

Leases

Navigating the guidance in
ASC 842



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Introduction

On February 25, 2016, the FASB released ASU 2016-02, *Leases*, completing its long-term project to overhaul lease accounting. The ASU codifies ASC 842, *Leases*, which replaces the guidance in ASC 840 *Leases*. ASC 842 is effective for public business entities in fiscal years beginning after December 15, 2018. The effective date for most other entities is deferred for one year, meaning that most calendar-year private companies will be required to adopt the new standard in 2020. Early adoption is permitted for all entities.

The guidance in ASC 842 should generally be applied as follows:

- **Determine whether a contract is or contains a lease:** A lease conveys the right to control the use of identified property, plant, or equipment for a period of time in exchange for consideration.
- **Identify the lease and nonlease components in the contract, and allocate consideration to them:** Lease components are accounted for under ASC 842, and nonlease components are accounted for under other relevant U.S. GAAP. Both lessees and lessors are permitted to combine qualifying lease and nonlease components.
- **Classify the lease component(s):** Lessees must classify leases as either finance or operating leases, and lessors must classify leases as sales-type, direct financing, or operating leases.
- **Measure and recognize the lease component(s):** Lessees must recognize an asset and liability on the statement of financial position for most leases, measured primarily based on the present value of the remaining lease payments. Lessors must recognize a net investment in the lease, and derecognize the underlying asset, for sales-type and direct financing leases. For operating leases, lessors retain the underlying asset on the statement of financial position.
- **Recognize lease expense or lease income over the lease term:** Lessors and lessees must generally recognize lease income or expense for operating leases on a straight-line basis over the lease term. For finance leases, lessees must recognize interest expense based on the effective interest method and amortization expense generally on a straight-line basis (the same way that capital leases are accounted for under legacy GAAP) over the lease term. Lessors must recognize up-front selling profit or loss on sales-type leases and interest income on the net investment in the lease over the lease term for both sales-type and direct financing leases.

ASC 842 also addresses entities' accounting for subleases, sale-leaseback transactions, and arrangements in which the lessee is involved in constructing the underlying asset.

Entities have two choices for transition – a modified retrospective method, which requires application of ASC 842 as of the beginning of the earliest period presented, or an alternative “current-period adjustment” method, which requires application of ASC 842 as of the effective date.

Since ASU 2016-02 was issued, the FASB has issued the following ASUs to clarify and amend the guidance in ASC 842, all of which are reflected in this guide:

- ASU 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*
- ASU 2018-10, *Codification Improvements to Topic 842, Leases*

- ASU 2018-11, *Leases (Topic 842): Targeted Improvements*
- ASU 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*
- ASU 2019-01, *Leases (Topic 842): Codification Improvements*

The remainder of this guide

- Summarizes the leasing guidance and examples
- Includes “Grant Thornton insights” on various topics
- Provides practical insights on how the guidance may differ from legacy GAAP (“At the crossroads”)
- Includes illustrative examples to demonstrate how to apply the guidance

1. Definitions

There are many key terms and concepts referenced throughout ASC 842. These terms and concepts apply to both lessees and lessors, and affect the classification, recognition, and measurement of leases. These terms and concepts are discussed in this section, and are referenced throughout the other sections of this publication.

1.1 Commencement date

The lease accounting model in ASC 842 is based on the concept of control. Lease accounting is triggered when control over the right to direct the use of an underlying asset transfers from the lessor to the lessee. This transfer of control occurs on the commencement date of the lease, which is the date when the lessor makes the underlying asset available for the lessee to use. The commencement date can occur even if the lessee has not begun to use the underlying asset at that date. For instance, although a leased railcar might initially sit empty in the lessee's rail yard, as long as the lessee controls the right to use the asset (that is, the lessee can use the asset whenever it chooses), the lease has commenced and should be accounted for by both parties.

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



At the crossroads: Commencement date versus inception date

Under ASC 842, many measurement inputs related to the lease, such as the discount rate and the fair value of the underlying asset, are determined at the lease *commencement date*, whereas under legacy GAAP, these inputs are determined at lease inception. Lease *inception* is the date when the contract containing the lease is executed, meaning that there is a signed document as evidence of the agreement and all principal provisions have been negotiated. Under ASC 842, lease components are identified at the commencement date of the lease, concurrently with determining the appropriate classification for each lease component and with measuring and allocating the consideration in the contract. These determinations are made based on the facts and circumstances as of the commencement date, whereas under legacy GAAP, these determinations are made based on the facts and circumstances as of the inception date of the lease.

Since there might be a significant difference between lease inception and lease commencement dates, ASC 842 requires a lessee to disclose information about leases that create significant rights and obligations if the inception date has already occurred but the lease has not yet commenced as of the reporting date, to ensure that financial statement users have information about the company's future commitments.



Lease with an inception date before and commencement date after year-end

Lessee and Lessor enter into an agreement to lease a building. The lease is signed on November 30, 20X1, and Lessor will make the underlying asset available for use by Lessee on February 1, 20X2. Therefore, the commencement date will occur, and the lease will be measured and recorded, on February 1, 20X2. The lease is not recognized on Lessee's statement of financial position at December 31, 20X1. However, the lease inception date has occurred, and Lessee is required to disclose information about the lease in the notes to its 20X1 financial statements, provided the lease creates significant rights and obligations for Lessee.

In some situations, the lessor makes the underlying asset available to the lessee before the lessee either begins using the asset or starts making lease payments. For example, a lessee leases space in an office building and must install leasehold improvements in the leased office space before moving in, at which point, it must begin making lease payments. In this situation, the lessee obtains the right to use the underlying asset once it can access the space to begin constructing its leasehold improvements. Therefore, the lease commences when the lessee gains access, regardless of when the lessee is required to begin making lease payments.



Distinguishing lease inception and commencement dates

On January 1, Lessee executes a contract with Lessor for the right to use an office building for a period of five years. However, Lessor must make repairs to the building before granting Lessee access, including repairs to the building's foundation. Once the repairs are completed on March 1, Lessee is granted access to the building, at which time Lessee's contractor can begin installing leasehold improvements. In this example, the contract inception date is January 1, and the commencement date of the lease is March 1.

Now, assume that Lessee is not required to begin making lease payments until its contractor finishes constructing the leasehold improvements, which occurs on June 1. The commencement date of the lease is still March 1, because that is when Lessor makes the asset available for use by Lessee, regardless of whether Lessee's obligation to make lease payments is deferred for some period of time.

As a result, Lessee must classify, measure, and record the lease on March 1.



ASC 842-10-55-19

In some lease arrangements, the lessor may make the underlying asset available for use by the lessee (for example, the lessee may take possession of or be given control over the use of the underlying asset) before it begins operations or makes lease payments under the terms of the lease. During this period, the lessee has the right to use the underlying asset and does so for the purpose of constructing a lessee asset (for example, leasehold improvements).

ASC 842-10-55-20

The contract may require the lessee to make lease payments only after construction is completed and the lessee begins operations. Alternatively, some contracts require the lessee to make lease payments when it takes possession of or is given control over the use of the underlying asset. The timing of when lease payments begin under the contract does not affect the commencement date of the lease.

For building and ground leases, ASC 842 makes no distinction between the right to use the underlying asset during a construction period and the right to use the asset once the construction has been completed. Both a lessee and a lessor should recognize lease cost or income in the same manner both during and after the construction period. For example, a lessee might enter into a ground lease and begin constructing a cell tower (a leasehold improvement) on the leased land. Likewise, a lessee might enter into a lease of office space and begin installing partitions, lights, and other leasehold improvements within the leased office space. The lessee should begin recognizing lease cost and the lessor should either recognize lease income or derecognize the underlying asset when the ground or office leases commence, which might occur concurrent with or prior to the lessee beginning construction of its leasehold improvements.



ASC 842-10-55-21

Lease costs (or income) associated with building and ground leases incurred (earned) during and after a construction period are for the right to use the underlying asset during and after construction of a lessee asset. There is no distinction between the right to use an underlying asset during a construction period and the right to use that asset after the construction period. Therefore, lease costs (or income) associated with ground or building leases that are incurred (earned) during a construction period should be recognized by the lessee (or lessor) in accordance with the guidance in Subtopics 842-20 and 842-30, respectively. That guidance does not address whether a lessee that accounts for the sale or rental of real estate projects under Topic 970 should capitalize rental costs associated with ground and building leases.

A master lease agreement that provides the lessee with the right to use multiple assets may contain multiple lease components with multiple commencement dates. See Section 1.10 for more information on master lease agreements.

1.2 Initial direct costs

Initial direct costs are the incremental costs of entering into a lease that are only incurred as a direct result of the lease being executed. Examples of initial direct costs include commissions paid upon executing the lease and costs paid to existing tenants as an incentive to vacate the leased premises. These costs are incurred only if the lease is executed and would not have been incurred if the lease had been drafted and negotiated, but ultimately had not been signed by both parties.

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

A cost that would have been incurred if the lease had been negotiated and drafted but ultimately not executed does not qualify as an initial direct cost and is therefore expensed as incurred. These costs include general overhead costs (depreciation, occupancy and equipment costs, idle time); costs related to activities performed by the lessor for advertising, soliciting potential lessees, servicing existing leases, and other ancillary activities; and costs related to activities that occur before the lease is obtained, such as acquiring tax or legal advice, negotiating lease conditions, or evaluating the creditworthiness of a lessee. Similarly, lease-related payroll costs would not be considered incremental, as they could not be avoided if a lease were not executed.



ASC 842-10-30-9

Initial direct costs for a lessee or a lessor may include, for example, either of the following:

- a. Commissions
- b. Payments made to an existing tenant to incentivize that tenant to terminate its lease.

ASC 842-10-30-10

Costs to negotiate or arrange a lease that would have been incurred regardless of whether the lease was obtained, such as fixed employee salaries, are not initial direct costs. The following items are examples of costs that are not initial direct costs:

- a. General overheads, including, for example, depreciation, occupancy and equipment costs, unsuccessful origination efforts, and idle time
- b. Costs related to activities performed by the lessor for advertising, soliciting potential lessees, servicing existing leases, or other ancillary activities
- c. Costs related to activities that occur before the lease is obtained, such as costs of obtaining tax or legal advice, negotiating lease terms and conditions, or evaluating a prospective lessee's financial condition.



At the crossroads: Initial direct costs

Under legacy GAAP, "initial direct costs" of a lease are defined more broadly than in ASC 842, and include many costs associated with the origination of a lease, such as evaluating a lessee's financial condition, negotiating lease terms, preparing documents, and closing the transaction. ASC 842 defines "initial direct costs" more narrowly, including only costs that are truly incremental to executing a lease, such as broker commissions and amounts paid to existing tenants to facilitate early termination of their existing leases. Costs related to evaluating a lessee's financial condition, negotiating lease terms, preparing documents, and closing the transaction are no longer considered initial direct costs under ASC 842. Therefore, lessees and lessors alike will find that more of their lease-related costs are expensed as incurred under ASC 842 than under legacy GAAP.

The following example from ASC 842-10-55 illustrates a lessee and lessor's analysis of costs incurred to obtain a lease and their assessment of whether those costs meet the definition of "initial direct costs."



Example 27—Initial Direct Costs

ASC 842-10-55-240

Lessee and Lessor enter into an operating lease. The following costs are incurred in connection with the lease:

Travel costs related to lease proposal	\$ 7,000
External legal fees	22,000
Allocation of employee costs for time negotiating lease terms and conditions	6,000
Commissions to brokers	10,000
Total costs incurred by Lessor	<u>\$ 45,000</u>
External legal fees	\$ 15,000
Allocation of employee costs for time negotiating lease terms and conditions	7,000
Payments made to existing tenant to obtain the lease	20,000
Total costs incurred by Lessee	<u>\$ 42,000</u>

ASC 842-10-55-241

Lessor capitalizes initial direct costs of \$10,000, which it recognizes ratably over the lease term, consistent with its recognition of lease income. The \$10,000 in broker commissions is an initial direct cost because that cost was incurred only as a direct result of obtaining the lease (that is, only as a direct result of the lease being executed). None of the other costs incurred by Lessor meet the definition of initial direct costs because they would have been incurred even if the lease had not been executed. For example, the employee salaries are paid regardless of whether the lease is obtained, and Lessor would be required to pay its attorneys for negotiating and drafting the lease even if Lessee did not execute the lease.

ASC 842-10-55-242

Lessee includes \$20,000 of initial direct costs in the initial measurement of the right-of-use asset. Lessee amortizes those costs ratably over the lease term as part of its total lease cost. Throughout the lease term, any unamortized amounts from the original \$20,000 are included in the measurement of the right-of-use asset. The \$20,000 payment to the existing tenant is an initial direct cost because that cost is only incurred upon obtaining the lease; it would not have been owed if the lease had not been executed. None of the other costs incurred by Lessee meet the definition of initial direct costs because they would have been incurred even if the lease had not been executed (for example, the employee salaries are paid regardless of whether the lease is obtained, and Lessee would be required to pay its attorneys for negotiating and drafting the lease even if the lease was not executed).



Grant Thornton insights: Initial direct costs in ASC 842 versus contract costs in ASC 340-40

The terms “initial direct costs” and “costs to obtain a contract,” used in ASC 842 and the cost deferral guidance related to revenue contracts in ASC 340-40, *Other Assets and Deferred Costs: Contracts With Customers*, respectively, have similar definitions. In ASC 842, initial direct costs are defined as “incremental costs of a lease that would not have been incurred if the lease had not been obtained.” In ASC 340-40, incremental costs of obtaining a contract are described as “those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission).” In paragraph BC306 of ASU 2016-02, the Board notes that these terms are aligned intentionally and can be viewed conceptually in the same way. Accordingly, entities should consider whether their processes for identifying initial direct costs and incremental costs of obtaining a contract are aligned.

1.3 ‘Reasonably certain’ threshold

The FASB established a “reasonably certain” threshold for determining the likelihood that a lessee will exercise an option in a lease. This threshold applies to a lessee’s option to extend or terminate a lease and to purchase the underlying asset. An entity should consider all relevant economic factors, including those related to the contract, the underlying asset, the market, and the entity, when determining whether a lessee is “reasonably certain” to exercise an option in a lease. Each factor should be considered both on its own and in conjunction with other factors to the extent that they are interrelated. Examples of considerations contributing to the assessment of “reasonably certain” include, but are not limited to, the following factors:

- How contractual terms and conditions for optional periods compare with current market rates, including
 - The amounts of lease payments made during the optional periods
 - The amounts of any variable lease payments or other contingent payments, such as payments for termination penalties or residual value guarantees
 - The terms and conditions of options that can be exercised after the initial optional periods. For example, a purchase option that is exercisable at a price that is expected to be below the then-current fair value of the underlying asset, but is only exercisable during an optional renewal period, might contribute to an entity’s assessment of whether the renewal option is reasonably certain to be exercised.
- Leasehold improvements that are expected to have significant economic value to the lessee when an option to extend, terminate, or purchase the underlying asset can be exercised. A lessee that has made a significant investment in a leased asset or property may have a greater economic incentive to continue a contract or purchase an underlying asset at the end of the lease term.
- Costs relating to the termination of the lease and signing a new lease, including the costs of negotiation, relocation, identification of another asset to lease, and costs to return the underlying asset to the condition or location specified in the contract
- The importance of the underlying asset to the lessee’s operations, including whether the asset is specialized and where it is located



ASC 842-10-55-26

At the commencement date, an entity assesses whether the lessee is reasonably certain to exercise or not to exercise an option by considering all economic factors relevant to that assessment—contract-based, asset-based, market-based, and entity-based factors. An entity's assessment often will require the consideration of a combination of those factors because they are interrelated. Examples of economic factors to consider include, but are not limited to, any of the following:

- a. Contractual terms and conditions for the optional periods compared with current market rates, such as:
 1. The amount of lease payments in any optional period
 2. The amount of any variable lease payments or other contingent payments, such as payments under termination penalties and residual value guarantees
 3. The terms and conditions of any options that are exercisable after initial optional periods (for example, the terms and conditions of a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates).
- b. Significant leasehold improvements that are expected to have significant economic value for the lessee when the option to extend or terminate the lease or to purchase the underlying asset becomes exercisable.
- c. Costs relating to the termination of the lease and the signing of a new lease, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee's operations, or costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location.
- d. The importance of that underlying asset to the lessee's operations, considering, for example, whether the underlying asset is a specialized asset and the location of the underlying asset.

The following excerpts from Examples 23 and 24 in ASC 842-10-55 illustrate how to apply the guidance on assessing whether a lessee is "reasonably certain" to exercise a purchase option. Example 23 considers a situation where a lessee has the option to purchase the underlying asset at the end of the lease term at an amount that is significantly below its expected residual value. Example 24 discusses a situation where the underlying asset is customized to the specifications of the lessee, and is integral to the lessee's business operations.



Example 23—Lessee Purchase Option (excerpt)

ASC 842-10-55-211

Lessee enters into a 5-year lease of equipment with annual lease payments of \$59,000, payable at the end of each year. There are no initial direct costs incurred by Lessee or lease incentives. At the end of Year 5, Lessee has an option to purchase the equipment for \$5,000. The expected residual value of the equipment at the end of the lease is \$75,000. Because the exercise price of the purchase option is significantly discounted from the expected fair value of the equipment at the time the purchase option becomes exercisable, Lessee concludes that it is reasonably certain to exercise the purchase option.

Example 24—Lessee Purchase Option (excerpt)

ASC 842-10-55-218

Lessee enters into a 5-year lease of specialized equipment with annual lease payments of \$65,000, payable in arrears. There are no initial direct costs or lease incentives. At the end of Year 5, Lessee has an option to purchase the equipment for \$90,000, which is the expected fair value of the equipment at that date. Lessor constructed the equipment specifically for the needs of Lessee. Furthermore, the specialized equipment is vital to Lessee's business; without this asset, Lessee would be required to halt operations while a new asset was built or customized. As such, Lessee concludes that it is reasonably certain to exercise the purchase option because the specialized nature, specifications of the asset, and its role in Lessee's operations create a significant economic incentive for Lessee to do so.



Grant Thornton insights: Reasonably certain versus more-likely-than-not

The threshold for including an optional period in the lease term is whether or not the entity is "reasonably certain" that the lessee will exercise an option to extend the lease. "Reasonably certain" is intended to be a high threshold, and reflects the existence of a significant economic incentive for a lessee to exercise the option. The Board intentionally set this threshold at a higher level than the "more-likely-than-not" threshold used in other areas of GAAP, which is generally regarded as being more than a 50 percent likelihood of an event occurring.



At the crossroads: Reasonably assured and reasonably certain

Legacy GAAP uses the term "reasonably assured" with respect to whether an optional period should be included in the lease term. The term that ASC 842 uses is "reasonably certain," which converges the terminology in ASC 842 with the terminology used in IFRS Standards. The Board states in paragraph BC195 of ASU 2016-02 that it views "reasonably assured" and "reasonably certain" as synonyms, and expects that the terms should be applied in the same way. Therefore, although the legacy GAAP terminology has changed under ASC 842, the Board expects that the terms will be applied in the same manner.

1.4 Lease payments

Many types of payments may be required under a lease agreement, but only certain payments are included in the measurement of lease payments for purposes of classifying and recognizing the lease. These items are summarized in Figure 1.1 below, and discussed in detail in the rest of this section.

Figure 1.1: Lease payments at a glance

Include in lease payments	Exclude from lease payments
<ul style="list-style-type: none"> + Fixed payments and in-substance fixed payments, reduced by lease incentives paid or payable to the lessee + Variable lease payments dependent on a rate or index + Exercise price of options that a lessee is reasonably certain to exercise + Termination penalties if termination is reasonably certain + Fees paid by the lessee to owners of a special-purpose entity for structuring the transaction + Amounts probable of being owed under a residual value guarantee (lessee only) 	<ul style="list-style-type: none"> - Variable lease payments not dependent on an index or a rate - Guarantee of the lessor's debt - Amounts allocated to nonlease components

According to ASC 842, "lease payments" include the following elements:

- Fixed payments, including in-substance fixed payments, minus lease incentives paid or payable to the lessee. "In-substance fixed payments" are lease payments that appear to contain variability but are effectively unavoidable, such as consumer price index (CPI) linked payments subject to a fixed floor that is virtually certain to be applied at each payment adjustment date. "Lease incentives" include payments made to, or on behalf of, a lessee, as well as losses incurred by a lessor from assuming a lessee's preexisting lease with a third party.
- Variable lease payments that depend on an index or a rate, such as LIBOR or CPI
- The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise that option
- Lease termination penalty if the lease term assumes that a lease termination option will be exercised, triggering payment of the penalty
- Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction
- Amounts that the lessee is probable of owing under a residual value guarantee (applies to the lessee's analysis only)

ASC 842 also specifically excludes the following types of payments from the definition of "lease payments":

- Variable lease payments other than those dependent on an index or a rate

- A guarantee of the lessor's debt by the lessee
- Amounts allocated to nonlease components in accordance with the guidance in 842-10-15-33 through 15-42

Lease Payments: See paragraph 842-10-30-5 for what constitutes lease payments from the perspective of a lessee and a lessor.



ASC 842-10-30-5

At the commencement date, the lease payments shall consist of the following payments relating to the use of the underlying asset during the lease term:

- a. Fixed payments, including in substance fixed payments, less any lease incentives paid or payable to the lessee (see paragraphs 842-10-55-30 through 55-31).
- b. Variable lease payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date.
- c. The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise that option (assessed considering the factors in paragraph 842-10-55-26).
- d. Payments for penalties for terminating the lease if the lease term (as determined in accordance with paragraph 842-10-30-1) reflects the lessee exercising an option to terminate the lease.
- e. Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction. However, such fees shall not be included in the fair value of the underlying asset for purposes of applying paragraph 842-10-25-2(d).
- f. For a lessee only, amounts probable of being owed by the lessee under residual value guarantees (see paragraphs 842-10-55-34 through 55-36).

ASC 842-10-30-6

Lease payments do not include any of the following:

- a. Variable lease payments other than those in paragraph 842-10-30-5(b)
- b. Any guarantee by the lessee of the lessor's debt
- c. Amounts allocated to nonlease components in accordance with paragraphs 842-10-15-33 through 15-42.

1.4.1 Fixed and in-substance fixed payments

Lessees are required to include fixed payments, including in-substance fixed payments, in the calculation of lease payments.

Fixed payments

Fixed payments are unavoidable payments that are specified in the lease.

In-substance fixed payments

In-substance fixed payments are payments that may appear variable in form, but are, in substance, unavoidable.



ASC 842-10-55-31

Lease payments include in substance fixed lease payments. In substance fixed payments are payments that may, in form, appear to contain variability but are, in effect, unavoidable. In substance fixed payments for a lessee or a lessor may include, for example, any of the following:

- a. Payments that do not create genuine variability (such as those that result from clauses that do not have economic substance)
- b. The lower of the payments to be made when a lessee has a choice about which set of payments it makes, although it must make at least one set of payments.

A common example of in-substance fixed payments are payments that escalate based on changes in the CPI, subject to a cap. For example, a lease might specify that lease payments increase each year by three times the annual change in CPI, subject to a cap of 2 percent per annum. If the lease payments are structured to increase by 2 percent per year (that is, it is highly likely, based on historical information, that three times the annual percentage change in CPI will exceed 2 percent), what would otherwise appear to be variable CPI-based payments are considered in-substance fixed payments.

The economic substance of the variability of the payments must be considered when assessing in-substance fixed payments. That is, variability based on performance or usage of the underlying asset might be more substantive in the context of a lease than variability based on an external index or rate. Therefore, payments based on a level of activity or volume of use of the underlying asset would be viewed as variable rather than in-substance fixed payments, even if the level of activity or use is highly certain, while payments that appear to contain variability based on an index (such as CPI) but are structured such that the payments are virtually certain to be fixed would be viewed as in-substance fixed payments.



In-substance fixed payments

Example 1: CPI-based adjustments

Lessee enters into an equipment lease specifying that for each month throughout the lease term, Lessee must pay Lessor the sum of (a) \$1,000 and (b) the greater of (i) \$200 or (ii) the most recent month-over-month percentage change in CPI times \$1,000. The month-over-month percentage change in CPI has not exceeded 2 percent over the past 120 months.

Lessee determines that the lease payments consist of the fixed payment of \$1,000 per month plus an in-substance fixed payment of \$200 per month. Although the monthly payment appears to contain variability, Lessee deems it remote that the variable component will exceed \$200 per month. Since the

additional \$200 monthly payment is effectively unavoidable and does not vary based on the asset's level of activity or the volume of use, the total monthly fixed payment is \$1,200.

Example 2: Two possible payment streams

A lease of a retail space in a newly developed shopping complex specifies lease payments of \$100,000 per year plus 1 percent of the lessee's annual sales in that space. If by the end of year two the occupancy rate of the shopping center is above 90 percent, the minimum lease payments will increase by 5 percent for the remaining three years, meaning the annual payments will increase to \$105,000 per year for the remainder of the lease. If by the end of year two the occupancy rate of the shopping center is below 90 percent, then the annual payments remain at \$100,000, but the lessee must remit an additional payment of \$20,000 to the lessor at the beginning of year three.

As there are two possible payment streams, the parties must analyze each possibility separately. If the occupancy threshold is not reached by the end of year two, the minimum payments are \$520,000. If the occupancy threshold is reached by the end of year two, the minimum payments are \$515,000. Regardless of the likelihood that the occupancy threshold will be achieved, the minimum unavoidable payment is \$515,000, and therefore fixed payments of \$515,000 are included in the lease payments by the lessee and lessor.

The payment of 1 percent of sales is a variable payment based on the use of the asset and is therefore excluded from the calculation of lease payments. Variable payments are recognized by both parties once the sales have occurred and the payments are no longer variable.

Example 3: Production-based payments

Lessee enters into a lease of solar panels, which specifies that Lessee will pay an amount to Lessor each month equal to the product of (a) a fixed price and (b) the number of megawatt hours of electricity produced by the solar panels during that month. Although some minimum amount of megawatt hours of electricity is virtually certain to be produced each month (provided the solar panels are operable), the payments are variable rather than in-substance fixed because they are based on the underlying assets' level of productivity.



Grant Thornton insights: Contracts that specify various conditional rates

Lease contracts may specify various rental rates that take effect based on current conditions. For example, oil drilling rig contracts specify a variety of "day rates" that correspond to certain conditions, such as when the rig is operating, when it is being moved, and when it is unable to operate due to weather conditions. In certain conditions the day rate could be zero. In contracts where the rate could fluctuate within a range that includes zero, a question arises whether the contract includes in-substance fixed payments or solely variable payments.

We believe that these types of contracts contain in-substance fixed payments, based on the contractual rate that reflects the lowest, nonprotective commercial rate included in the contract. A rate of zero would not be appropriate, as such a rate represents a protective contract provision for the lessee rather than a commercial contract rate.

1.4.2 Lease incentives

The definition of lease payments includes fixed payments less any incentives paid or payable to the lessee. In addition, any fixed payments included in the consideration in the contract that are not part of the lease payments must be reduced by any other incentives paid or payable to the lessee. Lease incentives include (1) payments made by the lessor to or on behalf of the lessee, and (2) losses incurred by the lessor assuming a lessee's lease with a third party.

As an inducement to enter into certain lease arrangements, the lessor may transfer cash directly to the lessee or make payments to third parties on the lessee's behalf. This practice is common in real estate leases, where a lessor might fund the lessee's improvements to the leased space. The funding might occur via a lump-sum transfer of cash from the lessor to the lessee, periodic reimbursement of qualifying costs incurred by the lessee, or direct payment from the lessor to the third-party contractor hired to construct the improvements. Regardless of the form, the amounts transferred from the lessor to the lessee or to a third party on the lessee's behalf are lease incentives that reduce the consideration in the contract for both the lessee and lessor.

In addition, a lessor might offer to assume a lessee's existing lease as an incentive for the lessee to enter into a new lease. Any loss incurred by the lessor in connection with assuming a lessee's existing lease is a lease incentive that reduces the consideration in the contract. The lessee's and lessor's estimate of this loss would likely differ since the parties would perform independent estimates based on information readily available to each. For example, the lessor might base its estimate on expected sublease income, information that is not readily available to the lessee.



ASC 842-10-55-30

Lease incentives include both of the following:

- a. Payments made to or on behalf of the lessee
- b. Losses incurred by the lessor as a result of assuming a lessee's preexisting lease with a third party. In that circumstance, the lessor and the lessee should independently estimate any loss attributable to that assumption. For example, the lessee's estimate of the lease incentive could be based on a comparison of the new lease with the market rental rate available for similar underlying assets or the market rental rate from the same lessor without the lease assumption. The lessor should estimate any loss on the basis of the total remaining costs reduced by the expected benefits from the sublease of use of the assumed underlying asset.

1.4.3 Variable payments

A variable payment is a payment in a lease that varies based on changes in facts and circumstances occurring after the commencement date, other than the passage of time. Examples of variables on which payments may be based include sales at a retail location or megawatts of electricity produced by a power plant. A variable payment may also be based on a rate or an index, for example, CPI, the prime rate, or LIBOR.

Variable Lease Payments: Payments made by a lessee to a lessor for the right to use an underlying asset that vary because of changes in facts or circumstances occurring after the commencement date, other than the passage of time.

The only variable payments included in “lease payments” are those that are based on an index or rate. A common example is payments that increase over the lease term based on increases in CPI. Variable payments based on an index or rate are included in lease payments based on the index or rate as of the lease commencement date. The rate is not updated after commencement, unless there is a lease modification that is not treated as a separate contract or another event occurs that requires remeasurement, as discussed in Section 5.7 and 5.8 for lessees and Section 6.9 for lessors.



Variable payments based on an index or a rate

Example 1

A five-year lease that requires annual payments in advance specifies that the first payment is \$100,000, and that each subsequent payment will increase by one month LIBOR at the end of each year. One month LIBOR at the commencement date of the lease is 2 percent. Since variable payments based on an index or rate are included in the lease payments based on the index or rate at the commencement date of the lease, the lease payments in this example equal \$520,404, which reflects a series of five payments starting at \$100,000 and escalating by 2 percent per year on a compounding basis.

Example 2

A five-year lease that requires annual payments in advance specifies that the first payment will be \$100,000, and that each subsequent payment will increase by the percentage increase in CPI over the past 12 months. If CPI decreases over a 12-month period, then the annual payment is the same as the prior year’s payment. Since variable payments based on an index or rate are included in the lease payments based on the index or rate at the commencement date of the lease, the future lease payments are calculated assuming CPI is unchanged over the lease term. Therefore, in this example, lease payments would equal \$500,000, which reflects a series of five fixed payments of \$100,000.

Variable payments not based on an index or a rate are excluded from lease payments in calculating the consideration in the contract.



Grant Thornton insights: Variable payments that reset to market rates

It is common for leases to require that payments “reset” to market rates from time to time. When this is the case, the adjusted lease payments are considered variable. We believe that the market rental rate is a “rate,” as described in ASC 842-10-30-5(b) (included at the beginning of Section 1.4), although ASC 842 does not explicitly state this.

The guidance on lease payments in paragraph 28 of IFRS 16, *Leases*, which is an area of the new lease accounting guidance where the FASB and IASB reached converged decisions, specifies that “payments that vary to reflect changes in market rental rates” is an example of variable lease payments that depend on an index or a rate. Therefore, similar to other variable payments that are based on an index or rate, variable payments that are based on market rental rates should be included in lease payments as of the commencement date using the market rental rate at lease commencement.

For example, a ten-year lease might require fixed payments for the first five years of the contract, with payments for years six through ten equal to whatever the market rental rate is as of the end of year five. In this contract, the lease payments for years six through ten are variable until the end of year five, when they become fixed at the then-current market rate. The lease payments measured at the commencement date would include payments for years six through ten of the lease term based on the current market rental rate as of the lease commencement date. If the lease payments for years one through five are fixed at \$100,000 per year, and that amount represents a market rental rate as of lease commencement, then the lease payments included in the consideration in the contract would equal \$1 million.

Continuing this example, the parties to the lease would not remeasure the lease payments when the payments for years six through ten become fixed. As noted in ASC 842-10-35-4(b), a change in a reference index or rate that was used to calculate some or all of the variable lease payments does not constitute a resolution of a contingency that would require an entity to remeasure lease payments. Rather, any difference between the actual lease payments in years six through ten and the lease payments included in the consideration in the contract at lease commencement for years six through ten would be recognized in the period incurred, in the same manner as variable lease payments that are not based on an index or rate.

