exposure created by the provision of a residual value guarantee to a lessor. For example, if the \nresidual value of the underlying asset was lower than the guaranteed amount at the end of a lease , the \nthird party would make the necessary payments to satisfy the lessee’s residual value guarantee to the \nlessor. When third -party insurance is for the benefit of the lessor, a lessee may not reduce lease \npayments when measuring the lease unless the less or explicitly releases the lessee from their \nobligation under the residu al value guarantee, including any obligation should the third party default. \nAdditionally, any payments by a lessee to acquire third party residual value insurance are executory \ncosts, which should not be included in lease payments. \nIf a lease contains a provision that provides the lessor with the right to require the lessee to purchase \nthe underlying asset by the end of the lease term, the stated purchase price should be included in l ease \npayments. This is because the purchase price is effectively a residual value guarantee that the lessee is \nrequired to pay (i.e. , the payment of the purchase price is outside of the lessee’s control). See Question \nLG 3 -18 for further discussion. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 102}), Document(page\_content='Lease classification \n3-33Questi on LG 3-18 \nShould a lessee consider a residual value guarantee in the lease classification determination differently \nthan how it considers the guarantee when measuring its lease liability? \nPwC response \nYes. The probability of having to satisfy a residual v alue guarantee is not considered for purposes of \nlease classification , but is considered when measuring a lease liability. To illustrate, a lessee may \nprovide a guarantee that the leased property will have a value that is no less than $100 at the end of \nthe lease . The lessee believes it is probable it will owe $15 under this guarantee . In such a situation , it \nwould include the present value of the full residual value guarantee amount (i.e., $100) when \ndetermining how to classify the lease, but it would incl ude only the present value of the amount it is \nprobable of owing (i.e., $15) when measuring its lease liability. \nResidual value guarantees obtained from a third party \nIf a residual value guarantee is provided by a third party unrelated to the lessor , and n one of the other \ncriteria in ASC 842 -10-25-2 are met, the lessor should evaluate whether the lease should be classified \nas a direct financing lease. A lessor would classify a lease as a direct financing lease if the lease meets \nboth of the criteria in ASC 842 -10-25-3(b). \nASC 842 -10-25-3 \nWhen none of the criteria in paragraph 842-10-25-2 are met : \na.A lessee shall classify the lease as an operating lease.\nb.A lessor shall classify the lease as either a direct fina ncing lease or an op erating lease. A lessor\nshall classify the lease as an operating lease unless both of the following criteria are met, in which\ncase the lessor shall classify the lease as a direct financ ing lease:\n1.The present value of the sum of the lease payments and any residual value guaranteed by the\nlessee that is not already reflected in the lease payments in ac cordance with paragraph\n842-10-30-5(f) and/ or any other third party unrelated to the lessor equals or exceeds\nsubstantially all of the fair value of the underlying asset .\n2.It is probable that the lessor will collect the lease payments plus any amount necessary to\nsatisfy a residual value guarantee.\nFor a lease to be classified as a direct financing lease, the l ease payments and any amount necessary to \nsatisfy a residual value guarantee should be probable of collection at lease commencement. If the \nlessor determines collection is not probable, the lease should be classified as an operating lease. See \nLG 3.3.4. 7 for information on collect ibility. \nExample LG 3-16 illustrates the effect of a residual value guarantee on lease classification. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 103}), Document(page\_content='Lease classification \n3-34EXAMPLE LG 3-16 \nResidual value guarantee – third party \nLessor Corp enters into a lease of non -specialized construction equipment with Lessee Corp. The fair \nvalue of the equipment at l ease commencement is $50 0,000. Lessee Corp does not provide a residual \nvalue guarantee. \nLessor Corp estimates that the fair value of the construction equipment at the end of t he lease will be \n$150,000. While Lessor Corp acknowledges the value of the asset may declin e below $15 0,000 in the \nfuture, Lessor Corp conclude s there is less than a 1% chance of the value falling below $100,000 . \nTherefore, t o protect its investment , Lessor Corp obtains residual val ue insurance from a third party \ncovering any loss incurred by Lessor Corp if the value declines to between $150,000 to $100,000 . That \nis, if the residual value falls below $15 0,000, Le ssor is covered for the first $ 50,000 of loss. The risk of \nloss associated with the value of the equipment falling below $10 0,000 is retained by Lessor Corp . \nAssume Lessor Corp has already evaluated the lease classification criteria and concluded the lease is \nnot a sales -type lease . \nHow should L essor Corp classify the lease? \nAnalysis \nLessor Corp should classify the lease as an operating lease . When determining whether the present \nvalue of the lease payments and the residual value guarantee amount to substantially all the fair value \nof the underlying asset, Lessor Corp would consider the nominal amount of retained risk of $100,000, \nrather than the fair value of its retained risk . Assuming that the present value of the $100,000 \nunguaranteed residual val ue is great enough, the present value of the lease payments and the \nguaranteed residual will not amount to substantially all the fair value of the underlying asset. In that \ncase, and considering that at lease commencement, the lease did not meet any of the criteria to be \nclassified as a sales -type lease , the lease would not meet the criteria to be classified as a direct finance \nlease. \nThe same conclusion would be reached if the residual value guarantee was provided by Lessee Corp as \nopposed to a third part y. \nLoan guarantees and loans to the lessor \nASC 842 -10-30-6 specifically excludes lessee guarantees of the lessor ’s debt from the definition of \nlease payments and does not address loans by the lessee to the lessor. Consistent with long -standing \npractice, w e believe that a lessee ’s guarantee of the lessor ’s debt or a loan to the lessor may, in some \ncircumstances, be considered a residual value guarantee and shou ld be treated as such in the \nassessment of lease classification . \nFor example, i f the lessor ’s debt is nonrecourse , or the lessor has no significant assets other than the \nunderlying leased assets , the substance of the lessee ’s remaining guarantee at the ex piration of the \nlease term may be a guarantee of the residual value of the underlying assets . This is because there is \nlittle substantive difference between a payment by the lessee to the lessor ’s nonrecourse lender \npursuant to a loan guarantee and a direc t payment by the lessee to the lessor under a residual value \nguarantee. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 104}), Document(page\_content='Lease classification \n3-35Portfolio level residual value guarantees \nASC 842 -10-55-9 and ASC 842 -10-55-10 discuss portfolio level residual value guarantee s. \nASC 842 -10-55-9 \nLessor s may obtain residual value guarantees for a portfolio of underlying assets for which settlement \nis not solely based on the residual value of the individual underlying assets. In such cases, the lessor is \neconomically assured of receiving a minimum residual value for a portfolio of assets that are subject to \nseparate leases but not for each individual asset. Accordingly, when an asset has a residual value in \nexcess of the “guaranteed” amount, that excess is offset against shortfalls in residual value that ex ist in \nother assets in the portfolio . \nASC 842 -10-55-10 \nResidual value guarantees of a portfolio of underlying assets preclude a lessor from determining the \namount of the guaranteed residual value of any individual underlying asset within the portfolio. \nConsequently, no such amounts should be considered when evaluating the lease classification criteria \nin paragraphs 842 -10-25-2(d) and 842 -10-25-3(b)(1) . \nGenerally, when assessing the classification criteria, a lessor should not include residual value \nguarant ees when it applies to a portfolio of leased assets (unless they represent a single lease \ncomponent ) because the classification analysis is performed on an asset by asset basis and it is not \npossible to determine the amount of the guaranteed residual value for each individual asset. \nA pooled residual value guarantee covering multiple leases can rarely be included in the assessment of \nthe lease payments criterion when determining lease classification . The guidance in ASC 842-10-55-10 \nwas largely carried forward from ASC 840. Under limited circumstances, however, the “portfolio \neffect” observed in ASC 842-10-55-9 may not exist for groups of leased assets that are similar. \nConsequently , and consistent with how practice evolved in this area under ASC 840, we believe it may \nbe acceptable for a lessor to consider a pooled residual value guarantee in the assessment of the lease \npayments criterion if the following characteristics exist : \n□Each of the leases commence at the same time\n□The ends of the lease te rms are contemporaneous\n□The leased assets are physically similar to one another\n□The variability around the expected residual values is expected to be highly correlated\nThe classification of a lease that includes a residual value guar antee that applie s to a portfolio of leased \nassets by a lessee is not addressed by ASC 842 . Generally, we believe a lessee should include the full \namount of the potential payment payable unde r a residual value guarantee to each of the individual \nassets (unless they represent a single lease component) because the classification analysis is \nperformed on an asset by asset basis and it is not possibl e to determine the amount of the guaranteed \nresidual value for each individual asset . We believe th is would appl y, for exam ple, to a single residual \nvalue guarantee in a lease of a building and the underlying land, as the building and land are always \nseparate lease components (refer to LG 2.5 for guidance on determining lease components). However, \nunde r limited circums tances, if the four char acteristics noted abo ve are present , it may be acceptable ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 105}), Document(page\_content='Lease classification \n3-36for a lessee to include a ratable allocation of the potential payment payable unde r the residual value \nguarantee to the individual assets within the portfolio. \n3.3.4.5 Fair value of the underlying asset \nThe lease pa yments criterion requires a lessee and lessor to compare the present value of lease \npayments and any residual value guaranteed by the lessee to the fair value of the underlying asset. The \nASC 842 Glossary provides the following definition of fair value . \nDefinition from ASC 842 Glossary \nFair value ( second definition) : The price that would be received to sell an asset or paid to trans fer a \nliability in an orderly transaction between market participants at the measurement date. \nThis criteri on requires the comparison of the lease payments to the fair value of the lease component \n(i.e., the underlying asset) , not to the fair value of the right to use the asset subject to the lease \narrangement . This is an important distinction because most leases are for a period shorter than the \neconomic life of the underlying asset , therefore, the fair value of the asset and the right to use the asset \nwill differ . Additionally, when a lease component includes multiple underlying assets, the fair value \nshould be for the group, which may differ from the sum of the fair values of the individual assets . \nOther factors , such as tax credits, may impact fair value. A lease arrangement may allow a lessor to \nretain certain tax credits related to the underlying asset ; for example, tax credits related to the \nconstruction and ownership of the underlying asset. Tax credits are typically associated with the \nownership of, not the use of, the underlying asset. Therefore, tax credits retained by the lessor should \nbe excluded from the determination of fair value . \nFees paid to special -purpose entity owners should be excluded from the fair value of the underlying \nasset as discussed in ASC 842 -10-30-5. However, these fees should be included as lease payments. \nExcerpt from ASC 842 -10-30-5(e) \nFees paid by the lessee to the owners of a special -purpose entity for structuring the transaction ... shall \nnot be included in the fair value of the underlying asset for purposes of applying paragraph 842 -10-25-\n2(d). \nASC 842 -30-55-17A includes an exception to the guidance in ASC 842 -10-30-5(e) for lessors (that are \nnot manufacturers or dealers) that allows them to use the cost of the unde rlying leased asset (subject \nto applicable volume or trade discounts) instead of fair value when assessing lease classification and \nmeasuring the lease. Thus, qualifying lessors can capitalize acquisition and delivery cost s, including \nsales taxes, associat ed with the underlying asset. Because fair value , when applying the exception in \nASC 842 -30-55-17A, equals the qualifying lessor’s cost, no selling profit or loss is recognized at lease \ninception for sales -type and direct financing leases. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 106}), Document(page\_content='Lease classification \n3-37ASC 842 -30-55-17A \nNotwithstanding the definition of fair value , if a lessor is not a manufacturer or a dealer, the fair value \nof the underlying asset at lease commencement is its cost, reflecting any volume or trade discounts \nthat may apply. However, if there has been a significant lapse of time between the acquisition of the \nunderlying asset and lease commencement, the definition of fair value shall be applied. \nASC 842 -10-55-3 provides guidance regarding the classification of a lease when it is not practicable for \na reporting entity to determine the fair value of the underlying asset. \nASC 842 -10-55-3 \nIn some cases, it may not be practicable for an entity to determine the fair value of an underlying asset. \nIn the context of this Topic, practicable means that a reasonable estimate of fair value can be made \nwithout undue cost or ef fort. It is a dynamic concept; what is practicable for one entity may not be \npracticable for another, what is practicable in one period may not be practicable in another, and what \nis practicable for one underlying asset (or class of underlying asset) may n ot be practicable for another. \nIn those cases in which it is not practicable for an entity to determine the fair value of an underlying \nasset, lease classification should be determined without consideration of the criteria in paragraph s \n842-10-25-2(d) and 842-10-25-3(b)(1) .\nLessees and lessors should generally be able to estimate the fair value of an underlying a sset. As \nsuggested in ASC 842-10-55-3, an y assertion that it is not practicable to arrive at such estimate s would \nbe based on facts and circumstances of the specific transaction at that point in time , and not based on \na model or a policy. Given the ubiquitous use of fair value measurements throughout other accounting \ntopics, it would be unusual for lessees or lessors to be unable to do so for purposes of classifying leases. \nFor example, we believe entities will often be able to estimate the fair value of a portion of an asset by \nreference to the fair value of the entire asset, as adjusted for distinct features of the leased asset, when \nthose significantly affect the comparison. See PwC ’s Fair value measurem ents guide for further \ndiscussion of fair value measurements. \nQuestion LG 3-19 \nCan a lessee recognize a right -of-use asset that exceeds the fair value of the underlying asset? \nPwC response \nASC 842 does not specifically preclude a lessee from recording a right -of-use asset that exceeds the fair \nvalue of the underlying asset. However, it would be unusual for a lessee to knowing ly pay more than \nfair value for an asset. Consequently, in these circumstances, a lessee should question the factors \nconsidered in the measurement of the right -of-use asset. For example, a lessee should reconsider the \ndiscount rate, the identification of l ease and nonlease components, the allocation of consideration to \nthe components , and the fair value of the underlying asset. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 107}), Document(page\_content='Lease classification \n3-383.3.4.6 Discount rate \nLessees and lessors should discount lease payments at the lease commencement date using the ra te \nimplicit in the lease. If the information necessary to determine the rate implicit in the lease is not \nreadily available, a lessee should use its incremental borrowing rate. \nRate implicit in the lease \nThe rate implicit in the lease is defined in the ASC 842 Glossary . \nPartial d efinition from ASC 842 Glossary \nRate Implicit in the Lease: The rate of interest that, at a given date, causes the aggregate present value \nof (a) the lease payments and (b) the amount that a lessor expects to derive from the underlying asset \nfollowing the end of the lease term to equal the sum of (1) the fair value of the underlying asset minus \nany related investment tax credit retained and expected to be realized by the lessor and (2) any \ndeferred initial direct costs of the lessor. \nA lessor may be required to calculate different discount rates when classifying a lease. When \nevaluating the lease payments criterion to determine whether the lease is a sales -type lease, the rate \nimplicit in the lease should include initial direct costs if, at lease commencement, the fair value of the \nunderlying asset equals its carrying value. However, if the fair value of the underlying asset does not \nequal its carrying value, the rate implicit in the lease should exclude initial direct costs. \nIf the lease is not classified as a sales -type lease, a lessor should include initial direct costs when \ncalculating the rate implicit in the lease to determine whether the lease is a direct finance lease or an \noperating lease. In this case, i nitial direct c osts should be included regardless of whether or not the fair \nvalue of the underlying asset is equal to its carrying value. \nIf a lessee can ascertain the fair value of the underlying asset, the residual value estimated by the \nlessor , and initial direct co sts incurred by the lessor, it can calcula te the lessor’s implicit rate . For \nexample, it may be possible for a lessee to calculate the rate implicit in the lease if (a) the lease \nincludes an automatic transfer of title or a bargain purchase option because the lessor’s estimated \nresidual value would be zero, and (b) the lessee concludes that any reasonable amount of initial direct \ncosts would have an insignificant e ffect on the rate. A lessee may also be able to obtain the necessary \ninformation directly from the lessor. However, such information is rarely available to the lessee \nconsidering the sensitive nature of the information to the lessor and the potential impact it could have \non existing or future lease negotiations. Accordingly, lessees and lessors wil l often use a different \ndiscount rate for the same lease. \nAlthough a lessee might be able to reasonably estimate the elements required to calculate the rate \nimplicit in the lease , it may not do so . If the rate implicit in the leas e is not readily determinable , a \nlessee must use its incremental borrowing rate for purposes of classifying the lease and measuring the \nright -of-use asset and lease liability. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 108}), Document(page\_content='Lease classification \n3-39Question LG 3-20 \nWhen calculating the rate implicit in the lease, should the fair value of the residual asset be limited to \nthe lease commencement date fair value of the underlying asset? \nPwC response \nYes. Long standing practice has been that a lessor’s estimate of the residual value of leased property \nshould not exceed the fair value of the leased property at lease inception. However, a literal read of the \ndefinitions of “lease receivable” and “unguaranteed residual asset” in ASC 842 may suggest it is \nappropriate to not limit the estimated residual value to the underlying asset’s fair value at lease \ncommencement. This interpretation would result in a rate implicit in the lease that would consider \nfuture infla tion in the asset’s fair value. This would cause most leases to be classified as operating, \neven those designed to be sales. It also, in the case of a sales -type lease, would result in the recognition \nof estimated future increases in the value of the asset at the commencement date of the lease. We do \nnot believe th ese would be appropriate result s. Consequently, we believe current practice should \ncontinue and the estimated residual value of a leased asset should not exceed its fair value at lease \ncommencemen t. \nQuestion LG 3-21 \nWould it be appropriate for a lessor to use a negative discount rate ? \nPwC response \nNo. The FASB confirmed that they did not intend for the rate implicit in the lease to be less than zero. \nIncremental borrowing rate \nThe ASC 842 G lossary provides the following definition of incremental borrowing rate . \nDefinition from ASC 842 Glossary \nIncremental Borrowing Rate: The rate of interest that a lessee would have to pay to borrow on a \ncollateralized basis over a similar term an amount eq ual to the lease payments in a similar economic \nenvironment. \nASC 842 requires a lessee to use a secured rate. Accordingly, the use of unsecured funding sources \nmay not be considered , even when a lessee is not reasonably able to borrow all the funds necessary on \na secured basis . The standard does not dictate the nature of the assets collateralizing the borrowing. \nWe believe any form o f collateral can be used to determine the incremental borrowing rate , as long as \nthe borrowing is fully collateralized. Even though lessees must use a rate that is fully collateralized, a \nfully collateralized rate is not the same as a risk -free rate. Accordingly, lessees (other than nonpublic \nbusiness entity lessees that elect to use a risk -free discount rate —see Private co mpany considerations \nsection below), must consider their particular credit characteristics (e.g., their credit profile ) when \ndetermining their incremental borrowing rate for each lease. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 109}), Document(page\_content='Lease classification \n3-40The incremental borrowing rate is based on a borrowing with a term tha t is similar to the term of the \nassociated lease. Therefore, when an entity is establishing the incremental borrowing rate based on a \nborrowing, it should ensure that the borrowing has similar payment terms as in the lease. For \nexample, if the lease requir es monthly payments, the borrowing should also have monthly payment \nterms. If the borrowing does not have monthly payments, then the appropriate adjustments to the rate \nshould be made to make sure it approximates the payment terms in the lease. \nWhen a lea se includes renewal, termination , or purchase options, it is not clear whether options that \nare not determined to be reasonably certain of exercise (i.e. , options not included in the lease term at \nthe lease commencement date) should be considered. We belie ve a lessee may make an accounting \npolicy election to either include or exclude options that are not reasonably certain of exercise when \ndetermining the term of the borrowing . While the lease term determined at lease commencement (i.e. , \nexclusive of any op tions not reasonably certain of exercise) is an acceptable term to consider when \ndetermining the incremental borrowing rate, we believe the existence of options to renew or terminate \na borrowing arrangement would affect the rate a lender would charge irres pective of whether or not \nthe options are reasonably certain of exercise. Accordingly, we believe the consideration of all options \nin an arrangement, whether reasonably certain of exercise or not, is appropriate when determining the \nincremental borrowing rate and consistent with the definition and principal of the rate. \nQuestion LG 3-22 \nIs a lessee limited by a loan -to-value ratio when determining the incremental borrowing rate? \nPwC response \nNo. The loan -to-value ratio would be relevant if the collateral was limited to the right -of-use asset. \nHowever, since we believe the standard permits the use of any collateral for determining the \nincremental borrowing rate and the lessee must assume its borrowing is 100% collateralized , the loan -\nto-value ratio is irrelevant. \nQuestion LG 3-23 \nShould a lessee assume the collateralized borrowing is recourse or non -recourse? \nPwC response \nA lessee should assume the lender has recourse to the other assets of the lessee. This assumption may \nresult in a lower incremental borrowing rate when the lessee has sufficient other assets (e.g. , a high \ncredit quality corporation). However, if the entity has little to no other assets (e.g. , a special purpose \nentity with no other significant assets), this assumption may have little to no impact. In either \nscenario, lessee specific facts and circumstances should be considered when determining the \nincremental borrowing rate. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 110}), Document(page\_content='Lease classification \n3-41Example LG 3-17 illustrates how a lessee might determine the incremental borrowing rate. \nEXAMPLE LG 3-17 \nIncremental borrowing rate – renewal option \nLessee Corp enters into a lease of equipment with Lessor Corp. Lease payments are $100,000 per year \n(payable in equal monthl y installments) . The lease has a noncancel lable term of 3 years with a 2 year \nrenewal option. At lease commencement, Lessee Corp concludes the renewal option is not reasonably \ncertain of exercise (i.e. , the lease term is 3 years). \nAt lease comm encement, Lessee Corp obtains the following rate quotes from its third -party lender to \nborrow on a fully collateralized basis: \n□5% interest rate to borrow $300,000 for a 3 -year term (payable in equal monthly installments)\n□5.5% interest rate to borrow $ 300,000 for a 3-year term with an option to borrow an additional\n$200,000 at the end of 3 years for an additi onal 2 years (payable in equal monthly installments) .\nAssume Lessee Corp concludes the rates are reasonable and consistent with prevailing market rates \nand its historical borrowings. \nWhich rate should Lessee Corp conclude represents the incremental borro wing rate? \nAnalysis \nIt depends. If Le ssee Corp’s accounting policy is to utilize the lease term at the lease commencement \ndate (i.e. , 3 years), the incremental borrowing rate of 5% would be appropriate . \nIf Lessee Corp ’s accounting policy is to utilize the lease term inclusive of the renewal option, the \nincremental borrowing rate of 5.5% would be appropriate. This rate considers that a lender would \nadjust the rate to reflect the option in the arrangement to renew the bo rrowing for an additional 2 \nyears even though the renewal option was not determined to be reasonably certain of exercise at the \nlease commencement date . Generally, the inclusion of a renewal option will increase the incremental \nborrowing rate, resulting in the recognition of a smaller right -of-use asset and lease liability. \nRegardless of the accounting policy election made, Lessee Corp should apply the policy consistently to \nall leases. \nPortfolio discount rate \nLessees and lessors may apply a single discou nt rate to a portfolio of leases if they can conclude that its \napplication does not create a material difference when compared to individually determined discount \nrates applied to each of the leases in the portfolio. While a reporting entity is not require d to \nquantitatively demonstrate immateriality , it should be able to demonstrate that the leases in the \nportfolio have similar characteristics , such that it is reasonabl e to expect that the application of the \nportfolio -level discount rate will not materially differ from the application of discrete discount rates at \nthe individual lease level. When assessing materiality, reporting entities should also consider whether \na small change in the discount rate could result in different lease classifica tion, such as when the lease ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 111}), Document(page\_content='Lease classification \n3-42payments are close to substantially all of the fair value of the underlying assets. Example LG 3-18 \ndemonstrates this concept. \nEXAMPLE LG 3-18 \nDiscount rate – portfolio discount rate \nLessee Corp enters into 20 separate leases with Lessor Corp for a fleet of similar vehicles ; each vehicle \nis of similar make and model, although certain features may vary (e.g. , interior, radio, electronics ). \nEach lease has a term of three years. Depending on the vehicle’ s parti cular features, annual fixed lease \npayments range from $3,75 0 to $4,000. There are no purchase options or renewal options. \nCan Lessee Corp and Lessor Corp apply a single discount rate to the portfolio of leases? \nAnalysis \nAssuming the underlying asset s are similar , have similar lease terms , the value and range of lease \npayments do not vary greatly , interest rates have remained stable throughout the evaluation peri od, \nand that the lease payments do not approach substantially all of the fair value of the underlying assets, \nit is reasonable to conclude that the application of a single portfolio -level discount rate would not \ncreate a material difference in classificati on when compared to applying individually determined \ndiscount rates to each of the leases in the portfolio. \nQuestion LG 3-24 \nWould it be appropriate for a subsidiary to use the incremental borrowing rate of its parent? \nPwC response \nIt depends. We believe it may be acceptable for a subsi diary to use its parent’s incremental borrowing \nrate if the subsidiary can demonstrate that the lessor looked to the parent’s credit standing when \nnegotiating lease terms. This would be evident if the parent guarantees the subsidiary’s lease. Using a \nreaso nable lender standard (i.e. , what knowledge would a reasonable lender have when pricing debt) , \nwe believe this assertion can also be substantiated when one of the following factors are present: \n□The p arent has a central treasury function with cash pooling arrangements between the p arent\nand all subsidiary lessees; the parent regularly “sweeps” cash in and out to centrally manage\nliquidity\n□The lease is contractually linked to other general parent obligations\n□The lease includes covenants that are tied to the creditworthiness of the p arent\n□The p arent’s internal funding arrangements provide a full backstop for the lease obligation of the\nsubsidiary lessee', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 112}), Document(page\_content='Lease classification \n3-433.3.4.7 Private company considerations \nASC 842- 20-30-3 provi des a practical expedient for entities that are not publi c busine ss entities , \nwhich a llows a lessee to use a risk-fr ee rate for a period compara ble to the lease term. Sin ce a risk-free \nrate is lower than an incremental borrowing ra te for a specific entity, it will resu lt in a high er lease \nliability a nd right- of-use asset. Use of a risk-fr ee rate is an accounting policy elec tion a nd was \noriginally required t o be applied consistently for all lea ses upon election . Howeve r, in resp onse to \nconcerns raised in the post implementation review, to provide more flexibility and reduce \nimplementation costs, in Novembe r 202 1, the FASB issued ASU 2021- 09, Discou nt Rat e for Lessees \nThat Are N ot Public Busi ness Entities. U pon adoption, ASU 2021- 09 perm its entities othe r tha n public \nbusiness entit y lessees to apply this election to l eases by class of underlying as set, rather than to all \nleases. Lessees choosing this election should, nevertheless, use the rate implicit in the lease when it is \nreadily determinable. See FSP 14.2.3.1 for disclosure requirements, and LG 9.11 for the effective date \nand transition requirements, of ASU 2021-09 . \nThe expedi ent to use a risk-fr ee rate may only be electe d by lessee s that are no t public business \nentities. Othe r lessees may not us e a risk-fr ee rate in lease classifica tion or meas urement. \nCollectibi lity (lesso rs) \nLessors are required to eval uate whethe r lease payments , and any amount necessary to satisfy a \nresidual value guarantee , are probabl e of collection , as discussed in ASC 842- 30-25-3 for sales-type \nleases. A sales-type lease is similar to a sale of the underlying asse t. As such, when there is significant \nconcern regarding the collectibility of payments due unde r the terms of the contract, sale treatment \nmay be delayed. \nASC 842 -30-25-3 \nThe guidance in paragraphs 842 -30-25-1 through 25 -2 notwithstanding, if collect ibility of the lease \npayments , plus any amoun t necessary to satisfy a residual value guarantee provided by the lesse e, is \nnot probable at the commencement date, the lessor shall not derecognize the underlying asset but \nshall recognize lease payments received –including variable lease payments –as a depos it liability until \nthe earlier of either of the following: \na.Collect ibility of the lease payments, plus any amount necessary to satisfy a residual value\nguarantee provided by the lessee , becomes probable. If collect ibility is not probable at the\ncommencemen t date, a lessor shall continue to assess collect ibility to determine whether the lease\npayments and any amount nec essary to satisfy a residual value guarantee are probable of\ncollection.\nb.Either of the following events occurs :\n1.The contract has been te rminated , and the lease payments received from the lessee are\nnonrefundable.\n2.The lessor has repossessed the underlying asset, it has no further obligation under the contract\nto the lessee, and the lease payments received from the lessee are nonrefunda ble.', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 113}), Document(page\_content='Lease classification \n3-44The term “probable” is defined in US GAAP as “likely to occur,” and is generally interpreted as at least \na 75% likelihood. A lessor’s assessment of probability of collection should be performed at lease \ncommencement and reflect both the lessee’s abili ty and intent to pay as amounts become due \nconsidering all relevant facts and circumstance s. See RR 2.6.1.5 for additional information on \nassessing the probability of collection. \nIf a lessor concludes at lease commencement that the lease meets the criteri a to be classified as a sales -\ntype lease, but collection of lease payments or any amount due to satisfy a residual value guarantee is \nnot probable, the lessor should not derecognize the asset or recognize any selling profit. Any lease \npayments received should be recorded as a deposit liability until either of the criteria outlined in ASC \n842-30-25-3 occur s. See LG 4.3.1 for guidance addressing how to account for a lea se once the\ncollect ibility criteria are met.\nDirect financing leases should be classified as an operating lease if lease payments, plus any amount \nnecessary to satisfy a residual value guarantee, including third party guarantees, are not probable of \ncolle ction at lease commencement . The lessor cannot classify the lease as a direct financing lease \nbecause the conversion of the lessor’s asset risk to credit risk (which occurs when a lessor effectively \ntransfers the risks and rewards of ownership of the under lying asset to the lessee) is nonsubstantive. \nEven when a lease is classified as an operating lease, the lessor should still assess the collect ibility of \npayments. At lease commencement, if a lessor determines that operating lease payments are not \nprobabl e of collection, the recognition of lease income is limited to the lesser of the following: \n□Lease income that would have been recorded to date (i.e. , straight -line rental income), plus\nvariable lease payments\n□Lease payments, including variable lease payments, received to date\n3.3.5 Underlying asset is of a specialized nature \nA lease of an underlying asset that is of such a specialized nature that it is expe cted to have no \nalternative use to the lessor at the end of the lease term should be classified as a sales -type or direct \nfinancing lease by the lessor . This is because a lessor would be expected to price the lease to ensure it \nreceives a return of its ini tial investment plus interest from the lessee. For example, if a lessor invests \nin the construction of a gas pipeline that will connect land owned by the lessee to a main pipeline and \nthe pipeline has no alternative use beyond the lessee ’s need to transpor t gas, the lessor would be \nexpected to price the lease to ensure a return during the noncance llable term of the lease . \nThe evaluation of whether an underlying asset is expected to have an alternative use to the lessor at the \nend of the lease term should co nsider any contractual restrictions and practical limitations o n the \nlessor’ s ability to change or redirect the use of the underlying asset , as discussed in ASC 842 -10-55-7. \nASC 842 -10-55-7 \nIn assessing whether an underlying asset has an alternative use to the lessor at the end of the lease \nterm in accordance with paragraph 842 -10-25-2(e), an entity should consider the effects of contractual \nrestriction s and practical limitations on a lessor’ s ability to readily direct that asset for another use (for \nexampl e, selling it or leasing it to an entity other than the lessee). A contractual restriction on a lessor’s \nability to direct an underlying asset for another use must be substantive for the asset not to have an \nalternative use to the lessor. A contractual res triction is substantive if it is enforceable. A practical ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 114}), Document(page\_content='Lease classification \n3-45limit ation on a lessor’ s ability to direct an underlying asset for another use exists if the lessor would \nincur significant economic losses to direct the underlying asset for another use. A signific ant economic \nloss could arise because the lessor either would incur significant costs to rework the asset or would \nonly be able to sell or re -lease the asset at a significant loss. For example, a lessor may be practically \nlimited from redirecting assets th at either have design specifications that are unique to the lessee or \nthat are located in remote areas. The possibility of the contract with the customer being terminated is \nnot a relevant consideration in assessing whether the lessor would be able to read ily direct the \nunderlying asset for another use. \n3.4 Application of the “reasonably certain” threshold \nReasonably certain should be considered a high threshold . While there are no bright lines, the FASB \nhas indicated that the threshold is similar to “ reasonably assured” in existing GAAP , which implies a \nprobability of 75%. An assessment of whether a lessee is reasonabl y certain to exercise a renewal, \ntermination , or purchase option should consider the substance rather than the legal form of the \ncontract. \nAn entity should assess whether it is reasonably certain that the lessee will exercise an option by \nconsidering all factors relevant to that assessment, includin g contract -, asset -, market -, and entity -\nbased factors. Certain factors , such as economic penalties , may make exercise of a renewal, \ntermination , or purchase option reasonably certain of exercise. Factors to consider include: \n□Whether the purpose or location of the asset is unique\n□The availability of comparable replacement assets\n□For real estate leases, the cost of moving to another location and any r elated disruption to\noperations\n□For equipment leases, the cost of any disruption to operat ions that would be experienced by\nchanging equipment\n□The contractual terms associated with extending or terminating the lease term ; for example, the\nlease payments during a renewal period , any termination payments, and whether those payments\nare fixed, var iable , or contingent\n□The importance of the leased asset to the lessee’s operations ; for example, a headquarters building\nmight be so closely associated with the lessee’s image that it makes the possibility of relocation\nremote , or a particular facility or unit of equipment might be so integral to a manufacturing\nprocess that either purchase or continuation of the lease is reasonably certain\n□Leasehold improvements or other assets whose value would be impaired if the lessee were to\nrelocate or cease use of th e leased asset\n□Punitive tax consequences when an option is exercise d (or not exercise d) to purchase the\nunderlying asset, renew the lease term , or terminate the lease prior to the stated expiration date\nDepending on the information available, a lessor and a lessee may arrive at different conclusions as to \nwhether certain options appear reasonably certain to be exercised . Lessor s will typically have less \nknowledge of lessee -specific factors , which may impact their analysis. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 115}), Document(page\_content='Lease classification \n3-46See LG 3.3.2 and LG 3.3.3 for information on economic penalties and purchase, renewal , and \ntermination options. See LG 3.3.4. 4 for information on how guarantees impact the assessment of this \ncriterion. See ASC 842 -10-55-26 for additional examples of economic factors to consid er. \n3.5 Lessee classification examples \nLessee classification is based on whether a lease is effectively a financed purchase or an arrangement \nto obtain usage rights to an asset for a specified period. If one or more of the classification criteria in \nASC 842 -10-25-2 are met, the lease should be classified as a finance lease by the lessee . If none of the \ncriteria are met, the lease should be classified as a n operating lease. The following examples illustrate \nsome of the items that lessees will need to consider w hen evaluating lease classification : \n□Finance leases: Example LG 3-19 and Example LG 3-20\n□Operating leases: Example LG 3-21, Example LG 3-22, and Example LG 3-23\nEXAMPLE LG 3-19 \nLease classification – non-specialized digital imaging equipment lease (lessee) \nLessee Corp enters into a lease of non -specialized digital imaging equipment with Lessor Corp. The \nfollowing table summarizes information about the lease and the leased assets. \nLease term 5 years , no renewal option \nEconomic life of the \nequipment 6 years \nPurchase option None \nAnnual lease payments $1,100 \nPayment date Annually on January 1 \nLessee Corp’s incremental \nborrowing rate 7% \nThe rate Lessor Corp charges Lessee Corp in the lease is not \nreadily determinable by Lessee Corp . \nOther □Title to the asset remains with Lessor Corp upon lease\nexpiration\n□The fair value of the equipment is $5,000; Lessee Corp\ndoes not guarantee the residual value of the equipment at\nthe end of the lease term\n□Lessee Corp pays for all maintenance of the equipment\nseparate from the lease\n□There are no initial direct costs incurred by Lessee Corp\n□Lessor Corp does not provide any incentives', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 116}), Document(page\_content='Lease classification \n3-47How should Lessee Corp classify the lease? \nAnalysis \nLessee Corp should assess the lease classification using the criteria outlined in ASC 842 -10-25-2 and \nASC 842 -10-25-3. \nCriteria Analysis \nTransfer of ownership Ownership of the asset does not transfer to \nLessee Corp by the end of the lease term . \nPurchase option which the lessee is reasonably \ncertain to exercise The lease does not contain a purchase option . \nLease term is for the major part of the remaining \neconomic life of the asset Lessee Cor p is utilizing the asset for \napproximately 83% of the economic life of the \nasset (5 -year lease /6-year economic life) , which \nis deemed to be a major part . \nSum of present value of lease payments and any \nresidual value guarantee by the lessee amounts to \nsubstantially all of the fair value of the underlying \nasset The present value of the lease payments \n(discounted at Lessee Corp’s incremental \nborrowing rate of 7%) is $4,825 . \nTherefore, the present value of the lease \npayments amounts to approximately 97% of the \nfair value of the leased asset ($4,825 /$5,000) , \nwhich is substantially all of the fair value of the \nleased asset . \nSpecialized nature The digital imaging equipment is non -\nspecialized and could be used by another party \nwithout major modifications . \nLessee Corp should classify the lease as a finance lease because the lease term is for the major part of \nthe economic life of the equipment and the present value of the lease payments amounts to \nsubstantially all of the fair value of the underlying asset. \nSee Example LG 4-2 for an illustration of the initial recognition and measurement of this type of lease. \nEXAMPLE LG 3-20 \nLease classification – real estate lease with a purchase option (lessee) \nLessee Corp enters into a property (land and building) lease with Lessor Corp. The following table \nsummarizes information about the lease and the leased asset. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 117}), Document(page\_content='Lease classification \n3-48Lease term 10 years \nRenewal option Five 5-year renewal options \nIf exercised, the annual lease payments are reset to then \ncurrent market rents . \nEconomic life of the property 40 years \nFair value of the leased \nproperty $5,000,000 \nPurchase option Lessee Corp has an option to purchase the property at the end \nof the lease term for $3,000,000 . \nAnnual lease payments The first annual lease payment is $500,000 , with increases of \n3% per year thereafter . \nPayment date Annually on January 1 \nIncentive Lessor Corp gives Lessee Corp a $200,000 incentive for \nentering into the lease (payable at the beginning of year 2) , \nwhich is to be used for normal tenant improvements . \nDiscount rate Since both the lease payments required during the lease and \nthe purchase option price are fixed, Lessee Corp can combine \nthese cash flows with its estimate of the property’s fair value \nto determine that the interest rate Lessee Corp incurs during \nthe lease is 9.04%. However, because Lessee Corp cannot be \nsure of Lessor Corp’s estimate of fair value or whether Lessor \nCorp realized any investment tax credits with respect to the \nproperty, this rate is not the rate implicit in the lease. \nConsequently , Lessee Corp compares the rate to other \nevidence of its borrowing rates in similar circumstances, and \nconcludes that this rate is a reasonable estimate of its \nincremental borrowing rate. \nOther □Title to the property remains with Less or Corp upon lease\nexpiration\n□Lessee Corp does not guarantee the residual value of the\nreal estate asset\n□Lessee Corp pays for all maintenance, taxes , and\ninsurance on the property separate from the lease\n□There are no initial direct costs incurred by Lessee Corp\nHow should Lessee Corp classify the lease? \nAnalysis \nLessee Corp should assess the lease classification using the criteria outlined in ASC 842 -10-25-2 and \nASC 842-10-25-3. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 118}), Document(page\_content='Lease classification \n3-49Criteria Analysis \nTransfer of ownership Ownership of the asset does not transfer to \nLessee Corp by the end of the lease term . \nPurchase option which the lessee is reasonably \ncertain to exercise The lease contains an option to purchase the \nproperty for $3,000,000 , which is below the fair \nvalue of the real estate asset at lease \ncommencement and its expected value at the \ndate of exercise. Options to purchase real estate \nat a price below commencement date fair value \nare generally considered to be reasonably certain \nof exercise since real estate generally appreciates \nin value ; therefore , a significant economic \nincentive to exercise the purchase option exists. \nLease term is for the major part of the remaining \neconomic life of the asset The lease term is 10 years. The five 5-year \nrenewal options available to Lessee Corp are not \nreasonably certain of exercise (at lease \ncommencement) because the renewal options \nrequire rent to be reset to market rates when \nexercised . Therefore, Lessee Corp is utilizing the \nasset for 25% of the economic life of the asset \n(10-year lease /40-year economic life) , which is \nnot deemed to be a major part . \nSum of present value of lease paym ents and any \nresidual value guarantee by the lessee amounts \nto substantially all of the fair value of the \nunderlying asset The lease payments net of the incentive Lessor \nCorp pays Lessee Corp are $ 5,531,940 (see \nbelow for a schedule of payments). The present \nvalue of the lease payments (discounted at the \nrate Lessor Corp charges in the lease of \napproximately 9.04%) is $3,737,510 . \nBecause the purchase option is reasonably \ncertain of being exercised, it should be included \nas a lease payment at the end of the lease term. \nUsing the 9.04% rate Lessor Corp charges \nLessee Corp , the present value of the purchase \noption is $ 1,262,490 . \nTherefore, the present value of the lease \npayments represents 100% of the fair value of \nthe leased asset (($3,737,510 + \n$1,262,490)/$5,000,000 ). \nSpecialized nature Although the property is in a specific location, it \ncould be used by another party without major \nmodifications . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 119}), Document(page\_content='Lease classification \n3-50The following table shows the schedule of lease payments. \nDate Amount \nYear 1 500,000 \nYear 2 (515,000 – 200,000 lease incentive) 315,000 \nYear 3 530,450 \nYear 4 546,364 \nYear 5 562,754 \nYear 6 579,637 \nYear 7 597,026 \nYear 8 614,937 \nYear 9 633,385 \nYear 10 652,387 \nTotal $5,5 31,940 \nLessee Corp should classify the lease as a finance lease because , at lease commencement, the fixed \nprice purchase option available to Lessee Corp at the end of the initial lease term (i.e., after 10 years) is \nreasonably certain to be exercised by Lessee Co rp. As a result, Lessee Corp has effectively obtained \ncontrol of the underlying asset. The lease also has payments equal to substantially all of the fair value \nof the underlying asset. \nSee Example LG 4-3 for an illustration of the initial recognition and m easurement of this type of lease. \nEXAMPLE LG 3-21 \nLease classification – automobile lease (lessee) \nLessee Corp leases an automobile from Lessor Corp. The following table summarizes information \nabout the lease and the leased asset. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 120}), Document(page\_content='Lease classification \n3-51Lease term 3 years , no renewal option \nEconomic life of the \nautomobile 6 years \nPurchase option Lessee Corp has the option to purchase the automobile at fair \nmarket value upon expiration of the lease . \nMonthly lease payments $500 \nPayment date Beginning of the month \nLessee Corp’s incremental \nborrowing rate 6% \nThe rate Lessor Corp charges Lessee Corp in the lease is not \nreadily determinable by Lessee Corp . \nOther □Title to the automobile remains with Lessor Corp upon\nlease expiration\n□The fair value of the automobile is $30,000; Lessee Corp\ndoes not guarantee the residual value of the automobile at\nthe end of the lease term\n□Lessee Corp pays for all maintenance of the automobile\nseparate from the lease\n□There are no initial direct costs incurred by Lessee Corp\n□Lessor Corp does not provide any incentives\nHow should Lessee Corp classify the lease? \nAnalysis \nLessee Corp should assess the lease classification using the criteria outlined in ASC 842 -10-25-2 and \nASC 842 -10-25-3. \nCriteria Analysis \nTransfer of ownership Ownership of the asset does not transfer to \nLessee Corp by the end of the lease term . \nPurchase option which the lessee is reasonably \ncertain to exercise At lease commencement, it is not reasonably \ncertain that Lessee Corp wil l exercise the \npurchase option . \nLessee Corp d oes not have a significant \neconomic incentive to exercise the purchase \noption because the option is at fair value at the \nexpiration of the lease . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 121}), Document(page\_content='Lease classification \n3-52Criteria Analysis \nLease term is for the major part of the remaining \neconomic life of the asset Lessee Corp is utilizing the asset for 50% of the \neconomic life of the asset (3 -year lease /6-year \neconomic life) , which i s not deemed to be a \nmajor part . \nSum of present value of lease payments and any \nresidual value guarantee by the lessee amounts to \nsubstantially all of the fair value of the underlying \nasset The present value of the lease payments \n(discounted at Lessee Corp’s incremental \nborrowing rate of 6% because the rate charge d \nin the lease is not readily determinable) is \n$16,5 18. \nTherefore, the present value of the lease \npayments amounts to approximately 55% of the \nfair value of the leased asset \n($16,518/$30,000) , which is not deemed to be \nsubstantial ly all of the fair value of the leased \nasset . \nSpecialized nature The automobile is non -specialized and could be \nused by another pa rty without major \nmodifications . \nLessee Corp should classify the lease as an operating lease because none of the criteria in ASC 842 -10-\n25-2 and ASC 842 -10-25-3 have been met.\nSee Example LG 4-4 for an illustration of the initial recognition and measurement of this type of lease. \nEXAMPLE LG 3-22 \nLease classification – copier with lease and nonlease components (lessee) \nLessee Corp leases a copier from Lessor Corp. The following table summarizes information about the \nlease and the leased asset. \nLease term 3 years , no renewal option \nEconomic life of the copier 5 years \nPurchase option None \nAnnual lease payments $500 , which includes Lessor maintenance for the term of the \nlease. \nLessor Corp normally leases the same copier for $475 per year \nand offers a maintenance contract for $75 per year. \nPayment date Annually on January 1 \nLessee Corp’s incremental \nborrowing rate 5.5% \nThe rate Lessor Corp charges Lessee Corp in the lease is not \nreadily determinable by Lessee Corp . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 122}), Document(page\_content='Lease classification \n3-53Other □Title to the copier remains with Lessor Corp upon lease\nexpiration\n□The fair value of the copier is $2,000; Lessee Corp does\nnot guarantee the residual value of the copier at the end\nof the lease term\n□Lessee Corp pays $100 in legal fees related to the\nnegotiation of the lease, which are t reated as initial direct\ncosts\n□Less or Corp does not provide any incentives\nLessee Corp has not made an accounting policy election to not separate the lease and nonlease \ncomponents for this class of asset . \nHow should Lessee Corp classify the lease? \nAnalysis \nLessee Corp should first separate the contract into its lease and nonlease components. Per ASC 842 -\n10-15-33, a lessee should allocate the consideration in a contract to the lease and nonlease components\nbased on their relative standalone price , as shown here .\nStandalone \nprice \n(A) Allocated % \n(A/$550) = (B) Annual lease \npayment \n(C) Allocated lease \npayment \n(B × C) = D \nAnnual copier \nlease payment $475 86.36% $ 500 $432 \nAnnual \nmaintenance \ncontract fee 75 13.64% 500 68 \nTotal $550 100.00% $500 \nLessee Corp should then assess the lease classification using the criteria outlined in ASC 842 -10-25-2 \nand ASC 842 -10-25-3. \nCriteria Analysis \nTransfer of ownership Ownership of the asset does not transfer to \nLessee Corp by the end of the lease term . \nPurchase option which the lessee is reasonably \ncertain to exercise The lease does not contain a purchase option . \nLease term is for the major part of the remaining \neconomic life of the asset Lessee Corp is utilizing the asset for 60% of the \neconomic life of the asset (3 -year lease /5-year \neconomic life) , which is not deemed to be a \nmajor part . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 123}), Document(page\_content='Lease classification \n3-54Criteria Analysis \nSum of present value of lease payments and an y \nresidual value guarantee by the lessee amounts to \nsubstantially all of the fair value of the underlying \nasset The present value of the lease payments \nallocated to the lease component (discounted at \nLessee Corp’s incremental borrowing rate of \n5.5% ) is $1, 229. \nTherefore, the present value of the lease \npayments amounts to approximately 61% of the \nfair value of the leased asset ($1,229 /$2,000) , \nwhich is not deemed to be substantially all of \nthe fair value of the leased asset . \nSpecialized nature The copier is non -specialized and could be used \nby another party without major modifications . \nLessee Corp should classify the lease as a n operating lease because none of the criteria in ASC 842 -10-\n25-2 and ASC 842 -10-25-3 have been me t.\nSee Example LG 4-5 for an illustration of the initial recognition and measurement of this type of lease. \nEXAMPLE LG 3-23 \nLease classification – lease payments tied to an index (lessee) \nLessee Corp enters into a lease of equipment with Lessor Corp. The following table summarizes \ninformation about the lease and the leased assets. \nLease term 4 years , no renewal option \nEconomic life of the \nequipment 7 years \nPurchase option None \nAnnual lease payments The first annual payment is $1,500 . \nThe a nnual payment increases each subsequent year by an \namount equal to the prior year rent multiplied by the Prime \nRate. For example, if the Prime Rate is 3%, then the lease \npayment would be $1 ,545 ($1,500 + ($1,500 × 3%)). \nPayment date Annually on January 1 \nLessee Corp’s incremental \nborrowing rate 8% \nThe rate Lessor Corp charges Lessee Corp in the lease is not \nreadily determinable by Lessee Corp . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 124}), Document(page\_content='Lease classification \n3-55Other □Title to the asset remains with Lessor Corp upon lease\nexpiration\n□The fair value of the equipment is $10,000; Lessee Corp\ndoes not guarantee the residual value of the equipment at\nthe end of t he lease term\n□Lessee Corp pays for all maintenance of the equipment\nseparate from the lease\n□There are no initial direct costs incurred by Lessee Corp\n□Lessor Corp does not provide any incentives\nPrime rate at the lease commencement date is 3%. The Prime Rate is expected to increase .25% each \nyear (i.e. , the Prime Rate is expected to be 3.25% at the beginning of year 2). \nHow should Lessee Corp classify the lease? \nAnalysis \nLess ee Corp should assess the lease classification using the criteria outline d in ASC 842 -10-25-2 and \nASC 842 -10-25-3. \nCriteria Analysis \nTransfer of ownership Ownership of the asset does not transfer to \nLessee Corp by the end of the lease term . \nPurchase option which the lessee is reasonably \ncertain to exercise The lease does not contain a purchase option . \nLease term is for the major part of the remaining \neconomic life of the asset Lessee Corp is utilizing the asset for 57% of the \neconomic life of the asset (4 -year lease /7-year \neconomic life) , which is not deemed to be a \nmajor part . \nSum of present value of lease payments and any \nresidual value guarantee by the lessee amounts to \nsubstantially all of the fair value of the underlying \nasset The variable lease payment should be included \nin fixed lease payments using the Prime rate at \nlease commencement . The total payments are \n$6,275 . \nThe present value of the lease payments \n(discounted at Lessee Corp’s incremental \nborrowing rate of 8 %) is $5,59 5. \nTherefore, the present value of the lease \npayments amounts to approximately 5 6% of the \nfair value of the leased asset ($5,5 95/$10,000) , \nwhich is not deemed to be substantially all of \nthe fair value of the leased asset . \nSpecialized nature The equipment is non -specialized and could be \nused by another party without major \nmodifications . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 125}), Document(page\_content='Lease classification \n3-56The following table shows the schedule of lease payments. \nDate Amount \nYear 1 $1,500 \nYear 2 1,545 \nYear 3 1,591 \nYear 4 1,639 \nTotal $6,275 \nLessee Corp should classify the lease as a n operating leas e because none of the criteria in ASC 842 -10-\n25-2 and ASC 842 -10-25-3 have been met.\nSee Example LG 4-6 for an illustration of the initial recognition and measurement of this type of lease. \n3.6 Lessor classification examples \nA lessor should determine lease classification based on whether the lease effectively represents a \nfinancing or a sale, as opposed to simply conveying usage rights , by determining whether the lease \ntransfers substantially all of the risks and rewards of ownership of the underlying asset. Generally, this \napproach yields a conclusion that is consistent with existing US GAAP for direct financing leases, \nsales -type leases , and operating leases. \nAt lease commencement, a lessor should not recognize selling profit and revenue if the lease does not \nalso transfer control of the underlying asset to the lessee. While this represents a change from existing \nUS GAAP, it aligns with the concept of what constitutes a sale in the new revenue recognit ion \nstandard. \nThe following examples i llustrate some of the items that lessors will need to consider when classifying \nleases : \n□Sales type lease: Example LG 3-24 and Example LG 3-25\n□Operating lease: Example LG 3-26', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 126}), Document(page\_content='Lease classification \n3-57EXAMPLE LG 3-24 \nLease classification – non-specialized digital imaging equipment lease (lessor) \nLessor Corp enters into a lease of non -specialized digital imaging equipment with Lessee Corp. The \nfollowing table summarizes information about the lease and the leased assets. \nLease term 5 years , no renewal option \nEconomic life of the \nequipment 6 years \nPurchase option None \nAnnual lease payments $1,100 \nPayment date Annually on January 1 \nFair value of the leased \nequipment $5,000 \nLessor Corp’s carrying value \nof the leased equipment $4,500 \nRate implicit in the lease 7.04 % \nOther □Title to the asset remains with Lessor Corp upon lease\nexpiration\n□Lessee Corp does not guarantee the residual value of the\nequipment at the end of the lease term and Lessor Corp\ndoes not obta in any third -party residual value insurance\n□Estimated fair value of the equipment at the end of the\nlease term is $250\n□Lessee Corp pays for all maintenance of the equipment\nseparate from the lease\n□There are no initial direct costs incurred by Lessee Corp\n□Lessor Corp does not provide any incentives\nHow should Lessor Corp classify the lease? \nAnalysis \nLessor Corp should assess the lease classification using the criteria outlined in ASC 842 -10-25-2 and \nASC 842 -10-25-3. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 127}), Document(page\_content='Lease classification \n3-58Criteria Analysis \nTransfer of ownership Ownership of the asset does not transfer to \nLessee Corp by the end of the lease term . \nPurchase option which the lessee is reasonably \ncertain to exercise The lease does not contain a purchase option . \nLease term is for the major part of the remai ning \neconomic life of the asset Lessee Corp is utilizi ng the asset for \napproximately 8 3% of the economic lif e of the \nasset (5 -year lease /6-year economic life) , which \nis deemed to be a major part . \nSum of present value of lease payments and any \nresidual value guarantee by the lessee amounts to \nsubstantially all of the fair value of the underlying \nasset The present value of the lease payments \n(discounted at the rate Lessor Corp charges in \nthe lease of 7.04 %) is $4 ,822. \nTherefore, the present value of the lease \npaym ents amounts to approximately 9 6% of the \nfair v alue of the leased asset ($4, 822/$5,000) , \nwhich is deemed to be substantially all of the \nfair value of the leased asset . \nSpecialized nature The digital imaging equipment is non -\nspecialized and could be used by another pa rty \nwithout major modifications . \nLessor Corp should classify the lease as a sales -type lease because the lease term is for a major part of \nthe economic life of the equipment and the present value of the lease payments amount s to \nsubstantially all of the fair value of the underlying asset. Accordingly, Lessee Corp has obtained control \nof the underlying asset, which is economically similar to Lessor Corp selling the asset to Lessee Corp. \nSee Example LG 4-7 for an illustration of the initial recognition and measurement of this type of lease. \nEXAMPLE LG 3-25 \nLease classification – real estate lease with a purchase option (lessor) \nLessor Corp enters into a property (land and building) lease with Lessee Corp. The following table \nsummarizes information about the lease and the leased asset. \nLease term 10 years \nRenewal option Five 5-year renewal options \nIf exercised, the annual lease payments are reset to then \ncurrent market rents . \nEconomic life 40 years \nFair value of the property $5,000,000 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 128}), Document(page\_content='Lease classification \n3-59Lessor Corp’s carrying value \nof the leased property $5,000,000 \nPurchase option Lessee Corp has an option to purchase the property at the end \nof the lease term for $3,000,000 . \nAnnual lease payments The first annual payment is $500,000 , with increases of 3% \nper year thereafter . \nPayment date Annually on January 1 \nIncentive Lessor Corp gives Lessee Corp a $200,000 incentive for \nentering into the lease (payable at the beginning of year 2) , \nwhich is to be used for normal tenant improvements . \nRate implicit in the lease Approximately 9.04% \nOther □Title to the property does not automatically transfer to\nLessee Corp upon lease expiration\n□Lessee Corp does not guarantee the residual value of the\nreal estate asset\n□Lessee Corp pays for all maintenance, taxes , and\ninsurance on the property separate from the lease\n□There are no initial direct costs incurred by Lessor Corp\nHow should Lessor Corp classify the lease? \nAnalysis \nLessor Corp should assess the lease classification using the criteria outlined in ASC 842 -10-25-2 and \nASC 842 -10-25-3. \nCriteria Analysis \nTransfer of ownership Ownership of the asset does not transfer to \nLessee Corp by the end of the lease term . \nPurchase option which the lessee is reasonably \ncertain to exercise The lease contains an option to purchase the \nproperty for $3,000,000 , which is below the \nfair value of the real estate asset at lease \ncommencement and its expected value at the \ndate of exer cise. Options to purchase real estate \nat a price below commencement date fair value \nare generally considered to be reasonably \ncertain of exercise since real estate generally \nappreciates in value. Thus , a significant \neconomic incentive to exer cise the purch ase \noption exists . \nLease term is for the major part of the remaining \neconomic life of the asset The lease term is 10 years; the five 5-year \nrenewal options available to Lessee Corp are \nnot reasonably certain of exercise (determined \nat lease commencement) because they require ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 129}), Document(page\_content='Lease classification \n3-60Criteria Analysis \nrent to be reset to market rates at the time of \nexercise . \nTherefore, Lessee Corp is utilizing the asset for \n25% of the economic life of the asset (10 -year \nlease /40-year economic life) , which is not \ndeemed to be a major part . \nSum of present value of lease payments and any \nresidual value guarantee by the lessee amounts to \nsubstantially all of the fair value of the underlying \nasset The lease payments net of the incentive Lessor \nCorp pays Lessee Corp are $ 5,531,940 (see \nbelow for a schedule of payments). The present \nvalue of the lease payments (discounted at the \nrate Lessor Corp charges in the lease of \napproximately 9.04%) is $3, 737,510 . \nBecause the purchase option is reasonably \ncertain of being exercised, it should be included \nas a lease payment at the end of the lease term. \nUsing the rate Lesso r Corp charges Lessee Corp \n(approximately 9.04%), the present value of the \npurchase option is $1, 262,490. \nTherefore, the present value of the lease \npayments equals 100% of the fair value of the \nleased asset (($3,737,510 + \n$1,262,490) /$5,000,000 ). \nSpecialized nature Although the property is in a specific location, it \ncould be used by another party without maj or \nmodifications . \nThe following table shows the schedule of lease payments. \nDate Amount \nYear 1 500,000 \nYear 2 (515,000 – 200,000 lease incentive) 315,000 \nYear 3 530,450 \nYear 4 546,364 \nYear 5 562,754 \nYear 6 579,637 \nYear 7 597,026 \nYear 8 614,937 \nYear 9 633,385 \nYear 10 652,387 \nTotal $5,531,940 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 130}), Document(page\_content='Lease classification \n3-61Lessor Corp should classify the lease as a sales-type lease because at lease commencement, Lessee \nCorp is reasonably certain to exercise its fixed -price purchase option at the end of the initial lease term \n(i.e., after 10 years) . As a result, Lessee Corp has effectively obtained control of the underlying asset, \nwhich is economically similar to Lessor Corp selling the underlying asset to Lessee Corp . Due to the \nexercise price of the option, the lease would also result in payments equal to substantially all of the fair \nvalue of the underlying asset. \nSee Example LG 4-8 for an illustration of the initial recognition and measurement of this type of lease. \nEXAMPLE LG 3-26 \nLease classification – automobile lease (lessor) \nLessor Corp leases an automobile to Lessee Corp. The following table summarizes information about \nthe lease and the leased asset. \nLease term 3 years , no renewal option \nEconomic life of the \nautomobile 6 years \nFair value of the automobile $30,000 \nLessor Corp’s carrying value \nof the automobile $30,000 \nPurchase option Lessee Corp has the option to purchase the automobile at fair \nmarket value upon expiration of the lease . \nMonthly lease payments $500 \nPayment date Beginning of the month \nRate implicit in the lease 9.56 % \nOther □Title to the automobile remains with Lessor Corp upon\nlease expiration\n□The expected residual value of the automobile at the end\nof the lease term is $19,000; Lessee Corp does not\nguarantee the residual value of the automobile at the end\nof the lease term\n□Lessee Corp pays for all maintenance of the automobile\nseparately from the lease\n□There are no initial direct costs incurred by Less or Corp\n□Lessor Corp does not provide any incentives', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 131}), Document(page\_content='Lease classification \n3-62How should Less or Corp classify the lease? \nAnalysis \nLessor Corp should assess the lease classification using the criteria outlined in ASC 842 -10-25-2 and \nASC 842 -10-25-3. \nCriteria Analysis \nTransfer of ownership Ownership of the asset does not transfer to \nLessee Corp by the end of the lease term . \nPurchase option which the lessee is reasonably \ncertain to exercise At lease commencement , Lessee Corp is not \nreasonably certain to exercise the purchase \noption because it is at fair market value , which \ndoes not provide a significant economic \nincentive . \nLease term is for the major part of the remaining \neconomic life of the asset Lessee Corp is utilizing the asset for 50% of the \neconomic life of the asset (3 -year lease /6-year \neconomic life) , which is not deemed to be a \nmajor part . \nSum of present value of lease payments and any \nresidual value guarantee by the lessee amounts \nto substantially all of the fair value of the \nunderlying asset The present value of the lease payments \n(discounted at the rate Lessor Corp charges in \nthe lease of 9.56 %) is $15,720 . \nTher efore, the present value of the lease \npayments amounts to approximately 52% of the \nfair value of the leased asset ($ 15,720 /$30,000) , \nwhich is not deemed to be substantially all of the \nfair value of the leased asset . \nSpecialized nature The automobile is non -specialized and could be \nused by another party without major \nmodifications . \nLess or Corp should classify the lease as an operating lease because none of the criteria in ASC 842 -10-\n25-2 or ASC 842 -10-25-3 have been met.\nSee Example LG 4-10 for an illustration of the initial recognition and measurement of this type of \nlease. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 132}), Document(page\_content='Chapter 4: Accounting \nfor leases —updated \nJune 2021', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 133}), Document(page\_content='Accounting for leases \n4-24.1 Accounting for leases overview \nThis chapter addresses the initial and subsequent accounting for a lease by a lessor and a lessee, \nincluding impairment and derecognition. \nWhile lease classification does not impact the initial recogn ition of leases on the balance sheet for a \nlessee, how a lease is classified will determine how lease expense is recognized in the income statement \nsubsequent to initial recognition. For a lessor, the initial and subsequent recognition of a lease \ndepends o n its classification. LG 4.2 and LG 4.3 discuss the initial recognition and measurement for a \nlessee and a lessor. LG 4.4 and LG 4.5 discuss the impact of lease classification on the accounting \nsubsequent to initial recognition. LG 4.6 and LG 4.7 discuss t he impairment model to be used by \nlessees and lessors. Lease class ification is discussed in LG 3. \nThe modification, remeasurement, and termination of a lease are discussed in LG 5. \n4.2 Initial recognition and measurement – lessee \nThe leases standard requires l essees to record a right -of-use asset and a lease liability for all leases \nother than those that, at lease commencement, have a lease term of 12 months or less. A reporting \nentity can elect an accounting policy by class of und erlying asset not to record su ch short -term leases \non the balance sheet. See LG 2.2.1 for information on the short -term lease measure ment and \nrecognition exemption. \nSimilar to accounting policies in other areas of GAAP, reporting entities may be able to establish \nreasonable capitalizat ion thresholds below which assets and liabilities related to a lease are not \nrecognized. When establishing an appropriate capitalization threshold, a lessee should evaluate all \nrelevant quantitative and qualitative factors i mpacting both the financial stat ements and the footnote \ndisclosures, including quantitative information about a lessee’s lease costs. This could result in a lower \ncapitalization threshold than would be determined based on the financial statement effects al one. \nWe do not believe it is app ropriate for a lessee to net the right -of-use asset and lease liability when \nestablishing a capitalization threshold. We believe all financial statement line items should be \nevaluated individually and in the aggregate when e stabli shing an appropriate thres hold. \nThe following sections discuss the initial recognition and measurement of the right -of-use asset and \nlease liability for finance leases and operating leases. \n4.2.1 Measuring the lease liability \nOn the lease commencement date , a lessee is required to measur e and record a lease liability equal to \nthe present value of the remaining lease payments, discounted using the rate implicit in the lease (or if \nthat rate cannot be readily determined, the lessee’s incremental borrowing rat e). Lease payments used \nin measu ring the lease liability are amounts due to the lessor excluding any payments that a lessee \nmakes at or before lease commencement. As discussed in LG 3.3.4, there are six items that should be \nfactored into measuring lease pa yments. Lease arrangements shoul d be thoroughly reviewed to ensure \nthat all applicable payments are being considered. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 134}), Document(page\_content='Accounting for leases \n4-3With some exceptions, the lease payments used to measure the lease liability should be the same as \nthose used to determine lease classifi cation. Two of these exceptions are: \n□To classify a lease, a lessee should use all lease payments (i.e., including payments made at or\nbefore the commencement date), whereas only the remaining payments due should be used to\nmeasure the lease liability at le ase commencement\n□For lease class ification purposes, the entire potential payment under a residual value guarantee\nshould be included in the lease payments. The lease liability recorded at lease commencement\nshould only include amounts probable of being owe d by the lessee under residual v alue guarantees\nSee LG 3.3.4.6 and LG 3.3.4 for information on determining the discount rate and lease payments for \nlease classification purposes. \n4.2.2 Measuring the right -of-use asset \nASC 842 -20-30-5 provides guidance on measu ring the right -of-use asset at t he commencement date. \nASC 842 -20-30-5 \nAt the commencement date, the cost of the right -of-use asset shall consist of all of the following: \na.The amount of the initial measurement of the lease liability\nb.Any lease payments made to the lessor at or before the c ommencement date, minus any lease\nincentives received\nc.Any initial direct costs incurred by the lessee (as described in paragraphs 842 -10-30-9 through\n30-10).\nThe items added to the lease liability to determine the costs of t he right -of-use asset are discus sed in \nthe following sections. \n4.2.2.1 Payments/incentives occurring at or before commencement \nLease payments made prior to lease commencement (for use of the underlying asset) should be \nrecorded as prepaid rent. This prepaid amoun t should then be reclassified to the right -of-use asset on \nthe lease commencement date. Thus, the right -of-use asset is increased for any lease payments made \nby a lessee at or before the lease commencement date. See LG 3.3.4.2 for information on lease \nince ntives. \n4.2.2.2 Initial direct costs \nInitial direct costs should be recorded as an increase in the lessee’s right -of-use asset but should not be \nrecorded as part of the lease liability. \nInitial direct costs are incremental costs of a lease that would not have been incurred had the lease not \nbeen executed. Costs directly or indirectly attributable to negotiating and arranging the lease (e.g., \nexternal legal costs to draft or negotiate a le ase or an allocation of internal legal costs) are not \nconsidered initial direct costs. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 135}), Document(page\_content='Accounting for leases \n4-4Figure LG 4 -1 provide s examples of costs included and excluded from initial direct costs. \nFigure LG 4 -1 \nExamples of costs included and excluded from initial direct cos ts \nIncluded Excluded \n□Certain s ubstantive incentive -based\ncommissions (including payments to\nemployees acting as selling agents)\n□Lease documentation preparation costs\nincurred after the execution of the lease ( e.g.,\nregulatory and other filing fees )\n□Legal fees that are contingent on successful\nexecution of the lease\n□Certain payments to existing tenants to move\nout\n□Consideration paid for a guarantee of a\nresidual asset by an unrelated third party□Employee salaries (including commissions\nthat are in -substanc e salaries)\n□Internal engineering costs\n□Negotiating lease term and conditions\n(including the preparation of d rafts)\n□Legal fees for services rendered before the\nexecution of the lease\n□Advertising\n□Other origination efforts\n□Depreciation\n□Costs related to an idle asset\nAny costs that would have been incurred even if the lessee or the lessor failed to execute the l ease are \nnot incremental costs and should be excluded from initial direct costs. Determining whether a \npayment is an incremental cost may depend on the facts and circumstances. For example, ASC 842 -\n10-55-240 through ASC 842 -10-55-242 provides an example in which external legal fees are excluded\nfrom initial direct costs because the lessee would be required to pay its attorneys for negotiating the\nlease even if the lease were not executed. However, when a lessee and lessor execute a legally -binding\nlease com mitment prior to drafting the lease agreement, legal fees for drafting may be incremental\ncosts that can be accounted for as initial direct cost s.\nSales tax payments \nSome leases of equipment require that the lessee make sales tax payments directly to a ta xing \nauthority. The specifics of each arrangement vary greatly by jurisdiction. Certain sales taxes may be \nconsidered lessee costs. If this is t he case, the sales tax payment is not a lease payment. We believe that \na lessee must carefully assess when the l egal obligation arises for the sales tax in order to determine if \nthe amount should be recorded as an initial direct cost. \nIf a legal obligation that requires the lessee to pay sales tax arises at lease commencement, it should be \naccounted for as a liabil ity and an initial direct cost. For example, if a lessee enters into a 5 -year lease \nwith a rent payment of $100 per year and is obligated to pay $8 as sales tax per year to the taxing \nauthority whether or not the lease is cancelled, the lessee should recor d $40 ($8 per year × 5 years, \nignoring present value for example purposes) as a separate liability (i.e., not a lease liabil ity) and initial \ndirect costs at the lease commencement date. \nIf the legally obligating event to pay sales tax occurs over time, sal es tax should be accounted for as \nincurred. For example, if the rent is billed every month (whether at the beginning or end of the \nmonth), sales tax should be expensed in that month, except that sales tax for any rent billed at \ncommencement date should be accounted for as an initial direct cost . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 136}), Document(page\_content='Accounting for leases \n4-5Question LG 4-1 addresses minimum annual guarantee payment arrangements. \nQuestion LG 4-1 \nLessee Corp enters into a five-year real estate lease with a minimum annual guarantee (MAG) \npayment structure in each year of the lease. The MAG amount is contractually set for the first year and \nis known at lease commencement. For each subsequent year, the MAG amount is reset based on a \npercentage of sales in the prior year. The reset MAG amount can go up and down compared to t he \nprior year. There is no floor. \nHow should Lessee Corp account for the MAG payment structure? \nPwC response \nWe believe the first year’s MAG amount is the only in -substance fixed payment in the arrangement. \nTherefore, at commencement, Lessee Corp should ca lculate the lease liability and right -of-use asset \nbased on the present value of the first year’s MAG amount. We further be lieve that Lessee Corp should \naccount for all payments resulting from future MAG resets similar t o variable lease payments that do \nnot depend on an index or a rate . Although the MAG is established at the end of the preceding year, it \nis not incurred until the subsequent year. Therefore, Lessee Corp should recognize future MAG resets \nin the period in which the obligation for those paymen ts is incurred. Since the only fixed payment is \nthe first year’s MAG at lease commencement, Lessee Corp will not have a lease liability on its books for \nthe remaining lease term after the first year . The right -of-use asset will be amortized over the entire \nlease term. \n4.2.2.3 Examples – lessee initial recognition and measurement \nExample LG 4 -1, Example LG 4 -2, Example LG 4 -3, Example LG 4 -4, Example LG 4 -5, and Example \nLG 4 -6 illustrate the measurement of a right -of-use asset and a lessee’s accounting for leases. \nEXAMPLE LG 4 -1 \nMeasuring the right -of-use asset \nLessee Corp and Lessor Corp execute a 10 -year lease of a railcar wi th the following terms on January 1, \n20X9: \n□The lease commencement date is February 1, 20X9.\n□Lessee Corp must pay Lessor Corp the first month ly rental payment of $10,000 upon execution of\nthe lease.\n□Lessor Corp will pay Lessee Corp a $50,000 cash incentive to enter into the lease payable upon\nlease execution .\nLessee Corp incurred $1,000 of initial direct costs, which are payable on February 1 , 20X9. \nLessee Corp calculated the initial lease liability as the present value of the remaining unpaid lease \npayme nts discounted using its incremental borrowing rate because the rate implicit in the lease could \nnot be readily determined; the initial leas e liability is $900,000. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 137}), Document(page\_content='Accounting for leases \n4-6How would Lessee Corp measure the right -of-use asset and record this lease? \nAnalysis \nLesse e Corp would measure the right -of-use asset as follows: \nInitial measurement of lease liability $900,000 \nLease payments made to Lessor Corp before the commencement date (i.e., \nbefore the first lease payment) 10,000 \nLease incentive received from Lessor Corp at lease execution date (50,000) \nInitial direct costs 1,000 \nInitial measurement of right -of-use asset $861,000 \nOn January 1, 20X9 (the lease execution date), Lessee Corp would record the following journal entries: \nDr. Prepaid rent $10,000 \nCr. Cash $10,000 \nTo record the initial lease payment due at lease inception \nDr. Cash $50,000 \nCr. Lease incentive $50,000 \nTo record receipt of the lease incentive from the lessor. \nOn February 1, 20X9 (the lease commencement date), Lessee Corp would record the following journal \nentries: \nDr. Right -of-use asset $900,000 \nCr. Lease liability $900,000 \nTo record the right -of-use asset and lease liability \nDr. Lease incentive $50,000 \nCr. Right -of-use asset $50,000 \nTo reclassify the lease incentive as an offset to the right -of-use asset ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 138}), Document(page\_content='Accounting for leases \n4-7Dr. Right -of-use asset $10,000 \nCr. Prepaid rent $10,000 \nTo reclassify the prepaid rent as an offset t o the right -of-use asset \nDr. Right -of-use asset $1,000 \nCr. Accrued expenses $1,000 \nTo record the initial direct costs \nEXAMPLE LG 4 -2 \nFinance lease initial recognition – non-specialized digital imaging equipment lease (lessee) \nLessee Corp enters in to a lease of non -specialized digital imaging equipment with Lessor Corp on \nJanuary 1, 20X9. The following table summarizes information about the lease and the leased assets. \nLease term 5 years, no renewal option \nRemaining e conomic l ife of the \nleased equ ipment 6 years \nPurchase option None \nAnnual lease payments $1,100 \nPayment date Annually on January 1 (first payment made at lease \ncommencement) \nLessee Corp’s incremental \nborrowing rate 7% \nThe rate Lessor Corp charges Lessee Corp in the lease is not \nreadily determinable by Lessee Corp. \nOther □Title to the asset remains with Lessor Corp upon lease\nexpiration\n□The fair value of the equipment is $5,000 at\ncommencement ; Lessee Corp does not guarantee the\nresidual value of the equip ment at the end of the leas e\nterm\n□Lessee Corp pays for all maintenance of the equipment\nseparate from the lease\n□There are no initial direct costs incurred by Lessee Corp\n□Lessor Corp does not provide any incentives\nHow would Lessee Corp measure and recor d this lease at commencement ? ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 139}), Document(page\_content='Accounting for leases \n4-8 Analysis \nBased on the facts Lessee Corp could reasonably conclude that the lease is a finance lease as the lease \nterm is a major part of the remaining economic life of the equipment (see LG 3 .3 for lease \nclassification criteria ). \nLessee Corp would first calculate the lease liability as the present value of the four remaining unpaid \nannual fixed lease payments of $1,100 discounted at Lessee Corp’s incremental borrowing rate of 7%; \nthis amount is $3,725. \nThe right -of-use asset is equal to the lease liabil ity plus the $1 ,100 rent paid on the lease \ncommencement date. \nLessee Corp would record the following journal entry on the lease commencement date . \nDr. Right -of-use asset $4,825 \nCr. Lease liability $3,725 \nCr. Cash $1,100 \n \nSee Example LG 4 -11 for an illustration of the subsequent measurement and recognition for this fact \npattern. \nEXAMPLE LG 4 -3 \nFinance lease recognition – real estate lease with a purchase option (lessee) \nLessee Corp enters into a property (land and building) lease with Lessor Corp on January 1, 20X9. The \nfollowing table summarizes information about the lease and the leased asset. \nLease term 10 years \nRenewal option Five 5 -year renewal options \nIf exercised, the annual lease payments are reset to then current \nmarket rents \nRemaining e conomic life 40 years \nFair value of the leased \nproperty at commencement $5,000,000 \nPurchase option Lessee Corp has an option to purchase the property at the end of the \nlease term for $3,000,000. Lessee Corp is reasonably certain to \nexercise this option. \nAnnual lease payments The first annual lease payment is $500,000, with increases of 3% \nper year th ereafter (see schedule of lease payments below). \nPayment date Annually on January 1 (first payment made at lease commencement) ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 140}), Document(page\_content='Accounting for leases \n4-9Incentive Lessor Corp gives Lessee Corp a $200,000 incentive for entering \ninto the lease (payable at the beginning of year 2), which is to be \nused for normal tenant improvements. \nLessee Corp’s incremental \nborrowing rate 9.04% \nThe rate that Lessor Corp charges Lessee Corp in the leas e is not \nreadily determinable by Lessee Corp. \nOther □Title to the property does not automatically transfer to Lessee\nCorp upon lease expiration\n□Lessee Corp does not guarantee the residual value of the real\nestate asset\n□Lessee Corp pays for all maintenanc e, taxes, and insurance on\nthe property separate from the lease\n□There are no initial direct costs incurred by Lessee Corp\nThe schedule of lease payments (excluding the purchase option) is shown below. \nDate Amount \nYear 1 (paid at commencement) $500,000 \nYear 2 ($515,000 – $200,000 lease incentive) 315,000 \nYear 3 530,450 \nYear 4 546,364 \nYear 5 562,754 \nYear 6 579,637 \nYear 7 597,026 \nYear 8 614,937 \nYear 9 633,385 \nYear 10 652,387 \nTotal $5,531,940 \nHow would Lessee Corp measure and record this lease at commencement ? \nAnalysis \nBased on the facts Lessee Corp could reasonably conclude that the lease is a finance lease because the \nfixed price purchase option is reasonably certain to be exercised (see LG 3.3 for lease classificatio n \ncriteria ). ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 141}), Document(page\_content='Accounting for leases \n4-10Lessee Corp wou ld first calculate the lease liability as the present value of the remaining unpaid \nannual lease payments, less the lease incentive paid in year 2, plus the exercise price of the purchase \noption using a discount rate of 9.04%. \nPV of annual lease payments, less lease incentive $3,237,510 \nPV of purchase option at end of lease term 1,262,490 \nTotal lease liability $4,500,000 \nThe right -of-use asset is equal to the lease liability plus the $500,000 rent paid on the lease \ncommencement date ($5, 000,000) . \nLess ee Corp would record the following journal entry on the lease commencement date . \nDr. Right -of-use asset $5,000,000 \nCr. Lease liability $4,500,000 \nCr. Cash $500,000 \nSee Example LG 4 -12 for an illustration of the subsequent measurement and recognition for this fact \npattern . \nEXAMPLE LG 4 -4 \nLessee operating lease recognition – automobile lease \nLessee Corp leases an automobile from Lessor Corp on January 1, 20X9. The following table \nsummarizes information about the lease and the leased asset. \nLease term 3 years, no renewal option \nRemaining e conomic life of the \nautomobile 6 years \nPurchase optio n Lessee Corp has the option to purchase the automobile at fair \nmarket value upon expiration of the lease. \nMonthly lease payments $500 (first payment made at lea se commencement) \nPayment date Beginning of the month \nLessee Corp’s incremental \nborrowing rate 6% \nThe rate Lessor Corp charges Lessee Corp in the lease is not \nreadily determinable by Lessee Corp. \nOther □Title to the automobile remains with Lessor Corp upo n\nlease expiration', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 142}), Document(page\_content='Accounting for leases \n4-11□The fair value of the automobile is $30,000 at\ncommencement ; Lessee Corp does not guarantee the\nresidual value of the automobile at the end of the lease\nterm\n□Lessee Corp pays for all maintenance of the automobile\nseparate from the lease\n□There are no initial direct costs incurred by Lessee Corp\n□Less or Corp does not provide any incentives\nHow would Lessee Corp measure and record this lease at commencement ? \nAnalysis \nBased on the facts Lessee Corp could reasonably conclude that t his leas e is an operating lease as none \nof the criteria for finance lease classification are met (see LG 3.3 for lease classification criteria) . \nLessee Corp would first calculate the lease liability as the present value of the remaining unpaid \nmonthly fixed lease payments discounted at Lessee Corp’s incremental bo rrowing rate of 6%; this \namount is $16,018. \nThe right -of-use asset is equal to the lease liability plus the $500 rent paid on the lease \ncommencement date ($16,518). Lessee Corp would record the following journal entry on the lease \ncommencement date . \nDr. Right -of-use asset $16,518 \nCr. Cash $500 \nCr. Lease liability $16,018 \nSee Example LG 4 -13 for an illustration of the subsequent measurement and recognition for this fact \npattern . \nEXAMPLE LG 4 -5 \nLesse e operating lease recognition \nLessee Corp leases a copier from Lessor Corp on January 1, 20X9. The following table summarizes \ninformation about the lease and the leased asset. \nLease term 3 years, no renewal option \nRemaining e conomic life of the \ncopier 5 years \nPurchase option None \nAnnual lease payments $500, which includes Lessor Corp maintenance for the term of \nthe lease ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 143}), Document(page\_content='Accounting for leases \n4-12Lessor Corp normally leases the same copier for $475 per year \nand offers a maintenance contract for $75 per year. \nPayment date Annu ally on January 1 (first payment made at lease \ncommencement) \nLessee Corp’s incremental \nborrowing rate 5.5% \nThe rate Lessor Corp charges Lessee Corp in the lease is not \nreadily determinable by Lessee Corp. \nOther Title to the copier remains with Lessor Cor p upon lease \nexpiration \nThe fair value of the copier is $2,000 at commencement ; \nLessee Corp does not guarantee the residual value of the copier \nat the end of the lease term \nLessee Corp pays $100 in legal fees related to filing the \nexecuted lease with the r egulatory aut horities , which are \ntreated as initial direct costs \nLessor Corp does not provide any incentives \nLessee Corp has not made an accounting policy election to not separate the lease and nonlease \ncomponents for this class of asset. \nHow would Lesse e Corp measur e and record this lease at commencement ? \nAnalysis \nThe arrangement contains a copier lease (lease component) and maintenance (nonlease component). \nAn allocation of the annual $500 fixed payment between the copier lease and maintenance would be \nmade as follows: \nStandalone \nprice \n(A) Relative % \n(A/$550) = \n(B) Annual fixed \npayment (C) Allocated annual \npayment (B × C) \nAnnual copier \nlease payment $475 86.4% $500 $432 \nAnnual \nmaintenance \ncontract fee 75 13.6% $500 68 \nTotal $550 100% $500 \nBased on the facts Lessee Corp could reasonably conclude that the lease is an operating lease as none \nof the criteria for finance lease classification are met (see LG 3.3 for classification criteria) . \nLessee Corp would first calculate the lease liability as the present value of the remaining unpaid \nannual allocated lease payment amount of $432 discounted at Lessee Corp’s incremental borrowing \nrate of 5.5%; this amount is $798. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 144}), Document(page\_content='Accounting for leases \n4-13The right -of-use asset is the sum of the lease liability, plus the $432 lease pa yment made on the lease \ncommencement date and the initial direct costs paid by Lessee Corp ($100); this amount is $1,330 \n($798 + $432+ $100). \nLessee Corp would record the following journal entry on the lease commencement date . \nDr. Right -of-use asset $1,33 0 \nCr. Lease liability $798 \nCr. Cash $532 \nEXAMPLE LG 4 -6 \nLessee operating lease recognition – lease payments tied to an index \nLessee Corp enters into a lease of equipment with Lessor Corp on January 1, 20X9. The following table \nsummarizes information about the lease and the leased assets. \nLease term 4 years, no renewal option \nRemaining e conomic life of the \nleased equipment 7 years \nPurchase option None \nAnnual lease payments The first annual payment is $1,500 \nThe annual payment increases each year by the prime rate on \nJanuary 1st. For example, if the prime rate is 3% on January 1, \n201X, then the lease payment for year two would be $1,545 \n($1,500 + ($1,500 × 3%)). \nPayment date Annually on January 1 (first payment made at lease \ncommencement) \nLesse e Corp’s incremental \nborrowing rate 8% \nThe rate Lessor Corp charges Lessee Corp in the lease is not \nreadily determina ble by Lessee Corp. \nOther □Title to the asset remains with Lessor Corp upon lease\nexpiration\n□The fair value of the equipment is $10,000 at\ncommencement ; Lessee Corp does not guarantee the\nresidual value of the equipment at the end of the lease\nterm\n□Lessee Corp pays for all maintenance of the equipment\nseparate from the lease\n□There are no initial direct costs incurred by Lessee Corp\n□Lessor Co rp does not provide any incentives', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 145}), Document(page\_content='Accounting for leases \n4-14Prime rate at the lease commencement date is 3%. The lease payments based on the prime rate at \ncommencement are: \nDate Amount \nLease commencement $1,500 \nYear 2 1,545 \nYear 3 1,591 \nYear 4 1,639 \nTotal $6,275 \nHow would Lessee Corp measure and record this lease at commencement ? \nAnalysis \nBased on the facts, Lessee Corp could reasonably conclude that the lease is an operating lease as none \nof the criteria for finance lease classification are met (see LG 3.3 for classifica tion criteria) . \nLessee Corp would first calculate the lease liability as the present value of the remaining unpaid fixed \nlease payments plus the variable lease payment (based on the Prime rate at the lease commencement \ndate) discounted at Lessee Corp’s in cremental borrowing rate of 8%; this amount is $4,096. Even if \nthe Pri me rate is expected to increase each year, the lease payments must be calculated using the rate \nat lease commencement and the rate will only be updated upon certain lease remeasurement e vents \n(see LG 5). \nThe right -of-use asset is equal to the lease liabil ity plus the first lease payment made at lease \ncommencement ($5,596). \nLessee Corp would record the following journal entry on the lease commencement date . \nDr. Right -of-use asset $5,596 \nCr. Lease liability $4,096 \nCr. Cash $1,500 \n4.3 Initial recognition and measurement – lessor—\nupdated September 2021 \nAs discussed in LG 3, leases are classified by a lessor as either a sales -type, direct financing, or \noperating lease. While lessees are re quired to record a lease liability and right -of-use a sset for all \nleases, the model applied by lessors depends on the type of the lease. The following sections discuss \ninitial recognition for the lessor. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 146}), Document(page\_content='Accounting for leases \n4-154.3.1 Sales -type lease \nA lessor should classify a lease th at meets any of the criteria in ASC 842 -10-25-2 as a sales -type lease \n(see LG 3.3 for lease classification criteria) . In a sales -type lease, the lessor transfers control of the \nunderlying asset to the lessee. Accordingly, the lessor should derecognize the leased asset and record \nits net investment in the lea se at lease commencement (consistent with the principle of a sale in ASC \n606). As discussed in ASC 842 -30-30-1, the net investment in the lease consists of the lease receivable \nand the unguaranteed resid ual asset. \nThe unguaranteed residual asset is the pr esent value of the lessor’s estimated value of the leased asset \nreturned to it at the end of the lease term, less a residual value guarantee, if any. There is no \nunguaranteed residual asset for the lesso r when the lessee retains the underlying asset at the end of \nthe lease term, as would be the case when a lease either transfers ownership to the lessee or a purchase \noption is reasonably assured of exercise. \nASC 842 -30-30-1 describes the measurement of a lessor’s net investment in a sales -type lease. \nASC 842 -30-30-1 \nAt the commencement date, for a sales -type lease, a lessor shall measure the net investment in the \nlease to include both of the following: \na.The lease receivable, which is measured at the present value, discounted using the rate implicit in\nthe l ease, of:\n1.The lease payments (as described in paragraph 842 -10-30-5) not yet received by the lessor\n2.The amount the lessor expects to derive from the underlying asset following the end of\nthe lease term that is guaranteed by the lessee or any other third party unrelated to the lessor.\nThe unguaranteed residual asset at the present value of the amount the lessor expects to\nderive from the underlying asset following the end of the lease term that is not guaranteed\nby the lessee or any other third pa rty unrelated to the lessor, discounted using the rate\nimplicit in the lease.\nThe lessor should recognize any profit or loss arising from the sale of the underlying asset (through the \nlease). See LG 4.3.1 .1. for more details . \nInitial direct costs should be recognized as an expense unless the fair value of the underlying asset \nequals its carrying amount (i.e., there is no selling profit or loss). When there is no selling profit or \nloss, the initial direct c osts should be deferred and recognized over the lease. \n4.3.1.1 Sales type lease — Selling profit/loss \nAt the lease commencement date, the lessor is required to calculate the selling profit or loss as (1) the \nfair value of the underlying asset (or the sum of lease receivable and any prepaid lease payments b y \nlessee, if lower); minus (2) the carrying amount of the underlying asset net of any unguaranteed \nresidual asset; minus (3) any deferred initial direct costs of the lessor. The sales price in a sales -type \nlease i s assumed to be the fair value of the under lying asset unless the present value of the lease \npayments is lower than the fair value of the asset. This could be the case when the lease has an ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 147}), Document(page\_content='Accounting for leases \n4-164.3.1.2 unguarantee d residua l asse t that reduce s the receivab le recognize d at lease commencement . This \nshou ld not have a significan t impac t on the sellin g profi t or loss, however , becaus e the presen t valu e of \nthe unguarantee d residua l asse t is also subtracte d from the carryin g amoun t of the underlyin g asset \n(i.e., a cost of sales) . See Example LG 4-7 for an illustratio n of how to calculat e sellin g profi t when a \nlease contain s an unguarantee d residua l value. \nVariabl e payments \nIt is commo n for supplier s in certai n industrie s to structur e transaction s with significan t variable \npayments . Supplier s in thes e industrie s are willin g to acce pt variabilit y in payment s becaus e they \nbelie ve such arrangement s wou ld be profitab le overa ll and lowe r fixed payment s can mak e an \narrangemen t attracti ve to the customer. \nTher e are instance s when transaction s with variab le payment s may qualif y as a transfe r of contro l to \nthe custome r unde r the new revenu e recognitio n standar d (ASC 606) . Such transaction s may also \nqualif y as a sales-ty pe lease unde r the new lease s guidance . This is becaus e the revenu e standar d states \nthat the transfe r of title is only one of the indicator s for contro l bein g transferre d to a customer . \nWhethe r a transactio n with variab le payment s is subje ct to the revenu e guidan ce or the leases \nguidan ce may impac t when revenu e is recognize d by a supplier . Unde r the lease s standar d, variable \npayment s that do not depen d on an inde x or rate are not recognize d until the contingenc y is resolved. \nUnde r the new revenu e recognitio n standar d, variab le payment s may be recognize d as revenue \nupfron t (whe n earne d) provide d certai n condition s are met.\nWhe n a transactio n with variab le payment s qualifie s as both a sale unde r the new revenu e recognition \nstandar d and a sales-ty pe lease unde r the new lease s standar d, the lease s standar d shou ld be applied . \nThis may lead to the recognitio n of a sellin g loss ( i.e., a day-on e loss) by the lesso r even if the overall \narrangemen t is expecte d to be profitable . In respons e to concern s raise d in the post implementation \nreview , the FAS B publishe d ASU 2021- 05, which upon adoptio n require s a lesso r to classif y a lease \nwith variab le lease payment s (that do not depen d on a rate or index ) as an operatin g lease at the lease \ncommencemen t date if classifyin g the lease as a sales-ty pe lease (or direct financin g lease ) would \nresu lt in recognitio n of a sellin g loss. Operatin g lease lessor s can elect an optiona l practica l expedient \nto aggregat e nonleas e component s that otherwis e woul d have been accounte d for unde r the new \nrevenue standard with the associated lease component and account for the combined component \nunder the revenue standard if certain conditions are met. See LG 9.11 for the effective date and \ntransition requirements of ASU 2021-05. See Example LG 4-9 for an illustration of a lease with \nvariable payments. See LG 2.4.4.1 for the component practical expedient available to lessors. \nPresentation \nLeas e classificatio n does not determin e how sellin g profi t or loss shou ld be presente d in a lessor’s \ninco me statement . Presentatio n shou ld be determine d by the lessor’ s busines s model ; when lease s are \nused as an alternative means of realizing value from the goods that it would otherwise sell, a sales-\ntype lease should be recorded as revenue and cost of goods sold. See FSP 14.3.2.1 for information on \nthe presentation of selling profit or loss in the statement of comprehensive income. \nInitia l direc t cost s in a sales-typ e lease \nThe guidan ce for identifyin g initia l direct costs is the same for a lesso r as it is for a lessee . Additionally, \nthe term “initia l direc t costs ” unde r the new lease s guidan ce is the same as incrementa l costs of ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 148}), Document(page\_content='Accounting for leases \n4-17obtaining a contract under the new revenue guidance. The two terms ar e intended to be applied in the \nsame manner in terms of which costs get capitalized. \nInitial direct costs may be more significant for a lessor because they are usually the party that solicits \nlessees as part of their sales activities, are often the party to engage attorneys to prepare the legal \ndocuments, and often pay commissions incurred in connection with execution of a lease. See LG \n4.2.2.2 for information on initial direct costs and Figure LG 4 -1 for the examples of costs included and \nexcluded from in itial direct costs. \nA lessor should expense the initial direct costs associated with a sales -type lease unless the fair value of \nthe underlying asset equals its carrying amount (i.e., there is no selling profit or loss). This accounting \nis similar to the a ccounting for a seller’s costs in a contract for similar goods. See RR 11.2 for \ninformation on a seller’s accounting for contract costs. \nIniti al direct costs incurred in connection with a sales -type lease with no selling profit or loss should \nbe deferred and recognized over the lease term using a method that produces a constant periodic rate \nof return on the lease when combined with the interest income on the lease receivable and the residual \nasset (i.e., in the same manner as for a direct financing lease) . \nIn arrangements that include both lease and nonlease components, the initial direct costs should be \nallocated to the various components and accounted for in accordance with the guidance applicable to \neach component. Initial direct costs may be treated d ifferently depending upon the nature of the \nnonlease components. \n4.3.1.3 Sales -type lease — Collectibility not probable \nASC 842 -30-25-3 to ASC 842 -30-25-6 describes how a lessor should recognize and measure a sales -\ntype lease when collectibility of the lease receivable is not probable at the commencement date. \nASC 842 -30-25-3 \nThe guidance in paragraphs 842 -30-25-1 through 25 -2 notwithstanding, if collect ibility of the lease \npayments, plus any amount necessary to satisfy a residual value guarantee provided by t he lessee, is \nnot probable at the commencement date, the lessor shall not derecognize the underlying asset but \nshall recognize lease payments receiv ed—including variable lease payments —as a deposit liability until \nthe earlier of either of the following: \na.Collectibility of the lease payments, plus any amount necessary to satisfy a residual value\nguarantee provided by the lessee, becomes probable. If col lectibility is not probable at the\ncommencement date, a lessor shall continue to assess collectibility to de termine whether the lease\npayments and any amount necessary to satisfy a residual value guarantee are probable of\ncollection.\nb.Either of the followin g events occurs:\n1.The contract has been terminated, and the lease payments received from the lessee\nare n onrefundable.\n2.The lessor has repossessed the underlying asset, it has no further obligation under the contract\nto the lessee, and the lease paym ents received from the lessee are nonrefundable.', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 149}), Document(page\_content='Accounting for leases \n4-18ASC 842 -30-25-4 \nWhen collectibility is not probable at the commencement date, at the date the criterion in paragraph \n842-30-25-3(a) is met (that is, the date at which collectibility of the lease payments pl us any amount\nnecessary to satisfy a residual value guarantee provided by the lessee is asses sed as probable), the\nlessor shall do all of the following:\na.Derecognize the carrying amount of the underlying asset\nb.Derecognize the carrying amount of any deposit liability recognized in accordance with paragraph\n842-30-25-3\nc.Recognize a net investment in t he lease on the basis of the remaining lease payments and\nremaining lease term, using the rate implicit in the lease determined at the commencement date\nd.Recognize selling profit or selling loss calculated as:\n1.The lease receivable; plus\n2.The carrying amount of the deposit liability; minus\n3.The carrying amount of the underlying asset, net of the unguaranteed residual asset.\nASC 842 -30-25-5 \nWhen collectibility is not probable at the commencement date, at the date the criterion in paragra ph \n842-30-25-3(b) is met, the lessor shall derecognize the carrying amount of any deposit liability\nrecognized in accordance with paragraph 842 -30-25-3, with the corresponding a mount recognized as\nlease income.\nWhen collectibility of the lease receivable f rom a sales -type lease is not probable at the original \ncommencement date, the lessor should defer the recognition of the sale until collectibility becomes \nprobable. This is cons istent with the collectibility guidance in ASC 606, which similarly states that a \nsupplier should defer recognition of a sale to a customer if collectibility of the consideration is not \nprobable. \nIn such circumstances, a lessor should not derecognize the u nderlying assets at the lease \ncommencement date, and should not recognize a net investment in the lease and selling profit or loss \n(other than initial direct costs). Instead, it should recognize all lease payments received as a deposit \nliability until the earlier of when collectibility becomes probable or the contract is terminated o r \ncompleted and the lease payments it received are nonrefundable. Initial direct costs associated with \nthe lease should be expensed at the original lease commencement date. Duri ng this period, the lessor \nshould not recognize interest expense on the deposit liability, and it should continue to depreciate the \nunderlying asset. \nWhen collectibility subsequently becomes probable, a lessor should derecognize the carrying amount \nof the underlying asset and deposit liability from its balance sheet and recognize th e net investment in \nthe lease as well as any selling profit or loss. After making these adjustments, a lessor should follow the \nsubsequent measurement guidance for a sales -type lease (see LG 4.5.1). ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 150}), Document(page\_content='Accounting for leases \n4-19If the collectibility of lease payments or guaranteed re sidual value do not become probable before the \ncontract is terminated, or it repossesses the underlying asset and the lease payments are \nnonrefundable, a lessor should derecogni ze the carrying amount of any deposit liability recognized \nwith the correspondi ng amount recognized as lease income. The lessor should continue to apply the \nimpairment guidance in ASC 360 to the underlying asset. \nASC 842 -30-25-6 \nIf collectibility is proba ble at the commencement date for a sales -type lease or for a direct financing \nlease, a lessor shall not reassess whether collectibility is probable. Subsequent changes in the credit \nrisk of the lessee shall be accounted for in accordance with the impairmen t guidance applicable to the \nnet investment in the lease in paragraph 842 -30-35-3. \nIf the collectibility of lease payments and any residual value guarantee is deemed to be probable at the \ncommencement date, any subsequent deterioration in the lessee’s cred it quality will not require a \nlessor to change its accounting or classification of a lease. However, the lessor’s net investment in the \nlease would be subject to the financial instruments impairment guidance in ASC 310 and any \ndeterioration in the credit q uality of the lessee should be captured through an impairment charge. \nHowever, a lessor should consider the guidance for credit losses in ASC 326 , Financial Instruments -\nCredit Losses , once that guidance is adopted. See LG 4.7 for further discussion on im pairment. \n4.3.1.4 Examples – lessor accounting for sales -type leases \nExample LG 4 -7 and Example LG 4 -8 illustrate a lessor’s accounting for a sales -type lease. \nEXAMPLE LG 4 -7 \nSales -type lease recognition – non-specialized digital imaging equipment lease (lessor) \nLessor Corp enters into a lease of non -specialized digital imaging equipment with Lessee Corp on \n1/1/X9. Lessor Corp is a manufacturer of digital imaging equipment that uses both direct sales and \nleases as a means of selling its products. The following tab le summarizes information about the lease \nand the leased as sets. \nLease term 5 years, no renewal option \nRemaining e conomic life of the \nleased equipment 6 years \nPurchase option None \nAnnual lease payments $1,100 \nPayment date Annually on January 1 (first payment is made at lease \ncommencement) \nFair value of the leased equipment \nat commencement $5,000 \nLessor Corp’s carrying value of the \nleased equipment $4,500 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 151}), Document(page\_content='Accounting for leases \n4-20Rate implicit in the lease 7.04% \nOther □Title to the asset remains with Lessor Corp upon lease\nexpiration\n□Lessee Corp does not guarantee the residual value of the\nequipment at the end of the lease term and Lessor Corp\ndoes not obtain any third -party residual value insurance\n□Estimated fair value of the equipment at the end of the\nlease term is $250\n□Lessee Corp pays for all maintenance of the equ ipment\nseparate from the lease\n□There are no initial direct costs incurred by Lessor Corp\n□Lessor Corp does not provide any incentives\nHow would Lessor Corp measure and record this lease at commencement ? \nAnaly sis \nBased on the facts Lessor Corp could reaso nably conclude that the lease is a sales -type lease as the \nlease term is a major part of the remaining economic life of the equipment (see LG 3 for lease \nclassification criteria ). \nLessor Corp would first deter mine the total net investment in the lease as the present value of the lease \nreceivable and the unguaranteed residual asset. \n□The present value of the lease receivable is equal to the present value of the remaining lease\npayments discounted at 7.04%; this amount is $3,722.\n□The present value of the unguaranteed residual asset discounted at 7.04% is $178.\n□Lessor Corp’s net investment in the lease is $3,900 (the sum of the lease receivable ($3,722) and\nthe unguaranteed residual asset ($178)).\nTo determine the selling profit or loss arising from the le ase, Lessor Corp would calculate the \ndifference between the fair value of the underlying asset (or the lease receivable plus any proceeds \nreceived at or before lease commencement, if lower) and the carrying amount of the underlying asset \nnet of any unguara nteed residual asset. Since the present value of the lease receivable plus the upfront \nproceeds ($4,822) is lower than the fair value of the underlying asset ($5,000), t he selling profit is \ncalculated as follows: \nPresent value of the lease receivable \nPlus, the lease payment received at lease commencement $3,722 \n1,100 \nLess, the carrying value of leased asset ($4,500) net of unguaranteed residual asset \n($178) (4,322) \nSelling profit $500 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 152}), Document(page\_content='Accounting for leases \n4-21Lessor Corp would record revenue at lease commencement equal to the lease receivable amount plus \nthe lease payment received at lease commencement ($4,822). Cost of goods sold would be recorded as \nthe difference between the carrying value of the leased asse t ($4,500) and the discou nted value of the \nunguaranteed residual asset ($178) . \nLessor Corp would record the following journal entry on the lease commencement date .\nDr. Lease receivable $3,722\nDr. Cash $1,100 \nDr. Unguaranteed residual asset $178 \nDr. C ost of goods sold $4,322 \nCr. Property, plant and equipment (leased asset) $4,500 \nCr. Revenue $4,822 \nSee Example LG 4 -15 for an illustration of the subsequent measurement and recognition for this fact \npattern. \nEXAMPLE LG 4 -8 \nSales -type lease recognition – real estate with a purchase option (lessor) \nLessor Corp enters into a property (land and building) lease with Lessee Cor p on January 1, 20X9. The \nfollowing table summarizes information about the lease and the leased asset. \nLease term 10 years \nRenewal option Five 5 -year ren ewal options \nIf exercised, the annual lease payments are reset to then \ncurrent market rents. \nRemaining e conomic life 40 years \nFair value of the leased property at \ncommencement $5,000,000 \nLessor Corp’s carrying value of the \nleased property $5,000,000 \nPurchase option Lessee Corp has an option to purchase the property at the end \nof the lease term for $3,000,000 . Lessee Corp is reasonably \ncertain to exercise this option . \nAnnual lease payments The first annual payment is $500,000, with increases of 3% per \nyear thereafter (see schedule below). ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 153}), Document(page\_content='Accounting for leases \n4-22Payment date Annually on January 1 (first payment is made at lease \ncommencement) \nIncentive Lessor Corp gives Lessee Corp a $200,000 incentive for \nentering into the lease (payable at the beginning of year 2), \nwhich i s to be used for normal tenant improvements. \nRate implicit in the lease Approxima tely 9.04% \nOther □Title to the property does not automatically transfer to\nLessee Corp upon lease expiration\n□Lessee Corp does not guarantee the residual value of the\nreal es tate asset\n□Lessee Corp pays for all maintenance, taxes, and insurance\non the property separate from the lease\n□There are no initial direct costs incurred by Lessor Corp\nThe schedule of lease payments (excluding the purchase option exercise price) is show n below. \nDate Amount \nLease commencement $500,000 \nYear 2 ($515,000 – $200,000 lease incentive)\* 315,000 \nYear 3 530,450 \nYear 4 546,364 \nYear 5 562,754 \nYear 6 579,637 \nYear 7 597,026 \nYear 8 614,937 \nYear 9 633,385 \nYear 10 652,387 \nTotal $5,531,940 \n\*See FSP 14 for presentation considerations for the lease incentive receivable.\nLessor Corp uses leases for the purposes of providing financing, therefore it presents any selling \nprofit or loss in a single line item in the income statement. See FSP 14.3.2.1 f or information on the \npresentation of selling profit or loss in the statement of comprehensive income. \nHow wou ld Lessor Corp measure and recor d this lease at commencement ? ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 154}), Document(page\_content='Accounting for leases \n4-23Analysis \nBased on the facts Lessor Corp could reasonably conclude that the lease is a sales -type lease because it \ngrants Lessee Corp a fixed price purchase option to purchase the asset underlying the lease and Lessee \nCorp is reasonably certain to exercise that purchase option (see LG 3.3 for classification criteria) . \nLessor Corp would firs t determine the t otal net investment in the lease by calculating the present value \nof the lease receivable and the unguaranteed residual asset. \n□The present value of the lease receivable is $4,500,000. This is the present value of the remaining\nfixed lease payments, less t he lease incentives payable to Lessee Corp, plus the exercise price of the\npurchase option discounted at approximately 9.04%, the rate implicit in the lease. The exercise\nprice of the purchase option is included in the lease receivable bec ause it is reason ably certain that\nLessee Corp will exercise the option.\n□Since it is reasonably certain that Lessee Corp will exercise its purchase option, Lessor Corp does\nnot expect to derive any additional value from the underlying asset; therefore, th e unguaranteed\nresidual asset value is zero.\n□Lessor Corp’s net investment in the lease is $4,500,000 (the sum of the lease receivable\n($4,500,000) and the unguaranteed residual asset ($0)).\nLessor Corp would record the following journal entry on the leas e commencement da te.\nDr. Lease receivable $4,5oo,000 \nDr. Cash $500,000 \nCr. Property, plant and equipment (leased asset) $5,000,000 \nExample LG 4 -9 illustrate s a lessor’s accounting for a lease with variable lease payments that result in \na day-one los s under a sales -type lease classification (assuming the lessor has adopted ASU 2021 -05). \nEXAMPLE LG 4 -9 \nLessor’s accounting for a l ease with variable lease payments that result in a day -one loss under a sales -\ntype lease classification (assuming the lessor has adopted ASU 2021 -05) \nLessor Corp will install an x -ray machine in a hospital (customer/lessee) and maintain it for a period \nof five years. Lessor Corp can substitute the x -ray machine only in the event of malfunction, which is \nexpected to be infrequen t. The customer will make all operational decisions (e.g., decide in which \ndepartment the x -ray machine will be used, hours of its operation) and its employees will operate the \nmachine. The customer will be responsible for providing all of the consumables needed (e.g., x -ray \nfilms, chemicals). The customer will bear the risk of loss in the event of damage or theft and will be \nresponsible for purchasing insurance to protect against physical loss of the machine. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 155}), Document(page\_content='Accounting for leases \n4-24As is customary in this industry, Lessor Corp does not intend to reposse ss the machine at the end of \nthe term. Consequently, the customer may decide to continue to use the machine or scrap it after the \nfive-year period. \nThe supply of x -ray machines is part of Lessor Corp’s ongoing major or central op erations. Other facts \nof the arrangement are: \nLease term 5 years (noncancellable) \nRemaining e conomic life 5 years \nPayments from the customer $5/click of the x -ray machine to take an x -ray \nFixed maintenance fee of $2,000/year for 5 years (payable at \nthe end of each month) \nVariable payments estimate during \nthe term of the arrangement $125,000 \nFair value of the leased asset at \ncommencement $100,000 \nLessor Corp’s carrying value of the \nleased asset $80,000 \nEstimated fair value of the leased \nasset at the e nd of 5 years $0 \nStandalone price for leasing a \nsimilar asset for 5 years $100,000 \nStandalone price for maintenance \nfor 5 years $10,000 \nInception date and commencement \ndate January 1 \nOther Collecti bility of payments from the customer is probable \nLessor Corp has not made an accounting policy election to not separate the lease and nonlease \ncomponents for this class of asset. \nLessor Corp has adopte d ASU 2021- 05, Lessor s – Certain Lease s with Variable Lease Payments . \nHow should Lessor Corp account for the lease component at commencement date? ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 156}), Document(page\_content='Accounting for leases \n4-25The arrangement contains two components - a lease component (the lease of the x-ray machine) and a \nnonlease component (the maintenance services). \nThe lease component qualifies as a sales-type lease because the lease term is for the major part of the \nremaining economic life of the X-ray machine (see LG 3.3 for lease classification criteria). \nContract consideration is $10,000 ($2,000 × 5), which is the fixed amount for maintenance over the \nfive years. Contract consideration excludes the $5/click because it relates to the lease component and \nis a variable payment that does not depend on an index or a rate. Therefore, Lessor Corp would \nallocate the contract consideration between the components under the new leases guidance as follows: \nComponent Standalone price \n(A) Allocation % \n(A/$110,000) \n(B) Allocation of \ncontract \nconsideration \n(B\*$10,000) \nLease $100,000 90.91% $9,091 \nMaintenance 10,000 9.09% 909 \nTotal $110,000 100% $10,000 \nThe lease would be classified as a sales-type lease since the lease term equals the remaining economic \nlife of the asset. However, in this example, the application of sales-type lease accounting would result \nin a day-one loss of $70,909 at commencement ($9,091 consideration allocated to the lease minus \n$80,000 carrying value of the leased asset) since the only fixed payments required under the contract \ntotal $10,000. As such, the lease must be classified as operating under ASU 2021- 05, which this \nexample assumes has been adopted by Lessor Corp . \nAs the lease is classified as an operating lease, Lessor Corp will continue to reflect the x-ray machine \non its balance sheet at its carrying value and depreciate it in accordance with Lessor Corp’s normal \ndepreciation policy. See LG 4.5.2 for the subsequent accounting for an operating lease.Direct financing \nlease \n4.3.2 Direct financing lease \nWhen a lease is not a sales-type lease but meets the criteria to be classified as a direct financing lease \n(see LG 3.3 for lease classification criteria), the lease transaction effectively converts the lessor’s risk \narising from the underlying asset (that is, asset risk) into credit risk. Consequently, the most faithful \nrepresentation of a lessor’s involvement in a lease that transfers substantially all of the risks and \nrewards incidental to ownership of the underlying asset to a lessee is to recognize the lessor’s financial \nnet investment in the lease and recognize financial (interest) income on that net investment over the \nlease term. \nAs described in ASC 842- 30-25-7, a lessor should derecognize the leased asset underlying a direct \nfinancing lease and record a net investment in the lease at lease commencement. The net investment \nin the lease should be measured in the same manner as a sales-type lease adjusted for selling profit \nand initial direct costs. See LG 4.3.1 for information on measuring the net investment in a sales-type \nlease. Any selling profit and initial direct costs should be deferred and included in the net investment Analysis', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 157}), Document(page\_content='Accounting for leases \n4-26in the lease. These amounts should be recognized over the lea se term in a manner that will produce, \nwhen combined with the interest income on the lease receivable and the residual asset, a constant \nperiodic rate of return on the lease (see ASC 842 -30-55-31 through ASC 842 -30-55-39 for an \nillustrative example) . Selli ng losses should not be deferred. See LG 4 .3.2.1 for the accounting for \nselling loss es due to variable lease payments . \n4.3.2.1 Direct financing lease — Initial measurement \nASC 842 -30-30-2 provides guidance of the measureme nt of the net investment in a direct financing \nlease. (Note that ASC 842 -30-30-1(a) and ASC 842 -30-30-1(b) are reproduced in LG 4.3.1.) \nASC 842 -30-30-2 \nAt the commencement date, for a direct financing lease, a lessor shall measure the net investment in \nthe lease to inc lude the items in paragraph 842 -30-30-1(a) through (b), reduced by the amount of any \nselling profit.\nSelling profit is not recognized at the commencement of a direct financing lease because it does not \ntransfer control of the underlying asset to the lessee . This treatment is consistent with the principle of \na sale in ASC 606. However, when a lease meets the criteria to be classified as a direct financing lease, \nit transfers substantially all the risks and rewards of ownership of the underlying asset to one or more \nthird parties and effectively converts the lessor’s risk arising from the underlying asset into credit risk. \nTherefore, the most faithful representation of a lessor’s involvement in such a lease is to recognize the \nlessor’s financial net investment in the lease (excluding selling profit) and recognize selling profit as \ninterest income on that net investment. \nThe different ways of measuring the net investment in a lease for a sales -type lease and a direct \nfinancing lease (i.e., a sales -type lease inc ludes the selling profit recognized at commencement) results \nin the same total income but differences in the timing of income recognition. Another difference in the \ninitial measurement of a net investment in a sales -type lease versus that rec orded for a di rect financing \nlease is the accounting for initial direct costs. In a sales -type lease, initial direct costs ordinarily are \nexpensed as incurred and are excluded in the computation of the rate implicit in the lease . In a direct \nfinancing leas e (and in a sales-type lease whe n the fair value of the underlying asset equals its carrying \namount), the initial direct costs are deferred and included in the net investment in the lease and thus \nare included in the calculation of the rate implicit in the lease . \nAs d iscussed in LG 4.3.1.3, in a sales -type lease, collectibility only impacts sale recognition. In a direct \nfinancing lease, however, collectibility impacts lease classification. As described in LG 3.3.4.7, when \ncollectibility of lease payments or the residua l value guarantee is not probable at lease \ncommencement, a lessor should classify the lease as an operating lease, even though it would \notherwise have met the criteria for classification as a direct financing lease. The classification of such \nleases are no t reassessed when there is a subsequent improvement in the lessee’s credit quality (i.e., \nthese operating leases remain classified as operating leases even when the collectibility subsequently \nbecome probable). See LG 4.3.3.1 for the recognit ion and measur ement of an operating lease when \ncollectibility is not probable. \nAn arrangement with variable lease payments that is classified as a direct financing lease may lead to a \nselling loss o r a day -one loss even if the overall arrangement is expect ed to be profitable. In response \nto concerns raised in the post implementation review , the FASB published ASU 2021 -05, which upon ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 158}), Document(page\_content='Accounting for leases \n4-274.3.3 adoptio n require s a lesso r to classif y a lease with variab le lease payment s (that do not depen d on a rate \nor index) as an operating lease at the lease commencement date if classifying the lease as a direct \nfinancing lease (or sales-type lease) would result in recognition of a selling loss. See LG 9.11 for the \neffecti ve date and transitio n requirement s of ASU 2021- 05. \nOperatin g leas e — lessor \nAn operatin g lease is neithe r a sale nor financin g of an asset . In addition , upon adoptio n of ASU 2021-\n05, ASC 84 2 also require s a lesso r to classif y a lease with variab le lease payment s (that do not depend \non a rate or index ) as an operatin g lease at the lease commencemen t date if classifyin g the lease as a \nsales-ty pe or a direct financin g lease wou ld resu lt in recognitio n of a sellin g loss. If a lease is classified \nas operating , the lesso r shou ld keep the asse t underlyin g the lease on its balan ce shee t and continu e to \ndepreciat e the asse t base d on its estimate d usefu l life. Renta l revenu e from leas e payment s shou ld be \nrecognize d on a straight-lin e basis (or anothe r systemati c basis if that basis is mor e representati ve of \nthe pattern in which income is earned from the underlying asset over the term of the respective lease). \nSee LG 9.11 for the effective date and transition requirements of ASU 2021-0 5. Based on the definition \nof lease payments in ASC 842-1 0-30-5(f), a lessor should not include any residual value guarantee \nfrom a lessee as a lease payment. A lessor should record an unbilled rent receivable, which is the \namount by which straight-line rental revenue exceeds rents currently billed in accordance with the \nlease. \nExcerpt from ASC 8 42-10-30-5\nAt the commencement date, the lease payments shall consist of the following payments relating to the \nuse of the underlying asset during the lease term: \n... \nf. For a lessee only, amounts probable of being owed by the lessee under residual valu e guarantees (see\nparagraphs 842 -10-55-34 through 55 -36).\nQuestions often arise as to whether a lessor should recognize uneven rent payments on some basis \nother than straight -line if the rent increases are designed to reflect estimated future market rents. \nAlthough t hese type of rent increases are common in real estate leases, we believe that the income \nshould be recorded on a straight -line basis even in these situations. \n4.3.3.1 Operating lease — Collectibility is not probable \nASC 842 -30-25-12 describes the recogn ition and m easurement for a lessor in an operating lease when \ncollectibility of the lease payments plus any amount necessary to satisfy the residual value guarantee is \nnot probable at the commencement date. \nASC 842 -30-25-12\nIf collectibility of the lease payments pl us any amount necessary to satisfy a residual value guarantee \n(provided by the lessee or any other unrelated third party) is not probable at the commencement date, \nlease income shall be limited to the lesser of the income that would be recognize d in accord ance with \nparagraph 842 -30-25-11(a) through (b) or the lease payments, including variable lease payments, that \nhave been collected from the lessee. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 159}), Document(page\_content='Accounting for leases \n4-28ASC 842 -30-25-13 \nIf the assessment of collectibility changes after the commencement date, any difference between the \nlease income that would have been recognized in accordance with paragraph 842 -30-25-11(a) through \n(b) and the lease payments, including variable lease payments, that have been collected from the lessee\nshall be recognized as a curren t-period adjustment to lease income.\nThe initial recognition and measurement for an operating lease is not impacted by the collectibility of \nthe payments from the lessee. The lessor continues to recognize the underlying asset on its balance \nsheet and conti nues to depreciate the asset based on its estimated useful life. However, subsequent to \ninitial recognition, a lessor’s lease income is limited to the lesser of the straight -line rental income (or \nanother systematic basis if that basis is more representati ve of the pattern in which income is earned \nfrom the underlying asset over the term of the respective lease) or the lease payments that have been \ncollected from the lessee. \nWhen the collectibility of the lease payments subsequently becomes probable, the le ssor should \nrecognize the difference between the cumulative lease income recognized to date and the amount that \nwould have been recognized had the lessor followed the measurement guidance for an operating lease \nwithout the limitation described in ASC 842 -30-25-12. The amount is recorded as an adjustment to \nlease income in the period in which collectibility is first deemed probable. After such adjustment, the \nlessor should follow the general guidance for subsequent measurement of an operating lease (see LG \n4.5.2). Lessors are required to continually assess collect ibility over the lease term (see LG 8.9 for \nsubsequent accounting considerations). \n4.3.3.2 Examples – lessor accounting for operating leases \nExample LG 4 -10 illustrates a lessor’s accounting for an operatin g lease. \nEXAMPLE LG 4 -10 \nLessor operating lease recognition – automobile lease \nLessor Corp leases an automobile to Lessee Corp on January 1, 20X9. The following table summarizes \ninformation about the lease and the leased asset. \nLease term 3 years, no renewa l option \nRemaining e conomic life of the \nautomobile 6 years \nFair value of the automobile at \ncommencement $30,000 \nLessor Corp’s carrying value of the \nautomobile at commencement $30,000 \nPurchase option Lessee Corp has the option to purchase the automobile at fair \nmarket value upon expiration of the lease. \nMonthly lease payments $500 for the first year ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 160}), Document(page\_content='Accounting for leases \n4-29 $550 for the second year \n$600 for the third year \nPayment date Beginning of the month (first payment is made at lease \ncommencement) \nRate implici t in the l ease 8% \nOther □ Title to the automobile remains with Lessor Corp upon \nlease expiration \n□ The expected residual value of the automobile at the end of \nthe lease term is $19,000; Lessee Corp does not guarantee \nthe residual value of the automobile at the end of t he lease \nterm \n□ Lessee Corp pays for all maintenance of the automobile \nseparate from the lease \n□ There are no initial direct costs incurred by Lessor Corp \n□ Lessor Corp does not provide any incentives \nHow would Lessor Corp measure an d record this lease at com mencement ? \nAnalysis \nBased on the facts Lessor Corp could reasonably conclude that the lease is an operating lease as none \nof the criteria for sales -type or direct financing lease treatment have been met (see LG 3.3 for \nclassification criteria ). Since the lease is classified as an operating lease, no asset or liability would be \nrecorded at lease commencement . Lessor Corp would keep the automobile on its books as an asset and \ndepreciate it in accordance wi th its normal depreciation policy. \nSee Example LG 4 -16 for an illustration of the subsequent measurement and recognition for this fact \npattern. \n4.4 Subsequent recognition and measurement – lessee \nOver the lease term, a lessee must amortize the right -of-use a sset and record interest expense on the \nlease liabili ty created at lease commencement. The income statement recognition and classification are \nbased on how the lease is classified. See LG 3 for information on lease classification. \n4.4.1 Finance leases \nFinance l eases are accounted for in a manner similar to financ ed purchases. The right -of-use asset is \namortized to amortization expense. Interest expense is recorded in connection with the lease liability. \nFigure LG 4 -2 describes how expenses are recognized for fi nance leases. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 161}), Document(page\_content='Accounting for leases \n4-30 Figure LG 4 -2 \nLessee finance lease exp ense recognition \nExpense classification Income statement recognition pattern \nAmortization expense Straight -line recognition over the shorter of the useful \nlife of the asset or the lease term \nInterest expense Interest method \n \nExample LG 4 -11 illustrates the subsequent measurement of a right -of-use asset and lease liability. \nEXAMPLE LG 4 -11 \nFinance lease subsequent measurement and recognition – non-specialized digital imaging equipment \nlease (l essee) \nLessee Corp enters into a lease of non -specialized digit al imaging equipment with Lessor Corp on \nJanuary 1, 20X9. The following table summarizes information about the lease and the leased assets. \nLease term 5 years, no renewal option \nRemaining e conomic life of the \nleased equipment 6 years \nPurchase option Non e \nAnnual lease payments $1,100 \nPayment date Annually on January 1 (first payment made at lease \ncommencement) \nLessee Corp’s incremental \nborrowing rate 7% \nThe rate Lessor Corp charges Lessee Corp in the lease is not \nreadily determinable by Lessee Corp. \nOther □ Title to the asset remains with Lessor Corp upon lease \nexpiration \n□ The fair value of the equipment is $5,000 at \ncommencement; Lessee Corp does not guarantee the \nresidual value of the equipment at the end of the lease \nterm \n□ Lessee Corp pays for all mai ntenance of the equipment \nseparate from the lease \n□ There are no initial direct costs incurred by Lessee Corp \n□ Lessor Corp does not provide any incentives \n \nHow would Les see Corp measure the right -of-use asset and lease liability over the lease term? ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 162}), Document(page\_content='Accounting for leases \n4-31 Analysis \nBased on the facts Lessee Corp could reasonably conclude that t he lease is a finance lease as the lease \nterm is a major part of the remaining economic life of the equ ipment (see LG 3 .3 for lease \nclassification criteria ). \nAt commencement, Lessee Corp woul d first calculate the lease liability as the present value of the four \nremaining unpaid annual fixed lease payments of $1,100 discounted at Lessee Corp’s incremental \nborrowing rate of 7%; this amount is $3,725. \nThe right -of-use asset is equal to the lease liability plus the $1,100 rent paid on the lease \ncommencement date ($4,825) . \nLessee Corp would amortize the right -of-use asset on a straight -line basis over the leas e term because \nthe remaining economic life is greater than the lease term. \n Amortization Right -of-use asset \nLease commencement $4,825 \nYear 1 $965 3,860 \nYear 2 965 2,895 \nYear 3 965 1,930 \nYear 4 965 965 \nYear 5 965 0 \n $4,825 \n \nInterest expense on the lease liability would be calculated using a rate of 7%, the same discount rate \nused to i nitially measure the lease liability. The lease liability would change as follows (assuming \nbeginning of year payments): \n \nPayment Principal \npaid Interest \npaid Interest \nexpense Lease liability \n(end of year) \nLease commencement $3,725 \nYear 1 \* $261 3,986 \nYear 2 1,100 839 261 202 3,088 \nYear 3 1,100 898 202 139 2,127 \nYear 4 1,100 961 139 73 1,100 \nYear 5 1,100 1,027 73 0 0 \n $4,400 $3,725 $675 $675 \n\*No payment is reflected in Year 1 because the first payment was made at lease commencement and is not included in the \nlease liability. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 163}), Document(page\_content='Accounting for leases \n4-32 Adding the amortization and interest expense from the two charts above, the total expense recorded \nper period is higher in earlier periods and decreases throughout the lease term (from $1,226 in year 1 \nto $965 in year 5). \n4.4.1.1 Finance lease with a purchase option \nWhen a lease is classified as a finance lease because it contains a purchase option that the lessee is \nreasonably c ertain to exercise, the lessee has an additional payment to make related to the exercise of \nthe purchas e option. This additional lease payment should be included in the lease liability as a \npayment occurring at the date the lessee expects to exercise the p urchase option, which is typically at \nthe end of the lease term. Interest expense will be calculated on the full amount of the lease liability, \nwhich includes the present value of the purchase option payment. Because it is reasonably certain that \nthe lesse e will obtain the asset at the end of the lease term, the right -of-use asset should be amortized \nover t he useful life of the asset, rather than over the lease term. \nExample LG 4 -12 illustrates the measurement of a finance lease with a purchase option. \nEXAMPLE LG 4 -12 \nFinance lease subsequent measurement and recognition – real estate lease with a purchase option \n(lessee) \nLessee Corp enters into a property (land and building) lease with Lessor Corp on January 1, 20X9. The \nfollowing table summarizes informat ion about the lease and the leased asset. \nLease term 10 years \nRenewal option Five 5 -year renewal opti ons \nIf exercised, the annual lease payments are reset to then current \nmarket rents \nRemaining e conomic life 40 years \nFair value of the leased \nproperty at commencement $5,000,000 \nPurchase option Lessee Corp has an option to purchase the property at the en d of the \nlease term for $3,000,000. Lessee Corp is reasonably certain to \nexercise this option. \nAnnual lease payments The first annual lease payment is $500,000, with increases of 3% \nper year thereafter (see schedule of lease payments below). \nPayment da te Annually on January 1 (first payment made at lease commencement) \nIncentive Lessor Corp gives Lessee Corp a $200,000 incentive for en tering \ninto the lease (payable at the beginning of year 2), which is to be \nused for normal tenant improvements. \nLessee Corp’s incremental \nborrowing rate 9.04% \nThe rate that Lessor Corp charges Lessee Corp in the lease is not \nreadily determinable by Lessee Corp. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 164}), Document(page\_content='Accounting for leases \n4-33 Other □ Title to the property does not automatically transfer to Lessee \nCorp upon lease expiration \n□ Lessee Corp does not guarantee the residual value of the real \nestate asset \n□ Lessee Corp pays for all maintenance, taxes, and insurance on \nthe property separate from the lease \n□ There are no initial direct costs incurred by Lessee Corp \nThe schedule of lease payments (exc luding the purchase option) is shown below. \nDate Amount \nYear 1 (paid at commencement) $500,000 \nYear 2 ($515,000 – $200,000 lease incentive) 315,000 \nYear 3 530,450 \nYear 4 546,364 \nYear 5 562,754 \nYear 6 579,637 \nYear 7 597,026 \nYear 8 614,937 \nYear 9 633,385 \nYear 10 652,387 \nTotal $5,531,940 \nHow would Lessee Corp measure the right -of-use asset and lease liability over the lease term? \nAnalysis \nBased on the facts Lessee Corp could reasonably conclude that t he lease is a finance lease because it \ngrants Le ssee Corp a fixed price purchase option that Lessee Corp is reasonably certain to exercise (see \nLG 3.3 fo r lease classification criteria ). \nAt commencement, Lessee Corp would first calculate the lease liability as the present value of the \nremaining unpaid annual lease payments, less the lease incentive paid in year 2, plus the exercise price \nof the purchase o ption using a discount rate of 9.04%; the amount is $4,500,000. \nThe right -of-use asset is equal to the lease liability plus the $500,000 rent paid on the lease \ncommencement date ($5,000,000). \nSince the purchase option is reasonably certain to be exercise d, Lessee Corp would amortize the right -\nof-use asset over the economic life of the underlying asset (40 years). Annual amortization expense \nwould be $1 25,000 ($5,000,000 /40 years). ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 165}), Document(page\_content='Accounting for leases \n4-34 Interest expense on the lease liability would be calculated as shown in the following table. This table \nincludes all expected cash flows during the lease term, including the lease incentive paid by Lessor \nCorp and Lessee Corp’ s purchase option. See Example LG 4 -3 for a schedule of payments. \nPayment Interest expense Lease liabilit y \n(end of year) \nLease commencement $4,500,000 \nYear 1 $0\* $406,840 4,906,840 \nYear 2 315,000\*\* 415,143 5,006,983 \nYear 3 530,450 404,718 4,881,251 \nYear 4 546,364 391,912 4,726,800 \nYear 5 562,754 376,466 4,540,511 \nYear 6 579,637 358,098 4,318,972 \nYear 7 597,026 336,497 4,058,443 \nYear 8 614,937 311,323 3,754,829 \nYear 9 633,385 282,206 3,403,650 \nYear 10 652,387 248,737 3,000,000 \nYear 101 3,000,0 00 — — \n $8,031,940 $3,531,940 \n\* No payment is reflected in Year 1 because the Year 1 payment was made at lease commencement and is not included in the \nlease liability. \n\*\* In Year 2, a payment of $515,000 was made but the lease incentive of $200,000 was also received. \n1 Exercise of purchase option at the end of term \n \nAlthough the lease was for 10 years, the asset had an economic life of 40 years. When Lessee Corp \nexercis es its purchase option at the end of the 10 -year lease, it would have fully extinguis hed its lease \nliability but continue depreciating the asset over the remaining useful life. \n4.4.2 Operating leases — lessee \nOperating lease expense is recorded in a single fina ncial statement line item on a straight -line basis \nover the lease term. This differs from finance lease expense recognition which is typically higher in the \nearlier years of a lease and declines over time. \nThe lessee could compute the periodic straight -line expense at the lease commencement date based on \nthe sum of the following, divided by the lease term: ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 166}), Document(page\_content='Accounting for leases \n4-35 □ The total lease payments under the lease plus \n□ Any initial direct costs incurred by the lessee, less \n□ Any lease incentives received from the lessor \nIn Exa mple LG 4 -13, the amortization of the right -of-use asset is described as the differen ce between \nthe straight -line lease expense, as computed above, and the accretion of interest on the lease liability \neach period. In order to calculate the amortization of the right -of-use asset, “interest” must be \ncalculated each period on the lease liabil ity. However, there is no amount recorded as interest expense. \nThe “interest” amount is used to accrete the lease liability and to amortize the right -of-use asset. \nRather than calculate the periodic amortization of the right -of-use asset, the guidance in ASC 842 \ndescribes how to measure the right -of-use asset at each reporting date. ASC 842 -20-35-3 describes the \nmeasurement of the right -of-use asset at any point in time af ter the lease commencement date, as \nfollows: \n□ The balance of the lease liability, adj usted for \n□ Any prepaid or accrued lease payments, \n□ Any unamortized initial direct costs, and \n□ The remaining balance of any lease incentives received. \nBoth of these approaches result in the same balance for a right -of-use asset. \nExample LG 4 -13 illustrates a lessee’s subsequent measurement and recognition of an operating lease. \nEXAMPLE LG 4 -13 \nLess ee operating lease subsequent measurement and recognition – automobile lease \nLessee Corp leases an automobile from Lessor Corp on January 1, 20X9. The following tab le \nsummarizes information about the lease and the leased asset. \nLease term 3 years, no rene wal option \nRemaining e conomic life of the \nautomobile 6 years \nPurchase option Lessee Corp has the option to purchase the automobile at fair \nmarket value upon expir ation of the lease. \nMonthly lease payments $500 (first payment made at lease commencement) \nPayment date Beginning of the month \nLessee Corp’s incremental \nborrowing rate 6% \nThe rate Lessor Corp charges Lessee Corp in the lease is not \nreadily determinable by Lessee Corp. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 167}), Document(page\_content='Accounting for leases \n4-36 Other □ Title to the automobile remains with Lessor Corp upon \nlease expiration \n□ The fair value of the automobile is $30,000 at \ncommencement; Lessee Corp does not guarantee the \nresidual value of the automobile at the end of the lease \nterm \n□ Lessee Corp pays for all maintenance of the automobile \nseparate from the lea se \n□ There are no initial direct costs incurred by Lessee Corp \n□ Lessor Corp does not provide any incentives \n \nHow would Lessee Corp measure the right -of-use asset and lease liability ov er the lease term? \nAnalysis \nBased on the facts Lessee Corp could reasonab ly conclude that t his lease is an operating lease as none \nof the criteria for finance lease classification are met (see LG 3.3 for lease classification criteria) . \nAt commencement, Le ssee Corp would first calculate the lease liability as the present value of the \nremaining unpaid monthly fixed lease payments discounted at Lessee Corp’s incremental borrowing \nrate of 6%; this amount is $16,018. \nThe right -of-use asset is equal to the leas e liability plus the $500 rent paid on the lease \ncommencement date ($16,5 18). \nLessee Corp is required to pay $500 per month for three years, so the total lease payments are \n$18,000 ($500 × 36 months). Lessee Corp would then calculate the straight -line lea se expense to be \nrecorded each period by dividing the total lease payments by the total number of periods. The monthly \nstraight -line expense would be $500 ($18,000 ÷ 36 months). The rental payment and the straight -line \nexpense are equal as the lease does n ot contain any escalation provisions or other required or optional \npayments. \nLessee Corp would calculate the amortization of the lease liability as shown in the following table. This \ntable is shown on an annual basis for simplicity; the schedule would be c alculated on a monthly basis \nto reflect the frequency of the lease payments. \n Payment “Interest” on the \nlease liability\* Lease liability \nLease commencement $16,018 \nYear 1 $5,500\*\* $820 11,338 \nYear 2 6,000 500 5,838 \nYear 3 6,000 162 — \n $17,500 $1,48 2 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 168}), Document(page\_content='Accounting for leases \n4-37 \*Although these amounts are labelled as “interest,” there is no interest expense recorded in the income statement. These \namounts are calculated on the lease liability on a monthly basis in order to determine the ending balance of the lease liabil ity; \nhowever, there is only one straight -line lease expense recorded in the income statement. See LG 4.4.2 for additional \ninformation. \n\*\*This amount excludes the first month’s payment since it was made at lease commencement and is not included in the lease \nliabi lity. \nThe amortization of the right -of-use asset is calculated a s the difference between the straight -line lease \nexpense ($500 per month) and the interest calculated on the lease liability. The following table shows \nthis calculation. This table is shown o n an annual basis for simplicity; the schedule would be calculate d \non a monthly basis to reflect the frequency of the lease payments. \n Straight -line \nexpense (A) Interest on \nlease liability \n(B) Amortization \n(A – B) Right -of-use \nasset \nCommencement $16,5 18 \nYear 1 $6,000 $820 $5,180 11,338 \nYear 2 6,000 500 5,500 5,838 \nYear 3 6,000 162 5,838 — \n $18,000 $1,482 $16,518 \n \nExample LG 4 -14 discusses timing of lease cost recognition in contract manufacturing arrangements. \nEXAMPLE LG 4 -14 \nContract manufacturi ng arrangements \nCustomer Corp enters into a 5 -year contract manufacturing agreement with Supplier Corp. Other facts \nof the arrangement are: \n□ Customer Corp has exclusive use of Supplier Corp’s manufacturing facility for five years \n□ Customer Corp will issue non-cancellable purchase orders to Supplier Corp periodically \nthroughout the five -year period \n□ Customer Corp is not required to order a minimum volume of products over the five -year period \nalthough Customer Corp expects to use substantially all of the manuf acturing capacit y during the \nterm of the arrangement \n□ Price per unit of the manufactured product is specified in the agreement \n□ Supplier Corp ships the products free on board destination to Customer Corp’s facility and \nCustomer Corp is contractually obligate d to pay Supplie r Corp upon delivery of products Example \nLG 4 -1 discusses timing of lease cost recognition in contract manufacturing arrangements. \nCustomer Corp’s facility ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 169}), Document(page\_content='Accounting for leases \n4-38□Customer Corp has identified a lease component (i.e., the right to use Supplier Corp ’s\nmanufacturing facility) and non -lease components in the arrangement\nAssume that Customer Corp has appropriately determined that the contract manufacturing \narrangement contains a lease under ASC 842. \nWhen should Customer Corp recognize the lease cost ass ociated with the lease component? \nAnalysis \nWe believe payments by Customer Corp to Supplier Corp allocated to the lease component are variable \nlease payments and should be recognized in the period when the manufactured product is delivered. \nIn other words, it would not be appropriate to recognize a lease cost in a period when there is no \ndelivery of the manufactured product. Note that this issue arises only when it is concluded that \nCustomer Corp directs the use of Supplier Corp’s manufacturing facility. See LG 2. 