In some cases, a lease requires the lessee to remit noncash consideration to the lessor, and an entity must consider whether such consideration is included in the lease payments.



Grant Thornton insights: Noncash consideration provided to a lessor

The guidance in ASC 842-10-30-6 and 55-15 specifically excludes certain types of noncash consideration from lease payments, including a lessee’s guarantee of the lessor’s debt and a lessee’s indemnification for environmental contamination. While these forms of noncash consideration are specifically excluded from lease payments under ASC 842, they are still recognized in the financial statements of the lessee in accordance with other Codification Topics.

Leases may also contain other types of noncash consideration, such as shares of stock and equity warrants. All noncash consideration not specifically excluded from lease payments should be included in lease payments based on its fair value at the lease commencement date. For example, if a lease includes a provision that the lessee will issue fully vested stock warrants to the lessor, the fair value of those warrants at the lease commencement date would be included in lease payments when calculating the present value of lease payments for classification and recognition purposes. Entities may refer to the guidance in ASC 606, *Revenue from Contracts with Customers*, for measuring noncash consideration as a starting point in measuring the value of the noncash consideration in a leasing arrangement.

Distinguishing variable lease payments from asset retirement obligations (AROs)

Costs that a lessee must incur to revert a modified underlying asset back to its original condition before returning it to the lessor generally do not meet the definition of a lease payment. Instead, such costs should be accounted for in accordance with ASC 410-20, *Asset Retirement and Environmental Obligations: Asset Retirement Obligations*. On the other hand, costs that a lessee must incur to dismantle and remove an underlying asset from the lessee's property at the end of the lease term should be considered lease payments or variable lease payments, provided the contract obligates the lessee to bear the costs of dismantling and removing the leased asset.

For example, the costs associated with a lessee's contractual obligation to remove its own cell tower from land it is leasing before returning the land to the lessor are accounted for based on the guidance on asset retirement obligations in ASC 410-20. In contrast, a lessee's cost to dismantle and remove leased manufacturing equipment from its facility so that the equipment can be returned to the lessor at the end of the lease term is treated as a variable lease payment associated with the equipment lease.



ASC 842-10-55-37

Obligations imposed by a lease agreement to return an underlying asset to its original condition if it has been modified by the lessee (for example, a requirement to remove a lessee-installed leasehold improvement) generally would not meet the definition of lease payments or variable lease payments and would be accounted for in accordance with Subtopic 410-20 on asset retirement obligations. In contrast, costs to dismantle and remove an underlying asset at the end of the lease term that are imposed by the lease agreement generally would be considered lease payments or variable lease payments.

Variable lease payments and derivative instruments

The guidance in ASC 815, *Derivatives and Hedging*, specifically excludes leases from its scope. However, ASC 815 does note that a derivative instrument embedded in a lease should be evaluated to determine if it meets the criteria for separation, including whether it is clearly and closely related to the economic characteristics and risks of the host lease contract. Items such as lease payments that vary based on (a) sales and (b) market rental rates are not considered embedded derivatives that require separation from the lease. This is because (a) contracts with an underlying based on volumes of sales of one of the parties to the contract are scoped out of ASC 815, and (b) contracts with an underlying based on market rental rates would likely be clearly and closely related to the economic characteristics and risks of the lease host contract, respectively.



ASC 842-10-15-43

Paragraph 815-10-15-79 explains that leases that are within the scope of this Topic are not derivative instruments subject to Subtopic 815-10 on derivatives and hedging although a derivative instrument embedded in a lease may be subject to the requirements of Section 815-15-25. Paragraph 815-10-15-80 explains that residual value guarantees that are subject to the guidance in this Topic are not subject to the guidance in Subtopic 815-10. Paragraph 815-10-15-81 requires that a third-party residual value guarantor consider the guidance in Subtopic 815-10 for all residual value guarantees that it provides to

determine whether they are derivative instruments and whether they qualify for any of the scope exceptions in that Subtopic.

ASC 815-10-15-79

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

ASC 815-15-25-1

An embedded derivative shall be separated from the host contract and accounted for as a derivative instrument pursuant to Subtopic 815-10 if and only if all of the following criteria are met:

- a. The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.
- b. The hybrid instrument is not remeasured at fair value under otherwise applicable generally accepted accounting principles (GAAP) with changes in fair value reported in earnings as they occur.

A separate instrument with the same terms as the embedded derivative would, pursuant to Section 815-10-15, be a derivative instrument subject to the requirements of this Subtopic. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

Indemnification clause for tax benefits

Some leases indemnify lessors on an after-tax basis for certain tax benefits that they might lose if there is a change in tax law. While these indemnification payments seem to meet the definition of variable lease payments, they are not of the same nature as other payments that are contemplated in the variable lease payment guidance. Because these payments are based on specific tax law, they must be accounted for under ASC 460, *Guarantees* in a way that reflects the tax law association. These indemnification clauses should not have an impact on lease classification.



ASC 842-10-55-38

Some leases contain indemnification clauses that indemnify lessors on an after-tax basis for certain tax benefits that the lessor may lose if a change in the tax law precludes realization of those tax benefits. Although the indemnification payments may appear to meet the definition of variable lease payments, those payments are not of the nature normally expected to arise under variable lease payment provisions.

ASC 842-10-55-39

Because of the close association of the indemnification payments to specific aspects of the tax law, any payments should be accounted for in a manner that recognizes the tax law association. The lease classification should not be changed.

1.4.4 Exercise price of an option to purchase the underlying asset

Lease payments include the exercise price of an option to purchase the underlying asset if it is reasonably certain that the lessee will exercise that option. The lessee and the lessor must each evaluate whether it is reasonably certain that the lessee will exercise the option, and each party might reach a different conclusion. Refer to Section 1.3 for information about determining whether an event is “reasonably certain” to occur.

Unlike a lessee call option, which allows a lessee to purchase the underlying asset, the exercise price of a lessor put option, which is similar to a residual value guarantee as discussed in Section 1.4.7, *must* be reflected in the lease payments. Since the lessee is obligated to pay the exercise price based on events outside its control (and within the lessor’s control), the exercise price is included in the lease payments.



ASC 842-10-30-3

At the commencement date, an entity shall assess an option to purchase the underlying asset on the same basis as an option to extend or not to terminate a lease, as described in paragraph 842-10-30-2.

ASC 842-10-55-35

If the lessor has the right to require the lessee to purchase the underlying asset by the end of the lease term, the stated purchase price is included in lease payments. That amount is, in effect, a guaranteed residual value that the lessee is obligated to pay on the basis of circumstances outside its control.

1.4.5 Lease termination penalties

A lease may specify a penalty that must be paid if the lessee terminates the lease early. The ASC Master Glossary defines a “penalty” as follows:

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

- a. Disburse cash
- b. Incur or assume a liability
- c. Perform services
- d. Surrender or transfer an asset or rights to an asset or otherwise forego an economic benefit, or suffer an economic detriment. Factors to consider in determining whether an economic detriment may be incurred include, but are not limited to, all of the following:
 1. The uniqueness of purpose or location of the property
 2. The availability of a comparable replacement property
 3. The relative importance or significance of the property to the continuation of the lessee’s line of business or service to its customers

4. The existence of leasehold improvements or other assets whose value would be impaired by the lessee vacating or discontinuing use of the leased property
5. Adverse tax consequences
6. The ability or willingness of the lessee to bear the cost associated with relocation or replacement of the leased property at market rental rates or to tolerate other parties using the leased property.

A penalty for early termination of a lease is included in the lease payments if it is deemed reasonably certain that the lease will be terminated early and the penalty will be incurred. Whether the lease will be terminated early is determined in accordance with the guidance on the lease term in ASC 842-10-30-1, as discussed in Section 1.5. The penalty for lease termination is included in lease payments if the option to terminate is the lessee's, and it is reasonably certain that the lessee will terminate the lease before the end of the contractual term.

Example 26 in ASC 842-10-55 illustrates a lessee's analysis to determine whether to include a termination penalty in the lease payments.



Example 26—Termination Penalties

ASC 842-10-55-236

Lessee enters into a 10-year lease of an asset, which it can terminate at the end of each year beginning at the end of Year 6. Lease payments are \$50,000 per year during the 10-year term, payable at the beginning of each year. If Lessee terminates the lease at the end of Year 6, Lessee must pay a penalty to Lessor of \$20,000. The termination penalty decreases by \$5,000 in each successive year.

ASC 842-10-55-237

At the commencement date, Lessee concludes that it is not reasonably certain it will continue to use the underlying asset after Year 6, having considered both the significance of the termination penalty (in absolute terms and in relation to the remaining lease payments after the date the termination option becomes exercisable) and the other factors in paragraph 842-10-55-26.

ASC 842-10-55-238

Accordingly, Lessee determines that the lease term is six years. At the commencement date, Lessee measures the lease liability on the basis of lease payments of \$50,000 for 6 years plus the penalty of \$20,000 payable at the end of Year 6.

1.4.6 Fees paid by the lessee to owners of a special-purpose entity

Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction are included in the calculation of lease payments. However, these fees are not included in determining the fair value of the underlying asset for purposes of classifying the lease.

1.4.7 Amounts probable of being owed under a residual value guarantee

The amount that a lessee is probable to owe under a residual value guarantee is included in the lessee's (and not the lessor's) calculation of lease payments. A residual value guarantee exists when the lessee guarantees the minimum value of the underlying asset that will be returned to the lessor at the end of the lease term.

Residual Value Guarantee: A guarantee made to a lessor that the value of an underlying asset returned to the lessor at the end of a lease will be at least a specified amount.

A lessee must estimate the amount that it is probable to owe the lessor to satisfy a residual value guarantee, and include that amount in the lease payments. In paragraph BC214 of ASU 2016-02, the Board explains that it considered, but rejected, a model that would require accounting for residual value guarantees separately from the related leases, on the basis that such guarantees are linked to the value of the underlying asset and may meet the definition of a derivative. Ultimately, the Board decided to stipulate in ASC 815-10-15-80 that residual value guarantees accounted for under ASC 842 are excluded from the scope of the derivatives guidance, recognizing that they are so closely related to other terms and conditions in a lease that separating them from the lease could be misleading.

Lease provisions that require the lessee to reimburse the lessor for a deficiency in residual value due to damage, extraordinary wear, or excessive usage are not considered residual value guarantees. These payments are similar to variable lease payments, since they cannot be determined at the lease commencement date and accordingly are excluded from the calculation of lease payments.



ASC 842-10-55-34

A lease provision requiring the lessee to make up a residual value deficiency that is attributable to damage, extraordinary wear and tear, or excessive usage is similar to variable lease payments in that the amount is not determinable at the commencement date. Such a provision does not constitute a lessee guarantee of the residual value.

A lessee may obtain a residual value guarantee from an unrelated third party for the benefit of the lessor. Unless the lessor expressly releases the lessee from an obligation under the lease as both the primary obligor and the secondary obligor (in case the third party defaults on its obligation to pay the guarantee), this third-party guarantee would not reduce the lease payments. If the lessor explicitly releases the lessee from all or a portion of its primary and secondary obligation related to the residual value guarantee, then the lessee must reduce the amount of the guaranteed residual value included in the lease payments, to the extent that it has been released from its obligation. Amounts that the lessee pays to a third party to secure a guarantee are treated as executory costs, which are expensed as incurred, and not included in lease payments or initial direct costs.



ASC 842-10-55-36

A residual value guarantee obtained by the lessee from an unrelated third party for the benefit of the lessor should not be used to reduce the amount of the lessee's lease payments under paragraph 842-10-30-5(f) except to the extent that the lessor explicitly releases the lessee from obligation, including the secondary obligation, which is if the guarantor defaults, a residual value deficiency must be made up. Amounts paid in consideration for a guarantee by an unrelated third party are executory costs and are not included in the lessee's lease payments.



At the crossroads: Residual value guarantee and lease payments

Legacy GAAP requires lessees and lessors to include the entire amount of a residual value guarantee in the calculation of "minimum lease payments."

In contrast, ASC 842 requires that lease payments from the lessee's perspective include only amounts that the lessee is probable to owe to the lessor under a residual value guarantee. Lessors do not include such amounts in their lease payment calculations.

Residual value guarantees and derivative instruments

The guidance in ASC 815 specifically excludes residual value guarantees that are accounted for under ASC 842 from its scope. However, a third party that is guaranteeing the residual value of an underlying asset in a lease (the guarantor) should consider the guidance in ASC 815 to determine whether the guarantee must be accounted for as a derivative instrument.



ASC 815-10-15-80

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

ASC 815-10-15-81

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

Residual value guarantee on a portfolio of assets

Sometimes a lessor obtains a residual value guarantee for a portfolio of underlying assets that are leased under separate contracts, such as a fleet of vehicles. This type of residual value guarantee cannot be apportioned to individual underlying assets, as it is not possible to determine the guaranteed residual

value on an asset-by-asset basis. Therefore, a residual value guarantee related to a portfolio of assets should be excluded from the present value calculation under ASC 842-10-25-2(d) and 25-3(b)(1).



ASC 842-10-55-9

Lessors may obtain residual value guarantees for a portfolio of underlying assets for which settlement is not solely based on the residual value of the individual underlying assets. In such cases, the lessor is economically assured of receiving a minimum residual value for a portfolio of assets that are subject to separate leases but not for each individual asset. Accordingly, when an asset has a residual value in excess of the “guaranteed” amount, that excess is offset against shortfalls in residual value that exist in other assets in the portfolio.

ASC 842-10-55-10

Residual value guarantees of a portfolio of underlying assets preclude a lessor from determining the amount of the guaranteed residual value of any individual underlying asset within the portfolio. Consequently, no such amounts should be considered when evaluating the lease classification criteria in paragraphs 842-10-25-2(d) and 842-10-25-3(b)(1).

1.5 Lease term

ASC 842 defines the “lease term” as the noncancellable period during which the lessee has the right to use the underlying asset, adjusted for any extension or termination options that the lessee is reasonably certain to exercise, as well as any options to extend or terminate the lease that are controlled by the lessor. The lease term includes free-rent periods, and begins at the commencement date of the lease. See Section 1.1 for more information about the commencement date.

Lease Term: The noncancellable period for which a lessee has the right to use an underlying asset, together with all of the following:

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

The lease term is a key input for determining (1) whether the lease covers a major part of the underlying asset’s remaining economic life as part of the lease classification analysis, (2) the lessee’s incremental borrowing rate, and (3) the future period over which lease payments should be projected for purposes of calculating their present value at the lease commencement date.

**ASC 842-10-30-1**

An entity shall determine the lease term as the noncancellable period of the lease, together with all of the following:

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

ASC 842-10-30-2

At the commencement date, an entity shall include the periods described in paragraph 842-10-30-1 in the lease term having considered all relevant factors that create an economic incentive for the lessee (that is, contract-based, asset-based, entity-based, and market-based factors). Those factors shall be considered together, and the existence of any one factor does not necessarily signify that a lessee is reasonably certain to exercise or not to exercise an option.

ASC 842-10-55-25

The lease term begins at the commencement date and includes any rent-free periods provided to the lessee by the lessor.

1.5.1 Noncancellable period

In assessing the noncancellable period of a lease, an entity should consider the definition of a contract and determine the period during which the contract is enforceable. ASC 606 describes the contract term as the “contractual period over which the parties to the contract have present enforceable rights and obligations.” Enforcing the rights and obligations in a contract is a matter of law. Because practices and processes for establishing contracts vary among entities and across jurisdictions, each entity should consider its established practices and processes when determining whether its agreements create enforceable rights and obligations. If the lessee and the lessor both have the right to terminate the lease without the other party’s permission and face only an insignificant penalty for doing so, the lease would not be considered enforceable.

Contract: An agreement between two or more parties that creates enforceable rights and obligations.

The noncancellable period extends from the commencement date of the lease to the date at which the contract is no longer enforceable.



Grant Thornton insights: Noncancellable period

Questions have arisen in practice about identifying the noncancellable period when the lessee and lessor each have the unilateral right to terminate the contract at different points during the contract term.

For example, Lessee and Lessor enter into a lease that commences on January 1, 20X1. Lessee has the option to renew the lease exercisable on or before December 31, 20X1. If Lessee exercises this renewal option, then Lessor must permit Lessee to continue using the underlying asset through December 31, 20X2. On or before December 31, 20X2, Lessee may request another extension of the lease through December 31, 20X3; however, Lessor is not required to honor this request and could terminate the lease on December 31, 20X2. Neither Lessee nor Lessor would incur a more than insignificant penalty for terminating the lease at December 31, 20X1 or 20X2.

In this example, we believe that the period from January 1, 20X1 through December 31, 20X1 is the noncancellable period. Although the contract is no longer enforceable once both Lessee and Lessor each have the right to terminate the lease without permission from the other party, and without incurring more than an insignificant penalty, which occurs at December 31, 20X2, Lessee's unilateral right to terminate the contract at December 31, 20X1 indicates that, as of the lease commencement date, the noncancellable period is one year.

We believe that ASC 842-10-55-23 describes one, but not the only, situation in which a lease is no longer enforceable. In other words, although a lease is no longer enforceable when both the lessee and lessor each have the unilateral right to terminate the lease without incurring more than an insignificant penalty, the lease might become unenforceable at an earlier date, such as when the lessee has the unilateral right to terminate (or not renew) the lease without incurring more than an insignificant penalty.

We also note that the definition of "lease term" in the ASC Master Glossary includes the noncancellable period "together with" periods covered by a lessee's option to extend the lease if the lessee is reasonably certain to exercise that option. Therefore, we do not believe that the noncancellable period may be longer than the lease term.



ASC 842-10-55-23

An entity should determine the noncancellable period of a lease when determining the lease term. When assessing the length of the noncancellable period of a lease, an entity should apply the definition of a contract and determine the period for which the contract is enforceable. A lease is no longer enforceable when both the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

1.5.2 Lessee option to extend or terminate a lease

A contract may provide a lessee with the right to extend a lease beyond its noncancellable period, or to terminate a lease before the end of its contractual term. In determining the lease term for a lease with a lessee renewal or termination option, the lessee and the lessor must separately assess whether the

lessee is *reasonably certain* to exercise (or not exercise) the option using the information that is available to them. (For more information about the term “reasonably certain,” refer to Section 1.3.) Since the lessee and lessor may have different information at-hand, they could arrive at different conclusions about the likelihood that the lessee will exercise an option, and therefore use different lease terms in accounting for the same lease. If a lessee is reasonably certain to exercise a renewal option, the period covered by that renewal option is included in the lease term. If a lessee is not reasonably certain to exercise a renewal option, the period covered by the renewal option is excluded from the lease term. Likewise, if it is reasonably certain that a lessee will not exercise a termination option, the period after that termination option becomes exercisable is included in the lease term.



Grant Thornton insights: ‘Month-to-month’ or ‘evergreen’ leases

Some leases are structured to automatically renew each month unless one of the parties to the contract notifies the other that it wishes to terminate the agreement. These types of leases are sometimes referred to as “month-to-month” or “evergreen” leases. We believe that the lease term for such contracts must be evaluated in the same manner as any other lease, and that it is not appropriate to presume that these leases are “short term.”

Even if both parties have the right to terminate the contract at the end of each month (or another relatively short period of time), it is still necessary for both parties to consider whether the lessee is reasonably certain not to exercise each monthly termination option in order to determine the term of the lease. For example, a lessee might not exercise the termination option because doing so would trigger a more than insignificant penalty.

Consider the following scenario: Lessee and Lessor enter into an equipment lease that automatically renews on a monthly basis and can extend to a maximum term of three years at a fixed monthly rate. Both Lessee and Lessor can terminate the lease at the end of each month by notifying the other party. To assess the lease term associated with this arrangement, both parties must consider whether Lessee is reasonably certain not to exercise each monthly termination option.

If Lessee or Lessor determines that Lessee is reasonably certain not to terminate the lease any time prior to 15 months after the commencement date, then the lease term is 15 months. Even though both Lessee and Lessor have the right to terminate the lease at the end of each month in this example, the contract is deemed enforceable for 15 months from the commencement date, since it is not until 15 months after commencement when both parties have the right to terminate the contract without incurring more than an insignificant penalty. This conclusion presumes that no longer being reasonably certain not to exercise a termination option corresponds with not incurring more than an insignificant penalty in connection with terminating the lease, which we believe will generally be the case.



ASC 842-10-55-24

If only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term, as described in paragraph 842-10-30-1(b). If only a lessor has the right to terminate a lease, the lease term includes the period covered by the option to terminate the lease, as described in paragraph 842-10-30-1(c).

If a lease contains multiple options, each option is separately assessed to determine if it is reasonably certain that it will or will not be exercised. A lessee may determine that it is reasonably certain to exercise one or more options, but not others, based on the relevant facts and circumstances.



Grant Thornton insights: Lease term determination for head lease with sublease renewal options

Some practitioners have questioned whether periods covered by lessee renewal options must be included in the lease term if a factor outside the lessee's control could compel the lessee to exercise a renewal option.

On one hand, ASC 842-10-30-1 states that only periods covered by an option to extend a lease that is controlled by the lessor *must* be included in the lease term (periods covered by options to extend a lease controlled by the lessee might or might not be included in the lease term depending on whether the lessee is reasonably certain to exercise the option).

On the other hand, in paragraph BC197 of ASU 2016-02 the Board explains that the approach for including optional periods in the lease term under ASC 842 "accounts for renewal options only when it is reasonably certain that they will be exercised *or when exercise is outside the control of the entity* (such as when a lessor controls a lessee's exercise of a renewal option or a termination option)" (emphasis added).

Based on discussion with the FASB staff, we believe that only periods covered by options controlled by the lessor (and not by other third parties, including a sublessee) *must* be included in the lease term. Periods covered by options controlled by any party other than the lessor might or might not be included in the lease term based on an assessment of whether it is reasonably certain that the option will be exercised.

1.5.3 Fiscal funding clauses

A fiscal funding clause in a lease gives a governmental entity the right to exit a lease if it does not receive sufficient funds through the appropriation process to make the lease payments.

Fiscal Funding Clause: A provision by which the lease is cancelable if the legislature or other funding authority does not appropriate the funds necessary for the governmental unit to fulfill its obligations under the lease agreement.

When a lease contains a fiscal funding clause, the parties must assess the likelihood that the lease will be cancelled pursuant to the clause. If the parties determine that the likelihood of the clause being exercised is more than remote, the lease term should include only those periods for which the parties deem funding is reasonably certain, and should exclude periods for which there is more than a remote likelihood that the fiscal funding clause will be triggered

**ASC 842-10-55-27**

The existence of a fiscal funding clause in a lease agreement requires an assessment of the likelihood of lease cancellation through exercise of the fiscal funding clause. If it is more than remote that the fiscal funding clause will be exercised, the lease term should include only those periods for which funding is reasonably certain.

1.6 Economic life

The lease term is assessed relative to an asset's remaining economic life when determining lease classification. The economic life of an asset can be expressed either as the period over which the asset is expected to be economically usable by one or more users, or as a quantity of output (in terms of production or use) expected to be obtained from an asset by one or more users.

Economic Life: Either the period over which an asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from an asset by one or more users.

1.7 Guarantees and indemnifications

The guidance in ASC 842 refers to ASC 460, to evaluate the accounting for certain guarantees and indemnifications.

**ASC 842-10-55-32**

Paragraph 460-10-15-4(c) states that, except as provided in paragraph 460-10-15-7, the provisions of Subtopic 460-10 on guarantees apply to indemnification agreements (contracts) that contingently require an indemnifying party (guarantor) to make payments to an indemnified party (guaranteed party) based on changes in an underlying that is related to an asset, a liability, or an equity security of the indemnified party. Paragraph 460-10-55-23A provides related implementation guidance for a tax indemnification provided to a lessor.

1.7.1 Indemnification payments

An indemnification clause in a lease that contingently requires the guarantor to make payments to the guaranteed party based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party should be evaluated under ASC 460.

**ASC 460-10-15-4**

Except as provided in paragraph 460-10-15-7, the provisions of this Topic apply to the following types of guarantee contracts:

- a. Contracts that contingently require a guarantor to make payments ... to a guaranteed party based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party. For related implementation guidance, see paragraph 460-10-55-2.
- b. Contracts that contingently require a guarantor to make payments ... to a guaranteed party based on another entity's failure to perform under an obligating agreement (performance guarantees). For related implementation guidance, see paragraph 460-10-55-12.
- c. Indemnification agreements (contracts) that contingently require an indemnifying party (guarantor) to make payments to an indemnified party (guaranteed party) based on changes in an underlying that is related to an asset, a liability, or an equity security of the indemnified party.
- d. Indirect guarantees of the indebtedness of others, even though the payment to the guaranteed party may not be based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party.

ASC 460-10-15-7 lists the types of contracts that fall outside the scope of ASC 460, including a lessee's guarantee of the residual value of the underlying asset when a lease expires under ASC 842, and contingent payments that are variable lease payments.

**ASC 460-10-15-7 (excerpt)**

The guidance in this Topic does not apply to the following types of guarantee contracts:

- a. A guarantee or an indemnification that is excluded from the scope of Topic 450 (see paragraph 450-20-15-2—primarily employment-related guarantees)
- b. A lessee's guarantee of the residual value of the underlying asset at the expiration of the lease term under Topic 842
- c. A contract that meets the characteristics in paragraph 460-10-15-4(a) but is accounted for as variable lease payments under Topic 842.

1.7.2 Tax indemnification

A lessee accounts for a tax indemnification provided by the lessee to a lessor by recognizing a liability at lease inception under the guidance in ASC 460.

**ASC 460-10-55-23A**

This implementation guidance addresses the application of this Subtopic to the recognition and initial measurement of a tax indemnification provided by a lessee to a lessor. Paragraph 460-10-25-4 requires that the lessee (guarantor) account for a tax indemnification provided to the lessor by recognizing a liability at lease inception (which is also the inception of the indemnification clause). Section 460-10-30 requires that the measurement objective of that initial recognition be the fair value of the lessee's obligation under the indemnification agreement.

1.8 Discount rate

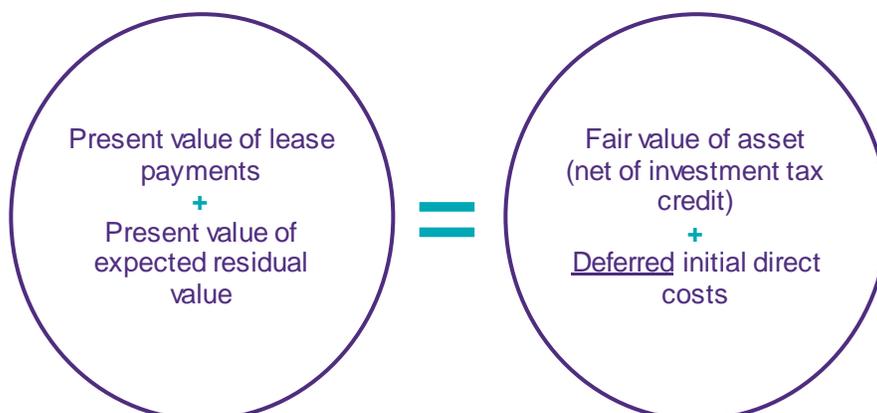
To compute the present value of lease payments, a lessor should use a discount rate equal to the rate implicit in the lease. A lessee, on the other hand, should compute the present value of lease payments by using (a) the rate implicit in the lease if it can be readily determined, (b) the lessee's incremental borrowing rate, or (c) a risk-free rate, if the lessee is not a public business entity and it elects to use a risk-free rate as an accounting policy.

Discount Rate for the Lease: For a lessee, the discount rate for the lease is the rate implicit in the lease unless that rate cannot be readily determined. In that case, the lessee is required to use its incremental borrowing rate. For a lessor, the discount rate for the lease is the rate implicit in the lease.

Rate Implicit in the Lease: The rate of interest that, at a given date, causes the aggregate present value of (a) the lease payments and (b) the amount that a lessor expects to derive from the underlying asset following the end of the lease term to equal the sum of (1) the fair value of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor and (2) any deferred initial direct costs of the lessor. However, if the rate determined in accordance with the preceding sentence is less than zero, a rate implicit in the lease of zero shall be used.

Figure 1.2: Rate implicit in the lease

The rate at which:



1.8.1 Lessor discount rate

A lessor should compute the present value of lease payments using the rate implicit in the lease, based on information available at the lease commencement date. The rate implicit in the lease is defined as the rate that causes the aggregate present value of the lease payments and the lessor's estimate of the asset's residual value at the end of the lease term to equal the sum of (1) the asset's fair value, less any investment tax credit retained and expected to be realized by the lessor, and (2) the lessor's deferred initial direct costs.

A lessor's determination of whether initial direct costs are deferred depends on whether:

1. At the commencement date, the fair value of the underlying asset is different than its carrying amount.
2. The present-value calculation is being performed to determine whether a lease is a sales-type lease.

When calculating the rate implicit in the lease for purposes of determining whether a lease qualifies as a sales-type lease, the lessor must assume that no initial direct costs will be deferred if, at the commencement date, the fair value of the underlying asset is different than its carrying amount.

If a lessor determines that a lease is not a sales-type lease, then the lessor must presume that initial direct costs are deferred when computing the rate implicit in the lease to determine whether the lease is a direct financing lease.

For examples of how to calculate the rate implicit in the lease, refer to the examples in Section 6.1.2 for a sales-type lease and Section 6.2.2 for a direct financing lease.



ASC 842-10-25-4

A lessor shall assess the criteria in paragraphs 842-10-25-2(d) and 842-10-25-3(b)(1) using the rate implicit in the lease. For purposes of assessing the criterion in paragraph 842-10-25-2(d), a lessor shall assume that no initial direct costs will be deferred if, at the commencement date, the fair value of the underlying asset is different from its carrying amount.



Grant Thornton insights: Discount rates associated with a direct financing lease

A lessor might use three different discount rates in the process of classifying and measuring a lease that is ultimately classified as a direct financing lease.

The lessor uses the first discount rate to determine whether the lease should be classified as a sales-type lease. For this purpose, the rate implicit in the lease is calculated assuming no initial direct costs will be deferred if, at the commencement date, the fair value of the underlying asset is different than its carrying amount.

If the lease is not a sales-type lease, the lessor uses the second discount rate to recalculate the present value of the sum of the lease payments, including any third-party residual value guarantee, to determine whether the lease is a direct financing lease or an operating lease. For this purpose, the lessor must presume that initial direct costs are deferred, regardless of whether the lessor presumed they were deferred in calculating the first rate. If the lease is a direct financing lease, this rate should be used as the discount rate to initially measure the components of the net investment in the lease.

A lessor uses the third discount rate to determine the amount of periodic interest income to recognize, which reflects the deferred profit component, if any, of a direct financing lease. This discount rate reconciles the net investment in the lease at lease commencement (net of deferred selling profit) with the expected residual value of the asset at the end of the lease.

1.8.2 Lessee discount rate

A lessee should use the rate implicit in the lease as the discount rate if that rate is readily determinable. If the lessee cannot readily determine the rate implicit in the lease, it should use its incremental borrowing rate as the discount rate. Lessees that are not public business entities have the option to use a risk-free rate as the discount rate for the lease.



ASC 842-20-30-2

The discount rate for the lease initially used to determine the present value of the lease payments for a lessee is calculated on the basis of information available at the commencement date.

ASC 842-20-30-3

A lessee should use the rate implicit in the lease whenever that rate is readily determinable. If the rate implicit in the lease is not readily determinable, a lessee uses its incremental borrowing rate. A lessee that is not a public business entity is permitted to use a risk-free discount rate for the lease, determined using a period comparable with that of the lease term, as an accounting policy election for all leases.

Rate implicit in the lease

A lessee should use the rate implicit in the lease if the lessee can readily determine that rate. In paragraph BC132 of ASU 2016-02, the Board provides some insight into how it views the notion of “readily determinable” within the context of substantive substitution rights, which are relevant for

identifying leases under ASC 842. In particular, the Board explains that a customer (potential lessee) is not expected to exert undue effort in determining whether a supplier has substantive substitution rights. Accordingly, we believe that a lessee need not exert undue effort in obtaining the rate implicit in a lease.



Grant Thornton insights: Lessee's ability to estimate the rate implicit in the lease

The rate implicit in the lease is defined as the rate that causes the aggregate present value of the lease payments plus the lessor's estimate of the asset's residual value at the end of the lease term to equal the sum of (1) the asset's fair value, less any investment tax credit retained that the lessor expects to realize, and (2) the lessor's deferred initial direct costs.

In our view, a lessee will be unable to readily determine the rate implicit in a lease in most cases, unless the rate is provided by the lessor. The calculation of the rate implicit in the lease requires lessor-specific inputs, including the lessor's estimate of the underlying asset's residual value at the end of the lease term and the amount of initial direct costs incurred and deferred by the lessor.

For well capitalized, creditworthy lessees, the rate implicit in the lease might be greater than the lessee's incremental borrowing rate. Accordingly, practitioners have questioned whether it is appropriate for a lessee to develop estimates of the underlying asset's residual value and the lessor's deferred initial direct costs to compute the rate implicit in the lease, since using a discount rate higher than the lessee's incremental borrowing rate would result in a smaller lease liability balance for the lessee. For example, a lessee could hire a valuation specialist to develop an estimate of the underlying asset's residual value at the end of the lease term by using an accepted "industry standard" technique and data set, which would be a similar to the process and inputs used by the lessor.

In our view, it would not be appropriate for a lessee to use its own estimates of residual value and deferred initial direct costs to compute the rate implicit in the lease. The guidance in ASC 842-20-30-3 clearly states that if the rate implicit in the lease is not "readily determinable," a lessee must use either its incremental borrowing rate or, if it's a nonpublic business entity, a risk-free rate (if it chooses) as its discount rate.

Incremental borrowing rate

If a lessee cannot readily determine the rate implicit in the lease, it should use its incremental borrowing rate to compute the present value of the lease payments. A lessee's incremental borrowing rate is the rate of interest that the lessee would pay to borrow an amount equal to the lease payments on a collateralized basis over a similar term in a similar economic environment. Refer to Appendix A for more information about determining the incremental borrowing rate.



At the crossroads: Incremental borrowing rate

Under legacy GAAP, an "incremental borrowing rate" is defined as the rate that a lessee would use to fund the purchase of the underlying asset at the inception of the lease.

Under ASC 842, the "incremental borrowing rate" is the rate of interest a lessee would pay to borrow an amount equal to the lease payments on a collateralized basis over a similar term in a similar economic environment.

Therefore, when adopting ASC 842, lessees need to reconsider how they compute the incremental borrowing rate. Under ASC 842, it is no longer acceptable to use a hypothetical borrowing rate that would be incurred to finance the purchase of the underlying asset.

Risk-free rate (for lessees that are not public business entities)

Lessees that are not public business entities can make an accounting policy election to use a risk-free rate to compute the present value of the lease payments. The risk-free rate should be determined at lease commencement using a period similar to the term of the lease. If this election is made, the lessee must use the risk free rate for all leases.

Determining the incremental borrowing rate on a portfolio basis

In paragraph BC120 of ASU 2016-02, the Board notes that a portfolio approach may be used to apply the guidance in ASC 842, provided that an entity reasonably expects that the results of applying ASC 842 to the portfolio would not differ materially from applying it to individual leases. The Board cautioned that judgment is required in determining the size and composition of the portfolio(s) to ensure that the results are not materially different than a lease-by-lease application. The Board does not expect entities to perform a quantitative evaluation to support using a portfolio approach. Paragraph BC121 of ASU 2016-02 indicates that a portfolio approach may also be applied to calculating estimates, such as the discount rate, and to determining and reassessing the lease term.

Paragraph BC201 of ASU 2016-02 discusses using the portfolio approach to apply a single incremental borrowing rate to a portfolio of leases, if a reasonable portfolio can be determined. A “reasonable portfolio” consists of leases that share common key characteristics, such as lease terms and underlying assets.

The Board also notes in paragraph BC201 that there are situations in which a subsidiary might use the parent’s incremental borrowing rate, such as when the subsidiary lacks a separate treasury function, which leads to the parent, through the process of negotiating the lease, guaranteeing the lessee’s payments to the lessor. In such a case, the Board noted that the pricing of the lease is more significantly influenced by the credit standing of the parent rather than that of the subsidiary.

The following example from ASC 842 illustrates the guidance for a lessee on using a portfolio approach to establish the discount rate for a lease.



Example 2—Portfolio Approach to Establishing the Discount Rate for the Lease

ASC 842-20-55-18

Lessee, a public entity, is the parent of several consolidated subsidiaries. During the current period, 2 subsidiaries entered into a total of 400 individual leases of large computer servers, each with terms ranging between 4 and 5 years and annual payments ranging between \$60,000 and \$100,000, depending on the hardware capacity of the servers. In aggregate, total lease payments for these leases amount to \$30 million.

ASC 842-20-55-19

The individual lease contracts do not provide information about the rate implicit in the lease. Lessee is BBB credit rated and actively raises debt in the corporate bond market. Both subsidiaries are unrated

and do not actively engage in treasury operations in their respective markets. On the basis of its credit rating and the collateral represented by the leased servers, Lessee's incremental borrowing rate on \$60,000 through \$100,000 (the range of lease payments on each of the 400 leases) would be approximately 4 percent. Lessee notes that 5-year zero-coupon U.S. Treasury instruments are currently yielding 1.7 percent (a risk-free rate). Because Lessee conducts its treasury operations centrally (that is, at the consolidated group level), it is reasonably assumed that consideration of the group credit standing factored into how each lease was priced.

ASC 842-20-55-20

Lessee may determine the discount rate for the lease for the 400 individual leases entered into on different dates throughout the current period by using a portfolio approach. That is, Lessee can apply a single discount rate to the portfolio of new leases. This is because during the period, the new leases are all of similar terms (four to five years), and Lessee's credit rating and the interest rate environment are stable. Because the pricing of the lease is influenced by the credit standing and profile of Lessee rather than the subsidiaries (that is, because Lessee conducts treasury operations for the consolidated group), Lessee concludes that its incremental borrowing rate of 4 percent is an appropriate discount rate for each of the 400 leases entered into by Lessee's 2 subsidiaries during the period. Because Lessee is a public entity, it is not permitted to use a risk-free discount rate.

1.9 Fair value

In measuring the fair value of the underlying asset in a lease, an entity must consider the definition of fair value in ASC 820, *Fair Value Measurement*. The ASC Master Glossary defines fair value as:

Fair Value(2): The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

The Master Glossary defines "market participants" as follows.

Market Participants: Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

- a. They are independent of each other, that is, they are not related parties, although the price in a related-party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms
- b. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary
- c. They are able to enter into a transaction for the asset or liability
- d. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so.

Furthermore, an “orderly transaction” is defined as:

Orderly Transaction: A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).

Entities are required to estimate the fair value of the underlying asset when classifying a lease if it is practicable to do so. For the purposes of this guidance, it is “practicable” to make an estimate if a reasonable estimate can be determined without undue cost or effort. What is considered practicable depends on the relevant facts and circumstances in each situation, and could vary from entity to entity or from asset to asset. If an entity determines that measuring the fair value of the underlying asset is not practicable, the entity should exclude the fair value criteria in ASC 842-10-25-2(d) and ASC 842-10-25-3(b)(1) from its analysis of lease classification.



ASC 842-10-55-3

In some cases, it may not be practicable for an entity to determine the fair value of an underlying asset. In the context of this Topic, practicable means that a reasonable estimate of fair value can be made without undue cost or effort. It is a dynamic concept; what is practicable for one entity may not be practicable for another, what is practicable in one period may not be practicable in another, and what is practicable for one underlying asset (or class of underlying asset) may not be practicable for another. In those cases in which it is not practicable for an entity to determine the fair value of an underlying asset, lease classification should be determined without consideration of the criteria in paragraphs 842-10-25-2(d) and 842-10-25-3(b)(1).

Also, for purposes of evaluating the fair value classification criteria in ASC 842-10-25-2(d) and ASC 842-10-25-3(b)(1), the calculation of the fair value of the underlying asset should be reduced by any related investment tax credit that the lessor retains and expects to realize.



ASC 842-10-55-8

When evaluating the lease classification criteria in paragraphs 842-10-25-2(d) and 842-10-25-3(b)(1), the fair value of the underlying asset should be reduced by any related investment tax credit retained by the lessor and expected to be realized by the lessor.

1.9.1 Lessors that are not manufacturers or dealers

Lessors that are not manufacturers or dealers are required to use cost, adjusted for any volume or trade discounts, as the fair value of the underlying asset when classifying and measuring leases. If a significant

amount of time has elapsed between the date the asset was acquired and the date the lease commences, these lessors, which typically include financial institutions and captive finance entities, must determine the asset's fair value in accordance with ASC 820.



ASC 842-30-55-17A

Notwithstanding the definition of fair value, if a lessor is not a manufacturer or a dealer, the fair value of the underlying asset at lease commencement is its cost, reflecting any volume or trade discounts that may apply. However, if there has been a significant lapse of time between the acquisition of the underlying asset and lease commencement, the definition of fair value shall be applied.

1.10 Master lease agreements

A master lease agreement governs the rights to use multiple assets over the term of the agreement. Each asset underlying a master lease agreement represents a separate lease component, unless it meets the criteria to be combined with other lease components outlined in ASC 842-10-15-28. Furthermore, each of the assets underlying a master lease agreement could be made available to the lessee at a different date. Therefore, a master lease agreement may contain multiple lease components, each with a unique commencement date.

A master lease may specify a minimum number of assets or a dollar value for the assets that the lessor must transfer to the lessee during the life of the agreement. If this is the case, the parties do not account for each transfer as a lease modification. Instead, the parties apply the guidance on separating components of a contract and allocating contract consideration in ASC 842-10-15.

A master lease may provide the right, but not the obligation, for a lessee to obtain additional assets under the agreement, or it may not specify a minimum quantity or dollar value of assets that the lessee is required to take control of over the life of the agreement. If this is the case, the lessee accounts for each additional underlying asset that it takes control of over the lease term as a lease modification using the guidance on assessing lease modifications in ASC 842-10-25. Note that such a modification might require accounting for the incremental right of use as a separate lease component.



ASC 842-10-55-17

Under a master lease agreement, the lessee may gain control over the use of additional underlying assets during the term of the agreement. If the agreement specifies a minimum number of units or dollar value of equipment, the lessee obtaining control over the use of those additional underlying assets is not a lease modification. Rather, the entity (whether a lessee or a lessor) applies the guidance in paragraphs 842-10-15-28 through 15-42 when identifying the separate lease components and allocating the consideration in the contract to those components. Paragraph 842-10-55-22 explains that a master lease agreement may, therefore, result in multiple commencement dates.

ASC 842-10-55-18

If the master lease agreement permits the lessee to gain control over the use of additional underlying assets during the term of the agreement but does not commit the lessee to doing so, the lessee's

taking control over the use of an additional underlying asset should be accounted for as a lease modification in accordance with paragraphs 842-10-25-8 through 25-18.

ASC 842-10-55-22

There may be multiple commencement dates resulting from a master lease agreement. That is because a master lease agreement may cover a significant number of underlying assets, each of which are made available for use by the lessee on different dates. Although a master lease agreement may specify that the lessee must take a minimum number of units or dollar value of equipment, there will be multiple commencement dates unless all of the underlying assets subject to that minimum are made available for use by the lessee on the same date.

2. Lease identification

The guidance in ASC 842 applies to contracts that convey the right to control the use of identified property, plant, and equipment for a period of time in exchange for consideration. For a contract to qualify as a lease under ASC 842, a customer must have both the right to receive substantially all of the economic benefits from using an asset and the right to control the asset's use.

2.1 Scope of leasing guidance

A contract that conveys a right to control the use of identified property, plant, or equipment for a period of time in exchange for consideration is within the scope of ASC 842. Accordingly, contracts that convey the right to use an asset other than property, plant, or equipment are accounted for under other guidance. Examples of these types of contracts, and the relevant sections of the Codification, are summarized in Figure 2.1 below.

Figure 2.1: Contracts accounted for under other guidance

Contract	Applicable guidance
Right to use intangible assets	ASC 350, <i>Intangibles – Goodwill and Other</i>
Right to explore for or use minerals, oil, natural gas, and similar nonregenerative resources, including (1) an intangible right to explore for natural resources, and (2) a right to use land containing natural resources, unless other rights beyond just the right to explore is included in the right to use the land. Excludes equipment used to explore for these natural resources.	ASC 930, <i>Extractive Activities – Mining</i> , and ASC 932, <i>Extractive Activities – Oil and Gas</i>
Right to use biological assets, including timber	ASC 905, <i>Agriculture</i>
Right to use inventory	ASC 330, <i>Inventory</i>
Right to use assets under construction. Note that an entity should first determine whether the construction project is within the scope of ASC 842-40 on sale-leaseback transactions; refer to Section 7 for information about sale-leaseback transactions.	ASC 360, <i>Property, Plant, and Equipment</i>



ASC 842-10-15-1

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

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



At the crossroads: Scope of leasing guidance

The scope of the lease accounting guidance under ASC 842 is intended to be similar to the scope of the guidance under legacy GAAP (ASC 840). The new guidance specifies the same exclusions and exceptions, and introduces no major changes to whether long-term land leases, leases of assets other than fixed or capital assets, service concession arrangements, repurchase agreements, and other types of contracts are analyzed under the leasing guidance or other GAAP.

The question of whether a contract is within scope of the leasing guidance is particularly important for lessees to consider, because operating lease accounting for lessees is changing dramatically under ASC 842. Under the new guidance, lessees are required to recognize assets and liabilities on their statements of financial position for nearly all leases, including operating leases, which have historically been accounted for “off-balance sheet.”

2.1.1 Lease versus service contract

In some circumstances, it can be challenging for entities to determine whether an arrangement is a service contract or a lease. Service contracts and leases give rise to different rights and obligations, which drives the differences in accounting for the two types of contracts. In paragraph BC40 through BC43 of ASU 2016-02, the Board discusses some of the characteristics of each type of arrangement, which are summarized in Figure 2.2 below.

Figure 2.2: Lease versus service contract characteristics

Lease characteristics	Service contract characteristics
Lessor fulfills its obligation by transferring the right to use an asset at the commencement date	Supplier fulfills its obligation by performing throughout the contract period, and its performance to date does not continue to benefit the customer throughout the remaining service period
Lessee continues to benefit throughout the lease term from lessor's initial performance of making the asset available for the lessee's use upon lease commencement	Customer obtains economic benefits from the service only as the supplier performs
Lessee cannot avoid making lease payments without breaching the contract once the right to use an asset has been transferred at lease commencement	Customer typically has an obligation to pay for the services as they are provided

Embedded leases

A service or other contract may contain the right to use an underlying asset. The right to use an underlying asset embedded in a contract must be analyzed to determine if it meets the definition of a lease. If the right of use meets the definition of a lease, then it is accounted for under ASC 842. Common arrangements that contain embedded leases include

- Outsourced manufacturing arrangements that may grant exclusive use of equipment or space in the manufacturer's facility
- Arrangements that bundle a service and a device
- Sale of consumables with "free" equipment
- Data center and other outsourced information technology arrangements that may provide exclusive use of assets

2.1.2 Service concession arrangements

A service concession arrangement is a contract in which an entity agrees to operate a public sector entity's infrastructure, such as a toll road or an airport. Such contracts may require the entity to construct, upgrade, or maintain that infrastructure. Specifically, a service concession arrangement is a contract in which a grantor (a public-sector entity) (1) controls or is able to modify or approve the scope of services the operating entity provides, who the services are provided to, and the pricing, and (2) controls the residual interest in the infrastructure after the agreement ends. While ASC 842 does not address whether service concession arrangements are within its scope, the guidance in ASC 853, *Service Concession Arrangements*, explicitly precludes service concession arrangements from being accounted for under the leasing guidance in ASC 842.



ASC 853-10-15-2

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

ASC 853-10-15-3

A public-sector entity includes a governmental body or an entity to which the responsibility to provide public service has been delegated. In a service concession arrangement, both of the following conditions exist:

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

ASC 853-10-25-2

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

2.1.3 Sales with repurchase rights

Certain sales agreements provide the seller with an option or an obligation to repurchase the same asset that was sold, an asset that is substantially the same as the asset sold, or another asset that is a component of the original asset sold. Sales contracts with such repurchase rights are evaluated under the revenue guidance in ASC 606 and, in certain circumstances, that guidance will require the arrangement to be accounted for as a lease.

According to ASC 606, if a contract includes a forward (a seller's obligation to repurchase an asset) or a call option (a seller's right to repurchase an asset), the seller should account for the contract in one of two ways:

- As a lease if it can or must repurchase the asset for an amount that is less than the original selling price and the contract is not part of a sale-leaseback transaction
- As a financing arrangement if it can or must repurchase the asset for an amount that is greater than or equal to the original selling price

While the customer may have physical possession of the asset, the customer does not have control of the asset if its ability to direct the use of, and to obtain substantially all of the remaining benefits from, the asset is limited due to the seller's repurchase obligation or right.

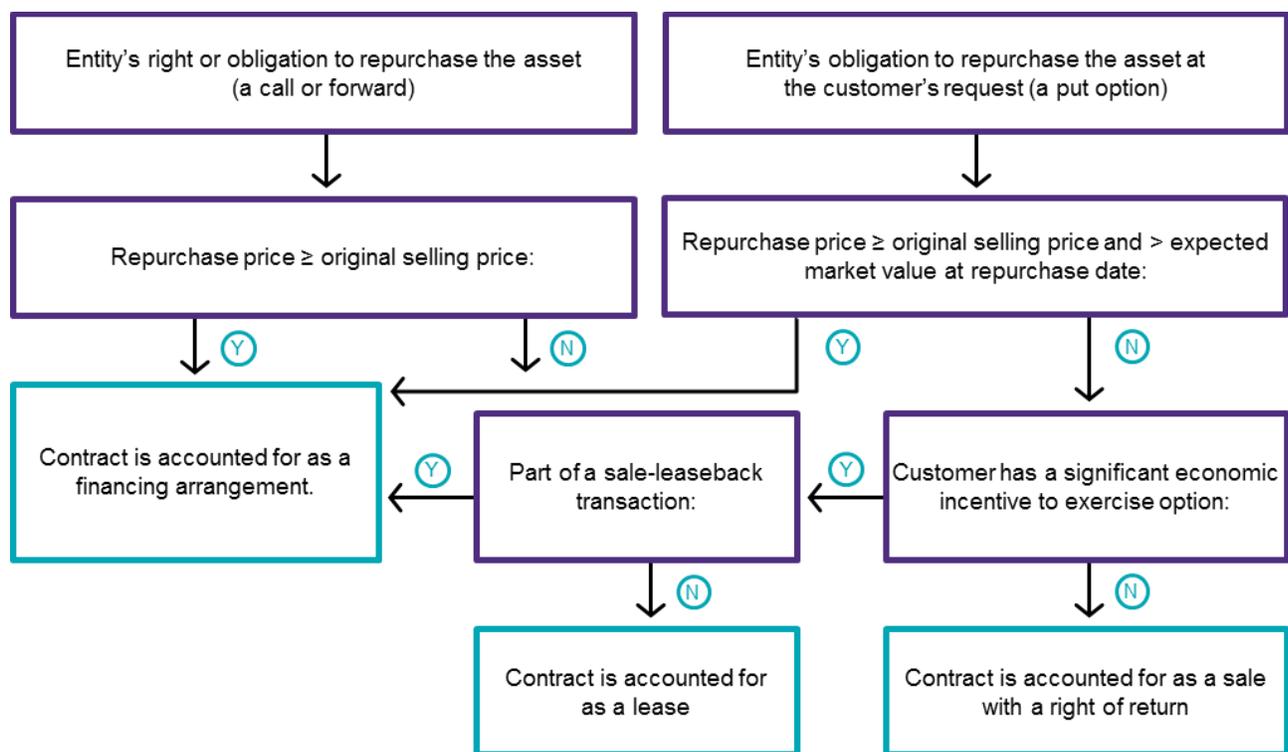
If a customer is granted the right to require the seller to repurchase the asset (a put option) at a price that is less than the original selling price, the seller should assess whether the customer has a significant economic incentive to exercise this right. This assessment takes into consideration various factors, including the relationship between the repurchase price and the expected market value of the asset at the date of repurchase. If the repurchase price is expected to significantly exceed the asset's then-current

market value, a significant economic incentive exists for the customer to exercise its put option. The agreement is then accounted for as a lease because the customer is effectively paying the seller for the right to use the asset for a period of time, unless the contract is a part of a sale-leaseback arrangement, in which case, the agreement is accounted for as a financing arrangement. See Section 7 for a discussion about accounting for sale-leaseback transactions.

If the customer does not have a significant economic incentive to exercise the put option, the seller accounts for the agreement as a sale with a right of return under ASC 606.

If a contract grants the customer a put option, and if the repurchase price of the asset is equal to or greater than its original selling price and more than the asset’s expected market value, the contract is accounted for as a financing arrangement under ASC 606. In such circumstances, the seller continues to recognize the asset and a liability initially measured at the asset’s selling price.

Figure 2.3: Accounting for repurchase rights and obligations



ASC 606-10-55-68

If an entity has an obligation or a right to repurchase the asset (a forward or a call option), a customer does not obtain control of the asset because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset even though the customer may have physical possession of the asset. Consequently, the entity should account for the contract as either of the following:

- a. A lease in accordance with Topic 842 on leases, if the entity can or must repurchase the asset for an amount that is less than the original selling price of the asset unless the contract is part of a sale and leaseback transaction. If the contract is part of a sale and leaseback transaction, the entity should account for the contract as a financing arrangement and not as a sale and leaseback transaction in accordance with Subtopic 842-40.
- b. A financing arrangement in accordance with paragraph 606-10-55-70, if the entity can or must repurchase the asset for an amount that is equal to or more than the original selling price of the asset.

ASC 606-10-55-72

If an entity has an obligation to repurchase the asset at the customer's request (a put option) at a price that is lower than the original selling price of the asset, the entity should consider at contract inception whether the customer has a significant economic incentive to exercise that right. The customer's exercising of that right results in the customer effectively paying the entity consideration for the right to use a specified asset for a period of time. Therefore, if the customer has a significant economic incentive to exercise that right, the entity should account for the agreement as a lease in accordance with Topic 842 on leases unless the contract is part of a sale and leaseback transaction. If the contract is part of a sale and leaseback transaction, the entity should account for the contract as a financing arrangement and not as a sale and leaseback transaction in accordance with Subtopic 842-40.

2.2 Definition of a lease

The Codification defines a contract as an agreement between two or more parties that creates enforceable rights and obligations. The parties to a contract must evaluate its terms to determine whether it contains a lease at the inception date, which is the date the contract is executed. ASC 842 defines a "lease" as a contract or part of a contract that conveys the right to control the use of identified property, plant, and equipment for a period of time in exchange for consideration.

Contract: An agreement between two or more parties that creates enforceable rights and obligations.

Lease: A contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.



ASC 842-10-15-2

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

ASC 842-10-15-3

A contract is or contains a lease if the contract conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. A period of time may be described in terms of the amount of use of an identified asset (for example, the number of production units that an item of equipment will be used to produce).

An entity determines whether a contract conveys the right to control the use of an asset by assessing whether the customer has both (a) the right to obtain substantially all of the economic benefits from using the asset, and (b) the right to direct the use of the asset throughout the period of use. If both of these criteria are met, along with the other components of the definition of a lease under ASC 842 (that is, an identified asset and period of time), then a contract is or contains a lease. In making these determinations, an entity should consider all of the relevant facts and circumstances. After the inception date, an entity is not required to reassess whether a contract contains a lease unless there is a change to the terms and conditions of the contract.



ASC 842-10-15-4

To determine whether a contract conveys the right to control the use of an identified asset (see paragraphs 842-10-15-17 through 15-26) for a period of time, an entity shall assess whether, throughout the period of use, the customer has both of the following:

- a. The right to obtain substantially all of the economic benefits from use of the identified asset (see paragraphs 842-10-15-17 through 15-19)
- b. The right to direct the use of the identified asset (see paragraphs 842-10-15-20 through 15-26).

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

ASC 842-10-15-6

An entity shall reassess whether a contract is or contains a lease only if the terms and conditions of the contract are changed.

ASC 842-10-15-7

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



Grant Thornton insights: Identifying a lease in a joint operation

In certain industries, such as oil and gas exploration, multiple entities often enter into an arrangement to jointly undertake an activity, sometimes involving the formation of a separate legal entity. If completing the joint activity requires the use of leased equipment, such as a drilling rig, it is important to determine whether one of the entities participating in the arrangement—or the arrangement itself—is the customer from the equipment owner's perspective. The customer must determine whether its contract with the equipment owner meets the definition of a lease.

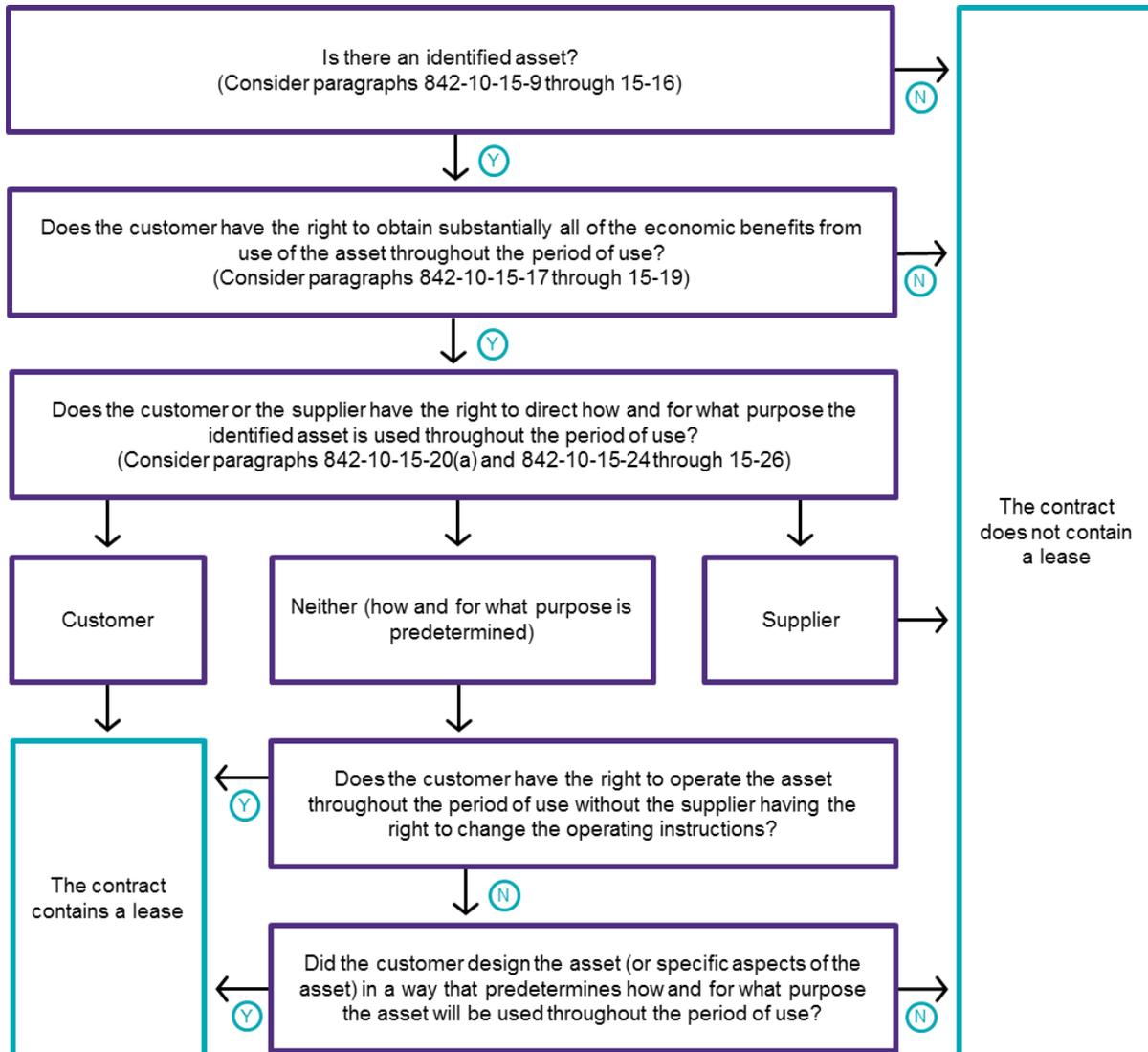
ASC 842-10-15-4 clarifies that a joint arrangement, even one not structured as a separate legal entity, could be a customer with respect to a contract that involves the use of an identified asset. In other words, lease accounting cannot be avoided by conveying the right to control the use of an identified

asset to a joint arrangement that is not structured as a separate legal entity (a non-entity joint arrangement).

In a non-entity joint arrangement, it is common for one of the parties to the arrangement (the operator) to directly enter into a contract with the owner of an asset, and to use that asset to carry out the joint arrangement's activities. In these scenarios, it is important for the operator to consider whether it is subleasing the asset to the joint arrangement, in which case, the operator must separately account for the head lease with the asset owner and the sublease with the joint arrangement. Further complicating the accounting for these arrangements is the fact that industry-specific guidance in U.S. GAAP might require proportionate consolidation of the joint arrangement by its participants. Each non-operator would then apply the proportionate consolidation guidance to record its portion of the lease liability and right-of-use asset of the joint arrangement.

Figure 2.4: Lease identification flowchart

The following flowchart, adapted from ASC 842-10-55-1, illustrates the process for determining whether a contract contains a lease.



2.2.1 Period of time

A key characteristic of a lease is that it conveys the right to use an asset for a certain period of time. That period of time, known as the “period of use” in ASC 842, is the total time during which an asset is used to fulfill a contract with a customer, including the sum of any nonconsecutive periods of time. ASC 842-10-15-3 explains that the period of use might be expressed in terms of how much or how long the asset is used rather than a fixed period of time. For example, a contract might convey the right to use a piece of equipment for whatever period of time is necessary for the equipment to produce one thousand units of output.

It is also not necessary for the period of use to consist of a single continuous period of time. If a contract provides the right to use an asset over nonconsecutive periods of time, the period of use is the sum of those nonconsecutive periods.

Period of use: The total period of time that an asset is used to fulfill a contract with a customer (including the sum of any nonconsecutive periods of time).

There is a key distinction between the *period of use* and the *contract term*. The contract term spans the period of time between the inception date of the contract and its termination, while the period of use is the subset of the contract term during which the customer (lessee) has the right to use the underlying asset. Determining whether a contract meets the definition of a lease depends on an assessment of the customer's rights during the period of use. Therefore, the period of use might comprise only a portion of the term of a contract that is or contains a lease, and might commence at a later date than the inception date of the contract.

For example, an entity might enter into a 36-month contract (January 1, 20X7 through December 31, 20X9) with a building owner to lease certain office space only during 24 months of the contract term, as illustrated in Figure 2.5. From April 1 through December 31, 20X8, the lessor leases the space to other tenants. In this example, the contract term is 36 months, but the period of use is only 24 months, consisting of two nonconsecutive 12-month periods. For purposes of determining whether this contract contains a lease under ASC 842, the parties must focus on the rights conveyed to the customer during the period of use rather than throughout the contract term.

Figure 2.5 Components of the contract term



ASC 842-10-15-5

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

2.2.2 Inception date versus commencement date

Understanding the distinction between the *inception date* of a contract and the *commencement date* of a lease is critical to properly identifying and accounting for leases under ASC 842. An entity must determine whether a contract is or contains a lease at the contract inception date, which is the date when the contract is executed. The commencement date of the lease is the date when a lessor makes an underlying asset available for the lessee's use and might occur after the contract inception date. Under

ASC 842, a lease component in a contract must be measured and recognized at the commencement date of the lease.

In many leases, the inception date matches the commencement date of the lease, meaning the leased asset is available for the lessee's use concurrently with executing the contract. However, in some cases, there is a period of time that elapses between the inception date and the commencement date of the lease.

Figure 2.5 illustrates a lease that commences three months after the inception date. In this example, the lessee and lessor must determine whether the contract is or contains a lease on January 1, 20X7. However, they would not measure and begin accounting for the lease until April 1, 20X7, which is the commencement date of the lease.

See Section 1.1 for additional information about the commencement date of a lease.

2.3 Identified asset

A lease must specify, either explicitly or implicitly, an identified asset. When an asset is not explicitly identified in the contract, an entity must determine whether the contract implicitly identifies an asset by simply requiring the use of an asset to fulfill the contract from its commencement. In other words, even if the customer cannot identify the particular asset that will be used to fulfill the contract, the fact that an asset is required to fulfill the contract is sufficient to implicitly identify an asset.