3.2.2 for a \ndiscussion of dispatch r ights. \n4.5 Subsequent recognition and measurement – lessor—\n4.5.1 updated September 202 1 \nThe subsequent measurement of sales-type, direct financing, and operating leases differs significantly. \nAs discusse d in LG 4.3, in sales-type and direct financing leases, lessors replace the underlying asset \non their balance sheet with a net investment in the lease, while in operating leases, lessors retain the \nunderlying asset on their balance sheet. \nFor sales-type and direct financing leases, lessors recor d interest income on the net investment in \naddition to any selling profit or loss; however, the timing for recognizing any selling profit or loss \ndiffers. In a sales-type lease that transfers contro l to the lessee, selling profit or loss should be \nrecognize d at lease commencement. In a direct financing lease, a selling loss is recognize d at lease \ncommencement, but selling profit is deferre d and recognize d over the lease term. As discusse d in LG \n4.3.1. 1 (for a sales-type lease) an d LG 4.3.2.1 (for a direct financing lease), upon adoption of ASU 2021-\n05, ASC 842 requires a lessor to classify a lease with variable lease payments that do not depen d on a \nrate or index as an operating lease at the lease commencement date if classifying the lease as a sales-\ntype or direct financing lease would result in recognition of a selling loss. See LG 9.11 for the effective \ndate and transition requirements of ASU 2021-0 5. \nIn operating leases, lessors recor d lease income on a straight-line basis over the lease term. \nA lessor should recognize variable lease payments in the period in which they are earned for a lease \nclassifie d as sales-type, direct financing, or operating. \nLessor sales-type leases and direct financing lease \nThe lessor in both a sales- type lease and direct financing lease should measure its net investment in a \nlease on an amortize d cost basis subsequent to initially recording the lease. \nFor sales-type leases, in which a transfer of contro l occurs, any selling profit or loss is recognized at the \ncommencement date (see LG 4.3.1.1 for the accounting for selling losses due to variable lease ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 170}), Document(page\_content='Accounting for leases \n4-39 payments) . Therefore, the only income statement effect during the lease term results from recognizing \ninterest income on the lease receivable and accretio n on the unguaranteed residual asset. \nFor direct financing leases, a transfer of control does not occur, so se lling profit is not recognized at \nthe commencement date, but is instead recognized over the lease term (a selling loss is recognized at \nthe comme ncement date). Therefore, any deferred profit is recognized in addition to the interest \nincome on the lease rec eivable and accretion on the unguaranteed residual asset. For a direct financing \nlease , a selling loss is recognized at lease commencement (see LG 4.3.2.1 for the accounting for selling \nlosses due to variable lease payments ). \nInterest on the lease receivable is calculated by multiplying the rate implicit in the lease by the \noutstanding receivable balance each period. The receivable is increased for accrued interest and \nreduced by cash payments received from the lesse e. \nThe unguaranteed residual asset is recorded at its present value and accreted to its final expected value \nat the expiration of the lease term also using the rate implicit in the leas e. \nExample LG 4 -15 illustrates the subsequent measurement and recogni tion of a sales -type lease. \nEXAMPLE LG 4 -15 \nSales -type lease subsequent measurement and recognition – non-specialized digital imaging \nequipment lease (lessor) \nLessor Corp enters into a l ease of non -specialized digital imaging equipment with Lessee Corp on \n1/1/X9. Lessor Corp is a manufacturer of digital imaging equipment that uses both direct sales and \nleases as a means of selling its products. The following tab le summarizes information a bout the lease \nand the leased assets. \nLease term 5 years, no renewal option \nRemaining e conomic life of the \nleased equipment 6 years \nPurchase option None \nAnnual lease payments $1,100 \nPayment date Annually on January 1 (first payment is made at lease \ncommencement) \nFair value of the leased equipment \nat commencement $5,000 \nLessor Corp’s carrying value of the \nleased equipment $4,500 \nRate implicit in the lease 7.04% ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 171}), Document(page\_content='Accounting for leases \n4-40 Other □ Title to the asset remains with Lessor Corp upon lease \nexpiration \n□ Lessee Corp does not guarantee the residual value of the \nequipment at the end of the lease term and Lessor Corp \ndoes not obtain any third -party residual value insurance \n□ Estimated fair value of the equipment at the end of the \nlease ter m is $250 \n□ Lessee Corp pays for all mai ntenance of the equipment \nseparate from the lease \n□ There are no initial direct costs incurred by Lessor Corp \n□ Lessor Corp does not provide any incentives \n \nHow would Lessor Corp account for the leasing transaction after lease commencement? \nAnalysis \nBased on the facts Lessor Corp could reasonably conclude that t he lease is a sales -type lease as the \nlease term is a major part of the remaining economic life of the equipment (see LG 3 .3 for lease \nclassification criteria) . \nAt commencement, Lessor Corp would first determine the total net investment in the lease as the \npresent value of the lease receivable and the unguaranteed residual asset. \n□ The present value of the lease receivable is equal to the present value of the remai ning lease \npayments discounted at 7.04%; this amount is $3,722. \n□ The present value of the unguaranteed residual asset discounted at 7.04% is $178. \n□ Lessor Corp’s net investment in the lease is $3,900 (the sum of the lease receivable ($3,722) and \nthe unguaran teed residual asset ($178)). \nSince cont rol has been deemed to have transferred to Lessee Corp, profit is recognized by Lessor Corp \nat lease commencement. The selling profit is calculated as follows: \nPresent value of the lease receivable $3,722 \nPlus, th e lease payment received at lease commence ment 1,100 \nLess, the carrying value of leased asset ($4,500) net of unguaranteed residual asset \n($178) (4,322) \nSelling profit $500 \n \nLessor Corp would record revenue at lease commencement equal to the lease receivable amount plus \nthe lease payment receiv ed at lease commencement ($4,822). Cost of goods sold would be recorded as \nthe difference between the carrying value of the leased asse t ($4,500) and the discounted value of the \nunguaranteed residual asset ($178) . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 172}), Document(page\_content='Accounting for leases \n4-41 In order to account for the transaction af ter lease commencement, Lessor Corp would first schedule \nout the cash flows on the lease receivable as shown in the following table. \n \nPayment Interest \nincome Lease \nreceivable \nLease commencement $3,722 \nYear 1 \* $262 3,984 \nYear 2 1,100 203 3,087 \nYear 3 1,100 140 2,127 \nYear 4 1,100 73 1,100 \nYear 5 1,100 — — \n $4,400 $ 678 \n\* In year 1, payment was made at lease commencement, so it is not included in the lease receivable. \n \nInterest paid to Lessor Corp at the beginning of year 2 would be accr ued during year 1 (via a debit to \nlease receivable and credit to interest income). \nLessor Corp would also record accretion on the residual asset. Like the interest on the lease receivable, \nthe accretion on the residual asset would be recorded during year 1 (via a debit to the residual asset \nand credit to income). \n Accretion Residual asset \nLease commencement $178 \nYear 1 $13 191 \nYear 2 13 204 \nYear 3 14 218 \nYear 4 15 233 \nYear 5 17 250 \n $72 \nUpon the expiration of the lease, Lessor Corp would reclassi fy the $250 net investment (which consists \nsolely of the residual asset based on the Lessor Corp’s business model) as PP&E or inventory. The \n$250 represents Lessor Corp’s best estimate of the value of the asset established at the beginning of \nthe lease. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 173}), Document(page\_content='Accounting for leases \n4-42 4.5.2 Lessor operating leases \nSince a lessor in an operating leas e does not derecognize the underlying asset, it should continue to \ndepreciate the asset in accordance with its normal depreciation policy. The lessor should record lease \nincome on a straight -line bas is over the lease term ( unless another systematic and rat ional basis is \nmore representative of the pattern in which benefit is expected to be derived from the use of the \nunderlying asset) . The difference between the cash received and the straight -line leas e income \nrecognized is recorded as rent receivable. If ca sh flows are higher than the lease income, deferred rent \nis recorded on the balance sheet. See LG 8.9 for the impact of collectibility of lease payments on a \nlessor’s pattern of revenue recognition f or an operating lease. \nExample LG 4 -16 illustrates the subsequent measurement and recognition of operating lease for \nlessors. \nEXAMPLE LG 4 -16 \nLessor operating lease subsequent measurement and recognition – automobile lease \nLessor Corp leases an automobile to Lessee Corp on January 1, 20X9. Th e following table summarizes \ninformation about the lease and the leased asset. \nLease term 3 years, no renewal option \nRemaining e conomic life of the \nautomobile 6 years \nFair value of the automobile at \ncommencement $30,000 \nLessor Corp’s carrying value of the \nautomobile at commencement $30,000 \nPurchase option Lessee Corp has the option to purchase the automobile at fair \nmarket value upon expiration of the lease. \nMonthly lease payments $500 for the first year \n$550 for the second year \n$600 for the third year \nPayment date Beginning of the month (first payment is made at lease \ncommencement) \nRate implicit in the lease 8% \nOther □ Title to the automobile remains with Lessor Corp upon \nlease expiration \n□ The expected residual v alue of the automobile at the end of \nthe lease term is $19,000; Lessee Corp does not guarantee \nthe residual value of the automobile at the end of the lease \nterm ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 174}), Document(page\_content='Accounting for leases \n4-43 □ Lessee Corp pays for all maintenance of the automobile \nseparate from the lease \n□ There are no in itial direct costs incurred by Lessor Corp \n□ Lessor Corp does not provide any incentives \n \nHow would Lessor Corp account for the leasing transaction after lease commencement? \nAnalysis \nBased on the facts Lessor Corp could reasonably conclude that t his lease is an operating lease as none \nof the criteria for sales -type or direct financing lease treatment have been met (see LG 3.3 for lease \nclassification criteria) . As this is an operating lease, Lessor Corp would not record a net investment \nand would retain the autom obile in property, plant, and equipment on its balance sheet, and it would \ncontinue to depreciate the asset. \nLessor Corp would likely determine that the most appropriate income recognition pattern is straight -\nline over the economic useful life of the asset (as no other systematic and rational basis is more \nrepresentative of the pattern in which benefit is expected to be derived from the use of the underlying \nasset ). As such, Lessor Corp would calculate the straight -line rental income per period by div iding the \ntotal rent payments to be made over the lease term by the total number of periods. In this example, the \nstraight -line income Lessor Corp would record is $550 per month calculated as follows. \n Monthly rent Annual total \nYear 1 $500 $6,000 \nYear 2 550 6,600 \nYear 3 600 7,200 \n $19,800 \nNumber of periods 36 \nStraight -line rent per period $550 \nLessor Corp would record the excess between the $550 monthly rental income and the actual rental \npayments required by the lease agreement in year one as defer red rent receivable on the balance sheet. \nSubsequently, any difference between the actual rental payments and the $550 monthly rental would \nreduce the deferred rent receivable. The following table shows the calculation of the deferred rent \nreceivable at th e end of each year. For the sake of simplicity, this table is shown on an annual basis; the \nactual schedule would be calculated on a monthly basis to match the frequency of lease payments. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 175}), Document(page\_content='Accounting for leases \n4-44Cash payments \n(A) Straight -line \nincome \n(B) Increase \n(decrease ) \n(B – A) Deferred \nrental \nreceivable \nbalance \nCommencement $ — \nYear 1 $6,000 $6,600 $600 600 \nYear 2 6,600 6,600 — 600 \nYear 3 7,200 6,600 (600) — \n$19,800 $19,800 $ — \nLessor Corp would continue to depreciate the underlying asset over the economic usefu l life of the \nasset. \n4.6 Impairment – lessee \n4.6.1 \n4.6.2 A lessee’s right- of-use asset is subject to the same asset impairment guidance in ASC 360 applied to \nother elements of property, plant, and equipment. See PPE4 for further guidance on impairments of \ntangible and intangible assets. \nImpairment-finance leases (lessee) \nIf a lessee records an impairment charge on a right- of-use asset associate d with a finance lease, it \nshou ld revise the amortization expense by calculating a new straight-line amortization based on the \nrevise d asset value. \nImpairment — operating lease (lessee) \nAs noted in LG 4.4.2, the amortization of an operating lease right- of-use asset generally increases over \nthe lease term. As a result, throughout the lease term, the net book value of a right- of-use asset \nresulting from an operating lease is typically greater than it would have been had the lease been \nclassified as a finance lease. Because of this higher value, a right-o f-use asset arising from an \noperating lease may have a higher risk of impairment. Refer to PPE 5.2.7 for right-o f-use asset \nimpairment considerations. \nIf there is an impairment charge for a right- of-use asset associate d with an operating lease, it would \nnot impact the value of the recorde d lease liability absent a modification to the lease terms or a \nreassessment of options to renew. As discusse d in LG 5.3.1, an impairment resulting from market-\nbase d factors that are not within the lessee’s contro l is not, in itself, a trigger for the lessee to reassess \nthe lease term or an option to purchase the underlying asset. \nOnce the right- of-use asset for an operating lease is impaired, lease expense will no longer be \nrecognize d on a straight-line basis. A lessee should continue to amortize the lease liability using the \nsame effective interest metho d as before the impairment charge. The right- of-use asset, however, \nshou ld be subsequently amortize d on a straight-line basis. The resulting accounting is similar to the \naccounting a lessee would apply to a finance lease (see LG 4.4.1), however, the lease is still classifie d as ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 176}), Document(page\_content="Accounting for leases \n4-45 an operating lease, and a lessee should continue to follow operating lease presentation and disclosure \nguidance. \n4.7 Impairment – less or \nA lessor’s evaluation and accounting for an impairment will depend on the lease classificati on. Sales -\ntype and direct financing leases are financial assets, whereas the underlying asset in an operating lease \nis property, plant and equipment. \n4.7.1 Impairment — Sales -type and direct financing leases (lessor) \nA lessor should assess its entire net invest ment in the lease for impairment and recognize any \nimpairment loss in accordance with the loan impairment guidance in ASC 310 until ASC 326 adopted. \nOnce ASC 326 is adopted, that guidance should be applied to the net investment in the lease. See LI 7 \nfor g uidance. \nThe net investment in a sales type lease consists of the sum of the following: \n□ Lease receivable , which is the present value of the lease paym ents and the guaranteed residual \nvalue of the asset \n□ Unguaranteed residual asset , which is the expected un guaranteed residual value of the asset \nat the end of the lease term \nFor direct financing leases, the net investment includes these same amounts reduce d by the amount of \nany deferred selling profit. \nBoth the lease receivable and the unguaranteed residual a sset must be considered when assessing the \nnet investment in the lease for impairment. \n4.7.1.1 Impairment — lease receivable \nWhen evaluating the loss allowan ce for the lease receivable portion of the net investment in the lease, \nthe lessor can only consider the lessee’s right to use the asset during the lease term as collateral for the \nlease receivable and not the right to the residual asset. This is because i n most cases, the only asset \nthat is available to the lessee is its right to use the leased asset during the lease term. Generally, the \nlessee has no right over the residual asset, unless the lessee has purchase option that it is reasonably \ncertain of bein g exercised or title is transferred at the end of the lease term . \nWhile not an exhaustive list, a lessor should consider the following in developing its estimate of \nexpected credit losses related to the lease receivable: \n□ The lessee's credit risk as it rel ates to its ability to pay the cash flows during the lease \n□ The lessee’s credit risk as it relates to its ability to pay lessee -provided residual value guarantees \n□ The lessee’s credit risk as it relates to amounts due on exercise of a purchase option reason ably \ncertain of being exercised ", metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 177}), Document(page\_content='Accounting for leases \n4-46 □ The mitigating impact of cash flows associated with guaranteed and ungua ranteed residual values \nof the leased asset \n4.7.1.2 Impairment — unguaranteed residual asset \nThe amount used to assess impairment of the unguaranteed residual asset would be an assumed lump \nsum payment related to the expected residual value at the end of the lease term. This could be, for \nexample, the sale of the asset at auction. \n4.7.2 Impairment — operating leases (lessor) \nLessors should follow the guidance in ASC 360 regarding the impairment of long -lived assets for \nassets subject to an operating lease. See PPE 5 for further guidance on the impairment of tangible and \nintangible assets. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 178}), Document(page\_content='PwC 1 Chapter 5: \nModification and \nremeasurement of a \nlease —updated June 2021', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 179}), Document(page\_content='Modification and remeasurement of a lease \n5-2 5.1 Modification and remeasurement of a lease overview \nThis chapter addresses the accounting for modifications, including termination, of a lease contract. It \nalso addresses the accounting for lease remeasurements for reassessment events that are not \nmodifications. \nDepending on the facts and circumstances, a lease modification may be accounted for by the lessee \nand lessor as either (1) two contracts – the original contract and a separate new contract , or (2) one \nmodified contract . The separate new contract in (1) should be evaluated for whether it contain s a lease. \nSimilarly, the one modified contract should be evaluated for whether it contains a lease. When a lease \nmodification is accounted for as one modified lease, the lessee and lessor must reconsider the lease \nclassific ation and remeasure the lease. \nASC 842 also describes other circumstances in which a lessee must reconsider certain assumptions \nmade at the lease commencement date (e.g., whet her exercise of a renewal or purchase option is \nreasonably certain) and remeasure the lease liability and adjust the related right -of-use asset. In some \nof those cases, ASC 842 requires a lessee to reassess the classification of a lease. \nA lessee is requi red to remeasure its lease liability and adjust the related right -of-use asset upon the \noccurrence of the following: \n□ Lease modifications not accounted for as a separate contract \n□ A triggering event within the lessee’s control that changes the certainty of a lessee exercising an \noption to renew or terminate the lease, or purchase the underlying asset \n□ An event written in the contract occurs that obligates the lessee to exercise or not exercise an \nextension or termination option \n□ A change to the amount probabl e of being owed by the lessee under a residual value guarantee \n□ The resolution of a contingency upon which variable lease payments are based such that those \npayments become fixed \nA bankruptcy filing may be a remeasurement trigger for a lessee although chan ges in circumstances \nbefore the bankruptcy filing that are within the lessee’s control may trigger a remeasurement before \nsuch filing. See BLG 1.2 for information about voluntary and involuntary bankruptcy filing s. \nIn March 2020, the FASB issued ASU 2020 -04, Reference Rate Reform (Topic 848), Facilitation of \nthe Effects of Reference Rate Reform on Financial Reporting , that provides temporary relief from \ncontract modification requirements related to reference rate ref orm. Under this guidance, both lessees \nand lessors may elect an optional practical expedient to not apply modification accounting to all \ncontract modifications that replace a reference rate if certain criteria are met. For more details , see \nchapters 1, 2 , and 4 of PwC ’s Reference rate reform guide . \nA lessor is not required to remeasure a lease unless the lease contract is modified. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 180}), Document(page\_content='Modification and remeasurement of a lease \n 5-3 5.2 Accounting for a lease modification – lessee \nA lessee and lessor may amend the terms of a lease for a variety of reasons. The ASC 842 Glossary \ndefines a lease modification. \nDefinition from ASC 842 Glossary \nLease Modification: A change to the terms and conditions of a contract that results in a change in the \nscope of or the consideration for a lease (for example, a c hange to the terms and conditions of the \ncontract that adds or terminates the right to use one or more underlying assets or extends or shortens \nthe contractual lease term). \nThe following are examples of lease terms which may be amended after the lease comm encement date: \n□ A lease extension \n□ Early termination of the lease \n□ A change in the timing of lease payments \n□ Leasing additional space in the same building \n5.2.1 Lessee accounting for a lease modification \nAs illustrated in Figure LG 5-1, a lessee’s accounting treat ment of a lease modification depends on the \ntype of modification made to the lease. A lease modification can result in either a separate new \ncontract that is accounted for separate from the original contract or a single modified contract . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 181}), Document(page\_content='Modification and remeasurement of a lease \n5-4 Figure LG 5-1 \nLessee analysis of a change in a lease \n \nA lessee should account for any direct costs, lease incentives, or other payments made by the lessee or \nlessor in connection with a lease modification in the same manner as those items would be accounted \nfor in connection with a new lease. See LG 4.2.2.2 for information on direct costs. See LG 3.3.4.2 for \ninformation on lease incentives. \n', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 182}), Document(page\_content='Modification and remeasurement of a lease \n 5-5 5.2.1.1 Separate new contract — lessee \nASC 842 -10-25-8 provides guidance on whether a lessee should account for a lease modification as a \nnew contract (separate from the existing contract ). \nASC 842 -10-25-8 \nAn entity shall account for a modification to a contract as a separate contract (that is, separate from \nthe original contract) when both of the following conditions are present: \na. The modification grants the lessee an additional right of use not included in the original lease (for \nexample, the right to use an additional asset). \nb. The lease p ayments increase commensurate with the standalone price for the additional right of \nuse, adjusted for the circumstances of the particular contract. For example, the standalone price \nfor the lease of one floor of an office building in which the lessee alrea dy leases other floors in that \nbuilding may be different from the standalone price of a similar floor in a different office building, \nbecause it was not necessary for a lessor to incur costs that it would have incurred for a new lessee. \nAn additional right of use is granted when the lease contract is modified to give the lessee a right to use \nan additional underlying asset that was not included in the original lease. For example, when the floor \nspace under lease is increased or a lessee receives the right t o use a new standalone asset. A \nmodification to increase the lease term is not considered an additional right of use . \nAccounting for the separate new contract \nWhen a lessee concludes that a lease modification should be accounted for as a new contract that is \nseparate and apart from the original lease, the new contract should be evaluated for whether it is a \nlease or contains a n embedded lease (see LG 2.3 for the definition of a lease). If the new contract is a \nlease or contains an embedded lease , the new le ase should be accounted for as any other new lease \n(classified as finance or operating and measured accordingly). See LG 3 for information on lease \nclassification and LG 4 for information on lease measurement. \nThe new lease is recorded on the commencement date of the new lease, which is the date the lessee has \naccess to the leased asset. For example, if a lessee modifies a lease to use additional space in a \nbuilding, the new lease should be recorded once that space is available for use. See LG 3.2.1 for \ninformation on lease commencement. \nExample LG 5-1 illustrates a lessee’s accounting for a modification as a separate new lease. \nEXAMPLE LG 5-1 \nModification that is a separate new lease \nLessee Corp enters into a 5 -year lease for 2,000 square feet of warehous e space with Lessor Corp for \n$10,000 per month. \nAt the end of year one, Lessee Corp and Lessor Corp agree to amend their lease contract to include an \nadditional 1,000 square feet of warehouse space in the same building for the remaining four years of \nthe lease. Lessee Corp will pay an additional $6,000 per month for the additional space. The ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 183}), Document(page\_content='Modification and remeasurement of a lease \n5-6 additional $6,000 is in line with the current market rate to lease 1,000 square feet of warehouse space \nin that particular building at the date that the modification is agreed to. Lessee Corp will make one \nmonthly payment of $16,000 per month after the mod ification. There is no other change in the terms \nand conditions. The contract for the additional 1,000 square feet of space, and the combined 3,000 \nsquare feet of space meet the definition of a lease. \nHow should Lessee Corp account for this lease modificat ion? \nAnalysis \nLessee Corp should account for the lease modification as a separate contract because the modification \ngrant ed Lessee Corp an additional right of use at a price that is commensurate with the standalone \nprice for the additional space. Based on the facts, since the new contract meet s the definition of a lease, \nat the new lease’s commencement date, Lessee Corp would have two separate leases as follows : \n□ The original lease for 2,000 square feet for four remaining years \n□ A new lease for the additional 1,000 square feet for four years \nThe accounting for the original lease is not impacted by the modification. The new lease would be \naccounted for as any other new lease, i.e., classified as finance or operating and measured accordingly. \nSee LG 3 for information on lease classification and LG 4 for information on lease measurement. \n5.2.1.2 Single m odified contract — lessee \nIf a lease modification is not accounted for as a separate contract , a lessee should reassess whether the \ncontract contains a lease . If the modified contract is a lease or contains a n embedded lease , a lessee \nshould reallocate contract consideration, reassess the lease classification, remeasure the lease liability, \nand adjust the right -of-use asset. For information about the definition of a lease , see LG 2.3. For \ninformation on determining lease classification see LG 3. For information on remeasuring the lease \nliability and adjusting the right -of-use asset see LG 5.3. 3 and LG 5.3. 4. \nA modified lease could have multiple components. For example, if a lease is modified such that an \nadditional right of use is granted (e.g., additional space is leased) but the modification is not recorded \nas a separate new contract, there will be two separate lease components in the new modified lease. See \nExample 17 beginning at ASC 842 -10-55-168 for additional information. \nA lease may be denominated in a currency that is not the same as a lessee’s functional currency. See \nLG 8.8 for information regarding what exchange rate a lessee should use to remeasure a right -of-use \nasset into the lessee’s functional currency when there is a lease modification that is not accounted as a \nseparate new lease . \n5.3 Accounting for lease remeasurement – lessee—\nupdated September 2021 \nA lessee should reallocate the contract consideration among the lease and nonlease components, \nremeasure its lease liability, and adjust the related right -of-use asset upon the occurrence of certain \neven ts. How the lease liability is remeasured and the right -of-use asset adjusted will depend on the ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 184}), Document(page\_content='Modification and remeasurement of a lease \n 5-7 reason for the lease remeasurement; in some cases, it will result in an entry to profit or loss. A lessee \nmay also need to do one or more of the following depe nding on the reason for lease remeasurement: \n□ Reassess whether a contract is (or contains) a lease \n□ Reallocate contract consideration \n□ Reassess the lease classification \n□ Update the discount rate used to remeasure the lease liability \n□ Account for initial direct costs, lease incentives, and any other payment made or received in \nconnection with a modification to a lease in the same manner as those items would be accounted \nfor in connection with a new lease ( see LG 4.2.2) . \nFigure LG 5 -2 provides an overview of the circumstances that could lead to lease remeasurement . \nFigure LG 5-2 \nAccounting for a lease remeasurement \n \nReassess \nfor \ndefinitio\nn of a \nlease \n(LG 2) Reallocate \ncontract \nconsiderati\non (LG \n2.4.3 and \nLG 5. 3.3) Update \ndiscount \nrate \n(LG 3.3.4.6) Reassess \nclassificatio\nn (LG 3) Remeasure \nthe lease \nliability \nand adjust \nthe right -\nof-use \nasset \n(LG 5.3. 3 \nand \nLG 5.3. 4) \nContract \nmodification: \nLease contract is \nmodified in such a \nway that the \ncombined contract \nis accounted for as \none lease (LG 5.2) ⚫ ⚫ ⚫ ⚫ ⚫ \nChange in lease \nterm: An event \noccurs that gives \nthe lessee a \nsignificant \neconomic incentive \nto exercise, or not \nexercise, a renewal \noption (LG 5.3.1) or \nan event written in \nthe contract occurs \nthat obliga tes the \nlessee to exercise or \nnot exercise an \nextension or \ntermination option ⚫ ⚫ ⚫ ⚫ ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 185}), Document(page\_content='Modification and remeasurement of a lease \n5-8 \nReassess \nfor \ndefinitio\nn of a \nlease \n(LG 2) Reallocate \ncontract \nconsiderati\non (LG \n2.4.3 and \nLG 5. 3.3) Update \ndiscount \nrate \n(LG 3.3.4.6) Reassess \nclassificatio\nn (LG 3) Remeasure \nthe lease \nliability \nand adjust \nthe right -\nof-use \nasset \n(LG 5.3. 3 \nand \nLG 5.3. 4) \nChange in \npurchase option \nassessment: An \nevent occurs that \ngives the lessee a \nsignificant \neconomic incentive \nto exercise, or not \nexercise, a purchase \noption (LG 5.3.1) ⚫ ⚫ ⚫ ⚫ \nContingency \nresolution: \nA contingency on \nwhich variable \npayments are based \nis met such that the \nvariable payments \nbecome fixed (LG \n5.3.1) ⚫ ⚫ \nChange in RVG: \nAmounts owed \nunder a residual \nvalue guarantee \nbecome probable \n(LG 5.3.1) ⚫ ⚫ \nWhen reassessing lease classification for the events noted in Figure LG 5-2, a lessee should consider \nthe terms and conditions as of that date. In other words, the lessee should reassess lease classification \nusing the fair value and remaining economic life of the underlying asset on the reassessment date. \nAs discussed in ASC 842 -10-15-6, a lessee must reassess whether a contract is (or contains) a lease \nonly if the provisions of the contract are changed. \nA lease may be denominated in a currency that is not the same as a lessee’s functional currency. See \nLG 8.8 for information regarding what exchange rate a lessee should use to remeasure a right -of-use \nasset into the lessee’s functional currency when a lease is required to be remeasured. \n5.3.1 Lease remeasurement — lessee \nA lessee should remeasure the lease liability and adjust the right -of-use asset upon the occurrence of \nany of the events described in ASC 842 -10-35-4. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 186}), Document(page\_content='Modification and remeasurement of a lease \n 5-9 Excerpt from ASC 842 -10-35-4 \nA lessee shall remeasure the lease payments if any of the following occur: \na. . . . \nb. A contingency upon which some or all of the variable lease payments that will be paid over the \nremainder of the lease term are based is resolved such that those payments now meet the \ndefinition of lease payments. For example, an event occurs that results in variable lease payments \nthat were linked to the performance or use of the underlying asset becoming fixed payments for \nthe remainder of the lease term . However, a change in a reference index or a rate upon which \nsome or all of the variable lease payments in the contract are based does not constitute the \nresolution of a contingency subject to (b) (see paragraph 842 -10-35-5 for guidance on the \nremeasurement of variable lease payments that depend on an index or a rate). \nc. There is a change in any of the following: \n 1. The lease term, as described in paragraph 842 -10-35-1. A lessee shall determine the revised \n lease payments on the basis of the revised lease term. \n 2. The assessment of whether the lessee is reasonably certain to exercise or not to exercise an \n option to purchase the underlying asset, as described in paragraph 842 -10-35-1. A lessee shall \n determine the revised lease payments to reflect the change in the assessment of the purchase \n option. \n 3. Amounts probable of be ing owed by the lessee under residual value guarantees. A lessee shall \n determine the revised lease payments to reflect the change in amounts probable of being owed \n by the lessee under residual value guarantees. \nQuestion LG 5 -1 and Question LG 5 -2 discuss how consumer price index provisions may or may not \nresult in a lease remeasurement. \nQuestion LG 5-1 \nLessee Corp enters into a five -year lease with payments that increase based on increases in the \nConsumer Price Index (CPI), but canno t decrease (i.e., the increase creates a new floor for lease \npayments). As CPI increases, should a lessee remeasure a lease liabi lity to include the impact of the \nincrease to date? \nPwC response \nNo, a lessee should not remeasure a lease liability when paym ents increase based on a change in CPI. \nBased on an exception in the leases standard, the change to a reference index upon which some or all \nof the variable lease payment is based does not constitute the resolution of a contingency. The lease \npayments cont inue to be variable as they may increase based on future changes in the CPI. The \npayments are not fixed and therefore do not meet the definition of lease payments. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 187}), Document(page\_content='Modification and remeasurement of a lease \n5-10 Question LG 5-2 \nLessee Corp enters into a five -year lease with payments that increase based on increases to the CPI, \ncapped at a cumulative increase of 7%. When CPI reaches the cap, should lease payments be adjusted \nto include the 7% increase? \nPwC response \nYes. The lease payments become fixed because additional increases in CPI will not change the payment \namount (because CPI is capped at 7%); therefore, the payments meet the definition of lease payments. \nQuestion LG 5-3 discusses the accounting by a lessee for reimburs ing the lessor for capital \nimprovements . \nQuestion LG 5 -3 \nLessor Corp and Lesse e Corp enter into a 5 -year operating lease of real estate on January 1, 20X1. The \nlease permits Lessor Corp to pass on depreciation costs to Lessee Corp for capital improvements made \nto the building during the lease term . The capital improvements are not an additional performance \nobligation promised by Lessor Corp to Lessee Corp and therefore are not part of the common area \nmaintenance nonlease component or a separate nonlease component. On January 1, 20X2, Lessor \nCorp co mpletes a roof replacement project at a total cost of $100,000 with a useful life of 10 years. \nUnder the lease provisions, Lessee Corp will be responsible to pay additional rent of $ 10,000 per year \n($100,000 /10 years) during the four - year remaining lease term. How should Lessee Corp account for \nthe obligation to pay the additi onal rent to Less or Corp? \nPwC response \nThe amount of consideration due to Lessor Corp over the remainder of the lease term upon completion \nof the roof replacement is a variable rent provision that Lessee Corp does not recognize at \ncommencement. Once the amount is determinable upon completion of the roof replacement, we \nbelieve Lessee Corp should account for the additional payment as a resolution of a contingency. The \nlease liability should be remeasured to include the additional fixed payments when they become \nknown (see LG 5.3.3 for more detail s about remeasurement of lease liability) with a corresponding \nadjustment to the right -of-use asset (see LG 5.3.4 for more details about right -of-use asset \nadjustment s). \nWhen there is a change in the lease term or probability of exercising an option based on the occurrence \nof any of the events described in ASC 842 -10-35-1, in connection with remeasuring the lease liability \nand adjusting the right -of-use asset, a lessee should also reassess the lease classification. \nASC 842 -10-35-1 \nA lessee shall reassess t he lease term or a lessee option to purchase the underlying asset only if and at \nthe point in time that any of the following occurs: \na. There is a significant event or a significant change in circumstances that is within the control of \nthe lessee that dire ctly affects whether the lessee is reasonably certain to exercise or not to exercise \nan option to extend or terminate the lease or to purchase the underlying asset. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 188}), Document(page\_content='Modification and remeasurement of a lease \n5-11b.There is an event that is written into the contract that obliges the lessee to exercise (or not to\nexercise) an option to extend or terminate the lease.\nc.The lessee elects to exercise an option even though the entity had previously determined that the\nlessee was not reasonably certain to do so.\nd.The lessee elects not to exercise an option even though the entity had previously determined that\nthe lessee was reasonably certain to do so.\nASC 842 -10-55-28 \nExamples of significant events or significant changes in circumstances that a lessee should consider in \naccordance with paragraph 842-10-35-1 include, but are not limited to, the following: \na.Constructing significant leasehold improvements that are expected to have significant economic\nvalue for the lessee when the option becomes exercisable\nb.Making significant modifications or cu stomizations to the underlying asset\nc.Making a business decision that is directly relevant to the lessee’s ability to exercise or not to\nexercise an option (for example, extending the lease of a complementary asset or disposing of an\nalternative asset)\nd.Subleasing the underlying asset for a period beyond the exercise date of the option.\nA change in market -based factors alone (e.g., increases in market rents such that rents during renewal \nperiod would now be considered a bargain or change in the current price to purchase a comparable \nasset) should not trigger reassessment of the lease term or a lessee option to purchase the underlying \nasset. A lessee is not required to continually reassess the lease term absent a significant event or \nchange in circumstanc es. \n5.3.2 Change in timing or amount of payment for a lease incentive \nLease incentives for a lessee may be structured in different ways. For example, incentive amounts may \nbe fixed or variable subject to a cap; they may be paid to the lessee upfront or over tim e. Often, \nincentives are negotiated to reimburse the lessee for amounts spent by the lessee to furnish or improve \nthe leased property , up to a maximum negotiated amount . The amount and timing of the incentive \nmay depend on the pace at which the lessee furn ishes or improves the leased asset. Although the \namount and timing of the incentive paid to the lessee could vary after lease commencement, it is \ngenerally very unlikely that a lessee would forgo any incentive it negotiated to receive from the lessor. \nAcco rdingly, we believe the lessee should treat the incentive in this scenario as an "in substance fixed \npayment" from the lessor to the lessee. We believe a le ssee should estimate the timing of the maximum \ncontractual incentive not yet received and record it as a negative lease payment . This would impact \nlease classification and the amount reco gnized for the lease liability and right -of-use asset at lease \ncommencement . \nSubsequent to lease commencement, if the actual receipt of the cash from the lessor differs in either \ntiming or amount from the original estimate used to record the lease incentive , we believe the lessee \nshould analogize to the remeasurement guidance for a lessee and remeasure the lease liability (and \nhence the right -of use asset) using the same discount rate used at the lease commencement date. \nSee Example LG 5-9 for an illustration. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 189}), Document(page\_content='Modification and remeasurement of a lease \n5-125.3.3 Remeasurement of lease liability \nA lease liability should be remeasured on the effective date of the reassessment event or modification \n(the date that the modification is approved by both the lessee and lessor) as if the lease were a new \nlease that commences on that date. \nBefore remeasuring the lease liability, a lessee must first reallocate the remaining contract \nconsideration between the le ase and nonlease components using the relative standalone price of each \ncomponent on the remeasurement date if the remeasurement is due to one of the following: \n□Lease contract is modified in such a way that the combined contract is accounted for as one lea se\n□An event that is within the control of the lessee occurs that gives the lessee a significant economic\nincentive to exercise, or not exercise a renewal option or purchase option or an event written in the\ncontract occurs that obligates the lessee to exer cise or not exercise an extension or termination\noption\nHowever , if the remeasurement is due to either (1) a contingency on which variable payments are \nbased is met su ch that th e variable payment become fixed or (2) a mounts owed under a residual v alue \nguarantee become probable, the reallocation of remaining consideration can be done in two ways. A \nlessee can make an accountin g policy choice to either use: \n□the same basis as the initial allocation of the consideration in the contract (or the latest\nmodification not accounted for as a separate contract), or\n□the relative standalone price of each component on the remeasurement date.\nA lessee should apply its policy consistently for all remeasurements. See LG 2.4.3 for information \nregarding the a llocation of consideration. \nASC 842 -20-35-4 and ASC 842 -20-35-5 provide guidance on the remeasurement of a lease liability. \nASC 842 -20-35-4 \nAfter the commencement date, a lessee shall remeasure the lease liability to reflect changes to the lease \npayments as described in paragraphs 842 -10-35-4 through 35 -5. A lessee shall recognize the amount \nof the remeasurement of the lease liability as an adjustment to the right -of-use asset. However, if the \ncarrying amount of the right -of-use asset is reduced to zero, a lessee shall recognize any remaining \namount of the remeasurement in profit or loss. \nASC 842 -20-35-5 \nIf there is a remeasurement of the lease liability in accordance with paragraph 842 -20-35-4, the lessee \nshall update the discount rate for the lease at t he date of remeasurement on the basis of the remaining \nlease term and the remaining lease payments unless the remeasuremen t of the lease liability is the \nresult of one of the following: \na.A change in the lease term or the assessment of whether the lessee will exercise an option to\npurchase the underlying asset and the discount rate for the lease already reflects that the lessee\nhas an option to extend or terminate the lease or to purchase the underlying asset.', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 190}), Document(page\_content='Modification and remeasurement of a lease \n5-13b.A change in amounts probable of being owe d by the lessee under a residual value guarantee (see\nparagraph 842 -10-35-4(c)(3)).\nc.A change in the lease payments resulting from the resolution of a contingency upon which some or\nall of the variable lease payments that will be paid over the remainder of the lease term are based\n(see paragraph 842 -10-35-4(b)).\nThe discount rate should not be updated if there is a remeasurement due to a change in lease term or \npurchase option if the discount rate at lease commencement already reflected the options. As \ndiscussed in LG 3.3.4.6 , the lessee must make a policy election to determine the discount rate either \nbased on the lease term used for accounting purposes or based on the initial lease term plus any \nextension, termination , and/or purchase options available to the lessee, even when they are not \nreasonably certain of exercise. For example, if a lessee with a five -year lease with a three -year renewal \noption used a discount rate at lease commencement that already considered the three -year renewal \noption, the di scount rate should not be adjusted upon remeasurement. \nFor lease payments that vary based on a rate or index, the lessee should determine the lease payments \nusing the rate or index in effect at the lease remeasurement date. For example, a lessee with leas e \npayments based on LIBOR should determine the future lease payments using the LIBOR spot rate on \nthe lease remeasurement date. \nThe lease liability should be recorded at the remeasured amount with an adjustment to the right -of-\nuse asset. \n5.3.4 Right -of-use asset adjustment \nThe right -of-use asset will need to be adjusted upon a modification that decreases the lessee’s right of \nuse. This may occur, f or example, when the floor space under lease is decreased or a lessee no longer \nhas the right to use a standalone asset. A modification to shorten the lease term is not considered a \ndecrease in the right of use . A decrease in the right of use is treated as either a full or partial \ntermination of the lease. See L G 5.5 for information on the right -of-use asset adjustment in these \ncases. \nFor all other changes (e.g., those that give an additional right of use, extend or shorten the lease term, \nor increase or decrease lease payments), the lessee should adjust the rig ht-of-use asset by an amount \nequal to the adjustment to the lease liability. Because the original lease is not considered terminated \n(since the lessee continues to have the right to use the asset identified in the original lease), the lessee \ngenerally shou ld not recognize a gain or loss as a result of the modification. However, if the carrying \namount of the right -of-use asset is reduced to zero, a lessee should recognize any remaining amount of \nthe remeasurement in net income. \n5.3.5 Lease expense subsequent to r emeasurement \nThe determination of lease expense subsequent to remeasurement will depend on the new lease \nclassification and whether that classification has changed. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 191}), Document(page\_content='Modification and remeasurement of a lease \n5-145.3.5.1 Finance lease upon remeasurement \nIf a lease is classified as a finance lease upon remeasurement (regardless of the classification before \nremeasurement), a lessee should calculate interest expense on the lease liability based on the discount \nrate at the remeasurement date. The right -of-use asset amortization expense should be determined by \ncalculating a new straight -line amortization amount using the revised right -of-use asset value and \nlease term. When the lease liability is remeasured and the right -of-use asset is adjusted, amortization \nof the right -of-use asset should be adjusted prosp ectively from the date of remeasurement. \n5.3.5.2 Operating lease upon remeasurement \nIf there is no change to the classification of an operating lease upon remeasurement, a lessee should \ncalculate the single lease expense after the remeasurement as follows: \nFuture undiscounted cash flows + (the right -of-use asset after the remeasurement – \nthe lease liability after the remeasurement) \nRemaining lease term \nIf a lease originally classified as a finance lease is remeasured and classified as an operating lease, any \ndifference between the carrying amount of the right -of-use asset after recording the remeasurement \nadju stment and the carrying amount of the right -of-use asset that would have resulted from initially \nclassifying the lease as an operating lease should be accounted for like a rent prepayment or a lease \nincentive. See LG 4.2.2.1 for information on accounting for rent prepayments and lease incentives. \n5.3.6 Illustrative examples of lease remeasurement \nExample LG 5-2, Example LG 5-3, Example LG 5-4, Example LG 5-5, Example LG 5-6, Example LG 5-\n7, Example LG 5-8 and Example LG 5-9 illustrate how to remeasure a lease for a lease modification or \nother event. \nEXAMPL E LG 5-2 \nRemeasurement of an operating lease with variable lease payments - no change to lease classification \nOn January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease property to be used \nas a retail store. The following table summar izes information about the lease and the leased property : \nLease commencement date January 1, 20X1 \nInitial lease term 5 years \nRenewal option 3 years \nRema ining economic life of the leased property 35 years \nPurchase option None \nAnnual lease payments for the initial term $100,000 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 192}), Document(page\_content='Modification and remeasurement of a lease \n5-15Annual lease payments for the renewal option $114,400 \nLease increase based on changes in the \nConsumer Price Index (CPI) □The annual lease payment in the base term\nwill increase based on the annual increase in\nthe CPI at the end of the preceding year. For\nexample, the payment due on 01/01/X2 will\nbe based on the CPI available at 12/31/X1.\n□The CPI at lease commencement is 120.\nPayment date Annually on January 1 \nLessee Corp’s incremental borrowing rate 5% \nThe rate Lessor Corp charges Lessee Corp in the \nlease is not readily determinable by Lessee Corp \nOther □Title to the property remains with Lessor\nCorp upon lease expiration\n□The fair value of the property is $4 mill ion at\ncommencement\n□Lessee Corp incurs $10,000 as initial direct\ncosts\n□Lessor Corp does not provide any incentives\nAt the lease commencement date, Lessee Corp did not have a significant economic incentive to \nexercise the renewal option. In the first quarter of 20X4, Lessee Corp installed unique tenant \nimprovements into the retail store with an estimated five -year economic life. Lessee Corp determined \nthat it would only recover the cost of the improvements if it exercises the renewal option, creating a \nsignificant economic incentive to extend. \nThe following table summarizes information pertinent to the lease remeasurement. \nRemeasured lease term 5 years; 2 years remaining in the initial term \nplus 3 years in the renewal period \nLessee Corp’s incremental borrowing rate \non the remeasurement date 6% \nThe rate Lessor Corp charges Lessee Corp in \nthe lease is not readily determinable by Lessee \nCorp \nRema ining economic life of the leased property 32 years \nFair value of the leased property at \nremeasurement date $3.8 million \nCPI on the remeasurement date 125 \nRight -of-use asset immediately before the \nremeasurement $199,238 \nLease liability immediately before the \nremeasurement $195,238 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 193}), Document(page\_content='Modification and remeasurement of a lease \n5-16How would Lessee Corp account for the remeasurement? \nAnalysis \nInstalling the improvements was a significant event controlled by Lessee Corp, which is now \nreasonably certain that it will exercise its renewal option based on the significant economic incentive \nto extend. Lessee Corp would therefo re be required to reassess lease classification and remeasure the \nlease in the first quarter of 20X4. \nBased on the facts at lease commencement, Lessee Corp could reasonably conclude that the lease was \nan operating lease since none of the criteria for a fi nance lease were met (see LG 3.3 for lease \nclassification criteria). At the remeasurement date, Lessee Corp would reassess lease classification and \ncould reasonably conclude that the lease is still an operating lease since none of the criteria for a \nfinanc e lease are met (see LG 3.3 for lease classification criteria). \nBalance sheet impact \nTo remeasure the lease liability, Lessee Corp would first calculate the present value of the future lease \npayments for the new lease term (using the updated discount rate of 6%). The following table shows \nthe present value of the future lease payments base d on an updated CPI of 125. Since the initial lease \npayments were based on a CPI of 120, the CPI has increased by 4%. As a result, Lessee Corp would \nincrease the future lease payments by 4% for those payments in the initial lease term (years 4 and 5). \nAs shown in the table, the revised lease liability would be $490,597 . \nYear 4 Year 5 Year 6 Year 7 Year 8 Total \nLease \npayment $104,000 $104,000 $114,400 $114,400 $114,400 $551,200 \nDiscount 0 5,887 12,584 18,348 23,784 60,603 \nPresent value $104,000 $98,113 $101,816 $96,052 $90,616 $490,597 \nTo calculate the adjustment to the lease liability, Lessee Corp would compare the recalculated and \noriginal lease liability balances on the remeasurement date. \nRevised lease liability $490,597 \nOriginal lease liability 195,238 \n$295,359 \nLessee Corp would record the following journal entry to adjust the lease liability. \nDr. Right -of-use asset $295,359 \nCr. Lease liability $295,359 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 194}), Document(page\_content='Modification and remeasurement of a lease \n5-17After the adjustment , the right -of-use asset will be equal to $494,597 (original balance of $199,238 + \n$295,359). \nIncome statement impact \nThe single lease expense would be recalculated using the following formula. \nFuture undiscounted cash flows at the remeasurement date + (th e right -of-use asset \nafter the remeasurement – the lease liability after the remeasurement) \nRemaining lease term \n$551,200 + ($494,597 - $490,597) \n5 = $111,040 single lease expense \nThe annual single lease expense of $111,040 would be recognized for the remaining term of the lease. \nEXAMPLE LG 5-3 \nRemeasurement of finance lease for a change in expected purchase option exercise - no impact to lease \nclassification \nOn January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to l ease manufacturing \nequipment. The following table summarizes information about the lease and the leased asset : \nLease commencement date January 1, 20X1 \nLease term 5 years with no renewal option \nRemaining e conomic life of the equipment 6 years \nAnnual lease payments $100,000 \nPayment date Annually on January 1 \nPurchase option Lessee Corp can purchase the equipment from \nLessor Corp at the end of the lease term for \n$30,000; this is not considered a bargain \npurchase option \nLessee Corp’s incremental borrowing rate 5% \nThe rate Lessor Corp charges Lessee Corp in \nthe lease is not readily determinable by Lessee \nCorp \nOther □Title to the asset does not automatically\npass to Lessee Corp upon lease expi ration\n□The fair value of the asset is $ 500,0 00 at\ncommencement. Lessee Corp does not', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 195}), Document(page\_content='Modification and remeasurement of a lease \n5-18guarantee the residual value of the \nequipment at the end of the lease term \n□There are no initial direct costs incurred by\nLessee Corp\n□Lessor Corp does not provide any\nincentives\nAt the lease commencement date, it was not reasonably certain that Lessee Corp would exercise the \npurchase option because the lease for the manufacturing facility (where the leased equipment is used) \nwas ending in five years. Since Lessee Corp was not certain if it wou ld continue to occupy its current \nmanufacturing location after five years, there was a reasonable possibility that the equipment under \nlease would no longer be used after that time because the equipment was designed specifically for the \ncurrent facility. \nOn January 1, 20X3, Lessee Corp negotiated a modification to the manufacturing facility lease \nagreement to extend that lease for another ten years. As a result of that modification, Lessee Corp is \nnow reasonably certain that it will exercise the purchase o ption in the equipment lease (in three years). \nThe following table summarizes information pertinent to the lease remeasurement. \nRemeasurement date January 1, 20X3 \nLessee Corp’s incremental borrowing rate on \nJanuary 1, 20X3 3% \nThe rate Lessor Corp charges Lessee Corp in \nthe lease is not readily determinable by \nLessee Corp \nRema ining economic life of the leased equipment 4 years \nFair value of the leased equipment at \nremeasurement date $300,000 \nRight -of-use asset immediately before the \nremeasurement $272,757 \nLease liability immediately before the \nremeasurement $285,941 \nHow would Lessee Corp account for the remeasurement? \nAnalysis \nMaking the modification to the manufacturing facility lease agreement was a significant event \ncontrolled by Lessee Corp, which is now reasonably certain that it will exercise its purchase option in \nthe equipment lease. Lessee Corp would therefore be requir ed to reassess lease classification and \nremeasure the equipment lease on January 1, 20X3 (the beginning of year 3 of the lease). ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 196}), Document(page\_content='Modification and remeasurement of a lease \n5-19Based on the facts at lease commencement , Lessee Corp could reasonably conclude that the lease was \na finance lease as the leas e term was a major part of the remaining economic life of the equipment (see \nLG 3.3 for lease classification criteria). At the remeasurement date , Lessee Corp would reassess lease \nclassification and based on the facts could reasonably conclude that the lea se is still a finance lease as \nthe lease term is a major part of the remaining economic life of the equipment . \nBalance sheet impact \nTo remeasure the lease liability, Lessee Corp would first calculate the present value of the future lease \npayments for the l ease term plus the purchase option using the updated discount rate of 3% , which \nincludes the assumed exercise of the purchase option and a term of 3 years (i.e., the remaining term of \nthe lease). The following table shows the future lease payments includin g the payment of $30,000 at \nthe end of the original lease term to exercise the purchase option. As shown in the table, the revised \nlease liability would be $318,801. \nYear 3 lease \npayment Year 4 lease \npayment Year 5 lease \npayment Purchase \noption \npayment Total \nLease \npayment $100,000 $100,000 $100,000 $30,000 $330,000 \nDiscount 0 2,913 5,740 2,546 11,199 \nPresent \nvalue $100,000 $97,087 $94,260 $27,454 $318,801 \nTo calculate the adjustment to the lease liability, Lessee Corp would compare the recalculated and \noriginal lease liability balances on the remeasurement date. \nRevised lease liability $318,801 \nOriginal lease liability 285,941 \n$32,860 \nLessee Corp would record the following journal entry to adjust the lease liability. \nDr. Right -of-use asset $32,860 \nCr. Lease liability $32,860 \nAfter the adjustment, the right -of-use asset will be equal to $ 305,617 (original balance of $ 272,757 + \n$32,860 ). ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 197}), Document(page\_content='Modification and remeasurement of a lease \n5-20Income statement impact \nLessee Corp would calculate the interest expense (based on discount rate of 3%) on the lease liability \nfrom the remeasurement date as follows. \nYear Remaining cash \npayments Annual lease \npayment Liability balance after \nannual payment Interest \nexpense \n3 $330,000 $100,000 $218,801 $6,564 \n4 $230,000 $100,000 $125,365 $3,760 \n5 $130,000 $100,000 $29,126 $874 \nThe revised straight -line amortization of the right -of-use asset should be recalculated as shown in the \nfollowing table. \nRight -of-use asset immediately before the remeasurement $272,757 \nAdjustment to the right -of-use asset 32,860 \nAdjusted right -of-use asset balance $305,617 \nRemaining economic life at the remeasurement date \* 4 years \nRecalculated annual right -of-use asset amortization $76,404 \n\*Remaining economic life of the asset is used as opposed to remaining lease term because it is assumed that the purchase \noption will be exercised.\nEXAMPLE LG 5-4 \nRemeasurement of a finance lease for a change in the probability of payment for a residual value \nguaran tee - lease classification not required to be reassessed \nOn January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease manufacturing \nequipment. The following table summarizes information about the lease and the leased asset : \nLease commen cement date January 1, 20X1 \nLease term 5 years with no renewal option \nRema ining e conomic life of the equipment 6 years \nAnnual lease payments $100,000 \nPayment date Annually on January 1 \nLessee Corp’s incremental borrowing rate 5% ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 198}), Document(page\_content='Modification and remeasurement of a lease \n5-21The rate Lessor Corp charges Lessee \nCorp in the lease is not readily \ndeterminable by Lessee Corp \nOther □Title to the asset does not\nautomatically pass to Lessee Corp\nupon lease expiration\n□The fair value of the asset is\n$500,000 at commencement.\nLessee Corp has guaranteed that the\nresidual value of the manufacturing\nequipment will be at least $15,000\nat the end of the lease term\n□There are no initial direct costs\nincurred by Lessee Corp\n□Lessor Corp does not provide any\nincentives\nAt the lease commencement date, it was not probable that Lessee Corp would make a payment under \nthe residual value guarantee. On January 1, 20X3, a change in technology made the technology in the \nleased equipment outdated. As a result, Lessee Corp now expe cts a decline in the fair value of the \nequipment and at the end of the lease term, payment of $10,000 is probable under the residual value \nguarantee. \nThe following table summarizes information pertinent to the lease remeasurement. \nRemeasurement date Janua ry 1, 20X3 \nRemaining economic life of the leased equipment 4 years \nFair value of the leased equipment at remeasurement date $200,000 \nRight -of-use asset immediately before the \nremeasurement $272,757 \nLease liability immediately before the \nremeasurement $285,941 \nHow would Lessee Corp account for the remeasurement? \nAnalysis \nSince Lessee Corp now determines that it is probable that it will have to make a payment under the \nresidual value guarantee, Lessee Corp would be required to remeasure the lease on the date of the \nchange (i.e., Ja nuary 1, 20X3) including the residual value guarantee amount probable of being paid at \nthe end of year 5 (i.e., $10,000) . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 199}), Document(page\_content='Modification and remeasurement of a lease \n5-22Based on the facts Lessee Corp could reasonably conclude that the lease was a finance lease at lease \ncommencement as the lease term is a major part of the remaining economic li fe of the equipment (see \nLG 3.3 for lease classification criteria). However, Lessee Corp should not reassess the lease \nclassification based on the guidance in ASC 842 -10-25-1. \nBalance sheet impact \nTo remeasure the lease liability, Lessee Corp would first calculate the present value of the future lease \npayments for the lease term (using the discount rate of 5% determined at lease commencement) plus \nthe residual value guarantee. The following table shows the future lease payments, including the \npayment of $1 0,000 at the end of year 5 for the residual value guarantee. As shown in the table, the \nrevised lease liability would be $294,579. \nYear 3 lease \npayment Year 4 lease \npayment Year 5 lease \npayment Residual \nvalue \nguarantee \npayment Total \nLease \npayment $100,000 $100,000 $100,000 $10,000 $310,000 \nDiscount 0 4,762 9,297 1,362 15,421 \nPresent value $100,000 $95,238 $90,703 $8,638 $294,579 \nTo calculate the adjustment to the lease liability, Lessee Corp would compare the recalculated and \noriginal lease liability balances on the remeasurement date. \nRevised lease liability $294,579 \nOriginal lease liability 285,941 \n$8,638 \nLessee Corp would record the following journal entry to adjust the lease liability. \nDr. Right -of-use asset $8,638 \nCr. Lease liability $8,638 \nAfter the adjustment, the right -of-use asset will be equal to $281,395 (original balance of $272,757 + \n$8,638). \nIncome statement impact \nLessee Corp would calculate the interest expense on the lease liability from the remeasurement date as \nfollows. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 200}), Document(page\_content='Modification and remeasurement of a lease \n5-23Year Remaining cash \npayments Annual lease \npayment Liability balance Interest expense \n3 $310,000 $100,000 $194,579 $9,729 \n4 $210,000 $100,000 $104,308 $5,215 \n5 $110,000 $100,000 $9,524 $476 \nThe revised straight -line amortization of the right -of-use asset should be recalculated as shown in the \nfollowing table. \nRight -of-use asset immediately before the remeasurement $272,757 \nAdjustment to the right -of-use asset 8,638 \nAdjusted right -of-use asset balance $281,395 \nRemaining lease term at the remeasurement date 3 years \nRecalculated annual right -of-use asset amortization $93,798 \nEXAMPLE LG 5-5 \nAccounting for a modified operating lease that extends the lease term - no change to lease \nclassification \nOn January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease property to be used \nas a retail store. The following table summarizes information about the lease and the leased property : \nLease commencement date January 1, 20X1 \nLease term 5 years with no renewal option \nRemaining economic life of the leased property 35 years \nPurchase option None \nAnnual lease payments $100,000 \nPayment date Annually on January 1 \nLessee Corp’s incremental borrowing rate 5% \nThe rate Lessor Corp charges Lessee \nCorp in the lease is not readily \ndeterminable by Lessee Corp \nOther □Title to the asset remains with\nLessor Corp upon lease expiration', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 201}), Document(page\_content='Modification and remeasurement of a lease \n5-24□The fair value of the property is $4\nmillion at commencement\n□Lessee Corp incurs $10,000 as\ninitial direct costs\n□Lessor Corp does not provide any\nincentives\nOn January 1, 20X4, Lessee Corp and Lessor Corp amend the original lease contract to extend the \nterm of the lease for an additional three years. \nThe following table summarizes information pertinent to the lease modification. \nModification date January 1, 20X4 \nModified annual lease payments $110,000 \nLessee Corp’s incremental borrowing rate on \nJanuary 1, 20X4 6% \nThe rate Lessor Corp charges Lessee \nCorp in the lease is not readily \ndeterminable by Lessee Corp \nRema ining economic life of the leased property 32 years \nFair value of the property at the modificatio n date $3.8 million \nRight -of-use asset immediately before the modification $199,238 \nLease liability immediately before the modification $195,238 \nAssume that any additional right of use, the original contract , and the modified contract meet the \ndefinition of a lease. \nHow would Lessee Corp account for the lease modification? \nAnalysis \nDetermine if the lease modification is a separate new contract \nAs the modification does not grant an additional right of use, Lessee Corp would conclude that that the \nmodification is not a separate new contract . Since the modified contract meets the definition of a lease, \nLess ee Corp would account for one new modified lease as of January 1, 20X 4. \nReassess lease classification based on the terms of the modified lease \nBased on the facts at lease commencement , Lessee Corp could reasonably conclude that the lease was \nan operating lease since none of the criteria for a fina nce lease are met (see LG 3.3 for lease \nclassification criteria). At the modification date , Less ee Corp could reasonably conclude that the lease \ncontinues to be an operating lease since none of the criteria for a finance lease are met. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 202}), Document(page\_content='Modification and remeasurement of a lease \n5-25Account for the modified lease \nLessee Corp would remeasure the lease as of the modification date as follows : \nBalance sheet impact \nThe lease liability is remeasured by calculating the present value of the remaining future lease \npayments for the modified lease term using Le ssee Corp’s current discount rate of 6% . The modified \nlease has five years remaining (two years remaining in the initial term plus three years added with the \nmodification). The modified lease liability would be $491,162 as shown in the table below. \nYear 4 Year 5 Year 6 Year 7 Year 8 Total \nLease \npayment $110,000 $110,000 $110,000 $110,000 $110,000 $550,000 \nDiscount 0 6,226 12,100 17,642 22,870 58,838 \nPresent value $110,000 $103,774 $97,900 $92,358 $87,130 $491,162 \nTo calculate the adjustment to the lease liability, Lessee Corp would compare the recalculated and \noriginal lease liability balance on the modification date. \nRevised lease liability $491,162 \nOriginal lease liability 195,238 \n$295,924 \nLessee Corp would record the following journal entry to adjust the lease liability. \nDr. Right -of-use asset $295,924 \nCr. Lease liability $295,924 \nAfter the adjustment, the right -of-use asset will be equal to $495,162 (original balance of $199,238 + \n$295,924). \nIncome statement impact \nLessee Corp would recalculate the single lease expense using the following formula. \nFuture undiscounted cash flows at the remeasurement date + (the right -of-use asset \nimmediately after the remeasurement - the lease liability immediately after the \nremeasurement ) \nRemaining lease term ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 203}), Document(page\_content='Modification and remeasurement of a lease \n5-26The amounts are as follows: \n$550,000 + ($495,162 - $491,162) \n5 = $110,800 single lease expense \nLessee Corp would recognize annual single lease expense of $110,800 for the remaining term of the \nlease. \nEXAMPLE LG 5-6 \nAccounting for a modified operating lease with a decrease in lease term - no change to lease \nclassification \nOn January 1, 20X1, Lessee Corp enters into a contract with Les sor Corp to lease property to be used \nas a retail store. The following table summarizes information about the lease and the leased property : \nLease commencement date January 1, 20X1 \nLease term 5 years with no renewal option \nRema ining economic life of the leased property 35 years \nPurchase option None \nAnnual lease payments $100,000 \nPayment date Annually on January 1 \nLessee Corp ’s incremental borrowing rate 5% \nThe rate Lessor Corp charges Lessee \nCorp in the lease is not readily \ndeterminable by Lessee Corp \nOther □Title to the asset remains with\nLessor Corp upon lease expiration\n□The fair value of the property is $4\nmillion at commencement\n□Lessee Corp incurs $10,000 as\ninitial direct costs\nOn January 1, 20X2, Lessee Corp and Lessor Corp amend the original lease contract to decrease the \nterm of the lease to three years and increase the annual lease payments to $110,000 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 204}), Document(page\_content='Modification and remeasurement of a lease \n5-27The following table summarizes information pertinent to the lease modification. \nModification date January 1, 2 0X2 \nRevised remaining lease term 2 years \nModified annual lease payments $110,000 \nLessee Corp’s incremental borrowing rate on \nJanuary 1, 20X2 6% \nThe rate Lessor Corp charges Lessee \nCorp in the lease is not readily \ndeterminable by Lessee Corp \nRemaining economic life of the leased property 34 years \nFair value of the property at the modification date $4 million \nRight -of-use asset immediately before the modification $380,325 \nLease liability immediately before the modification $372,325 \nAssume that any additional right of use, the original contract , and the modified contract meet the \ndefinition of a lease. \nHow would Lessee Corp account for the lease modification? \nAnalysis \nDetermine if the lease modification is a separate new contract \nAs the modification does not grant an additional right of use, Lessee Corp would determine that the \nmodification is not a separate new contract. Since the modified contract meets the definition of a lease, \nLess ee Corp would account for one new mod ified lease as of January 1, 20X2. \nReassess lease classification based on the terms of the modified lease \nBased on the facts at commencement date , Lessee Corp could reasonably conclude that the lease was \nan operating lease since none of the criteria for a finance lease were met (see LG 3.3 for lease \nclassification criteria). At lease modification date , Less ee Corp could reasonably conclude that the \nlease continues to be an operating lease since none of the criteria for a finance lease are met. \nAccount for the modified lease \nLessee Corp would remeasure the lease as of the modification date as follows : \nBalance sheet impact \nLessee Corp would remeasure the lease liability on the date of the modification by calculating the \npresent value of the remaining two futu re lease payments for the modified lease term using Lessee ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 205}), Document(page\_content='Modification and remeasurement of a lease \n5-28Corp’s current discount rate of 6%. The modified lease liability would be $213,774, as shown in the \ntable below. \nYear 2 Year 3 Total \nLease payment $110,000 $110,000 $220,000 \nDiscount 0 6.226 6,226 \nPresent value $110,000 $103,774 $213,774 \nAlthough the lease liability has been decreased as a result of the modification, it is not a partial \ntermination of the lease because there was no change to the underlying asset being leased. Therefore, \nto calculate the adjustment to the lease liability, Lessee Corp would compare the recalculated and \noriginal lease liability balances on the modification date. \nOriginal lease liability $372,325 \nRevised lease liability 213,774 \n$158,551 \nLessee Corp would record the following journal entry to adjust the lease liability. \nDr. Lease liability $158,551 \nCr. Right -of-use asset $158,551 \nAfter the adjustment, the right -of-use asset will be equal to $221,774 (original balance of $380,325 - \n$158,551). \nIncome statement impact \nLessee Corp would recalculate the single lease expense using the following formula. \nFuture undiscounted cash flows at the remeasurement date + (the right -of-use asset \nimmediately after the remeasurement - the lease liability immediately after the \nremeasurement) \nRemaining lease term \nThe amounts are as follows: \n$220,000 + ($ 221,774 - $213,774 ) \n2 = $11 4,000 single lease expense \nLessee Corp would recognize annual single lease expense of $11 4,000 for the remaining term of the \nlease. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 206}), Document(page\_content='Modification and remeasurement of a lease \n5-29EXAMPLE LG 5-7 \nAccounting for a change in consideration in an operating lease - no change in lease classification \nOn January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease property to be used \nas a retail store. The following table summarizes information about the lease and the leased property : \nLease commencement date January 1, 20X1 \nInitial lea se term 5 years (includes a termination option \navailable after year 3 with a termination \npenalty which is not reasonably certain \nof exercise at commencement date ) \nRemaining economic life of the leased property 35 years \nPurchase option None \nAnnual lease payments $100,000 \nPayment date Annually on January 1 \nLessee Corp ’s incremental borrowing rate 5% \nThe rate Lessor Corp charges Lessee \nCorp in the lease is not readily \ndeterminable by Lessee Corp \nOther □Title to the asset remains with Lessor\nCorp upon lease expiration\n□The fair value of the property is $4\nmillion at commencement\n□Lessee Corp incurs $10,000 as initial\ndirect costs\nOn January 1, 20X4, Lessee Corp considers terminating the lease and relocat ing to another location. \nTo entice Lessee Corp to remain in its location, Lessor Corp agrees to amend the original lease contract \nto reduce the annual lease payments in the last two years to $90,000. The termination penalty in the \ncontract remains the same . Lessee Corp ultimately concludes that it will remain in the lease through \nthe initial lease term. \nThe following table summarizes information pertinent to the lease modification. \nModification date January 1, 20X4 \nModified annual lease payments $90,000 \nLessee Corp’s incremental borrowing rate on \nJanuary 1, 20X4 4% \nThe rate Lessor Corp charges Lessee \nCorp in the lease is not readily \ndeterminable by Lessee Corp ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 207}), Document(page\_content='Modification and remeasurement of a lease \n5-30Remaining economic life of the leased property 32 years \nFair value of the leased property at the modification date $3.7 million \nRight -of-use asset immediately before the modification $199,238 \nLease liability immediately before the modification $195,238 \nAssume that any additional right of use, the original co ntract and the modified contract meet the \ndefinition of a lease. \nHow would Lessee Corp account for the lease modification? \nAnalysis \nDetermine if the lease modification is a separate new contract \nAs the modification does not grant an additional right of use, Lessee Corp would determine that the \nmodification is not a separate new contract. Since the modified contract meets the definition of a lease, \nLess ee Corp would account for one new modified lease as of January 1, 20X4. \nReassess lease classification based on the terms of the modified lease \nAt lease commencement, since Lessee Corp is reasonably certain to not exercise the termination \noption, a lease term of five years was used. Based on the facts Lessee Corp could reasonably conclude \nthat the lease was an operating lease at lease commencement since none of the criteria for a finance \nlease are met (see LG 3.3 for lease classification criteria). At the lease modification date , Less ee Corp \ncould reasonably conclude that the lease continues t o be an operating lease since none of the criteria \nfor a finance lease are met. \nAccount for the modified lease \nLessee Corp would remeasure the lease as of the modification date as follows : \nBalance sheet impact \nLessee Corp would remeasure the lease liabili ty on the date of the modification by calculating the \npresent value of the remaining future lease payments for the modified lease term using Lessee Corp’s \ncurrent discount rate of 4%. The modified lease liability would be $176,538, as shown in the table \nbelow. \nYear 4 Year 5 Total \nLease payment $90,000 $90,000 $180,000 \nDiscount 0 3,462 3,462 \nPresent value $90,000 $86,538 $176,538 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 208}), Document(page\_content='Modification and remeasurement of a lease \n5-31To calculate the adjustment to the lease liability Lessee Corp would compare the recalculated and \noriginal lease liability balances on the modification date. \nRevised lease liability $176,538 \nOriginal lease liability 195,238 \n($18,700) \nLessee Corp should record the following journal entry to adjust the lease liability. \nDr. Lease liability $18,700 \nCr. Right -of-use asset $18,700 \nAfter the adjustment, the right -of-use asset will be equal to $180,538 (original balance of $199,238 - \n$18,700). \nIncome statement impact \nLessee Corp would recalculate the single lease expense using the following formula. \nFuture undiscounted cash flows at the remeasurement date + (the right -of-use asset \nimmediately after the remeasurement - the lease liability immediately after the \nremeasurement) \nRemaining lease term \nThe amounts are as follows: \n$180,000 + ($180,538 - $176,538 ) \n2 = $92,000 single lease expense \nLessee Corp would recognize annual single lease expense of $ 92,000 for the remaining term of the \nlease. \nEXAMPLE LG 5-8 \nAccounting for a modified finance lease – lease classification changes to an operating lease \nOn January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease manufacturing \nequipment. The following table summarizes information about the lease and the leased equipment : \nLease commencement date January 1, 20X1 \nLease term 10 years with no renewal option \nRemaining e conomic life of the leased equipment 12 years \nPurchase option None ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 209}), Document(page\_content='Modification and remeasurement of a lease \n5-32Annual lease payments $100,000 \nPayment date Annually on January 1 \nLessee Corp’s incremental borrowing rate 5% \nThe rate Lessor Corp charges Lessee Corp in \nthe lease is not readily determinable by \nLessee Corp \nOther □Title to the asset remains with Lessor\nCorp upon lease expiration\n□The fair value of the property is $1.2\nmillion at commencement\n□Lessee Corp incurs $10,000 as i nitial\ndirect costs\nOn January 1, 20x4, Lessee Corp and Lessor Corp amend the original lease contract to decrease the \nremaining term of the lease to four years and increase the annual lease payments to $110,000. \nThe following table summarizes informatio n pertinent to the lease remeasurement required upon the \nchange from a finance to an operating lease . \nModification date January 1, 20x4 \nRemeasured remaining lease term 4 years \nModified annual lease payments $110,000 \nLessee Co rp’s incremental borrowing rate on the \nremeasurement date 6% \nThe rate Lessor Corp charges Lessee Corp in \nthe lease is not readily determinable by \nLessee Corp \nRemaining economic life of the leased equipment 9 years \nFair value of the leased equipment at the \nmodification date $900,000 \nRight -of-use asset immediately before the \nremeasurement $574,548 \nLease liability immediately before the \nremeasurement $607,569 \nAssume that any additional right of use, the original contract , and the modified c ontract meet the \ndefinition of a lease. \nHow would Lessee Corp account for the remeasurement? ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 210}), Document(page\_content='Modification and remeasurement of a lease \n5-33Analysis \nDetermine if the lease modification is a separate new contract \nAs the modification does not grant an additional right of use, Lessee Corp would determine that the \nmodification is not a separate new contract. Since the modified contract meets the definition of a lease, \nLess ee Corp would account for one new modified lease as of January 1, 20X4. \nReassess lease classification based on the terms of the modified lease \nBased on the facts at lease commencement date , Lessee Corp could reasonably conclude that the lease \nwas a finance lease as the lease term was a major part of the remaining economic life of the equipment \n(see LG 3.3 for lease classification criteria). At the lease modification date , Lessee Corp could \nreasonably conclude that the lease is an operating lease since none of the criteria for a finance lease are \nmet. \nAccount for the modified lease \nLessee Corp would remeasure the lease as of the modification date as follows : \nBalance sheet impact \nTo remeasure the lease liability, Lessee Corp would first calculate the present value of the future lease \npayments for the new lease term (using the updated discount rate of 6%). As shown in the table, the \nrevised lease liability would be $404,031. \nYear 4 Year 5 Year 6 Year 7 Total \nLease \npayment $110,000 $110,000 $110,000 $110,000 $440,000 \nDiscount 0 6,226 12,100 17,462 35,969 \nPresent value $110,000 $103,774 $97,900 $92,358 $404,031 \nTo calculate the adjustment to the lease liability, Lessee Corp would compare the recalculated and \noriginal lease liability balances on the remeasurement date. \nRevised lease liability $404,031 \nOriginal lease liability 607,569 \n($203,538) \nLessee Corp would record the following journal entry to adjust the lease liability. \nDr. Lease liability $203,538 \nCr. Right -of-use asset $203,538 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 211}), Document(page\_content='Modification and remeasurement of a lease \n5-34After the adjustment, the right -of-use asset will be equal to $371,010 (original balance of $574,548 - \n$203,538). \nIncome statement impact \nThe single lease expense would be recalculated using the following formula. \nFuture undiscounted cash flows at the remeasurement date + (the right -of-use asset \nafter the remeasurement - the lease liability immediately after the remeasurement) \nRemaining lease term \n$440,000 + ($371,010 - 404,031) \n4 = $101,745 single lease expense \nThe annual single lease expense of $101,745 would be recognized for the remaining term of the lease. \nEXAMPLE LG 5-9 \nRemeasurement due to change in timing of leasehold incentive receivable \nOn January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease a building. The \nfollowing table summarizes information about the lease and the leased property : \nLease commencement date January 1, 20X1 \nLease term 5 years with no renewal option \nRemaining e conomic life of the leased property 30 years \nPurchase option None \nAnnual lease payments $1,000,000 \nPayment date January 1 \nLessee Corp’s incremental borrowing rate 5% \nThe rate Lessor Corp charges Lessee Corp in the \nlease is not readily determinable by Lessee Corp \nLease incentive Lessor Corp agrees to reimburse Lessee Corp up \nto $300,000 for leasehold improvements \ncompleted within the first two years of the lease \nOther □Title to the asset remains with Lessor Corp\nupon lease expiration\n□Lessee Corp incurs no initial direct costs\nIt is unlikely Lessee Corp would forgo any lease incentive it negotiated to receive from Lessor Corp . \nLessee Corp expects that it will complete the improvements two years after lease commencement . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 212}), Document(page\_content='Modification and remeasurement of a lease \n5-35Lessee Corp finishes the leasehold improvements in one year (as opposed to the original estimate of \ntwo years ) and utilizes the entire lease incentive of $300,0 00. The payment for the lease incentive was \nreceived on 12/31/X 1. The following table summarizes information pertinent to leasehold \nimprovements completion date. \nRemaining lease term 4 years \nRight -of-use asset immediately before leasehold \nimprovements completion date $3,497,534 \nLease liability immediately before leasehold \nimprovements completion date $3,437,534 \nHow should Lessee Corp account for the difference in timing from the original estimate? \nAnalysis \nSince it is unlikely Lessee Corp would forgo any lease incentive it negotiated to receive from Lessor \nCorp, Lessee Corp would account for the incentive as an in -substance fixed payment to be received \nfrom Lessor Corp. Lessee Corp would consider the lease incenti ve as a negative lease payment two \nyears after lease commencement since Lessee Corp expects that is when it will complete the \nimprovements . \nBased on the facts , Lessee Corp could reasonably conclude that the lease is an operating lease at lease \ncommencement since none of the criteria for a finance lease are met (see LG 3.3 for lease classification \ncriteria). \nWhen measuring the lease liability at lease commencement, Lessee Corp would include the lease \nincentive as a negative lease payment based on the expect ed timing of completion of leasehold \nimprovements (i.e., two years after commencement date) . The lease liability at commencement would \nbe $4,273,842 calculated as follows: \n1/1/X1 1/1/X2 12/31/X2 1/1/X3 1/1/X4 1/1/X5 Total \nLease \npayment $1,000,000 $1,000,000 (300,000) $1,000,000 $1,000,000 $1,000,000 $4,700,000 \nDiscount 0 (47,619) 27,891 (92,971) (136,162) (177,298) (426,158) \nPresent \nvalue $1,000,000 $952,381 (272,109) $907,029 $863,838 $822,702 $4,273,842 \nWhen the timing of the receipt of the lease incentive changes from the original estimate at \ncommencement, the lease liability must be remeasured using the discount rate at lease \ncommencement. In this example, the lease liability is remeasured at 12/31/x1 (concurrent with the \nreceipt of the incentive payment ). \nTo remeasure the lease liability, Lessee Corp would first calculate the present value of the future lease \npayments for the remaining lease term (using the original discount rate of 5%). As shown in th e \nfollowing table, the revised lease liability would be $3,723,248. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 213}), Document(page\_content='Modification and remeasurement of a lease \n5-361/1/ X2 1/1/ X3 1/1/ X4 1/1/ X5 Total \nLease payment $1,000,000 $1,000,000 $1,000,000 $1,000,000 $4,000,000 \nDiscount 0 47,619 92,971 136,162 276,752 \nPresent value $1,000,000 $952,381 $907,029 $863,838 $3,723,248 \nTo calculate the adjustment to the lease liability, Lessee Corp would compare the recalculated and \noriginal lease liability balances on the remeasurement date. \nRevised lease liability $3,723,248 \nOriginal lease liability 3,437,534 \n($285,714) \nLessee Corp would record the following journal entry to adjust the lease liability. \nDr. Cash (for lease incentive received) $300,000 \nCr. Right -of-use asset $14,286 \nCr. Lease liability $285,714 \nAfter the adjustment, the right -of-use asset will be equal to $3,483,248 (original balance of $3 ,497,534 \n-$14,286 ).\nThe single lease expense would be recalculated using the following formula. \nFuture undiscounted net cash flows at the remeasurement date + (the right -of-use \nasset immediately after the remeasurement - the lease liability immediately after \nthe remeasurement) \nRemaining lease term \n$4,000,000 + ($3,483,248 -$3,723,248 ) \n4 = $940,000 single lease \nexpense \nQuestion LG 5-4 discusses amortization of a right -of-use asset that has been impaired and \nsubsequently modified or remeasured. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 214}), Document(page\_content='Modification and remeasurement of a lease \n5-37Question LG 5 -4 \nIf a lessee impairs a right -of-use asset in an operating lease and then either modifies the lease such \nthat the mo dification is not considered a new lease or a remeasurement event occurs, should the lessee \ncontinue to amortize the ROU asset on a straight -line basis ? \nPwC response \nYes. We believe the lessee should continue to amortize the right -of-use asset on a straight -line basis if \nan impairment of a right -of-use asset in an operating lease is subsequently followed by a lease \nmodification that is not considered a new lease or a remeas urement event occurs. See LG 4.6.2 for \nmore details about right -of-use asset amortization upon an impairment . \n5.4 Reassessment of the short -term lease exemption \nA lessee should reassess whether a short -term lease continues to qualify for the short -term lease \nmeasurement and recognition exemption when any of the following events occur: \n□The lease term changes because it becomes reasonably certain that the lessee wil l exercise its\nrenewal option such that, after the change, the remaining lease term extends more than 12 months\nfrom the end of the previously -determined lease term\n□The lease term changes because it becomes reasonably certain that the lessee will not exerc ise a\ntermination option such that, after the change, the remain ing lease term extends more than 12\nmonths from the end of the previously determined lease term\n□The lessee becomes reasonably certain to exercise its option to purchase the underlying asset\nIf the lease no longer meets the requirements for the short -term lease measurement and recognition \nexemption , the lessee should apply the guidance discussed in LG 3 to determine the lease \nclassification. \nSee LG 2.2.1 for information on the short -term lease measurement and recognition exemption . \n5.5 Accounting for a lease termination – lessee—updated \nSeptember 2021 \nWhen a lease is terminated in its entirety, there should be no remaining lease liability or right -of-use \nasset. Any difference between the carrying amounts of the right -of-use asset and the lease liability \nshould be recorded in the income statement as a gain or loss; if a termination penalty is paid, that \namount should be included in the gain or loss on termination. \nIf a lessee continues to use the a sset for a period of time after the lease termination is agreed upon, the \ntermination should be accounted for as a lease modification based on the modified lease term (through \nthe planned lessee exit date). For example, if the lessee and lessor agree to te rminate a lease in six \nmonths with a termination penalty, the lease should be accounted for as a modified lease with a six -\nmonth term. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 215}), Document(page\_content='Modification and remeasurement of a lease \n5-38Terminating the lease of one asset before the end of the lease term and leasing a similar asset from the \nsame lessor may not always be considered a full termination of the original lease. In some cases, it may \nbe treated as a modification. For example, if a lessee negotiates to terminate a lease of one fl oor of a \nbuilding and concurrently negotiates a new lease of a differe nt floor in the same building, this would \nbe accounted for as a modification if the new lease was not priced at market . This is an important \ndistinction to make because the accounting can vary significantly. A lease termination results in a gain \nor loss ch arged to the income statement immediately. A modification does not result in an immediate \ncharge to the income statement, unless the modification is a considered a partial term ination (see LG \n5.5.1 ). In that case, there would be some impact to the income s tatement. However, the income \nstatement impact will not be the same as it would be for a full lease termination. \n5.5.1 Accounting for a partial lease termination — lessee \nA modification of a lease may result in a partial termination of the lease. Examples of events that result \nin a partial termination include terminating the right to use one or more underlying assets and \ndecreasing the leased space. A decrease in lease term is not considered a partial termination event. A \npartial termination should be recorded by adjusting the lease liability and right -of-use asset. The right -\nof-use asset should be decreased on a basis proportionate to the partial termination of the existing \nlease. The difference between the decrease in the carrying amount of the le ase liability resulting from \nthe modification and the proportionate decrease in the carrying amount of the right -of-use asset \nshould be recorded in the income statement. \nThere are two ways to determine the proportionate reduction in the right -of-use asset. It can be based \non either the reduction to the right -of-use asset or on the reduction to the lease liability. For example, \nif a lessee decreases the amount of space it is leasing in an office building by 45% and as a result, the \nlease liability decreases by 50%, the right -of-use asset could be decreased by either 45% or 50%. See \nExample 18 beginning at ASC 842 -10-55-177 and Example LG 5 -10 for example s of lessee accounting \nfor partial lease termination s. \nA lessee should treat its selected method as an acco unting policy election by class of underlying asset. \nThe policy should be applied consistently to all modifications that decrease the scope of a lease. \nExample LG 5 -10 illustrates a lessee’s accounting for modification of an operating lease without a \nchan ge in lease classification. \nEXAMPLE LG 5 -10 \nAccounting for a modified operating lease with a partial termination - no change to lease classification \nOn January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease property to be used \nas a warehouse. The following table summarizes information about the lease and the leased property : \nLease commencement date January 1, 20X1 \nLease term 5 years with no renewal option \nLeased property 100,000 square feet of warehouse \nspace \nRemaining economic life of the leased property 30 years ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 216}), Document(page\_content='Modification and remeasurement of a lease \n5-39Purchase option None \nAnnual lease payments $100,000 \nPayment date January 1 \nLessee Corp’s incremental borrowing rate 5% \nThe rate Lessor Corp charges Lessee \nCorp in the lease is not readily \ndeterminable by Lessee Corp \nOther □Title to the leased property\nremains with Lessor Corp upon\nlease expiration\n□Fair value of the leased property at\ncommencement $2.5 million\n□Lessee Corp incurs $10,000 initial\ndirect costs\nOn January 1, 20X2, Lessee Corp and Lessor Corp amend the original lease contract to decrease the \nleased space from 100,000 square feet to 50,000 square feet, effective immediately. Commensurate \nwith the reduction in leased space, the annual lease payment will be reduced from $100,000 a year to \n$50,000 a year. Lessee Corp is also required to pay Lessor Corp a one-time termination penalty of \n$30,000 along with its next lease payment . \nThe following table summarizes information pertinent to the lease modifica tion. \nModification date January 1, 20X2 \nRemaining lease term 4 years \nRevised leased property 50,000 square feet \nRevised annual lease payments $50,000 \nTermination penalty $30,000 \nLessee Corp’s incremental borrowing rate on \nJanuary 1, 20X2 6% \nThe rate Lessor Corp charges Lessee \nCorp in the lease is not readily \ndeterminable by Lessee Corp \nRemaining economic life of the leased property 29 years \nFair value of the leased property at the modification date $1.25 million \nRight -of-use asset immediately before the modification $380,325 \nLease liability immediately before the modification $372,325 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 217}), Document(page\_content='Modification and remeasurement of a lease \n5-40Lessee Corp has historically accounted for the lease of 100,000 square feet as one lease component. \nLessee Corp has previously made an accounting policy election to calculate the reduction in the right -\nof-use asset in proportion to the reduction to the rig ht of use (i.e., decrease in leased space). Assume \nthat any additional right of use, the original contract , and the modified contract meet the definition of \na lease. \nHow would Lessee Corp account for the lease modification? \nAnalysis \nDetermine if the lease modification is a separate new contract \nAs the modification does not grant an additional right of use, Lessee Corp would determine that the \nmodification is not a separate new contract. Since the modified contract meets the definition of a lease, \nLessee Co rp would account for one new modified lease as of January 1, 20X4. \nDetermine if the modification is a partial termination \nSince Lessee Corp surrenders control of 50,000 square feet of space immediately the modification is a \npartial termination . \nReassess l ease classification based on the terms of the modified lease \nBased on the facts at lease commencement , Lessee Corp could reasonably conclude that the lease was \nan operating lease since none of the criteria for a finance lease were met. At the lease modific ation \ndate , Lessee Corp could reasonably conclude that the lease continues to be an operating lease since \nnone of the criteria for a finance lease are met (see LG 3.3 for lease classification criteria). \nAccount for the modified lease \nLessee Corp would rem easure the lease as of the modification date as follows : \nBalance sheet impact \nLessee Corp would remeasure the lease liability on the date of the modification by calculating the \npresent value of the remaining four future lease payments, including the termin ation penalty, for the \nmodified lease term using Lessee Corp’s current discount rate of 6%. The modified lease liability would \nbe $213,651, as shown in the following table. \nYear 2 Year 3 Year 4 Year 5 Total \nLease payment $80,000 $50,000 $50,000 $50,000 $230,000 \nDiscount 0 2,830 5,500 8,019 16,349 \nPresent value $80,000 $47,170 $44,500 $41,981 $213,651 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 218}), Document(page\_content='Modification and remeasurement of a lease \n5-41To calculate the adjustment to the lease liability, Lessee Corp would compare the recalculated and \noriginal lease liability balances on the modification date. \nOriginal lease liability $372,325 \nRevised lease liability 213, 651 \n$158, 674 \nThe lessee has an accounting policy choice for remeasuring the right -of-use asset either (a) based on \nthe change in lease liability; or (b) based on the remaining right of use. The remeasurement of the \nright -of-use asset under both these approaches is illustrated below. \n(a)Remeasuring the right -of-use asset based on the change in lease liability\nUnder the policy election to remeasure the right -of-use asset in proportion to the change in lease \nliability, the post -modification right -of-use asset is $218,241 (pre -modification right -of-use asset of \n$380,325 multiplied by 42.6% reduction in lease liability ($158,674 divided by $372,325)). To \ncalculate the adjustment to the right -of-use asset , Lessee Corp would compare the recalculated and \noriginal right -of-use asset balances on the modification date as follows . \nOriginal right of use asset $380,325 \nRevised right of use asset 218,241 \n$162,084 \nLessee Corp would record the following journal entry to adjust the lease liability and right -of-use asset, \nwith the difference between the adjustment to the lease liability and right -of-use asset being recorded \nto the income statement. \nDr. Lease liability $158,674 \nDr. Loss 3,410 \nCr. Right of use asset $162,084 \nIncome statement impact \nLessee Corp would recalculate the single lease expense using the following formula. \nFuture undiscounted cash flows at the remeasurement date + (the right -of-use \nasset immediately after the remeasurement - the lease liability immediately after \nthe remeasur ement) \nRemaining lease term \n$230,000 + ($218,241 - $213,651) \n4 = $58,648 single lease expense \nLessee Corp would recognize single annual lease expense of $58,648 for the remaining term of the \nlease. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 219}), Document(page\_content='Modification and remeasurement of a lease \n5-42 (b) Remeasuring the right -of-use asset based on the remaining right of use \nUnder the accounting policy election to remeasure the right -of-use asset in proportion to the \nremaining right of use (i.e., decrease in leased space) , the post -modification right -of-use asset is \n$190,163 (pre -modification right -of-use asset of $380,325 multiplied by the 50% reduction in leased \nspace ). To calculate the adjustment to the right -of-use asset , Lessee Corp would compare the \nrecalculated and original right -of-use asset balances on the modification date as follows . \nOriginal right of use asset $380,325 \nRevised right of use asset 190,163 \n $190,16 2 \nThe adjustment to the lease liability is $186,162 (pre -modification lease liability of $372,325 \nmultiplied by the 50% reduction in leased space). \nLessee Corp would record the following journal entry to adjust the lease liability and right -of-use asset , \nwith the difference between the adjustment t o the lease liability and right -of-use asset being recorded \nto the income statement . \nDr. Lease liability $186,162 \nDr. Loss 4,000 \nCr. Right of use asset $190,16 2 \nNext, Lessee Corp would adjust the lease liability to equal the present value of the remaining future \nlease payments (as calculated above). The adjustment would be calculated as follows: \nPresent value of remaining future lease payments $213,651 \nLease liability balance (after adjustment from the journal entry above) $186,163 \n $27,488 \nLessee Corp would record the following journal entry: \nDr. Right of use asset $27,488 \nCr. Lease liability $27,488 \nAfter this entry, the post -modification right -of-use asset would be $217,651 and the post -modification \nlease liability would be $213,651. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 220}), Document(page\_content='Modification and remeasurement of a lease \n5-43Income statement impact \nLessee Corp would recalculate the single lease expense using the following formula. \nFuture undiscounted cash flows at the remeasurement date + (the right -of-use asset \nimmediately after the remeasurement - the lease liab ility immediately after the \nremeasurement) \nRemaining lease term \n$230,000 + ($ 217,651 - $213,651 ) \n4 = $58,500 single lease expense \nLessee Corp would recognize single annual lease expense of $58,500 for the remaining term of the \nlease. \nA comparison of the income statement and balance sheet impact under the two alternative policy \nchoices is below. \nRemeasuring \nright -of-use \nasset based on Balance sheet Income statement \* \nRevised lease \nliability Revised right -\nof-use asset Loss recorded \nat modification \ndate Annual lease \nexpense for \nremaining \nlease term \nChange in lease \nliability $213,651 $218,241 $3,410 $58,648 \nRemaining right \nof use $213,651 $217,651 $4,000 $58,500 \n\* Note the total income statement impact for either method should be the same over the entire lease term, the difference is \ntiming over when the amounts are recognized. In this example, th e total income statement impact for each meth od does not \nmatch exactly due to rounding. \nWhen a lessee and l essor agree to early terminate a portion of the leased asset (e.g., a floor of a \nbuilding or a portion of a warehouse) against payment of a termina tion penalty by the lessee to the \nlessor, the lessee should ap ply modification accountin g to the remaining lease. That is, termination \naccounti ng should not be applied, and the lessee should allocate the termination penalty to the \nremaining lease. If there are multiple components in the remai ning lease, the lessee should allocate \nthe termination penalty to these components based on the ir relative standalone price at the contract \nmodification date. The subsequent accounting will depend on the classification o f the remaining lease \ncomponents. \nThere may be a situatio n when a lessee and less or have multiple lease con tracts with each oth er and \nthey a gree that the lessee will early exit one lease in si x mont hs against payment of a termination \npenalty and simultaneousl y modify another lease. In t his instance, the lessee should apply \nmodification accounting to all the l eases and allocate the termination penal ty and the remaining \ncontract consideratio n for all the l eases to all the lease components based o n their relative standalone \nprice at the modification date. The subsequent accounting will depend on the classification of each of \nthe lease components. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 221}), Document(page\_content='Modification and remeasurement of a lease \n5-44When a lessee and a lessor have multiple leases between them and agree to early terminate one lease \nwith immediate exit by the lessee from the leased property against payment of a termination penalty \nwith out amending any of the other leases, the lessee should apply termination accounting to the early \nterminated lease . That is, the lessee should expense the entire termination penalty. However, if in \naddition to agreeing to early terminate one lease with imm ediate exit by the lessee from the leased \nproperty , the lessee and lessor also modify another lease, we believe the lessee should allocate the \ntermination penalty and the remaining contract consideration for the leases that will continue to all \nthe lease c omponents , including the terminated lease , based on their relative standalone price at the \nmodification date. The subsequent accounting for the remaining lease components will depend on \ntheir classification. \nExample LG 5-11 illustrates recognition of a termination penalty by a lessee due to a lease modification \nwhen the lease term of one lease is extended and another lease with the same lessor is early terminated \nwith immediate exit by the lessee from the property at the lease amendment date . \nEXAMPLE LG 5 -11 \nAccounting for a concurrent early lease termination of one lease and a lease extension of another lease \nbetween the same lessee and lessor - no change to lease classification \nLessee Corp is 2 years into a 7-year operating lease for an office building and 3 years into a 5 -year \noperating lease for a warehouse with Lessor Corp. Lessor Corp and Lessee Corp agree to concurrently \namend the two leases such that Lessee Corp will (a) extend the term of office building lease by three \nmore years (i.e., a total remaining lease term of eight years), (b) vacate the warehouse immediately at \nthe amendment date, and (c) pay Lessor Corp a termination penalty of $2 million at the lease \namendment date . Lessee Corp will continue to classify the office build ing lease as an operating lease \nafter the amendment. \nThe remaining rents under the warehouse lease are above market at the lease amendment date . The \nfair value of the amount that would need to be paid to someone to assume the warehouse lease is $2.5 \nmillio n. \nAssume that the present value of the remaining lease payments on the office building lease at the \nlessee’s discount rate on the lease amendment date is $10 million and the fair value of the comparable \nmarket rents is $ 9 million. \nHow should Lessee Corp account for the lease amendments? \nAnalysis \nThe leas es standard does not address the scenario in this example. We believe in this fact patte rn, $12 \nmillion ($2 million termination payment for the warehouse lease + $10 mi llion present value of \nremaining rent on the office building lease ) should be allocated to both the lease termination and the \namendment . The amount allocated to the warehouse lease should be expensed at the amendment date \nand the amount allocated to the office building lease shou ld be recognized as straight -line rent expense \nduring the remaining eight -year lease term. The allocation is as follows : ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 222}), Document(page\_content='Modification and remeasurement of a lease \n5-45(in million$) Fair value \n(A) Relative % \n(A/$11.50) \n(B) Actual amount \n(C) Allocated \namount \n(B × $12.0 ) \n(D) \nWarehouse \nlease \ntermination \npayment $2.5 21.7% $2.0 $2.6 \nOffice building \nlease remaining \nlease payments 9.0 78.3% $10.0 9.4 \nTotal $11.50 100% $12.0 $12.0 \nBased on the above, Lessee Corp would expense $2.6 million as termination for the warehouse lease \nand recognize $9.4 million as straight -line rent expense during the remaining eight -year lease term for \nthe office building lease. \n5.5.2 Purchase of a leased asset during the lease term — lessee \nA lessee’s accounting for the purchase of an underlying asset is descr ibed in ASC 842 -20-40-2. \nASC 842 -20-40-2 \nThe termination of a lease that results from the purchase of an underlying asset by the lessee is not the \ntype of termination of a lease contemplated by paragraph 842 -20-40-1 but, rather, is an integral part \nof the purchase of the underlying asset. If the lessee purchases the underlying asset, any difference \nbetween the purchase price and the carrying amount of the lease liability immediately before the \npurchase shall be recorded by the lessee as an adjustment of th e carrying amount of the asset. \nHowever, this paragraph does not apply to underlying assets acquired in a business combination, \nwhich are initially measured at fair value in accordance with paragraph 805 -20-30-1. \n5.6 Accounting for a lease modification – less or—updated \nSeptember 2021 \nA lessor’s accounting for a lease modification depends on the type of modification made to the lease. \nDepending on the changes made to the lease contract, a lease modification can result in either a \nseparate new contract (i.e., accounted for separate from the original contract ) or a new modified \ncontract . \nFigure LG 5 -3 illustrates the steps to determine the accounting for a change made to a lease. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 223}), Document(page\_content='Modification and remeasurement of a lease \n5-46Figure LG 5-3 \nLessor’s accounting for a lease modification \nA lessor should account for all initial direct costs, lease incentives, and any other payments made to or \nby the entity in connection with a modification to a lease in the same manner as those items would be \naccounted for in connection with a new lease. \n5.6.1 Separate new contract — lessor \nA lessor should apply the same accounting as a lessee for a modification that results in a separate new \ncontract . See LG 5.2.1.1 for more information on a lessee’s accounting for a separate new contract . \n5.6.2 Single m odified lease — lessor \nIf a lease modification is not accounted for as a separate contract , a lessor should reassess the modified \ncontract for whether it is a lease or contains a lease . If the modified contract is a lease or contains an \nembedded lease , a lessor should account for as a single new lease from the effective date of the \n', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 224}), Document(page\_content='Modification and remeasurement of a lease \n5-47modification. Since the modified lease is recorded as a single new lease, the lease classification should \nbe reassessed based on the modified terms. We believe a lessor should use the relative standalone \nselling prices at the modification date to allocate the remaining contract consideration among the \napplicable contract components at the modification date. See LG 2.3 for information about the \ndefinition of a lease. See LG 2.4.3 for information on the allocation of contract consideration to \ncomponents. The accounting treatment depends on the lease type before and after the modification. \nSee LG 3 for information on lease classification. \n5.6.2.1 Direct financing lease prior to the modification \nThe accounting for the modification of a direct financing lease will depend on how the lease is \nclassified after it is modified. \nFigure LG 5 -4 summarizes the accounting for the modification of a direct financing lease. \nFigure LG 5-4 \nAccounting for the modification of a direct financing lease \nModified lease \nclassification Lessor accounting Example \nDirect financing lease The net investment in the modified lease does not \nchange at the modification date. The lessor should \nadjust the discount rate for the modified lease so that \nthe initial net investment in the modified lease \nequals the carrying amount of the net investment in \nthe original lease, net of any deferred selling profit, \nimmediately before the effective date of the \nmodification plus any capitalized initial direct costs \nincurred in conjunction with the modification Example LG 5-10 \nSales -type lease The lessor should account for the modified lease in \naccordance with ASC 842 -30. The commencement \ndate of the modified lease is the effective date of the \nmodification. In order to calculate the selling profit \nor loss on the lease, the fair value of the underlying \nasset is its fair value at the effective date of the \nmodification and its carrying amount is the carrying \namount of the net investment in the original lease \nimmediately before the effective date of the \nmodification. Initial direct costs incurred in \nconjunction with a modification sh ould be expensed \nunless the fair value of the underlying asset at the \nmodification date equals its carrying amount (i.e ., \nthere is no selling profit). In that case, the initial \ndirect costs would be deferred and recognized over \nthe lease term using a metho d that produces a \nconstant periodic rate of return on the lease when \ncombined with the interest income on the lease \nreceivable and the residual asset. \nIn applying the lease classification criteria, it is \npossible for lease arrangements with variable lease \npayments to be classified by a lessor as a sales -type Example LG 5-11 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 225}), Document(page\_content='Modification and remeasurement of a lease \n5-48Modified lease \nclassification Lessor accounting Example \nlease. T his may lead to the recognition o f a selling \nloss (i.e., day-one loss) by the lessor even if the \noverall arrangement is expected t o be profitable . In \nresponse t o concerns raised in the post \nimplementation revi ew, the FASB published ASU \n2021- 05, which upon adoption requires a lessor to \nclassify a lease with variable lease payments (that do \nnot depend on an index or a rate) as a n operating \nlease at the lease commencement date if classifying \nthe lease as a sales-type lease (or direct financing \nlease) would result in recognition of a selling loss. \nSee LG 9.11 for the effective date and transition \nrequirements of ASU 2021-05. See Example LG 4- 9 \nfor an illustration of a lease with variab le payments. \n Operating lease The lessor should recognize the underlying asset at \nthe carrying amount of the net investment in the \noriginal lease immediately before the effectiv e date of \nthe modification. Initial direct costs incurred in \nconjunction with the modification are initially \ncapitalized and then recognized as an expense on the \nsame basis as lease income. Example LG 5-12 \nExample LG 5-12, Example LG 5-13 and Example LG 5-14 illustrate the accounting for the \nmodification of a direct financing lease. \nEXAMPLE LG 5-12 \nModification of a direct financing lease that does not impact classification \nOn January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease non -specialized \ndigital imaging equipment. The following table summarizes information about the lease and the leased \nequipment at lease commencement . \nLease comme ncement date January 1, 20X1 \nLease term 5 years, no renewal option \nRema ining e conomic life of the leased equipment 10 years \nPurchase option None \nAnnual lease payments $195,000 \nPayment date January 1 \nFair value of the leased equipment at commencement $1,200,000 \nLessor Corp’s carrying value of the leased equipment at \ncomme ncement $1,200,000 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 226}), Document(page\_content='Modification and remeasurement of a lease \n5-49Estimated residual value $400,000 \nResidual value guarantee $300,000 residual value guarantee is \nprovided by a third party unrelated to \nLessee Corp or Lessor Corp \nRate implicit in the lease 5.0% \nOther Title to the asset remains with Lessor \nCorp upon lease expiration \nAt the end of year 1 of the lease, Lessor Corp agrees to modify the lease to extend the lease by one year. \nThe key information at the modification date is shown in the following table. \nModification date December 31, 20X1 \nRemaining modified lease term 5 years, no renewal option \nRemaining economic life 9 years \nPurchase option None \nAnnual lease payment $168,00 0 \nPayment date January 1 \nFair value of the leased equipment at the modification \ndate $1,000,000 \nLessor Corp’s carrying amount of net investment in the \nlease on the modification date $1,055,201 (interest income of $50,201 \nwas recorded in the first year of the \nlease) \nEstimated residual value $360,000 \nResidual value guarantee $275,000 residual value guarantee is \nprovided by a third party unrelated to \nLessee Corp or Lessor Corp \nRate implicit in the modified lease 6.75% \nThe modified lease consideration is at a discount to the current market rate for the additional term for \nthis particular lease contract. Collectibility of lease payments is probable. A ny additional right of use, \nthe original contract and the modified contract meet the definition of a lease. \nHow would Lessor Corp account for the lease modification? ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 227}), Document(page\_content='Modification and remeasurement of a lease \n5-50Analysis \nDetermine if the lease modification is a separate new contract \nAs the modification does not grant an additional right of use (an increase in lease term is not \nconsidered an additional right of use) , Lessor Corp would determine that the modificatio n is not a \nseparate new contract. Since the modified contract meets the definition of a lease, Lessor Corp should \naccount for one new modified lease as of December 31, 20X1. \nReassess lease classification based on the terms of the modified lease \nBased on t he facts at lease commencement, Lessor Corp could reasonably conclude that the lease was \nnot a sales -type lease because none of the criteria in ASC 842 -10-25-2 were met (see LG 3.3 for lease \nclassification criteria). Lessor Corp could further reasonably co nclude that the lease was a direct \n]financing lease because the sum of the present value of the lease payments and the present value of \nthe residual asset guaranteed by the third -party guarantor was substantially all of the fair value of the \nleased equipme nt and collectibility of the lease payments was probable. Therefore, Lessor Corp would \ninitially recognize a net investment in the lease of $1,200,000 and derecognized the carrying value of \nthe equipment of $1,200,000. \nAt the lease modification date , Less or Corp would base its lease classification reassessment on the \nequipment fair value as of the modification date and discount rate implicit in the modified lease \n(6.75%). Lessor Corp could reasonably conclude that t he lease is not a sales -type lease becaus e none of \nthe criteria in ASC 842 -10-25-2 are met (see LG 3.3 for lease classification criteria) . Lessor Corp could \nfurther reasonably conclude that the lease is a direct financing lease because the sum of the present \nvalue of the lease payments and the pr esent value of the residual asset guaranteed by the third -party \nguarantor is substantially all of the fair value of the leased equipment and collectibility of the lease \npayments is probable. \nAccount for the modified lease \nTo account for the modified lease , Lessor Corp would carry forward the net investment in the lease \nimmediately before the effective date of the modification ($1,055,201); this would be the opening \nbalance of the net investment in the modified lease. To retain the same net investment in th e lease \nwhile the lease payments, lease term, and estimated residual value have changed, Lessor Corp must \nadjust the discount rate for the lease from the rate implicit in the modified lease of 6.75% to the rate \nthat when applied to the total remaining leas e payments and the estimated residual value produces a \npresent value equal to the initial net investment of $1,055,201, which is 4.66%. Prospectively, Lessor \nCorp would recognize interest income on the lease based on 4.66%. \nEXAMPLE LG 5-13 \nModification of a direct financing lease that changes lease classification to a sales -type lease \nOn January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease non -specialized \ndigital imaging equipment. The following table summarizes information about th e lease and the leased \nequipment at lease commencement . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 228}), Document(page\_content='Modification and remeasurement of a lease \n5-51Lease commencement date January 1, 20X1 \nLease term 5 years, no renewal option \nRemaining e conomic life of the leased \nequipment 10 years \nPurchase option None \nAnnual lease payments $195,000 \nPayment date January 1 \nFair value of the leased equipment at \ncommencement $1,200,000 \nLessor Corp’s carrying value of the leased \nequipment at commencement $1,200,000 \nEstimated residual value $400,000 \nResidual value guarantee $300,000 residual value guarantee is provided \nby a third party unrelated to Lessee Corp or \nLessor Corp \nRate implicit in the lease 5.0% \n Other Title to the asset remains with Lessor Corp upon \nlease expiration \nAt the end of year 2 of the lease, Lessor Corp agrees to modify the lease to extend the lease term by \nthree years. The key information at the modification date is as shown in the following table. \nModification date January 1, 20X3 \nRemaining modified lease term 6 years, no renewal option \nRemaining economic life 7 years \nPurchase option None \nAnnual lease payment $190,00o \nPayment date January 1 \nFair value of the leased equipment at the \nmodification date $1,000,000 \nLessor Corp’s carrying amount of net investment \nin the lease on the modification date $903,169 (interest income of $93,169 was \nrecorded in the first 2 years of the lease) ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 229}), Document(page\_content='Modification and remeasurement of a lease \n5-52Estimated residual value $100,000 \nResidual value guarantee $75,000 residual value guarantee is provided by \na third party unrelated to Lessee Corp or Lessor \nCorp \nRate implicit in the modified lease 8.49% \nThe modified lease consideration is at a discount to the current market rate for the additional term for \nthis particular lease contract. The collectibility of lease payments is probable. A ny additional right of \nuse, the original contract , and the modified contract meet the definition of a lease. \nHow would Lessor Corp account for the lease modification? \nAnalysis \nDetermine if the lease modification is a separate new contract \nAs the modification does not grant an additional right of use (an increase in lease term is not \nconsidered an additional right of use) , Lessor Corp would determine that the modification is not a \nseparate new contract . Since the modified contract meets the definition of a lease, Lessor Corp would \naccount for one new modified lease as of January 1, 20X3. \nReassess lease classification based on the terms of the modified lease \nBased on the facts at lease commencement, Lesso r Corp could reasonably conclude that the lease was \nnot a sales -type lease because none of the criteria in ASC 842 -10-25-2 were met (see LG 3.3. for lease \nclassification criteria). Lessor Corp could further reasonably conclude that the lease was a direct \nfinancing lease because the sum of the present value of the lease payments and the present value of the \nresidual asset guaranteed by the third -party guarantor was substantially all of the fair value of the \nleased equipment and collectibility of the lease pa yments is probable. Therefore, Lessor Corp would \ninitially recognize a net investment in the lease of $1,200,000 and derecognized the carrying value of \nthe equipment of $1,200,000. \nAt the lease modification date , Lessor Corp could reasonably conclude that the lease is a sales -type \nlease because the remaining lease term of six years represents a major part of the remaining economic \nlife of seven years (see LG 3.3. for lease classification criteria) . \nAccount for the modified lease \nTo account for the modified lease, Lessor Corp would recognize a net investment in the sales -type \nlease of $1,000,000 (the fair value of the equipment on that date) and derecognize the net investment \nin the original direct financing lease of $903,169. The difference between these two amounts ($96,831) \nis the selling profit. See LG 4.3.1.1 for further details on accounting for selling profit. \nAfter the modification, Lessor Corp would account for the lease in accordance with ASC 842 -30, as it \nwould any other sales -type lease. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 230}), Document(page\_content='Modification and remeasurement of a lease \n5-53EXAMPLE LG 5-14 \nModification of a direct financing lease that changes lease classification to an operating lease \nOn January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease non -specialized \ndigital imaging equipment. The following tabl e summarizes information about the lease and the leased \nequipment at lease commencement . \nLease commencement date January 1, 20X1 \nLease term 5 years, no renewal option \nRemaining e conomic life of the leased \nequipment 10 years \nPurchase option None \nAnnual lease payments $195,000 \nPayment date January 1 \nFair value of the leased equipment at \ncommencement $1,200,000 \nLessor Corp’s carrying value of the leased \nequipment at commencement $1,200,000 \nEstimated residual value $400,000 \nResidual value guarantee $300,000 residual value guarantee is provided \nby a third party unrelated to Lessee Corp or \nLessor Corp \nRate implicit in the lease 5.0% \nOther Title to the asset remains with Lessor Corp upon \nlease expiration \nAt the end of year 1 of the lease, Lessor Corp agrees to modify the lease to shorten the lease term by \ntwo years. The key information at the modification date is shown in the following table. \nModification date January 1, 20X2 \nRemaining modified lease term 2 years, no renewal option \nRemaining economic life 9 years \nPurchase option None \nAnnual lease payment $190,00o ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 231}), Document(page\_content='Modification and remeasurement of a lease \n5-54Payment date January 1 \nFair value of the leased equipment at the \nmodification date $1,000,000 \nLessor Corp’s carrying amount of net investment \nin the lease on the modification date $1,055,201 (interest income of $50,201 was \nrecorded in the first year of the lease) \nEstimated residual value $700,000 \nResidual value guarantee No residual value guarantee is provided \nRate implicit in the modified lease 5.43% \nThe modified lease consideration is at a discount to the current market rate for the additional term for \nthis particular lease contract. Collectibility of lease payment i s probable. A ny additional right of use, \nthe original contract , and the modified contract meet the definition of a lease. \nHow would Lessor Corp account for the lease modification? \nAnalysis \nDetermine if the lease modification is a separate new contract \nAs the change in lease term is not an additional right of use, Lessor Corp would determine that the \nmodification is not a separate new contract. Since the modified contract meets the definition of a lease, \nLessor Corp would account for one new modified lease a s of January 1, 20X2. \nReassess lease classification based on the terms of the modified lease \nBased on the facts at lease commencement, Lessor Corp could reasonably conclude that the lease was \nnot a sales -type lease because none of the criteria in ASC 842-10-25-2 were met (see LG 3.3 for lease \nclassification criteria). Lessor Corp could further reasonably conclude that the lease was a direct \nfinancing lease because the sum of the present value of the lease payments and the present value of the \nresidual asset guaranteed by the third -party guarantor was substantially all of the fair value of the \nleased equipment and collectibility of the lease payments was probable. Therefore, Lessor Corp would \ninitially recognize a net investment in the lease of $1,200,00 0 and derecognized the carrying value of \nthe equipment of $1,200,000. \nAt the lease modification date , Lessor Corp could reasonably conclude that the modified lease as an \noperating lease because it does not meet any of the criteria to be classified as a sa les-type lease or \ndirect financing lease (see LG 3.3 for lease classification criteria) . \nAccount for the modified lease \nLessor Corp would account for the modified lease by derecognizing the net investment in the lease of \n$1,055,201 and recognizing the equipment at the same amount. If collectibility of the lease payments \nis probable, Lessor Corp would recognize the remaining lease payments on a straight -line basis over \nthe two -year modified lease team and record depreciation on the equipm ent. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 232}), Document(page\_content='Modification and remeasurement of a lease \n5-555.6.2.2 Operating lease prior to the modification — lessor \nThe accounting for the modification of an operating lease will depend on how the lease is classified \nafter it is modified. \nFigure LG 5 -5 summarizes the accounting for the modification of an operatin g lease. \nFigure LG 5-5 \nAccounting for the modification of an operating lease \nModified lease \nclassification Lessor accounting Example \nDirect financing lease The net investment in the lease on the modification \ndate equals the lessor’s carrying value of the asset \nadjusted for any accrued rent asset or liability on \nthat date. Any selling profit and initial direct costs \nincurred in conjunction with the modification are \ndeferred and included in the measurement of the \ninitial net investment in the modified lease . Any \nunamortized initial direct costs associated with the \noriginal lease may continue to be included in the \nmeasurement of the initial net investment in the \nmodified lease. \nSales -type lease The net investment in the lease on the modification \ndate will equal fair value of the asset. Selling \nprofit/loss would be adjusted for any prepaid or \naccrued rent on that date and any initia l direct costs \nincurred in conjunction with the modification. \nIn applying the lease classification crit eria, it is \npossible for lease arrangements with variabl e lease \npayment s to be classified by a lessor as a sales-type \nlease. T his may lead to the recognition o f a selling \nloss (i.e., day-one loss) by the lessor even if the \noverall arrangement is expected t o be profitable . In \nresponse t o concerns raised in the post \nimplementation review, the FASB published ASU \n2021- 05, which upon adoption requires a lessor to \nclassify a lease with variable lease payments (that \ndo not depend on an index or a rate) as an \noperatin g lease at the lease comme ncemen t date if \nclassifying the lease as a sales-type l ease (or direct \nfinancing lease) would result in recognition of a \nselling loss. See LG 9.11 for the effective date and \ntransition requirements of ASU 2021-05. See \nExample LG 4-9 for an illustration of a lease with \nvariable payments. Example LG 5-16 \nOperating lease No gain or loss is recognized as a result of the \nmodification. A new straight -line lease income is \ncalculated based on the remaining payments \nadjusted for any prepaid or accrued rent at the date \nthe modification is recorded. Any initial direct costs \nincurred in conjunction with the modification are \ninitially capitalized and then recognized as an \nexpense on the same basis as le ase income. Example LG 5-15 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 233}), Document(page\_content='Modification and remeasurement of a lease \n5-56Example LG 5-15 and Example LG 5-16 illustrate the accounting for the modification of an operating \nlease and a sales -type lease, respectively . \nEXAMPLE LG 5-15 \nModification of an operating lease that does not impact lease classification \nOn January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease property to be used \nas a retail store. The following table summarizes information about the lease and the leased property \nat lease commencement . \nLease commencem ent date January 1, 20X1 \nLease term 5 years, no renewal option \nPurchase option None \nAnnual lease payments $500,000 in the first 2 years and $510,000 in \neach year thereafter \nPayment date January 1 \nRemaining e conomic life of the leased property 40 years \nFair value of the leased property at \ncommencement $7,000,000 \nOther Title to the asset remains with Lessor Corp upon \nlease expiration \nOn January 1, 20X4, Lessee Corp and Lessor Corp amend the original lease contract to increase the \nterm of the lease for an additional three years. The key information at the modification date is shown \nin the following table. \nModification date January 1, 20 X4 \nRemaining modified lease term 5 years, no renewal option \nPurchase option None \nAnnual lease payments $507,000 for the next two years and $509,000 \nfor the three years added to the term \nPayment date January 1 \nAccrued rent asset $8,000 \nRemaining economic life of the leased property 37 years \nFair value of the leased property at the \nmodification date $6,750,000 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 234}), Document(page\_content='Modification and remeasurement of a lease \n5-57Estimated residual value $50,000 \nRate implicit in the modified lease 3.28% \nThe increase in lease consideration is at a discount to the current market rate for the additional term \nfor this particular lease contract. Collectib ility of lease payments is probable. A ny additional right of \nuse, the original contract , and the modified contract meet the definition of a lease. \nHow would Lessor Corp account for the lease modification? \nAnalysis \nDetermine if the lease modification is a separate new contract \nSince there is no additional right of use (an increase in lease term is not considered an additional right \nof use), Lessor Corp would determine that the modification is not a separate new contr act. As the \nmodified contract meets the definition of a lease, Lessor Corp would account for one new modified \nlease as of January 1, 20X4. \nReassess lease classification based on the terms of the modified lease \nBased on the facts at lease commencement, Les sor Corp could reasonably conclude the lease was an \noperating lease because it did not meet any of the criteria to be classified as a sales -type lease or as a \ndirect financing lease (see LG 3.3 for lease classification criteria). At the lease modification date , \nLessor Corp could reasonably conclude that the modified lease is an operating lease because it does \nnot meet any of the criteria to be classified as a sales -type lease or as a direct financing lease. \nAccount for the modified lease \nLessor Corp would recognize the lease payments to be received under the modified lease, net of its \naccrued rent asset balance immediately before the modification, on a straight -line basis over the \nremaining five -year lease term as shown below. \n1/1/X4 $507,000 \n1/1/X5 507,000 \n1/1/X6 509,000 \n1/1/X7 509,000 \n1/1/X8 509,000 \nTotal payments $2,541,000 \nLess: accrued rent asset ($8,000) \nNet payments $2,533,000 \nLessor Corp would recognize annual straight -line income of $506,600 ($2,533,000 ÷ 5 years). ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 235}), Document(page\_content='Modification and remeasurement of a lease \n5-58EXAMPLE LG 5-16 \nModification of an operating lease that changes lease classification to a sales -type lease \nOn January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease non -specialized \ndigital imaging equipment. The following table summa rizes information about the lease and the leased \nequipment at lease commencement . \nLease commencement date January 1, 20X1 \nLease term 5 years, no renewal option \nPurchase option None \nAnnual lease payments $150,000 in the first year with a \n4% increase each year thereafter \nPayment date January 1 \nRemaining e conomic life of the leased equipment 10 years \nCarrying value and fair value of the equipment at lease \ncommencement $1,300,000 \nAt the beginning of year 4 of the lease, Lessee Corp and Lessor Corp agree to extend the lease term for \nfour additional years. The key components at the modification date are shown in the following table. \nModification date January 1, 20X4 \nRemaining modified lease term 6 years, no renewal option \nPurchase option None \nAnnual lease payments $173,000 \nPayment date Annually on January 1 \nAccrued rent asset $19,229 \nRemaining economic life of the leased equipment 7 years \nLessor Corp’s carrying value of the leased equipment $910,000 \nFair value of the equipment at the \nmodification date $1,000,000 \nEstimated residual value $50,000 \nRate implicit in the modified lease 3.28% ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 236}), Document(page\_content='Modification and remeasurement of a lease \n5-59The modified lease consideration is at a discount to the current market rate for the additional term for \nthis particular lease contract. Any additional right of use , the original contract , and the modified \ncontract meet the definition of a lease. \nHow would Lessor Corp account for the lease modification? \nAnalysis \nDetermine if the lease modification is a separate new contract \nSince the change in lease term is not an additional right of use , Lessor Corp would not account for the \nmodification as a new lease, se parate from the original five -year lease. As the modified contract meets \nthe definition of a lease, Lessor Corp would account for one new modified lease as of January 1, 20X4. \nReassess lease classification based on the terms of the modified lease \nBased on facts a t lease commencement, Lessor Corp could reasonably conclude that the lease was an \noperating lease because none of the criteria in ASC 842 -10-25-2 were met (see LG 3.3 for lease \nclassification criteria). Lessor Corp would calculate a straight -line r ental revenue amount of $162,490 \nannually. At lease modification , Lessor Corp could reasonably conclude that the modified lease is a \nsales -type lease s ince the modified lease is for a major part of the remaining economic life of the \nequipment. \nAccount for the modified lease \nLessor Corp would record a selling profit based on the following: \nLease receivable $959,000 \nLess: carrying value of the leased asset at the modification date (910,000) \nPlus: present value of the unguaranteed residual value 41,000 \nLess: accrued rent asset balance before the modification (19,229) \nSelling profit $70,771 \nThe net investment in the modified lease is $1,000,000 (lease receivable plus unguaranteed residual \nvalue). \nAfter the modification, Lessor Corp would account for the lease in accordance with ASC 842 -30, as it \nwould any other sales -type lease, using the di scount rate for the lease at the modification date. \n5.6.2.3 Sales -type lease prior to the modification \nThe accounting for the modification of a sales -type lease will depend on how it is classified after it is \nmodified. \nFigure LG 5 -6 summarizes the accounting for the modification of a sales -type lease. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 237}), Document(page\_content='Modification and remeasurement of a lease \n5-60Figure LG 5-6 \nAccounting for the modification of a sales -type lease \nModified lease \nclassification Lessor accounting Example \nDirect financing \nlease The net investment in the modified lease does not \nchange at the modification date. The lessor should \nadjust the discount rate for the modified lease so that \nthe initial net investment in the modified lease equals \nthe carrying amount of the net investment in the \noriginal lease, net of any deferred selling profit \nimmediately before the effective date of the \nmodification plus any capitalized initial direct costs \nincurred in conjunction with the modification. The accounting is \nthe same as shown \nin Example LG 5-10 \nSales -type lease Same as a direct financing lease The accounting is \nthe same as shown \nin Example LG 5-10 \nOperating lease The lessor should recognize the underlying asset at the \ncarrying amount of the net investment in the original \nlease immediately before the effective date of the \nmodification. Any initial direct costs incurred in \nconjunction with the modification are expensed on the \nsame basis as the lease income. The accounting is \nthe same as shown \nin Example LG 5-12 \n5.7 Accounting for lease remeasurement – lessor \nA lessor is not subject to lease remeasurement guidance similar to the remeasurement guidance for a \nlessee. A lessor should account for the exercise by a lessee of an option to extend or terminate the lease \nor to purchase the underlying asset as a lea se modification unless the exercise of that option by the \nlessee is consistent with the assumptions that the lessor made in accounting for the lease at the \ncommencement date of the lease (or the most recent effective date of a modification that is not \nacco unted for as a separate contract). \nQuestion LG 5-9 discusses the accounting by a lessor for reimbursement of capital improvements . \nQuestion LG 5-5 \nLessor Corp and Lessee Corp enter into a 5 -year operating lease of real estate on January 1, 20X1. The \nlease permits Lessor Corp to pass on depreciation costs to Lessee Corp for capital improvements made \nto the building during the lease term . The capital improvements are not an additional performance \nobligation promised by Lessor Corp to Lessee Corp. On January 1 , 20X2, Lessor Corp completes a roof \nreplacement project at a total cost of $100,000 . Lessor Corp has determined the useful life of the \nimprovement to be 10 years. On January 1, 20X2 Lessor Corp determines that Lessee Corp will be \nresponsible to pay additi onal rent of $ 10,000 per year ($100,000 /10 years) during the four - year \nremaining lease term. When should Lessor Corp recognize revenue from the additi onal rent it will \ncollect from Lessee Corp? ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 238}), Document(page\_content='Modification and remeasurement of a lease \n5-61PwC response \nThe amount of consideration due to Lessor Corp over the remainder of the lease term is determinable \nupon completion of the roof replacement. However, since the capital improvement is not a separate \ncomponent, we believe Lessor Corp should record the additi onal rent associated with the capital \nimprovement over the remaining lease term consistent with satisfaction of Lessor Corp’s obligation to \ncontinue to provide Lessee Corp the usage of the underlying asset over the lease term (i.e., on a \nstraight -line basi s over the reminder of the lease term, or $10,000 annually). \n5.8 Accounting for a lease termination – lessor—updated \nSeptember 2021 \nA lessor’s accounting for the underlying asset at the end of the lease term is described in ASC 842 -30-\n35-5.\nASC 842 -30-35-5 \nAt the end of the lease term, a lessor shall reclassify the net investment in the lease to the appropriate \ncategory of asset (for example, property, plant, and equipment) in accordance with other Topics, \nmeasured at the carrying amount of the net investmen t in the lease. The lessor shall account for the \nunderlying asset that was the subject of a lease in accordance with other Topics. \nIf a lease is fully terminated prior to the end of the lease term, a lessor should follow the guidance in \nASC 842 -30-40-2. \nASC 842 -30-40-2 \nIf a sales -type lease or a direct financing lease is terminated before the end of the lease term, a lessor \nshall do all of the following: \na.Test the net investment in the lease for impairment in accordance with Topic 310 on receivables\nand recognize any impairment loss identified\nb.Reclassify the net investment in the lease to the appropriate category of asset in accordance with\nother Topics, measured at the sum of the carrying amounts of the lease receivable (less any\namounts still expecte d to be received by the lessor) and the residual asset\nc.Account for the underlying asset that was the subject of the lease in accordance with other Topics.\nIf a lessee continues to use the asset or a portion of the asset for a period time after the lease \ntermination is agreed upon, the termination should be accounted for as a lease modification based on \nthe modified lease term (through the planned exit date). For example, if the lessee and lessor agree to \nterminate a lease in six months with a termination penalty, the lease should be accounted for as a \nmodified lease with a six -month term. \nQuestion LG 5 -6 discusses the accounting by a lessor for a termination penalty paid by a lessee due to \na modification of two leases between them with immediate exit of one property by the lessee at the \nlease modification date . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 239}), Document(page\_content='Modification and remeasurement of a lease \n5-62Question LG 5 -6 \nLessor Corp is 2 years into a 7 -year operating lease for an office building and 3 years into a 5 -year \noperating lease for a warehouse with Lessee Corp. Lessor Corp and Lessee Corp a gree to concurrently \namend the two leases such that Lessee Corp will (a) extend the term of office building lease by three \nmore years (i.e., a total remaining lease term of eight years), (b) vacate the warehouse immediately at \nthe amendment date, and (c) p ay Lessor Corp a termination penalty of $2 million at the lease \namendment date. Lessee Corp will continue to classify the office building lease as an operating lease \nafter the amendment. \nHow should Lessor Corp account for these lease amendments ? \nPwC response \nWhile this fact pattern is not addressed exactly in the leases standard, we believe the guidance in ASC \n842-10-25-15 can be applied by analogy.\nUnder ASC 842 -10-25-15, if an operating lease is modified and the modification is not accounted for as \na separate contract, a lessor should account for the modification as a termination of the existing lease \nand creation of a new lease at the modification date . If the new lease created is an operating lease, the \nlessor should include any prepaid or accrued rent balance from the original lease as part of the lease \npayments for the modified lease. \nBased on an an alogy to ASC 842-10-25-15, we believe Lessor Corp should account for the $2 million \npayment received from Lessee Co rp for the warehouse lease termination as prepaid rent and include it \nas part of the lease payments for the modified office building lease . Lessor Corp would subsequently \nrecognize $2 million lease income on a straight -line basis over the remaining eight -year lease term . \nQuestion LG 5 -7 discusses the income statement recognition by a lessor for a payment made to a lessee \nto induce the lessee to terminate an operating lease before the end of the lease term when the payment \nmeets the definition of initial direct cost . \nQuestion LG 5 -7 \nLessor Corp makes a payment to Lessee Corp to induce Lessee Corp to terminate the lease before the \nend of the lease term so that Lessor Corp may enter into a new lease with a different lessee . The new \nlease with the new lessee is classified as operating by Lessor Corp and Lessor Corp determines the \npayment made by Lessor Corp to Lessee Corp meets the definition of an initial direct cost . \nShould Lessor Corp recognize the payment to Lessee Corp as an expense or as a reduct ion in revenue \nin its income statement if Lessor Corp determines that the payment to Lessee Corp meets the \ndefinition of initial direct cost ? \nPwC response \nLessor Corp needs to first determine whether the payment made by Lessor Corp to Lessee Corp meets \nthe definition of an initial direct cost (see LG 4.2.2.2 for initial direct costs). If it does, based on the \nguidance ASC 842 -30-25-11(c), Lessor Corp should recognize the initial direct cost as an expense, and \nnot as a reduction in revenue in its income sta tement, over the term of the new lease on the same basis \nas lease income in its income statement (which is generally on a straight -line basis). ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 240}), Document(page\_content='PwC 1 Chapter 6: \nSale and leaseback \ntransactions —\nupdated June 2021 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 241}), Document(page\_content='Sale and leaseback transactions \n6-26.1 Sale and leaseback transactions : chapter overview \nThis chapter discusses the specifi c accounting considerations applicable to sale and leaseback \ntransactions . Different accounting outcomes can exist depending on the structure of the transaction. \nIn addition, the accounting treatment can be complex. It is important to understan d the accounting \nguidance and key considerations when evaluating a sale and leaseback transaction. \nDetermining whether a sale has occurre d in the context of a sale and leaseback transaction is very \nimportant an d determines the initia l and subsequent accounting. This chapter details the accounting \nfor both when the transaction qualifies as a sale an d when it does not fro m both the seller-lessee’s and \nbuyer-lessor’s perspectives. \nSee FSP 14 for information on the disclosure requirements for sale and leaseback transactions by \nboth seller-lessees and buyer-lessors. \n6.2 Sale and leaseback transactions : introduction \nIn a sale and leaseback transaction, one party (the seller -lessee) sells an asset it owns to another party \n(the buyer -lessor) and simultaneously leases back all or a portion of the same asset for all, or part of, \nthe asset ’s remaining economic life . The seller -lessee transfers legal ownership of the asset to the \nbuyer -lessor in exchange for consideration , and then makes period ic rental payments to the buyer -\nlessor to retain the use of the asset . \nSale and leaseback transactions occur in a number of situations and are economically attractive for \nseller -lessees as they can be used to : \n□Generate cash flows\n□Effectively refinance at a lower rate due to the transfer of tax ownership and related tax benefits\n□Reduce exposure to the risks of owning assets\n□Result in less financing reflected on the balance sheet than under a traditional mortgage\n□Provide temporary transition space to a seller -lessee that is relocating to a new property\nReporting entities often enter into sale and leaseback transactions with appreciated assets , such as real \nestate, as well as large -ticket assets , such as airplanes, rail cars , and freight ships. \nWhile some transactions are easily identified as sales and leasebacks, certain arrangements required to \nbe accounted for as a sale and leaseback may not be as obvious . For example, w hen a lease will not \ncommence until after an asset is constructed, the lessee may obtain control of the underlying asset \nduring the construction period , prior to lease co mmencement. This arrangement may be subject to \nsale and leaseback accounting. \n6.2.1 Sale and l easeback -sublease transactions \nA sale and leaseback -sublease occurs when a seller -lessee enters into a sale and leaseback of an \nunderlying asset that is subject to an existing operating lease or is subleased (or intended to be ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 242}), Document(page\_content='Sale and leaseback transactions \n6-3subleased ) by the seller -lessee to another party under an operating lease. For example, an entity may \npurchase a vehicle and lease it to a third party under an operating lease. If the entity then sells the \nvehicle to a bank and leases it back under an operating lease , the entity is now a lessee -sublessor and \nsubject to sale and leaseback accounting, as described in this chapter . \n6.3 Sale and leaseback: determining whether a sale has \noccur red—updated September 2021 \nA transaction is accounted for as a sale of an underlying asset and a leaseback of that underlying asset \nonly if th e initial transaction qualifies as a sale in accordance with ASC 606, Revenue from Contracts\nwith Customers (the “revenue standard ”).\nTo qualify as a sale of an asset under the revenue standard , the seller -lessee needs to ensure the \ncustomer (in this case, the buyer -lessor) obtain s control of the asset. ASC 842-40-25-1 references the \nrevenue standard for purposes of evaluating whether the transfer of an asset should be accounted for \nas a sale. \nASC 842 -40-25-1 \nAn entity shall apply the following requirements in Topic 606 on revenue from contracts with \ncustomers when determining whether the transfer of an asset shall be accounted for as a sale of the \nasset: \na.Paragraphs 606 -10-25-1 through 25 -8 on the existence of a contract\nb.Paragraph 606 -10-25-30 on when an entity satisfies a performance obligation by transferring\ncontrol of an asset.\nSale and leaseback transactions must also be evaluated to determine whether the classification of the \nleaseback or the existence of a seller -lessee repurchase option prevent accounting for the transfer of \nthe asset as a sale. See LG 6.3.4 for information on the impact of lease classification on qualification as \na sale and LG 6.3.5 for information on repurchase rights and obligations and renewal rights in a sale \nand leaseback transaction. \n6.3.1 Sale and leaseback: Existence of a contract \nThe first step is to identify the contract. A contract can be written, oral, or implied by an entity ’s \ncustomary business practices. Generally , any agreement that creates legally enforceable rights and \nobligations mee ts the definition of a contract. \nASC 606 -10-25-1 lists the criteria that must be met for a reporting entity to conclude that a contract \nexists. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 243}), Document(page\_content='Sale and leaseback transactions \n6-4 Excerpt from ASC 606 -10-25-1 \nAn entity shall account for a contract with a customer… only when all of the foll owing criteria are met: \na. The parties to the contract have approved the contract (in writing, orally, or in accordance with \nother customary business practices) and are committed to perform their respective obligations. \nb. The entity can identify each party ’s rights regarding the goods or services to be transferred. \nc. The entity can identify the payment terms for the goods or services to be transferred. \nd. The contract has commercial substance (that is, the risk, timing, or amount of the entity ’s future \ncash flows is expected to change as a result of the contract). \ne. It is probable that the entity will collect substantially all of the consideration to which it will be \nentitled in exchange for the goods or services that will be transferred to the customer. \nSee RR 2.6 for information on identifying and evaluating the existence of a contract. \n6.3.2 Sale and leaseback: Control i ndicators \nWhen evaluating if control has been transferred to the buyer -lessor in a sale and leaseback transaction, \nASC 842 requires a report ing entity to look to the five transfer of control indicators in the revenue \nstandard , which are : \n□ The reporting entity has a present right to payment \n□ The customer has legal title \n□ The customer has physical possession \n□ The customer has the significant risks and rewards of ownership \n□ The customer has accepted the asset \nThis is a list of indicators, not criteria. Not all of th e indicators need to be met for a reporting entity to \nconclude that control has transferred to the buyer -lessor in a sale and leaseback transaction ; the \nfactors should be evaluated collectively to determine whether the buyer -lessor has obtained control. \nThis assessment should be focused primarily on the buyer -lessor ’s perspective. Judgment will be \nrequired to determin e whether a sale has occurred . The conclusion will be based on the facts and \ncircumstances of the transaction. See RR 6.2 for information on determining whether control of an \nasset has been transferred. \nThe sections that follow describe how e ach of the ind icators are applied in the context of a sale and \nleaseback transaction . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 244}), Document(page\_content='Sale and leaseback transactions \n6-5 6.3.2.1 Sale and leaseback: P resent right to payment \nA buyer -lessor ’s present obligation to pay could indicate that the seller -lessee has transferred the \nability to direct the use of the asse t and the buyer -lessor has obtain ed substantially all of the remaining \nbenefits from the asset . The seller ’s motivation i n a typical sale and leaseback transaction is to \ngenerate liquidity . According ly, the buyer -lessor typically pays the agreed upon purchase price for the \nasset upfront , in which case this indicator would be satisfied . In instances where the buyer -lessor does \nnot make an upfront payment, the seller -lessee will need to further evaluate whe ther a present right to \npayment exists. \n6.3.2.2 Sale and leaseback: Buyer -lessor has legal title \nThe party that has legal title is typically the party that can direct the use of and receive the benefits \nfrom an asset. The benefits of holding legal title include the ability to sell an asset, exchange it for \nanother good or service, or use it to secure or settle debt, all of which indicate that the holder has \ncontrol. \nWhile not determinative in isolation , we believe the transfer of legal title to a buyer is an imp ortant \nindicator when distinguishing between whether a transaction results in a sale or a lease of an asset . \n6.3.2.3 Sale and leaseback: Buyer -lessor has physical possession \nPhysical possession of an asset typically gives the holder the ability to direct the use of and obtain \nbenefits from that asset ; therefore , it is an indicator of which party controls the asset. However, \nphysical possession does not, on its own, determine which party has control. A reporting entity should \nconsider the facts and circumstances of each arrangement to determine whether physical possession \ncoincides with the transfer of control. \nIn a typical sal e and leaseback transaction, the buyer -lessor obtains legal title to the asset concurrent \nwith commencement of the leaseback term. The buyer -lessor obtains the rights of ownership and is \ndeemed to have physical possession of the asset , but grants the selle r-lessee a right -of-use interest (i.e., \na lease) in the underlying asset . \n6.3.2.4 Buyer -lessor has significant risks and rewards of ownership \nA seller -lessee that has transferred risks and rewards of ownership of an asset has typically transferred \ncontrol to the buyer -lessor , but not in all cases. Both parties to the arrangement will need to determine \nwhether control has transferred in the event the seller -lessee has retained some of the risks or rewards \nof ownership . \nJudgment may be required when determining if the buyer -lessor has obtained the significant risks and \nrewards of ownership or if certain risks have been retained by the seller -lessee that would preclude the \nbuyer -lessor from control ling the asset . \n6.3.2.5 Sale and leaseback: Buyer -lessor has accepted the asse t \nWhether the buyer -lessor has accepted the asset , as with all indicators of transfer of control, should be \nviewed from the buyer -lessor ’s perspective. Whether the buyer -lessor has f ormal ly accept ed the asset \nshould be taken into consideration along with the other indicators that control has been obtained by ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 245}), Document(page\_content='Sale and leaseback transactions \n6-6 the buyer -lessor in a sale and leaseback transaction. See RR 6.5 for information about customer \nacceptance. \n6.3.2.6 Prospective lessee obtain s control prior to com mencement \nDepending on the terms of an arrangement, a prospective lessee may obtain control of an underlying \nasset prior to lease commencement . If a lessee obtains control of an underlying asset before the lease \ncommencement date , the transaction should b e accounted for as a sale and a leaseback. When \nassessing control , a key factor to consider is whether the lessee has obtained legal title to the asset; \nhowever, this factor is not necessarily determinative , as discussed in ASC 842 -40-55-2. \nASC 842 -40-55-1 \nA lessee may obtain legal title to the underlying asset before t hat legal title is transferred to the lessor \nand the asset is leas ed to the lessee. If the lessee controls the underlying asset (that is, it can direct its \nuse and obtain substantially all of its remaining benefits) before the asset is transferred to the lessor, \nthe transaction is a sale and leaseback transaction that is accounted for in accordance with this \nSubtopic . \nExcerpt from ASC 842 -40-55-2 \nIf the lessee obtai ns legal title, but does not ob tain control of the underlying asset before the asset is \ntransferred to the lessor, the transaction is not a sale and leaseback transaction. \nExample LG 6-1, Example LG 6-2, and Example LG 6 -3 illustrate the assessment of whether a lessee \nhas obtained control of the underlying asset prior to lease commencement. \nEXAMPLE LG 6-1 \nSale and leaseback transaction – lessee obt ains control prior to lease commencement \nContracto r Corp wants to lease a new vehicle for five years. The vehicle manufacturer is not willing to \nenter into lease arrangements, so Contractor Corp identifies a bank that is willing to purchase the \nvehicle and enter into a lease under an agreement that Cont ractor Corp expects to classify as an \noperating lease. \nContractor Corp purchases the vehicle from the manufacturer, takes possession and obtain s legal title . \nShortly thereafter, Contractor Corp sells the vehicle to the bank. The sale agreement requires the bank \nto reimburse Cont ractor Corp for all costs incurred to acquire the vehicle from the manufacturer and \nprovides the bank with legal title to the vehicle. Concurrent with the sale, Contractor Corp and the \nbank enter into a five -year lease of the vehicle. \nShould Contractor Corp account for the transaction as a sale and leaseback? \nAnalysis \nBecause Contractor Corp purchased the vehicle from the manufacturer, obtained legal title, accepted \nthe asset, had physical possession of the asset, and ha d the significant risks and rewards of ownership, \nContractor Corp obtained control of the asset prior to selling the asset to the buyer - lessor (the bank). \nAlthough Contractor Corp intended to lease the vehicle and only temporarily obtained control, the ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 246}), Document(page\_content='Sale and leaseback transactions \n6-7 transaction should be accounted for as a sale and leaseback because Contractor Corp obtained control \nof the underlying asset prior to lease commencement. \nEXAMPLE LG 6-2 \nSale and leaseback transaction – lessee obtains title, but not control prior to lease co mmencement \nContractor Corp wants to lease a new vehicle for five years. The vehicle manufacturer is not willing to \nenter into lease arrangements, so it arranges for a lease between Contractor Corp and a bank . \nContractor Corp expects to classify the lease as an operating lease . For tax reasons, Contractor Corp \nobtains legal title , immediately transfers it to the bank , and concurrently enters into a five -year lease of \nthe vehicle with the bank . \nShould Contractor Corp account for the transaction as a sale and leaseback? \nAnalysis \nNo. Contractor Corp should account for the transaction as a lease arrangement with the bank and not \na sale and leaseback. Contractor Corp obtained legal title to the asse t prior to the lessor (the bank) and \nprior to the commencement of the lease, but did not obtain control of the underlying asset. Although \nContractor Corp had temporary title, it did not obtain the significant risks and rewards of ownership \nand none of the other indicators of control were present. \nEXAMPLE LG 6-3 \nSale and leaseback transaction – lessee sells or transfers its purchase option \nLessee Corp holds an option to purchase an asset and sell or transfer the option (without obtaining \ntitle of the asset) to Lessor Corp provided Lessor Corp will exercise the purchase option and lease the \nasset to Lessee Corp. Lessor Corp , a third party, exercise s the purchase option and leases the asset to \nLessee Corp. \nShould Lessee Corp and Lessor Corp account for the tra nsaction as a sale and leaseback? \nAnalysis \nThere are mixed views on accounting for this type of transaction. To be in the scope of sale and \nleaseback accounting, Lessee Corp should have control of the underlying asset before the purchase \noption is exercised by Lessor Corp. To do this, Lessee Corp and Lessor Corp should analyze various \nfactors , such as the substance of the purchase option , whether it is exercisable immediately , and \nwhether the option strike price is at the current fair value . The tra nsfer of an immediately exercisable \noption at a fixed price would presumably be within the scope of the sale leaseback rules. In contrast, \nthe transfer of an option whose strike price is at prevailing fair value at the time of exercise may not \nfall within the sale leaseback rules , particularly when substantially similar assets are readily available \nin the marketplace . The evaluation is judgmental and needs to be based on facts and circumstances . \n6.3.3 Lessee involvement in construction of leased asset \nWhen a prospective lessee is involved in the construction or design of an underlying asset prior to \nlease commencement (commonly referred to as a “build -to-suit” lease), the lessee should evaluate ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 247}), Document(page\_content='Sale and leaseback transactions \n6-8 whether it controls the asset during the construction perio d. Generally, the evaluation of whether a \nlessee controls an asset under construction is similar to the evaluation in the revenue recognition \nstandard to determine whether a performance obligation is satisfied over time. \nASC 842 -40-55-5 lists several exam ples that demonstrate when a lessee has obtained control during \nthe construction period . \nASC 842 -40-55-5 \nIf the lessee controls the underlying asset being constructed before the commencement date, the \ntransaction is accounted for in accordance with this Subtopic. Any one (or more) of the following \nwould demonstrate that the lessee controls an underlying asset that is under construction before the \ncommencement date: \na. The lessee has the right to obtain the partially constructed underlying asset at any po int during the \nconstruction period (for example, by making a payment to the lessor). \nb. The lessor has an enforceable right to payment for its performance to date, and the asset does not \nhave an alternative use (see paragraph 842 -10-55-7) to the owner -lessor. In evaluating whether \nthe asset has an alternative use to the owner -lessor, an entity should consider the characteristics of \nthe asset that will ultimately be leased. \nc. The lessee legally owns either : \n1. Both the land and the property improvements (for example, a building) that are under \nconstruction \n2. The non -real-estate asset (for example, a ship or an airplane) that is under construction. \nd. The lessee controls the land that property improvements will be constructed upon (this includ es \nwhere the lessee enters into a transaction to transfer the land to the lessor, but the transfer does \nnot qualify as a sale in accordance with paragraphs 842 -40-25-1 through 25 -3) and does not enter \ninto a lease of the land before the beginning of constr uction that, together with renewal options, \npermits the lessor or another unrelated third party to lease the land for substantially all of the \neconomic life of the property improvements. \ne. The lessee is leasing the land that property improvements will be constructed upon, the term of \nwhich, together with lessee renewal options, is for substantially all of the economic life of the \nproperty improvements, and does not enter into a sublease of the land before the beginning of \nconstruction that, together with renewal options, permits the lessor or another unrelated third \nparty to sublease the land for substantially all of the economic life of the property improvements. \nThe list of circumstances above in which a lessee controls an underlying asset that is under \nconstruction before the commencement date is not all inclusive. There may be other circumstances \nthat individually or in combination demonstrate that a lessee controls an underlying asset that is \nunder construction before the commencement date. \nThere hav e been questions raised as to the meaning of “at any point during the construction period”. \nThose questions focus on whether the provision require s the lessee to have the right to obtain the asset \neither (1) at all time s during the construction period (whi ch could include contingent events that are ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 248}), Document(page\_content='Sale and leaseback transactions \n6-9 only triggered upon events within the lessee’s control) or (2) only based on some contingency or stated \nevent. We believe a lessee would be considered the owner of the asset during the construction period if \nthe lessee has the right to obtain the partially -constructed asset at some point during the construction \nperiod (i.e., a call/purchase option) . If the lessee does not have the right at all times, ownership of the \nasset would be imputed at the point in time tha t the lessee has the right to obtain the partially -\nconstructed asset (e.g., when a purchase option becomes exercisable). \nWe believe a lessee’s call option that becomes exercisable solely due to the passage of time would cause \nthe lessee to have control of the partially -constructed asset immediately. If the option is contingent \nupon any other event, and that event is within the lessor’s control or based on the occurrence of an \nexternal event, control does not pass to the lessee until the contingency is reso lved. \nThere may be circumstances in which the purchase option becomes exercisable only upon contingent \nevents occurring, such as when the lessee or the lessor is in default. In these cases, the lessee would \ngenerally be considered to have the right to obta in the partially -constructed asset if the contingent \nevent were within the control of the lessee. All facts and circumstances should be considered carefully. \nFor example, a lease that provides a lessee the right to acquire the partially -constructed asset i f the \nlessee is in default may be considered within the control of the lessee. However, a lessee default under \nthe lease contract may result in economic consequences to the lessee, such as triggering cross defaults \nin the lessee’s other arrangements. The r ight to acquire the partially -constructed asset in this \ncircumstance may not be considered substantive. \nThe existence of a lessee -provided indemnification for preexisting environmental contamination does \nnot, in isolation, result in the lessee obtaining c ontrol of the underlying asset prior to lease \ncommencement regardless of the likelihood of loss as a result of the indemnity. \nThe list of circumstances provided by ASC 842-40-55-5 is not all inclusive ; there may be other \ncircumstances that individually or in combination demonstrate that a lessee cont rols an underlying \nasset under construction before the lease commencement date. As additional circumstances have not \nyet substantially developed in practice, entities will be required to carefull y evaluate the facts and \ncircumstances of each arrangement. For example, we believe if a lessee is required to make lease \npayments regardless of whether the lessor completes construction of the asset (i.e. , a date -certain \nlease) and the lease is expected t o be classified as a finance lease, the lessee has obtained control of the \nasset from lease inception, rather than the lease commencement date. Additionally, we believe a lessee \nthat is required to fund substantially all (i.e., 90% or more ) of the costs of construction that are \nprobable of being incurred during the construction period may have obtained control. However, we do \nnot believe this example is similar to the prescriptive rules in ASC 840. For example, we do not believe \na lessee has obtained contro l of the asset under construction solely because it is required to pay the \nfirst costs of construction or is responsible for cost overruns that are unlimited when such cost \noverruns are not probable of represent ing substantially all of the costs of constru ction. \nWe believe a put option held by the lessor to put the asset under construction to the lessee should be \nassessed to determine whether the lessor has a significant economic incentive to exercise its put right \nconsistent with the guidance regarding repurchase agreements in the new revenue standard. If an \nincentive exists, the lessee would be assumed to control the construction in process and would be \nconsidered the owner of the asset during the construction period. For further guidance, refer to \nRR 8.7 . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 249}), Document(page\_content='Sale and leaseback transactions \n6-10 Examp le LG 6-4 and Example LG 6-5 illustrate the assessment of whether a lessee has obtained \ncontrol of the underlying asset under construction prior to lease commencement. See ASC 842 -40-55-\n39 through ASC 842 -40-55-44 for additional examples. \nEXAMPLE LG 6-4 \nSale and leaseback transaction – lessee obtains control of construction in progress \nUniversity would like to construct a new library on a parcel of land next to its campus. University \nacquires the parcel of land and enters into an agreement with Developer Corp, an independent third \nparty, under which Developer Corp will lease the parcel of land from University, construct the library, \nand lease the completed library to University. Both the ground lease to Developer Corp and th e library \nlease to University h ave 20 -year lease term s. Rental rates on both leases are consistent with prevailing \nmarket rents for similar leased assets. The economic life of the library is 40 years. \nDoes University control the underlying asset during the construction period? \nAnalysi s \nUniversity controls the underlying asset during the construction period because the ground lease to \nDeveloper Corp is for a term that is less than substantially all of the economic life of the property \nimprovements (20-year ground lease/40 -year economic life = 50% ). Accordingly, University should \naccount for the underlying asset during the construction period similar to any other owned asset under \nconstruction (i.e., under ASC 360 , Property, Plant, and Equipment ). Additionally, an y construction \ncosts paid for by Developer Corp should be recorded by University as a financial liability. \nIn symmetry with University ’s accounting, Developer Corp should not recognize the asset under \nconstruction. Rather, Developer Corp should account for any payments it makes during the \nconstruction period as a collateralized loan to the lessee in accordance with ASC 310 , Receivables. \nEXAMPLE LG 6-5 \nSale and leaseback transaction – lessee does not obtain control of construction in proc ess (real estate) \nLaw Firm enters into an arrangement with Developer Corp to lease an office building for 10 years \ncontingent upon Developer Corp completing construction of the asset in accordance with the \nconstruction plan. The construction plan includes Law Firm -specific improveme nts necessary for Law \nFirm to begin operations at the lease commencement date. The budgeted cost of construction is $10 \nmillion. The useful life of the asset is 40 years. Law Firm is obligated to reimburse Developer Corp for \nincreases in the cost of steel from the inception date of the arrangement to the completion date of the \nconstruction project up to a maximum of $250,000. During the construction period, Law Firm has \naccess to the building in order to inspect the progress of the construction and to make discretionary \nimprovements. \nDuring the construction period, Law Firm reimburses Developer Corp for $200,000 due to increase s \nin the cost of steel during the construction period. In addition, Law Firm incurred $100,000 of \nadditional construction costs rela ted to discretionary tenant improvements, including branding \nelements. \nDoes Law Firm control the underlying asset during the construction period? ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 250}), Document(page\_content='Sale and leaseback transactions \n6-11 Analysis \nLaw Firm did not obtain control of the underlying asset during the construction period , therefore i t \nshould account for the transaction as a lease arrangement with Developer Corp . Although Law Firm \nhad access to the asset, incurred costs related to both structural and normal tenant improvements, and \nhad financial risks related to the construction of the asset, Law Firm did not obtain control of the asset \nunder construction before the lease commencement date (i.e. , the construction completion date) . \nExcept for the payment for increases in the cost of steel, Developer Corp does not have an enforceable \nright to payment unless and until construction is completed. Law Firm ’s exposure to steel costs is \ninsignificant relative to the overall construction budget. In addition, none of the other indicators of \ncontrol in ASC 842 -40-55-5 are present . \n6.3.3.1 Sale of CIP with a lease for completed building \nIn certain cases an entity may have begun constructing an asset prior to selling it to a developer. The \ndeveloper will continue work on the construction in pro gress (CIP) and will lease the asset back to the \nseller once c onstruction is complete. As this concept is not specifically addressed by ASC 842, a \nnumber of views have evolved regarding whether this type of transaction is in the scope of the sale and \nleaseback rules . We believe each of the following views is supporta ble: \n□ Any sale of CIP is in scope: This view does not consider the stage of completion or the amount \nof costs incurred. Even if $1 of soft costs, such as planning and architecture, are incurred, the \ntransaction is subject to the sale and leaseback rules. \n□ Any sale of CIP that includes a physical asset is in scope: This view does not consider how \nmuch construction has been done but rather focuses on if there is a physical asset being sold (such \nas a poured foundation or steel beams) . This view would not incl ude a sale if only soft costs or land \nclearing costs were incurred because these costs do not result in a physical asset. \n□ Only CIP that represents the underlying leased asset is in scope : Under this view, an \nentity should qualitatively determine when the CIP is representative of the underlying asset that \nwill ultimately be leased back upon the c omplet ion of construction. This analysis will require \njudgment and should consider quantitative thresholds used elsewhere in GAAP to help with the \noverall quali tative assessment. For example, if the fair value of the CIP represents 10 % or more of \nthe expected value of the c ompleted construction , this would be an indicator that the CIP \nrepresents the underlying leased asset. \n□ Only CIP that is substantially similar to the completed construction project should \nbe in the scope: This view qualitatively determines when the CIP is substantially similar to the \nunderlying asset that will ultimately be leased back upon the complet ion of construction. This \nanalysis will requ ire judgment and should consider quantitative thresholds used elsewhere in \nGAAP. For example, if the fair value of the CIP sold represents 90% or more of the expected value \nof the completed construction, this would be an indicator that the CIP is substanti ally similar to \nthe underlying leased asset. \nAn entity should establish an accounting policy based on any of the views above and apply it \nconsistently to all similar transactions. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 251}), Document(page\_content='Sale and leaseback transactions \n6-12 6.3.3.2 Lessee controls the asset under construction \nIf a lessee controls the underlying asset under construction before the lease commencement date , the \nlessee should account for the underlying asset during the construction period similar to any other asset \nunder construction that it controls. For example, if a lessee determines th at it controls an underlying \nreal estate asset under construction, the lessee should account for the real estate asset under \nconstruction in accordance with ASC 360, Property, Plant, and Equipment . Any costs of construction \npaid for by the lessor should be recognized by the lessee as a financial liability. \nSimilar to the lessee’s accounting, a lessor that has not obtained control of the underlying asset should \naccount for payments it makes during the construction period as a collateralized loan to the lessee in \naccordance with ASC 310, Receivables. In other words, the accounting between the lessee and lessor \nshould be symmetrical. A lessor should not recognize the asset under construction. \nOnce a lessee is the deemed owner of the asset under construction, the arrangement is within the \nscope of the sale and l easeback guidance and both the lessee and the lessor should evaluate whether \nthe transaction represents a qualified sale and leaseback or a financing arrangement. Initially, the \nevaluation should occur as of the date the lessee is determined to have obtain ed control. Generally, \nonce a lessee has obtained control of an underlying asset under construction, it is unlikely that control \nwill transfer to the lessor before construction of the underlying asset has been completed. Unless, and \nuntil, the lessee trans fers control of the underlying asset to the lessor, the lessee will continue to be the \ndeemed the accounting owner of the underlying asset. \nIf the transaction otherwise meets the criteria to qualify for sale and leaseback accounting, as \ndiscussed in LG 6 .4, the lessee should recognize the sale of the asset when it transfers control of the \nunderlying asset to the lessor. \nSee LG 6.5 for additional information on the accounting for failed sale and leaseback transactions. \nQuestion LG 6 -1 describes the lesse e’s accounting for the land when the lessee is the deemed owner of \nan asset under construction on the land. \nQuestion LG 6-1 \nWhat are the accounting implications for land when the lessee is deemed to be the accounting owner \nof the building under constructio n but the land on which the building being constructed is either \nowned by the lessor, or is leased by the lessor from an unrelated third party? \nPwC response \nThe land on which the building is being constructed would typically meet the definition of a lease (see \nLG 2.3) and both the lessee and lessor would need to account for the land lease under ASC 842. The \ncommencement date of the land lease would usually be the date on which construction activities begin. \nNote that if the lessee was not the deemed owner o f the building under construction, the land lease \nwould typically commence at the construction completion date. \nExample LG 6 -6 illustrates a lessor’s derecognition of construction in progress when the lessee is the \ndeemed owner during construction. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 252}), Document(page\_content='Sale and leaseback transactions \n6-13 EXAMPL E LG 6-6 \nSale and leaseback transaction – lessor’s accounting for derecognition of construction -in-progress \nwhen lessee is the deemed the owner during construction \nLandlord Corp is constructing a building that is expected to cost $100 million. During the construction \nperiod , Landlord Corp enters into an agreement to lease the building to Lessee Corp once co nstruction \nis complet e. The agreement includes an option for Lessee Corp to purchase the construction in \nprogress at any point during the construction period at its then prevailing fair value . Due to the \npurchase option, Lessee Corp is the deemed owner of the building under construction at the \nagreement ’s effective date . Landlord Corp incurred $15 million in construction costs with a fair value \nof $18 million at the agreement effective date. \nHow should Landlord Corp measure the receivable from Lessee Corp upon derecognition of the \nconstruction -in progress at the agre ement effective date ? \nAnalysis \nIf Landlord Corp does not have an obligation to complet e the construction, we believe it should \nrecognize an $18 million receivable with a gain of $3 million ($18 million - $15 million) upon \nderecognition of the construction in progress. However , if Landlord Corp has an obligation to \ncomplete construction, we believe , consistent with Question 2 -3 in Chapter 2 of the Revenue from \ncontracts with customers guide, Landlord Corp should initially measure the receivable at $15 million \nplus the proportionate profit earned to date based on percentage of construction completion . \n6.3.3.3 Lessee does not control the asset under cons truction \nIf a lessee does not obtain control of the underlying asset under construction, the transaction is not \nsubject to the sale and leaseback guidance. In those circumstances, the lessee should apply judg ment \nto determine how to account for costs it in curs during construction . Such costs, for example, may \nrelate to its own assets, such as leasehold improvements, or they may relate to the right to use the \nlessor ’s assets. If such costs relate to leasehold improvements, the lessee should generally account for \nthose costs in accordance with ASC 360. Payments made by the lessee for the right to use the asset \nshould be accounted for as lease payments under ASC 842, regardless of when the payments occur or \nthe form of such payments. For example, if the lessee pays for (or contributes) construction materials \nto construct the lessor ’s asset , such payments are included in lease payments. \nExample LG 6-7 illustrates the application of this guidance. \nEXAMPLE LG 6-7 \nSale and leaseback transaction – construction costs incurred by a lessee that does not obtain control of \nconstruction in process (real estate) \n Law Firm enters into an arrangement with Developer Corp to lease an office building for 10 years \ncontingent upon Developer Corp completing con struction of the asset in accordance with the \nconstruction plan. The construction plan includes Law Firm -specific improvements necessary for Law \nFirm to begin operations at the lease commencement date. The budgeted cost of construction is $10 \nmillion. The useful life of the asset is 40 years. Law Firm is obligated to reimburse Developer Corp for \nincreases in the cost of steel from the inception date of the arrangement to the completion date of the ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 253}), Document(page\_content='Sale and leaseback transactions \n6-14 construction project up to a maximum of $250,000. During the construction period, Law Firm has \naccess to the building in order to inspect the progress of the construction and to make discretionary \nimprovements. \nLaw Firm reimburses Developer Corp for $200,000 due to increases in the cost of steel during the \nconstru ction period. In addition, Law Firm incurred $100,000 of additional construction costs related \nto discretionary tenant improvements, including branding elements. \nHow should Law Firm account for the costs incurred during the construction period? \nAnalysis \nThe $200,000 of construction cost overruns paid by Law Firm are lease payments because they were \nrequired per the terms of the lease agreement in order for the lessee to obtain the right to use the \nunderlying asset and do not represent payment for a good or service provided to Law Firm . \nAccordingly, Law Firm should recognize such costs as prepaid rent. See LG 4.2.2 for information on \nthe accounting for prepaid rent. \nLaw Firm should account for the $100,000 of construction costs incurred as lessee assets (i.e., \nleasehold improvements) that would be depreciated over the shorter of their useful lives or the lease \nterm. \n6.3.4 Impact of lease classification on qualification as a sale \nIn evaluating a potential sale and leaseback, whether a sale has occurred can be impacted by the \nclassification of the lease. If a leaseback is classified as a finance lease (seller -lessee) or a sales -type \nlease (buyer -lessor), then no sale has occurred and the transaction should be accounted for as a failed \nsale and l easeback. This is because a finance lease is effectively a purchase of an asset and a sales -type \nlease is effectively a sale of an asset, not a lease. Accordingly, the transaction would result in the seller -\nlessee effectively transferring control of the as set to the buyer -lessor (i.e. , a sale) and immediately \nreacquiring control (i.e. , a purchase). See LG 3 for information on lease classification. See LG 6. 5 for \ninformation on the accounting for failed sale and leaseback transactions. \nQuestion LG 6-2 describes the accounting when the leaseback of a building is a finance lease and the \nleaseback of the underlying land is an operating lease in a sale and leaseback transaction involving \nland and building. \nQuestion LG 6-2 \nA seller -lessee sel ls land and building and simultaneously leases them back from the buyer -lessor. The \nbuilding leaseback is classified as a finance lease , and the land leaseback is classified as an operating \nlease. Does the finance leaseback of the building preclude sale an d leaseback accounting for the land? \nPwC response \nNo. Under ASC 842 -10-15-29 the right to use the land and building are separate components. \nTherefore, in this example, the finance leaseback of the building will not preclude sale and leaseback \naccounting for the land. However, if the land leaseback is classified as a finance lease , it would be ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 254}), Document(page\_content='Sale and leaseback transactions \n6-15unusual for the building leaseback to be classified as anything other than a finance lease because of the \nretained control of the underlying land. \n6.3.5 Repurchase rights and obligations in a sale and leaseback \nA repurchase right gives the seller -lessee the right (or obligation) to repurchase the asset after it has \nbeen sold to the buyer -lessor. There are three forms of repurchase rights . \n□A seller -lessee ’s obligation to repurchase and the buyer -lessor ’s obligation to sell the asset (a\nforward)\n□A seller -lessee ’s right to repurchase the asset (a call option)\n□A buyer -lessor ’s right to require the seller -lessee to repurchase the asset (a put option)\nAn arrangeme nt to repurchase the asset that is negotiated between the buyer -lessor and seller -lessee \nafter control of th e asset has been transferred to the buyer -lessor is not a repurchase agreement \nbecause the buyer -lessor is not obligated to resell the asset as part of the initial transaction. The \nsubsequent decision to repurchase the asset does not affect the buyer -lessor ’s ability to direct the use \nof or obtain the benefits of the asset . See RR 8.7 for additional guidance on repurchase rights. \nAdditional considerat ion should be given to the substance of the arrangement. If the substance of the \narrangement suggests that the repurchase agreement was contemplated as part of the initial sales \ntransaction, it may be considered a repurchase right and should be evaluated a ccordingly. \nAs discussed in RR 8.7, certain sale transactions that contain a put or call option that cannot be \nrecognized as sales are accounted for as leases to the customer. However, if such a failed sale is \naccompanied by a leaseback , it should be accounted for as a financing arrangement because the seller \nretains the right to use the asset. See LG 6.5 for further information on how to account for a failed sale \nand leaseback transaction. \n6.3.5.1 Repurchase option s, fixed price renewal option s and forward s \nThe guidance for repurchase rights in the revenue standard should be applied to sale and leaseback \ntransactions with certain clarifications unique to sale and leaseback transactions . In the revenue \nstandard , sale recognition is precluded when the party that would be the seller -lessee has a substantive \nrepurchase option or obligation with respect to the underlying asset . If so, the buyer -lessor has not \nobtained control . A non -substantive repurchase option does not preclude sale accounting. See RR 8.7 \nfor additional guidance on repurchase rights. \nExcerpt from ASC 606 -10-55-68 \nIf an entity has an obligation or a right to repurchase the asset (a forward or a call option), a customer \ndoes not obtain control of the asset because the customer is limited in its ability to direct the use of, \nand obtain substantially all of the remaini ng benefits from, the asset even though the customer may \nhave physical possession of the asset. \nDespite the prohibition in the revenue guidance, the existence of a repurchase option does not always \npreclude recognition of a sale in a sale and leaseback arr angement . ASC 842-40-25-3 provides specific ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 255}), Document(page\_content='Sale and leaseback transactions \n6-16guidance on evaluating a repurchase option in a sale and leaseback transaction. A repurchase option \ndoes not preclude sale and leaseback accounting if both of the following criteria are met . \n□The repurchase option is exercisable by the seller -lessee only at the then -prevailing fair value of\nthe asset\n□Alternative assets are readily available in the marketplace , which are substantially the same as the\nunderlying asset\nIf the underlying asset is real estate or integral equipment as defined in ASC 978 (i.e., any physical \nstructure or equipment attached to the real estate that cannot be removed and used separately without \nincurring significant cost) , the transaction would fail to meet the second criteria regar dless of the \nexercise price of the repurchase option because each location is unique ; therefore, alternative real \nestate assets or integral equipment that are readily available in the marketplace will not be considered \nsubstantially the same as the underly ing real estate asset or integral equipment . \nJudgment may be required to determine whether other types of non-real estate assets are considered \nsubstantially the same as the underlying asset . Generally, if alternative assets are readily available in \nthe m arketplace, which are substantially the same as the underlying asset, the seller -lessee would be \nindifferent as to whether it (1) repurchase d the asset it previously sold and leased back, or (2) \npurchase d another asset that is substantially the same in the marketplace. Accordingly, we believe the \nless generic the underlying asset, the more difficult it would be to assert that alternative assets readily \navailable in the marketplace are substantially the same as the underlying asset. \nArrangements with a fixed price repurchase option d0 not qualify as a sale because the exercise price \nwill not necessarily reflect the then -preva iling fair value of the asset. If an arrangement has a fixed \nprice renewal option that extend s to substantially all of the economic life of the asset, the entity may \nneed to evaluate whether the fixed price renewals are economically similar to a fixed price repurchase \noption that would preclude sale accounting. As this concept is not addressed by ASC 842, a number of \nviews have evolved. On e view is that a renewal option is fundamentally not the same as a repurchase \noption and would therefore not preclude sale accounting. Another view is that a fixed price renewal \noption that extends to substantially all of the economic life of the asset is equivalent to a fixed \nrepurchase option that would preclude sale accounting. We believe this analysis should be based on \nfacts and circumstances and may inv olve consider ation of the pricing of the arrangement in the \nrenewal period . \n6.3.5.2 Buyer -lessor has a put option \nA put option allows a buyer -lessor to require the seller -lessee to repurchase the underlying asset at its \ndiscretion. Generally , a put option indic ates that the seller -lessee has relinquished control over th e \nasset . However, t he revenue standard precludes sale accounting when a buyer -lessor has a significant \neconomic incentive to exercise a put option. \nASC 606 -10-55-72 \nIf an entity has an obligation to repurchase the asset at the customer ’s request (a put option) at a price \nthat is lower than the original selling price of the asset, the entity should consider at contract inception \nwhether the customer has a significant economic incentive to exercise that right. The customer ’s \nexercising of that right results in the customer effectively paying the entity consideration for the right \nto use a specified asset for a period of time. Therefore, if the customer has a significant economic ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 256}), Document(page\_content='Sale and leaseback transactions \n6-17incentive to exercise that right, the entity should account for the agreement as a lease in accordance \nwith Topic 84 2 on leases unless the contract is part of a sale and leaseback transaction. If the contract \nis part of a sale and leaseback transaction, the entity sho uld account for the contract as a financin g \narrangement and not as a sale and leaseback transaction in accordance with Subtopic 84 2-40. \nThe seller -lessee must assess the contract at inception to determine whether the buyer -lessor has a \nsignificant economic incentive to exercise its put option . It should consider all relevant factors in its \nassessment, including the following: \n□How the repurchase price compares to the expected market value of the asset at the date of\nrepurchase\n□The amount of time until the r ight expires\nA buyer -lessor has a significant economic incentive to exercise a put option when the repurchase price \nis expected to significantly exc eed the market value of the asset at the time of repurchase. See RR 8 .7 \nfor additional information . \nIf it i s determined that the buyer -lessor has a significant economic incentive to exercise a put option, \nno sale has occurred and the sale and leaseback transaction should be accounted for as a financing \narrangement. If the buyer -lessor does not have a significan t economic incentive to exercise a put \noption, then sale accounting is not precluded. See LG 6.5 for further discussion of how to account for a \nfailed sale and leaseback transaction. \n6.3.5.3 Seller -lessee has a right of first offer \nSome sale -leaseback agreements may provide the seller -lessee with a "right of first offer," which allows \nthe seller -lessee to make an offer to purchase the underlying asset at the end of the lease term based \non a current valuation of the asset before the b uyer -lessor may solicit offers from third parties. We \nbelieve that a sale -leaseback agreement containing a right of first offer should be carefully analyzed to \ndetermine whether the buyer -lessor is economically or contractually compelled to accept the off er. For \nexample, a buyer -lessor may conclude it is (1) economicall y compelled if it is required to pay a \nsubstantive p enalty if it does not accept the offer or (2) contractually compelled to accept the offer per \nthe terms of the lease agreement. \nIf the buy er-lessor is not compelled to accept the seller -lessee’s offer, the right of first offer would \ntypically not prevent sale accounting. If the buyer -lessor is compelled to accept the offer, the right of \nfirst offer is effectively a repurchase option held by the seller -lessee , which may , prevent the \ntransaction from qualifying as a sale. See LG 6.3.5.1 for more information on the evaluation of a seller -\nlessee repurchase option. \nA right of first offer may also economically or contractually compel the seller -lessee to make an offer to \nacquire the underlying asset. If the seller -lessee is compelled to make an offer, the right of first offer is \neffectively a buyer -lessor put option. See LG 6.3.5.2 for more information on the evaluation of a buyer -\nlessor put option . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 257}), Document(page\_content='Sale and leaseback transactions \n6-18 6.3.5.4 Seller -lessee has a contingent repurchase option \nSome sale and leaseback agreements may provide the seller -lessee with a repurchase option which \nallows the seller -lessee the right to repurchase the underlying asset if a specific contingent event \noccurs. The specific contingent event may be in the seller -lessee’s control , in the buyer -lessor’s control , \nor outside either party’s control. Examples of contingent events include significant damage or \ndestruction of the leased asset and a lessor’s change of control. We believe a ll facts and circumstances \nshould be considered to determine if a contingent repur chase option is similar in substance to an \nunconditional repurchase option or a put option held by the buyer -lessor under the new revenue \nstandard. For further guidance, refer RR 8.7.1.1 for conditional call options. \n6.4 When the t ransaction qualifies as a sal e \nIf the buyer -lessor obtains control of the asset , the sale (by the seller -lessee) or purchase (by the buyer -\nlessor) and the leaseback should be accounted for separately , with the lease being accounted for in \naccordance with ASC 842 . \nASC 842 -40-25-4 \nIf the transfer of the asset is a sale in accordance with paragraphs 842 -40-25-1 through 25 -3, both of \nthe following apply: \na. The seller -lessee shall: \n1. Recognize the transaction price for the sale at the point in time the buyer -lessor obtains \ncontrol of the asset in accordance with paragraph 606 -10-25-30 in accordance with the \nguidance on determining the transaction price in paragraphs 606 -10-32-2 through 32-27 \n2. Derecognize the carrying amount of the underlying asset \n3. Account for the lease in accordance with Subtopic 842 -20. \nb. The buyer -lessor shall account for the purchase in accordance with other Topics and for the lease \nin accordance with Subtopic 84 2-30. \nThe accounting considerations for the purchase and sale transaction , as well as the leaseback , are \ndiscussed in the following section . \n6.4.1 Accounting by the s eller -lessee \nThe seller -lessee should derecognize the underlying asset and recognize a gain or loss on sale as \nappropriate. If the transaction is at market terms, the presence of the leaseback does not affect the \nrecognition of a gain or loss on sale. Therefore, if a seller -lessee leases back an entire asset or a portion \nof the asset (e.g., one floor of a multi -floor office building ), the gain or loss generated from the sale is \nnot affected. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 258}), Document(page\_content='Sale and leaseback transactions \n6-19 A seller -lessee should account for the gain or loss generated from a sale and leaseback transaction \nconsistent with the guidance in the revenue s tandard, similar to a sale without a leaseback . \nSee LG 6.4.4 for a discussion o f accounting for a transaction entered into at off -market terms. \nExample LG 6-8 and Example LG 6-9 illustrate how a seller -lessee would account for a gain or loss on \nsale gene rated from a sale and leaseback transaction. \nEXAMPLE LG 6-8 \nSale and leaseback transaction – gain on sale \nA seller -lessee enters into a sale and leaseback transaction of its corporate headquarters with a buyer -\nlessor for a market value sales price of $20 million . The seller -lessee leases back the asset for ten years \nin exchange for $200,000 per year in rental payments. The seller -lessee ’s net carrying amount of the \nasset at the date of sale is $15 million. Assume the leaseback is classified as an operating lease for \npurposes of this example. \nHow should the seller -lessee account for the asset sale? \nAnalysis \nThe sale result s in a gain on sale of $5 million ($20 million sales price - $15 million carrying amount of \nasset ). Since the sale and leaseback transaction is at market value and the leaseback is classified as a n \noperating lease , the presence of the leaseback does not impact the accounting for the sale ; the seller -\nlessee should recognize the gain on sale of $5 million in the period in which the sale is recognized. \nEXAMPLE LG 6-9 \nSale and leaseback transaction – loss on sale \nA seller -lessee enters into a sale and leaseback transaction of its corporate headquarters with a buyer -\nlessor for a market value sales price of $20 million. The seller -lessee leases back the asset for ten years \nin exchange for $200,000 per year in rental payments. The seller -lessee’s net carrying amount of the \nasset at the date of sale is $25 million. Assume the leaseback is classified as an operating lease. \nHow should the seller -lessee account for the asset sale? \nAnalysis \nThe sale result s in a loss on sale of $5 million ($20 million sales price - $25 million carrying amount of \nasset ). Since the sale and leaseback transaction is at market value, the presence of the leaseback does \nnot impact the accounting for the sale ; the seller -lessee should recognize the loss on sale of $5 million \nin the period in which the sale is recognized (assuming an impairment of the asset was not requir ed to \nbe recorded in an earlier period ). \n6.4.2 Accounting by the b uyer -lessor \nTo determine the appropriate accounting treatment, a buyer -lessor should determine if the transaction \nmeets the definition of a business combination under ASC 805, Business Combinations, or if the ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 259}), Document(page\_content='Sale and leaseback transactions \n6-20 transaction will be account ed for as an asset acquisi tion. The buyer -lessor should value the tangible \nproperty independently from the terms of the leaseback and should value and account for the \nleaseback in the same manner as any other lease. See LG 3 and LG 4 for guidance on lease \nclassification and the acc ounting for leases, respectively. See PwC ’s Business combinations and \nnoncontrolling interests guide for information on accounting related to business combinations and \nasset acquisitions. \n6.4.3 Costs in a sale and leaseback transaction \nThe seller -lessee will incur c osts in connection with a sale and leaseback transaction. Transaction costs \nthat the sel ler-lessee would have had to pay to a third party if the asset were sold outright (e.g., absent \na leaseback) should be accounted for as part of the sale transaction. These seller expenses reduce the \ngain (or increase the loss) on the sale. Any additional c osts due to the leaseback should be evaluated to \ndetermine if they should be deferred as initial direct costs . See LG 4.2 .2.2 for information about the \nevaluation of initial direct costs. \nIn some cases, the seller -lessee may be required to pay costs incurr ed by the buyer -lessor in \nconnection with purchasing the asset, financing the acquisition of the asset, or entering into the sale \nand leaseback transaction. The seller -lessee will need to use judgment to determine if these costs \nshould be accounted for as a reduction of the sales price or as a cost associated with the leaseback. \nCertain transactions may occur in which a seller -lessee sells an asset for an amount that is less than its \nfair value. See Example LG 6-10. In this situation, the seller -lessee should apply the guidance for sale \nand leaseback transactions entered into at off -market terms , as discussed in LG 6.4.4. \nThe buyer -lessor ’s accounting for transaction costs depend s on whether the transaction is consid ered a \nbusiness combination or an asset acquisition. If the transaction is considered a business combination, \ntransaction costs are expensed as incurred ; if considered an asset acquisition, transaction costs are \ncapitalized. The buyer -lessor should defer a ny debt acquisition costs (e.g., costs relating to the \nfinancing) and initial direct costs of entering into the lease (e.g., negotiating and arranging the lease). \nSee LG 4. 3.1.2 for information on initial direct costs. \nIf a sale and leaseback transaction d oes not qualify for sale accounting, it is considered a failed sale \nand leaseback and should be accounted for as a financing transaction. All transaction costs incurred by \nthe seller -lessee and buyer -lessor should be evaluated to determine if they should b e accounted for as \ndebt issuance or debt origination costs, respectively. See FG 1.2 .2 for information on debt issuance \ncosts . See LI 4.4 for information on debt origination fees and costs. \nWhen debt origination costs are capitalized by a buyer -lessor in a failed sale and leaseback transaction \nthat subsequently qualifies as a sale, the buyer -lessor should record the underlying asset (e.g. , \nproperty, plant , and equipment) or net investment in the lease at the carrying amount of the financial \nasset (e.g. , loan receivable) when the lease is classified as an operating lease or direct financing lease, \nrespectively. Regardless of the classification , the initial measurement of the asset recognized wh en the \nbuyer -lessor obtains control of the underlying asset (i.e. , when the transaction qualifies as a sale) \nshould include any unamortized debt origination costs . See LG 6.5.2 for information on the accounting \nfor a failed sale and leaseback by a buyer -lessor. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 260}), Document(page\_content='Sale and leaseback transactions \n6-21 6.4.4 Off-market sale and leaseback transactions \nSale and leaseback transactions entered into at off -market terms should be adjusted so that the sale is \nrecorded at fair value. A reporting entity should determine whether the sale and leaseback is an off -\nmarket transaction by considering either of the following, whichever is more readily determinable : \n□ The sale price compared to the fair value of the underlying asset \n□ The present value of the contractual lease payments compared to the present value of fair market \nvalue lease payments \nThe use of observable prices and observable information should be maximized when making this \nassessment. For example, if comparable sales of assets similar to an underlying asset exist, an \nobservable fair value for the underlyi ng asset can be determined at the time of the transaction. The \nobservable fair value should be used to determine the gain or loss and any related adjustment, rather \nthan basing an adjustment on an estimate of market rental rates if comparable rental rates are not \nreadily available. \nIf part of the consideration includes amounts related to the settlement of preexisting contracts or other \narrangements, those other arrangements should be considered before determining whether the \ntransaction was entered into at off -market terms. Similarly , if the sales proceeds or lease payments \ninclude variable amounts (e.g. , contingent consideration) , the variable amounts should be estimated \nand included in the evaluation. \nWhen the sale of an asset is not at fair value or the lease payments are not at m arket rates , the seller -\nlessee and buyer -lessor should make adjustments so that the sale is recognized at fair value , as \ndiscussed in ASC 842 -40-30-2. \nASC 842 -40-30-2 \nIf the sale and leaseback transaction is not at fair value, the entity shall adjust the sale price of the \nasset on the same basis the entity used to determine that the transaction was not at fair value in \naccordance with paragraph 842 -40-30-1. The entity s hall account for both of the following: \na. Any increase to the sale price of the asset as a prepayment of rent \nb. Any reduction of the sale price of the asset as additional financing provided by the buyer -lessor to \nthe seller -lessee. The seller -lessee and the bu yer-lessor shall account for the additional financing \nin accordance with other Topics. \nAs discussed in ASC 842 -40-30-4, if a sale and leaseback transaction is between related parties, the \nadjustments required by ASC 842 -40-30-2 should not be made; however , the lessee and lessor should \ndisclose the related party transaction in accordance with ASC 850, Related Party Disclosures . \n6.4.4.1 Seller -lessee : transaction with off-market terms \nA seller -lessee may sell an asset for an amount that is different than the fair value of the asset. If the \nsales proceeds are less than the fair value of the asset , the difference should be recognized as prepaid ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 261}), Document(page\_content='Sale and leaseback transactions \n6-22 rent. If the sales proceeds are higher than the fair value of the asset , the excess should be considered \nadditional bor rowing. \nAn off-market adjustment must also be considered when assessing the classification of the leaseback . \nIt is possible that the adjustment could cause an otherwise operating lease to be classified as a finance \nlease , precluding sale accounting altoget her. \nSale price or leaseback payments are less than fair value \nThe stated sale price of an underlying asset may be less than its fair value , or the present value of the \ncontractual leaseback payments may be less than the present value of market rental payments. A \nseller -lessee should increase the initial leaseback right -of-use asset for the difference between the sale \nprice and fair value , similar to prepa id rent. This would have the effect of increasing the gain or \nreducing the loss on sale. \nExample LG 6-10 illustrates the seller -lessee ’s accounting when the stated sale price of an underlying \nasset is less than its fair value. \nEXAMPLE LG 6-10 \nSale and leaseback transaction – seller -lessee sells underlying asset for less than fair value \nA seller -lessee purchase s manufacturing equipment at a price of $5.5 million , which equals fair value. \nShortly after buying the equipment, the seller -lessee sells it to a buyer -lessor for $5 mil lion. The seller -\nlessee leases back the equipment for 10 years in exchange for annual rent payments of $400,000 , \npayable at the beginning of each year . The seller -lessee ’s incremental borrowing rate i s 6%. \nHow should the seller -lessee account for the difference between the property ’s sales price and its fair \nvalue ? \nAnalysis \nThe seller -lessee sold the underlying asset for $5 million , which is less than its fair value of $5.5 \nmillion . The seller -lessee should account for the difference as an adjustment to the initial leaseback \nright -of-use asset , similar to the accounting for a prepayment of rent. The adjustment also increase s \nthe sale price to $5.5 million (for accounting purposes) , and as a result, the seller -lessee would not \nrecord a loss on sale. \nThe right -of-use asset is initially equal to the lease liability . The lease liability is $3,120,676 , calculated \nby determining the present value of the contractual lease payments of $4,000,000 at 6% . The off-\nmarket adjustment of $500,000 is added to the right -of-use asset . Because the off -market adjustment \nis accounted for similar to a prepayment of rent to the buyer -lessor (i.e. , a day -one payment), it should \nnot be discounted . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 262}), Document(page\_content='Sale and leaseback transactions \n6-23 The seller -lessee should record the following journal ent ry to record this transaction. \nDr. Cash $5,000,000 \nDr. Right -of-use asset $3,620,676 \nCr. Equipment $5,5 00,000 \nCr. Lease liability $3,120,676 \nSale price or leaseback payments are greater than fair value \nThe stated sale price of an underlying asset may be greater than its fair value , or the present value of \ncontractual leaseback payments may be greater than the present value of market rental payments. \nA seller -lessee should accoun t for the excess of the sale price or leaseback payments over the fair value \nof the asset as additional financing from the buyer -lessor separate from the lease liability. The initial \nmeasurement of the right -of-use asset is not impacted by recording the ad justment as additional \nfinancing. The seller -lessee ’s total rental payments should be allocated between the lease liability and \nthe additional buyer -lessor financing. If the rent payments contain variable consideration, we believe \namounts allocated to the additional buyer -lessor financing should be accounted for by analogy to the \ninterest method described in ASC 310. See LG 2.4. 5 for information on the allocation of payments \nbetween lease liability and financing. See LI 6.5 .1.2 for information on accounting for variable rate \nloans , which we believe should be applied in these fact patterns. \nExample LG 6-11 illustrates the accountin g by the seller -lessee when the sale price of an underlying \nasset is greater than its fair value. \nEXAMPLE LG 6-11 \nSale and leaseback transaction – seller -lessee sells underlying asset for a price that is greater than fair \nvalue \nA seller -lessee sells a buil ding with a remaining economic life of 40 years to an unrelated buyer -lessor \nfor a price of $30 million. The seller -lessee ’s net carrying amount of the building is $20 million. \nSimultaneously, the seller -lessee enters into a lease contract with the buyer -lessor for the right to use \nthe asset for 10 years, with annual rental payments of $1 million payable at the end of each year. \nThe buyer -lessor obtains control o f the asset in accordance with the requirements in the revenue \nstandard and therefore the transaction is accounted for as a sale and leaseback by both the seller -\nlessee and buyer -lessor. Initial direct costs of the transaction are ignored for purposes of t his example. \nComparable sales figures of recent transactions for similar properties are readily available. Based on \nthose comparable sales, the estimated fair value of the underlying asset is $28 million. Both the seller -\nlessee and buyer -lessor determine t hat these comparable sales provide better evidence to assess \nwhether the transaction is priced off-market than determining the market rental payments of the \nleaseback. Since the sale s price of the underlying asset is not at fair value, both the seller -lessee and \nbuyer -lessor are required to make adjustments to recognize the sale and leaseback transaction at fair \nvalue. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 263}), Document(page\_content='Sale and leaseback transactions \n6-24 The leaseback is classified as a n operating lease by both the seller -lessee and buyer -lessor and the \nseller -lessee ’s incremental borrowing rate is 6% (the buyer -lessor’s interest rate implicit in the \nleaseback is not known to the seller -lessee) . \nHow should the seller -lessee account for the amount by which the sales price of the property exceeds \nits fair value? \nAnalysis \nThe seller -lessee sold the building for $30 million , which is greater than its fair value of $28 million . \nThe difference should be re corded by the seller -lessee as additional financing from the buyer -lessor \nseparate from the lease liabi lity. \nThe right -of-use asset is equal to the lease liability . The lease liability is $5,360, 087, calculated as the \npresent value of the contractual lease payments of $ 10 million at 6% ($7,360, 087), less the $2 million \noff-market adjustment. The financial liability is equal to the difference between the sales price and the \nfair value of $2 million . The gain on sale is the difference between the sale price ($30 million) and \ncarrying value ($20 million) , less the off -market adjustment of $2 million . \nThe seller -lessee should record the following journal entry to record this transaction. \nDr. Cash $30,000,000 \nDr. Right -of-use asset $5,360, 087 \nCr. Building $20,000,000 \nCr. Lease liability $5,360, 087 \nCr. Financial liability $2,000,000 \nCr. Gain on sale $8,000,000 \nEach annual rental payment of $1,000,000 would be allocated pro rata between the lease liability and \nthe financial liability. The amount allocated to the financial liability would be $271,73 6 ($1,000,000 × \n[$2,000,000/ $7,360, 087]). The remaining $728,264 of the total rental payment would be allocated to \nthe lease. The seller -lessee will recognize $728,26 4 as lease expense each year of the leaseback . The \n$271,736 represents payment of the financial liability and interest expense . Interest expense is \ncalculated as $120,00 0 in year 1 , declining to $15,38 1 in year 10 based on an amortization schedule \nusing the 6% incremental borrowing rate . \nSee LG 4.4.2 for information on operating lease expense recognition. \n6.4.4.2 Buyer -lessor : transaction with off-market terms \nThe buyer -lessor may purchase an asset for an amount that is different from the fair value of the asset. \nIf the sales proceeds (i.e., purchase price) are less than the fair value of the asset , the difference should \nbe recognized as prepaid rent. If the sales proceeds are higher than the fair value of the asset , the \nexcess should be considered a loan to the lessee . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 264}), Document(page\_content='Sale and leaseback transactions \n6-25 Sale price or leaseback payments are less than fair value \nThe stated sale price of an underlying asset may be less than its fair value , or the present value of the \ncontractual leaseback payments may be less than the present value of market rental payments. A \nbuyer -lessor should account for such a difference as a prepayment of rent by the seller -lessee , which \nshould be recognized as lease income along with the contractual leaseback payments. See LG 4. 2.2.1 \nfor details on the accounting for the prepayment of rent. The buyer -lessor should record the \nunderlying asset at its fair value . \nSale price or leaseback payments are greater than fair value \nThe stated sale price of underlying asset may be greater than its fair value , or the present value of the \ncontractual leaseback payments may be greater than the present value o f market rental payments. A \nbuyer -lessor should account for the excess of the sale price or leaseback payments over the fair value \nas additional financing (i.e., a loan receivable) to the seller -lessee and record the underlying asset at its \nfair value . The buyer -lessor’s total leaseback payment should be allocated between the lease and \nadditional financing . If the leaseback payment contains variable consideration, amounts allocated to \nthe additional financing should be accounted for in accordance with ASC 310. See LG 2.4. 4 for \ninformation on the allocation of leaseback payments between the lease and additional financing. See \nLI 6.5 .1.2 for information on accounting for variable rate loans. \nExample LG 6-12 illustrates the buyer -lessor ’s accounting when the sale price of an underlying asset \nhas been increased (i.e. , is greater than its fair value ). \nEXAMPLE LG 6-12 \nSale and leaseback transaction – buyer -lessor buys an underlying asset for an amount greater than fair \nvalue \nA seller -lessee sells a building with a remaining economic life of 40 years to an unrelated buyer -lessor \nfor a price of $30 million. The seller -lessee’s net carrying amount of the building is $20 million. \nSimultaneously, the seller -lessee enters into a lease contract with the buyer -lessor for the right to use \nthe asset for 10 years, with annual rental payments of $1 million payable at the end of each year. \nThe buyer -lessor obtains control of the asset in accordance with the require ments in the revenue \nstandard and therefore the transaction is accounted for as a sale and leaseback by the buyer -lessor and \nthe seller -lessee . Initial direct costs of the transaction are ignored for purposes of this example. \nComparable sales figures of re cent transactions for similar properties are readily available. Based on \nthose comparable sales, the estimated fair value of the underlying asset is $28 million. The buyer -\nlessor determine s that these comparable sales provide better evidence to assess whet her the \ntransaction is priced off -market than determining the market rental payments of the leaseback. Since \nthe sales price of the underlying asset is not at fair value, the buyer -lessor is required to make an \nadjustment to recognize the sale and leasebac k transaction at fair value. \nThe leaseback is classified as an operating lease by the buyer -lessor . The buyer -lessor ’s interest rate \nimplicit in the leaseback is 8%. \nHow should the buyer -lessor account for the amount by which the sales price of the property exceeds \nits fair value? ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 265}), Document(page\_content='Sale and leaseback transactions \n6-26 Analysis \nThe buyer -lessor acquired the building for $30 million , which is greater than its fair value of $28 \nmillion ; therefore , there is an excess of sale price as compared to the fair value of the underlying asset \nof $2 million. \nThe buyer -lessor should account for the purchase, including the additional financing to the seller -\nlessee , as follows. \nDr. Building $28,000,000 \nDr. Loan r eceivable $2,000,000 \nCr. Cash $30,000,000 \nEach annual leaseback payment of $1,000,000 would be allocated between the lease income and the \nloan receivable by the buyer -lessor . To calculate the repayment of princip al, the $1,000,000 annual \nlease payments would be allocated using the percentage derive d by taking the excess of $2,000,000 \ndivided by $6,710, 081 (which is the present value of ten lease payments of $1,000,000 discounted at \n8%). This yields a percentage of 29.8%, in which case the annual lease payment of $1,000,000 would \nbe allocated as foll ows. \nDebt service $298,0 59 \nLease income $701,9 41 \nThe buyer -lessor would recognize $701,9 41 as lease income each period of the leaseback . Interest \nincome on the loan receivable would be calculated as $160,000 in year 1 , declining to $22,0 78 in year \n10 based on an amortization schedule using the 8% implicit interest rate . \n6.5 Failed sale and leaseback transaction \nWhen a sale and leaseback transaction does not qualify for s ale accounting, the transaction must be \naccounted for as a financing transaction by the seller -lessee and a lending transaction by the buyer -\nlessor , as discussed in ASC 842 -40-25-5. \nASC 842 -40-25-5 \nIf the transfer of the asset is not a sale in accordance with paragraphs 842 -40-25-1 through 25 -3, both \nof the following apply: \na. The seller -lessee shall not derecognize the transferred asset and shall account for any amounts \nreceived as a financial liability in accordance with other Topics. \nb. The buyer -lessor shall not recognize the transferred asset and shall account for the amounts paid \nas a receivable in accordance with other Topics. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 266}), Document(page\_content='Sale and leaseback transactions \n6-27 6.5.1 Accounting for a failed sale and leaseback by a s eller -lessee \nTo account for a failed sale and leaseback transaction as a financing arrangement , the seller -lessee \ndoes not derecognize the underlying asset ; the seller -lessee continue s depreciating the asset as if it was \nthe legal owner. The sales proceeds received from the buyer -lessor should be recognized as a financial \nliability . \n6.5.1.1 Allocation of the leaseback payments by a seller -lessee \nA seller -lessee will make rental payments under the leaseback . These payments should be allocated \nbetween interest expense and principal repayment o f the financial liability. To determine the amount \nallocat ed to interest expense , the seller -lessee should use its incremental borrowing rate. However, a \nseller -lessee may need to adjust the interest rate initially or during the course of the leaseback, as \ndiscussed in ASC 842 -40-30-6. \nASC 842 -40-30-6 \nThe guidance in paragraph 842 -40-25-5 notwithstanding, the seller -lessee shall adjust the interest \nrate on its financial liability as necessary to ensure that both of the following apply: \na. Interest on the financial liability is not greater tha n the principal payments on the financial \nliability over the shorter of the lease term and the term of the financing. The ter m of the financing \nmay be shorter than the lease term because the transfer of an asset that does not qualify as a sale \ninitially may qualify as a sale at a point in time before the end of the lease term. \nb. The carrying amount of the asset does not exceed th e carrying amount of the financial liability at \nthe earlier of the end of the lease term or the date at which control of the asset will transfer to the \nbuyer -lessor (for example, the dates at which a repurchase option expires if that date is earlier \nthan t he end of the lease term ). \nInterest on the financial liability greater than the principal payments on the financial liability will \ncause the carrying amount of the financial liability to increase rather than decreas e (“negative \namortization ”). This g enerally occurs when a seller -lessee ’s incremental borrowing rate resul ts in an \nallocation of interest expense that exceeds the seller -lessee ’s rent al payments to the buyer -lessor. \nWhen the use of a lessee ’s incremental borrowing rate results in negative a mortization of the financial \nliability at the end of the amortization period (the shorter of the lease term or the term of the \nfinancing) , the seller -lessee should instead use an imputed interest rate that will eliminate the negative \namortization. See Exam ple LG 6-12. \nA projected net book value of the underlying asset that exceeds the carrying amount of the financial \nliability at the earlier of (1) the end of the lease term or (2) the date the buyer -lessor obtains control of \nthe asset would have the effect of deferring a loss until that time . Similar to adjusting the interest rate \nto ensure that negative amortization does not occur, a seller -lessee that determines a loss will result \nfrom the application of its incremental borrowing rate should use the imputed interest rate . Generally, \nthe imputed interest rate should be the rate that would result in the net carrying value of the \nunderlying asset and the carrying amount of the financial liability being equal at the earlier of the end \nof the lease term o r the date the buyer -lessor obtains control of the asset . See ASC 842 -40-55-31 \nthrough ASC 842 -40-55-38 for a detailed example of a failed sale and leaseback transaction requiring \nadjustment to the seller -lessee ’s incremental borrowing rate due to a projected built -in loss. If an ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 267}), Document(page\_content='Sale and leaseback transactions \n6-28 imputed interest rate was used in this circumstance, the rate should not be subsequently lowered if \nthere is an impairment of the underlying asset . \nIf a seller -lessee accounts for a sale and leaseback transaction as a financ ing arrangement because \nthere is a repurchase option , unless the purchase option price is fixed and exercise is determined to be \nreasonably certain at lease commencement, the effective interest rate applied to the financial liability \nwill typically require adjustment when it becomes probable that the repurchase option will be \nexercised. This is because the effective interest rate determined at lease commencement did not factor \nin the price of the purchase option . Accordingly, the seller -lessee should adjust the effective interest \nrate such that the carrying value of the financial liability upon exercise of the option is equivalent to \nthe exercise price of the purchase option . If the repurchase option price is not fixed, the seller -lessee \nshould estimate the exercise price and reflect any subsequent revisions as adjustments to the effective \ninterest rate. \nThe carrying amount of the asset should not be changed as a result of a financing transaction ; \ntherefore, the asset should not be written up upo n exercise of the repurchase option . \n6.5.1.2 Buyer -lessor obtains control of the asset \nA sale may occur at any point in time when the buyer -lessor obtains control of the asset during or at \nthe end of a leaseback period. When the sale is ultimately recognized in a previously failed sale and \nleaseback transaction, the seller -lessee should recognize any remaining balance of the financial \nliability as the proceeds on the final sale of the underlying asset . The gain or loss equals the difference \nbetween those proceeds and the carrying amount of the underlying asset . \nIf the buyer -lessor obtains control of the underlying asset prior to the end of the leaseback period, the \ndate that control transfers to the buyer -lessor is the lease comm encement date for purposes of the \nseller -lessee initially measuring the right -of-use asset and lease liability. \nExample LG 6-13, Example LG 6-14, Example LG 6-15, and Example LG 6-16 illustrate the accounting \nby the seller -lessee both when the buyer -lesso r does and does not obtain control prior to the end of the \nleaseback term . \nEXA MPLE LG 6-13 \nFailed sale and leaseback – buyer -lessor does not obtain control of the underlying asset prior to the \nend of the leaseback term \nA seller -lessee sells a building for $950,000 cash and agrees to lease the building back for five years. \nConsider the following facts about this transaction: \n□ The net carrying amount of the building as of the date of sale is $800,000 \n□ The annual leaseback payment is $100,000 \n□ Annual depreciatio n expense is $80,000 \n□ The seller -lessee does not guarantee the residual value of the asset at the end of the lease back term \n□ The seller -lessee has a repurchase option that allows it to buy the building at the then -prevailing \nfair market value at any time during the lease term ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 268}), Document(page\_content='Sale and leaseback transactions \n6-29 □ The seller -lessee ’s incremental borrowing rate is 9.3 % and the interest rate implicit in the \nlease back is not known \nHow should the seller -lessee account for the sale and leaseback of the building? \nAnalysis \nBecause the seller -lessee has a repurchase option and there are no alternative buildings that are \nsubstantially the same and readily available in the marketplace , the buyer -lessor does not obtain \ncontrol of the building prior to the end of the leaseback term. T he transaction does not qualify for sale \naccounting and should be accounted for as a financing. The net carrying amount of the asset would \nremain on the seller -lessee ’s books and the seller -lessee would continue to record annual depreciation \nexpense of $80,000. \nThe cash proceeds received from the buyer -lessor would be recorded as a financial liability and the \nannual lease payments allocated between interest expense and a reduction of the financial liabi lity. \nInterest expense should be calculated by multiplying the beginning balance of the financial liability by \nthe incremental borrowing rate of 9.3%. In year 1, t he seller -lessee would record interest expense of \n$88,350 ($950,000 × 9.3%). The reduction of the financial liability is calculated as the difference \nbetween the annual leaseback payment and the allocation of interest expense ($100,000 payment – \ninterest expense of $88,350 = $11,650). \nAt the e nd of the fifth year, the leaseback and repurchase option expire and the buyer -lessor would \nobtain control of the asset . At that time, the seller -lessee would recognize the sale of the asset and any \ngain that result ed from removing the underlying asset and financial liability from its books. \nThe financing method is illustrated below : \nPeriod Net \ncarrying \namount Asset \nvalue Accumulated \ndepreciation Financial \nliability Reduction \nof \nobligation Interest \nexpense \nInception $800,000 $1,200,000 $400,000 $950,000 $ – $ – \nYear 1 720,000 1,200,000 480,000 938,350 11,650 88,350 \nYear 2 640,000 1,200,000 560,000 925,617 12,733 87,267 \nYear 3 560,000 1,200,000 640,000 911,699 13,918 86,082 \nYear 4 480,000 1,200,000 720,000 896,487 15,212 84,788 \nYear 5 400,000 1,200,000 800,000 879,860 16,627 83,373 \nUse of t he incremental borrowing rate would not produce unusual results ( e.g., a built -in loss or \nnegative amortization) . At the end of the five -year leaseback term , the seller -lessee would recognize \nthe sale of the building with a gain of $479,860 (financial liability of $879,860 – $400,000 net \ncarrying amount ). The interest rate should not be decreased in order to eliminate recognition of the \nend-of-transaction gain. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 269}), Document(page\_content='Sale and leaseback transactions \n6-30 EXAMPLE LG 6-14 \nFailed sale and leaseback – buyer -lessor does not obtain control of the underlying asset prior to the \nend of the leaseback term \n A seller -lessee sells a building for $950,000 cash and agrees to lease the building back for five years. \nConsi der the following facts about this transaction: \n□ The net carrying amount of the building as of the date of sale is $800,000 \n□ The annual leaseback payment is $75,000 \n□ Annual depreciatio n expense is $80,000 \n□ The seller -lessee does not guarantee the residual value of the asset at the end of the lease back term \n□ The seller -lessee has a repurchase option that allows it to buy the building at the then -prevailing \nfair market value at any time during the lease term \n□ The seller -lessee’ s incremental borrowing rate is 9.3 % and the interest rate implicit in the \nlease back is not known \nHow should the seller -lessee account for the sale and leaseback of the building? \nAnalysis \nBecause the seller -lessee has a repurchase option and there are no alternative buildings that are \nsubstantially the same and readily available in the marketplace, the buyer -lessor does not obtain \ncontrol of the building prior to the end of the leaseback te rm. The transaction would not qualify for \nsale accounting and should be accounted for as a financing . \nIn this case, application of t he financing method based on the seller -lessee ’s incremental borrowing \nrate of 9.3% yields the following : \nPeriod Net \ncarryin g \namount Asset \nvalue Accumulated \ndepreciation Financial \nliability Increase \nof liability Interest \nexpense \nInception $800,000 $1,200,000 $400,000 $950,000 $ – $ – \nYear 1 720,000 1,200,000 480,000 963,350 13,350 88,350 \nYear 2 640,000 1,200,000 560,000 977,942 14,592 89,592 \nYear 3 560,000 1,200,000 640,000 993,89 1 15,949 90,949 \nYear 4 480,000 1,200,000 720,000 1,011,32 3 17,432 92,432 \nYear 5 400,000 1,200,000 800,000 1,030,37 6 19,053 94,053 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 270}), Document(page\_content='Sale and leaseback transactions \n6-31 Use of the seller -lessee ’s incremental borrowing rate results in annual interest expense in excess of \nannual lease payments of $75,000 , which increases the financial liability over the term of the lease \n(i.e., negative amortization ). Since n egative amortization is prohibited, t he se ller-lessee should impute \nthe interest rate that eliminates the negative amo rtization . \nIn this example, an imputed interest rate of approximately 7. 89% results in interest expense of \n$75,000 , which is equivalent to the annual lease payment. Because the interest expense no longer \nexceeds the annual lease payment, the re would not be any negative amortization. \nApplication of t he financing method based on the imputed interest rate of approximately 7. 89% is \nillustrated below: \nPeriod Net \ncarrying \namount Asset value Accumulated \ndepreciation Financial \nliability Increase of \nliability Interest \nexpense \nInception $800,000 $1,200,000 $400,000 $950,000 $ – $ – \nYear 1 720,000 1,200,000 480,000 950,000 – 75,000 \nYear 2 640,000 1,200,000 560,000 950,000 – 75,000 \nYear 3 560,000 1,200,000 640,000 950,000 – 75,000 \nYear 4 480,000 1,200,000 720,000 950,000 – 75,000 \nYear 5 400,000 1,200,000 800,000 950,000 – 75,000 \nAt the end of the five -year leaseback term, the seller -lessee would recognize the sale of the building \nwith a gain of $550,000 ( financial liability of $950,000 – $400,000 net carrying amount). \nEXAMPLE LG 6-15 \nFailed sale and leaseback – buyer -lessor does not obtain control of the underlying asset prior to the \nend of the le aseback term \n A seller -lessee sells a building for $950,000 cash and agrees to lease the building back for five years. \nConsider the following facts about this transaction: \n□ The net carrying amount of the building as of the date of sale is $800,000 \n□ The annua l leaseback payment is $200,000 \n□ Annual depreciatio n expense is $80,000 \n□ The seller -lessee does not guarantee the residual value of the asset at the end of the leaseback term \n□ The seller -lessee has a repurchase option that allows it to buy the building at the then -prevailing \nfair market value at any time during the lease term ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 271}), Document(page\_content='Sale and leaseback transactions \n6-32 □ The seller -lessee’s incremental borrowing rate is 9.3% and the interest rate implicit in the \nleaseback is not known \nHow should the seller -lessee account for the sale and le aseback of the building? \nAnalysis \nBecause the seller -lessee has a repurchase option and there are no alternative buildings that are \nsubstantially the same and readily available in the marketplace , the buyer -lessor does not obtain \ncontrol of the building pr ior to the end of the leaseback term. T he transaction does not qualify for sale \naccounting and should be accounted for as a financing. \nIn this case, application of t he financing method based on the seller -lessee ’s incremental borrowing \nrate of 9.3% is illu strated below : \nPeriod Net \ncarrying \namount Asset value Accumulated \ndepreciation Financial \nliability Reduction \nof liability Interest \nexpense \nInception $800,000 $1,200,000 $400,000 $950,000 $ – $ – \nYear 1 720,000 1,200,000 480,000 838,350 111,650 88,350 \nYear 2 640,000 1,200,000 560,000 716,317 122,033 77,967 \nYear 3 560,000 1,200,000 640,000 582,934 133,383 66,617 \nYear 4 480,000 1,200,000 720,000 437,147 145,787 54,213 \nYear 5 400,000 1,200,000 800,000 277,802 159,345 40,655 \nUse of the seller -lessee ’s incremental borrowing rate results in a financial liability of $277,80 2, which \nis less than the asset ’s carrying amount of $400,000 ; therefore, a built -in loss exist s. Since a built -in \nloss is prohibited, the seller -lessee would increase the interest rate until the financial liability equaled \nthe expected carrying value of the asset. In this example, an imputed interest rate of approximately \n11.93% is required. \nThe fina ncing method based on the imputed interest rate of 11.9 3% is illustrated below: \nPeriod Net \ncarrying \namount Asset \nvalue Accumulated \ndepreciation Financial \nliability Reduction \nof liability Interest \nexpense \nInception $800,000 $1,200,000 $400,000 $950,000 $ – $ – \nYear 1 720,000 1,200,000 480,000 863,297 86,703 113,297 \nYear 2 640,000 1,200,000 560,000 766,255 97,043 102,957 \nYear 3 560,000 1,200,000 640,000 657,638 108,618 91,384 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 272}), Document(page\_content='Sale and leaseback transactions \n6-33 Period Net \ncarrying \namount Asset \nvalue Accumulated \ndepreciation Financial \nliability Reduction \nof liability Interest \nexpense \nYear 4 480,000 1,200,000 720,000 536,069 121,570 78,430 \nYear 5 400,000 1,200,000 800,000 400,000 136,068 63,932 \nSince the financial liability and net carrying amount of the asset are equal on the date the buyer -lessor \nobtains control, t he seller -lessee would recognize the sale of the building with no gain or loss . \nEXAMPLE LG 6-16 \nFailed sa le and leaseback – seller -lessee sells asset and b uyer -lessor obtains control of the underlying \nasset prior to the end of the l easeback term \n A seller -lessee sells a building for $950,000 cash and agrees to lease the building back for five years. \nConsider the following facts about this transaction: \n□ The net carrying amount of the building as of the date of sale is $800,000 \n□ The annual leaseback payment is $100,000 \n□ Annual depreciatio n expense is $80,000 \n□ The seller -lessee does not guarantee the residual value of the asset at the end of the lease back term \n□ The seller -lessee has a repurchase option that allows it to buy the building at the then -prevailing \nfair market value at any time during the lease term \n□ The seller -lessee’ s incremental borrowing rate is 9.3 % and the interest rate implicit in the \nlease back is not known \nAssume the lease cont ract is modified at the end of the third year to remov e the seller -lessee ’s \nrepurchase option . As a result , the buyer -lessor obtains control of the asset at the end of the third year. \nHow should the seller -lessee account for the sale and leaseback of the building? \nAnalysis \nBecause the seller -lessee has a repurchase option and there are no alternative buildings that are \nsubstantially the same and readily available in the marketplace , the buyer -lessor does not obtain \ncontrol of the building at the transa ction effective date. T he transaction would not qualify for sale \naccounting and should be accounted for as a financing at the transaction effective date . \nAt the e nd of the third year, due to the modification, the buyer -lessor obtains control of the asset . At \nthat time, the seller -lessee would recognize the sale of the asset and any gain that result ed from \nremoving the underlying asset and financial liability from its books. \nApplication of t he financing method for this scenario is illustrated below : ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 273}), Document(page\_content='Sale and leaseback transactions \n6-34 Period Net \ncarrying \namount Asset value Accumulated \ndepreciation Financial \nliability Reduction \nof liability Interest \nexpense \nInception $800,000 $1,200,000 $400,000 $950,000 $ – $ – \nYear 1 720,000 1,200,000 480,000 938,350 11,650 88,350 \nYear 2 640,000 1,200,000 560,000 925,617 12,733 87,267 \nYear 3 560,000 1,200,000 640,000 911,699 13,918 86,082 \nAt the end of the third year when the repurchase option is removed , the seller -lessee would assess the \nclassification of the lease because the lease was contractually modified . If classified as an operating \nlease , the seller -lessee would remove the financial liability and asset from its book s and recognize a \ngain of $351,699 ($911,699 financial liability – $560,000 net carrying amount ). The date of transfer of \ncontrol is considered the lease commencement date. However, i f the seller -lessee classified the lease as \na finance lease , no sale has occurred and the transaction would continue to be accounted for as a failed \nsale and leaseback. See LG 6.3.4 for information on the impact of lease classification on qualification \nas a sale. \n6.5.1.3 Accounting by the seller -lessee when the leaseback is for a portion of the asset \nWhen a failed sale and leaseback transaction involves a seller -lessee that leases back only a portion of \nthe asset , there are additional accounting considerations. Since the asset is not derecognized by the \nseller -lessee , there may be leases associated with other portions of the asset . These leases must be \naccounted for by the seller -lessee , and rental income should be imputed for the other leases , offset by \nadditional imputed debt service. \nExample LG 6-17 illustrate s how a seller -lessee should account for a leaseback of a portion of an \nunderlying asset when there are other leases in place. \nEXAMPLE LG 6-17 \nSeller -lessee sells an asset and leases back a portion of the asset \nA selle r-lessee sells a shopping center in whi ch it occupies the anchor store to a buyer -lessor and leases \nback only its store location . Consider the following facts about this transaction: \n□ The shopping center is one legal asset \n□ The shopping center is sold at fair value and the leaseback rentals reflect market rental rates \n□ The seller -lessee has a repurchase option \n□ There are no alternative assets that are substantially the same and readily available in the \nmarketplace \nHow should the seller -lessee account for the sale and leaseback of the building? ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 274}), Document(page\_content='Sale and leaseback transactions \n6-35 Analysis \nBecause the seller -lessee has a repurchase option and there are no alternative assets that are \nsubstantially the same and readily available in the marketplace , the transaction would not qualify for \nsale accounting. It should be accounted for as a financing transaction. The net carrying amount of the \nasset would remain on the seller -lessee ’s books and the seller -lessee would continue to record annual \ndepreciation expense . \nThe cash proceeds received from the buyer -lessor would be recorded as a financial liability . The rental \npayments made to the buyer -lessor for use of the anchor store would be re -characterized as debt \nservice on the financing. In ad dition, since the seller -lessee does not have use of the other stores \n(which are retain ed on its balanc e sheet ), it should impute rental income for the lease of the stores \noffset by additional impute d debt service. \nThe transaction should not be accounted for as a part ial sale and part ial financing. \nIt may be difficult to apply the imput ed revenue model, previously described, when the asset involved \nin the sale and leaseback transaction is not fully utilized at the transaction date. When applying the \nimputed revenue model, a seller -lesse e should consider the amount of asset usage and time necessary \nto lease vacancies. If the buyer -lessor is expected to lease the asset to third parties , we believe it is \nacceptable for the seller -lessee to impute rental income based on rents due from actual tenants ; \nhowever, it may be difficult for the seller -lessee to apply this approach as it is no longer the legal owner \nof the asset and may not have access to the necessary information . Accordingly, we also believe it is \nacceptable for the seller -lessee to impute estimated market rental income as if the buyer -lessor is \nleasing all of the other stores from the seller -lessee (and subletting the stores to other tenants). \nHowever, the specific facts and circumstances, including the expected time necessary to lease the \nvacant space, should be considered when applying this alternative approach. For example, i f 20% of \nthe stores in the strip shopping center were vacant at the time of the sale and leaseback transactio n \nand it typically requires several months to l ease vacant space, it would be inappropriate to assume that \nthe buyer -lessor was immediately leasing 100 % of such vacant space from the seller -lessee at a market \nrental rate. \n6.5.2 Accounting for a failed sale and leaseback by a b uyer -lessor \nTo account for a failed sale and leaseback transaction as a financing arrangement , the buyer -lessor \nrecords t he initial payment to the seller -lessee as a financial asset (i.e., a loan receivable ). \nAs the seller -lessee makes rental payments , the buyer -lessor should allocate the payments between \ninterest income and principal repa yments on the financial asset. \nTo determine the amount allocat ed to interest income , the buyer -lessor should utilize an interest rate \nbased on the guidance in ASC 835, Interest , specifically, ASC 835 -30-25-12 through ASC 835 -30-25-\n13. Accordingly, the buyer -lessor ’s interest rate may not be the same as the seller -lessee ’s rate, \nparticularly when the seller -lessee has adjusted its interest rate to avoid negative amortization or a \nbuilt -in-loss. Variable payments should be accounted for in accordance with ASC 310. See LI 6.5 .1.2 \nfor information on accounting for variable rate loans. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 275}), Document(page\_content='Sale and leaseback transactions \n6-36 6.5.2.1 Accounting by the bu yer-lessor when it obtains control of the asset \nA buyer -lessor may obtain contro l of the asset at any time , including at the end of the leaseback period . \nIf a sale is ultimately recognized in a failed sale and leaseback transaction, the remaining balance of \nthe financial asset represents the cost of the underlying asset that the buyer -lessor purchases. \nExample LG 6-18 and Example LG 6-19 illustrate the accounting for a failed sale and leaseback by the \nbuyer -lessor , including the accounting by the buyer -lessor when control is obtained. \nEXAMPLE LG 6-18 \nFailed sale and leaseback – buyer -lessor obtain s control of the underlying asset at the end of the \nleaseback term \nA seller -lessee sells a building for $950,000 cash and agrees to lease the building back for five years. \nConsider the following facts about t his transaction: \n□ The net carrying amount of the building as of the date of sale is $800,000 \n□ The annual leaseback payment is $100,000 \n□ Annual depreciatio n expense is $80,000 \n□ The seller -lessee does not guarantee the residual value of the asset at the end of the lease back term \n□ The seller -lessee has a repurchase option that allows it to buy the building at the then -prevailing \nfair market value at any time during the lease term \n□ The buyer -lessor’s interest rate implicit in the lease back is 9% \nHow should the buyer -lessor account for the sale and leaseback of the building? \nAnalysis \nBecause the seller -lessee has a repurchase option and the re are no alternative buildings that are \nsubstantially the same and readily available in the marketplace , the buyer -lessor does not obtain \ncontrol of the underlying asset prior to the end of the leaseback term. The transaction would not \nqualify for sale accounting and should be accounted for as a lending transaction by the buyer -lessor. \nThe asset would not be recor ded by the buyer -lessor and the original purchase price of $950,000 \nwould be recorded as a financial asset. \nThe a nnual leaseback payments from the seller -lessee of $100,000 would be allocated between \ninterest income and principal repayments on the financial asset. Because the cash flows supporting the \nfinancial asset are the same as the cash flows underlying the leaseback, applying the guida nce to \ndetermine the appropriate interest rate in ASC 835 results in a rate similar to the rate implicit in the \nleaseback, or 9%. I n year 1, for example, the buyer -lessor would record interest income of $85,500 \n(calculated by multiplying the beginning bala nce of the financial asset, $950,000 by 9%). The \nprincipal repayment is calculated as the difference between the annual leaseback payment and the \nallocation of interest income ($100,000 payment – interest income of $85,500 = $14,500 ). ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 276}), Document(page\_content='Sale and leaseback transactions \n6-37 At the end of the fi fth year, the leaseback and repurchase option expire and the buyer -lessor would \nobtain control of the asset . At that time, the buyer -lessor would recognize the purchase of the asset and \nremove the financial asset from its books. \nApplication of t he financi ng method is illustrated below: \nPeriod Lease payment Financial asset Principal \nrepayment Interest \nincome \nInception $ – $950,000 $ – $ – \nYear 1 100,000 935,500 14,500 85,500 \nYear 2 100,000 919,695 15,805 84,195 \nYear 3 100,000 902,468 17,227 82,773 \nYear 4 100,000 883,690 18,778 81,222 \nYear 5 100,000 863,22 2 20,46 8 79,532 \nAt the end of the five -year leaseback term, the buyer -lessor would record its purchase of the asset at a \npurchase price of $863,22 2, the remaining balance of the financial asset at that time . \nEXAMPLE LG 6-19 \nBuyer -lessor obtain s control of the underlying asset prior to the end of the leaseback term \n A seller -lessee sells a building for $950,000 cash and agrees to lease the building back for five years. \nConsider the following facts about this transaction: \n□ The net carrying amount of the building as of the date of sale is $800,000 \n□ The annual leaseback payment is $100,000 \n□ Annual depreciatio n expense is $80,000 \n□ The seller -lessee does not guarantee the residual value of th e asset at the end of the lease back term \n□ The seller -lessee has a repurchase option that allows it to buy the building at the then -prevailing \nfair market value at any time during the lease term \n□ The buyer -lessor’s interest rate implicit in the lease back is 9% \nAssume the lease cont ract is modified at the end of the third year to remove the seller -lessee ’s \nrepurchase option . As a result , the buyer -lessor obtains control of the asset at the end of the third year. \nHow should the buyer -lessor account for the sale and leaseback of the building? ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 277}), Document(page\_content='Sale and leaseback transactions \n6-38 Analysis \nBecause the seller -lessee has a repurchase option and there are no alternative buildings that are \nsubstantially the same and readily available in the marketplace , the buyer -lessor does not obtain \ncontrol of the building at the transaction effective date. T he transaction would not qualify for sale \naccounting and should be accounted for as a financing at the transaction effective date . \nAt the e nd of the third year, due to the modification, the buyer -lessor obtains control of the asset . At \nthat time, the buyer -lessor would recognize the purchase of the asset and remove the financial asset \nfrom its books. \nApplication of t he financing method for this scenario is illustrated below : \nPeriod Lease payment Financial asset Principal \nrepayment Interest \nincome \nInception $ – $950,000 $ – $ – \nYear 1 100,000 935,500 14,500 85,500 \nYear 2 100,000 919,695 15,805 84,195 \nYear 3 100,000 902,468 17,227 82,773 \nAt the end of the third year , the buyer -lessor would record its purchase of the asset at a purchase price \nof $902,468, the remaining balance of the financial asset at that time. Any unamortized debt \norigination costs are inherently in the p urchase price of the asset (i.e. , the initial carrying amount of \nthe property, plant , and equipment). \nThe buyer -lessor would classify the lease as an operating lease when control transfers (i.e. , the lease \ncommencement date). \nIf the lease were classified as a direct finance lease, the buyer -lessor would record the net investment \nin the lease at the carrying amount of the financial asset (i.e. , $902,468). The buyer -lessor would \nsubsequently recognize income based on the rate that produces a constant periodic rate of return on \nthe net investment in the lease. S ee LG 4.3.2 for information on the accounting for direct finance \nleases. \n6.6 Imp act of sale and leaseback transactions on business \ncombinations \nIn a business combination , an acquiree may have previously applied sale and leaseback accounting in a \ntransaction with a third party that was separate from the business combination. Refer to BCG 4.3.3.7 \nfor the accounting imp act of sale and leaseback transactions on business combinat ions. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 278}), Document(page\_content='Chapter 7: \nLeveraged leases –updated \nMay 2023 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 279}), Document(page\_content="Leveraged leases \n7-27.1 Leveraged leases overview \nLeveraged leases are those leases that meet the criteria in ASC 840- 10-25-43(c). The guidance on \nleveraged leases has not been carried forward int o the leasing standard. Instea d, ASC 842- 10-65-1(z) \ngrandfathers the accounting f or leveraged leases existi ng at its effective date. Accordingly, a lessor \nshould continue to apply the guidance in ASC 840 to leveraged leases that commenced prior to the \neffective date of ASC 842. See LG 9 for information on effective date and transition. \nBecause ASC 842 does not allow a new lease to be accounted for as a leveraged lease, any new lease \nshould be accounted for as either operating, sales-type, or direct financing leases, as required under \nASC 842. \n7.2 Definition and characteristics of a leveraged lease \nThe Glossary in ASC 842-50 defines a leveraged lease . \nDefinition from ASC 842 -50-20 \nLeveraged Lease : From the perspective of a lessor , a lease that was classified as a leveraged lease in \naccordance with the leases guidance in effect before the effective date and for which the \ncommencement date is before the effective date. \nPrior to the adoption of ASC 842, a lease was considered a leveraged lease if the terms of the \narrangement met specified criteria. It had to qualify as a direct financing lease under ASC 840 -10-25-\n43(b) and meet the criteria specific for leveraged leases in ASC 840 -10-25-43(c) (see LG 7.2.1) . \nExcerpt from ASC 840 -10-25-43 \nIf the lease at inception meets any of the four lease classification criteria in paragraph 840-10-25-1 and \nboth of the criteria in the preceding paragraph, it shall be classified by the lessor as a sales -type lease, a \ndirect financing lease, a leveraged lease, or an operating l ease as follows: \na.Sales -type lease. ..\nb.Direct financing lease. A lease is a direct financing lease if it meets all of the following conditions:\n1.It meets any of the criteria in paragraph 840-10-25-1 and both of the criteria in the preceding\nparagra ph.\n2.It does not give rise to manufacturer's or dealer's profit (or loss) to the lessor.\n3.It does not meet the criteria for a leveraged lease in (c).\nc.Leveraged lease. Leases that meet the criteria of sales -type leases set forth in (a) shall not be\naccounted for as leveraged leases but shall be accounted for as prescribed in paragraph 840-30-\n25-6. A lease is a leverage d lease if it has all of the following characteristics:\n1.It meets the criteria in (b)(1) and (b)(2) for a direct financing lease.", metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 280}), Document(page\_content="Leveraged leases \n7-32.It involves at least three parties: a lessee, a long -term creditor, and a lessor (commonly called\nthe equity participant).\n3.The financing provided by the long -term creditor is nonrecourse as to the general credit of the\nlessor (although the creditor may have recourse to the specific property leased and the\nunremitted rentals relating to it). The amount of the financing is sufficien t to provide the\nlessor with substantial leverage in the transaction.\n4.The lessor's net investment (see paragraph 840-30-25-8) declines during the early years once\nthe investment has been completed and rises during the later years of the lease before its fi nal\nelimination. Such decreases and increases in the net investment balance may occur more than\nonce .\nLeveraged lease classification applies only to lessors. Lessees should account for leveraged leases in \nthe same manner as nonleveraged leases and classif y them as operating or finance leases, as \nappropriate. The grandfathering of leveraged leases, therefore, does not affect lessees; they should \napply the applicable transition guidance to their leases upon adopting ASC 842. \n7.2.1 Classification criteria for leve raged leases \nLeveraged leases have the following characteristics: \n□The terms of the lease meet the criteria to be classified as a direct financing lease, as defined in\nASC 840\n□The lease involves at least three parties: a lessee, a long -term creditor, and a lessor\n□The financing provided by the long -term creditor is nonrecourse to the general credit of the lessor\nand must provide the lessor (the equity investor) substantial leverage in the transaction\n□The lessor’s net investment in the leverage d lease declines during the early years of the lease term\nand subsequently rises\n7.2.1.1 Classification as a direct financing lease under ASC 840 \nThe definition of a direct financing lease under ASC 842 differs from its definition under ASC 84 0. \nClassification as a direct financing under ASC 840 was only possible when the lease did not give rise to \nprofit or loss to the lessor at lease inception, i.e., the cost (or carrying value, if different) and fair value \nof the leased asset must be equal. If cost (or carrying value, if different) did not equal fair value at lease \ninception, the lessor could not classify the lease as a direct financing lease and it would be ineligible f or \nleveraged lease accounting ; rather, it would be classif ied as either a sales -type or operat ing lease, as \nappropriate. Unless the asset is acquired contemporaneously with the execution of the lease, the \nlessor’s cost (or carrying value, if different), and fair value of the underlying asset subject to a lease, are \ntypically not the same at lease i nception and, therefore, classification as a direct financing lease or \nleveraged lease under ASC 840 was rare. An example of a situation whe n a lease may have qualif ied as \na direct financing lease is whe n a bank acquire d a building from a third party and lease d it under a \ncapital lease (as defined by ASC 840) to the lessee. In this case, the cost and fair value of the real estate \n(land and building) would likely be the same given the purchase and concurrent sales -type lease. ", metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 281}), Document(page\_content="Leveraged leases \n7-47.2.1.2 “Down -and -up pattern” of a leveraged lease \nTo qualify as a leveraged lease, t he lessor’s net investment in the leveraged lease must decline during \nthe early years of the lease term and subsequently rise . Income from a leveraged lease is recognized by \nthe lessor by applying a level rate of return to the net investment, but only in the periods that the net \ninvestment is positive. Because the calculated return is an after -tax amount, the cash flows from \naccelerated tax benefits are included in the overall leveraged lease cash flows. These cash flows occur \nin the early years of the lease and result in a rapid recovery of (i.e., decline in) the net investment, \noften causing the net investment to turn negative. The lessor will ultimately “reinvest” in the leve raged \nlease through the repayment of deferred tax liabilities, causing the net investment to increase in the \nlater periods of the lease. This typical “down -and-up pattern ” in the net investment causes a \nsubstantial portion of the income to be recognized in the early periods of the lease, which is a \nrecognition pattern that is far more accelerated than a typical loan amortization (i.e., effective interest) \npattern. \nWhile the “down -and-up pattern ” of a leveraged lease is typically created by the tax -related cash flows, \nASC 840 -10-25-43(c)(4) does not require that the pattern be created from the tax -related cash flows. \nMoreover, it does not require that the net investment in the leveraged lease go negative (in which case \nthe balance of the deferred tax credit would exceed the pretax investment in the leveraged lease) at any \npoint during the lease term. When the “ down -and-up pattern ” results from non tax -related cash flows, \njudgment may be required to determine whether the “down -an-up pattern ” is sufficient to q ualify for \nleveraged lease accounting. \n7.2.1.3 Applying leveraged lease classification to partnerships \nThe classification criteria in ASC 840 -10-25-43(c), which requires that the lessor's net investment, as \ndefined, decline during the early years and rise during the later years of the lease, was generally not \nmet in a partnership because the income tax benefits of the transaction are not realized by the \npartnership entity. \nGenerally, partnerships as lessors in an otherwise leveraged lease -type transaction did not account for \nthe lease as a leveraged lease in situa tions whe n income tax benefits resulting from the transaction \n(e.g., investment tax credits (ITCs) and the use of accelerated depreciation) were not available to the \nentity, but, instead, were realized directly by the partners. \nASC 740 -10-25-46 describes two methods to account for ITCs: the “flow -through method” and the \n“deferral method.” The deferral method, under which the tax credit is reflected in net income over the \nlife of the acquired property, besides being described in ASC 740 -10-25-46 as “conside red preferable,” \nis more consistent with the income recognition model for a leveraged lease. Refer to TX 3.3. 5.2 for \nmore information about these two methods. If a partner's investment in the lease, as defined, would \nhave met the requirements of ASC 840 -10-25-43(c) because of the partner's ability to reflect the \nrelated income tax benefits, and the partner accounts for the ITC under the “deferral method ,” (as \nopposed to the “flow -through method”), the partner may have used leveraged -lease accounting to \nreco rd its share of partnership income. \n7.2.2 Economic rationale for leveraged leases \nHistorically, leveraged leases were attractive to lessees that were unable to take advantage o f the tax \nbenefits typically associated with owning property, such as accelerated dep reciation and investment \ntax credits. Lessors would typically obtain nonrecourse financing for 65% to 80% of the cost of the ", metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 282}), Document(page\_content='Leveraged leases \n7-5leased asset (tax regulations required the lessor to have a minimum of 20% of the cost of the leased \nasset “at -risk”). This typical ly enabled lessors to claim all the tax benefits of owning the asset, \nincluding deductions for interest expense on the nonrecourse financing, despite a relatively small \ninvestment. \nThe tax benefits associated with investing in the asset are typically reali zed relatively early in the lease \nterm. Given the early return of investment, a lessor in a leveraged lease was able to offer a lessee a \nlower cost of borrowing than the lessee might have been able to obtain in a financed purchase \ntransaction. \nChanges in tax regulations related to depreciation and investment tax credits, as well as the reduction \nin corporate tax rates during the 1980’s reduced the tax benefits of leveraged leases to lessors, as well \nas their attractiveness to investors. Accordingly, many e xisting leveraged leases are in the later part of \ntheir lease terms. \n7.2.3 Presentation and income recognition of leveraged leases \nThe balance sheet presentation (as described in ASC 840 -30-30-14) and income recognition pattern \nfor a leveraged lease (as describe d in ASC 840 -30-35-33 through ASC 840 -30-35-36) are both unique \nmodels. \nLeveraged leases are presented as a net asset on the lessor’s balance sheet. The net asset equals the \nsum of the total rents receivable from the lessee and the estimated residual valu e of the asset at the \nexpiration of the lease less the debt service associated with the nonrecourse debt, all reduced by \nunearned income. This net presentation is attractive to lessors as it enhances its investment return on \nassets. \nThe accounting treatme nt prescribed for leveraged leases requires one overall method of income \nrecognition (level rate of return for those years when net investment in the lease is positive, based \nupon the after -tax cash flows projected at the inception of the leveraged lease) for all components of \nincome to be realized, including investment tax credit. \nAlthough the accounting for leveraged leases is inherently inconsistent with accounting for other \ncollateralized financings, the FASB decided to allow lessors to continue to app ly the leveraged lease \nmodel because of the relatively small population of leveraged leases, the relative age of the lease \narrangements, and the fact that this accounting model is only applicable to lessors. A leveraged lease \nmay no longer be grandfathered if the lessor modifies or changes the characteristics of the lease , as \ndescribed in LG 7.3 .1. \n7.2.3.1 Leveraged lease: presentation of investment tax credit \nThe examples included in ASC 84 2-50-55-6 through ASC 842-50-55-15 indicate the inclusion of ITC \namortization with income tax expense. There is, however, a large body of practice that reflects ITC \namortization as part of pretax revenue. Disclosure of the method applied is recommended. \nThe examples in ASC 842-50-55-6 through ASC 842-50-55-15 indicate t hat the unamortized balance \nof deferred ITC would be presented in the lessor\'s balance sheet as a component of "unearned and \ndeferred income" deducted in arriving at the net investment in the leveraged lease included among \nassets. This presentation is cons istent with the discussion in ASC 255 -10-55-8. \nThe treatment of deferred investment tax credit s as a temporary difference is discussed in TX 3.3. 5. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 283}), Document(page\_content='Leveraged leases \n7-67.3 Changes to a leveraged lease arrangement \nOnce a lessor adopts ASC 842, it may only continue to apply leverag ed lease accounting to leases \ngrandfathered at the transition date . A lessor should account for any leveraged lease that is modified \non or after the effective date of ASC 842 as a new lease as of the effective date of the modification in \naccordance with th e guidance in ASC 842-10 and ASC 842 -30. See LG 3 for information on lease \nclassification. \nA leveraged lease arrangement may be changed in one or more ways during the lease term, including \nthrough the following events or actions: \n□Lessor actions that chang e the fundamental characteristics of a leveraged lease transaction, for\nexample, refinancing the nonrecourse debt\n□An agreement by the lessor and lessee to modify or restructure the provisions of the lease\n□Changes in the assumptions regarding the total amo unt or projected timing of related cash flows\nDepending on the type of change in the leveraged lease, the lessor may be required to: \n□Reassess the lease classification in accordance with ASC 840 -10-35-4 and discontinue accounting\nfor the lease as a leverag ed lease if the characteristics required for leveraged lease accounting are\nno longer present\n□Discontinue the use of leveraged lease accounting and account for the modified arrangement as a\nnew lease under ASC 842\n□Recalculate the net investment in the leve raged lease and record a gain or loss in the period of the\nchange, without reassessing the classification of the lease\n7.3.1 Changes to the fundamental characteristics \nAs noted in LG 7.2, an arrangement must have certain characteristics to qualify for leveraged lease \naccounting. A lessor may change aspects of the fundamental structure of an existing lease without \nnecessarily changing the provisions of the agreement with the lessee. If, as a result of such changes, \none or more of the defining characteristics of a leveraged lease are no longer present, the lessor may be \nrequired to discontinue leveraged lease accounting and reclassify the lease. If a lessor is required to \ndiscontinue leveraged lease accounting, it should classify the lease on the date it is changed as either \nan operating, sales -type, or direct financing lease based on the guidance in ASC 842. \nExamples of changes that could cause a lessor to discontinue leverage lease accounting include: \n□A lessor repays all of the nonrecourse debt, such that the tra nsaction no longer has a long -term\ncreditor\n□A lessor repays a portion of the nonrecourse debt, such that the amount of nonrecourse debt no\nlonger represents “substantial leverage” in the transaction\n□A lessor replaces the nonrecourse debt with recourse debt', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 284}), Document(page\_content='Leveraged leases \n7-77.3.1.1 Leveraged lease: requirement for a long -term creditor \nIn addition to other criteria, a leveraged lease transaction must have a long -term creditor that provides \nthe lessor with substantial leverage in the transaction, as discussed in ASC 840 -10-25-43(c). T hat \nguidance does not define the required duration that the long -term creditor must remain in the \ntransaction to qualify as a leveraged lease and does not define how much debt would provide \n“substantial leverage.” Historically, “long -term” was interpreted as nonrecourse financing being \npresent for a majority of the lease term. \nWhen a lessor changes any aspect of the nonrecourse debt payment pattern, it should evaluate \nwhether the repayment causes the lease to fail the requirement to have a long -term credito r necessary \nto continue to classify the lease as a leveraged lease. \n7.3.1.2 Leveraged lease: requirement for substantial leverage \nWhen a lessor repays all or a portion of the nonrecourse debt, it should also consider whether the \narrangement, as altered, provides the lessor with substantial leverage. As discussed above, most \nleveraged leases were originally structured to provide as much as 80% leverage in the transaction. \nHowever, historically, a lease that was initially financed with more than 50% debt at lease \ncommencement was generally accepted to have had enough leverage to have qualified for leveraged \nlease accounting, provided that the debt outstanding remained significant throughout the duration of \nthe nonrecourse debt. When nonrecourse debt amortizes ratably over its term, this requirement is \ntypically met. \nAs noted above, whenever a lessor changes any aspect of the nonrecourse debt payment pattern, it \nshould evaluate its specific facts and circumstances to determine whether this requirement continues \nto be met such that the arrangement continues to qualify f or leveraged lease accounting. \n7.3.1.3 Leveraged lease: requirement for nonrecourse debt \nTo be considered nonrecourse debt, the lender may only have recourse to the following interests in the \nlease: \n□Unremitted rents\n□Variable rents not included in the lease receiv able (i.e., contingent rents as defined by ASC 840 )\n□The underlying asset\n□A residual value guarantee from the lessee\nIf the lessor refinances the nonrecourse debt with debt that has other recourse features, the \nrefinancing would disqualify the lessor from applying leveraged lease accounting. In general, the \nfinancing may not have features under which non -rental amounts due to the lessor are subordinate to \nthe financing. Examples of such non -rental amounts include amounts remitted to the lessor to pay for \nexecutory costs (e.g., property insurance) or for services the lessor provides to the lessee. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 285}), Document(page\_content='Leveraged leases \n7-87.3.2 Modifications to a leveraged lease \nA lessor and lessee may negotiate changes to a leveraged lease. For example, the lessor may reduce or \nrestructure the rents or e nter into a new arrangement to lease the asset to a new lessee. The guidance \nin ASC 842 -10-65-1(z), however, does not allow a lease to be accounted for as a leveraged lease if the \nterms of the lease are modified on or after the effective date of ASC 842. The lessor should classify any \nsuch lease as a new lease as of the modification date, and classify the lease as either an operating, \nsales -type, or direct financing lease based on the guidance in ASC 842. See LG 3 for information on \nlease classification. \nAs noted in LG 7.2, leveraged lease classification applies only to lessors. Accordingly, whenever a \nleveraged lease is modified, notwithstanding that the lessor should account for the modified \nagreement as a new lease, the lessee may not ha ve to do so. Rather, the lessee should account for the \nmodification in accordance with the guidance in ASC 842 -10-25-8. See LG 5 for information on lease \nmodifications. \n7.3.2.1 Leveraged lease: replacing the lessee \nWhen the original lease agreement is replaced by a new agreement with a different lessee, the original \nleveraged lease is considered terminated. As discussed in LG 7.3, since ASC 842 does not permit new \nleveraged leases, the lessor should classify the new lease as operating, sales -type, or direct financ ing \nbased on the guidance in ASC 842. See LG 3 for information on lease classification. \n7.3.2.2 Discontinuing the use of leveraged lease accounting \nAs previously noted, changes to a leveraged lease may require a lessor to account for the lease as a new \nlease. To a pply the guidance in ASC 842, the lessor should separately account for each of the \ncomponents of its net investment that had been subject to leveraged lease accounting in accordance \nwith the applicable GAAP for that component. Accordingly, the lessor shoul d separately report the \nproperty subject to the new lease and the nonrecourse debt (i.e., the lessor will gross -up its balance \nsheet). While ASC 840 -30-40-7 contains specific guidance on how a lessor should measure the leased \nproperty upon termination of a lease, that guidance was superseded by ASC 842. See LG 5.8 for \nguidance on how the lessor should measure the leased property upon termination of a lease. \nDue to the unique income recognition pattern for leveraged leases, deferred taxes included in the net \ninvestment in the leveraged lease are accounted for in a manner prescribed by ASC 842 -50-35-4. \nWhen a lessor discontinues use of leveraged lease accounting, it should also adjust any associated \ndeferred tax assets or liabilities to reflect the amount it w ould have recognized had it accounted for \nthose deferred taxes in accordance with ASC 740. The adjustment should be recognized in income tax \nexpense in the period in which leveraged lease accounting is discontinued. \n7.3.3 Leveraged lease: changes in the underly ing assumptions \nASC 842-50-35-6 requires a lessor to review the estimated residual value and all other important \nassumptions used to determine the estimated total net income from the leveraged lease on at least an \nannual basis. T he projected timing of inc ome tax cash flows generated by the lease is an important \nassumption that should also be reviewed annually, or more frequently if events or circumstances \nindicate a change in the timing has occurred or might occur. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 286}), Document(page\_content='Leveraged leases \n7-9Changes in important assumptions require a lessor to recognize immediate gains or losses and change \nits scheduled income recognition, prospectively. However, changes to assumptions alone would not \ntypically require a lessor to reassess lease classification. \nExamples of changes in other importan t assumptions that would likely change the total estimated net \nincome from a leveraged lease include: \n□A change in the estimated amount of federal or state income taxes to be paid over the term of the\nlease\n□A change in enacted income tax rates, as well as those that result from a change in state\napportionment factors. (As noted in ASC 842 -50-35-14, a lthough interest and penalties assessed\nby the IRS change the estimated total net income from the lease, practice as well as the leveraged\nlease literature has excluded interest and penalties from the leveraged lease accounting .)\n□A change in assumptions regarding the deductibility of certain transaction -related expenses\n□Decreases in estimated residual value judged to be other -than -temporary; an upward adjustment\nof estimated residual value is not allowed\n□Other changes in the amount or timing of lease -related cash flows, for example, changes in the\namount or timing of rent collections\nAs required by ASC 842 -50-35-6, the rate of return and the allocation of income to positive investment \nyears should be recalculated from the inception of the lease. The change in the net investment as of the \ndate the arrangement is modified should be recognized as a gain or loss in the current period. The \ncollectability of restructure d lease payments and realization of the residual value should also be \nassessed. However, as discussed in ASC 842 -50-35-8, the lessor should not record an upward \nadjustment to the leased property’s residual value even if the amount of the lessee’s residual value \nguarantee is increased; this would be similar to recognizing a gain contingency, which is prohibited. \nThe pretax gain or loss recognized should be included in income from continuing operations before \nincome taxes in the same line item in which levera ged lease income is recognized. The tax effect of the \nrecognized pretax gain or loss should be included in the income tax line item. \n7.3.3.1 Leveraged lease: change in timing of income tax cash flows \nASC 842 -50-35-6(c) requires lessors to recalculate the rate of return from a leveraged lease when the \nprojected timing of income tax cash flows changes. As required by ASC 842-50-35-11, o nly changes in \nthe timing of the tax benefits that are directly related to a leveraged lease require the lessor to \nrecalculate the rate of return in the leveraged lease. Changes in timing that result from an alternative \nminimum tax (AMT) credit or a net op erating loss (NOL) carryforward of the lessor do not require a \nrecalculation, because such changes are not directly related to that lease. \nWhile a change in timing that is not directly related to the leveraged lease transaction would not, by \nitself, trigg er a requirement to recalculate the rate of return in the leveraged lease , the leveraged lease \nliterature requires that, if a recalculation is required for other reasons, the recalculation should include \nan update of all assumptions used in the leveraged l ease. Accordingly, any such recalculation must \ninclude the actual or expected changes in timing of all cash flows, including those due to AMT credits \nand NOL carryforwards, if significant. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 287}), Document(page\_content='Leveraged leases \n7-10Issues related to AMT credits are addressed in ASC 842-50-35-16 through ASC 842 -50-35-20. In \nparticular, an entity should include assumptions regarding the effect of the AMT, considering its \nconsolidated tax position in leveraged lease transactions. These assumptions require, at a minimum, \nannual review, and any change th at affects estimated after -tax net income should be accounted for in \nthe manner prescribed. \nAn enterprise whose tax position frequently varies between AMT and regular tax would not be \nrequired to recalculate each year unless there was an indication that th e original assumptions \nregarding total after -tax net income from the lease were no longer valid. In that circumstance, the \nenterprise would be required to revise the leveraged lease computations in any period in which total \nnet income from the leveraged le ase changes due to the effect of the AMT on cash flows for the lease. \nAs noted in LG 7.2.2, a lessor typically realizes the tax benefits associated with leveraged leases \nrelatively early in the lease term . However, historically, taxing authorities often ch allenged lessors’ tax \npositions related to leveraged leases, including both the amount s and the timing of the accelerated tax \nbenefits . As such, there may be some uncertainty about a lessor’s tax positions related to its leveraged \nleases. See TX 15 for mor e information about accounting for uncertain ty in income taxes. \nIf, during the lease term, the expected timing of income tax cash flows is revised, the leveraged lease \nwould be recalculated. The recalculation should incorporate: \n□actual cash flows up to th e date of the recalculation;\n□projected cash flows between the date of the recalculation and the date of any projected\nsettlement;\n□a projected settlement amount on the date of the projected settlement; and\n□projected cash flows following the date of the projected settlement.\nASC 842-50-35-8 through ASC 842-50-35-9 require the lessor to account for changes in the estimated \ntiming of inco me tax cash flows . \nASC 842 -50-35-9 \nThe projected timing of income tax cash flows generated by the leveraged lease is an important \nassumption and shall be reviewed annually, or more frequently, if events or changes in circumstances \nindicate that a change i n timing has occurred or is projected to occur. The income effect of a change in \nthe income tax rate shall be recognized in the first accounting period ending on or after the date on \nwhich the legislation effecting a rate change becomes law . \nASC 842 -50-35-10 \nA revision of the projected timing of the income tax cash flows applies only to changes or projected \nchanges in the timing of income taxes that are directly related to the leveraged lease transaction. For \nexample, a change in timing or projected timing of the tax benefits generated by a leveraged lease as a \nresult of any of the following circumstances would require a recalculation because that change in \ntiming is directly related to that lease: \na.An interpretation of the tax law', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 288}), Document(page\_content="Leveraged leases \n7-11b.A change in the lessor’s as sessment of the likelihood of prevailing in a challenge by the taxing\nauthority\nc.A change in the lessor’s expectations about settlement with the taxing authority.\nThe changes referred to in ASC 842-50-35-10(b) and ASC 842-50-35-10(c) require a recalculation in \ntwo situations involving a change in timing of tax -related cash flows . \nThe first situation is when there is a change in the amount of an expected settlement with the tax \nauthorities, for example, when the expected settlement changes from a 70/30 settlement (that is, a \nsettlement in which the lessor would retain 70 % of the timing benefit that is claimed on the tax return \nand would concede 30 % of that benefit) to a 60/40 settlement. This represents only a change in timing \nof tax -related cash flows b ecause the lost leveraged lease income will be re -recognized over the \nremaining lease term. For example, assume that the IRS disallows a portion of a lessor's depreciation \ndeductions, and the lessor enters into a settlement that reflects payment of the rel ated back taxes to \nthe IRS. The tax basis to the lessor of the leased property would be increased accordingly, and the \nlessor would enjoy the benefit of the additional tax deductions later in the lease term. The total net \nincome from the lease would not ch ange; however, the rate of return inherent in the leveraged lease \nwould be lower. As a result, the lost income would be recycled. \nThe second situation is when only the timing of the expected settlement changes, for example, when \nthe lessor originally expec ted a 70/30 settlement to occur in a one period, but then changed the \nexpected settlement date to one year later . Some lessors may be anticipating settling their tax \nexposures over a period of time. For example, they might expect to settle with the IRS for certain open \nyears prior to settling for other (later) open years. If so, the projected cash flows should reflect the \nmultiple settlements as they are expected to occur. \nThe recalculation should not incorporate interest and penalties that have been assess ed or that are \nexpected to be assessed. Such interest and penalties should be accounted for outside the leveraged \nlease model, in accordance with ASC 740. \nTo determine the estimated tax cash flows to be reflected in the recalculation, the lessor should fol low \nthe guidance in ASC 740. As described in TX 15.3.1.8, uncertain tax positions that relate only to the \ntiming of when an item is included on a tax return are automatically deemed to have met the \nrecognition threshold for purposes of applying the guidanc e in ASC 740. Therefore, if it can be \nestablished that the only uncertainty is when an item is taken on a tax return, such positions have \nsatisfied the recognition step for purposes of the guidance in ASC 740, and any uncertainty related to \ntiming should b e assessed as part of measurement. In these situations, the amounts to be included in \nthe recalculation of the leveraged lease should reflect the largest amount of benefit that is greater than \n50% likely of being realized. See TX 15.4 for more information on measuring the tax benefit to be \nrecorded on uncertain tax positions . \nBecause taxable income for most states is based on federal taxable income, lessors should consider the \neffects that estimated changes in the timing of federal income tax cash flows will have on the related \nstate income tax cash flows. \nAdvance payments and deposits made to the taxing authorities should not be considered cash flows of \nthe leveraged lease; rather, they should be included in any recalculation as of the actual settl ement \ndate or the expected settlement date. ", metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 289}), Document(page\_content="Leveraged leases \n7-12Example LG 7 -1 illustrates how a lessor should consider changes in estimates in timing of income tax \ncash flow s used to remeasur e a leveraged lease . \nEXAMPLE LG 7 -1 \nChange in the estimated timing of income tax cash flows \nA leveraged lessor used its original leveraged lease calculation to recognize income from a leveraged \nlease. The original calculation reflected income tax -related cash flows consistent with the filing \nposition taken on the lessor’s tax return. A t the beginning of year 4, however, the taxing authorities \nquestioned the timing of certain tax deductions in the lessor's filing position. Accordingly, the lessor \nrecalculate d the leveraged lease cash flows and record ed an adjustment to the net investment in the \nleveraged lease. \nThe original leveraged lease calculation was based on the following amounts: \nYear Tax deduction Tax benefit at a 40% rate \n1 $142,857 $57,143 \n2 244,898 97,960 \n3 187,075 74,830 \n4 153,061 61,224 \n5 119,048 47,619 \n6 53,061 21,224 \n7 0 0 \n8 0 0 \n9 0 0 \n10 0 0 \nTotal $900,000 $360,000 ", metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 290}), Document(page\_content='Leveraged leases \n7-13The taxing authorities have asserted that depreciation deductions should be taken as follows: \nYear Tax deduction \n1 $50,000 \n2 100,000 \n3 100,000 \n4 100,000 \n5 100,000 \n6 100,000 \n7 100,000 \n8 100,000 \n9 100,000 \n10 50,000 \n$900,000 \nAccording to the taxing authorities, the entity has taken excess depreciation deductions of $324,830 \nduring the first three years of the lease and underpaid income taxes (excluding interest and penalties) \nby $129,932 (for the latter, assume an income tax rate of 40 %). This example ignores interest and \npenalties as they are accounted for outside the leveraged lease model. \nThe entity believes that it will eventually enter into a negotiated settleme nt with the taxing authorities. \nThe settlement is expected to reflect a compromise, whereby the entity and the taxing authorities will \nagree that the entity will retain a negotiated portion of the benefits that are reflected in the timing of \nthe deductions ; the remaining benefit inherent in the timing of the deductions will be disallowed. As a \nresult of the disallowance, the entity will have to make a payment for the back taxes owed. After the \nsettlement, the entity will be able to take the remaining deprec iation, including the amount that was \ndisallowed in connection with the settlement. \nHow should the lessor evaluate the change in expected income tax cash flows? \nAnalysis \nWhen the lessor determines that the timing of the income tax cash flows pertaining to the leveraged \nlease are uncertain (assumed to be at the beginning of the fourth year of the leveraged lease), the \nlessor must determine whether a recalculation of the leveraged lease is required. Since the previous \nleveraged lease calculation was based on the assumption that income tax cash flows were consistent \nwith the position taken on the tax return, a recalculation will be required if the income tax cash flows \nthat are determined in accordance with the guidance of ASC 740 now differ from those taken on the \ntax return. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 291}), Document(page\_content='Leveraged leases \n7-14In the first step of the recognition and measurement process under the guidance of ASC 740, the lessor \nwould conclude that the uncertainty only relates to the timing of the deductions and income for tax \npurposes. Accordingly, the recogniti on threshold would be reached and the lessor would proceeds to \nstep 2 to determine the appropriate measurement. \nBased on the expected settlement with the IRS, t he lessor considers various possible outcomes: \nScenario Portion of timing benefits \nretained Portion of timing \nbenefits disallowed \n% % \nA 100 0 \nB 90 10 \nC 80 20 \nD 70 30 \nE 60 40 \nF 40 60 \nG 20 80 \nH 0 100 \nThe entity would assign probabilities to each of the possible outcomes. The individual probabilities \nand the cumulative probabilities are as follows : \nScenario Probability Cumulative probability \n% % \nA 5 5 \nB 10 15 \nC 15 30 \nD 15 45 \nE 25 70 \nF 20 90 \nG 10 100 \nH 0 100 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 292}), Document(page\_content='Leveraged leases \n7-15Under ASC 740, the accounting is based on the scenario that reflects the most advantageous result that \nhas a cumulative probability of at least 50% ( more likely than not. ) Scenario E is the first scenario with \na cumulative probability that exceeds 50 %. Acc ordingly, the lessor would recalculate the leveraged \nlease, based on the cash flows implied by scenario E. \nThe entity projects that at the end of year seven it will make a $60,000 payment to the taxing \nauthorities to settle the tax dispute. The amount is d etermined as follows: at the end of year 7, the \nentity will have taken all $900,000 in depreciation deductions, including the $250,000 of deductions \nthat the taxing authorities challenged. Scenario E is based on the assumption that the taxing \nauthorities w ill allow 60 % of the aggressive deductions and disallow 40 %. Therefore, the amount of \ndisallowed deductions will be $100,000 [$250,000 x 40%], and the taxes payable will be $40,000, \nbased on an income tax rate of 40% . \nThe entity projects the following depr eciation deductions after the projected settlement: \nYear Tax deduction \n8 $40,000 \n9 40,000 \n10 20,000 \nThese amounts coincide with the disallowed deductions. Mechanically, they are equivalent to 60 % of \nthe amount in the table relating to the original leveraged lease calculation plus 40 % of the amount in \nthe table relating to the deductions originally asserted by the taxing authorities. \nFinally , the entity will use the following income tax -related cas h flows to recalculate the leveraged \nlease. \nYear Tax deduction Tax benefit at \na 40% rate \n1 $142,857 $57,143 \n2 244,898 97,960 \n3 187,075 74,830 \n4 153,061 61,224 \n5 119,048 47,619 \n6 53,061 21,224 \n7 (100,000) (40,000) \n8 40,000 16,000 \n9 40,000 16,000 \n10 20,000 8,000 \n$900,000 $360,000 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 293}), Document(page\_content='Leveraged leases \n7-167.4 Leveraged leases acquired in a business combination \nA leveraged lease acquired in a business combination should retain its original lease classification \nprovided it is not modified and it was eligible for grandfathering under ASC 842. The net investment \nin the leveraged lease is recorded at its fair value o n the acquisition date, which normally \napproximates the present value of expected cash flows. Upon acquisition, the acquirer should measure \nthe net investment in the leveraged lease at its fair value and separately recognize its component parts \n(i.e., the net rentals receivables, estimated residual value, and unearned income) on a gross basis. \nA separate liability would be recorded in purchase accounting for pre -acquisition interest and \npenalties determined in accordance with ASC 740. The effects of any su bsequent adjustment of the \npre-acquisition liability would be determined in accordance with ASC 740. \nThe post -acquisition leveraged lease accounting would be based on income tax cash flows that are \ndetermined in accordance with ASC 740. If the acquirer exp ects to enter into a settlement with the \ntaxing authorities relating to payment of back taxes for deductions taken earlier than may be \nappropriate under the tax laws, the leveraged lease cash flows typically include the following \ncomponents: \n□The benefit of tax deductions that the lessor anticipates taking on its tax return up to the date of a\nprojected settlement with the taxing authorities;\n□A projected settlement amount on the date of the projected settlement; and\n□Projected cash flows following the date of the projected settlement.\nSince the tax -related cash flows required by ASC 740 may be different from the cash flows that a \nmarket participant would use to determine the fair value of a leveraged lease, the rate that is used in \nthe leveraged lease accounti ng would not necessarily be the same as the rate that was used to \ndetermine the fair value of the leveraged lease on the acquisition date. \nInterest and penalties that accrue on a n acquired leveraged lease after its acquisition should be \nrecognized in expense, outside the leveraged lease model. If, after the acquisition, circumstances \nchange the timing of the estimated income tax -related cash flows, the lessor should recalculate the \nleveraged lease and reflect the cumulative catch -up adjus tment in net income. The lessor should also \nadjust the liability for post -acquisition interest and penalties, as appropriate, and record the effects of \nthe adjustment in expense. \nSee ASC 842 -50-55-27 through ASC 842 -50-55-33 for an illustration. See BCG 4. 3.3.7 for additional \ninformation on the accounting for leases acquired in a business combination. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 294}), Document(page\_content='1 Chapter 8: \nOther topics — updated \nOctober 2023', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 295}), Document(page\_content='Other topics \n8-28.1 Chapter o verview - leases \nThis chapter discusses the following topics : \n□Subleases\n□Sale s of leased assets\n□Sale s of lease receivables and unguaranteed residual assets\n□Sale s of equipment with guaranteed minimum resale amount\n□Business combinations\n□Remeasurement of right -of-use asset t o functional currency\n□Lessor operating leases – impact of collectibility on revenue and receivables\n□Application of CECL to leasing \n□Leasehold improvements\nLessors may execute lease transactions using limited partnerships, joint ventures, and trusts . Special -\npurpose lessor entities are also frequently used to structure leases , including synthetic leases. These \nlessor entities, as well as similar entities employed by a lessee , should be evaluated to determine \nwhether they should be consolidated by the le ssor or lessee. See PwC ’s Consolidation guide for more \ninformation . \n8.2 Accounting for s ubleases \nIn a sublease, an entity is both a lessee and a lessor for the same underlying asset . In a sublease a \nlessee subleases t he underlying asset to a third -party sublessee; the entity is then referred to as the \nintermediate le ssor (or sublessor). In a sublease transaction , the lease between the original lessee and \nlessor (referred to as the head lease ) remains in effect . Figure LG 8-1 illustrates a typical sublease \narrangement . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 296}), Document(page\_content='Other topics \n8-3Figure LG 8-1 \nTypical sublease arrangement \nS\nubleases can arise for many reasons –for example , when a lessee no longer requires leased space and \nsubleases the excess to another party. Another example is when a n intermediate lessor leases \nhardware to its customer (sublessee) bundle d with additional goods and services. A lease from the \nlessee back to the head lessor is typically not accounted for as a sublease. \nSee FSP 14.2.3, FSP 14.2.4, and FSP 14.3.2.3 for information on the disclosure requirements for subleases. \n8.2.1 Accounting by the intermediate lessor \nSub\nleases of right -of-use assets are within the scop e of ASC 842 and should be accounted for in the \nsame way as other leases. The intermediate lessor should separately account for the head lease and \nsublease unless it is relieved of its primary obligation under the head lease. Typically , a lessee would \nnot be relieved of its obligations under the head lease unless it is contractually replaced in the head \nlease with the sub lessee. See LG 8.2 .1.2 for additional information. See LG 3 and LG 4 for information \non the classification and accounting for the head lease prior to the intermediate lessor entering into a \nsublease . \nAs discussed in ASC 842 -10-25-6, an intermediate lessor should determine the classification of the \nsublease based on the underlying asset , rather than the right -of-use asset arising from the head lease. \nASC 842 -10-25-6 \nWhen classifying a sublease, an entity shall classify the sublease with reference to the underlying asset \n(for example, the item of property, plant, or equipment that is the subject of the lease) rather than w ith \nreference to the right -of-use asset. \n8.2.1.1 Intermediate lessor retains head lease primary obligation \nASC 842 -20-35-14 discusses the accounting for the head lease when an intermediate lessor enters into \na sublease and the intermediate lessor is not relieved of its primary obligation under the head lease. \nFigure LG 8-2 summarizes the accounting for various lease types. ASC 842 -20-35-15 specifies that t he \nintermediate lessor should use the rate implicit in the lease to cl assify the sublease and also measure \nthe net investment in a sublease classified as a sales -type or direct financing lease. If such rate cannot \n', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 297}), Document(page\_content='Other topics \n8-4be readily determined, the intermediate lessor should use the discount rate that it originally used to \naccount for the head lease . \nFigure LG 8-2 \nAccounting for a head lease and related sublease when the intermediate lessor is not relieved of its \nprimary obligation under the head lease \nLease classification Intermediate lessor accounting treatment \nSublease is classified as an \noperating lease □Regardless of whether it is an operating or finance lease , the\nintermediate lessor should continue to account for the head\nlease as before commencement of the sublease .\n□If the total remaining lease cost (on the head lease) for th e\nt\nerm of the sublease is more than the anticipated sublease\nincome for that same period , this is an indicator that the\ncarrying amount of the right -of-use asset associated with the\nhead lease may not be recoverable. The right -of-use asset\nshould be assessed for impairment in accordance with ASC360-10-35-21; we believe the lease provisions (e.g., the ter\nm\no\nf the head lease and sublease) should be considered when\nassessing whether there is an impai rment . See PPE 5.2.7 and\nLG 4.6 for guidance on the impairment of a right -of-use asset.\nThe original lease is a \nfinance lease and the \nsublease is a sales -type or \ndirect financing lease □The original right -of-use asset should be derecognized in\naccordance w ith the sales -type lease/direct financing leas e\nde\nrecognition guidance in ASC 842 -30-40-1 (see LG 5.7) and\nthe original lease liability should be accounted for as before\ncommencement of the sublease .\n□The intermediate lessor should evaluate its net investment i n\nt\nhe sublease for impairment in accordance with the guidance\nin ASC 842 -30-35-3. See LG 4.7 for information on the\nimpairment of a net investment in a lease.\nThe original lease is an operating lease and the sublease is a sales -type or \ndirect financing lease □The original right -of-use asset should be derecognized in\naccordance with the sales -type lease/direct financing leas\ne\nde\nrecognition guidance in ASC 842 -30-40-1 (see LG 5.7) and\nthe original lease liability should be accounted for based on\nthe accounting for a lease liability in a finance lease (see LG\n4). Note that since the sublease met one of the conditions for\na sales type or direct financing lease and the head lease didnot, the intermediate lessor should evaluate whether theoriginal assumptions relating to the head lease have changed .\n□The right -of-use asset should be evaluated for impairment\nprior to derecognition using the guidance in ASC 360 . See\nPPE 5.2.7 and LG 4.6 for information on the impairment of\nright -of-use asset s.\n□After derecognizing the right -of-use asset, t he net investmen\nt\ni\nn the sublease is s ubject to the impairment guidance in ASC\n842-30-35-3. See LG 4.7 for information on the impairmen t\no\nf a net invest ment in a lease.', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 298}), Document(page\_content='Other topics \n8-5As discussed in FSP 14.3.2, ASC 842-1 0-15-39A, provides lessors an election to exclude certain lessor \ncosts that are directly remitted by a lessee to a third party from consideration in the contract. A \nlessor that elects this policy would exclude those payments from gross presentation. We believe an \nintermediate lessor should similarly present any variable lessor costs, such as property taxes and \ninsurance, that are directly paid by the sublessee to the third-p arty biller on a net basis (i .e., no effect \non the intermediate lessor’s income statement). However, we do not believe this ASU applies to an \nintermediate l essor w hen a sublessee m akes fi xed o r variable rent payments to t he head l essor (rather \nthan to th e third-party biller) on b ehalf of the intermediate l essor (i.e., t he intermediate lessor s hould \nseparately recognize sublease income a nd ex pense under t he h ead lease). \nAccounting for t he h ead le ase \nSubletting a leased ass et may t rigger r emeasurement of the lessee -sublessor’s head l ease and may al so \nrequire the l essee -sublessor t o reassess l ease classification o f the h ead l ease. F or example, upon \nentering i nto a sublease, the i ntermediate l essor s hould c onsider the lease term (as defined b y Topic \n842) of the sub lease r elative to t he head l ease. T he intermediate l essor may n eed to update t he h ead \nlease term so t hat it is no t shorter than the s ublease t erm. S ee L G 5.3 fo r information o n the \nremeasurement and r e-assessment o f classification o f a lease by a lessee .