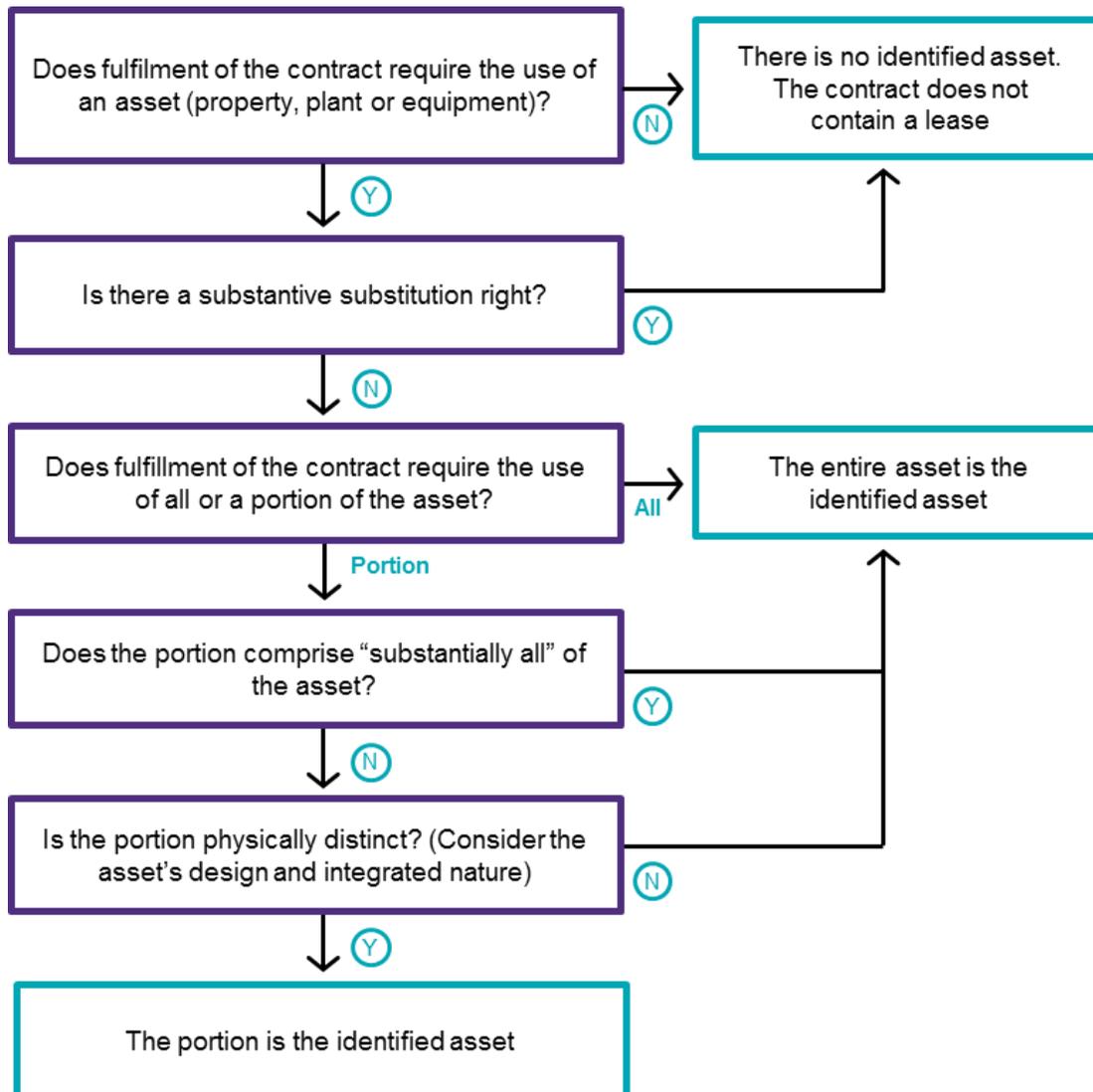


ASC 842-10-15-9

An asset typically is identified by being explicitly specified in a contract. However, an asset also can be identified by being implicitly specified at the time that the asset is made available for use by the customer.

ASC 842 clarifies that if a supplier has a substantive right to substitute the asset throughout the period of use, there is no identified asset and the contract does not contain a lease. The FASB reasoned that the supplier, and not the customer, controls how the asset is used if it has a substantive right to substitute an asset throughout the period of use, thereby deciding for what purpose a particular asset is used.

Figure 2.6 illustrates the process for determining whether a contract involves an identified asset and, if so, the unit of account that corresponds to the identified asset. In other words, if a contract involves the use of an identified asset, it is necessary to determine whether the identified asset is a portion of an asset (for example, the floor of a building) or the entire asset (for example, an entire multi-unit building).

Figure 2.6: Identified asset flowchart

The concept of an identified asset might seem broad considering an asset could be implicitly specified in a contract. However, the population of contracts that actually contain identified assets is narrowed somewhat by the requirement that customers and suppliers must consider whether a contract contains substantive substitution rights, as explained in the following section.

2.3.1 Substitution rights

A contract does not specify an identified asset if the supplier has a substantive substitution right that can be exercised throughout the period of use. A substitution right is considered “substantive” if the supplier both (1) has the practical ability to substitute alternative assets throughout the period of use, and (2) would benefit economically from exercising this right.

For example, a supplier that owns a fleet of railcars enters into a contract with a customer to transport the customer’s goods via railcar for a specified period of time. If the supplier has the practical ability to substitute certain railcars for other cars (that is, alternative cars are available and the supplier does not

require the customer's permission to substitute them) and would benefit economically from exercising its substitution right (for example, using railcars that are located closest to the point of origin of a shipment), then the contract would not be a lease because it lacks an identified asset.



ASC 842-10-15-10

Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A supplier's right to substitute an asset is substantive only if both of the following conditions exist:

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

Rights that allow the supplier to substitute an asset for repairs or maintenance, to replace an asset that is not functioning properly, or to provide a newly available technical upgrade to the original asset are not substantive substitution rights.



ASC 842-10-15-14

The supplier's right or obligation to substitute an asset for repairs or maintenance, if the asset is not operating properly, or if a technical upgrade becomes available, does not preclude the customer from having the right to use an identified asset.

If a substitution right is contingent on the occurrence of a future event that, at the inception of the contract, is considered unlikely to occur, then an entity should exclude that contingent right from its analysis of substitution rights in the contract. ASC 842 gives four examples of contingent events that would not be considered likely to occur as of the contract inception date:

- A future customer agrees to pay an above-market rate to use the asset.
- New technology is introduced that was not substantially developed at contract inception.
- The customer's use or performance of the asset differs from what was likely at contract inception.
- The market price of the asset changes significantly from what was expected at contract inception.

If a contract contains a supplier substitution right that is triggered by any of these events or by other events that are deemed not likely to occur at the inception date, then that substitution right is not substantive and would not preclude the contract from containing an identified asset.

**ASC 842-10-15-11**

An entity's evaluation of whether a supplier's substitution right is substantive is based on facts and circumstances at inception of the contract and shall exclude consideration of future events that, at inception, are not considered likely to occur. Examples of future events that, at inception of the contract, would not be considered likely to occur and, thus, should be excluded from the evaluation include, but are not limited to, the following:

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

A right to substitute an asset located on the supplier's premises is more likely to be substantive than a right to substitute an asset located on the customer's premises or elsewhere, because the cost of substituting an asset on the supplier's premises would likely be lower than the cost of substituting an asset on the customer's premises or elsewhere.

If a supplier can exercise its right to substitute an asset only on or after a particular date or when a specified event occurs, then the substitution right is not substantive because the supplier lacks the practical ability to substitute alternative assets throughout the period of use.

**ASC 842-10-15-12**

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

ASC 842-10-15-13

If the supplier has a right or an obligation to substitute the asset only on or after either a particular date or the occurrence of a specified event, the supplier does not have the practical ability to substitute alternative assets throughout the period of use.

Under ASC 842, customers are not required to take exhaustive measures to determine whether a contract contains a substantive substitution right. If a customer cannot readily determine whether a substantive substitution right exists, then it should assume that the contract lacks a substantive substitution right.



ASC 842-10-15-15

If the customer cannot readily determine whether the supplier has a substantive substitution right, the customer shall presume that any substitution right is not substantive.



Substantive substitution rights

A contract to use a copy machine for a period of time allows the supplier to replace the machine under certain circumstances, such as when the machine isn't operating properly. When evaluating whether this substitution right is substantive, the customer considers whether the supplier has the practical ability to exercise its substitution right and would benefit economically from doing so.

First, according to ASC 842-10-15-14, a supplier's right to substitute the asset when it is not operating properly is not a substantive substitution right. To the extent that the supplier has the right to substitute the asset in other circumstances, it is important to note that the copy machine is located on the customer's premises, and the supplier is unable to exercise its substitution right without the customer's permission to access the machine, which limits the supplier's practical ability to exercise its substitution right. In addition, the asset's location makes substitution more costly for the supplier than if the asset was located on the supplier's premises. Therefore, the customer determines that it is unlikely the supplier would benefit from exercising its substitution right given the costs involved with sending personnel to the customer's premises to substitute new equipment.

Based on this assessment, the customer determines that the supplier's substitution right is not substantive. If, alternatively, the customer lacks sufficient information to readily determine whether the supplier might benefit from exercising its right to substitute the copier, it should assume that the right is not substantive.

The following example from ASC 842-10-55 illustrates a contract in which substitution rights exist, but are determined not to be substantive.



Example 7 - Aircraft

ASC 842-10-55-92

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

ASC 842-10-55-93

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

ASC 842-10-55-94

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

ASC 842-10-55-95

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

ASC 842-10-55-96

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

ASC 842-10-55-97

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

ASC 842-10-55-98

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

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

ASC 842-10-55-99

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

Right to substitute asset throughout the 'period of use'

For a substitution right to be substantive, it must provide the supplier with the right to substitute the asset throughout the "period of use," as defined in ASC 842. Therefore, it is important to properly identify the period of use, as discussed in Section 2.2.1, before considering whether a substitution right is substantive.



Grant Thornton insights: Substitution rights for only a portion of the period of use

A five-year contract to use space in a shopping mall to operate a retail kiosk contains a substitution right that can be exercised beginning after year two of the contract. The substitution right gives the mall owner the option to substitute another location within the shopping mall for the space initially identified in the contract.

We believe that the period of use must be established before assessing whether a contract contains a substantive substitution right. In this example, we believe the period of use is five years, since that is the period of time during which the asset will be used to fulfill the contract between the supplier and its customer.

We do not believe that the contract term can be separated into multiple periods of use so that a lease exists only for the period of use that lacks a substantive substitution right (in this example, years one and two).

The guidance in ASC 842-10-15-10 states that a substitution right is substantive if the supplier can exercise its substitution right throughout the period of use. Since the substitution right in this example can only be exercised during three-fifths of the period of use, we believe that it is not substantive.

Conditional substitution rights

Sometimes a supplier's ability to substitute an alternative asset depends on the existence of certain conditions during the period of use. For example, a customer might periodically return a leased asset to the supplier's premises for storage when the asset is temporarily idled, and pick up the asset from the supplier's premises when it is again needed in the customer's operations. While the asset is stored at the supplier's premises, the supplier has the contractual right and the practical ability to substitute the asset.

We believe it is important to evaluate the nature of the conditions under which the supplier has the right and the ability to substitute an asset. If the conditions are within the customer's control, then we believe that the conditional substitution right does not allow the supplier to control the use of the asset. In other words, if the customer may choose to continually possess the asset throughout the term of the contract, then the supplier's ability to substitute the asset is conditional upon the customer's decision to temporarily relinquish physical possession of the asset, and the supplier's conditional substitution right does not preclude the customer from controlling the use of the asset.

According to paragraph BC129 of ASU 2016-02, "Topic 842 clarifies that if a supplier has a substantive right to substitute the asset throughout the period of use, there is not an identified asset and the contract does not contain a lease. That is because the supplier (and not the customer) controls the use of the asset if it can substitute that asset throughout the period of use, thereby deciding for what purpose the asset is used." Therefore, we believe it is important for entities to consider whether a substitution right allows the supplier, rather than the customer, to control the use of the asset when determining whether a substitution right is substantive.



Conditional substitution rights

Customer enters into a contract with Supplier to use 100 vehicles for two years. Customer's employees will use the vehicles in carrying out Customer's operating activities, including visiting current and prospective clients. From time to time Customer might not be able to use all of the vehicles under the contract. For example, if an employee that was assigned a vehicle resigns, that vehicle might be idled for a short period of time until it is redeployed for the departed employee's replacement. While a vehicle is idled, Customer has the option to store the vehicle at Supplier's premises. While the vehicle is at Supplier's premises, Supplier has the contractual right and the practical ability to provide that vehicle to another customer, provided that when Customer again requires use of the idled vehicle, Supplier provides a similar vehicle (same make and model) for Customer's use.

At the inception of the contract, Customer expects that it will periodically return vehicles to Supplier's premises for short periods of time for various reasons during the two-year contract term. However, Customer has the contractual right to retain possession of all 100 vehicles from the commencement date through the end of the contract term.

Customer determines that when an idled vehicle is stored at Supplier's premises during the contract term, Supplier has the practical ability to allow another customer to use that vehicle and Supplier would benefit economically from doing so. However, Supplier's ability to substitute an asset in this manner is conditional on Customer's decision to return the idled asset to the Supplier's premises. Since Supplier's practical ability to substitute an asset is effectively subject to Customer's approval (which is implicit in Customer's decision to store an idled asset on Supplier's premises), Supplier's substitution right does not allow Supplier to control the use of each asset under the contract during the contractual term. Accordingly, Supplier's substitution right is not substantive.

2.3.2 Portions of assets

Some contracts provide the customer with the right to use a capacity portion of an asset. For example, a customer has the right to use 30 percent of a fiber optic cable's capacity or 50 percent of the available square footage in a warehouse. For a capacity portion of an asset to represent an identified asset, it must be physically distinct. A stated *percentage* of an asset's capacity is not physically distinct.

ASC 842-10-15-16 provides examples of physically distinct portions of assets, such as one floor of a multilevel office building and a pipeline lateral that connects a single customer to a main pipeline. Similarly, an identified strand within a fiber optic cable represents a physically distinct portion of the fiber optic cable.

If a contract provides a customer with the right to use "substantially all" of the asset's capacity, then the identified asset is the entire asset, although technically the contract provides the right to use only a portion of the asset's capacity. While the term "substantially all" is not defined in ASC 842, the implementation guidance in ASC 842-10-55-2 states that when assessing lease classification, a reasonable approach is to conclude that 90 percent or more of an asset's fair value represents "substantially all" of the asset's fair value. Accordingly, we believe that it would be reasonable for an entity to evaluate whether a capacity portion of an asset represents substantially all of that asset's capacity using a 90 percent threshold.

**ASC 842-10-15-16**

A capacity portion of an asset is an identified asset if it is physically distinct (for example, a floor of a building or a segment of a pipeline that connects a single customer to the larger pipeline). A capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fiber optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset.

2.3.3 Physically distinct

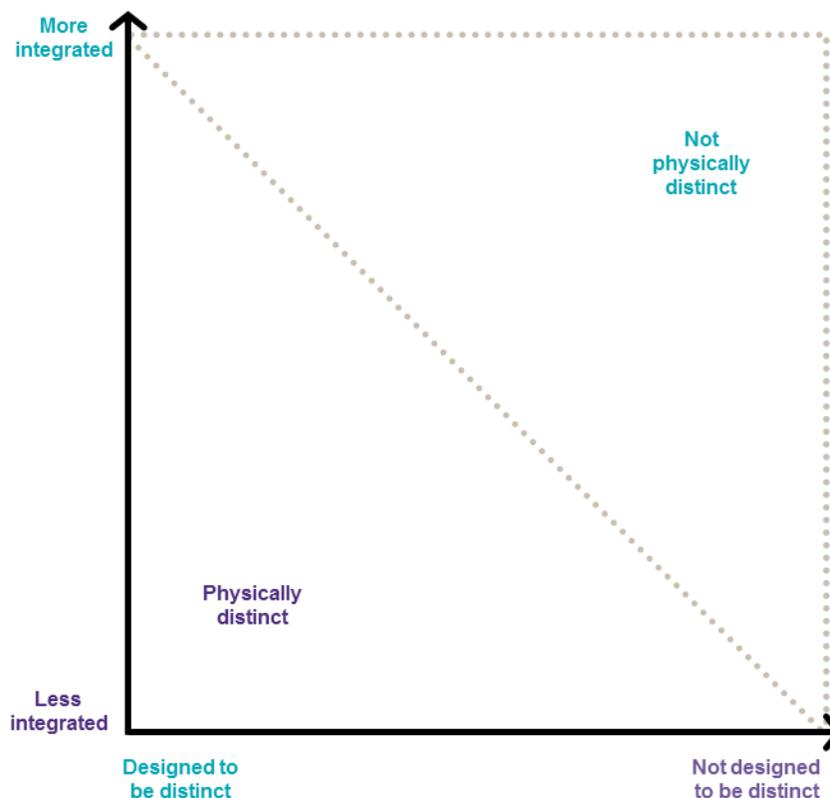
The guidance in ASC 842 does not address how to determine whether a capacity portion of an asset is physically distinct. If the capacity portion of an asset is physically distinct, then the capacity portion is the identified asset for purposes of determining whether the contract is or contains a lease. If the capacity portion is not physically distinct, then the entire asset, not just the capacity portion, is the identified asset for purposes of determining whether the contract is or contains a lease. This assessment is essential to determining whether the arrangement conveys to the customer both (a) the right to receive substantially all of the benefits from using the identified asset, and (b) the right to direct the use of the identified asset.

Determining whether a capacity portion of an asset is physically distinct requires judgment. In our view, an entity should consider both the asset's design and the level of integration between the larger asset and the capacity portion when making this assessment.

For example, assume that a cell tower is designed to accommodate multiple customers' electronic communication equipment, and each attachment point on the tower can be distinguished from other parts of the tower. In this case, an entity might determine that the attachment points are physically distinct portions of the asset and that the identified asset is the portion of the tower where each customer's equipment is attached. On the other hand, consider a utility pole that is designed to suspend electrical transmission wires, and as a secondary use allows customers to attach equipment, including data transmission wires, to various indistinguishable points on the pole beneath a certain height. In this case, an entity might conclude that the attachment point for such equipment is not a physically distinct portion of the asset and that the identified asset is the entire utility pole.

As another example, an entity that obtains the right to display an advertisement directly on an exterior wall of a building must consider whether the portion of the exterior wall used to display the advertisement is a physically distinct portion of the building. In this example, the building was designed to provide residential or commercial space for tenants' use rather than a surface for displaying advertisements, and the portion of the exterior wall used to display the advertisement does not have any unique characteristics relative to other parts of the building's exterior wall. Accordingly, an entity might conclude that the portion of the exterior wall is not a physically distinct portion of the building, and that the identified asset is therefore the entire building.

Figure 2.7 below illustrates our view that an entity's determination of whether a capacity portion of an asset is physically distinct can be informed by the level of integration of the capacity portion with the rest of the asset and the asset's design.

Figure 2.7: Physically distinct

When a contract conveys the right to use an entire asset, questions might arise about whether components of the asset should be evaluated as separate identified assets or whether the asset should be evaluated in the aggregate, including all of its components. In general, we do not believe that an entity should assess the components of a single integrated asset as separate lease components. This view is consistent with the following examples from ASC 842:

- Example 6, beginning at ASC 842-10-55-79, addresses a contract in which an entity agrees to transport a customer's goods on a specified ship, and the identified asset is the ship rather than space on the ship.
- Example 7, beginning at ASC 842-10-55-92, addresses a contract in which an entity agrees to provide an aircraft for a customer's use, and the identified asset is the aircraft rather than space on the aircraft.
- Example 9, beginning at ASC 842-10-55-108, addresses a contract in which an entity agrees to provide power generated by a solar farm to a customer. Although the solar farm consists of multiple pieces of equipment, including solar panels and electrical transmission equipment, the identified asset is the entire solar farm rather than its component parts.
- Example 10, beginning at ASC 842-10-55-124, addresses a contract in which an entity agrees to provide network services using identified servers. Although the servers consist of multiple

components, such as processors and storage, the identified asset is each server rather than its components.

The table in Figure 2.8 features several examples of how we believe an entity might determine the “identified asset” in arrangements where the unit of account is unclear.

Figure 2.8: Identified asset examples

Description	Identified asset	Commentary
Customer’s right to attach equipment to utility pole	Utility pole	The utility pole is not designed to accommodate nonelectrical transmission wires and other equipment, which is a secondary use of the asset. The portion of the utility pole used is highly integrated with the rest of the asset.
Customer’s right to attach equipment to cell tower	Space on the cell tower	The cell tower is designed to accommodate multiple customers’ equipment, and the portion of the tower used by each customer is easily distinguishable from other parts of the cell tower.
Customer’s right to display an advertisement on the side of a building	Building	Neither the wall nor the building were designed to display advertising, which is a secondary use of the asset. The portion of the wall used to display the advertisement is highly integrated with the rest of the building’s exterior.
Customer’s right to display an advertisement on a billboard	Billboard	The billboard is designed to display an advertisement. If the billboard contains multiple panels that can be used by different customers, then each panel can be easily distinguished from the other parts of the billboard.
Customer’s right to connect to “last mile” of pipeline or to the main pipeline via a pipeline lateral	Depends	The distinction between the “last mile” of a pipeline or any other distribution network (such as for electricity or data) and a “lateral” is subtle. Both connect a customer to the main pipeline, but the last mile represents a segment of the main pipeline between its terminus at a customer’s facility and the point where another customer can connect to the main pipeline, whereas a lateral represents a segment that branches off from the main pipeline. We believe whether the last mile or a lateral is physically distinct depends on whether it can be mechanically separated from the rest of the network. If the last mile or lateral can be

mechanically separated, then we believe it is physically distinct.

2.4 Right to control the use of the identified asset

A contract that contains a lease must convey to the customer the right to control the use of an identified asset. To control the use of an identified asset, the customer must have both the right to receive substantially all of the economic benefits from using the asset and the right to direct the use of the asset throughout the period of use.

2.4.1 Right to receive economic benefits

To meet the definition of a lease, a contract must provide the customer with the right to obtain substantially all of the economic benefits from using the asset throughout the period of use. The “period of use” is the period of time during which an asset is used to fulfill a contract with a customer, including nonconsecutive periods, as explained in Section 2.2.1. The economic benefits from using an asset include the asset’s primary output and by-products. For example, the economic benefits from using a solar farm include the power generated by the solar panels and renewable energy credits obtained from using the assets to generate power.



ASC 842-10-15-17

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

An entity must evaluate the right to receive economic benefits from using an asset based on the defined scope of the customer’s rights under the contract. For example, a customer that obtains the right to use a vehicle only within a certain territory specified in the contract could nevertheless have the right to obtain substantially all of the economic benefits from using that vehicle throughout the period of use. Although such restrictions might limit the economic benefits that are available from using an asset during the period of use, they do not prevent the customer from having the right to obtain all of the benefits that are available subject to the usage restrictions during the period of use.



ASC 842-10-15-18

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

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

Determining whether a customer has the right to obtain “substantially all” of the economic benefits from using the asset throughout the period of use can be challenging when an asset has multiple outputs that are sold to different customers, as illustrated in the following example.



Customer obtains less than 100 percent of economic benefits

A wind farm has two types of output: power and renewable energy credits. Customer A enters into a 10-year contract to purchase all of the power generated by the wind farm. Due to a pre-existing arrangement between the owner of the wind farm and Customer B, during the first three years of the contract, Customer B has the right to obtain all of the renewable energy credits granted from using the wind farm assets to generate power. For the remainder of the contract, Customer A has the right to obtain all of the renewable energy credits granted.

The identified asset in the contract is the wind farm, and the period of use is equal to the 10-year term of the contract because that is the period during which the identified asset is used to fulfill the contract with Customer A.

To determine whether it has the right to receive substantially all of the economic benefits from using the identified asset during the period of use, Customer A compares the fair value of the outputs it obtains over the period of use to the total fair value of the outputs generated during that period.

If, on average, the power generated by the wind farm represents 80 percent of the fair value of its output and the renewable energy credits represent the remaining 20 percent, then Customer A would have the right to obtain only 80 percent of the economic benefits from using the asset during the first three years of the contract. However, Customer A would have the right to obtain, on a fair value basis, approximately 94 percent (80 percent in the first three years and 100 percent for the remaining seven years) of the economic benefits from using the asset over the entire period of use.

ASC 842-10-55-2 states that when assessing lease classification, a reasonable approach is to conclude that 90 percent or more of an asset’s fair value represents “substantially all” of the asset’s fair value. In this case, since Customer A has the right to obtain more than 90 percent of the economic benefits from using the asset over the period of use, we believe it would be reasonable for Customer A to conclude that it has the right to obtain substantially all of the economic benefits from using the asset throughout the period of use.

If a contract requires a customer to remit to the supplier a portion of the cash flows generated by operating an asset (such as a fixed percentage of revenue generated from using retail space), those cash flows would be considered part of the economic benefits obtained by the customer from operating the asset, which the customer then pays to the supplier. Therefore, such a requirement would not preclude the customer from having the right to obtain substantially all of the benefits from operating the asset.

**ASC 842-10-15-19**

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

**Grant Thornton insights: ‘Economic benefits’ in a service contract with an embedded lease**

A service contract that contains the right to use an asset for no stated consideration (a “free lease”) must be evaluated to determine whether it contains an embedded lease. Often these arrangements include equipment that is incidental to the service provided.

For example, Entity A is a telecommunications provider that installs equipment on Entity B’s property that Entity A uses to provide telecommunication services to Entity B. Entities A and B must determine whether the contract contains a lease of the equipment from Entity A to Entity B. If the contract contains a lease of the equipment, then both entities must account for the right to use the equipment as a lease. If the contract does not contain a lease of the equipment, then the entities must consider whether Entity A is leasing space from Entity B on which to operate its equipment.

Alternatively, assume that Entity A also uses the equipment to provide services to other customers.

If Entity B does not obtain substantially all of the economic benefits from using the equipment, then both Entity A and Entity B would conclude that the contract does not contain a lease of the equipment. However, Entity A may be leasing space on which the equipment is located, which would make Entity B a lessor.

Assuming that Entity A’s right to use space on Entity B’s property meets the definition of a lease, Entity A should reflect the fair value of the “free lease” it is receiving as noncash consideration from Entity B, its customer, as part of the transaction price under ASC 606. In this scenario, the embedded lease causes an increase in Entity A’s total revenue compared to the stated consideration in the contract, because service revenue and lease cost must be presented on a gross basis. This “grossing up” of revenue and expense is required even when the stated consideration in the contract is equal to the observable stand-alone selling price of the nonlease service component.

Easements

In general, the term “easement” refers to a right to access, traverse, or otherwise use certain property for a specific purpose. For example, a private landowner might grant an easement to a midstream oil and gas company to run a pipeline across a plot of land otherwise used for farming, or the U.S. government might grant an easement to a railroad operator to run railroad tracks across federally owned land.

The first step in analyzing a contract that conveys a long-term right to use land, such as a land easement, is to consider whether the contract conveys the right to use an identified asset for a period of time. Perpetual rights to use land do not meet the definition of a lease because they do not identify a period of use. However, an exceptionally long-term right to use land, such as a 999 year easement, does specify a period of time, and could meet the accounting definition of a lease.

An entity must consider whether a contract that conveys to the customer the long-term right to use land also conveys substantially all of the economic benefits from using the land for the term of the contract. The outcome of this analysis depends on the particular facts and circumstances of the arrangement.

For example, the potential economic benefits associated with using identified land in an otherwise unused area might be limited to, or substantially consist of, benefits that are derived from running a pipeline over that land. In such circumstances, a pipeline company that enters into an easement might conclude that it has the right to substantially all of the economic benefits from using the land subject to that easement. On the other hand, the potential economic benefits associated with using farmland might consist of benefits from simultaneously running a pipeline over the land and from farming the land or having livestock graze on the land. In such circumstances, a pipeline company that enters into an easement might conclude that it does not have the right to substantially all of the economic benefits from using the land subject to that easement, depending on the relative value of the various outputs associated with using that land.



At the crossroads: Land easements in transition

In January 2018, the FASB issued ASU 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, which amends the guidance in ASC 842 to provide optional transition guidance for land easements not previously accounted for as leases under GAAP. Legacy GAAP does not contain clear guidance about how land easements should be accounted for, which has led to diversity in practice. The practical expedient offered under the optional transition guidance in ASU 2018-01 applies to easements existing or expired as of the date when the entity applies ASC 842, and allows entities that did not account for land easements as leases under legacy GAAP to continue to account for those easements under the guidance they had previously applied, such as ASC 350, *Intangibles – Goodwill and Other*.

2.4.2 Right to direct the use

In addition to providing the customer with the right to receive substantially all of the economic benefits from using the identified asset, a lease must provide the customer with the right to direct the use of the identified asset throughout the period of use.

A customer has the right to direct the use of the asset if either of the following conditions is met:

- The customer has the right to direct how and for what purpose the asset is used.
- If the decisions about how and for what purpose the asset is used are predetermined, either
 - The customer has the right to operate the asset or to direct others to operate the asset in a manner it determines.
 - The customer designed the asset in a way that predetermines how and for what purpose it is used throughout the period of use.

To determine whether the customer has the right to direct the use of an asset, an entity must consider the right to make decisions about the use of the asset only during the period of use. For example, if a customer's only decision-making right during the term of the contract is the right to specify the output of certain equipment before the period of use begins, and if the decisions about how and for what purpose the asset is used are *not* predetermined, then the customer would not have the right to direct the use of the equipment. In this scenario, the ability to specify the output before the period of use begins provides the customer with the same rights as any other customer that purchases goods or services. However, if the decisions about how and for what purpose the asset is used *are* predetermined, then the customer must consider whether it has the right to operate the equipment or whether it designed the asset in a way that predetermines how and for what purpose it is used throughout the period of use.



ASC 842-10-15-20

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

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

ASC 842-10-15-21

The relevant decisions about how and for what purpose an asset is used can be predetermined in a number of ways. For example, the relevant decisions can be predetermined by the design of the asset or by contractual restrictions on the use of the asset.

ASC 842-10-15-22

In assessing whether a customer has the right to direct the use of an asset, an entity shall consider only rights to make decisions about the use of the asset during the period of use unless the customer designed the asset (or specific aspects of the asset) in accordance with paragraph 842-10-15-20(b)(2). Consequently, unless that condition exists, an entity shall not consider decisions that are predetermined before the period of use. For example, if a customer is able only to specify the output of an asset before the period of use, the customer does not have the right to direct the use of that asset. The ability to specify the output in a contract before the period of use, without any other decision-making rights relating to the use of the asset, gives a customer the same rights as any customer that purchases goods or services.

Protective rights

Contractual protective rights, such as limiting the volume of output or limiting where the customer can use the asset, typically define the scope of the customer's right to use the asset, but do not, in and of themselves, prevent the customer from having the right to direct the use of the asset. For example, a limit on the number of miles that can be driven during the period of use in a car rental contract would not likely prevent the customer from having the right to direct the use of the automobile. Likewise, in a contract that conveys the right to use retail space in a shopping mall, limiting the hours of operation to times when the mall is open to the public would not likely prevent the customer from having the right to direct the use of the retail space.



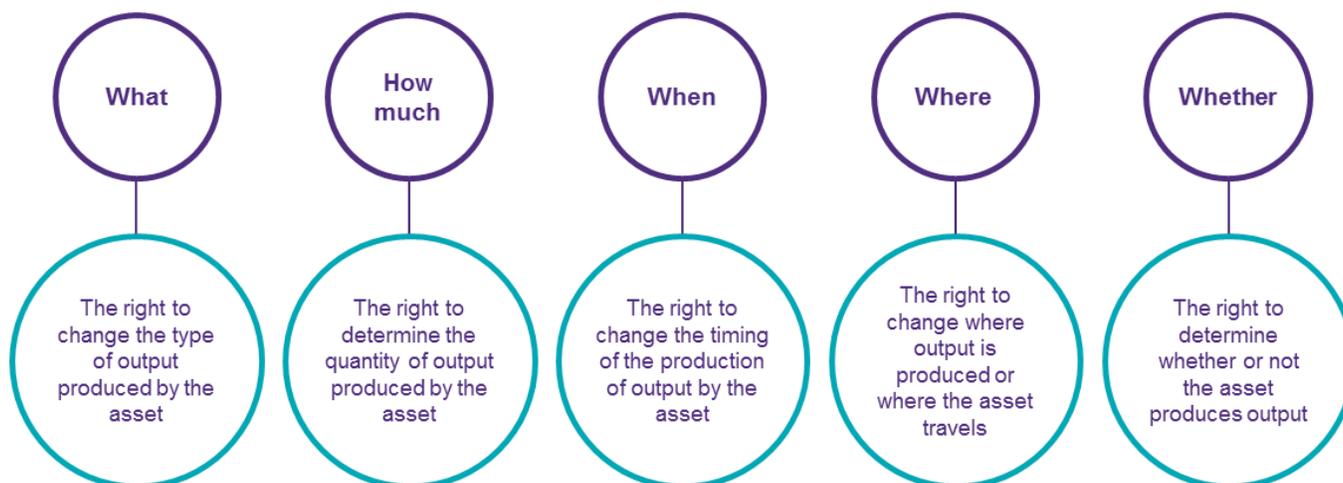
ASC 842-10-15-23

A contract may include terms and conditions designed to protect the supplier's interest in the asset or other assets, to protect its personnel, or to ensure the supplier's compliance with laws or regulations. These are examples of protective rights. For example, a contract may specify the maximum amount of use of an asset or limit where or when the customer can use the asset, may require a customer to follow particular operating practices, or may require a customer to inform the supplier of changes in how an asset will be used. Protective rights typically define the scope of the customer's right of use but do not, in isolation, prevent the customer from having the right to direct the use of an asset.

How and for what purpose an asset is used

To have the right to direct how and for what purpose an asset is used throughout the period of use, a customer must have the contractual right to *change* how and for what purpose the asset is used throughout that period. These decision-making rights are most relevant when they affect the economic benefits derived from using the underlying asset during the period of use. Examples of relevant decision-making rights are illustrated in Figure 2.9 below.

Figure 2.9: How and for what purpose an asset is used



**ASC 842-10-15-24**

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

ASC 842-10-15-25

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

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

In general, operational decisions, such as adjusting the speed and route of a cargo ship during a planned voyage, are subordinate to decisions about how and for what purpose an asset is used, such as when and to what destination a cargo ship will sail, in evaluating which party has the right to direct how and for what purpose an asset is used. These considerations are similar to how management's decisions about carrying out a business's operations are subordinate to decisions about operating and financing a business made by the board of directors in assessing how an entity is controlled.

**ASC 842-10-15-26**

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

direct the use of the asset if the relevant decisions about how and for what purpose the asset is used are predetermined (see paragraph 842-10-15-20(b)(1)).

In some cases, decisions about how and for what purpose an asset is used are predetermined under the contract. However, as discussed in paragraph BC138 of ASU 2016-02, the Board expects that there will be “relatively few cases” where all of the decisions about how and for what purpose an asset is used are predetermined. Therefore, it is important for entities to focus on the decisions about how and for what purpose an asset is used that can be made during the period of use. In cases where some decisions are predetermined, the conclusion about whether the customer has the right to direct the use of the asset depends on which party has the right to make decisions that are not predetermined about how and for what purpose the asset is used.

For example, a customer enters into a contract for the right to use manufacturing equipment for a fixed period of time. According to the contract, the equipment, located at the supplier’s facility, can produce only one type of output at a fixed quantity per hour. If the contract does not specify when the equipment must operate, then whichever party has the right to decide when or whether the equipment operates would likely have the right to direct how and for what purpose the equipment is used.

The following example from ASC 842-10-55 illustrates a situation where the customer’s right to direct the use of an asset, or lack thereof, is the defining factor in determining whether or not a contract contains a lease.



Example 6 – Ship

Case A—Contract Does Not Contain a Lease ASC 842-10-55-79

Customer enters into a contract with a ship owner (Supplier) for the transport of cargo from Rotterdam to Sydney on a specified ship. The ship is explicitly specified in the contract, and Supplier does not have substitution rights. The cargo will occupy substantially all of the capacity of the ship. The contract specifies the cargo to be transported on the ship and the dates of pickup and delivery.

ASC 842-10-55-80

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

ASC 842-10-55-81

The contract does not contain a lease.

ASC 842-10-55-82

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

ASC 842-10-55-83

Customer has the right to obtain substantially all of the economic benefits from use of the ship over the period of use. Its cargo will occupy substantially all of the capacity of the ship, thereby preventing other parties from obtaining economic benefits from use of the ship.

ASC 842-10-55-84

However, Customer does not have the right to control the use of the ship because it does not have the right to direct its use. Customer does not have the right to direct how and for what purpose the ship is used. How and for what purpose the ship will be used (that is, the transport of specified cargo from Rotterdam to Sydney within a specified time frame) are predetermined in the contract. Customer has no right to change how and for what purpose the ship is used during the period of use. Customer has no other decision-making rights about the use of the ship during the period of use (for example, it does not have the right to operate the ship) and did not design the ship. Customer has the same rights regarding the use of the ship as if it were one of multiple customers transporting cargo on the ship.

Case B—Contract Contains a Lease

ASC 842-10-55-85

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

ASC 842-10-55-86

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

ASC 842-10-55-87

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

ASC 842-10-55-88

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

ASC 842-10-55-89

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

ASC 842-10-55-90

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

- a. Customer has the right to obtain substantially all of the economic benefits from use of the ship over the five-year period of use. Customer has exclusive use of the ship throughout the period of use.

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

ASC 842-10-55-91

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

Right to direct the use of portions of assets

If a portion of an asset is determined to be physically distinct under the guidance in ASC 842, then that portion of the asset is the "identified asset" for purposes of assessing whether a contract is or contains a lease. In this situation, it can be challenging to determine whether the customer has the right to direct how and for what purpose the asset is used throughout the period of use since the identified asset is a component of the larger asset.

For example, a midstream oil and gas company (pipeline owner) constructs a pipeline lateral to connect its main pipeline system to a particular customer's facility. While it might appear that the customer has exclusive use of the lateral, it is important to consider whether the customer has the right to direct how and for what purpose the lateral is used throughout the period of use. In many cases, the pipeline owner has the right to manage the capacity and pressure in the lateral as part of operating the pipeline system, meaning that the customer does not have the ability to make all of the decisions on how and for what purpose the asset is being used during the period of use.

It is also important to consider whether the lateral can be mechanically separated from the main pipeline and, if so, which entity controls the separation. For example, if there is a valve where the lateral connects to the main pipeline and the customer controls whether that valve is open or closed, then the customer can likely decide to separately operate the lateral and make all of the decisions about how and for what purpose the lateral is used. However, if the pipeline owner controls the valve, then the customer would be less likely to have the right to direct how and for what purpose the lateral is used. An entity's conclusion in a given scenario depends on the particular facts and circumstances.

2.4.3 Right to direct the use of assets that the customer can neither access nor possess

It can be a challenge to determine whether the supplier or the customer has the right to make the "how and for what purpose" decisions in arrangements where a customer has the exclusive right to use an asset but does not possess it or is unable to directly access it. This might be the case when a customer enters into a contract to obtain all the power generated by a specified power plant or hires a vendor to provide network management services using specific remote servers.

If a customer neither possesses nor has the exclusive right to access an identified asset but has the exclusive right to use the asset, the customer is more likely to control how an identified asset is used when it has "dispatch rights," which allow it to specify the timing and/or the quantity of output produced by the asset.

The following examples in ASC 842 illustrate how a customer's dispatch rights can impact whether a contract meets the definition of a lease.



Example 9—Contract for Energy/Power

Case A—Contract Contains a Lease

ASC 842-10-55-108

A utility company (Customer) enters into a contract with a power company (Supplier) to purchase all of the electricity produced by a new solar farm for 20 years. The solar farm is explicitly specified in the contract, and Supplier has no substitution rights. The solar farm is owned by Supplier, and the energy cannot be provided to Customer from another asset. Customer designed the solar farm before it was constructed—Customer hired experts in solar energy to assist in determining the location of the farm and the engineering of the equipment to be used. Supplier is responsible for building the solar farm to Customer's specifications and then operating and maintaining it. There are no decisions to be made about whether, when, or how much electricity will be produced because the design of the asset has predetermined these decisions. Supplier will receive tax credits relating to the construction and ownership of the solar farm, while Customer receives renewable energy credits that accrue from use of the solar farm.

ASC 842-10-55-109

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

ASC 842-10-55-110

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

ASC 842-10-55-111

Customer has the right to control the use of the solar farm throughout the 20-year period of use because:

- a. Customer has the right to obtain substantially all of the economic benefits from use of the solar farm over the 20-year period of use. Customer has exclusive use of the solar farm; it takes all of the electricity produced by the farm over the 20-year period of use as well as the renewable energy credits that are a by-product from use of the solar farm. Although Supplier will be receiving economic benefits from the solar farm in the form of tax credits, those economic benefits relate to the ownership of the solar farm rather than the use of the solar farm and, thus, are not considered in this assessment.
- b. Customer has the right to direct the use of the solar farm. Neither Customer nor Supplier decides how and for what purpose the solar farm is used during the period of use because those decisions are predetermined by the design of the asset (that is, the design of the solar farm has, in effect, programmed into the asset any relevant decision-making rights about how and for what purpose the solar farm is used throughout the period of use). Customer does not operate the solar farm; Supplier makes the decisions about the operation of the solar farm. However, Customer's design of the solar farm has given it the right to direct the use of the farm (as described in paragraph 842-10-

15-20(b) (2)). Because the design of the solar farm has predetermined how and for what purpose the asset will be used throughout the period of use, Customer's control over that design is substantively no different from Customer controlling those decisions.

Case B—Contract Does Not Contain a Lease

ASC 842-10-55-112

Customer enters into a contract with Supplier to purchase all of the power produced by an explicitly specified power plant for three years. The power plant is owned and operated by Supplier. Supplier is unable to provide power to Customer from another plant. The contract sets out the quantity and timing of power that the power plant will produce throughout the period of use, which cannot be changed in the absence of extraordinary circumstances (for example, emergency situations). Supplier operates and maintains the plant on a daily basis in accordance with industry-approved operating practices. Supplier designed the power plant when it was constructed some years before entering into the contract with Customer; Customer had no involvement in that design.

ASC 842-10-55-113

The contract does not contain a lease.

ASC 842-10-55-114

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

ASC 842-10-55-115

Customer has the right to obtain substantially all of the economic benefits from use of the identified power plant over the three-year period of use. Customer will take all of the power produced by the power plant over the three-year term of the contract.

ASC 842-10-55-116

However, Customer does not have the right to control the use of the power plant because it does not have the right to direct its use. Customer does not have the right to direct how and for what purpose the plant is used. How and for what purpose the plant is used (that is, whether, when, and how much power the plant will produce) are predetermined in the contract. Customer has no right to change how and for what purpose the plant is used during the period of use, nor does it have any other decision-making rights about the use of the power plant during the period of use (for example, it does not operate the power plant) and did not design the plant. Supplier is the only party that can make decisions about the plant during the period of use by making the decisions about how the plant is operated and maintained. Customer has the same rights regarding the use of the plant as if it were one of many customers obtaining power from the plant.

Case C—Contract Contains a Lease

ASC 842-10-55-117

Customer enters into a contract with Supplier to purchase all of the power produced by an explicitly specified power plant for 10 years. The contract states that Customer has rights to all of the power produced by the plant (that is, Supplier cannot use the plant to fulfill other contracts).

ASC 842-10-55-118

Customer issues instructions to Supplier about the quantity and timing of the delivery of power. If the plant is not producing power for Customer, it does not operate.

ASC 842-10-55-119

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

ASC 842-10-55-120

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

ASC 842-10-55-121

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

ASC 842-10-55-122

Customer has the right to control the use of the power plant throughout the 10-year period of use because:

- a. Customer has the right to obtain substantially all of the economic benefits from use of the power plant over the 10-year period of use. Customer has exclusive use of the power plant; it has rights to all of the power produced by the power plant throughout the 10-year period of use.
- b. Customer has the right to direct the use of the power plant. Customer makes the relevant decisions about how and for what purpose the power plant is used because it has the right to determine whether, when, and how much power the plant will produce (that is, the timing and quantity, if any, of power produced) throughout the period of use. Because Supplier is prevented from using the power plant for another purpose, Customer's decision making about the timing and quantity of power produced, in effect, determines when and whether the plant produces output.

ASC 842-10-55-123

Although the operation and maintenance of the power plant are essential to its efficient use, Supplier's decisions in this regard do not give it the right to direct how and for what purpose the power plant is used. Consequently, Supplier does not control the use of the power plant during the period of use. Instead, Supplier's decisions are dependent on Customer's decisions about how and for what purpose the power plant is used.

Ultimately, whether or not a contract contains a lease depends on the type of decision-making rights the contract provides to the customer.

2.4.4 Assets used to obtain or use a good or service

Questions about whether a contract meets the definition of a lease often arise in arrangements where the use of an asset is incidental to the supplier providing goods or services to the customer. For example, a medical testing company might provide its customer with testing equipment along with “consumables” (nonreusable products) that allow the customer to perform medical tests using that equipment.

In these situations, the customer should begin the lease analysis by determining whether it possesses the identified asset. If the customer possesses the asset, then it is more likely that the customer has the right to make the relevant decisions about how and for what purpose the asset is used. In the medical testing equipment example, if the customer possesses the testing equipment, it could probably decide if and when to perform the tests, the quantity of tests to perform, and where the tests are performed. However, if the customer does not possess the testing equipment and sends the test samples to the supplier’s lab to be analyzed using specified equipment designated for the customer’s exclusive use, then the customer is less likely to decide when and where to perform the tests.

In some cases, the customer does not have the right to make the relevant decisions about how and for what purpose the asset is used, even though it possesses the identified asset. Example 10, Case A, in ASC 842-10-55 illustrates such a scenario. In contrast, Case B shows a scenario in which the customer does have the right to make the relevant decisions about how and for what purpose the asset is used.



Example 10—Contract for Network Services

Case A—Contract Does Not Contain a Lease

ASC 842-10-55-124

Customer enters into a contract with a telecommunications company (Supplier) for network services for two years. The contract requires Supplier to supply network services that meet a specified quality level. To provide the services, Supplier installs and configures servers at Customer’s premises; Supplier determines the speed and quality of data transportation in the network using the servers. Supplier can reconfigure or replace the servers when needed to continuously provide the quality of network services defined in the contract. Customer does not operate the servers or make any significant decisions about their use.

ASC 842-10-55-125

The contract does not contain a lease. Instead, the contract is a service contract in which Supplier uses the equipment to meet the level of network services determined by Customer.

ASC 842-10-55-126

Customer does not control the use of the servers because Customer’s only decision-making rights relate to deciding on the level of network services (the output of the servers) before the period of use—the level of network services cannot be changed during the period of use without modifying the contract. For example, even though Customer produces the data to be transported, that activity does not directly affect the configuration of the network services and, thus, it does not affect how and for what purpose the servers are used. Supplier is the only party that can make decisions about the use of the servers during the period of use. Supplier has the right to decide how data are transported using the servers, whether to reconfigure the servers, and whether to use the servers for another purpose. Accordingly, Supplier controls the use of the servers in providing network services to Customer. There

is no need to assess whether the servers are identified assets because Customer does not have the right to control the use of the servers.

Case B—Contract Contains a Lease

ASC 842-10-55-127

Customer enters into a contract with an information technology company (Supplier) for the use of an identified server for three years. Supplier delivers and installs the server at Customer's premises in accordance with Customer's instructions and provides repair and maintenance services for the server, as needed, throughout the period of use. Supplier substitutes the server only in the case of malfunction. Customer decides which data to store on the server and how to integrate the server within its operations. Customer can change its decisions in this regard throughout the period of use.

ASC 842-10-55-128

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

ASC 842-10-55-129

There is an identified asset. The server is explicitly specified in the contract. Supplier can substitute the server only if it is malfunctioning.

ASC 842-10-55-130

Customer has the right to control the use of the server throughout the three-year period of use because:

- a. Customer has the right to obtain substantially all of the economic benefits from use of the server over the three-year period of use. Customer has exclusive use of the server throughout the period of use.
- b. Customer has the right to direct the use of the server. Customer makes the relevant decisions about how and for what purpose the server is used because it has the right to decide which aspect of its operations the server is used to support and which data it stores on the server. Customer is the only party that can make decisions about the use of the server during the period of use.

In Example 10, Case A, above, a customer enters into a contract to obtain network services from a supplier. To provide those network services, the supplier uses servers located at the customer's premises. From the customer's perspective, it has purchased network services, but since delivery of those services relies on specified assets, the customer must evaluate whether it is leasing those assets.

Based on our discussions with the FASB staff, there are three critical assessments in this example that lead to the conclusion that the contract is not a lease:

1. Identifying the assets
2. Identifying the output of the assets
3. Identifying the relevant decisions about how and for what purpose the assets are used to provide the output

Each of these criteria is examined below.

Identifying the assets

Case A does not explain whether the servers are explicitly identified in the contract, but, since the servers are installed at the customer's premises, they are at least implicitly identified. The customer would be able to determine which particular servers are used by the supplier to provide the network services. Therefore, the identified asset in this arrangement is each individual server.

Identifying the output of the assets

In this case, the output of each individual server is not equivalent to the complete network services being provided to the customer. For a contract to qualify as a lease, the output must be determined for each identified asset, not in aggregate for a group of identified assets. The supplier has the right to reconfigure the network so that each server can either (1) perform a different function than it performed at the outset of the contract, or (2) be taken offline for a period of time and not contribute at all to the network services. As a result, the output of each server is not predetermined and depends on what role the server is playing in the network at any point in time.

Identifying relevant decisions about how and for what purpose assets are used to provide the output

Examples of decisions affecting how and for what purpose an asset is used include determining the type or quantity of output produced, as well as when, where, or whether output is produced.

With respect to each individual server in Case A, decisions that can be made under the contract include determining the type or quantity of output produced as well as if or when output is produced, assuming that the supplier lacks the right to change the physical location of the servers. For example, the available decisions include

- Whether a server hosts a particular software package or stores customer data (type)
- How much data a server processes (quantity)
- Whether a server is available continuously or only runs at particular times (when)
- Whether a server performs a function in the network or is taken offline (whether)

The contract specifies the level of network services, but does not stipulate how those services will be provided using the identified assets. Decisions about how and for what purpose each server will be used in the performance of the network services are made by the supplier over the term of the contract. Since the customer does not have the right to make the relevant decisions about how and for what purpose the identified assets (servers) are used, the contract for network services is not, and does not contain, a lease.

A key indicator that a contract conveys the right to direct the use of specified assets that are not in the customer's possession is whether customer has dispatch rights under the contract. In other words, if the customer can determine if and when the identified assets are used to generate output, then it is more likely that the contract is or contains a lease. In Example 10, Case A, the customer lacks dispatch rights with respect to the identified assets (each individual server). In other words, the customer cannot determine if or when each server generates output, even though the server is located on the customer's premises.

3. Components

Once an entity determines that a contract is or contains a lease, it must separate the contract into lease and nonlease components. A lease component represents the portion of a contract that meets the definition of a lease, and is the unit of account by which leases are classified and recorded. A lease component may represent the right to use one underlying asset or the right to use multiple underlying assets if the right to use a single underlying asset does not meet the definition of a lease on its own. In paragraph BC146 of ASU 2016-02, the FASB noted that the guidance on identifying separate lease components is similar to the guidance on identifying separate performance obligations in ASC 606, and that the Board expects the guidance in each Topic to be applied in a similar manner.

Other provisions in a contract that require the lessor to transfer goods or services to the lessee, such as maintenance services and supplies such as toner and paper in a contract to use a copy machine, are nonlease components. Payments associated with administrative tasks required to set up a contract or initiate a lease, and reimbursement or payment of the lessor's costs, do not represent components of a contract.

Under ASC 842, the consideration in the contract must be measured and allocated among lease and nonlease components. Lessees must allocate consideration based on the components' relative stand-alone prices. Lessors must perform this allocation based on components' relative stand-alone *selling* prices, similar to how the transaction price in a revenue arrangement is allocated under ASC 606.

3.1 Identifying lease and nonlease components

The initial and subsequent measurement guidance in ASC 842 applies only to lease components, so an entity must ensure that it has properly identified the lease and nonlease components in a contract before applying the lease accounting guidance. Within a contract, a lease component represents the customer's right to control the use of an identified asset, whereas a nonlease component represents any other good or service transferred to the lessee. For example, in a typical contract to use identified space in a multi-unit office building, the lease component is the right to control the use of the office space, and a nonlease component is the lessee's right to receive common area maintenance services from the building owner. Entities account for nonlease components based on other relevant U.S. GAAP, such as ASC 606.

3.1.1 Lease components

When there are multiple assets identified in a contract, an entity must evaluate each underlying asset to determine whether the right to use that asset is a separate lease component within the contract. This evaluation focuses on two criteria that must be met in order to account for a lease component separately from other lease components in a contract:

1. The lessee can benefit from the right to use the underlying asset either on its own or with other "readily available" resources.
2. The right to use the underlying asset is neither highly dependent on, nor highly interrelated with, rights to use other underlying assets in the contract.

**ASC 842-10-15-28**

After determining that a contract contains a lease in accordance with paragraphs 842-10-15-2 through 15-27, an entity shall identify the separate lease components within the contract. An entity shall consider the right to use an underlying asset to be a separate lease component (that is, separate from any other lease components of the contract) if both of the following criteria are met:

- a. The lessee can benefit from the right of use either on its own or together with other resources that are readily available to the lessee. Readily available resources are goods or services that are sold or leased separately (by the lessor or other suppliers) or resources that the lessee already has obtained (from the lessor or from other transactions or events).
- b. The right of use is neither highly dependent on nor highly interrelated with the other right(s) to use underlying assets in the contract. A lessee's right to use an underlying asset is highly dependent on or highly interrelated with another right to use an underlying asset if each right of use significantly affects the other.

To evaluate the first criterion, an entity should consider whether an underlying asset can be used on its own, or whether using the asset requires other inputs or interaction with other assets. Therefore, an entity must consider whether the resources needed to benefit from the right to use an identified asset are "readily available," which the guidance in ASC 842 describes as goods or services that are sold separately, either by the lessor or by other suppliers, or resources that the lessee has already obtained.

To evaluate the second criterion, an entity should consider whether each right of use significantly affects the others. Example 13 in ASC 842-10-55 illustrates a situation where rights of use are highly interdependent or interrelated.

**Example 13—Lease of a Turbine Plant (excerpt)****ASC 842-10-55-146**

Lessor leases a gas-fired turbine plant to Lessee for eight years so that Lessee can produce electricity for its customers. The plant consists of the turbine housed within a building together with the land on which the building sits. The building was designed specifically to house the turbine, has a similar economic life as the turbine of approximately 15 years, and has no alternative use. The lease does not transfer ownership of any of the underlying assets to Lessee or grant Lessee an option to purchase any of the underlying assets. Lessor does not obtain a residual value guarantee from Lessee or any other unrelated third party. The present value of the lease payments is not substantially all of the aggregate fair value of the three underlying assets.

ASC 842-10-55-147

While the lease of the plant includes the lease of multiple underlying assets, the leases of those underlying assets do not meet the second criterion necessary to be separate lease components, which is that the right to use the underlying asset is neither dependent on nor highly interrelated with the other rights of use in the contract. Therefore, the contract contains only one lease component. The rights to use the turbine, the building, and the land are highly interrelated because each is an input to the

customized combined item for which Lessee has contracted (that is, the right to use a gas-fired turbine plant that can produce electricity for distribution to Lessee's customers).

Based on the guidance in Example 13, an entity should evaluate whether the rights to use two or more assets are inputs to a combined item when determining whether rights of use are highly interrelated in a leasing contract. It is important for an entity to consider whether the lessee has contracted for the right to use each asset separately or together to produce a single output.

In a contract that is or contains a lease, a right to use an underlying asset that does not meet the two criteria for separation must be combined with another right of use, so that the combined right of use meets both criteria. The combined right of use is then accounted for as a single lease component.

Case A of Example 11 in ASC 842-10-55 illustrates how an entity would apply these criteria in a contract to use construction equipment.



Example 11—Allocation of Consideration to Lease and Nonlease Components of a Contract (excerpt)

Case A—Allocation of Consideration in the Contract

ASC 842-10-55-132

Lessor leases a bulldozer, a truck, and a crane to Lessee to be used in Lessee's construction operations for three years. Lessor also agrees to maintain each piece of equipment throughout the lease term. The total consideration in the contract is \$600,000, payable in \$200,000 annual installments.

ASC 842-10-55-133

Lessee and Lessor both conclude that the leases of the bulldozer, the truck, and the crane are each separate lease components because both of the criteria in paragraph 842-10-15-28 are met. That is:

- a. The criterion in paragraph 842-10-15-28(a) is met because Lessee can benefit from each of the three pieces of equipment on its own or together with other readily available resources (for example, Lessee could readily lease or purchase an alternative truck or crane to use with the bulldozer).
- b. The criterion in paragraph 842-10-15-28(b) is met because, despite the fact that Lessee is leasing all three machines for one purpose (that is, to engage in construction operations), the machines are not highly dependent on or highly interrelated with each other. The machines are not, in effect, inputs to a combined single item for which Lessee is contracting. Lessor can fulfill each of its obligations to lease one of the underlying assets independently of its fulfillment of the other lease obligations, and Lessee's ability to derive benefit from the lease of each piece of equipment is not significantly affected by its decision to lease or not lease the other equipment from Lessor.

ASC 842-10-55-134

In accordance with paragraph 842-10-15-31, Lessee and Lessor will account for the nonlease maintenance services components separate from the three separate lease components (unless Lessee elects the practical expedient in paragraph 842-10-15-37 or Lessor elects the practical expedient in paragraph 842-10-15-42A when the conditions in that paragraph are met—see Case B [paragraphs

842-10-55-138 through 55-140] for an example in which Lessee elects the practical expedient). In accordance with the identifying performance obligations guidance in paragraphs 606-10-25-19 through 25-22, Lessor further concludes that its maintenance services for each piece of leased equipment are distinct and therefore separate performance obligations, resulting in the conclusion that there are three separate lease components and three separate nonlease components (that is, three maintenance service performance obligations).

In Example 11, Case A, although the pieces of construction equipment are used together in Lessee's construction operations, the bulldozer, truck, and crane are not inputs to a combined single item, unlike the building and the turbine in Example 13. In other words, in Example 11, Lessee could benefit from the right to use the bulldozer in its construction activities without obtaining the right to use the truck or the crane from Lessor, whereas in Example 13, Lessee could not benefit from the right to use the building without also obtaining the right to use the gas-fired turbine from Lessor.

Leases of land and other assets

A lease involving land and other assets is not evaluated for separate lease components in the same manner as other leases involving multiple assets. The guidance in ASC 842 requires an entity to account for the right to use land as a separate lease component unless the accounting effect of separately accounting for the land component would be insignificant. An entity should not consider whether the lessee can benefit from the right to use land on its own or whether the right to use the land is highly dependent on, or highly interrelated with, other rights of use in the contract. ASC 842 provides two examples of situations where the "accounting effect" of separating the land component is insignificant: (1) separating the land component would not change the classification of any lease component in the contract, and (2) the *amount* recognized for the land lease component would be insignificant. In paragraph BC147 of ASU 2016-02, the Board notes that there may be additional circumstances in which the accounting effect of separating the land component would be insignificant, beyond the two examples provided in ASC 842.



ASC 842-10-15-29

The guidance in paragraph 842-10-15-28 notwithstanding, to classify and account for a lease of land and other assets, an entity shall account for the right to use land as a separate lease component unless the accounting effect of doing so would be insignificant (for example, separating the land element would have no effect on lease classification of any lease component or the amount recognized for the land lease component would be insignificant).

To determine whether separating a land component would affect lease classification, an entity might perform two lease classification assessments: one assuming the contract contains a single lease component, and another assuming the contract contains multiple lease components (for example, rights to use a building and land). However, it is not necessary in all cases to perform multiple classification tests to decide whether a contract involving the right to use land contains a single lease component. In some cases, it will be clear that separating the land component would have no impact on the classification outcome, but in other cases, an entity will need to allocate the consideration in the contract and perform a quantitative analysis to determine whether separate accounting for lease components is required.



Assessing the right to use land as a lease component

Consider the following two scenarios in which an entity evaluates whether the right to use land represents a separate lease component.

Scenario 1

Lessee is a professional services firm that leases a suite in a high-rise office building with a lease term of three years. Lessee is leasing less than 1 percent of the usable square footage of the high-rise building. The land beneath the building—the footprint of the high rise—is shared by all of the tenants.

Scenario 2

Lessee is a major grocery store chain that leases anchor tenant space in a strip shopping center with a lease term of 20 years. The leased space represents 65 percent of the usable space of the shopping center. The land beneath the grocery store is used only by Lessee.

Analysis

In Scenario 1, Lessee qualitatively determines that separating the land component from the building component would have an insignificant effect on its accounting for the arrangement and therefore does not separately account for the land component of the contract. To make this assessment, Lessee considers that the lease term likely represents a minor percentage of the building's economic life and that the land beneath the building is shared by many tenants. Therefore, it is unlikely that Lessee's separate accounting for its right to use its "share" of the land would have a significant impact on its accounting for the arrangement. Lessee might also consider whether it lacks an exclusive right to use any portion of the land beneath the building.

In Scenario 2, Lessee performs a more rigorous analysis of whether the accounting impact of not separating the land and the building lease components would be insignificant. In this scenario, the lease term likely represents more than a minor percentage of the building's remaining economic life, and the right to use the land beneath the leased building space is not shared by any other tenants. Without performing a quantitative analysis, it would be difficult for Lessee to determine whether separating the land component would have an insignificant effect on its accounting for the arrangement.

The following excerpt from Example 13 in ASC 842-10-55 continues the discussion previously included in this section to illustrate how an entity assesses a lease that includes land and other assets. In this case, the contract conveys the right to use a gas-fired turbine, the building the turbine is housed in, and the land beneath the building.



Example 13—Lease of a Turbine Plant (excerpt)

ASC 842-10-55-148

... [B]ecause the contract contains the lease of land, Lessee and Lessor also must consider the guidance in paragraph 842-10-15-29. Lessee and Lessor each conclude that the effect of accounting for the right to use the land as a separate lease component would be insignificant because Lessee's right to use the turbine, the building, and the land is coterminous and separating the right to use the land from the right to use the turbine and the building would not affect the lease classification of the

turbine/building lease component. Lessee and Lessor each conclude that a single lease component comprising the turbine, the building, and the land would be classified as an operating lease, as would two separate lease components comprising the land and the turbine/building, respectively.



At the crossroads: Leases involving land

The guidance for leases involving land under ASC 842 differs from the legacy guidance for leases involving land and buildings that do not meet the legacy transfer-of-ownership or bargain-purchase-option classification criteria. Under ASC 840-10-25-38(b), if the fair value of the land is less than 25 percent of the total fair value of the leased property at lease inception, the lessee would combine the land and the building and account for them as a single lease component.

Under the new guidance in ASC 842-10-15-29, this expedient is no longer available. An entity leasing land and other assets must account for the right to use land as a separate lease component, unless doing so would have an insignificant effect on the accounting.

3.1.2 Nonlease components

Many contracts provide goods or services in addition to the right to use an underlying asset. For example, contracts that convey the right to use equipment often include maintenance services related to the equipment. Contracts that convey the right to use real estate often provide common area maintenance services, which include activities like plowing snow from the parking lot in the winter or hiring a window washer to clean the exterior windows in an office building. Contracts can also include a promise to provide goods related to the leased asset under a supply agreement, such as providing toner for a leased copy machine. These services and goods are considered nonlease components in a contract, and are allocated a portion of the consideration in the contract, as discussed in Section 3.2.2 and 3.3.2.



At the crossroads: Accounting for maintenance activities

The accounting for maintenance activities under ASC 842 is a departure from the way these activities are accounted for under legacy GAAP. Under ASC 840, costs related to maintenance activities are generally treated as executory costs, based on the following definition of “minimum lease payments” in ASC 840-10-20:

Minimum lease payments comprise the payments that the lessee is obligated to make or can be required to make in connection with the leased property, excluding both of the following:

- a) Contingent rentals
- b) Any guarantee by the lessee of the lessor’s debt and the lessee’s obligation to pay (apart from the rental payments) executory costs such as insurance, maintenance, and taxes in connection with the leased property.

Under ASC 842, payments related to maintenance activities are consideration for a nonlease component of the contract, unlike payments that reimburse the lessor for the lessor’s insurance and tax

obligations. Therefore, the service that the lessor provides through maintenance activities is allocated a portion of the total consideration in the contract.