\n8\n.2.1.2 Intermediate lessor is relieved of head lease primary obligation \nASC 842-20-40-3 provides guidance on accounting for a head lease and sublease when the \nintermediate lessor is relieved of its primary obligation under the original lease . \nExcerpt from ASC 84 2-20-40-3 \nIf the nature of a sublease is such that the original lessee is relieved of the primary obligation under \nthe original lease, the transaction shall be considered a termination of the original lease . … Any \nconsideration paid or received upon termination that was not already included in the lease payments \n(for example, a termination payment that was not included in the lease payments based on the lease \nterm) shall be included in the determination of profit or loss to be recognized in accordance with \nparagraph 842 -20-40-1. If a sublease is a termination of the original lease and the original lessee is \nsecondarily liable, the guarantee obligation shall be recognized by the lessee in accordance with \nparagraph 405 -20-40-2. \nSee LG 5.5 for more detail s regarding termination of a lease. \n8.2.2 Accounting by the head lessor \nAs described in ASC 842 -30-35-7, a head lessor should continue to account for a lease that an \nintermediate lessor has subleased, sold , or transferred as it did before such transaction . Howev er, if \nthe lease is replaced by a new agreement with a new lessee, the head lessor should account for the \nchange in lessee as a termination of the original lease and the commencement of a new lease. See LG \n5.8 for more details regarding termination of a le ase. \n8.2.3 Accounting by the sub less ee \nA sublessee would account for the arrangement similarly to any new arrangement that it enters which is, or contains, a lease. As discussed in LG 3.3.4.6, l essees should discount lease payments at the lease ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 299}), Document(page\_content='Other topics \n8-6 commencement date using the rate implicit in the lease ; if the information necessary to determine the \nrate implicit in the lease is not readily available, a lessee should use its incremental borrowing rate. \nWhile a sublessee should determine its incremental borrowing rate as it would in any lease, q uestions \nhave arisen about how a sublessee should determine (and whether it can determine) the rate implicit \nin the lease. This is because there is more than one lessor in a sublease: should the sublessee \ndetermine the head lessor’s rate implicit in the head lease (based on the head lessor’s return on the \nunderlying asset), or the intermediate lessor’s rate implicit in the sublease (based on the intermediate \nlessor’s return on its right -of-use asset , rather than the underlying asset )? \nWe believe a sublessee should determine a discount rate similarly to how it would do so in any lease. A lessee must use the rate implicit in the lease to measure a lease liability when that rate is readily \ndeterminable . Typically, a le ssee does not have all the requisite information to readily determine the \nrate implicit in any lease and it should, therefore, use its incremental borrowing rate to measure the \nlease liability. However, when the sublease and head lease terms are identical, (e.g., the intermediate \nlessor and sublessee are common control entities, and the sublease and head lease are coterminous) , \nthe sublessee should use the rate implicit in the lease as the rate is readily determin able . \n8.3 Sale of leased assets \nA reporting entity may lease an asset in which it owns an interest (e.g., the lessee owns an interest in a \npartnership that owns the underlying asset). If the reporting entity sells its interest in the leased asset \n(e.g., sells its interest in the part nership that owns the underlying asset) , but continues to lease the \nasset , the accounting treatment depends on whether the lease is modified in connection with the sale , \nas discussed in ASC 842 -40-55-9. \n□ If the preexisting lease is modified in connection with the sale, the seller -lessee should account for \nthe transaction in accordance with the sale and leaseback guidance . See LG 6 for information on \nsale and leaseback transactions . \n□ If the preexisting lease is not modified in connection with the sale, then the seller -lessee should \naccount for the sale using other GAAP . \nWhile the guidance in ASC 84 2-40-55-8 refers to a circumstance in which the reporting entity acquires \nits ownership interest and enters into the lease at or near the same time, we believe this guidance should be applied regardless of the length of time between the acquisition date of the owner ship \ninterest and the lease . \nA sale or spinoff of a subsidiary that lease s the property to its parent is a sale and leaseback whether \nthe intercompany lease is modified or not. See LG 6 for information on sale and leaseback \ntransactions . \nASC 842 -40-55-10 provides additional guidance for when arrangements involve leases between parties \nunder common contr ol. \n8.4 Sale of l ease receivable s and residual asset s \nThe sale of a lease receivable (the right to receive lease payments and guaranteed residual values at \nlease commencement) should be accounted for under the provisions of ASC 860, Transfers and ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 300}), Document(page\_content='Other topics \n8-7 Servicing. ASC 860 does not address, however, a sale of the unguaranteed residual asset in sales- type \nand direct financing lease s. We believe s uch sales, including the sale of residual values guaranteed \nafter commencement , should be accounted for under ASC 842, which refers to the sale guidance in \nASC 606 (see LG 8.4.2 for more details) . \n8.4.1 Accounting for the sale of a lease receivable \nTo account for the sale of a lease receivable, a lessor should evaluate the d erecognition requirements of \nASC 860 to determine whether a transfer of a lease receivable qualifies as a sale (refer to TS 3). If it \ndoes not, a lessor should follow the secured borrowing guidance in ASC 860 (refer to TS 5). If it does, \nASC 842 -30-35-4 provides guidance on a lessor ’s accounting for the retained unguaranteed residual \nasset . \nASC 842 -30-35-4 \nIf a lessor sells substantially all of the lease receivable associated with a sales -type or a direct financing \nlease and retains an interest in the unguaranteed residual asset, the lessor shall not continue to accrete \nthe unguaranteed residual asset to its e stimated value over the remaining lease term. The lessor shall \nreport any remaining unguaranteed residual asset thereafter at its carrying amount at the date of the \nsale of the lease receivable and apply Topic 360 on property, plant, and equipment to deter mine \nwhether the unguaranteed residual asset is impaired. \n8.4.2 Sale of residual asset in a direct financing or sales -type lease \nThere is no specific guidance in ASC 842 on what model to apply to the sale of a residual asset that is \neither unguaranteed or guaranteed after the lease commencement date . (As noted in LG 8.4, a residual \nasset that was guaranteed at the lease commencement date is a financial asset, accounted for under the \nprovisions of ASC 860 .) Since an unguaranteed residual is n ot a financial asset , ASC 860 does not \napply . We believe the guidance in ASC 842-40-25-1 addressing the sale of nonfinancial asset s should \nbe applied to this type of transaction . Under that guidance, sale recognition is permitted provided the \nrequirements in ASC 606 for a sale are met. In other words, to determine when an unguaranteed \nresidual asset subject to a lease or a residual asset guaranteed after commencement should be \nderecognized, the lessor should apply the guidance in: \n□ ASC 606 -10-25-1 through AS C 606 -10-25-8 to determine the existence of a contract, and \n□ ASC 606 -10-25-30 to determine when the entity satisfies a performance obligation by transferring \ncontrol of an asset . \n8.4.3 Purchase of an interest in the residual value of a leased asset \nResidual asset s may be guaranteed or unguaranteed. A residual asset that is guaranteed at lease \ncommencement is considered a financial asset under ASC 860. An unguaranteed residual asset, or one that was guaranteed subsequent to lease commencement , is not a financial as set. \n8.4.3.1 Purchase of an unguaranteed residual asset \nASC 842 -30-40-4 refers to ASC 360 for guidance on a third -party ’s acquisition of an interest in the \nunguaranteed residual value of an asset from the lessor . As discussed in ASC 360 -10-25-4, the third ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 301}), Document(page\_content='Other topics \n8-8 party should record the interest as an asset on the date it is acquired ; the interest should be initially \nmeasure d using the guidance in ASC 360 -10-30-3 and ASC 360 -10-30-4. \nASC 360 -10-30-3 \nAn interest in the residual value of a leased asset recog nized under paragraph 360-10-25-4 shall be \nmeasured initially at the amount of cash disbursed, t he fair value of other consideration given, and the \npresent value of liabilities assumed. \nASC 360 -10-30-4 \nThe fair value of the interest in the residual value of the leased asset at the date of the agreement shall \nbe used to measure its cost if that fair v alue is more clearly evident than the fair value of assets \nsurrendered, services rendered, or liabilities assumed. \nASC 360 -10-35-14 provide s guidance on the subsequent accounting for an interest in the \nunguaranteed residual value of a leased asset. It should be carried at its acquisition cost until it is sold \n(or otherwise disposed of). If there is an other -than -temporary decline in the value, it should be \nwritten down to fair value with a loss recognized equal to the amount of the write -down. \nASC 360 -10-35-14 \nAn entity acquiring an interest in the residual value of any leased asset, irrespective of the \nclassification of the related lease by the lessor, shall not recognize increases to the asset ’s estimated \nvalue over the remaining term of the related lease, and the asset shall be reported at no more than its \nacquisition cost until sale or disposition. If it is subsequently determined that the fair value of the \nresidual value of a leased asset has declined below the carrying amount of the acquired inter est and \nthat decline is other than temporary, the asset shall be written down to fair value, and the amount of \nthe write -down shall be recognized as a loss. That fair value becomes the asset ’s new carrying amount, \nand the asset shall not be increased for a ny subsequent increase in its fair value before its sale or \ndisposition . \n8.4.3.2 Purchase of guaranteed residual asset \nIf the future residual value of a leased asset is guaranteed at lease commencement by either the lessee \nor another party , it is considered a fina ncial asset under ASC 860. Therefore, such guaranteed residual \nvalue would be accreted to the guaranteed amount by the purchaser if the transfer of the guaranteed \nresidual value qualifies as a sale under the derecognition requirements of ASC 860 (refer to TS 3). If it \ndoes not, a purchaser should follow the secured borrowing guidance in ASC 860 (refer to TS 5). If the \nresidual is guaranteed after the lease commencement date, it is considered the same as an \nunguaranteed residual asset by the purchaser and ac counted for as discuss ed in LG 8.4.3.1 . \n8.5 Sales of equipment with guaranteed minimum resale \namount \nASC 842 -30-55-2 through ASC 842 -30-55-4 address the accounting for sales incentive program s in \nwhich the manufacturer contractually guarantees that the purchaser will receive a minimum resale \namount at the time the equipment is disposed of (contingent on certain requirements ). ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 302}), Document(page\_content='Other topics \n8-9 ASC 842 -30-55-2 \nThe manufacturer provides the guarantee by agreeing to do either of the following: \na. Reacquire the equipment at a g uaranteed price at specified time periods as a means to facilitate its \nresale \nb. Pay the purchaser for the deficiency, if any, between the sales proceeds received for the equipment \nand the guaranteed minimum resale value. \nThere may be dealer involvement in these types of transactions, but the minimum resale guarantee is \nthe responsibi lity of the manufacturer. \nASC 842 -30-55-3 \nA sales incentive program in which an entity (for example, a manufacturer) contractually guarantees \nthat it has either a right or an obligation to reacquire the equipment at a guaranteed price (or prices) at \na specified time (or specified time periods) as a means to facilitate its resale should be evaluated in \naccordance with the guidance on satisfaction of performance obligations in paragraph 606 -10-25-30 \nand the guidance on repurchase agreements in paragraphs 60 6-10-55-66 through 55 -78. If that \nevaluation results in a lease, the manufacturer should account for the transaction as a lease using the \nprinciples of lease accounting in Subtopic 842 -10 and in this Subtopic. \nASC 842 -30-55-4 \nA sales incentive program in which an entity (for example, a manufacturer) contractually guarantees \nthat it will pay a purchaser for the deficiency, if any, between the sales proceeds received for the \nequipment and the guaranteed minimum resale value should be accounted for in accord ance with \nTopic 460 on guarantees and Topic 606 on revenue from contracts with customers . \nIf the transaction is not accounted for as a sale, the manufacturer -guarantor continues to recognize the \nasset. ASC 460 , Guarantees , would not be applicable because that guidance does not apply to a \nguarantee on a guarantor ’s own asset . \n8.5.1 Sale of asset with guaranteed residual under an operating lease \nASC 842 -30-55-6 through ASC 842 -30-55-9 describe the accounting for the sale of equipment with a \nguaranteed minimum resa le amount subject to an operating lease . \nASC 842 -30-55-6 \nIf the transaction qualifies as an operating lease, the net proceeds upon the equipment ’s initial transfer \nshould be recorded as a liability in the manufacturer ’s balance sheet. \nASC 842 -30-55-7 \nThe liability is then subsequently reduced on a pro rata basis over the period to the first exercise date \nof the guarantee to the amount of the guaranteed residual value at that date with corresponding \ncredits to revenue in the manufacturer ’s income statement. Any further reduction in the guaranteed \nresidual value resulting from the purchaser ’s decision to continue to use the equipment should be \nrecognized in a similar manner. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 303}), Document(page\_content='Other topics \n8-10ASC 842 -30-55-8 \nThe equipment should be included in the manufacturer ’s balance sheet and depreciated following the \nmanufacturer ’s normal depreciation policy. \nASC 842 -30-55-9 \nThe Impairment or Disposal of Long -Lived Assets Subsections of Subtopic 360 -10 on property, plant , \nand equipment provide guidance on the accounting for any potential impairment of the equipment. \nIf the customer elects to sell the equipment to a third party, the recorded liability should be reduced by \nthe amount, if any, paid by the manufacturer to the customer . With the sale of the asset , the \nmanufacturer has no remaining obligation to the custom er. Therefore, t he manufacturer should \nremove any remaining liability , derecognize the equipment from its balance sheet , and recognize any \nresulting gain or loss in net income in the period of the sale. \nIf the customer chooses to sell the equipment back to the manufacturer, the recorded liability should \nbe derecognized. If there is a difference between the recorded liability and the amount paid to the \ncustomer, the difference should be recognized as a gain or loss in the period of the sale . The \nmanufacturer should not adjust the carrying value of the asset. \n8.5.2 Evaluating residual value guarantees as potential derivative s \nResidual value guarantees that are subject to the accounting guidance in ASC 842 are not in the scope \nof the guidance in ASC 815, Derivatives and Hedging . This applies to residual value guarantees that \nare required to be used by the lessee or the lessor to classify the lease. Residual value guarantees not \nused to classify the lease must be evaluated under ASC 815 . This could include, for example, a residual \nvalue guarantee that the lessor obtained from a third party subsequent to lease commencement. \nAccounting by the third -party guarantor is also not subject to the guidance in ASC 842; the third -party \nguarantor should consider other accounting guidance. \n8.6 Leases acquired in a b usiness combination \nThe accounting for a lease acquired in a business combination depends on whether the acquiree is the \nlessee or lessor. See LG 7. 4 for information on t he accounting for a leveraged lease acquired in a \nbusiness combination. \n8.6.1 Acquiree in a business combinatio n is a lessee \nASC 842 -10-55-11 requires the acquiring entity in a business combination to retain the acquiree ’s \nprevious lease classification unless the lease is modified . (We generally believe that the acquirer \nshould reassess classification of an acquire d lease in an asset acquisition .) If the lease is modified and \nthe modification is not accounted for as a separate new lease , the modification is evaluated in \naccordance with the guidance on lessee lease modifications. See LG 5. 2 for information. ASC 805-20-\n30-24 (as amended by ASC 842) provides guidance on the recognition and measurement of lease s\nac\nquired in a business combination in which the acquiree is the lessee.', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 304}), Document(page\_content='Other topics \n8-118.6.1.1 Acquirer assesses renewal or purchase options differently \nNotwithstanding that an a cquiring entity should retain the acquiree’s previous lease classification, an \nacquirer’s assumptions as to whether it is reasonably certain to exercise an extension or purchase \noption are independent of an acquiree’s prior assumptions. For example, when an acquiree originally \nclassified a lease as an operating lease pre -acquisition, because it concluded that it was not reasonably \ncertain to exercise a purchase option, an acquirer may still conclude that it is reasonably certain to \nexercise the purchase opt ion. In that case, the acquirer would continue to classify the lease as an \noperating lease, in accordance with ASC 842 -10-55-11, even though it should include the purchase \noption in the measurement of the lease liability. We believe the acquirer should then recognize the \nlease cost over the useful life of the asset rather than over the lease term. This is consistent with the \nBoard’s conclusion , per BC 218, “ … that a purchase option is the ultimate option to extend the lease \nterm .” As such, the purchase option should be accounted for in the same way as an extension option \nfor a term equal to the remaining useful life of the underlying asset at the purchase option date. \nWe believe that there are two acceptable approaches for subsequently recognizing lease expense: \n□Approach 1: Recognize expense over the remaining useful life of the asset on a straight -line basis .\nU\nnder this approach, the periodic expense remains constant throughout the useful life of the asset.\nThe periodic amortization of the asset before the purchase option is exercised should equal the\nsingle lease expense recognized, less the interest on the lease liabilit y consistent with the\nrecognition pattern of an operating lease . When the purchase option is exercised, the asset should\nbe reclassified to property, plant , and equipment, and it should be subsequently depreciated as an\nowned asset over its remaining useful life.\n□Approach 2: Amortize the asset on an “ other than straight line basis , as permitted by ASC 842\nwhen that is more representative of the pattern in which benefit is expected to be derived from theright -to-use the underlying asset . Under this approac h, a lessee would recognize a single lease\nexpense as an operating lease, but it would compute the single lease expense as an amount\nnecessary to amortize the right- of-use asset over the remaining lease term to the balance that it\nwould have had if it were a finance lease. A lessee would typically recognize more lease expense\nbefore the purchase option is exercised than in Approach 1. A fter the purchase option is exercised,\nthe asset should be reclassified to property, plant , and equipment, and the rema ining net book\nvalue should be subsequently depreciated as an owned asset over its remaining useful life.\nASC 805 -20-30-24 \nFor leases in which the acquiree is a lessee, the acquirer shall measure the lease liability at the present \nvalue of the remaining lease payments, as if the acquired lease were a new lease of the acquirer at the \nacquisition date. The acquirer shall measure the right -of-use asset at the same amount as the lease \nliability as adjusted to reflect favorable and unfavorable terms of the lease when compared with \nmarket terms. \nAs discussed in ASC 805-20-25-28B, an acquirer may elect to apply the short -term lease measurement \nand recognition exemption to leases that have a remaining lease term of 12 months or less at the \nacquisition date. In addi tion to not recording the lease on the balance sheet, under this exception, the \nacquirer would not recognize an intangible asset if the terms of an operating lease are favorable \nrelative to market terms or a liability if the terms are unfavorable relative to market terms . See LG \n2.2.1 for information on the short -term lease measurement and recognition exemption , BCG 4.3.3.5 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 305}), Document(page\_content='Other topics \n8-12for information on favorable and unfavorable contracts , and BCG 4.3. 3.7 for information on lease \narrangements . \nASC 842 -20-35-13 provides guidance on the amortization of leasehold improvements acquired in a \nbusiness combination. \nASC 842 -20-35-13 \nLeasehold improvements acquired in a business combination or an acquisition by a not -for-profit \nentity shall be amortized over the shorter of the useful life of the assets and the remaining lease term \nat the date of acquisition. \n8.6.1.2 Acquirer’s policy to combine lease and nonlease component differs \nAs discussed in LG 2. 4.5.1 , lessees may elect an accounting policy to not separat e lease and nonlease \ncomponents, and account for both as a single lease component. The election to not separate lease and \nnonlease components, and ascribe all the consideration to the lease component, may result in classifying the lease as a finance lease. However, as noted in LG 8.6, ASC 842 -10-55-11 requires the \nacquiring entity in a business combination to retain the acquiree’s previous lease classification unless the lease is modified. A question arises as to how this guidance should be applied when an acquirer and acquiree elected different accounting policies regarding separation of lease and nonlease components. \nWe believe that an acquirer, generally, must conform an acquiree’s accounting policy elections to its \nown upon a business combination. Therefore, the acquirer would measure the assumed lease liability in accordance with its own election to separate or not separate lease and nonlease components. However, we believe that with respect to lease classification, the acquirer should retain the acquir ee’s \nlease classification in accordance with the guidance in ASC 842 -10-55-11, notwithstanding that the \nacquiree had a different pre -acquisition policy regarding separating lease and nonlease components. \n8.6.1.3 Acquisition of a related party lease with off -marke t terms \nAs discussed in LG 3. 2 ASC 842 -10-55-12 requires entities to account for related party leases based on \ntheir legally enforceable terms and conditions . Related parties, therefore, do not adjust their related \nparty lease accounting for off- market te rms or conditions. However, as discussed in LG 8.6.1.1, per the \nguidance in ASC 805, the carrying amount of a right -of-use asset acquired in a business combination is \nadjusted to reflect favorable or unfavorable market terms. The related party guidance in ASC 842 does \nnot address whether it applies in a business combination in which either the acquirer or acquiree, and \nthe lessor , are related parties. We believe that the acquirer in a business combination should follow the \nguidance in ASC 805 -20-30-24; it should measure the lease liability at the present value of the \nremaining lease payments (consistent with related party lease guidance in ASC 842) but should adjust \nthe measurement of the right- of-use asset for favorable or unfavorable terms. \n8.6.2 Acquiree in a business combination is a lessor \nASC 805 -20-30-25 provides guidance on the recognition and measurement of sales -type and direct \nfinancing leases acquired in a business combination. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 306}), Document(page\_content='Other topics \n8-13ASC 805 -20-30-25 \nFor leases in which the acquiree is a lessor of a sales- type lease or a direct financing lease , the acquirer \nshall measure its net investment in the lease as the sum of both of the following (which will equal the \nfair value of the underlying asset at the a cquisition date) : \na.The lease receivable at the present value, discounted using the rate implicit in the lease, of the\nfollowing, as if the acquired lease were a new lease at the acquisition date :\n1.The remaining lease payments\n2.The amount the lessor expe cts to derive from the underlying asset following the end of the\nlease term that is guaranteed by the lessee or any other third party unrelated to the lessor.\nb.The unguaranteed residual asset as the difference between the fair value of the underlying asset at\nthe acquisition date and t he carrying amount of the lease receivable , as determined in accordanc e\nwith (a), at that date.\nThe acquirer shall take into account the terms and conditions of the lease in calculating the \nacquisition -date fair value of an underlying asset that is subject to a sales -type lease or a direct \nfinancing lease by the acquire e-lessor . \nA customer relationship intangible or o ther nonlease -related assets associated with the lease may also \nbe recognized . \nWhen the acquiree in a business combination is a lessor in a lease classified as an operating lease, the \nunderlying asset would be recognized and measured at fair value unencumbered by the related lease . \nIn other words, the leased property (including any acquired tenant improvements) would be measured \nat the same amount, regardless of whether an operating lease is in place. An intangible asset or \nliability may also be recognized if the lease contract terms are favorable or unfavorable as compared to \nmarket terms. In addition, in certain circumstances, an intangible asset may be recognized at the \nacquisition date for the value associated with the existing lease (referred to as an “in-place” lease ) and \nfor an y value associated with the relationship the lessor has with the lessee. Further, a liability may be \nrecognized for any unfavorable renewal options or unfavorable written purchase options if the exercise \nis beyond the control of the lessor. See BCG 4.3. 3.7 for more information . \n8.7 Sales -type lease for a failed sale with a repurchase \noption \nA transaction to sell an asset may not meet the definition of a sale in ASC 606 if the seller fail s to \ntransfer control . This may happen when there is a call option to repu rchase the asset for an amount \nthat is less than its original selling price. In this circumstance, ASC 606 -10-55-68 requires the seller to \naccount for the arrangement as a lease in accordance with ASC 842 rather than a sale. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 307}), Document(page\_content='Other topics \n8-14ASC 606 -10-55-68 \nIf an entity has an obligation or a right to repurchase the asset (a forward or a call option), \na customer does not obtain control of the asset because the customer is limited in its ability to direct \nthe use of, and obtain substantially all of the remaining benefits from, the asset even though the \ncustomer may have physical possession of the asset. Consequently, the entity should account fo r \nthe contract as either of the following: \na.A lease in accordance with Topic 842 on leases, if the entity can or must repurchase the asset for\nan amount that is less than the original selling price of the asset unless the contract is part of a sale\nand leaseback transaction. If the contract is part of a sale and leaseback transaction, the entity\nshould account for the contract as a financing arrangement and not as a sale and leaseback\ntransaction in accordance with Subtopic 842-40.\nb.A financing arrangement in accordance with paragraph 606-10-55-70, if the entity can or must \nrepurchase the asset for an amount that is equal to or more than the original selling price of the\nasset.\nIt is possible for a “failed sale” transaction under ASC 606 to be classified as a sales -type lease under \nASC 842 because it meets , for example, the economic life or the present value criterion. Sales-type \nlease accounting requires the seller/lessor to recognize selling profit or loss at the commencement date \nas follows: \n□If the seller/lessor uses leases as an alternative means of realizing value from the goods that it\nwould otherwise sell, the sell er/lessor should present revenue and cost of goods sold relating to\nthe sales -type lease in separate line items so that income and expenses from sold and leased items\nare presented consistently.\n□If the seller/lessor uses leases for the purposes of providing financing, the seller/lessor should\npresent the profit or loss in a single line item.\nThus, even though a seller/lessor might not be able to recognize a sale under ASC 606 , it is possible for \nthe seller/lessor to recognize selling profit upfront (via rev enue and cost of sales or as a single line item \ndepending upon the seller/lessor’s business model ) if the seller/lessor account s for the transaction as a \nsales -type lease under ASC 842 . \nSee LG 3 for more details on lease classification, LG 4.3.1 for initi al recognition and measurement of a \nsales -type lease by a lessor , and LG 6.3.5 for repurchase rights and obligations in a sale. \n8.8 Remeasurement of right -of-use asset to functional \ncurrency \nA lease may be denominated in a currency that is not the same as a lessee’s functional currency. As \ndiscussed in ASC 842 -20-55-10, a lease liability is a monetary liability and a right -of-use asset is a \nnonmonetary asset. Therefore , a lease liability should be remeasured using the current period \nexchange rate at the reporti ng date with any changes recognized in the income statement. However, \nthe right -of-use asset should be measured at the historical exchange rate at the commencement date \nand is not affected by subsequent changes in the exchange rate . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 308}), Document(page\_content='Other topics \n8-15ASC 842 -20-55-10 \nThe right -of-use asset is a nonmonetary asset while the lease liability is a monetary liability. Therefore, \nin accordance with Subtopic 830 -10 on foreign currency matters, when accounting for a lease that is \ndenominated in a foreign currency, if remeasurem ent into the lessee’s functional currency is required, \nthe lease liability is remeasured using the current exchange rate, while the right -of-use asset is \nremeasured using the exchange rate as of the commencement date . \nAs discussed in LG 4.4.2, operating l ease expense is a single line item in the income statement that is \nthe sum of right -of-use asset amortization and accretion of the lease liability. We believe \nremeasurement of operating lease expense into a lessee’s functional currency involve s measuring t he \nright -of-use asset amortization at the historical exchange rate and the lease liability accretion at the \naverage exchange rate for the applicable period using the guidance under ASC 830 -10, Foreign \nCurrency Matters . \nQuestions have arisen regarding what exchange rate a lessee should use to remeasure a right -of-use \nasset into the lessee’s functional currency when there is a lease modification that is not accounted as a \nseparate new lease or when the lease is required to b e remeasured (see LG 5.2 for lease modification \naccounting and LG 5.3 for lease remeasurement accounting by a lessee). Based on discussions with the \nSEC staff, the following approaches are acceptable as an accounting policy choice , which should be \ndisclosed by a lessee : \n□Single exchange rat e approach: Under this approach, the old lease is essentially “terminated” and\na new lease is recognized by remeasuring the entire right -of-use asset using the exchange rate at\n(1)t\nhe lease modification date that is not accounted for as a new lease, or (2 ) the leas e\nr\nemeasurement date when the lease remeasurement is due to a change in the lease term or change\nin assessment of exercise of a lessee option to purchase the underlying asset. However, if the\nremeasurement is due to (a) a change in the amount probable of being owed under a residual\nvalue guarantee, or (b) resolution of a contingency that results in variable lease paymentsbecoming fixed, the historical exchange rate should be used to rem easure the entire right -of-use\nasset\n.\n□L\nayered approach: Under this approach, a lessee should remeasure only the additional right -of-\nuse asset due to a modification that is not accounted for as a new lease or any type of lease\nremeasurement using the excha nge rate at the modification or remeasurement date.\nExample LG 8 -1 illustrates application of the two approaches. \nEXAMPLE LG 8-1 \nRemeasurement of right -of-use asset to functional currency \nA US dollar functional currency lessee enters into a lease in e uros. The lease liability and right -of-use \nasset is 1,000 euros on the commencement date . At that date, the exchange rate is 1$ = 1 euro, so the \nlessee record s a lease l iability and right -of-use asset of $1,000. \nAt the end of the first reporting period , the exchange rate move s to $1.2 = 1 euro . There are no lease \npayments in this period. Under ASC 830, at the end of the first reporting period, the lessee remeasures \nthe lease liability to $1,200 (1.2 \* 1,000) and recognize s a foreign currency transaction loss of $200 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 309}), Document(page\_content='Other topics \n8-16($1,200 - $1,000) in current period earnings. Since the right -of-use asset is a nonmonetary asset, it is \nnot adjusted under ASC 830 and its functional currency balance remains at $1,000 . \nAt the end of the second reporting period , the exchange rate move s to $1.8 = 1 euro. There are no lease \npayments in this period. Under ASC 830, at the end of the second reporting period, the lessee \nremeasure s the lease liability to $1,800 (1.8 \* 1,000) and recognize s a foreign currency transaction loss \nof $600 ($1,8 00 - $1,200) in current period earnings . The right -of-use asset remain s at $1,000 . \nAdditionally, at the end of the second reporting period, the lessee and the lessor modify the rent \npayment resulting in an increas e in the lease liability from 1,000 to 1,15 0 euro . \nHow would the lessee account for the change in lease terms? \nAnalysis \nSingle exchange rate approach \nThe o ld lease is essentially terminated and a new lease is recognized. T he lessee would remeasure both \nthe right -of-use asset and the lease liability based on the current exchange rate at the end of the second \nreporting period and record the following journal entry : \nDr. Right -of-use asset $1,070 (1,150\*1.8 - $1,000) \nCr. Lease liability $270 (1,150\*1.8 - $1,800 ) \nCr. Gain $800 \nUnder this approach , in the second reporting period, the lessee ( 1) record s a net foreign currency \ntransaction gain of $200 (difference between $600 loss and $800 gain in that period), and (2) \nrecover s the entire cumulative foreign curren cy transaction loss that was recognized in the first and \nsecond reporting periods (cumulative $800 loss in the first and second reporting periods versus $800 \ngain in the second reporting period) . \nLayered approach \nThe l essee has an existing right -of-use asset of $1,000 , which as a nonmonetary asset cannot be \nremeasured to the current exchange rate. As part of the modification, the lessee has essentially \nacquired an additional right -of-use asset of 150 euro, which it woul d remeasure into its functional \ncurrency on the modification date. T he lessee would make the following journal entry: \nDr. Right -of-use asset $270 (1.8 \* 150) \nCr. Lease liability $270 (1.8\*[1,150 - 1,000]) \n8.9 Lessor operating leases – impact of collectibility \nassessment \nUnder ASC 842 , a lessor’s pattern of revenue recognition for an operating lease is impacted by its \nassessment of the collectibility of lease payments. If collectibility is probable at commencement, lease income is generally recogn ized on an accrual basis (generally on a straight -line basis) over the term of ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 310}), Document(page\_content='Other topics \n8-17the lease. Otherwise, lease income is limited to the lesser of (1) income that would have been \nrecognized if collectibility was probable, or (2) lease payments collected (i.e., a cash basis). \nCollectibility should be reassessed during the lease term. If collectibility is no longer probable (i.e., the lease subsequently becomes “troubled”), and cumulative cash receipts are less than lease income recognized to date, the excess lease income would be reversed. If collectibility changes back to probable, any difference between the lease income that would have been recognized if collectibility was always probable and the income actually recognized to date is recognized as current period lease \nincome, assuming the original agreement has not been modified or replaced. Probability in this context is assessed based on the credit standing of the lessee, and as such, collection issues arising from disputes over the calculation of variable rents should not be considered in a lessor’s evaluation of collectibility. \nThe new leases standard does not address whether, after performing a probability assessment under ASC 842, lessors can continue to record a general reserve under ASC 450, Contingencies , for operating \nlease receivables that are probable of collection. At its July 17, 2019 Board meeting , the FASB clarified \nthat lessors may elect an accounting policy to record a general reserve under ASC 450 for a portfolio of \noperating lease receivables th at are probable of collection. This election does not need to be consistent \nwith the accounting policy applied under the prior leases guidance, ASC 840. \nIf a lessor elects to record a general reserve, it may either be recorded as a reduction in revenue or as bad debt expense. A lease that subsequently becomes troubled would need to be removed from the general reserve pool and the associated lease receivable written -off. We believe the following methods \ncan be used to write off the lease receivable . \n□If a les sor elects to apply the general reserve model and elects to record the reserve as a reduction\nin revenue, the lessor should remove a troubled lease from the general pool by writing it offthrough lease income.\n□If a lessor elects to apply a general reserve model and elects to record the reserve as bad debt\nexpense, the lessor can elect one of two acceptable policies to remove a troubled lease from th\ne\ng\neneral reserve pool:\noDiscrete calculation: Write off the gross receivable from the troubled lease t hrough lease \nincome. Separately recalculate the general reserve exclusive of the troubled lease , recognizing \nthe change in bad debt expense.\noNet presentation: Write off the existing lease receivables balance net of the general allowanceattributable to th at lease through lease income.\nExample LG 8 -2 illustrates the application of the gross and net presentation alternatives. \nEXAMPLE LG 8-2 \nApplication of the gross and net presentation alternative s \nA lessor has several operating leases (after the adoption of ASC 842). The lessor believes collection of \nlease receivables is probable and applies a general reserve for the aggregate receivables that was recorded to bad debt expense. As of December 31, 20X1, the lessor had a $1,000 deferred operating lease receivab les balance (due to straight -lining of lease income) and a $50 general allowance against ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 311}), Document(page\_content='Other topics \n8-18the entire portfolio of the outstanding receivables balance. On June 30, 20X3, the lessor determined \nthat one of the leases in the portfolio, Lease X, was no longer pr obable of collection. At that time, the \nallowance for doubtful accounts attributable to Lease X was $6 and the outstanding gross lease \nreceivable balance for Lease X was $100. As substantially all of the lease payments are not deemed \ncollectible for Lease X, ASC 842 require s the lessor to recognize revenue only as cash i s received . \nAnalysis \nHow would the lessor write off the lease receivable? \nGross presentation \nThe lessor would write off the gross receivable for Lease X through lease income and reverse the \npreviously -recorded general allowance attributable to Lease X with a contra expense. The journal \nentries would be as follows: \nDr. Lease income $100 \nCr. Lease receivable $100 \nDr. Allowance for doubtful accounts $6 \nCr. Bad debt expense $6 \nN\net presentation \nThe lessor would write -off the lease receivable balance for Lease X, net of the allowance, through lease \nincome. The journa l entry would be as follows: \nDr. Lease income $94 \nDr. Allowance for doubtful accounts $6 \nCr. Lease receivable $100 \nIf the assessment of collectibility subsequently changes from not probable to probable (without a lease modification), the lessor would book a cumulative adjustment to lease income to re -establish the \naccrued deferred operating lease receivable as though the cash basis of accounting had never been \napplied. \n8.10 Application of CECL to leasing \nASU 2016 -13, Financial Instruments – Credit Losses (Topic 326) , the current expected credit loss \n(CECL) impairment model , is applicable to net investment s in leases associated with sales- type and \ndirect financing leases. See LI 13 for information about the effective date of AS U 2016 -13 and related \nreleases. \nOperating lease receivables are not in the scope of the CECL impai rment guidance. S ee FSP 8.9 for the \nimpact of collectibility on operating leases. \nThe FASB recognized that these net investments include both financial elements (e.g., rental payments, residual value guarantee) and non -financial elements (e.g., unguarante ed residual), but ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 312}), Document(page\_content='Other topics \n8-19concluded that applying a single impairment model to the recognized lease asset was preferable to \nassessing different elements of a single asset under different impairment models. Receivables arising \nfrom operating leases are not within t he scope of CECL. \nThe CECL model requires recognition of an allowance for credit losses on the date that a sales -type or \ndirect financing lease receivable is recognized, either through origination or acquisition. A variety of \ntechniques may be used to est imate the allowance, but the lessor ’s estimate of expected credit losses \nmust include a measure of the expected risk of credit loss even if that risk is remote. The CECL model also requires the measurement of credit losses to be on a collective (pool) basi s when individual assets \nshare similar risk characteristics. \nThe initial measurement of the allowance for credit losses is as follows: \n□For leases that are originated, the initial measurement of the allowance for credit losses will berecorded through earn ings. The allowance would be released with an offset to earnings i\nf\ne\nstimated collections improve.\n□For leases acquired either though a business combination or an asset purchase, we believe thelessor should assess whether the acquired leases would be considered purchased financial assetswith credit deterioration (PCD) as defined in ASC 326 . To the extent a lease is not considered PCD,\nthe initial measurement of the allowance for credit losses would be reported in current earnings(similar to an originated lease). If a lease is considered PCD, the initial measurement of theallowance for credit losses will create a basis adjustment to the amortized cost basis of the netinvestment in the lease. This “ gross up ” will impact the calculation of lease income over the life o\nf\nt\nhe lease. The allowance would be released with an offset to earnings if estimated collections\nimprove, similar to the treatment for originated assets . See LI 9 for additional information on PCD\nassets .\nThe CECL model requires assessments of allowance amounts to determine whether they should be written off against the amortized cost basis of the receivables. Receivables (and allowance accounts) are written off either in full or in part when such amounts are deemed uncollectible. Each element of a \nlease receivable (financial or non -financial) could cause a write -off. Companies may need to establish \npolicies and procedures to determine when receivables (and allowance balances) should be written off. \nSometimes a lessor may transfer the receivable associated with future rental payments but retain \nownership of the underlying leased asset. The lessor should apply the guidance in ASC 860 to \ndetermine whether such transfer would be accounted for as a sale resulting in derecognition of the \nreceivable. When the transfer of the receivable is accounted for as a sale, and the asset remaining \nrelates to the unguaranteed residual value, the leasing guidance states that the lessor should begin \napplying ASC 360 to determine whether the unguaranteed residual asset is impaired, ( i.e., the CECL \nmodel would no longer be applicable ). We believe this guidance should not be extended to address \nsituations when the lessor has not transferred receivables and the net investment of the lease consists of mainly the estimated residual value of the leased asset simply as a result of a lessee making \npayments. In these situations, we believe it is appropriate to continue applying the credit loss model in ASC 326 until the leased asset is obtained by the lessor at the end of the lease . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 313}), Document(page\_content='Other topics \n8-208.11 Leasehold improvements \nIn accordance with ASC 842 -20-35-12, leasehold improvements are amortized over the shorter of the \nuseful life of those leasehold improvements or the remaining lease term. However, if the lease \ntransfers ownership of the underlying ass et to the lessee or the lessee is reasonably certain to exercise \nan option to purchase the underlying asset, the lessee should amortize a leasehold improvement to the \nend of its useful life. \nASC 842 -20-35-12 \nLeasehold improvements shall be amortized over the shorter of the useful life of those leasehold \nimprovements and the remaining lease ter m, unless the lease transfers ownership of the underlying \nasset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying \nasset, in which case the lessee shall amortize the leasehold improvements to the end of their useful life. \nThere is an exception for leasehold improvements related to common control leases, further d iscussed \nin LG 8.11.1. \nLeasehold improvements are subject to the long -lived asset impairment guidance in ASC 360 . See PPE \n5.2 for impairment guidance. \n8.11.1 Leasehold improvements related to common control leases \nIn March 2023, the FASB issued ASU 2023 -01, Leases Topic (842): Common Control Arrangements , \nwhich requires a lessee in a common control lease to amortize related leasehold improvements over \ntheir useful li ves to the common control group regardless of the lease term. \nCommon control leases often have short lease term s (e.g. , one year) even when the commonly \ncontrolled lessee makes significant leasehold improvements with a useful life significantly longer than \nthe lease term. The ASU was issued to address concerns by stakeholders that fully amortizing \nleasehold improvements over a period shorter than the useful life of the improvements may result in \nfinancial reporting that does not faithfully represent the economics or the common con trol nature of \nthose improvements . One reason is because the lessee may continue to use the leased asse t after the \ninitial lease term by either extending the existing lease or entering into a new lease . Unlike \ntransactions involving entities that are not u nder common control, the decision on that continued use \nis often controlled by a single party in the control group. Further, if the le ssee ceases to use the leased \nasset, the leasehold improvement will often benefit another party within the control group. \nWhile t he ASU does not define “common control ,” we believe it would be assessed in a similar manner \nto how it is discussed in BC G 7.1.1. \nThe guidance in ASU 2023 -01 applies regardless of the lease term used for accounting purposes and \nfor as long as the lessee controls the use of the underlying leased asset through a lease . (See LG 3. 2 for \ndetails on how to determine the lease term for a common control lease. ) However, if the common \ncontrol lessor leases the right -of-use asset from a lessor that is not part of the same common control \ngroup and subleases the right -of-use asset to the common control lessee , the amortization period \nwould be limited to the lease term associated with the head lease of the underlying asset. Example LG \n8-3 illustrate s this concept.', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 314}), Document(page\_content='Other topics \n8-21EXAMPLE LG 8 -3 \nAmortizing leasehold improvement s in a common control lease \nLessee Co. leases a building from a lessor within the same common control group and u ses a lease \nterm of two y ears for accounting purposes . It install s leasehold improvements with a useful life of five \nyears to the common control group. Over what period should the leasehold improvements be \namortized? \nAnalysis \nLessee Co. should amortize the leasehold improvements over five yea rs; it would not be limited to the \ntwo-year lease term (as lease hold improvements in leases not with a common control entity would be) . \nIf Lessee Co. ceases to control the use of the underlying leased asset before the end of the leasehold \nimprovement s’ useful life to the common cont rol group (i.e., before year five ), it must account for the \nimprovements as being transferred to the lessor . In this case, L essee Co. would derecogniz e the \nremaining carrying amount of the leasehold improvements with a corresponding adjustment to equity \n(or net assets for not -for-profit entities). \n8.11.1.1 Impairment of leasehold improvements in common control leases \nCommon control leasehold improvements are subject to the long -lived asset impairment guidance in \nASC 360 -10-40-4, considering the useful life to the common control group . See PPE 5 .2 for \nimpairment guidance. \n8.11.1.2 Changes to common control group \nIf after the co mmencement date , the lessee and lessor become part of the same common control group \nor are no longer within the same common control group, any change in the required amortization period for the leasehold improvements sh ould be accounted for prospectively a s a change in \naccounting estimate in accordance with ASC 250 -10-45-17. \n8.11.1.3 Transition and effective date of ASU 2023 -01 \nASU 2023 -01 is effective for all entities in fiscal years beginning after December 15, 2023, including \ninterim periods within those fiscal years. Early adoption is permitted for both interim and annual \nfinancial statements that have not yet been made available for issuance. If an entity adopts the new \nguidance in an interim period, it should adopt as of the beginning of the fiscal year that includes that \ninterim period. \nEntities adopting the new guidance concurrently with ASC 842 may follow the same transition requirements used to apply ASC 842 or may use either of the prospective approaches described below. All other entities are required to apply the new guidance using one of the following methods: \n□Prospectively to all new leasehold improvements recognized on or after the date that the entityfirst applies ASU 2023 -01\n□Prospectively to all new and existing leasehold improvements recognized on or after the date tha\nt\nt\nhe entity first applies ASU 2023 -01, with any remaining unamortized balance of existing', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 315}), Document(page\_content='Other topics \n8-22leasehold improvements amortized over their remaining useful lives to the common control group \ndetermined at that date \n□Retrospectively to th e beginning of the period in which the entity first applied ASC 842 for\nleasehold improvements that exist at the date of adoption of ASU 2023 -01, with any leasehold\nimprovements that otherwise would not have been amortized or impaired recognized through acumulative -effect adjustment to the opening balance of retained earnings at the beginning of the\nearliest period presented\n8.11.1.4 Disclosure \nWhen the useful life of the leasehold improvements to the common control group exceeds the related \nlease term, a lessee is required to disclose the following information: \n□The unamortized balance of the leasehold improvements at the balance sheet date\n□The remaining useful life of the leasehold improvements to the common control group\n□The remaining lease term', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 316}), Document(page\_content='Chapter 9: \nEffective date and transition —\nupdated January 2023 ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 317}), Document(page\_content='Effective date and transition \n9-29.1 Effective date and transition overview \nAdopting the leases standard could be a significant undertaking. Some reporting entities will need a \nsignificant amount of lead time to make the necessary changes to their systems and processes. The \nstandard includes some practical expedients to ease the burden of transition. \nThis chapter discusses the effective date and transition guidance , including transition -related \ndisclosures. \n9.2 Effective date \nFigure LG 9-1 summarizes the effective dates for adopting the leases standard. Early adoption is \npermitted for both public and nonpublic business entities. \nFigure LG 9-1 \nLeases standard effective dates \nType of entity Effective date \nPublic business entities \nA not -for-profit entity that has issued, or is a \nconduit bond obligor for, securities that are \ntraded, listed, or quoted on an exchange or over -\nthe-counter market (except for those entities that \nhave not yet issued financial statements or made financial statements available for issuance as of June 3, 2020 reflecting adoption of ASC 842). \nAn employee benefit plan that files or furnishes \nfinancial statements to the SEC □Fiscal years, and interim periods withi n\nthose fiscal years, beginning after\nDecember 15, 2018\nA not-for-profit entity that has issued, or is a \nconduit bond obligor for, securities that are \ntraded, listed, or quoted on an exchange or over -\nthe-counter market that have not yet issued \nfinancial statements or made financial statements available for issuan ce as of June 3, \n2020 reflecting adoption of ASC 842. □Fiscal years , and interim periods withi n\nthose fiscal years, beginning after\nDecember 15, 2019 \nAll other entities not included above □Fiscal years beginning after December 15,\n2021 and interim periods within fiscal year s\nb\neginning after December 15, 2022', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 318}), Document(page\_content='Effective date and transition \n9-39.3 Overall transition and practical expedients \nUpon adoption of the leases standard, lessees and lessors are required to apply a modifie d \nretrospective transition approach . Reporting entities are permitted to choose one of two methods to \nrecognize and measure leases within the scope of the leases standard: \n□Adjust comparative periods: Apply the leases standard to each lease that existed at the\nbeginning of the earliest comparative period presented in the financial statements, as well as\nl\neases that commenced after that date. Under this method, p rior comparative period s presented\nare adjuste d. For leases that commenced prior to the beginning of the earliest comparative period \npresented, a cumulative effect ad justment is recognized at that date . The period from the\nbeginning of the earliest comparative period up until immediately before the effective date is\nreferred to as the “look -back perio d.”\n□Do not adjust comparative periods: Apply the guidance to each lease that had commenced as\nof the beginning of the reporting period in which the entity first applies the leases standard(referred to as the “application date ” or the “effective date ” under this method ) with a cumulative -\neffect adjustment as of that date . Prior comparative periods would not be adjusted under this\nmethod . An entity that applies this method must provide the required disclosures under ASC 840\nfor all periods to which ASC 8 40 is applied.\nRegardless of the transition method selected, the transition guidance in ASC 842 does not apply to leases that are entered into prior to the effective date of ASC 842 but have a commencement date after \nthe effective date of ASC 842. In these cases, the leases accounting model in ASC 842 should be \napplied at the commencement date of the lease. \nApplication of the modified retrospective transition approach under both of these methods to each \nlease type is discussed in the following sections. \nA lessee must apply the recognition requi rements in the leases standard to all leases (even for leased \nassets that are considered abandoned). However, a lessee may elect not to apply the recognition \nrequirements in the leases standard to short -term leases (a lease that at commencement date has a \nlease term of 12 months or less and does not contain a purchase option that the lessee is reasonably certain to exercise). \nQuestion LG 9- 1 and Question LG 9-2 discuss application of lease recognition requirements to short -\nterm leases. \nQuestion LG 9-1 \nIs a lease that has a remaining term at the application date of 12 months or less but whose lease term \nat the commencement date is greater than 12 months eligible for the short- term election? \nPwC response \nNo. A short -term lease is defined by the lease term at the commencement date of the lease. Therefore , \nif the lease has a lease term at the commencement date that is greater than 12 months , it is not eligible \nfor the short -term leases policy election even if the remaining lease term at the application date is 12 \nmonths or less. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 319}), Document(page\_content='Effective date and transition \n9-4Question LG 9-2 \nDoes the leases standard need to be applie d to leases that exist as of the beginning of the earliest \ncomparative period presented but expire or terminate before the effective date? \nPwC r esponse \nIt depends. For reporting entities that choose to apply the transition method in which prior \ncomparative periods are adjusted , we believe leases that exist as of the beginning of the earliest period \npresented and expire or terminate before the effective date are subject to the new standard in a \nreporting entity ’s comparative financial statements upon adoptio n. For example, a calendar year -end \nprivate company with an effective date beginning on January 1, 2022 choosing to adjust the \ncomparative period and adopting the leases standard on 1/1/20 22 should apply the new standard to a \nlease that existed on 1/1/20 21 and expired in 20 21. \nFor reporting entities that choose not to adjust prior comparative periods, the leases standard does not \nneed to be applied to leases that terminate prior to the effective date. \n9.3.1 Practi cal expedients \nASC 842 provides various optional transition practical expedients. A reporting entity is required to \ndisclose the use of any of the practical expedients. In summary, these include: \n□a package of practical expedients to not reassess :\now\nhether a contract is or contains a lease\nolease classification\noinitial direct costs\n□a practical expedient to use hindsight when determining lease term\n□a practical expedient to not reassess certain land easements\nEach of these expedients is explained in more de tail in subsequent sections. \n9.3.1.1 Package of practical expedients \nASC 842-10-65-1 provides a group of optional practical expedients that must be elected as a package \nand applied by a reporting entity to all of its leases consistently regardless of whether the entit y is a \nlessee or lessor. \nASC 842 -10-65-1(f) \nAn entity may elect the following practical expedients, which must be elected as a package and applied \nconsistently by an entity to all of its leases (including those for which the entity is a lessee or a lessor), \nwhen applying the pending content that lin ks to this paragraph to leases that commenced before the \neffective date: ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 320}), Document(page\_content='Effective date and transition \n9-51.An entity need not reassess whether any expired or existing contracts are or contain leases\n2.An entity need not reassess the lease classification for any expired or existing leases ( for example ,\nall existing leases that were classified as operating leases in accordance with Topic 840 will be\nclassified as operating leases, and all existing leases that were classified as capital leases in\naccordance with Topic 840 will be classified as finance leases).\n3.An entity need not reassess initial direct costs for any existing leases.\nDefinition of a lease \nIn most cases, reporting entities that choose not to apply these practical expedients will reach the same \nconclusions as they did under prior GAAP regarding whether a contract is a lease . In the limited \ncircumstances where differences exist, the guidance in ASC 842 is likely to result in a nonlease \nconclusion whe n previous GAAP would have concluded a contract was a lease. The practical \nexpedien ts should not be applied to grandfather incorrect assessments determined under prior GAAP. \nReporting entities should ensure that an analysis of contracts for embedded leases has been performed \nunder ASC 840 before using the practical expedient to carry ove r the conclusions upon adoption of \nASC 842. \nEITF Issue 01-8, Determining Whether an A rrangement is a L ease, provided guidance for \ndetermining whether an arrangement contains a lease under previous GAAP. The transition provisions \nof EITF Issue 01-8 explained that its provisions were effective for arrangements (a) agreed to or \ncommitted to, (b) modified, or (c) acquired in a business combination initiated after the beginning of a \nreporting entity ’s first reporting period beginning after May 28, 2003. As a result, arrangements at or \nbefore the effective date of EITF Issue 01-8 were grandfathered and companies were not required to \ndetermine if such arrangements were or contained leases under ASC 840. \nThe leases standard does not address whethe r or n ot arrangements that were grandfathered under \nEITF Issue 01-8 would continue to be grandfathered when a reporting entity adopts the leases \nstandard . We believe a reporting entity electing the package of practical expedients would not be \nrequired to reasses s whether arrangements grandfathered under EITF Issue 01-8 are or contain leases. \nHowever, if a reporting entity does not elect the package of practical expedients, we believe the entity \nshould assess all arrangements that were outstanding as of the applic ation date to determine if they \nare or contain leases under the new leases guidance, even if such arrangements were previously \ngrandfathered under EITF Issue 01-8. \nUpon adoption of the new leases guidance, a lessor that chooses to adjust comparative period s needs \nto consider the interaction of the effective date of the new revenue recognition guidance in ASC 606. A \nlessor that chooses to adjust comparative periods should apply the guidance in ASC 606 to c ontracts \nwith customers that were previously in the s cope of ASC 840 but no longer meet the defin ition of a \nlease under ASC 842 at the date of initial application of ASC 606 in the comparative periods . The \nlessor should apply the guidance in ASC 605 to such contracts in the comparative periods before the \ninitial application date of ASC 606 . Note that this only applies to financial statements issued after the \nadoption of the new leases guidance . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 321}), Document(page\_content='Effective date and transition \n9-6Lease classification \nUpon adoption of the leases standard, a reporting entity is required to determine the appropriate lease \nclassification for each lease subject to the standard, unless it elects the practical expedients. Although \nlessees with operating leases that adopt the package of practical expedi ents will still be required to \nrecognize leases on the balance sheet, lessees and lessors that elect the practical expedients will \ngenerally not need to reconsider how they classified leases that commenced before the effective date. Reconsideration would o ccur only if required by other lease guidance. \nIt is possible for a lease to be classified differently under the leases standard than it was under legacy \nguidance (e.g., leases previously classified as operating leases may now be classified as financing, sales- type, or direct financing leases and vice versa) but instances of such a difference in classification \nare expected to be infrequent. \nGiven that the practical expedients allow reporting entities to avoid reconsidering lease classification, \nwe expect that many lease arrangements will retain their original classification and therefore, the \naccounting for a change in classification is not discussed in this guide. Readers should refer to ASC \n842-10-65-1 for guidance.\nIrrespective of whether the package of practical expedients is elected , reporting entities will need to \napply the new leases guidance after the effective date , which may result in a subsequent change in \nlease classification in certain cases. For example, if after the effective date a triggering event occurs \nthat results in a reassessment of the lease term, the classification of the lease may change under ASC 842. See LG 5 for information on lease reassessment .\nQuestion LG 9-3 discusses when to reassess lease classification upon transition to AS C 842 . \nQuestion LG 9-3 \nIf a reporting entity does not elect the package of practical expedients, should the entity reassess lease \nclassification under the leases standard as of the lease commencement date or at the application date? \nPwC response \nWe believe a reporting entity should reassess lease classification as of the commencement date of the \nlease or the last time the lease classification was required to be reassessed (e.g., due to a modification ). \nFor a reporting entity that is not electing the package of practical expedients, the objective is to achieve \nthe lease classification that would have occurred had ASC 842 always been in effect. This can only \noccur if classification is assessed as of the most recent date that reassessment would have been \nrequired. \nInitial direct costs \nThe definition of initial direct costs under the leases standard is narrow er than the previous guidance. \nA reporting entity with unamortized ini tial direct costs that do not qualify for capitalization under the \nleases standard that elects the practical expedients may incur more amortization in future periods than if they had not elected the practical expedients. Nevertheless, a reporting entity ma y find that the \ncost of reassessing unamortized initial direct costs does not justify any perceived benefit. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 322}), Document(page\_content='Effective date and transition \n9-7Question LG 9- 4 discusses when to reassess initial direct costs upon transition to ASC 842 . \nQuestion LG 9-4 \nDoes a reporting entity need to reassess unamortized initial direct costs at transition to determine if \nthey meet the new definition of initial direct costs in ASC 842? \nPwC r esponse \nIf a reporting entity elects the package of practical expedients in ASC 842 -10-65-1(f) for all leases as o f \nthe effective date, it does not need to reassess whether initial direct costs meet the new definition at \nthe initial application date. Otherwise, a reporting entity will need to reassess the initial direct costs \nunder the new leases guidance and should account for the balances that no longer meet the definition as explained in the subsequent section. \nConsequences of not electing the package of practical expedients \nReporting entities that do not elect the package of practical expedients will need to reass ess all \narrangements to determine if the y meet the definition of a lease or contain an embedded lease under \nthe new leases guidance. They will also need to assess lease classification using the new criteria for all \ncontracts that meet the definition of a l ease under the new guidance and determine whether or not \ncertain prior expenditures meet the new narrow er definition of initial direct costs. This includes all \nleases acquired in a business combination . \nWhen the reporting entity does not apply the package of practical expedients , it will need to reallocate \nconsideration as of the lease commencement date for any contract that contains a lease component in \norder to reassess lease classification . If the entity is not electing the hindsight p ractical expedient, this \nallocation would start with the same lease payment data as used under ASC 840 (for example, \nreflecting the same lease term as what was used under ASC 840). T he lease payment data should be \nupdated to include amounts allocated to le ase components under ASC 842 ( for example, property \ntaxes and insurance related to the leased asset should be included in the contract consideration and \nallocat ed to lease components) . Classification is then reassessed as of the lease commencement date. If \nthe classification of the lease component does not change, then t he measure ment of the lease upon \nadoption of ASC 842 would use ASC 840’s definition of payments ; in other words, the entity would \nrevert to the amounts allocated to lease components under AS C 840 . \nWhen a reporting entity makes an accounting policy election to not separate nonlease components \nother than executory costs from the associated lease component at transition , a reallocation for \nnonlease components is not required in transition , as discussed in LG 9.4.1.2 . When a reporting entity \nelects to account for nonlease components other than executory costs as part of the lease component , \nit is more likely that lease classification will change (due to a pote ntial increase in the amounts \nconsidered to be lease payments). \nIf a reporting entity does not elect the package of practical expedients in ASC 842 -10-65-1(f), any \nunamortized initial direct costs at the initial application date that do not meet the new definition of \ninitial direct costs in ASC 842 should generally be written off as an adjustment to equity at the \napplication date (or to earnings when incurred for leases that commenced during the look -back period \nwhen comparative periods are adjusted) in accordance with ASC 842 -10-65-1(p) and ASC 842 -10-65-\n1(v)(3). However, for lessees with capital leases under ASC 840 that remain as finance leases under ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 323}), Document(page\_content='Effective date and transition \n9-8ASC 842, only such initial direct costs not included in the measurement of a capital lease asse t under \nASC 840 should be written off in accordance with ASC 842 -10-65-1(r)(3). Similarly, for lessors with \ndirect financing leases under ASC 840 that are either direct financing leases or sales -type leases under \nASC 842, any unamortized initial direct costs capitalized as part of the lessor ’s net investment in the \nlease in accordance with ASC 840 would not be written off , per ASC 842 -10-65-1(x)(1). \n9.3.1.2 Hindsight practical expedient \nUpon transition, a reporting entity is permitted to elect to use hindsight with respect to determining \nthe lease term (e. g., they may consider the actual outcome or updated expectations of lease renewals, \ntermination options, and purchase options) and in assessing any impairment of right -of-use assets for \nexisting leases. \nASC 842 -10-65-1(g) \nAn entity also may elect a practical expedient, which must be applied consistently by an entity to all of \nits leases (including those for which the entity is a lessee or a lessor) to use hindsight in determining \nthe lease term (that is, when considering lessee options to extend or terminate the lease and to \npurchase the underlying asset) and in assessing impairment of the entity ’s right -of-use assets. This \npractical exp edient may be elected separately or in conj unction with either one or both of the practical \nexpedients in (f) and (gg). \nAs noted, t his provision may be elected on its own or together with either or both practical expedients , \nor the land easements practical expedient , but represents a policy election that should be applied \nconsistently to all leases. \nWe expect that the application of hindsight will be challenging in many cases and could in some cases \nresult in a more complex transition process . \nWe believe hi ndsight extends only up until the effective date (e.g., 1/1/ 22 for a calendar year -end \nprivate company) and should not incorporate information that becomes available or events that occur \nafter that date . \nThe hindsight practical expedient can only be used to refresh estimates or evaluations of contractual \nterms that exist as of the time of measurement . A reporting entity that chooses to adjust comparative \nperiods at transition should not apply the hindsight practical expedient to push back a contractual \nmodification in terms such as (1) the impact of a n early termination when the option to terminate was \nnot included in the original contract or (2) an extension of the term of the lease when that extension \noption was not already included in t he original contract. \nSimilarly, for payments based on an index or a rate, a reporting entity that chooses to adjust \ncom parative periods would not push back the index or rate at the effective date to measure the lease \nliability as of a prior date . \nA reporting entity applying the hindsight practical expedient should consider the impact on its \ndetermination of whether a leas e is a short -term lease . For example, a lease may have commenced 15 \nmonths prior to the effective date with an original lease term of 10 months with a renewal option for \nan additional 10 months . Assume exercise of the renewal option was not reasonably assured at lease \ncommencement , but the company subsequently exercised the renewal option . This lease would not ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 324}), Document(page\_content='Effective date and transition \n9-9meet the definition of a short -term lease because the lease term as of its commencement date using \nhindsight i s 20 months. \nWhen applying hindsight for an operating lease with non -level rents, we believe a lessee or lessor \nshould apply the updated lease term by starting at the lease commencement date and recalculating \nwhat the accrued/deferred rent balances would have been as of the application date of the new leases \nguidance if the lease term known as of the effective date had been known at commencement . The \nlessee or lessor should record any difference between the prior and adjusted accrued/deferred \nbalances as of the application date as an adjustment to opening equity. \nQuestion LG 9- 5 and Question LG 9-6 discuss how to assess leases when electing the hindsight \npractical expedient for a lessee upon transition to ASC 842 . \nQuestion LG 9-5 \nDoes the election of hindsight by a reporting entity require the entity to undertake a fresh assessment \nof the facts and circumstances that are relevant in determining the lease term even if there have been \nno triggering events? \nPwC response \nWe believe a reporting entity should undertake a fresh assessment of the facts and circumstances \nwhen applying the hindsight practical expedient, taking into consideration all available information prior to the effective date that would be relevant in determining the term of the lease . For example, \nassume a calendar year -end private company adopts the leases standard on 1/1/20 22 and has chosen \nto adjust the comparative period (1/1/20 21 through 12/31/20 21) in transition . The entity has a lease \nthat commenced prior to 1/1/20 21 and the lessee exercised an extension option on 3/1/20 21. In this \nsituation, we believe if the lessee elects hindsight at the time of adoption on 1/1/20 22, the lessee \nshould recognize a lease liability and a right -of-use asset on 1/1/20 21 assuming the extended lease \nterm. \nThis is the case e ven if the lessee’ s extension option was not exercisable in the look -back period (for \nexample , if the extension option is only exercisable on or after 1/1/20 21) but as of the effective date \n(i.e., 1/1/2 022) it was reasonably certain that the lessee would exercise the extension option because of \na change in facts and circumstances from the original assessment date . Thus, the extended lease term \nshould be used. \nQuestion LG 9-6 \nHow does the use of hindsight interact with other practical expedients to either carryforward capital \nlease balances or to not reassess lease classification if electing the package of practical expedients? \nPwC r esponse \nASC 842 -10-65-1(r)(1) prescribes transition guidance for a lessee that has a capital lease under ASC \n840 that is classified as a finance lease under ASC 842. Under this guidance, the lessee should recognize a right -of-use asset and a leases liability at the carrying amount of the lease asset and the \ncapital lease obligation under ASC 840 at the initial application date. A literal application of this guidance may result in an anomalous discount rate for a lessee that has a capital lease under ASC 840 , \nespeci ally if the lessee elects both the package of practical expedients and applies hindsight (to ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 325}), Document(page\_content='Effective date and transition \n9-10determine the lease term) when transitioning to ASC 842. The application of hindsight could result in \na shortened (or lengthened) lease term because exercise of a renewal option may no longer be reasonably certain (or may have become reasonably certain). In this situation, the discount rate required to amortize the carrying value of the capital lease obligation (determined under ASC 840) to the appropriate amount by the end of the shortened (or lengthened) lease term may get significantly \nreduced (or increased). \nThis issue could occur whenever a lessee elects the package of practical expedients as well as the application of hindsight for its existing operating leases. In that case, the lessee would also need to apply the expedients to its existing capital leases. Because the lessee elected the package of practical \nexpedients, it would not reassess lease classification. \nGiven the transition guidance in ASC 842 -10-65-1(r)(1) states that the carrying amount of the capital \nlease asset and capital lease obligation under ASC 840 should be carried over into the right -of-use \nasset and lease liability, there are circumstances in which a literal application of that guidance in \nconjunction with hindsight would produce a materially distorted interest rate . This could result in a \nsignificant impact to subsequent expense recognition. Paragraph BC394 in the Basis for Conclusions \nof ASC 842 indicates that the Board intended for the ap plication of the hindsight election to result in \nmore accurate, updated information for financial statement users. Consequently, we believe a lessee \nmay apply the following approach to transition existing capital leases when the lessee elects to apply \nhindsight : \n□Apply hindsight at the lease inception date to determine the appropriate lease term and discount\nrate.\n□Using such discount rate, recalculate the new capital lease asset and capital lease obligationbalance (as well as any deferred initial direct cos ts balance) under ASC 840 using revised lease \npayments as of the initial application date as though the lease term was always the updated lease\nterm based on hindsight.\n□Any difference between the recalculated and existing balances at the initial application date should\nbe recorded as an adjustment to opening equity. Note, however, that i f the reporting entity has\nelected to adjust the comparative periods upon adoption and the lease commenced during the\ncomparative periods, the adjustment should be reflected in earnings during the comparative\nperiods.\nThe lessee should then follow the transition accounting in ASC 842 -10-65-1(r) through ASC 842 -10-\n65-1(t) using the recalculated balances.\nQuestion LG 9- 7 discusses how a lessor evaluates leases when electing the hindsight practical \nexpedient. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 326}), Document(page\_content='Effective date and transition \n9-11Question LG 9-7 \nWhat is the lessor transition accounting model for a lease previously classified as a sales -type lease or \ndirect financing lease under ASC 840 when a lessee elects the practical exped ient of hindsight for \npurposes of adopting the leases standard ? \nPwC r esponse \nWe believe that a principle similar to the one described in Question LG 9-6 would apply for lessors \nwith sales- type leases and direct financing leases . \nThe transiti on guidance in ASC 842 -10-65-1(x)(1) requires that a lessor continue to recognize a net \ninvestment in the lease at the carrying amount of the net investment under ASC 840. A literal \napplication of ASC 842 -10-65-1(x) could produce a materially distorted implicit interest rate in certain \ncases when a lessor also elects to apply hindsight. This could result in a significant impact to \nsubsequent income recognition. Paragraph BC394 in the Basis for Conclusions of ASC 842 indicates \nthat the Board int ended for the application of the hindsight election to result in more accurate, \nupdated information for financial statement users. Consequently, we believe a lessor may apply the \nfollowing approach to transition existing sales -type and direct financing lea ses when the lessor elects \nto apply hindsight : \n□Apply hindsight at the lease inception date to determine the appropriate lease term and implicit\ninterest rate.\n□Using such discount rate, recalculate the new net investment in the lease balance under ASC 840using the revised lease payments as of the application date as though the lease term was always the\nupdated lease term based on hindsight.\n□Any difference between the recalculated and existing balances at the application date should be\nrecorded as an adjustm ent to opening equity. Note, however, that if the reporting entity has\nelected to adjust the comparative periods upon adoption and the lease commenced during the\ncomparative periods, the adjustment should be reflected in earnings during the comparativeperiods.\nThe lessor should then follow the transition accounting in ASC 842 -10-65-1(x) using the recalculated \nbalances. \n9.3.1.3 Land easements practical expedient \nAn optional practical expedient is available that allows a reporting entity to choose to not apply the \nleases standard to certain existing land easements at transition. See LG 2.3.2.1 for additional \ninformation. \nASC 842 -10-65-1(gg ) \nAn entity also may elect a practical expedient to not assess whether existing or expired land easements \nthat were not previously accounted for as leases under Topic 840 are or contain a lease under this \nTopic. For purposes of (gg), a land easement (also co mmonly referred to as a right of way) refers to a \nright to use, access, or cross another entity’s land for a specified purpose. This practical expedient shall \nbe applied consistently by an entity to all its existing and expired land easements that were not ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 327}), Document(page\_content='Effective date and transition \n9-12previously accounted for as leases under Topic 840. This practical expedient may be elected separately \nor in conjunction with either one or both of the practical expedients in (f) and (g). An entity that elects \nthis practical expedient for existing or exp ired land easements shall apply the pending content that \nlinks to this paragraph to land easements entered into (or modified) on or after the date that the entity \nfirst applies the pending content that links to this paragraph as described in (a) and (b). A n entity that \npreviously accounted for existing or expired land easements under Topic 840 shall not be eligible for \nthis practical expedient for those land easements. \n9.4 Lessee transition \nThe transition guidance for a lessee differs depending on the classification of the lease. Given that the \npractical expedients discussed in LG 9 .3.1.1 allow reporting entities to avoid reconsidering lease \nclassification , we expect that many lease arrangements will retain their original classification and \ntherefore, the accou nting for a change in classification is not discussed in this guide. Readers should \nrefer to ASC 842 -10-65-1 for guidance. \n9.4.1 Lessee transition: o perating leases \nIf a lease was classified as an operating lease under the guidance in ASC 840 and will continue t o be \nclassified as an operating lease under the leases standard, the lessee should recognize a right -of-use \nasset and lease liability at the application date of the leases standard . The application date for \ncompanies that choose to adjust comparatives periods is the later of: (1) the beginning of the earliest \ncomparative period presented and (2) the commencement date of the lease. The application date for \ncompanies that choose to not adjust comparative periods is the effective date. \nHowever, as discussed i n LG 2.2.1, a lessee may elect not to recognize right -of-use assets and lease \nliabilities arising from short -term leases. If a lessee makes this election, it would not apply the \ntransition guidance outlined in this section to such leases. Instead, the less ee should continue to \nrecognize those lease payments on a straight -line basis and variable payments in the period in which \nthe obligation for those payments is incurred. \nFor leases other than short -term leases whe n a lessee has made an election to not reco gnize a lease \nliability and right -of-use asset, the lease liability should be calculated as the present value of the sum \nof (1) the remaining minimum rental payments (as defined under ASC 840) and (2) any amounts \nprobable of being owed by the lessee under a residual value guarantee. \nA lessee should measure the operating lease right -of-use asset at an amount equal to the lease liability, \nadjusted for the following: \n□Prepaid or accrued rent\n□Remaining balance of any lease incentives\n□Unamortized initial direct costs\n□Any impairment\n□The carrying amount of any liability related to the lease recognized in accordance with ASC 420,\nExit or Disposal Cost Obligations', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 328}), Document(page\_content='Effective date and transition \n9-13Unless the entity elects the package of practical expedients discussed in LG 9 .3.1.1, u namortized initial \ndirect costs remaining at the application date that would not have qualified for capitalization under the \nleases standard should be written off with an offsetting entry to equity (or earnings if the entity \nchooses to adjust comparative periods and the costs were incurred after the beginning of the earliest \nperiod presented ). \nAlso, refer to LG 9 .3.1.2 when the hindsight practical expedient is elected , regarding whether existing \nbalances should be adjusted . \nThe transition guidance in ASC 842 does not explicitly discuss the treatment of sublease liabilities \nunder ASC 840. These liabilities arise in certain sublease transactions when the underlyi ng asset was \nsublease d at a loss . Certain of these transactions are not in the scope of ASC 420 when the entity has \nnot ceased use of the leased space for the term of the head lease . We believe it would be appropriate to \nanalogize to the guidance for liabi lities under ASC 420 in transition to ASC 842. Consequently, the \nright -of-use asset recognized at transition should be reduced (netted) by the carrying amount of the \nsublease liability. Alternatively, we would not object to a reporting entity writing off a n existing \nsublease liability at the application date with an adjustment to opening equity at transition. In this \nlatter case, the reporting entity should also perform an impairment test of the right -of-use asset at the \napplication date . See LG 9 .4.1.3. \nQuestion LG 9-8 \nHow should the lessee treat the excess of the carrying amount of the existing liability re cognized in \naccordance with ASC 420, Exit or Disposal Cost Obligations , over the right -of-use asset to be \nrecorded at transition ? \nPwC r esponse \nThis s ituation is not specifically addressed in ASC 842 ; however, w e believe that the lessee can elect to \napply either of the follow methods: \n□Derecognize the excess ASC 420 liability through equity : In this scenario, the lessee\nwould debit the liability and credit equity for the amount in excess of the right -of-use asset (whic h\nis now zero ). Subsequent to transition, losses resulting from the sublease w ould be reflected in th e\nincome statement as they are incurred (subsequent to the e ffective date).\n□Recognize the excess ASC 420 liability as a negative ROU asset (presented as a\nliability within the financial statements ): This treatment w ould preserve the liability ,\nreducing future losses related to the sublease.\nAn entity should elect one method and apply it consistently to all leases impacted. \n9.4.1.1 Lessee : discount rate s in transition \nThe discount rate used to calculate the present value of the future payments should be determined at \nthe application date as discussed in LG 9 .3. For example, a calendar year -end private company \nadopting on January 1, 2022 that chooses not to adjust comparative periods would determine the rate \nas of January 1, 20 22. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 329}), Document(page\_content='Effective date and transition \n9-14See LG 3.3.4.6 for information on det ermining the discount rate, including specific private company \nconsiderations. When a lessee uses its incremental borrowing rate as the discount rate at transition, \nthe transition guidance does not specify whether the rate should be based on the original l ease term or \nthe remaining lease term. We believe that the selection of a rate that is based on either the original \nlease t erm or the remaining lease term is reasonable . The approach should be consistently applied . \n9.4.1.2 Lessee: lease payments in transition \nAt transition, a lessee is required to measure a lease liability for leases classified as operating under \ncurrent GAAP equal to the sum of the present value of (1) the remaining minimum rental payments (as \ndefined in ASC 840), and (2) any amount s probable of being owed by the lessee under a residual value \nguarantee as defined under the leases standard . When lease classification has not changed, the lease \npayments used for measurement purposes should be based on the same data as under ASC 840. If the \nentity has not elected hindsight, the lease term used to determine the payments should be the same as \nwhat was used under ASC 840 at lease inception (or the latest reassessment of lease term if the lease had been modified). \nVariable payments \nASC 840 require s that variable payments (contingent rentals) that are based on an index or rate be \nincluded in minimum lease payments based on the index or rate existing at lease inception (or as of \nthe modification date if the lease has been modified) . However, the re is diversity in practice regarding \nhow lessees treat rent payments based on an index or rate in their commitments footnote under ASC 840.\nS\nome lessees use the inception index or rate whereas others update the amount to reflect th e\nc\nurrent index or rate. The transition guidance in the new leases standard does not explicitly state\nwhether the index or rate used to measure the lease liability for an operating lease should be as of the\ntransition d ate or as of the inception of the lease .\nWe believe that if the lessee historically disclosed the amount of its commitments for operating leases \nusing the index or rate as of the inception of the lease (consistent with the index or rate in effect under \nASC 840 that was used to calculate the minim um rental payments ), then that rate should be used in \nmeasuring the initial lease liability at transition for existing leases . If a lessee that previously used the \ninception index or rate in its commitment footnote wan ts to use the current index or rate to measure \nthe lease liability at transition for existing leases, it would need to apply the guidance in ASC 250, \nAccounting Changes and Error Corrections , including an evaluation of preferability. Note that in \nevaluating preferability , the SEC staff has ind icated that it may be reasonable to conclude that the use \nof a current index or rate better reflects the lease liability at transition. \nWe believe that if the lessee historically disclosed the amount of its commitments for operating leases with variable pa yments based on an index or rate using the current index or rate, the lessee may \nmeasure the initial lease liability for its existing leases at transition by either (a) using the current \nindex or rate consistent with its existing policy for disclosures or (b) using the index or rate at the \ninception of the lease consistent with the definition of minimum rent payments in ASC 840 . In this \nlatter case, since the lessee is neither changing its recognition nor disclosure policies for operating \nleases, we do not believe that application of ASC 250 is required . \nSeparation of components in transition \nUnder the new leases guidance, a reporting entity is required to separate lease and nonlease \ncomponents. However, for new leases on or after the effective date of ASC 842 , a lessee may, as an ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 330}), Document(page\_content='Effective date and transition \n9-15accounting policy election by class of underlying asset, choose to not separate nonlease components \nfrom the associated lease components and instead account for each separate lease component and its \nassociated nonlease components as a single lease component. The new leases transition guidance does \nnot specify whether a lessee can make an accounting policy election to not sepa rate l ease and nonlease \ncomponents f or existing leases in calculating the lease liability at transition. \nUnder ASC 842, t he measurement of the lease liability for an existing operating lease includes the \npresent value of the remaining minimum rental p aymen ts (“as defined in ASC 840 ”). The term \n“minimum rental payments ,” however, is not actually defined in ASC 840 and the description of \n“minimum lease payments ” is unclear. We believe that the treatment of lease and nonlease \ncomponents in transition for existing leases depends on whether the lessee elects an accounting policy \nunder ASC 842 to not separate nonlease components from the associated lease component s (see LG \n2.4.4 .1). \nLessee does n ot elect to combine nonlease and lease components \nA lessee must separate nonlease components ( other than executory costs ) from the associated lease \ncomponents at transition for existing leases if the lessee has not made an accounting policy election to \ncombine them under ASC 842 for new leases . \nWhen a lease includes executory costs in the fixed rent payments (a gross lease), t he guidance in ASC \n840 with respect to accounting for those executory costs (such as insuran ce, maintenance, and \nproperty taxes ) to be paid by the lessor is unclear. With respect to a lessee, ASC 840 says that \nminimum lease payments include minimum rental payments called for by the lease over the lease term \nand comprise payments the lessee is obligated to make in connection with the leased property. As \nsuch, it does not directly address the treatment of executory costs. In the minimum lease payments \nclassification test, ASC 842 states that executory costs are exc luded. As such, the new guidance could \nbe read to imply that minimum lease payments include executory costs, hence the need to require \ntheir specific exclusion for purposes of the minimum lease payments classification test. \nSince the guidance in ASC 840 is unclear, we believe there were two acceptable historical practices for \na lessee to account for an operating gross lease : \n□The lessee could have chosen to separate executory costs from the remainder of the minimu m\nl\nease payments or\n□The lessee could have c hosen to include the fixed portion of executory costs within minim um lease\npayments\nNote that in this section , “fixed” could also include payments based on an index or rate. \nWe believe that a lessee has asserted a policy with regards to including or separa ting the fixed \nexecutory costs based on what the lessee disclosed in its commitments footnote. Note that variable or \ncontingent payments for executory costs would generally be excluded from minimum rental payments \nirrespective of the treatment of fixed executory costs . Therefore, we believe a lessee should transition \nits operating gross leases to ASC 842 consistent with its historical accounting policy as follows: \n□If a reporting entity has a historical accounting policy to excl ude executory costs from minimu m\nl\nease payments under ASC 840, then executory costs should be excluded from minimum rental', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 331}), Document(page\_content='Effective date and transition \n9-16payments in transition. Therefore, the portion of payments attributable to these executory costs \nwould not be included in the measure ment of the initial lease liability. \n□If a reporting entity has a historical accounting policy to include executory costs in minimum lease\npayments under ASC 840, then fixed executory costs should be included in minimum rental\npayments in transition. There fore, the fixed portion of payments attributable to th ose executory\ncosts would be included in the measurement of the initial lease liability.\nIf a lessee wants to change how executory costs are treated for existing leases , but is not electing to \ncombine nonlease and lease components under ASC 842, it would need to apply the guidance in ASC \n250, Accounting Changes and Error Corrections , including an evaluation of preferability . For \nexample, if the lessee has historically incl uded fixed executory costs in its commitments footnote and it \nwants to exclude these amounts from its lease liability at transition for existing leases, it would need to \ntreat this as a change in accounting policy and consider whether such a change is preferable. \nQuestion LG 9-9 considers how the treatment of executory costs at transition affects the units of \naccounting after transition . \nQuestion LG 9-9 \nHow does the treatment of executory costs at transition impact subsequent accounting in the event of \na reassessment trigger or a modification that is not considered a new lease? \nPwC r esponse \nWe believe a lessee’ s separat ion (or no n-separat ion) during transition creates a unit of accounting that \nshould be carried forward on and after the effective date. For example, assume a gross lease has two \nnonlease components : maintenance (an executory cost) and ancillary services (not associated with \nmaint enance) provided by the lessor. Assume the lessee chooses to separate nonlease components \nother than executory costs from the associated lease component during transition. If the lessee does \nnot separate maintenance from the lease component in transition due to its existing accounting policy \nunder ASC 840 but separate s the ancillary services at transition , the two units of accounting \nestablished in transition would be (1) the lease component that includes maintenance and (2) the \nancillary services nonlease component . These w ould remain consistent even in the event of a \nmodification that is not a new lease or remeasurement on or after the effective date. \nLessee elect s to combine nonlease and lease components \nA lessee may choos e to not separate nonlease components other than executory costs from the \nassociated lease components for existing leases at transition if , and only if, the lessee makes an \naccounting policy election by class of underlying asset to not separate nonlease components from the associated lease components for new leases on and after the effective date. We believe a lessee that \nelects to combine lease and nonlease components under ASC 842 may also apply that election to \nexisting leases at transition without applying ASC 250 Accounting Changes and Error Corrections , \nsince the change arises from the adoption of a new accounting standard. \nIf a lessee elects to not adjust the comparative periods, we believe the lessee should present their \ncomparative periods as they had before adopting ASC 842. We believe that the Board’s intent in ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 332}), Document(page\_content='Effective date and transition \n9-17providing the optional transition method was to allow entities to continue to report leases for the \ncomparative period as they had under ASC 840 . \n9.4.1.3 Lessee: i mpairment in transition \nAt transition , a lessee should consider whether adjustments are needed for any impairment when \ndetermining the amount of the right- of-use asset to record . \nWe believe that the FASB did not intend for lessees to adjust prior period impairment measurements \nor allocations to an asset group u nder ASC 360, Property, Plant, and Equipment upon adoption of the \nleases standard. If an asset group that includes an operating lease had been impaired under current GAAP, an allocation of the prior period asset group impairment should not be included in t he \nmeasurement of the operating lease right -of-use asset upon adoption of the leases standard. Instead, a \nright -of-use asset for a lessee ’s operating lease should be assessed for impairment under current \nGAAP, for example, ASC 420, Exit or disposal cost ob ligations (if the entity has ceased use of the \nleased asset), or ASC 840 (if the lessee subleased the underlying leased asset at a loss) during the look -\nback period. \nThe impairment provisions of ASC 360 would apply only on or after the effective date of the new \nstandard , unless the scenario in Question LG 9-10 applies. \nQuestion LG 9-10 \nIf previous impairments under ASC 360 in excess of the carrying value o f long -lived assets within the \nasset group were identified prior to the effective date, but were not able to be expensed because the \nassets cannot be written down below fair value (an “unrecognized impairment ”), is a lessee required to \nexpense any additional impairment resulting from the recogniti on of the right -of-use a sset as of the \neffective d ate? \nPwC r esponse \nWe believe that a n “unrecognized impairment ” should be recorded at the date that the right -of-use \nasset is initially recognized on the balance sheet. Therefore, if a reporting entity elects not to adjust \ncomparative periods, the impairment should be recorded as either as a charge to income or an equity adjustment at adoption since the impairment is first recorded at the date of initial application ( e.g., \nJanuary 1, 20 22 for a calendar year -end private company ). \n9.4.1.4 Lessee: f oreign currency in transition \nThe transition guidance in the leases standard does not address how to treat the effects of foreign \nexchange rates in a lease that is denominated in a currency other than a reporting entity ’s functional \ncurrency. As a result, certain questions have arisen. \nQuestion LG 9-11 and Question LG 9-12 discuss how leases denominated in a foreign currency should \nbe accounted for in transition . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 333}), Document(page\_content='Effective date and transition \n9-18Question LG 9-11 \nIn transitioning to ASC 842, what exchange rate should be used to determine lease payments for \npurposes of measuring a lessee ’s operati ng lease liability and right -of-use asset for existing operating \nleases? \nPwC r esponse \nFor leases that were classified as operating leases under ASC 840, a lessee should initially recognize a \nright -of-use asset and a lease liability at the application date described in LG 9 .3 \nWe believe it is reasonable to use the foreign exchange rate at the application date (rather than the commencement date) to determine l ease payments for both the lease liability and the right -of-use \nasset. This is because the transition guidance in the leases standard requires the right -of-use asset to \nbe initially equal to the lease liability adjusted for other items , which can only be accomplished by \nusing the foreign exchange rate at the application date. \nIn addition, ASC 830 -20-30-1 states: “At the date a foreign currency transaction is recognized, each \nasset, liability ... shall be measured initially in the functional currency of the recording entity by use of \nthe exchange rate in effect at that date. ” Consequently, the lessee sh ould use the foreign exchange rate \nin effect at the date of initial recognition of the right -of-use asset and lease liability. For a calendar \nyear -end nonpubl ic business entity with an effective date of January 1, 2022 choosing to adjust \ncomparative periods, this would be (a) January 1, 20 21 for an operating lease that commenced prior to \nJanuary 1, 20 21 or (b) the commencement date of the lease for a lease ente red into during the \ncomparative periods. For a calendar year -end nonpublic business entity choosing to not adjust \ncomparative periods, this would be January 1, 20 22. \nQuestion LG 9-12 \nFor a reporting entity that chooses to adjust comparative periods in transitio n, how should foreign \ncurrency gains or losses for a lessee ’s operating leases during the look -back period be accounted for \nafter the initial application date? \nPwC r esponse \nThe transition guidance in ASC 842 -10-65-1(d) of the leases standard states that a reporting entity \nshall adjust equity and, if it elects to adjust comparative periods, the other prior period comparative amounts, as if the new leases guidance always applied. \nFor reporting entities that choose to adjust comparative periods, base d on the general transition \nguidance in ASC 842 -10-65-1(d), subsequent to the application date the comparative income \nstatements presented should be adjust ed to reflect the effect of foreign currency exchange rate \nmovements on lease -related monetary assets and liabilities. These foreign exchange transaction gains \nor losses should be recognized in income during the comparative periods. \n9.4.1.5 Lessee: s ubsequent recognition and measurement in transition \nAfter initial recognition, a lessee should measure the lease liability and the right -of-use asset in \naccordance with the subsequent measurement guidance in the leases standard as described in LG \n4.4.2. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 334}), Document(page\_content='Effective date and transition \n9-199.4.2 Lessee: capital leases in transition \nIf a lease was classified as a capital lease under the guidance in ASC 840 and will be classified as a \nfinance lease under the leases standard, the lessee should reclassify the existing capital lease asset as a \nright -of-use asset and the existing obligation as a lease liability for each period the lease was \noutstanding beginning with the earliest period presented (if the entity chooses to adjust comparative \nperiods ) or the effective date (if the entity chooses not to adjust comparative periods ). That is, the \ninitial right -of-use asset and lease liability will be based on the guidance in ASC 840 for capital lease \nassets and capital lease obligations. However , refer to LG 9.3.1.2 and Question LG 9-6 when the \nhindsight practical expedient is elected. \nIf the entity elects the package of practical expedients discussed in LG 9 .3.1.1, it does not reassess \nunamortized initial direct costs. If a reporting entity does not elect the package of practical expedients, \ncosts that do not qualify for capitalization under the leases standard should be written off with an \noffsetting entry to equity unless the entity chooses to adjust comparative periods and the costs were \nincurred after the beginning of the earliest period presented , in which case they should be writte n off \nto earnings in the comparative period . Any unamortized initial direct costs that meet the definition of \ninitial direct costs under the leases standard should be included in the right -of-use asset established at \ntransition. \nFor reporting entities that choose to adjust comparative periods presented before the effective date, a \nlessee should measure the right -of-use asset and liability in accordance with the subsequent \nmeasurement guidance in Topic 840 during the comparative periods. \nBeginning on the e ffective date, a lessee should measure the right -of-use asset and lease liability in \naccordance with the subsequent measurement guidance in the leases standard (see LG 4.4.1). A lessee should not, however, remeasure the right -of-use asset or lease liability for changes in the amount \nprobable of being owed under a lessee -provided residual value guarantee. For leases that were capital \nleases under ASC 840 , in cases whe n remeasurement of the lease liability is required for any reason, \nthe lessee should continue to measure the residual value guarantee it provides on the basis of the stated amount, not the amount probable of being owed. See LG 5 for information on lease \nremeasurement . \n9.4.3 Lessee: m odifications during the look -back period \nGenerally, whe n there is no change in lease classification, a lessee that elects to adjust comparative \nperiods will apply the modification guidance in ASC 840 for modifications that occur during the \ncomparative periods presented . If the lease classification changes, the lessee should use the \nmodification model in ASC 842 irrespective of whether the modification took place during the \ncomparative periods or after the effective date. Absent a modification, a lessee should not reassess or \nremeasure leases during the comparati ve periods under the leases standard . \nQuestion LG 9-13 and Question LG 9-14 discuss how a lessee should account for lease modification s \nduring the look -back period . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 335}), Document(page\_content='Effective date and transition \n9-20Question LG 9-13 \nIf the lessee chooses to adjust comparative periods upon transition, w hat is the accounting for an \noperating le ase that is modified during comparative period s and the lease remains an operating lease ? \nPwC r esponse \nWhen a lease classified as an operating lease under ASC 840 continue s to be classified as an operating \nlease under ASC 842 , the transition provisions require application of a hybrid model . The lessee would \nrecognize a lease liability and a right -of-use asset under ASC 842 for such a lease using the amounts \ncalculated under ASC 840 at the application date. The transition provisions in ASC 842 further \nprescribe that the lessee should apply the modification and remeasurement guidance in ASC 842 should such a lease be modified after the look -back period. However, there is no guidance that \naddresses the accounting when a lease is modified during the comparative periods. In such a scenario, \nwe believe a hybrid model should be applied as follows: \n□The lessee should use the model for modifications in ASC 840 to determine the accounting for themodified oper ating lease.\nThe lessee should use the guidance in ASC 842 to recognize the modification, i.e., measure payments \nbased on ASC 840 but use the guidance in ASC 842 to adjust the lease liability and the right -of-use \nasset. \nQuestion LG 9-14 \nWhat is the account ing model when a capital lease under ASC 840 (classified as a finance lease under \nASC 842) is modified during the look -back period? \nPwC r esponse \nThe new leases guidance requires the modificati on guidance under ASC 842 to be followed when a \ncapital lease under ASC 840 (classified as a finance lease under ASC 842) is modified after the look -\nback period. There is no guidance when such a lease is modified during the look -back period. We \nbelieve the lessee should follow the modification guidance in ASC 840 to account for a modification during the look -back period since there was no change in the lease classification. \n9.4.4 Remeasurement events other than modifications \nAs discussed in LG 5.3, even if a lease is not modified, a lessee is required to remeasure lease payments \nand the lease liability in certain circumstances. This includes cases in which lease payments and term \nwould not be required to be reassessed under ASC 840 . One example of such a triggering event is a \nsignif icant event or a significant change in circumstances that is within the control of the lessee that \ndirectly affects whether the lessee is reasonably certain to exercise or not to exercise an option to \nextend or terminate the lease or to purchase the underlying asset. \nIn these scenarios, when a lessee recognizes a lease liability at transition, it should evaluate how the initial lease liability should reflect the remeasurement triggering event based on its transition \nelections. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 336}), Document(page\_content='Effective date and transition \n9-21As discussed in LG 9.4.1, at transition for an operating lease, the lessee’s lease liability should be \ncalculated as the present value of the sum of (1) the remaining minimum rental payments (as defined \nunder ASC 840) and (2) any amounts probable of being owed by the lessee under a r esidual value \nguarantee . \nAs discussed in LG 9 .4.2, for capital leases, the lessee should reclassify the existing capital lease asset \nas a right -of-use asset and the existing obligation as a lease liability . \nWhen a company does not elect to use hindsight, i t should continue to use the old lease payment data \nunder ASC 840 as required by ASC 842 -10-65-1(l)(1) and ASC 842 -10-65-1(r)(1) in transition unless \nand until a remeasurement triggering event occurs after the date of adoption of the leases standard \n(1/1/2 022 for a private calendar year -end company ). \nFigure LG 9-2 shows how a lessee should consider the occurrence of a triggering event that occurs \nprior to the effective date of the leases guidance in the transition for an operating lease. For purposes \nof the dates in the table, assume a private calendar year -end company is adopting the standard on \n1/1/20 22. \nFigure LG 9-2 \nTriggering events that occur prior to the effective date (p rivate calendar year -end company with an \neffective date of January 1, 2022 ) \nTriggering event \noccurs on \n12/31/20 21 or \nearlier Hindsight practical expedient is not elected Hindsight practical expedient is elected \nThe entity chooses to \nnot adjust comparative perio ds At transition on 1/1/20 22, \ncalculate the transition lease liability and right -of-use asset \nbased on the old lease payment \ndata under ASC 840 . Refer to LG \n9.4.1 and LG 9.4.2 for transition \naccounting for operating and capital leases , respectively . \nDifferences between the lease \nliability and the right -of-use asset \nnot otherwise specified would be recorded in opening equity . At transition on 1/1/20 22, calculate \nthe transition lease liability and right -of-use asset based on revised \ninform ation considering the \ntriggering event . Refer to LG 9.3.1.2, \nLG 9.4.1, and LG 9.4.2. Differences \nbetween the lease liability and the right -of-use asset not otherwise \nspecified would be recorded in \nopening equity. \nThe entity chooses to \nadjust comparative \nperiod (20 21) At transition, adjust the comparative period as follows: \n□As of 1/1/20 21, calculate the\ntransition lease liability and\nthe right -of-use asset based\non the old lease payment data\nunder ASC 840 . Refer to LG \n9.4.1 and LG 9.4.2 for\ntransition accounting for\noperating and capital leases, \nrespectively. Difference sAt transition, adjust the comparative \nperiod as follows: \n□As of 1/1/20 21, calculate the\ntransition lease liability and the\nright -of-use asset based on\nrevised information consideringthe triggering event . Refer to\nLG 9.3.1.2, LG 9.4.1, and LG\n9.4.2. Differences between th\ne\nl\nease liability and the right -of-\nuse asset not otherwise', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 337}), Document(page\_content='Effective date and transition \n9-22Triggering event \noccurs on 12/31/20 21 or \nearlier Hindsight practical expedient \nis not elected Hindsight practical expedient is elected \nbetween the lease liability and \nthe right -of-use asset not \notherwise specified would be recorded in opening equity \n(as of 1/1/20 21). \n□Roll the amounts forward for\n2021 following the\nsubsequent measurementrequirements in the leases\nguidance with adjustments , if\nany, recorded to the P&L in\nthe comparative period (refer\nto LG 9.4.1.5 and LG 9.4.2)\n.specified would be recorded in \nopening equity (as of 1/1/20 21). \n□Roll the amounts forward for2021 following the subsequent\nmeasurement requirements in\nthe leases guidance wit\nh\nd\nifferences, if any, recorded to\nthe P&L in the comparative\nperiod (refer to LG 9 .4.1.5 and\nLG 9.4.2).\nN\note that for remeasurement triggering events that occur after the effective date of the leases guidance \n(for example, an event on January 2, 20 22 for a p rivate calendar year -end company) a lessee should \nfollow the leases guidance discussed in LG 5 .3. \n9.5 Lessor transition \nThe transition guidance for a lessor differs in some respects depending on the classification of the \nlease. Given that the practical expedients discussed in LG 9 .3.1.1 allow reporting entities to avoid \nreconsidering lease classification, we expect that many lease arrangements will retain their original \nclassification and therefore, the accounting for a change in classification is not discussed in this guide. \nReaders should refer to ASC 842 -10-65-1 for guidance. \n9.5.1 Lessor: o perating leases in transition \nIf a lease was classified as an operating lease under the guidance in ASC 840 and will continue to be classified as an operating lease under the leases standard, the lessor should continue to recognize the carrying amount of the underlying asset and any lease assets or liabilities (for example, prepaid or \ndeferred rent) at the same amounts previously recognized in acc ordance with ASC 840. However, refer \nto LG 9 .3.1.2 when the hindsight practical expedient is elected. \nIf the entity elects the package of practical expedients discussed in LG 9 .3.1.1, it does not reassess \nunamortized initial direct costs. If a reporting entity does not elect the package of practical expedients, \nunamortized initial direct costs that do not qualify for capitalization under the leases standard should \nbe written off with an offsetting entry to opening equity unless the entity chooses to adjust \ncomparative periods and the costs were incurred after the beginning of the earliest period presented . \nIn this case, they should be written off to earnings in the comparative period . Unamortized initial \ndirect costs that qualify for capitalization under the leases standard (see LG 4.3.1.2) should remain \ncapitalized and continue to be expensed over the lease term. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 338}), Document(page\_content='Effective date and transition \n9-239.5.2 Direct f inanc ing and sales -type leases in transition \nIf a lease was classified as a direct financing or sales -type lease in accordance with ASC 840 and will be \nclassified similarly under the leases standard, the lessor should continue to recognize its net \ninvestment in the lease at the later of the earliest period presented or lease commencement. The net investment amount is the same as the carrying amount measured using the guidance in ASC 840 immediately before that date. However, see LG 9 .3.1.2 and Question LG 9-7 when the hindsight \npractical expedient is elected. \nFor a direct financing lease, the net investment in the lease should include any unamortized initial \ndirect costs capitalized in accordance with ASC 840. The transition guidance in the leases standard \ndoes not require lessors to write off initial direct costs that do not meet the definition of initial direct \ncosts under the new guidance even if the entity does not elect the package of practical expedients . \nFor lessors that choose to adjust comparative periods presented before the effective date, a lessor \nshould account for the lease in accordance with the subsequent measurement guidance in ASC 840 \nduring the comparative periods. Beginning on the effective date, a lessor should account for t he lease \nin accordance with the recognition and measurement guidance in the leases standard. See LG 4.5.1 for information. \n9.5.3 Leveraged leases in transition \nLeases that commenced before the effective date of the leases standard that were previously \nclassified as leveraged leases, may continue to be accounted for as leveraged leases by the lessor. \nLessors should apply the guidance in ASC 842-50, which is consistent with legacy leveraged lease \naccounting guidance. New leases (or leases not previously classified as leveraged leases) and \nleveraged leases modified on or after the effective date cannot be classified as leveraged leases but \nwill need to be classified using the new standard. See LG 7 for more information regarding leveraged \nleases. \n9.5.4 Separation and allocation of components \nUnder the leases guidance, a reporting entity is required to separate lease and nonlease components \nand allocate consideration in the contract to each component . However, a lessor may, as an accounting \npolicy election by class of underlying asset, choose to not separate nonlease components from the associated lease components and instead account for each separate lease component and its associated \nnonlease components as a single le ase component provided certain conditions are met . See LG 2.4 for \nmore information. \nQuestion LG 9-15 discusses contract consideration reallocation upon adoption of the revenue \nrecognition standard . ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 339}), Document(page\_content='Effective date and transition \n9-24Question LG 9-15 \nIs a reporting entity required to realloc ate contract consideration between revenue components and \nlease components when adopting the revenue standard (ASC 606) ? \nPwC r esponse \nThis question arises in the context of a reporting entity adopting the new revenue recognition standard \nbefore the leases standard . \nIf a reporting entity adopts the new revenue standard and the leases standard at the same time and \nalso elects the package of practical expedients in the leases standard , the entity is not required to \nreassess the accounting for lease components, including the allocations between lease and nonlease \ncomponents in contracts restated under the new revenue standard. \nHowever, the transition guidance in the new revenue standard does not explicitly provide any relief \nfrom the requirement to separate lease and nonlease components if a reporting entity adopts the new \nrevenue standard before the leases standard . \nThe FASB explained in a Board meeting on June 21, 2017 that it did not intend for a reporting entity to \nrevisit the allocat ion of contract consideration to lease components within the scope of the existing \nleases guidance when the entity adopts the new revenue standard. \nSimilarly, if an element were an executory cost under ASC 840, it would not need to be separated until \nthe adoption of ASC 842 . Also, a lessor can elect to not separate certain nonlease components under \nthe leases standard in certain cases as described in LG 2.4 . \n9.5.4.1 Presentation of tenant reimbursements \nLessors o f real e state fr equently p ass the cost s of insurance , main tenance, and property t axes \n(collectively , executory c osts) on to t heir l essees for r eimbursement, an d present the tenant \nreimbursements in a separate income statement l ine item under A SC 84 0. Executory costs as d efined \nunder A SC 8 40, however, are accounted fo r differently un der A SC 8 42. U nder ASC 842, p roperty taxes \nand i nsurance a re not se parate components in a n arrangement (i.e. , they are neither lease components \nnor nonlease c omponents; they are additional c onsideration in t he contract), whereas maintenance is \na nonlease c omponent that should be a ccounted for under A SC 606. (See LG 2 .4.1 for a dditional \ninformation o n identifying lease an d nonlease components.) These c hanges may l ead t o questions as t o \nhow l essors s hould present thes e recovered c osts for existing l eases u pon a dopting ASC 842. \nWe believe that upon adopting ASC 842, lessors that elect the package of practical expedients \ndescribed in LG 9.3.1.1 may continue (prospectively) to present existing leases in a consistent manner \nwith how t hey h ad done so previously . Because this differs f rom t he ac counting u nder ASC 8 42 that \nwill apply to new or modified leases, lessors s hould d isclose t he d ifference i n presentation o f their \nexisting l eases . Alternately, we believe that i t would b e acceptab le to conform t he p resentation of \nexisting l eases t o the presentation o f leases e ntered i nto o r modified a fter t he effective date of A SC \n842. \nAs d escribed i n LG 2 .4.4.1 , lessors m ay al so elect, by class of underlying as sets, to combine lease and \nnonlease components. Per AS C 842 -10-65-2, this election applies to “all n ew an d existing leases.” \nAccordingly, a lessor t hat e lects t o no t separate l ease an d nonlease components m ust al so combine ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 340}), Document(page\_content='Effective date and transition \n9-25such components for existing leases (for the applicable class of underlying asset) upon adoption, and it \nwould no longer be appropriate to present the nonlease maintenance component (or the reimbursable \ninsurance and property taxes) in a separate tenant re imbursement income statement line item after \nthe effective date of ASC 842. \nAs for the comparative periods prior to adopting ASC 842, we believe that lessors that have elected the transition method to not adjust prior periods should present their comparati ve periods as they had \nbefore adopting ASC 842. We believe that the Board’s intent in providing the optional transition method was to allow entities to continue to report leases for the comparative period as they had under ASC 840. \n9.5.5 Lessor: m odification during comparative periods \nGenerally, whe n there is no change in lease classification, a less or that elects to adjust comparative \nperiods will apply the modification guidance in ASC 840 for modifications that occur during the comparati ve periods presented. If the lease c lassification changes, the lessor should use the \nmodification model in ASC 842 irrespective of whether the modification took place during the \ncomparative periods or after the effective date. \nQuestion LG 9-16 discusses how lessors should account for lease modification s during the look -back \nperiod. \nQuestion LG 9-16 \nAssume a lessor elects the package of practical expedients upon adoption of the leases standard and \nchoose s to adjust comparative periods. What is the accounting if an operating or sales -type or direct \nfinancing lease under ASC 840 is modified during the look -back period? \nPwC r esponse \nThe transition provisions in ASC 842 do not provide any guidance on the accounting in this scenario. We believe the lessor should follow the modification guidance in ASC 840 should there be a \nmodification of the lease during the look -back period. Modification guidance under the leases \nstandard should be followed for a modification after the look -back period. \n9.6 Sale and lease back in transition \nA transaction previously accounted for as a sale and leaseback under ASC 840 should not be reassessed to determine whether it would have qualified as a sale (or purchase) under the guidance in ASC 606. Lessees and lessors should account for the lease in any transaction that qualified as a sale and leaseback in accordance with the lessee and lessor transition requirements. ASC 842 -10-65-1 also \nprovides guidance on the accounting for any deferred gain or loss balance after transition. \nASC 842 -10-65-1(dd) \nIf a previous sale and leaseback transaction was accounted for as a sale and capital leaseback in \naccordance with Topic 840, the transferor shall continue to recognize any deferred gain or loss that \nexists at the later of t he beginning of the earliest comparative period presented in the financial \nstatements and the date of the sale of the underlying asset (if an entity elects the transition method in ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 341}), Document(page\_content='Effective date and transition \n9-26(c)(1)) or that exists at the beginning of the reporting period in which the entity first applies the \npending content that links to this paragraph (if an entity elects the transition method in (c)(2)), as \nfollows: \n1.If the underlying asset is land only, straight line over the remaining lease term.\n2.If the underlying asset is not l and only and the leaseback is a finance lease, in proportion to the\namortization of the right -of-use asset.\n3.If the underlying asset is not land only and the leaseback is an operating lease, in proportion to the\nrecognition in profit or loss of the total l ease cost.\nASC 842 -10-65-1(ee ) \nIf a previous sale and leaseback transaction was accounted for as a sale and operating leaseback in \naccordance with Topic 840, the transferor shall do the following: \n1.Recognize any deferred gain or loss not resulting from o ff-market terms (that is, where the\nconsideration for the sale of the asset is not at fair value or the lease payments are not at market\nrates) as a cumulative -effect adjustment to equity unless the entity elects the transition method in\n(c)(1) and the dat e of sale is after the beginning of the earliest period presented, in which case any\ndeferred gain or loss not resulting from off -market terms shall be recognized in earnings in th e\nperiod the sale occurred.\n2.Recognize any deferred loss resulting from the consideration for the sale of the asset not being at\nfair value or the lease payments not being at market rates as an adjustment to the leaseback right -\nof-use asset at the later of the beginning of the earliest comparative period presented in th e\nfinancial statements and the date of the sale of the underlying asset (if an entity elects the\ntransition method in (c)(1)), or at the beginning of the reporting period in which the entity first\napplies the pending content that links to this paragraph (if an entity elects the transition method\nin (c)(2)).\n3.Recognize any deferred gain resulting from the consideration for the sale of the asset not being at\nfair value or the lease payments not being at market rates as a financial liability at the later of the\nbeginning of the earliest comparative period presented in the financial statements and the date of\nthe sale of the underlying asset (if an entity elects the transition method in (c)(1)), or at the\nbeginning of the reporting period in which the entity first applies the pending content that links to\nthis paragraph (if an entity elects the transition method in (c)(2)).\nA sale and leaseback transaction previously accounted for as a failed sale and leaseback transaction in \naccordance with ASC 840 should be reass essed under the leases standard to determine whether a sale \nwould have occurred (1) at any point on or after the beginning of the earliest period presented in the \nfinancial statements under the guidance in ASC 842 (if a reporting entity elects to adjust co mparative \nperiods ) or (2) at the effective date (if a reporting entity elects to not adjust comparative periods ). See \nLG 6 for information on sale and leaseback accounting. If a sale would have occurred, the sale and leaseback transaction should be accounted for using the lease transition guidance in ASC 842 -10-65-1 \non a modified retrospective basis from the date a sale is determined to have occurred. \nQuestion LG 9-17 discuss es application of sale and leaseback transition guidance for leases that existed \nprior to the effective date of the leases standard. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 342}), Document(page\_content='Effective date and transition \n9-27Question LG 9-17 \nMust lessors apply sale and leaseback transition guidance under the leases standard to failed sale and \nleaseback transactions under ASC 840 that existed prior to the effective date of the leases standard ? \nPwC r esponse \nWe do not believe that a buyer -lessor should reassess a successful purchase under the new standard. \nThe transition provisions require that transactio ns that “failed ” sale-leaseback accounting under ASC \n840 through the effective date be reassessed under the leases standard to determine if they would \nqualify as a sale during the look -back period. Since the sale -leaseback model under ASC 840 did not \napply to lessors, but the sale and leaseback model in the leases standard does, it is unclear whether the \ntransition guidance in the leases standard for previous failed sale and leaseback transactions applies to \nlessor accounting. \nWe believe a buyer -lessor sho uld not reassess a successful purchase with respect to a previous sale and \nleaseback transaction that did not qualify for sale -leaseback accounting under ASC 840. Instead, for \nsuccessful purchases, buyer -lessors should account for the leaseback in accordan ce with the normal \nlessor transition guidance. \n9.7 Build -to-suit leases in transition \nThe leases standard provide s transition guidance for certain existing build -to-suit arrangements. \nASC 842 -10-65-1(u) \nA lessee shall apply a modified retrospective transition approach for leases accounted for as build -to-\nsuit arrangements under Topic 840 that are existing at, or entered into after, the beginning of the \nearliest comparative period presented in the financial statements (if an entity elects the transition \nmetho d in (c)(1)) or that are existing at the beginning of the reporting period in which the entity first \napplies the pending content that links to this paragraph (if an entity elects the transition method in \n(c)(2)) as follows: \n1.If an entity has recognized assets and liabilities solely as a result of a transaction ’s build -to-suit\ndesignation in accordance with Topic 840, the entity shall do the following:\ni.If an entity elects the transition method in (c)(1), the entity shall derecognize those assets\nand liabi lities at the later of the beginning of the earliest comparative period presented in th e\nfinancial statements and the date that the lessee is determined to be the accounting owner o f\nthe asset in accordance with Topic 840.\nii.If an entity elects the transition method in (c)(2), the entity shall derecognize those asset s\nand liabilities at the beginning of the reporting period in which the entity first applies the\npending content that links to this paragraph.\niii.Any difference in (i) or (ii) shall be recorded as an adjustment to equity at the date that\nthose assets and liabilities were derecognized in accordance with (u)(1)(i) or (ii).', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 343}), Document(page\_content='Effective date and transition \n9-28iv.The lessee shall apply the lessee transition requirements in (k) through (t) to the lease.\n2.If the construction period of the build -to-suit lease concluded before the beginning of the earliest\ncomparative period presented in the financial statements (if the entity elects the transition method\nin (c)(1)) or if it concluded before the beginning of the reporting period in which the entity first \napplies the pending content that links to thi s paragraph (if the entity elects the transition method\nin (c)(2)), and the transaction qualified as a sale and leaseback transaction in accordance with\nSubtopic 840 -40 before that date, the entity shall follo w the general lessee transition requirements\nfor the lease.\nFor lessees that choose to adjust comparative periods in transition, the lessee should follow the build -\nto-suit transition guidance for derecognition of assets and liabilities and account for the lease \ntransaction during the look -back period as if the lease had not been accounted for in accordance with \nthe build -to-suit guidance. \nQuestions LG 9-18 and LG 9- 19 discuss accounting for existing build -to-suit transactions under the \nnew leases guidance. \nQuestion LG 9-18 \nShould lessees account for build -to-suit transactions that existed at transition under the new build -to-\nsuit guidance ? \nPwC r esponse \nThe leases stand ard does not specifically address how the new build -to-suit model in ASC 842 should \nbe applied to build -to-suit transactions that exist at transition . We believe the accounting will depend \non the stage of the project. \n□If there are no assets and liabilities recognized by the lessee as a result of a completed construction\nproject on the effective date (i.e., the lessee was either not the owner during construction under\nASC 840 or the transaction qualified as a sale -leaseback), we believe the lessee should fol low the \nnormal lease transition requirements for the lease at the effective date.\n□If construction is complete as of the effective date and assets and liabilities have been and still are\nrecognized by the lessee as a result of the construction project as of the effective date, we believe\nthe lessee should derecognize assets and liabilities record solely as a result of the build to suit\narrangement pursuant to ASC 842 -10-65-1(u)(1). Any difference should be recorded as an\nadjustment to equity. The lessee would then follow the normal lease transition guidance. Also refer \nto the response to Question LG 9-19 for additional guidance on these transactions .\n□If construction is still in progress as of the effective date, we believe the transaction should b e\nr\neassessed under the control -based build -to-suit model in the leases standard .\noIf the lessee was deemed to be the accounting owner under ASC 840 and is not deemed tocontrol the asset under the new leases standard, the lessee should derecognize the asse t under\nconstruction and the liabilities recorded solely as a result of applying build to suit lease\naccounting. Any difference should be recorded as an adjustment to equity. The lessee would', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 344}), Document(page\_content='Effective date and transition \n9-29then follow the normal lease transition guidance. Also , refer to the response to Question LG 9-\n18 for additional guidance . \noIf the lessee was not previously the accounting owner but is deemed to control the asset under\nconstruction under the new leases standard , the lessee should recognize the asset under\nconstruction and a liability (A) at the later of (1) the earliest period presented or (2) the date\ncontrol over the asset under construction was established if the entity chooses to adjust\ncomparative periods or (B) at the effective date if the entity chooses to not adjust comparative\nperiods . A lessee that controls the asset being constructed under the leases standard would\nalso need to assess the transaction under the sale and leaseback provisions of the leases\nstandard upon completion of construction.\noThe liability and asset under constructio n should remain on the balance sheet if the lessee was\npreviously the accounting owner and is deemed to control the a sset under the leases standard .\nA\n lessee that controls the asset being constructed under the leases standard would also need t o\nas\nsess the transaction under the sale and leaseback provisions of the leases standard upon\ncompletion of construction .\nQuestion LG 9-19 \nMust lessees apply sale and leaseback transition guidance under the leases standard to failed sale and \nleaseback transactions under ASC 840 that existed prior to the effective date of the leases standard \nwhen these transactions resulted from failed build -to-suit transactions under ASC 840? \nPwC r esponse \nUnder ASC 840 and the leases standard, a lessee that is deemed to be the owner of a construction project due to a failed build -to-suit transaction must evaluate the transaction upon construction \ncompletion to determine if it qualifies for sale -leaseback accounting. \nThe transition guidance in the leases standard does not explicitly address the transition for a transaction that failed the sale and leaseback guidance under ASC 840 once construction was completed (either prior to or during the look -back period) because the transaction failed the build -to-\nsuit guidance under ASC 840. We believe that in such instances, since the reason for the failed sale -\nleaseback was due to a failed build -to-suit under ASC 840, the lessee should apply the transition \nguidance applicable to the failed build -to-suit (i.e., the lessee would not have to apply the sale and \nleaseback transition guidance for a failed sale and leaseback transaction). Instead, the lessee would derecognize the assets and liabilities recorded solely as a result of transaction’s build -to-suit \ndesignation and record any difference as an adjustment to equity (1) at the later of the beginning of the look -back period and the date the lessee was determined to be the a ccounting owner under ASC 840, if \na reporting entity chooses to adjust comparative periods, or (2) at the effective date, if the entity chooses not adjust comparative periods. After such date, the lessee would follow the lessee transition requirements for the lease and record a right -of-use asset and lease liability for the lease. \nIt is not uncommon for a lessee to capitalize costs due to the application of build to suit that would \nhave also been capitalized were the lessee not the accounting owner. For example, the lessee may have funded part of the construction costs on behalf of the lessor. These costs would be considered prepaid rent and should be reflected as such in transition. Payments for leasehold improvements are another common example of assets that should remain on the lessee’s balance sheet after build to suit assets \nand debt are removed in transition. Prepaid rent and leasehold improvements would be reflected on ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 345}), Document(page\_content='Effective date and transition \n9-30the balance sheet at cost (amortized cost when the asset has been placed into ser vice prior to \ntransition .) If the lessee chooses to adjust comparative periods, then we believe the adjustments in \nthose comparative periods would include reversing the income statement effects of the recognition of \nany imputed ground rent expense recorded during the construction period as well as the interest \nexpense and depreciation expense recognized after construction was complete. \nThe methodology used for lease classification of the lease recorded upon adoption varies depending on \nwhether or not the l essee elects the package of practical expedients (discussed in LG 9 .3.1.1). \n□Lessee did not elect the package of practical expedients : In this case, the lessee is\nreassessing lease classification for all existing leases under ASC 842. Therefore, we believe thelessee should also apply ASC 842 to determine lease classification. The lessee can elect to useeither of the following dates to classify the lease:\noLease commencement date\nothe later of (1) the lease commencement date and (2) the date that the lessee first recognizesthe lease on the balance (i.e., the ASC 842 application date)\n□Lessee elects the package of practical expedients : In this case, the lessee is not reassessing\nlease classification for all existing leases (i.e., lease classification is based on ASC 840). Therefore,we believe that in addition to the two options listed above, the lessee can also elect to use ASC 840lease classification guidance and determine lease classification using the lease inception date and\nthe terms and conditions of the lease at that time\n.\nT\nhe options listed above should be elected as an accounting policy and must be applied consistently. \n9.8 Amounts previously recognized in business \ncombinations \nASC 842-10-65-1 provides guidance for reporting entities that have previously recognized an asset or a \nliability related to favorable or unfavorable terms of an operating lease under the business \ncombination guidance in ASC 805. \nASC 842 -10-65-1(h) \nIf an entity has previously recognized an asset or a liability in accordance with Topic 805 on business \ncombinations r elating to favorable or unfavorable terms of an operating lease acquired as part of a \nbusiness combination, the entity shall do all of the following: \n1.Derecognize that asset and liability (except for those arising from leases that are classified as\noperating leases in accordance with Topic 842 for which the entity is a lessor).\n2.Adjust the carrying amount of the right -of-use asset by a corresponding amount if the entity is a\nlessee.', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 346}), Document(page\_content='Effective date and transition \n9-313.Make a corresponding adjustment to equity if assets or liabilities arise from leases that are\nclassified as sales -type leases or direct financing lea ses in accordance with Topic 842 for which the\nentity is a lessor. Also see (w).\n9.8.1 Transition for certain leasehold improvements \nUnder ASC 840, leasehold improvements that are installed significantly after lease inception or \nacquired in a business combinati on can have an amortization period greater than the lease term used \nfor accounting purposes . This is because the lessee must use the shorter of the useful life of the assets, \nor a term that include s required lease periods and renewals that are deemed to be reasonably assured \nat the date that the leasehold improvements are purchased for amortization purposes , while the lease \nterm for accounting purposes is not updated in these cases. However, ASC 842 does not permit this \ntreatment. Instead it includes the following guidance : \nAmortization of Leasehold Improvements \nASC 842 -20-35-12: Leasehold improvements shall be amortized over the shorter of the useful life of \nthose leasehold improvements and the rem aining lease term, unless the lease transfers ownership of \nthe underlying asset to the lessee or the lessee is reasonably certain to exercise an option to purchase \nthe underlying asset, in which case the lessee shall amortize the leasehold improvements to the end of \ntheir useful life. \nASC 842 -20-30-13: Leasehold improvements acquired in a business combination or an acquisition \nby a not -for-profit entity shall be amortized over the shorter of the useful life of the assets and the \nremaining lease term at the date of acquisition. \nASC 842 does not have specific transition provisions for leasehold improvements. Therefore, q uestions \nhave arisen about whether the amortization period of these leasehold improvement s should be \nshortened to conform to the lease term us ed for accounting purposes upon adoption of ASC 842 . We \nbelieve that unless hindsight is elected, the amortization period for the leasehold improvements \nshould not be changed . However , based on informal discussions with the FASB s taff, a lessee could \nalter natively adjust the amortization to conform with the lease term either on a prospective basis or as \na cumulative catch -up adjustment through equity. \n9.9 Transition disclosure \nLessees and lessors should provide the transition disclosures required by ASC 250, Accounting \nChanges and Error Correction, except that the information described in ASC 250 -10-50-1(b)(2) and \nASC 250 -10-50-3 is not required. \nAdditionally, if a reporting entity uses any of the transition practical expedients discussed in LG 9.3.1, \nit is required to disclose the use of such expedients. \nExcerpt from ASC 250 -10-50-1 \nAn entity shall disclose all of the following in the fiscal per iod in which a change in accounting \nprinciple is made: ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 347}), Document(page\_content='Effective date and transition \n9-32a.The nature of and reason for the change in accounting principle, inc luding an explanation of why the\nnewly adopted accounting principle is preferable.\nb.The method of applying the change, including all of the following:\n1.A description of the prior -period information that has been retrospectively adjusted, if any.\n2.[Not required]\n3.The cumulative effect of the change on retained earnings or other components of equity or net\nassets in the statement of financial position as of the beginning of the earliest period presented.\n4.If retrospective application to all prior periods is impracticable, disclosure of the reasons\ntherefore, and a description of the alternative method used to report the cha nge (see paragraphs\n250-10-45-5 through 45 -7).\nc.If indirect effects of a change in accounting principle are recognized both of the following shall be\ndisclosed:\n1.A description of the indirect effects of a change in accounting principle, including the amounts\nthat have been recognized in the current period, and the related per -share amounts, if applicable\n2.Unless impracticable, the amount of the total recognized indirect effects of the accounting change\nand the related per -share amounts, if applicable, that are attributable to each prior period\npresented. Compliance with this dis closure requirement is practicable unless an entity cannot\ncomply with it after making every reasonable effort to do so.\nFinancial statements of subsequent periods need not repeat the disclosures required by this \nparagraph. If a change in accounting princi ple has no material effect in the period of change but is \nreasonably certain to have a material effect in later periods, the disclosures required by (a) shall be \nprovided whenever the financial statements of the period of change are presented. \n9.9.1 Lessee’s tra nsition disclosure for index or rate -based rent \nThere is diversity in practice in how lessees prepare their footnote disclosures under ASC 840 when \nrent payments in an operating lease depend on an index or rate. ASC 840 defines minimum lease payments as b eing based on the index or rate in effect at lease inception (unless there has been a \nmodification to that lease, in which case the index or rate at the modification date should be used). Lessees are required to base straight -line rent expense accruals for operating leases on this definition. \nSome lessees prepare their ASC 840 footnote disclosures consistent with the required recognition model , others update the inception date index or rate to reflect the current index or rate. For purposes \nof transitioning operating leases under ASC 840 to the new leases standard, a lessee should measure \nlease liabilities at the applicable date using the “remaining minimum rental payments,” as defined \nunder the current leases guidance. Given the diversity in practice, the issue is whether the index or rate in rent payments should be the index or rate at inception date of the lease or updated to reflect the current index or rate. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 348}), Document(page\_content='Effective date and transition \n9-33In addressing the diversity in practice, we understand the SEC staff would allow lessees to use an \nindex or rate for transitioning operating leases to ASC 842 that is consistent with the policy used for footnote disclosures under ASC 840. The SEC staff noted that a lessee may choose to change the policy it is currently using for ASC 840 operating lease footnote disclosures purposes for transitioning such leases to the new leases standard. However, this would be a change in accounting policy and the lessee \nwould be required to apply ASC 250, Accounting Changes and Error Corrections, which would \nrequire a determination that the new policy is preferable. The SEC staff observed that it was \nreasonable to conclude that the use of a current index or rate better reflects the lease liability and \nwould therefore be preferable. \nAs a result of the SEC staff’s views, for leases classified as operating leases under ASC 840, we believe a lessee may measure the opening lease liability under the new leases standard in the following \nmanner at transition: \n□If a lessee uses the current date index or rate in its ASC 840 operating lease financial statement\ndisclosures, the lessee could either (a) use the current date index or rate; or (b) use the leaseinception date index or rate consistent with how minimum rent payments are recognized.\n□If a lessee uses the inception date index or rate in its ASC 840 operating lease financial statementdisclosures, the lessee could either (a) use the current date index or rate but apply the change inaccounting guidance in ASC 250; or (b) continue to use the lease inception date index or rate.\n9.10 Five -year selected financial data table \nWe believe t hat the selected financial data table required by Regulation S -K Item 301 should follow the \ntransition provisions of the new leases guidance. Adjustments would only be required to those periods \nin the financial data table that correspond to the periods adjusted in the registrant ’s financial \nstatements included in the relevant filing. For example, a calendar year -end SEC registrant that is \nneither an emerging growth company nor a smaller reporting co mpany will have a Form 10 -K for the \nyear ending December 31, 2019 that will include financial statements for each of the three years in the \nperiod ending December 31, 2019 and selected financial data for each of the five years in the period ending December 31, 2019. Assume that the entity elects to adjust comparative periods presented. \nJanuary 1, 2017 is the beginning of the earliest comparative period presented in the financial \nstatements. Accordingly, the registrant would only apply the new standard to 2019, 2018 , and 2017 in \nthe selected financial data table. The selected financial data for 2016 and 2015 are not considered comparative financial statements and therefore do not change the date of initial application of the new \nleasing standard for purposes of GAAP. The 2016 and 2015 information included in the selected \nfinancial data table will be prepared using the prior lease accounting model. \nSimilarly, if a reporting entity chooses not to adjust comparative periods, the four prior years in the \nselected financial data table would not be adjusted. \nIn either case, c onsistent with Instruction 2 to Regulation S-K Item 301, the registrant must provide \ndisclosure regarding the lack of comparability of the data presented in the selected financial data table \n(if applicable and material). ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 349}), Document(page\_content='Effective date and transition \n9-349.11 Effective date and transition for ASU 2021- 05 \nOn July 19, 2021, t he FASB published ASU 2021 -05, Leases (Topic 842): Lessors —Certain Leases \nwith Variable Lease Payments , which upon adoption requires a lessor to classify a lease with variable \nlease payments (that do not depend on a rate or index) as an operating lease on commencement date if \nclassifying the lease as a sales -type or direct financing lease would result in a selling loss. \nFigure LG 9-3 summarizes the effective dates for adopting ASU 2021 -05. Early adoption is permitted \nfor both public and nonpublic business entities. \nFigure LG 9-3 \nASU 2021 -05 effective dates \nType of entity Effective date \nPublic business entities \nA not -for-profit entity that has issued, or is a \nconduit bond obligor for, securities that are \ntraded, listed, or quoted on an exchange or over -\nthe-counter market \nAn employee benefit plan that files or furnishes financial statements to th e SEC □Fiscal years, and interim periods withi\nn\nt\nhose fiscal years, beginning after\nDecember 15, 20 21\nAll other entities not included above □Fiscal years beginning after December 15,2021 and interim periods within fiscal year\ns\nb\neginning after December 15, 2022\nE\nntities that have not yet adopted ASC 842 on or before the issuance of ASU 2021 -05 (i.e., July 19, \n2021) should adopt ASU 2021 -05 at the same time as ASC 842 and use the same transition method \nused to adopt ASC 842 (i.e., adjust comparative periods with t he cumulative effect of transition \nrecognized at the beginning of the earliest period presented, or with the cumulative effect of transition \nrecognized at the beginning of the period of adoption and no adjustment of comparative periods) . See \nLG 9.3 for tra nsition methods available for ASC 842. \nEntities that have adopted ASC 842 on or before the issuance of ASU 2021 -05 (i.e., July 19, 2021) \nshould apply ASU 2021 -05 either (1) retrospectively to leases that commenced or were modified \n(where the modification is not accounted for as a separate contract under ASC 842 -10-25-8) on or \nafter the adoption of ASC 842, or (2) prospectively to leases that commence or are modifi ed (where the \nmodification is not accounted for as a separate contract under ASC 842 -10-25-8) on or after the date \nthat an entity first applies the ASU. \n9.12 Effective date and transition for ASU 2021 -09 \nOn November 11, 2021, the FASB published ASU 2021 -09, Leases (Topic 842): Lessors —Discount \nRate for Lessees That Are Not Public Business Entities , which upon adoption provides nonpublic \nbusiness entity lessees with a practical expedient to elect, as an accounting policy, to use a risk -free \nrate as the discount rate by class of underlying asset. ASU 2021 -09 requires the use of the rate implicit ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 350}), Document(page\_content='Effective date and transition \n9-35in the lease when readily determinable regardless of the election to otherwise use a risk-free rate for a \nclass of underlying asset. \nFigure LG 9-4 summarizes the effectiv e dates for adopting ASU 2021 -09. \nFigure LG 9-4 \nASU 2021 -09 effective dates \nType of entity Effective date \nNonp ublic business entities that have not \nadopted ASC 842 as of November 11, 2021 □The same as ASC 842 , i.e., fiscal years\nbeginning after December 15, 2021 and\ninterim periods within fiscal years\nbeginning after December 15, 2022\nNonp ublic business entities that have adopted \nASC 842 as of November 11, 2021 □Fiscal years beginning after December 15,\n2021 and interim periods within fiscal year s\nb\neginning after December 15, 2022. Early\nadoption is permitted.\nNonpublic business entities that have not yet adopted ASC 842 on or before the issuance of ASU 2021 -\n09 (i.e., November 11, 2021) should adopt ASU 2021 -09 at the same time as ASC 842 and use the same \ntransition method used to adopt ASC 842 (i.e., adjust comparative periods with the cumulative effect \nof transition recognized at the beginning of the earliest period presented, or with the cumulative effect \nof transition recognized at the beginning of the period of adoption and no adjustment of comparative \nperiods). See LG 9 .3 for transition methods available for ASC 842. \nUpon adoption of the ASU, n onpublic business entity lessees that have already adopted ASC 842 on or \nbefore the issuance of ASU 2021 -09 (i.e., November 11, 2021) should: \n□Adjust the lease liability using the discount rate calculated based on the remaining lease term of\nl\neases that exist at the beginning of the fiscal year of adoption of ASU 2021 -09 and recognize the \namount of change in the lease liability as an adjustment to the corresponding right -of-use asset.\noIf the adjustment would reduce the right -of-use asset to below zero, the lessee should reduc e\nt\nhe right -of-use asset to zero and recognize the remaining amount of the adjustment to\nretained earnings at the beginning of the fiscal year of adoption of the ASU.\noIf the adjustment would increase a right -of-use asset that was previously impaired, the lessee\nshould recognize the adju stment to retained earnings at the beginning of the fiscal year o f\na\ndoption of the ASU.\n□Not consider the adoption of the ASU as an event that would cause remeasurement and\nreallocation of the consideration in the contract (including lease payments) or reassessment o f\nl\nease term or lessee option to purchase the underlying asset or classification.\nChoose to apply or discontinue using the risk -free rate for any class of underlying asset. ', metadata={'source': 'PDFs\_and\_TXT\\PWC\_Leases\_Guide\_01\_31\_2024.pdf', 'page': 351})]