Lessor guarantees as nonlease components

A lessor should evaluate a commitment to guarantee the performance of an underlying asset, or to effectively protect the lessee from an underlying asset's obsolescence, based on the guidance on warranties in ASC 606-10-55-30 through 55-35. If the lessor's commitment goes beyond a typical product warranty, that commitment may itself be a service that the lessor is providing to the lessee, which would be treated as a nonlease component under ASC 842 and accounted for under ASC 606.



ASC 842-10-55-33

A lessor should evaluate a commitment to guarantee performance of the underlying asset or to effectively protect the lessee from obsolescence of the underlying asset in accordance with paragraphs 606-10-55-30 through 55-35 on warranties. If the lessor's commitment is more extensive than a typical product warranty, it might indicate that the commitment is providing a service to the lessee that should be accounted for as a nonlease component of the contract.



At the crossroads: Lessor guarantees

Under legacy GAAP, performance guarantees and warranties that protect a lessee from an underlying asset's obsolescence are considered in a lessor's lease classification analysis. A lessor would often classify a lease containing such a feature as an operating lease under legacy guidance. In contrast, these types of warranties do not preclude a lessor from accounting for a lease as a sales type or a direct financing lease under ASC 842. However, the warranty might represent a separate component that requires an allocation of some of the consideration in the contract.

The guidance in ASC 606 on warranties is included here for reference.



ASC 606-10-55-30

It is common for an entity to provide (in accordance with the contract, the law, or the entity's customary business practices) a warranty in connection with the sale of a product (whether a good or service). The nature of a warranty can vary significantly across industries and contracts. Some warranties provide a customer with assurance that the related product will function as the parties intended because it complies with agreed-upon specifications. Other warranties provide the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

ASC 606-10-55-31

If a customer has the option to purchase a warranty separately (for example, because the warranty is priced or negotiated separately), the warranty is a distinct service because the entity promises to provide the service to the customer in addition to the product that has the functionality described in the

contract. In those circumstances, an entity should account for the promised warranty as a performance obligation in accordance with paragraphs 606-10-25-14 through 25-22 and allocate a portion of the transaction price to that performance obligation in accordance with paragraphs 606-10-32-28 through 32-41.

ASC 606-10-55-32

If a customer does not have the option to purchase a warranty separately, an entity should account for the warranty in accordance with the guidance on product warranties in Subtopic 460-10 on guarantees, unless the promised warranty, or a part of the promised warranty, provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

ASC 606-10-55-33

In assessing whether a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, an entity should consider factors such as:

- a. Whether the warranty is required by law—If the entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a performance obligation because such requirements typically exist to protect customers from the risk of purchasing defective products.
- b. The length of the warranty coverage period—The longer the coverage period, the more likely it is that the promised warranty is a performance obligation because it is more likely to provide a service in addition to the assurance that the product complies with agreed-upon specifications.
- c. The nature of the tasks that the entity promises to perform—If it is necessary for an entity to perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (for example, a return shipping service for a defective product), then those tasks likely do not give rise to a performance obligation.

ASC 606-10-55-34

If a warranty, or a part of a warranty, provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, the promised service is a performance obligation. Therefore, an entity should allocate the transaction price to the product and the service. If an entity promises both an assurance-type warranty and a service-type warranty but cannot reasonably account for them separately, the entity should account for both of the warranties together as a single performance obligation.

ASC 606-10-55-35

A law that requires an entity to pay compensation if its products cause harm or damage does not give rise to a performance obligation. For example, a manufacturer might sell products in a jurisdiction in which the law holds the manufacturer liable for any damages (for example, to personal property) that might be caused by a consumer using a product for its intended purpose. Similarly, an entity's promise to indemnify the customer for liabilities and damages arising from claims of patent, copyright, trademark, or other infringement by the entity's products does not give rise to a performance obligation. The entity should account for such obligations in accordance with the guidance on loss contingencies in Subtopic 450-20 on contingencies.

3.1.3 Activities and payments that do not represent separate components

Only activities that either convey the right to use an asset or transfer a good or a service to a lessee are considered components in a contract. Therefore, administrative tasks undertaken by lessees and lessors to set up a contract, and a lessee's payments to reimburse the lessor for costs incurred in connection to the contract, do not represent separate components of a contract. Therefore, any payments made with respect to administrative tasks and reimbursements of the lessor's costs incurred in its role as lessor or owner of the underlying asset are included in the consideration in the contract on the same basis as other payments, and are allocated to lease and nonlease components, unless the payments are within the scope of ASC 842-10-15-40A, as described in Section 3.3.1. A common contractual provision that does not represent a separate component of a contract is a requirement for a lessee to pay property taxes and insurance premiums on the lessor's behalf. These provisions do not involve the transfer of a good or service to the lessee and therefore do not represent separate components of a contract. In other words, the counterparties to the property tax and insurance arrangements are the lessor (that is, the property owner) and either the taxing authority or the insurer, respectively. The lessee is not a direct beneficiary to either arrangement.



ASC 842-10-15-30

The consideration in the contract shall be allocated to each separate lease component and nonlease component of the contract (see paragraphs 842-10-15-33 through 15-37 for lessee allocation guidance and paragraphs 842-10-15-38 through 15-42 for lessor allocation guidance). Components of a contract include only those items or activities that transfer a good or service to the lessee. Consequently, the following are not components of a contract and do not receive an allocation of the consideration in the contract:

- a. Administrative tasks to set up a contract or initiate the lease that do not transfer a good or service to the lessee
- b. Reimbursement or payment of the lessor's costs. For example, a lessor may incur various costs in its role as a lessor or as owner of the underlying asset. A requirement for the lessee to pay those costs, whether directly to a third party or as a reimbursement to the lessor, does not transfer a good or service to the lessee separate from the right to use the underlying asset.

ASC 842-10-15-31

An entity shall account for each separate lease component separately from the nonlease components of the contract (that is, unless a lessee makes the accounting policy election described in paragraph 842-10-15-37). Nonlease components are not within the scope of this Topic and shall be accounted for in accordance with other Topics.

In paragraph BC158 of ASU 2016-02, the Board clarified that a lessee's payments made directly to a third party on the lessor's behalf should not be associated with a separate nonlease component because the payments (1) are not associated with a service provided by the lessor to the lessee, and (2) relate to an obligation of the lessor rather than the lessee.

In paragraph BC160, the Board notes that the majority of payments in a lease contract represent reimbursement of a lessor's costs in some form or another. For this reason, the Board felt it was necessary to include specific guidance on identifying components that should be allocated consideration under the contract.

**ASU 2016-02****BC158 (excerpt)**

... [T]he Board decided to provide guidance in Topic 842 on what constitutes a component in a contract and to clarify that only components get an allocation of the consideration in the contract. The Board decided that activities (or costs of the lessor) that do not transfer a good or service to the lessee are not components in a contract. For example, an entity would not account for a portion of the consideration in the contract that is attributable to paying the lessor's property taxes (or its hazard insurance) as a component if the lessor is the primary obligor for those taxes (or insurance) and the amounts paid are not for a service (for example, maintenance or operations services) provided by the lessor to the lessee.

BC160

The Board further noted that, beyond items like property taxes and hazard insurance, a lessee's payments are almost always reimbursing costs of the lessor, all the way down to the profit margin. Therefore, the Board decided that guidance of this nature was necessary to ensure that entities only allocated the consideration in the contract to those items or activities that actually provide a good or service to the lessee.

Example 12 in ASC 842-10-55 provides guidance for determining whether certain activities or payments represent components of a contract.

**Example 12—Activities or Costs That Are Not Components of a Contract****Case A—Payments for Taxes and Insurance Are Variable****ASC 842-10-55-141**

Lessor and Lessee enter into a five-year lease of a building. The contract designates that Lessee is required to pay for the costs relating to the asset, including the real estate taxes and the insurance on the building. The real estate taxes would be owed by Lessor regardless of whether it leased the building and who the lessee is. Lessor is the named insured on the building insurance policy (that is, the insurance protects Lessor's investment in the building, and Lessor will receive the proceeds from any claim). The annual lease payments are fixed at \$10,000 per year, while the annual real estate taxes and insurance premium will vary and be billed by Lessor to Lessee each year.

ASC 842-10-55-142

The real estate taxes and the building insurance are not components of the contract. The contract includes a single lease component—the right to use the building. Lessee's payments of those amounts solely represent a reimbursement of Lessor's costs and do not represent payments for goods or services in addition to the right to use the building. However, because the real estate taxes and insurance premiums during the lease term are variable, those payments are variable lease payments that do not depend on an index or a rate and are excluded from the measurement of the lease liability and recognized by Lessee in profit or loss in accordance with paragraph 842-20-25-5 or 842-20-25-6.

Lessor also recognizes those payments as variable lease payments in accordance with paragraph 842-10-15-40A because the real estate taxes and insurance premiums are paid by Lessor to the taxing jurisdiction and insurance company and reimbursed by Lessee to Lessor. However, if Lessee paid the costs directly to the third parties, those lessor costs would not be recognized by Lessor as variable payments because of the requirement in paragraph 842-10-15-40A. **Case B—Payments for Taxes and Insurance Are Fixed**

ASC 842-10-55-143

Assume the same facts and circumstances as in Case A (paragraphs 842-10-55-141 through 55-142), except that the fixed annual lease payment is \$13,000. There are no additional payments for real estate taxes or building insurance; however, the fixed payment is itemized in the contract (that is, \$10,000 for rent, \$2,000 for real estate taxes, and \$1,000 for building insurance). Consistent with Case A, the taxes and insurance are not components of the contract. The contract includes a single lease component, the right to use the building. The \$65,000 in payments Lessee will make over the 5-year lease term are all lease payments for the single component of the contract and, therefore, are included in the measurement of the lease liability.

Case C—Common Area Maintenance

ASC 842-10-55-144

Assume the same facts and circumstances as in Case B (paragraph 842-10-55-143), except that the lease is of space within the building, rather than for the entire building, and the fixed annual lease payment of \$13,000 also covers Lessor's performance of common area maintenance activities (for example, cleaning of common areas, parking lot maintenance, and providing utilities to the building). Consistent with Case B, the taxes and insurance are not components of the contract. However, the common area maintenance is a component because Lessor's activities transfer services to Lessee. That is, Lessee receives a service from Lessor in the form of the common area maintenance activities it would otherwise have to undertake itself or pay another party to provide (for example, cleaning the lobby for its customers, removing snow from the parking lot for its employees and customers, and providing utilities). The common area maintenance is a single component in this contract rather than multiple components, because Lessor performs the activities as needed (for example, plows snow or undertakes minor repairs when and as necessary) over the same period of time.

ASC 842-10-55-145

Therefore, the contract in Case C includes two components—a lease component (that is, the right to use the building) and a nonlease component. The consideration in the contract of \$65,000 is allocated between those 2 components (unless Lessee elects the practical expedient in paragraph 842-10-15-37 or Lessor elects the practical expedient in paragraph 842-10-15-42A when the conditions in that paragraph are met). The amount allocated to the lease component is the lease payments in accounting for the lease.



At the crossroads: Lease components

The requirement to separate an agreement into lease and nonlease components in ASC 842 is not new—it is a requirement under legacy GAAP as well. However, the implications of separating the lease and nonlease components of a contract under ASC 842 are more significant than under legacy GAAP,

particularly for lessees. Properly identifying lease and nonlease components can have a significant accounting impact under ASC 842 because (1) a lessee in an operating lease is required to recognize an asset and a liability associated with the right to use the underlying asset, and (2) measurement of the asset and liability excludes cash flows associated with nonlease components (unless a practical expedient is elected). In contrast, separating lease and nonlease components under legacy guidance frequently has an insignificant impact on a lessee's financial statements since (1) there is limited balance-sheet reporting associated with an operating lease, such that allocating more or less consideration to the nonlease component(s) does not decrease or increase, respectively, the carrying amount of a right-of-use asset and lease liability, and (2) the statement of comprehensive income recognition pattern for the lease and nonlease components in an operating lease is often the same.

3.1.4 Obligations to pay lessor taxes and insurance premiums

The lessor in Example 12 of ASC 842-10-55 is required, as the owner of the building, to pay both property taxes to the municipality in which the building is located and premiums to an insurance company for property insurance. In Example 12, these costs do not represent components of the contract based on two factors:

1. The lessor would owe the property taxes to the taxing authority regardless of whether it leases the building and who the lessee is.
2. The lessor is the named insured on the policy, meaning that the insurance protects the lessor's investment in the building, and the lessor would receive any proceeds from a claim made under the policy.



Grant Thornton insights: Evaluation of taxes and insurance paid by a lessee

Based on Example 12, we believe that amounts paid by a lessee to reimburse the lessor pursuant to a contract that contains a lease would not represent components of the contract if either (a) the lessor would incur the cost regardless of whether the asset is leased and who the lessee is, or (b) the lessor is the primary beneficiary of the payment.

If a lessor and lessee both enter into and benefit from an insurance policy, such as a vehicle insurance policy that provides collision and liability coverage, an entity might determine that the lessor is the primary beneficiary of the collision coverage and that the lessee is the primary beneficiary of the liability coverage.

If an insurance policy transfers a service to the lessee and therefore contains a nonlease component, such as the liability coverage mentioned above, we believe that an entity should carve out the cash flows associated with the nonlease component from the total insurance payment. In other words, we believe the guidance in ASC 842 requires an entity to bifurcate the insurance payments into portions related to lease and nonlease components of the contract, if the effect is material.

3.1.5 Lessee practical expedient

A lessee is permitted, as a practical expedient, to make an accounting policy election to combine a lease component with its associated nonlease component(s) into a single lease component by class of

underlying asset. Electing this expedient may simplify the accounting and reduce the administrative burden for lessees, but will result in a higher carrying value for the right-of-use asset and lease liability.



ASC 842-10-15-37

As a practical expedient, a lessee may, as an accounting policy election by class of underlying asset, choose not to separate nonlease components from lease components and instead to account for each separate lease component and the nonlease components associated with that lease component as a single lease component.

Case B from Example 11 of ASC 842-10-55 shows how to apply this expedient (refer to Case A from Example 11 in Section 3.1.1 for the background information related to this example). If the lessee in Example 11 elects the practical expedient for the class of underlying assets that includes construction equipment, the lessee would identify three lease components in the contract, one for each identified asset in the contract. Each lease component would include the right to use the underlying asset and the maintenance services associated with the right to use that particular asset.



Example 11—Allocation of Consideration to Lease and Nonlease Components of a Contract

Case B—Lessee Elects Practical Expedient Not to Separate Lease from Nonlease Components

ASC 842-10-55-138

Assume the same facts and circumstances as in Case A (paragraphs 842-10-55-132 through 55-137), except that Lessee has made an accounting policy election to use the practical expedient to not separate nonlease from lease components for its leased construction equipment. Consequently, Lessee does not separate the maintenance services from the related lease components but, instead, accounts for the contract as containing only three lease components.

ASC 842-10-55-139

Because Lessor regularly leases each piece of equipment bundled together with maintenance services on a standalone basis, there are observable standalone prices for each of the three combined components, each of which includes the lease and the maintenance services. Because each of the three separate lease components includes the lease of the equipment and the related maintenance services, the observable standalone price for each component in this scenario is greater than the observable standalone price for each separate lease component that does not include the maintenance services in Case A.

ASC 842-10-55-140

Lessee allocates the consideration in the contract (\$600,000) to the three separate lease components on a relative basis utilizing the observable standalone selling price of each separate lease component (inclusive of maintenance services) and then accounts for each separate lease component in accordance with the guidance in Subtopic 842-20, treating the allocated consideration as the lease

payments for each separate lease component. The standalone prices for each of the three combined lease components is as follows.

	<u>Standalone Price</u>	<u>Relative Standalone Price</u>
Bulldozer	\$ 230,000	\$ 215,625
Truck	130,000	121,875
Crane	280,000	262,500
	<u>\$ 640,000</u>	<u>\$ 600,000</u>

3.1.6 Lessor practical expedient

The Board provided a practical expedient allowing lessors to combine lease and associated nonlease components in contracts meeting certain criteria. A lessor making this election accounts for the lease and its associated nonlease component(s) as a single lease component. A lessor may apply the expedient if (1) the timing and pattern of transfer for the lease component and the nonlease component are the same, and (2) the lease component on its own would be classified as an operating lease. Lessors may elect this expedient by class of underlying asset.

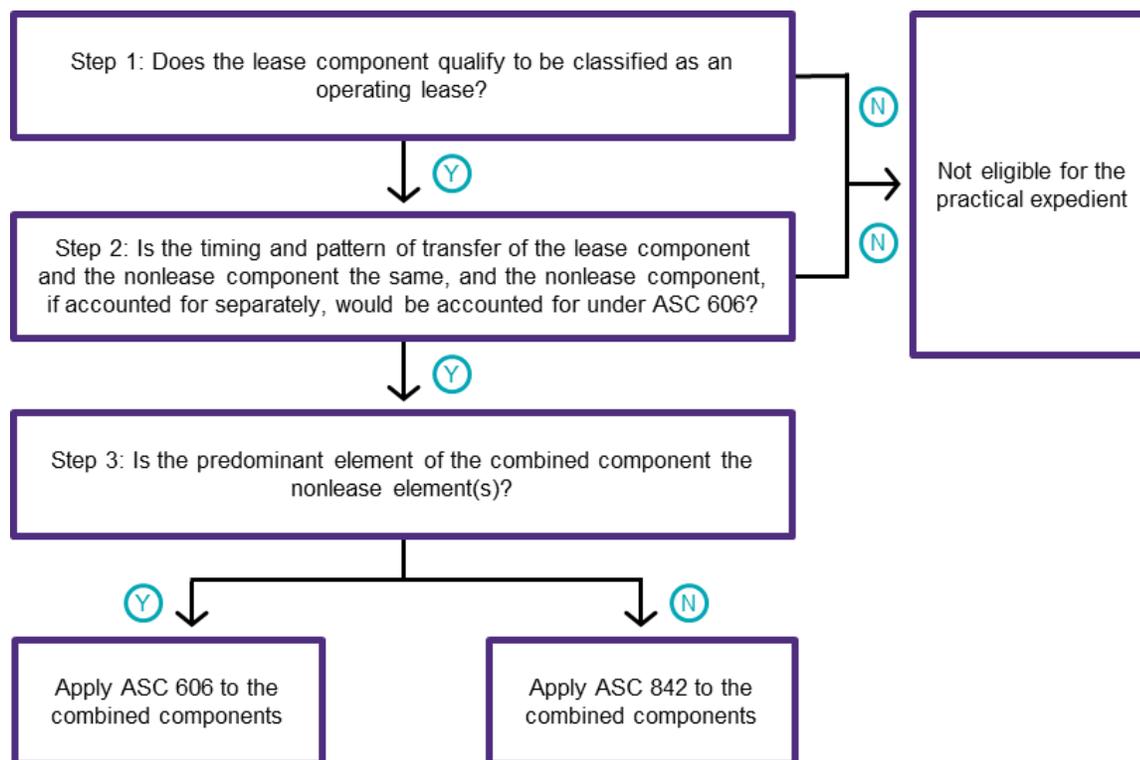
A lessor electing the practical expedient must apply it consistently to all lease and nonlease components eligible to be combined in that class of underlying asset. Lessors must disclose the election of the practical expedient as an accounting policy in the notes to the financial statements.



ASC 842-10-15-42A

As a practical expedient, a lessor may, as an accounting policy election, by class of underlying asset, choose to not separate nonlease components from lease components and, instead, to account for each separate lease component and the nonlease components associated with that lease component as a single component if the nonlease components otherwise would be accounted for under Topic 606 on revenue from contracts with customers and both of the following are met:

- a. The timing and pattern of transfer for the lease component and nonlease components associated with that lease component are the same.
- b. The lease component, if accounted for separately, would be classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3.

Figure 3.1: Overview of lessor practical expedient to combine lease and nonlease components

Qualifying for the practical expedient

In order to be combined into a single component, the nonlease component must otherwise qualify to be accounted for under ASC 606 and the lease and nonlease components must meet the following criteria:

- The lease component, if accounted for separately, meets the criteria to be classified as an operating lease.
- The timing and pattern of transfer of lease and nonlease components to the customer are the same.

Lease component is an operating lease

One of the criteria to apply the practical expedient is that the lease component, if accounted for separately from the nonlease component, must qualify to be classified as an operating lease. As a result, nonlease components associated with sales-type and direct financing leases cannot be combined.

A lessor classifies a lease as a sales-type lease if it meets any one of the five criteria discussed in Section 4.1. On the other hand, a lessor classifies a lease as a direct financing lease if it meets both of the criteria shown in Section 4.2. Finally, to be classified as an operating lease, the lease must not meet any of the sales-type criteria and may meet one, but not both, of the direct financing criteria, as discussed in Section 4.2.

In paragraph BC30 of ASU 2018-11 *Leases (Topic 842): Targeted Improvements*, the FASB notes that an entity may use a reasonable qualitative rather than quantitative analysis to determine whether a lease component would qualify as an operating lease if it were accounted for separately from the nonlease

component. This guidance should ease the burden of analysis and documentation for lessors looking to take advantage of this expedient.

Same timing and pattern of transfer

Another criterion that should be met to qualify for the practical expedient is that the lease component and nonlease component must have the same timing and pattern of transfer, and the nonlease component, if accounted for separately, would be accounted for under ASC 606. A lessor must determine whether the nonlease component is transferred over time or at a point in time under ASC 606. In an operating lease, a lessor transfers the right to use the underlying asset over time, which means that the nonlease component must also be transferred over time to qualify for the practical expedient.

In paragraph BC27 of ASU 2018-11, the FASB indicates that an entity should apply the series guidance in ASC 606-10-25-15 to determine whether the pattern of transfer is the same for the lease and nonlease components, which should result in a consistent application of the concepts in ASC 842 and ASC 606. To apply the series guidance to lease and nonlease components, an entity must meet the following two criteria:

1. The transfer of goods or services for both the lease and nonlease components is recognized over time.
2. The measurement used to recognize the progress of transferring the goods and services over time is the same for both the lease and nonlease component.



ASC 606-10-25-15

A series of distinct goods or services has the same pattern of transfer to the customer if both of the following criteria are met:

- a. Each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria in paragraph 606-10-25-27 to be a performance obligation satisfied over time.
- b. In accordance with paragraphs 606-10-25-31 through 25-32, the same method would be used to measure the entity's progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.



Grant Thornton insights: Pattern of transfer versus pattern of recognition

To qualify for the practical expedient, a lessor should evaluate whether the *pattern of transfer*, not the *pattern of revenue recognition*, is the same for both the nonlease and lease components (that is, over time). Under ASC 842, variable payments that are not based on an index or a rate are excluded from the definition of lease payments. What's more, variable payments allocated to a lease component are not recognized as lease revenue until the events causing the payments to vary have been resolved, which causes revenue recognition for lease components with variable payments to differ from those with fixed payments. The emphasis on the pattern of transfer rather than the pattern of revenue recognition ensures that nonlease components with variable payments may qualify for the expedient.

For example, it is common for a building lease to include common area maintenance services. The payments for these services are often based on actual amounts expended by the lessor and therefore

are considered variable payments, which are excluded from the definition of lease payments in ASC 842. The pattern of transferring the right to use the building occurs over time throughout the lease term. The pattern of transferring the services for common area maintenance also generally occurs over time, as the lessee benefits from the services throughout the lease term. Said differently, the pattern of transfer of services does not change based on whether the payments for the services are variable or fixed.



Example: Combining lease and nonlease components

Lessor enters into a contract that grants Lessee the right to use three floors in an office building for \$30,000 per month over a three-year term. The contract requires Lessor to provide common area maintenance for the duration of the lease.

Lessor determines that the right to use the space in the office building meets the definition of a lease. Lessor also identifies a nonlease component: its obligation to provide common area maintenance.

Lessor analyzes the lease and determines that the lease should be classified as an operating lease because it does not meet any of the five sales-type criteria or both of the two direct financing criteria.

Lessor then evaluates whether the timing and pattern of transfer of the common area maintenance is the same as the timing and pattern of transfer of the lease component (use of the building), which will be transferred over time. Lessor concludes that Lessee benefits from the common area maintenance over time, and that the same method (over time) should be used to measure the progress of transferring both the lease component and the nonlease component (common area maintenance).

Lessor chooses to apply the practical expedient to the building class of assets and combines the lease component and the common area maintenance into a single component, as they meet the qualifying criteria.

Contracts with multiple nonlease components

A lease contract may have multiple nonlease components. If a lease has multiple related nonlease components, only the nonlease components that qualify for the practical expedient may be accounted for as part of a combined component. Nonlease components that do not qualify, such as those that have a different pattern of transfer than the lease component, should be accounted for separately. In this case the lessor should measure the contract's consideration and allocate it between the combined component and the nonqualifying nonlease components accounted for separately.



ASC 842-10-15-42C

A lessor that elects the practical expedient in paragraph 842-10-15-42A shall combine all nonlease components that qualify for the practical expedient with the associated lease component and shall account for the combined component in accordance with paragraph 842-10-15-42B. A lessor shall separately account for nonlease components that do not qualify for the practical expedient. Accordingly, a lessor shall apply paragraphs 842-10-15-38 through 15-42 to account for nonlease components that do not qualify for the practical expedient.

Capitalized costs related to combined components

A lessor that elects to use the practical expedient to combine lease and nonlease components must also apply it to the capitalized costs associated with those components under the contract, such as initial direct costs or contract costs accounted for under ASC 340-40. In other words, the lessor must also combine the capitalized costs related to the combined lease and nonlease components as required in the allocation guidance in ASC 842-10-15-38.

Assessing 'predominant' component

Once a lessor has determined that the lease and nonlease components can be combined into a single component, it should assess whether the nonlease component is the “predominant” portion in the combined component. If the nonlease component is the predominant component, the combined component is accounted for as a performance obligation under ASC 606.

A “predominant” nonlease component in a combined component is one that the lessor reasonably expects a lessee to attribute more value to than its related lease component.



ASC 842-10-15-42B

A lessor that elects the practical expedient in paragraph 842-10-15-42A shall account for the combined component:

- a. As a single performance obligation in accordance with Topic 606 if the nonlease component or components are the predominant component(s) of the combined component. In applying Topic 606, the entity shall do both of the following:
 1. Use the same measure of progress as used for applying paragraph 842-10-15-42A(a)
 2. Account for all variable payments related to any good or service, including the lease, that is part of the combined component in accordance with the guidance on variable consideration in Topic 606.
- b. Otherwise, as an operating lease entirely in accordance with this Topic. In applying this Topic, the entity shall account for all variable payments related to any good or service that is part of the combined component as variable lease payments.

In determining whether a nonlease component or components are the predominant component(s) of a combined component, a lessor shall consider whether the lessee would be reasonably expected to ascribe more value to the nonlease component(s) than to the lease component.

ASC 842-10-55-149 provides an example of how to determine which asset is predominant in a lease component containing the right to use multiple assets. In the example, Lessee has a contract that provides the right to use three assets: a turbine, a building housing the turbine, and the land upon which the building and turbine sit. This example considers (1) the primary asset for which the lessee has entered into the contract, and (2) whether the other components in the contract would have any use or value to the lessee without the primary asset.

These same considerations may be applied when assessing the predominance of lease or nonlease components. In a building lease with common area maintenance services, for example, it is likely that the lessee's primary goal is to use space within the building, and that the maintenance services allow the lessee to continue to use the building. In this situation, a lessor might conclude that the nonlease component is not the predominant component and account for the combined component under ASC 842. On the other hand, in a contract to provide internet services that are delivered via a modem owned by the service provider, the primary goal is likely providing the internet services, and the lease of the modem merely enables those services to be provided. In this case, the service provider might conclude that the nonlease component is predominant and account for the combined component under ASC 606.



Example 13—Lease of a Turbine Plant (excerpt)

ASC 842-10-55-149

The predominant asset in the single lease component is the turbine. Lessee entered into the lease primarily to obtain the power-generation capabilities of the turbine. The building and land enable Lessee to obtain the benefits from use of the turbine. The land and building would have little, if any, use or value to Lessee in this contract without the turbine. Therefore, the remaining economic life of the turbine is considered in evaluating the classification of the single lease component

The concept of “predominant” is also used in ASC 606 and is illustrated in the discussion on sales-based or usage-based royalties in ASC 606-10-55-65A. This guidance, similar to that in ASC 842, defines “predominant” as an item that the entity reasonably expects the customer to attribute significantly more value to than other goods or services in the contract.



ASC 606-10-55-65A

The guidance for a sales-based or usage-based royalty in paragraph 606-10-55-65 applies when the royalty relates only to a license of intellectual property or when a license of intellectual property is the predominant item to which the royalty relates (for example, the license of intellectual property may be the predominant item to which the royalty relates when the entity has a reasonable expectation that the customer would ascribe significantly more value to the license than to the other goods or services to which the royalty relates).



Grant Thornton insights: Impact of applying ASC 842 versus ASC 606

The lessor's accounting for variable payments in a contract is significantly different depending on whether the combined contract is accounted for under ASC 606 or ASC 842. Variable payments not included in the definition of lease payments are excluded from lease income until a change occurs in facts and circumstances that triggers the variable payments.

If the lessor applies the revenue guidance in ASC 606, the combined component is accounted for as a single performance obligation that is satisfied over time. The lessor would determine the transaction

price in accordance with ASC 606, and estimate variable payments and apply the constraint described in ASC 606-10-32. That estimate is then updated and the constraint reassessed each subsequent reporting period.

For example, Lessor enters into a five-year building lease with Lessee in a contract that includes common area maintenance (CAM) services. Lessor elects to combine lease and nonlease components for the building asset class. The annual fixed payments in the lease are \$100,000 per year, and CAM costs will be charged to Lessee at Lessor's actual cost, which Lessor estimates to be \$10,000 per year.

If Lessor determines that the lease component is predominant, it would account for the combined component under ASC 842. The payments for CAM costs represent variable payments, since they will vary based on Lessor's actual expenses. In accordance with ASC 842-10-30-6, variable payments other than those based on an index or a rate are excluded from the definition of lease payments. Therefore, Lessor excludes the variable payments from the consideration in the contract and calculates contract consideration as \$500,000. Lessor recognizes lease revenue on a straight-line basis over the lease term. In year one, Lessor recognizes lease revenue of \$100,000, and revenue based on the actual CAM charges in the period they are incurred.

If Lessor determines that the CAM component is predominant, Lessor would account for the combined component under ASC 606. In accordance with ASC 606-10-32-5 to 32-11, Lessor determines the transaction price by combining the fixed payments of \$100,000 and the variable CAM payments at their estimated value, subject to the constraint in ASC 606-10-32, which limits the amount that may be recorded to the amount at which it is probable that a significant revenue reversal will not occur. The estimated CAM amount will be reevaluated at each reporting period. Lessor determines that the total compensation in the contract is \$550,000 (\$500,000 fixed payments + \$50,000 estimated CAM), which it recognizes over time on a straight-line basis. In year one, actual CAM costs are \$10,000, which is in line with Lessor's estimate. Lessor recognizes revenue of \$110,000 in year one.

3.1.7 Contract combinations

An entity must consider whether separate contracts should be combined and evaluated as a single contract. An entity is required to combine multiple contracts under ASC 842 when (1) the contracts are negotiated as a package with the same commercial objective, (2) amounts payable under each contract depend on one another, or (3) at least some of the rights to use the underlying assets in the contracts represent a single lease component. The third criterion applies in situations where multiple contracts contain rights to use assets that would not qualify as separate lease components if they were included in a single contract. For example, if the lessee and lessor in Example 13 (ASC 842-10-55-146 through 55-149) entered into separate contracts for use of the turbine and the building, then those contracts would be combined on account of each right-of-use being highly dependent on and highly interrelated with the other.



ASC 842-10-25-19

An entity shall combine two or more contracts, at least one of which is or contains a lease, entered into at or near the same time with the same counterparty (or related parties) and consider the contracts as a single transaction if any of the following criteria are met:

- a. The contracts are negotiated as a package with the same commercial objective(s).

- b. The amount of consideration to be paid in one contract depends on the price or performance of the other contract.
- c. The rights to use underlying assets conveyed in the contracts (or some of the rights of use conveyed in the contracts) are a single lease component in accordance with paragraph 842-10-15-28.

3.2 Lessee measurement, allocation, and subsequent measurement of consideration

It is important to properly identify the lease and nonlease components in a contract because ultimately the consideration in the contract will be allocated to those components and then recognized based on the appropriate guidance. Consideration allocated to lease components is recognized based on the guidance in ASC 842, and consideration allocated to nonlease components is recognized based on other U.S. GAAP, such as ASC 606 for revenue from contracts with customers.

The guidance on measuring and allocating the consideration in a contract differs for lessees and lessors. This section addresses only lessee measurement and allocation.

3.2.1 Lessee measurement

For a lessee, the consideration in the contract includes three components:

- The payments described in ASC 842-10-30-5 and discussed in detail in Section 1.4
- Any fixed payments or in-substance fixed payments, less any incentives received or receivable from the lessor, that are excluded from the payments described in ASC 842-10-30-5
- Any variable payments based on an index or rate that are excluded from the payments described in ASC 842-10-30-5, initially measured using the index or rate at the lease commencement date

The first bullet in the list above references the guidance in ASC 842-10-30-5, which describes the items that make up “lease payments.” However, it is not accurate to describe the first bullet in the list above simply as “lease payments,” because ASC 842-10-30-6 goes on to state that “lease payments” exclude amounts allocated to nonlease components in accordance with paragraphs 842-10-15-33 through 15-42. Since the “consideration in the contract” is the amount allocated between lease and nonlease components, the payments in the first bullet in the list above necessarily include the total amount of the items specified in ASC 842-10-30-5 before any allocation to lease and nonlease components occurs. In other words, the payments described in the first bullet above include nonlease payments if the contract includes nonlease components.

Fixed and variable payments that are not specified in ASC 842-10-30-5 but are included in the consideration in the contract, as discussed in the second and third bullets above, include fixed payments and variable payments based on an index or rate that are not explicitly related to the use of the underlying asset during the lease term. For example, a lessor might enter into a contract with a lessee to provide the right to use a piece of equipment for \$100 per year and to provide maintenance services related to the equipment for \$25 per year. Although the fixed annual payment of \$25 does not explicitly relate to the use of the underlying asset, it is nevertheless included in the consideration in the contract, along with the \$100 annual payment for the right to use the equipment.

**ASC 842-10-15-35**

The consideration in the contract for a lessee includes all of the payments described in paragraph 842-10-30-5, as well as all of the following payments that will be made during the lease term:

- a. Any fixed payments (for example, monthly service charges) or in substance fixed payments, less any incentives paid or payable to the lessee, other than those included in paragraph 842-10-30-5
- b. Any other variable payments that depend on an index or a rate, initially measured using the index or rate at the commencement date.

The guidance related to lease payments in ASC 842-10-30-5 is included here for reference. Refer to Section 1.4 for a full discussion of what constitutes lease payments.

**ASC 842-10-30-5**

At the commencement date, the lease payments shall consist of the following payments relating to the use of the underlying asset during the lease term:

- a. Fixed payments, including in substance fixed payments, less any lease incentives paid or payable to the lessee (see paragraphs 842-10-55-30 through 55-31).
- b. Variable lease payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date.
- c. The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise that option (assessed considering the factors in paragraph 842-10-55-26).
- d. Payments for penalties for terminating the lease if the lease term (as determined in accordance with paragraph 842-10-30-1) reflects the lessee exercising an option to terminate the lease.
- e. Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction. However, such fees shall not be included in the fair value of the underlying asset for purposes of applying paragraph 842-10-25-2(d).
- f. For a lessee only, amounts probable of being owed by the lessee under residual value guarantees (see paragraphs 842-10-55-34 through 55-36).

Payments associated with activities that do not transfer a good or service

As described in Section 3.1.3, payments associated with activities that do not transfer a good or service to the lessee, such as a lessee's reimbursement of the lessor's property taxes or insurance premiums, do not represent a separate component of the contract. According to Example 12 in ASC 842-10-55, payments associated with such activities (payments that are not for goods or services in addition to the right to use the underlying asset) are considered lease payments, which are included in the consideration in the contract if they meet any of the criteria in ASC 842-10-15-35.

Therefore, a lessee should include fixed payments that reimburse a lessor for its property taxes and insurance premiums in the consideration in the contract, and exclude variable payments to reimburse a

lessor from the consideration in the contract. As a result, the consideration in the contract will differ for gross and net leases.

In a typical gross lease, the lessee remits fixed payments to the lessor that represent consideration for both the lease and nonlease components in the contract, such as the right to use an office suite and common area maintenance. In addition, those payments are intended to reimburse the lessor for its property taxes and insurance premiums associated with its ownership of the underlying asset. In a gross lease, assuming an entity elects to separate the lease and nonlease components, the lessee allocates the total fixed payments in the contract to the lease and nonlease components, meaning that a portion of the payments to reimburse the lessor for property taxes and insurance premiums would be allocated to each component.

In a typical net lease, the lessee remits fixed payments to the lessor that represent consideration for the lease component in the contract. The lessee remits variable payments to the lessor as consideration for nonlease components, such as common area maintenance, as well as reimbursement of the lessor's actual property taxes and insurance premiums incurred. Since a lessee would not include variable payments that are not based on an index or rate in the consideration in the contract, its lease liability and right-of-use asset would generally be smaller in a net lease compared to a gross lease. However, similar to a gross lease, all of the payments, including variable payments for nonlease components and reimbursements of the lessor's property taxes and insurance premiums, would be allocated among the lease and nonlease components based on their relative stand-alone prices.

3.2.2 Lessee initial allocation

A lessee initially allocates the consideration in the contract to the separate lease components and nonlease components on the basis of their relative stand-alone prices.

Stand-alone price

To allocate the consideration in the contract to lease and nonlease components, a lessee must determine a stand-alone price for each component. If a component is sold separately by the lessor or other suppliers, then the lessee should use that observable price as the basis for that component's stand-alone price. However, oftentimes a nonlease component, such as maintenance, is not sold separately by the lessor and information about stand-alone transactions involving other suppliers is not readily available. In these cases, a lessee must estimate the component's stand-alone price.

The guidance in paragraph BC156 of ASU 2016-02 explains the "stand-alone" price concept for lessees. The Board decided not to reference the allocation guidance in ASC 606 for lessees as it did for lessors, since a lessee is a customer rather than a supplier. However, like ASC 606, ASC 842 requires a lessee to use a hierarchy for determining the stand-alone price if an observable stand-alone price is not available. If there is no observable stand-alone price, then a lessee should estimate the stand-alone price, maximizing the use of observable inputs. ASC 842 permits a lessee to use a residual estimation approach if there is no observable price and an estimate cannot be made. However, in line with the guidance in ASC 606, the use of a residual estimation approach is rarely appropriate, and should only be used in cases where the stand-alone price is highly variable or uncertain.



ASU 2016-02 BC156

The allocation guidance for lessees in Topic 842 does not reference other Topics; the Board decided that it will be less complex and more intuitive for lessees to include the allocation guidance within the leases Topic. The Board also decided that having lessees apply the revenue recognition guidance in

Topic 606 (as is the case for lessors) does not make conceptual sense because a lessee is the customer in a lease rather than the supplier. However, the allocation guidance for lessees is similar to that for lessors and also is broadly consistent with that in previous GAAP, although some additional rigor has been added to the process for determining the standalone price of a lease or nonlease component. That is, the Board decided that in determining the standalone price of lease and nonlease components of the contract, a lessee is required to use observable standalone prices, if available, before using an estimated standalone price. Furthermore, a lessee should maximize the use of observable inputs and apply estimation methods consistently in similar circumstances when estimating a standalone price. The Board decided that the ability to estimate standalone prices should include the ability to use a residual approach to estimate the standalone price, subject to the requirement to maximize the use of observable inputs in estimating the standalone price.



ASC 842-10-15-33

A lessee shall allocate (that is, unless the lessee makes the accounting policy election described in paragraph 842-10-15-37) the consideration in the contract to the separate lease components determined in accordance with paragraphs 842-10-15-28 through 15-31 and the nonlease components as follows:

- a. The lessee shall determine the relative standalone price of the separate lease components and the nonlease components on the basis of their observable standalone prices. If observable standalone prices are not readily available, the lessee shall estimate the standalone prices, maximizing the use of observable information. A residual estimation approach may be appropriate if the standalone price for a component is highly variable or uncertain.
- b. The lessee shall allocate the consideration in the contract on a relative standalone price basis to the separate lease components and the nonlease components of the contract.

Initial direct costs should be allocated to the separate lease components on the same basis as the lease payments.

ASC 842-10-15-34

A price is observable if it is the price that either the lessor or similar suppliers sell similar lease or nonlease components on a standalone basis.

3.2.3 Lessee subsequent measurement and allocation

A lessee revisits its measurement and allocation of the consideration in the contract when (1) it is required to remeasure the lease liability or (2) a contract modification occurs that is not accounted for as a separate contract under the modification guidance in ASC 842. For a discussion of lessee modifications and remeasurement events, please refer to Sections 5.7 and 5.8.

**ASC 842-10-15-36**

A lessee shall remeasure and reallocate the consideration in the contract upon either of the following:

- a. A remeasurement of the lease liability (for example, a remeasurement resulting from a change in the lease term or a change in the assessment of whether a lessee is or is not reasonably certain to exercise an option to purchase the underlying asset) (see paragraph 842-20-35-4)
- b. The effective date of a contract modification that is not accounted for as a separate contract (see paragraph 842-10-25-8).

3.3 Lessor measurement, allocation, and subsequent measurement of consideration

Similar to lessees, lessors must allocate the consideration in the contract among lease and nonlease components. For lessors, this allocation procedure is similar to the approach for allocating the transaction price to performance obligations under ASC 606.

Lessors recognize consideration allocated to lease components as income based on the guidance in ASC 842, and consideration allocated to nonlease components as income based on the guidance in ASC 606.

The new guidance on measuring and allocating the consideration in the contract differs for lessees and lessors. This section addresses only lessor measurement and allocation.

3.3.1 Lessor measurement

The guidance in ASC 842 calls for lessors to measure the consideration in a contract similarly to lessees, except for certain variable payments. See Section 3.2.1 for a discussion regarding the lessee's measurement of the consideration in the contract. From the lessor's perspective, the consideration in the contract includes variable payments that are not based on an index or a rate, provided that the payments (1) would be part of the transaction price under ASC 606, and (2) either relate specifically to the lessor's efforts to transfer, or an outcome from transferring, one or more nonlease goods or services to the lessee. Therefore, it is important for lessors to examine the nature of variable payments required under a contract to determine whether they are related specifically to a nonlease component.

Unless a lessor has elected to combine lease and nonlease components pursuant to the lessor practical expedient described in Section 3.1.6, it must allocate variable payments that relate, at least in part, to a lease component to both lease and nonlease components when the changes in facts and circumstances that trigger the variable payments occur. A lessor should recognize the portion of the payment allocated to the lease component under ASC 842, and the portion allocated to the nonlease component under other applicable accounting guidance, such as ASC 606.

A lessor should differentiate between lessor costs that are paid by the lessee directly to a third party and lessor costs that are reimbursed by the lessee. A lessor should exclude lessor costs paid by the lessee directly to a third party from variable payments and therefore from lease revenue. A lessor should also account for reimbursements of lessor costs received from the lessee as variable payments if they are excluded from the consideration in the contract.

As described in Section 3.1.4, payments made by a lessee on behalf of a lessor, or payments that reimburse a lessor for certain costs, do not represent separate components of a contract if either (a) the lessor would incur the cost regardless of whether the asset is leased and who the lessee is, or (b) the

lessor is the primary beneficiary of the payment. In some leasing arrangements, the lessor collects tax payments from the lessee and remits those amounts to the taxing authority on the lessee's behalf, or the lessee remits tax payments associated with the lease directly to the taxing authority. In these situations, a lessor must consider whether the tax payments represent amounts that the lessor would owe regardless of whether the leasing arrangement exists. In other words, the lessor should consider whether it is the primary obligor with respect to such tax payments. If the lessor determines itself to be the primary obligor for the tax payments, then it should separately present revenue and expense (that is, "gross up" its statement of comprehensive income) for the lessee's reimbursement of the lessor's costs or for the lessee's direct payment to the taxing authority on the lessor's behalf. Otherwise, the lessor should not recognize revenue or expense associated with such lessee payments.

However, a lessor may make an accounting policy election to exclude from its statement of comprehensive income taxes imposed on leasing revenue transactions by a government agency that are collected by the lessor from the lessee. Making such an election allows a lessor to forgo evaluating whether it is the primary obligor with respect to such taxes. Taxes within the scope of this election include sales tax, use tax, value-added tax, and some excise taxes. Taxes outside the scope of this election are taxes assessed on a lessor's total gross receipts, as well as taxes assessed on the lessor as the owner of the underlying asset, such as property taxes.

A lessor electing this accounting policy should exclude all taxes collected from the lessee that fall within the scope of this election from both consideration in the contract and variable payments that are not included in consideration in the contract. A lessor must disclose its accounting policy election, as discussed in Section 10.3.2.



ASC 842-10-15-39

The consideration in the contract for a lessor includes all of the amounts described in paragraph 842-10-15-35 and any other variable payment amounts that would be included in the transaction price in accordance with the guidance on variable consideration in Topic 606 on revenue from contracts with customers that specifically relates to either of the following:

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

Any variable payment amounts accounted for as consideration in the contract shall be allocated entirely to the nonlease component(s) to which the variable payment specifically relates if doing so would be consistent with the transaction price allocation objective in paragraph 606-10-32-28.

ASC 842-10-15-39A

A lessor may make an accounting policy election to exclude from the consideration in the contract and from variable payments not included in the consideration in the contract all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific lease revenue-producing transaction and collected by the lessor from a lessee (for example, sales, use, value added, and some excise taxes). Taxes assessed on a lessor's total gross receipts or on the lessor as owner of the underlying asset shall be excluded from the scope of this election. A lessor that makes this election shall exclude from the consideration in the contract and from variable payments not included in the consideration in the contract all taxes within the scope of the election and shall comply with the disclosure requirements in paragraph 842-30-50-14.

ASC 842-10-15-40

If the terms of a variable payment amount other than those in paragraph 842-10-15-35 relate to a lease component, even partially, the lessor shall not recognize those payments before the changes in facts and circumstances on which the variable payment is based occur (for example, when the lessee's sales on which the amount of the variable payment depends occur). When the changes in facts and circumstances on which the variable payment is based occur, the lessor shall allocate those payments to the lease and nonlease components of the contract. The allocation shall be on the same basis as the initial allocation of the consideration in the contract or the most recent modification not accounted for as a separate contract unless the variable payment meets the criteria in paragraph 606-10-32-40 to be allocated only to the lease component(s). Variable payment amounts allocated to the lease component(s) shall be recognized as income in profit or loss in accordance with this Topic, while variable payment amounts allocated to nonlease component(s) shall be recognized in accordance with other Topics (for example, Topic 606 on revenue from contracts with customers).

ASC 842-10-15-40A

The guidance in paragraph 842-10-15-40 notwithstanding, a lessor shall exclude from variable payments lessor costs paid by a lessee directly to a third party. However, costs excluded from the consideration in the contract that are paid by a lessor directly to a third party and are reimbursed by a lessee are considered lessor costs that shall be accounted for by the lessor as variable payments (this requirement does not preclude a lessor from making the accounting policy election in paragraph 842-10-15-39A).

**Variable payments for lessors and lessees**

Lessor leases space in its office building to Lessee. Under the lease, Lessor will also provide certain common area maintenance services, and Lessee will pay a fixed percentage of the actual maintenance costs that Lessor incurs to provide these services to all the tenants in the building. Lessor's cost of providing the service is variable; for example, one of the services provided is snow removal, which varies based on the number of snow events during the year.

Lessor and Lessee treat these variable payments differently. Lessor is required to estimate the total amount of the payments for common area maintenance services and include them in the total consideration for the lease, assuming that they relate solely to providing the common area maintenance service component of the contract, which is a nonlease component. Lessee, on the other hand, does not reflect these payments in the consideration in the contract, because the variability is not based on a rate or an index.

Example 14 in ASC 842-10-55 illustrates the distinction between variable payments that are specifically related to a nonlease component and those that are not.



Example 14—Determining the Consideration in the Contract—Variable Payments

Case A—Variable Payments That Relate to the Lease Component and the Nonlease Component

ASC 842-10-55-150

Lessee and Lessor enter into a three-year lease of equipment that includes maintenance services on the equipment throughout the three-year lease term. Lessee will pay Lessor \$100,000 per year plus an additional \$7,000 each year that the equipment is operating a minimum number of hours at a specified level of productivity (that is, the equipment is not malfunctioning or inoperable). The potential \$7,000 payment each year is variable because the payment depends on the equipment operating a minimum number of hours at a specified level of productivity. The lease is an operating lease.

ASC 842-10-55-151

In accordance with paragraph 842-10-15-35, variable payments other than those that depend on an index or a rate are not accounted for as consideration in the contract by Lessee. Therefore, the consideration in the contract to be allocated by Lessee to the equipment lease and the maintenance services at lease commencement includes only the fixed payments of \$100,000 each year (or \$300,000 in total). Lessee allocates the consideration in the contract to the equipment lease and the maintenance services on the basis of the standalone prices of each, which, for purposes of this example, are \$285,000 and \$45,000, respectively.

	Standalone Price	Relative Standalone Price
Lease	\$ 285,000	\$ 259,091
Maintenance	45,000	40,909
	<u>\$ 330,000</u>	<u>\$ 300,000</u>

Each \$100,000 annual fixed payment and each variable payment are allocated to the equipment lease and the maintenance services on the same basis as the initial allocation of the consideration in the contract (that is, 86.4 percent to the equipment lease and 13.6 percent to the maintenance services). Therefore, annual lease expense, excluding variable expense, is \$86,364. Lessee recognizes the expense related to the variable payments in accordance with paragraphs 842-20-25-6 and 842-20-55-1 through 55-2.

ASC 842-10-55-152

In accordance with paragraphs 842-10-15-39 through 15-40, Lessor also concludes that the potential variable payments should not be accounted for as consideration in the contract. That is because the potential variable payment each year is not solely related to performance of the nonlease maintenance services; the quality and condition of the underlying asset also substantively affect whether Lessor will earn those amounts. Therefore, Lessor's allocation of the consideration in the contract (\$300,000) in this Example is the same as Lessee. Lessor will allocate, in accordance with paragraph 842-10-15-40, the variable payments between the lease and nonlease maintenance services (on the same basis as the initial allocation of the consideration in the contract), when and if the productivity targets are met. Lessor will recognize the portion allocated to the lease at that time and will recognize the portion

allocated to the nonlease maintenance services in accordance with the guidance on satisfaction of performance obligations in Topic 606 on revenue from contracts with customers.

Case B—Variable Payments That Relate Specifically to a Nonlease Component

ASC 842-10-55-153

Assume the same facts and circumstances as in Case A (paragraphs 842-10-55-150 through 55-152), except in this scenario the maintenance services are highly specialized and no entity would expect the equipment to meet the performance metrics without the specialized maintenance services.

ASC 842-10-55-154

Lessee would account for the potential variable payments consistent with Case A. The rationale for this accounting also is consistent with that in Case A.

ASC 842-10-55-155

In contrast to Case A, Lessor concludes that the variable payments relate specifically to an outcome from Lessor's performance of its maintenance services. Therefore, Lessor evaluates the variable payments in accordance with the variable consideration guidance in paragraphs 606-10-32-5 through 32-13. If Lessor estimates, using the most likely amount method, that it will be entitled to receive the \$21,000 in variable payments and that it is probable that including that amount in the transaction price for the maintenance services would not result in a significant revenue reversal when the uncertainty of the performance bonus is resolved, the \$21,000 would be included in the consideration in the contract. Because allocating the \$21,000 entirely to the maintenance services would not result in an allocation that is consistent with the allocation objective in paragraph 606-10-32-28 (that is, it would result in allocating \$61,909 to the maintenance services and the remainder to the equipment lease, which would not reasonably depict the consideration to which Lessor expects to be entitled for each component), the entire consideration in the contract of \$321,000 is allocated on a relative standalone price basis as follows.

	<u>Standalone Price</u>	<u>Relative Standalone Price</u>
Lease	\$ 285,000	\$ 277,227
Maintenance	45,000	43,773
	<u>\$ 330,000</u>	<u>\$ 321,000</u>

ASC 842-10-55-156

The \$277,227 allocated to the equipment lease is the lease payment in accounting for the lease in accordance with Subtopic 842-30. Lessor will recognize the consideration in the contract allocated to the maintenance services in accordance with the guidance on the satisfaction of performance obligations in paragraphs 606-10-25-23 through 25-37. If the consideration in the contract changes (for example, because Lessor no longer estimates that it will receive the full \$21,000 in potential variable payments), Lessor will allocate the change in the transaction price on the same basis as was initially done.

Case C—Allocating Variable Payments Entirely to a Nonlease Component

ASC 842-10-55-157

Assume the same facts and circumstances as in Case B (paragraphs 842-10-55-153 through 55-156), except that in this scenario all of the following apply:

- a. The potential variable payments are \$14,000 per year (\$42,000 in total), and the annual fixed payments are \$93,000 per year (\$279,000 in total).
- b. While Lessor's estimate of the variable payments to which it will be entitled is \$42,000, Lessor concludes that it is not probable that including the full \$42,000 in potential variable payments in the consideration in the contract will not result in a significant revenue reversal (that is, the entity applies the constraint on variable consideration in paragraph 606-10-32-11). Lessor concludes that only \$28,000 is probable of not resulting in a significant revenue reversal. Therefore, the consideration in the contract is initially \$307,000 (\$279,000 + \$28,000).

ASC 842-10-55-158

In contrast to Case B, Lessor concludes that allocating the variable payments entirely to the maintenance services and the fixed payments entirely to the equipment lease is consistent with the allocation objective in paragraph 606-10-32-28. This is because \$42,000 (Lessor considers its estimate of the variable payments to which it expects to be entitled exclusive of the constraint on variable consideration in Topic 606 on revenue recognition) and \$279,000 approximate the standalone price of the maintenance services (\$45,000) and the equipment lease (\$285,000), respectively. Because the variable payments are allocated entirely to the maintenance services, if the consideration in the contract changes (for example, because Lessor concludes it is now probable that it will earn the full \$42,000 in variable payments), that change is allocated entirely to the maintenance services component in the contract.

Based on Example 14, it is our view that a lessor should include variable payments in the consideration in the contract if the lessor providing the nonlease component to the lessee is the only substantive contingency that the variable payments are based on.

In Example 14, Case A, the variable payments are excluded from the lessor's consideration in the contract because whether the equipment operates for a minimum number of hours at a specified level of productivity does not solely depend on the lessor providing maintenance services; reaching the specified performance thresholds also *substantively* depends on the quality and condition of the underlying asset.

Conversely, in Example 14, Case B, the lessor concludes that the maintenance services are so specialized that meeting the performance thresholds depends *solely* on the lessor providing those services.

Arguably, the variable payments in Case B also depend on the quality and condition of the underlying asset, but we believe that the Board's use of the term "substantively" in describing the conclusion in Case A is significant. An outcome that triggers a variable payment might be affected by many variables, but the key is which variables *substantively* affect the outcome. In Case A, both the performance of the maintenance services and the quality and condition of the asset are deemed to substantively affect whether the equipment meets the specified performance thresholds. In Case B, the maintenance services are so specialized that their performance has a relatively greater impact on whether the equipment meets the specified performance thresholds than the services in Case A. Likewise, in Case B, the quality and

condition of the underlying asset has relatively little to do with whether the performance thresholds are met. Therefore, in Case B, the only variable that substantively affects whether the thresholds are met is the performance of the maintenance services.

3.3.2 Lessor initial allocation

A lessor must allocate the consideration in the contract to the lease and nonlease components in accordance with the guidance in ASC 606-10-32-28 through 32-41, which requires allocation on a relative stand-alone selling price basis.



ASC 842-10-15-38

A lessor shall allocate (unless the lessor makes the accounting policy election in accordance with paragraph 842-10-15-42A) the consideration in the contract to the separate lease components and the nonlease components using the requirements in paragraphs 606-10-32-28 through 32-41. A lessor also shall allocate (unless the lessor makes the accounting policy election in accordance with paragraph 842-10-15-42A) any capitalized costs (for example, initial direct costs or contract costs capitalized in accordance with Subtopic 340-40 on other assets and deferred costs for contracts with customers) to the separate lease components or nonlease components to which those costs relate.

Stand-alone selling price for a lessor

A lessor determines the stand-alone selling price of the lease and nonlease components in a contract at contract inception.

Stand-alone selling price: The price at which an entity would sell a promised good or service separately to a customer.

ASC 606-10-32-31 through 32-35 describes how an entity should determine the stand-alone selling price for a promised good or service in a contract. The best evidence of the stand-alone selling price is the observable price charged by the entity to similar customers in similar circumstances. If an observable price is not available, then a lessor must estimate the stand-alone selling price, maximizing its use of observable inputs.



ASC 606-10-32-32

The standalone selling price is the price at which an entity would sell a promised good or service separately to a customer. The best evidence of a standalone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. A contractually stated price or a list price for a good or service may be (but shall not be presumed to be) the standalone selling price of that good or service.

If the stand-alone selling price is not observable because, for example, the entity does not sell the good or service separately, an entity should estimate the stand-alone selling price using all information that is reasonably available to the entity, maximizing the use of observable inputs.



ASC 606-10-32-33

If a standalone selling price is not directly observable, an entity shall estimate the standalone selling price at an amount that would result in the allocation of the transaction price meeting the allocation objective in paragraph 606-10-32-28. When estimating a standalone selling price, an entity shall consider all information (including market conditions, entity-specific factors, and information about the customer or class of customer) that is reasonably available to the entity. In doing so, an entity shall maximize the use of observable inputs and apply estimation methods consistently in similar circumstances.

As noted in paragraph BC269 of ASU 2014-09, information that is “reasonably available” to the entity may include, but is not limited to, the following items:

- Data points such as a stand-alone selling price of the good or service, costs incurred to manufacture or provide the good or service, related profit margins, published price listings, third-party or industry pricing, and the pricing of other goods or services in the same contract
- Information about market conditions such as supply and demand for the good or service in the market, competition, restrictions, and trends
- Entity-specific factors such as business pricing strategy and practices
- Information about the customer or class of customers such as type of customer, geographical region, and distribution channel

Evaluating the evidence related to estimating a stand-alone selling price may require significant judgment.

A lessor should establish policies and procedures for estimating stand-alone selling prices and apply those policies and procedures consistently to similar components. As a best practice, an entity should document its evaluation of the market conditions and entity-specific factors considered in estimating each stand-alone selling price, including factors that it considers to be irrelevant and the reasons why.

According to paragraph BC268 of ASU 2014-09, the Board decided not to preclude or prescribe any particular method for estimating the stand-alone selling price, as long as the method results in an estimate that provides a faithful representation of the price that the entity would use to separately sell the good or service to a customer. While ASC 606 does not prescribe an estimation method, it does indicate that the following methods are acceptable for estimating the stand-alone selling price when the selling price is not directly observable:

- Adjusted market assessment approach
- Expected cost-plus-a-margin approach
- Residual approach

**ASC 606-10-32-34**

Suitable methods for estimating the standalone selling price of a good or service include, but are not limited to, the following:

- a. **Adjusted market assessment approach**—An entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. That approach also might include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.
- b. **Expected cost plus a margin approach**—An entity could forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.
- c. **Residual approach**—An entity may estimate the standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract. However, an entity may use a residual approach to estimate, in accordance with paragraph 606-10-32-33, the standalone selling price of a good or service only if one of the following criteria is met:
 1. The entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (that is, the selling price is highly variable because a representative standalone selling price is not discernible from past transactions or other observable evidence).
 2. The entity has not yet established a price for that good or service, and the good or service has not previously been sold on a standalone basis (that is, the selling price is uncertain).

Adjusted market assessment approach

Under the adjusted market assessment approach, an entity evaluates the market in which it sells the goods or services and estimates the price that customers in that market would pay for those goods or services when sold separately. An entity could also look to competitor pricing information for similar goods or services and adjust that information to reflect its own costs and margins. In other words, if an entity's product differs from the competitor's product, those differences might indicate that the entity would not sell its product for the same price as its competitor.

Expected cost-plus-a-margin approach

Under the expected cost-plus-a-margin approach, an entity forecasts its expected costs to provide the good or service and adds an appropriate margin. When determining which costs to include in the selling price analysis, an entity should develop and consistently apply a methodology that considers direct and indirect costs, as well as other relevant costs considered in its normal pricing practices, such as research and development costs. Determining the margin to use when applying a cost-plus-a-margin approach requires significant judgment, particularly when the entity is not planning to separately sell a product or service. Furthermore, using an expected cost-plus-a-margin approach may not be appropriate in many circumstances, such as when direct fulfillment costs are not easily identifiable or when costs are not a significant input in setting the price for the goods or services.

Residual approach

Under the residual approach, an entity estimates the stand-alone selling price of a good or service by subtracting the sum of the observable stand-alone selling prices for other goods and services promised under the contract from the total consideration in the contract. This method is permitted only if either of the following conditions is met:

- *The selling price of the good or service is highly variable:* The entity sells the same good or service to different customers, at or near the same time, for a broad range of amounts so that a representative stand-alone price is not discernible.
- *The selling price of the good or service is uncertain:* The entity has not yet established a price for the good or service and the good or service has not been sold on a stand-alone basis.



At the crossroads: Using the residual approach

In paragraph BC273 of ASU 2014-09, the Board emphasizes that the “residual approach” under ASC 606 differs from the “residual method” used in legacy revenue GAAP.

In ASC 606, the residual approach is used to determine the stand-alone selling price of a distinct good or service. As a result, the distinct good or service cannot have a stand-alone selling price of zero because, by definition, a good or service that is distinct has value on a stand-alone basis.

In contrast, a good or service may have been assigned a value of zero under legacy GAAP, because the residual method was an allocation method. The Board noted in paragraph BC273 of ASU 2014-09 that if no, or very little, consideration is allocated to a good or service or to a bundle of goods or services as a result of applying the residual approach, the entity should consider whether the estimate is appropriate.

The table in Figure 3.2 presents examples of when it may or may not be appropriate to apply each of these methods to estimate the stand-alone selling price of a component.

Figure 3.2: When to apply select methods to estimate stand-alone selling price

Method	Description	May be appropriate	May not be appropriate
Adjusted market assessment approach	An entity looks to the relevant market to determine what a customer would pay for the good or service.	The good or service is not new to the market and sufficient data supports the market demand.	The entity is selling a new product or service.

Expected cost-plus-a-margin approach	An entity looks to entity-specific factors, such as the cost basis of the good or service.	The entity has sufficient data supporting the direct costs of providing the good or service.	The entity lacks sufficient data supporting the direct costs of providing the good or service.
Residual approach	An entity subtracts the sum of the observable stand-alone selling prices for other goods or services promised under the contract from the total consideration in the contract, to arrive at an estimated selling price for the remaining component(s).	In a contract with both (1) one or more goods or services with highly variable or uncertain stand-alone selling prices, and (2) the right to use a piece of equipment, at least one of the nonlease components has an observable stand-alone selling price.	The entity either (1) has information that can be used for the adjusted market assessment or expected cost-plus-a-margin approach, or (2) sells a component on a stand-alone basis but does not believe the price is representative of the stand-alone selling price.

Using a combination of approaches

A lessor may need to use a combination of approaches to estimate the stand-alone selling prices when two or more of the components in the contract have highly variable or uncertain stand-alone selling prices.



ASC 606-10-32-35

A combination of methods may need to be used to estimate the standalone selling prices of the goods or services promised in the contract if two or more of those goods or services have highly variable or uncertain standalone selling prices. For example, an entity may use a residual approach to estimate the aggregate standalone selling price for those promised goods or services with highly variable or uncertain standalone selling prices and then use another method to estimate the standalone selling prices of the individual goods or services relative to that estimated aggregate standalone selling price determined by the residual approach. When an entity uses a combination of methods to estimate the standalone selling price of each promised good or service in the contract, the entity shall evaluate whether allocating the transaction price at those estimated standalone selling prices would be consistent with the allocation objective in paragraph 606-10-32-28 and the guidance on estimating standalone selling prices in paragraph 606-10-32-33.

Variable payments and stand-alone selling price

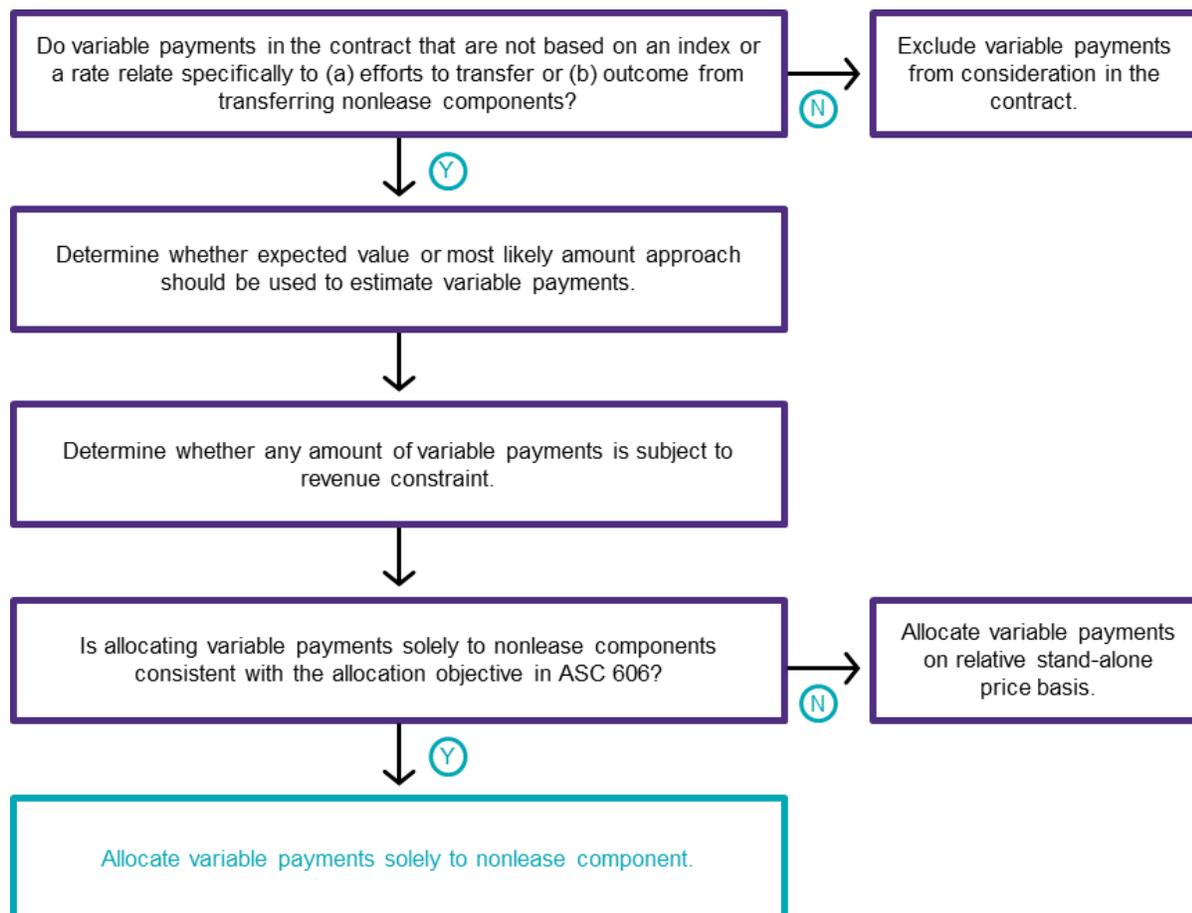
Exempted from the relative stand-alone selling price methodology are certain variable payments that specifically relate to either the lessor's efforts to transfer, or an outcome from transferring, one or more goods or services that are nonlease components of a contract. A lessor must allocate these payments entirely to the related nonlease component(s) if doing so is consistent with the allocation objective of ASC 606-10-32-28, which is to allocate consideration in a manner that depicts the amount of

consideration the lessor expects to be entitled to in exchange for transferring the nonlease component(s) to the lessee. If these payments relate partially to a lease component, then the lessor must allocate them among the lease and nonlease components based on relative standalone selling prices and recognize the portion assigned to the lease component in profit or loss in the period in which the changes in facts and circumstances on which the variable payment is based occur.

As illustrated in Example 14 in ASC 842-10-55 (see Section 3.3.1), a lessor is permitted to assess whether allocating variable payments solely to a nonlease component is consistent with the allocation objective in ASC 606 by comparing (1) the amount of consideration that would be allocated to the nonlease component if the variable payments were allocated solely to that component to (2) the component's stand-alone selling price. The larger the difference between these two amounts, the less likely it is that allocating the variable payments solely to the nonlease component would be consistent with the allocation objective in ASC 606. Although the guidance does not provide quantitative thresholds for making this determination, Case B in Example 14 illustrates a scenario where a difference between these amounts of approximately 38 percent of the stand-alone price is not consistent with the allocation objective in ASC 606. In contrast, Case C in Example 14 illustrates a scenario where a difference of approximately 7 percent of the stand-alone price is consistent with the allocation objective of ASC 606.

Figure 3.3: Lessor allocation of variable payments

The following flow chart illustrates a lessor's decision process for allocating variable payments in a contract.



Variable consideration and the constraint

The concept of the constraint on variable consideration is described in ASC 606. If an amount of consideration in a customer contract is variable, an entity evaluates whether to constrain the amount of estimated variable consideration. The objective of the constraint is for an entity to recognize revenue only to the extent it is probable that a significant reversal in cumulative revenue recognized for the contract will not occur when the uncertainty is resolved. In other words, an entity includes some or all of its estimate of variable consideration in the transaction price to the extent that it is probable that a significant revenue reversal will not occur when the uncertainty leading to the variability is resolved. For further discussion of the concept of the constraint, see Grant Thornton's *Revenue from Contracts with Customers: Navigating the guidance in ASC 606 and ASC 340-40*, (Grant Thornton's Revenue Guide) Section 5.1.1.



ASC 606-10-32-11

An entity shall include in the transaction price some or all of an amount of variable consideration estimated in accordance with paragraph 606-10-32-8 only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

Lessor allocation of consideration to 'common area maintenance'

Real estate lessors often provide common area maintenance (CAM) services to their tenants. Examples of CAM services include removing snow from a parking lot and walkways, cleaning a building lobby, and maintaining lawn and garden areas around a building.

The CAM component of a real estate lease is often subject to negotiation between the lessor and lessee. In its simplest form, a lessee in a multi-tenant real estate development pays a proportionate amount of costs incurred by the lessor for CAM services based on the relative square footage leased. For example, a lessee leasing 10 percent of the available square footage in an office building would pay 10 percent of the cost of the CAM services provided by the lessor. However, lessees and lessors often negotiate more complex formulas for calculating a tenant's share of CAM costs, and some contracts specify a fixed charge for CAM services rather than assigning a proportionate amount of costs incurred to each tenant.



Grant Thornton insights: CAM services

CAM services are typically considered a nonlease component of a contract, so a lessor must allocate consideration to the CAM component assuming the lessor has not elected, or does not qualify for, the combination practical expedient. In many cases, payments for CAM are variable based on the actual costs incurred by the lessor to provide the services, and relate specifically to the lessor's efforts to transfer those services. Therefore, a lessor may be required to (1) include the estimated CAM payments in the consideration in the contract and (2) allocate these payments solely to the nonlease CAM component.

We believe that real estate lessors must apply a consistent methodology to estimate the stand-alone selling price of each lease and nonlease component in a contract to properly apply the allocation guidance in ASC 842-10-15-38 through 15-39.

3.3.3 Lessor subsequent measurement and allocation

A lessor revisits the measurement and allocation of the remaining consideration in the contract if there is either a modification to the lease that is not accounted for as a separate contract or a change in the consideration in the contract. See Section 6.9 for a discussion of lease modifications for lessors.



ASC 842-10-15-41

A lessor shall remeasure and reallocate the remaining consideration in the contract when there is a contract modification that is not accounted for as a separate contract in accordance with paragraph 842-10-25-8.

If there is a change in the consideration in the contract other than a change resulting from a modification, the lessor should allocate the change based on the guidance in ASC 606 related to allocating changes in the transaction price.



ASC 842-10-15-42

If the consideration in the contract changes, a lessor shall allocate those changes in accordance with the requirements in paragraphs 606-10-32-42 through 32-45.

The guidance in ASC 606 states that entities should allocate changes in the transaction price to the performance obligations in the contract on the same basis used at contract inception. The guidance specifically notes that entities should not reallocate the transaction price to reflect changes in the stand-alone selling price after contract inception. Applying this guidance to leases, a lessor would not recalculate its allocation percentages for changes in the stand-alone selling prices after the lease inception date, and would allocate those changes based on its initial allocation percentages.

For example, assume that a lessor originally calculates a transaction price based on estimated variable amounts, but those estimates later change, and no other changes in the contract trigger a remeasurement. In this case, the new remaining consideration is simply allocated to the lease components based on the original allocation percentages. The lease has three components allocated 20 percent, 30 percent, and 50 percent of the total original consideration of \$100,000. If total consideration later changes to \$110,000, that change should be allocated as shown in the table below.

Component	Allocation percentage	Original allocation	Allocation after change
Component 1	20%	\$ 20,000	\$ 22,000
Component 2	30%	\$ 30,000	\$ 33,000

Component 3	50%	\$ 50,000	\$ 55,000
Total	100%	\$100,000	\$110,000



ASC 606-10-32-42

After contract inception, the transaction price can change for various reasons, including the resolution of uncertain events or other changes in circumstances that change the amount of consideration to which an entity expects to be entitled in exchange for the promised goods or services.

ASC 606-10-32-43

An entity shall allocate to the performance obligations in the contract any subsequent changes in the transaction price on the same basis as at contract inception. Consequently, an entity shall not reallocate the transaction price to reflect changes in standalone selling prices after contract inception. Amounts allocated to a satisfied performance obligation shall be recognized as revenue, or as a reduction of revenue, in the period in which the transaction price changes.

ASC 606-10-32-44

An entity shall allocate a change in the transaction price entirely to one or more, but not all, performance obligations or distinct goods or services promised in a series that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b) only if the criteria in paragraph 606-10-32-40 on allocating variable consideration are met.

ASC 606-10-32-45

An entity shall account for a change in the transaction price that arises as a result of a contract modification in accordance with paragraphs 606-10-25-10 through 25-13. However, for a change in the transaction price that occurs after a contract modification, an entity shall apply paragraphs 606-10-32-42 through 32-44 to allocate the change in the transaction price in whichever of the following ways is applicable:

- a. An entity shall allocate the change in the transaction price to the performance obligations identified in the contract before the modification if, and to the extent that, the change in the transaction price is attributable to an amount of variable consideration promised before the modification and the modification is accounted for in accordance with paragraph 606-10-25-13(a).
- b. In all other cases in which the modification was not accounted for as a separate contract in accordance with paragraph 606-10-25-12, an entity shall allocate the change in the transaction price to the performance obligations in the modified contract (that is, the performance obligations that were unsatisfied or partially unsatisfied immediately after the modification).

4. Lease classification

ASC 842 requires both lessors and lessees to determine the classification of a lease component at the commencement date of the lease. The “commencement date” is the date when the lessor makes the underlying asset available for the lessee’s use (see Section 1.1 for further discussion of the commencement date). If a contract contains multiple lease components, an entity must separately determine how to classify each individual lease component.

Under ASC 842, lessees classify a lease as either an “operating” or a “finance” lease, while lessors classify a lease as a “sales-type,” a “direct financing,” or an “operating” lease. Reassessment of lease classification is required only if either

- *For lessors and lessees:* The lease is modified and the modification is not accounted for as a separate contract.
- *For lessees only:* There is a change in either the lease term or the lessee’s assessment about whether it is reasonably certain to exercise a purchase option.



ASC 842-10-25-1

An entity shall classify each separate lease component at the commencement date. An entity shall not reassess the lease classification after the commencement date unless the contract is modified and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8. In addition, a lessee also shall reassess the lease classification after the commencement date if there is a change in the lease term or the assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset. When an entity (that is, a lessee or lessor) is required to reassess lease classification, the entity shall reassess classification of the lease on the basis of the facts and circumstances (and the modified terms and conditions, if applicable) as of the date the reassessment is required (for example, on the basis of the fair value and the remaining economic life of the underlying asset as of the date there is a change in the lease term or in the assessment of a lessee option to purchase the underlying asset, or as of the effective date of a modification not accounted for as a separate contract in accordance with paragraph 842-10-25-8).



At the crossroads: Timing of classification assessment

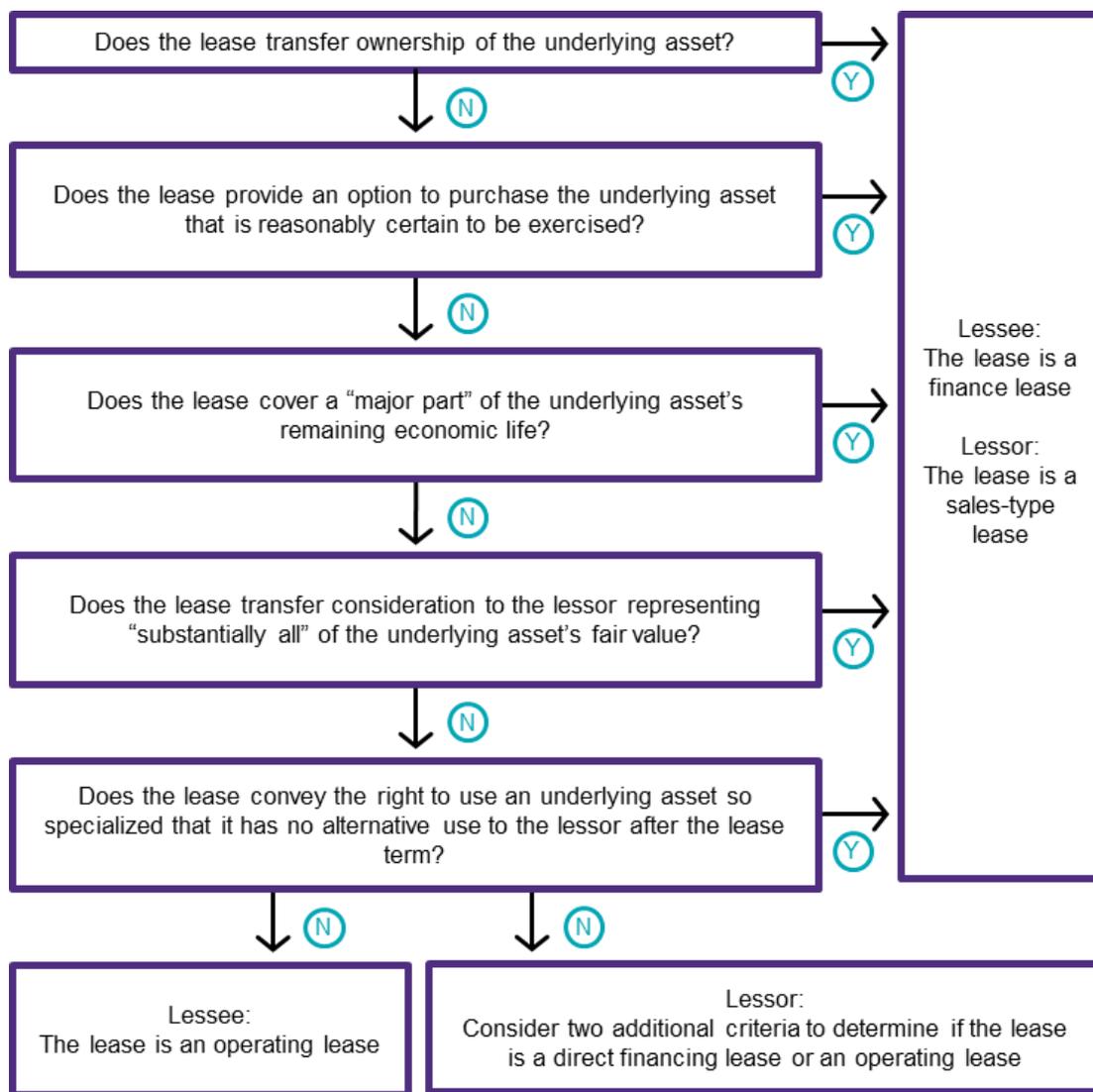
Legacy GAAP requires an entity to classify leases on the inception date of the lease. “Lease inception” is defined under legacy GAAP as the date of the lease agreement or commitment, meaning the date when a written agreement is signed by both parties, with all principal provisions negotiated. All inputs to the lease classification analysis, such as the fair value of the underlying asset, are measured at that date.

Under ASC 842, an entity assesses lease classification on the commencement date of the lease. The “commencement date” is the date when the lessor makes the underlying asset available for the lessee to use. Under ASC 842, all inputs to the lease classification analysis are measured at this date.

In many cases, the lease inception and commencement dates coincide, so that changing the classification assessment date from the inception to commencement date has no impact on the outcome upon transitioning to ASC 842. However, if the inception date precedes the commencement date, such as when an asset must be constructed before it is made available to the lessee, classifying a component at the commencement date could have a different result than if the assessment were performed at the inception date.

Figure 4.1: Lease classification

This figure illustrates the five classification criteria for a finance (lessee) or sales-type (lessor) lease.



4.1 Classification criteria – lessee and lessor

At the commencement date, an entity must consider five criteria to determine how to classify a lease. These criteria are designed to identify whether a lease is economically similar to a purchase or sale of the underlying asset. A lease that is economically similar to a sale or purchase of the underlying asset transfers to the lessee the right to direct the use of, and to obtain substantially all of the remaining benefits from, the asset. In other words, the lessee effectively controls the underlying asset. A lessor is deemed to have transferred control of the underlying asset to the lessee if the lease meets any one of the following criteria:

1. Transfers ownership of the underlying asset to the lessee.
2. Provides the lessee with an option to purchase the underlying asset that is “reasonably certain” to be exercised.
3. Covers a “major part” of the underlying asset’s remaining economic life.
4. Transfers consideration to the lessor representing “substantially all” of the underlying asset’s fair value, which is assessed based on the present value of the lease payments and the lessee’s guarantee of the underlying asset’s residual value, if any.
5. Conveys the right to use an underlying asset so specialized that it has no alternative use to the lessor following the lease term.

A lease meeting any one of these criteria is classified as a finance lease by the lessee and as a sales-type lease by the lessor. If a lease meets none of these criteria, then it is classified as an operating lease by the lessee and as either a direct financing or an operating lease by the lessor, subject to additional analysis.

Each of these criteria is examined in further detail in the following sections.



ASC 842-10-25-2

A lessee shall classify a lease as a finance lease and a lessor shall classify a lease as a sales-type lease when the lease meets any of the following criteria at lease commencement:

- a. The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- b. The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- c. The lease term is for the major part of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease.
- d. The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments in accordance with paragraph 842-10-30-5(f) equals or exceeds substantially all of the fair value of the underlying asset.
- e. The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.



At the crossroads

Lease classification criteria

Many of the lease classification criteria in ASC 842 appear similar to the lease classification criteria under legacy GAAP, but there are two major changes:

1. For the criteria that require comparing (1) the lease term to the remaining economic life of the asset and (2) the present value of lease payments to the asset's fair value, numerical thresholds have been removed.
2. A new criterion has been added relating to whether the underlying asset has an alternative use to the lessor at the end of the lease term.

Although the legacy numerical thresholds have been removed from the lease classification criteria, the guidance in ASC 842 clearly states that continuing to use the legacy numerical thresholds is a reasonable approach to applying the new lease classification criteria. The similarities between the new and legacy classification criteria allow many entities to continue using existing processes, perhaps with slight modifications, when applying the new classification guidance.

Classification of leases involving land

Under legacy GAAP, classification of a lease involving *only* land is based solely on the transfer-of-ownership and bargain-purchase criteria. Also under legacy GAAP, if a lease involves both land and building components, the classification of those components must be assessed separately only if the fair value of the land component is more than 25 percent of the fair value of both assets combined. If the building element meets either the lease term or minimum lease payments criterion, then the building element is classified by the lessee as a capital lease, and the land component as an operating lease. Otherwise, the two components are combined and accounted for as an operating lease.

In contrast, under ASC 842, both a lessee and a lessor are required to separately account for the land component of a lease unless doing so has an "insignificant" effect on the entity's accounting (see Section 3.1.1 for a discussion of this requirement).

4.1.1 Criterion 1: Transfer of ownership

When a lease specifies an automatic transfer of ownership, the lessee can direct the use of, and obtain the underlying benefit from, the asset both during and after the lease term. Meeting this criterion therefore indicates that the economic substance of the lease is akin to a sale, since the lessee effectively obtains control of the underlying asset.

This criterion is met when the lease specifies that the lessor will provide the documents necessary to legally transfer ownership of the asset to the lessee, including a bill of sale if applicable, provided that the lessee performs in accordance with the lease terms. A provision *requiring* the lessee to pay a nominal fee to the lessor when ownership of the asset is transferred does not preclude this criterion from being met. However, a provision that allows, but does not require, the lessee to pay an amount to obtain ownership of the underlying asset, regardless of whether the amount is nominal, does not constitute an automatic transfer of ownership and should instead be evaluated as an option to purchase the asset.



ASC 842-10-55-4

The criterion in paragraph 842-10-25-2(a) is met in leases that provide, upon the lessee's performance in accordance with the terms of the lease, that the lessor should execute and deliver to the lessee such documents (including, if applicable, a bill of sale) as may be required to release the underlying asset from the lease and to transfer ownership to the lessee.

ASC 842-10-55-5

The criterion in paragraph 842-10-25-2(a) also is met in situations in which the lease requires the payment by the lessee of a nominal amount (for example, the minimum fee required by the statutory regulation to transfer ownership) in connection with the transfer of ownership.

ASC 842-10-55-6

A provision in a lease that ownership of the underlying asset is not transferred to the lessee if the lessee elects not to pay the specified fee (whether nominal or otherwise) to complete the transfer is an option to purchase the underlying asset. Such a provision does not satisfy the transfer-of-ownership criterion in paragraph 842-10-25-2(a).

4.1.2 Criterion 2: Option to purchase

In the Board's view, as discussed in paragraph BC71 of ASU 2016-02, an option to purchase the underlying asset that a lessee is reasonably certain to exercise is not substantively different than a provision that automatically transfers ownership of the underlying asset from the lessor to the lessee at the end of the lease term. Therefore, like the automatic transfer-of-ownership criterion, satisfying this criterion indicates that the economic substance of the transaction is akin to a sale of the underlying asset to the lessee.

The Board intended "reasonably certain" to be a high threshold that would identify situations in which a lessee has a significant economic incentive to exercise an option. Refer to Section 1.3 for more information about the "reasonably certain" threshold.

4.1.3 Criterion 3: Lease term

The "economic life" of an asset can be expressed as either the period during which an asset is expected to be economically useful or the period that corresponds to a quantity of production (expressed in units or another relevant measure) that an asset is expected to generate. The classification guidance in ASC 842 considers coverage of the *remaining* economic life rather than the *total* economic life of an asset, as the concept of controlling the asset looks to whether the lessee can obtain the *remaining* economic benefits from using the asset. A lease term that spans the "major part" of the remaining economic life of the underlying asset indicates that a lease is economically similar to a purchase of the underlying asset, and that the lessee has the ability to obtain substantially all of the remaining economic benefits of the asset.

Economic Life: Either the period over which an asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from an asset by one or more users.

The guidance in ASC 842 precludes entities from applying the economic life criterion to classify a lease if, at the commencement date, the underlying asset is “at or near the end” of its economic life. The Board included this exception in ASC 842 because, without this exception, similar leases could be classified differently simply because they commence at different points during an asset’s economic life. For example, an asset with a 10-year total economic life could be leased to 10 different lessees, each for one year during its economic life. If the economic life criterion was applied to all 10 leases, then leases one through nine would not meet the criterion, and lease 10 would satisfy the criterion, potentially leading to different classification conclusions despite the economic similarity of all 10 leases.

Although ASC 842 does not stipulate “bright-line” thresholds for assessing what comprises the “major part” of an asset’s remaining economic life or when a lease commences “near the end” of an asset’s economic life, the implementation guidance in ASC 842-10-55-2 describes reasonable approaches that may be used in making these assessments. This guidance states that it would be reasonable to conclude that 75 percent or more of an asset’s remaining economic life comprises a “major part” of its remaining economic life. It would also be reasonable to conclude that an asset for which 25 percent or less of its economic life remains at lease commencement is “near the end” of its useful life.

The guidance in paragraph ASC 842-10-55-2 also states that it would be reasonable to conclude that 90 percent of an asset’s fair value represents “substantially all” of the asset’s fair value. The concept of “substantially all” is used in Criterion 4, as discussed in Section 4.1.4.



ASC 842-10-55-2

When determining lease classification, one reasonable approach to assessing the criteria in paragraphs 842-10-25-2(c) through (d) and 842-10-25-3(b)(1) would be to conclude:

- a. Seventy-five percent or more of the remaining economic life of the underlying asset is a major part of the remaining economic life of that underlying asset.
- b. A commencement date that falls at or near the end of the economic life of the underlying asset refers to a commencement date that falls within the last 25 percent of the total economic life of the underlying asset.
- c. Ninety percent or more of the fair value of the underlying asset amounts to substantially all the fair value of the underlying asset.



Grant Thornton insights: Judgment in lieu of bright-line thresholds

The guidance in ASC 842 does not mandate numerical thresholds and allows entities to use judgment in applying the economic life and fair value classification criteria. The guidance does suggest that certain quantitative thresholds, such as 75 percent and 25 percent of an asset’s remaining economic life and 90 percent of an asset’s fair value, are reasonable methods for applying the concepts of “major part,” “at or near the end,” and “substantially all,” respectively, as described in ASC 842’s lease classification criteria.

The Board's intent in excluding bright-line thresholds from the lease classification criteria, as discussed in paragraph BC73 of ASU 2016-02, is to ensure that transactions that are only immaterially different, such as one with a lease term comprising 74 percent of an asset's remaining economic life and one comprising 75 percent, do not end up with different accounting as a result of different classification outcomes. However, the Board also wanted to ensure that the guidance in ASC 842 is scalable for entities, meaning that entities can apply reasonable policies and controls to assess lease classification based on the size of their lease portfolios.

We believe that entities should use caution when applying judgment in this area, and should first consider how the terminology used in the lease classification criteria is already being applied in other areas of U.S. GAAP. For example, the notion of "substantially all" is referenced in other areas of U.S. GAAP and has often been thought of in terms of a 90 percent threshold. ASC 842 permits some leeway with respect to historical bright-line thresholds (for example, if the present value of the lease payments equals 91 percent of an asset's fair value, judgment could be applied in determining whether this constitutes substantially all of the asset's fair value). But, the further an entity's policy departs from historical thresholds, particularly those that relate to an entity's accounting policies outside the application of ASC 842, the more difficult we believe it will be to support that policy.

When there is more than one underlying asset included in a lease component, ASC 842-10-25-5 clarifies that the economic life attributable to the lease component should equal the economic life of the predominant asset within the lease component. In the Board's view, determining the predominant asset will be straightforward in most cases, and if it is not clear, an entity should reconsider whether the rights to use the underlying assets should be combined into a single lease component. See Section 3.1 for the guidance relevant to identifying lease components.



ASC 842-10-25-5

If a single lease component contains the right to use more than one underlying asset (see paragraphs 842-10-15-28 through 15-29), an entity shall consider the remaining economic life of the predominant asset in the lease component for purposes of applying the criterion in paragraph 842-10-25-2(c).

4.1.4 Criterion 4: Present value of lease payments and guaranteed residual value

If a lessee effectively guarantees that the lessor will recover substantially all of the underlying asset's fair value through the contractually required lease payments, then the lease is deemed to transfer control of the underlying asset from the lessor to the lessee. To make this assessment, an entity should compute both the present value of the lease payments and the present value of the residual value guaranteed by the lessee that is not already included in the lease payments. See Section 1.8 for information about determining the appropriate discount rate to use when computing these present values.

ASC 842 does not stipulate a "bright-line" threshold for assessing whether the present value of the lease payments and any lessee-guaranteed residual value represents "substantially all" of an asset's fair value, but, similarly to the economic life criterion, the implementation guidance in ASC 842-10-55-2 states that it is reasonable to conclude that an amount equal to 90 percent or more of an asset's fair value is "substantially all" of that fair value. See discussion of bright-line thresholds in Section 4.1.3.

Refer to Section 1.9 for guidance on determining the fair value of an asset.



Grant Thornton insights: 'First dollar loss' residual value guarantee

Certain leases require the lessee to guarantee the asset's residual value only up to a fixed amount. For example, a lessee leases equipment for which it guarantees a residual value of \$100,000 at the end of the lease term, but the amount the lessee will pay is capped at \$75,000. Therefore, the lessor is exposed to residual value risk only if it sells the equipment after the end of the lease term for \$25,000 or less.

Although the likelihood might be remote at lease commencement that the residual value will be less than \$25,000 when the lease expires, meaning that the lessee is effectively guaranteeing the full expected residual value of \$100,000, we believe that the contractually capped amount (in this case, \$75,000) should be used in assessing lease classification.

4.1.5 Criterion 5: No alternative use

An entity must consider whether the underlying asset is so specialized that it will have no alternative use to the lessor at the end of the lease term. If the asset has no alternative use to the lessor at the end of the lease term without the lessor incurring significant costs to rework the asset, or a significant change in circumstances during the lease term, then the lessee would consume all, or substantially all, of the asset's remaining economic benefits over the lease term and effectively control the underlying asset.

In evaluating this criterion, an entity should consider contractual restrictions and practical limitations on a lessor's ability to redirect the asset for another use after the lease term. For example, a lessor might lack the practical ability to redirect an asset for another use if, on account of the lessee's remote location, the lessor would incur significant costs to relocate the asset. Likewise, a substantive contractual term that prohibits the lessor from redirecting an asset that contains the customer's proprietary technology would indicate that the asset has no alternative use to the lessor after the lease term, regardless of whether that restriction could be lifted by terminating the contract. When assessing the impact of the terms of the contract on the lessor's ability to redirect the asset, an entity should not consider the possibility that the contract could be terminated.

In paragraph BC71(e) of ASU 2016-02, the Board notes that the no-alternative-use criterion is rarely met on its own. A contract that allows for the specialization of an asset to the point where it can be used only by the lessee often contains other provisions intended to transfer substantially all of the remaining benefits of the asset to the lessee. The Board notes that even if no alternative use is the only criterion met in a lease, the economic substance of the agreement is still akin to a sale, and therefore the lease should be accounted for as a sales-type and finance lease by the lessor and lessee, respectively.



ASC 842-10-55-7

In assessing whether an underlying asset has an alternative use to the lessor at the end of the lease term in accordance with paragraph 842-10-25-2(e), an entity should consider the effects of contractual restrictions and practical limitations on the lessor's ability to readily direct that asset for another use (for example, selling it or leasing it to an entity other than the lessee). A contractual restriction on a lessor's ability to direct an underlying asset for another use must be substantive for the asset not to have an

alternative use to the lessor. A contractual restriction is substantive if it is enforceable. A practical limitation on a lessor's ability to direct an underlying asset for another use exists if the lessor would incur significant economic losses to direct the underlying asset for another use. A significant economic loss could arise because the lessor either would incur significant costs to rework the asset or would only be able to sell or re-lease the asset at a significant loss. For example, a lessor may be practically limited from redirecting assets that either have design specifications that are unique to the lessee or that are located in remote areas. The possibility of the contract with the customer being terminated is not a relevant consideration in assessing whether the lessor would be able to readily direct the underlying asset for another use.



At the crossroads: No-alternative-use lease classification criterion

The no-alternative-use lease classification criterion is new under ASC 842. Although, as noted above, the Board expects it to be rare that this criterion is met on its own, entities will need to update their processes and controls around lease classification to incorporate this new criterion.



Lessee classification example

Lessee leases a piece of nonspecialized manufacturing equipment from Lessor. The noncancellable term is three years, with two one-year options to renew, both of which Lessee is reasonably certain to exercise. The annual lease payments start at \$50,000 at the beginning of year one, and increase each year based on the percentage increase in the consumer price index (CPI) each year.

Lessee provides a guarantee to Lessor that the residual value of the equipment will be at least \$10,000 at the end of the lease term. The lease does not transfer ownership to Lessee or provide an option for Lessee to purchase the equipment. At the lease commencement date, the remaining economic life of the equipment is seven years, and its fair value is \$265,000. Lessee cannot readily determine the rate implicit in the lease, and Lessee's incremental borrowing rate is 7 percent.

Lessee evaluates the five classification criteria as follows:

1. Does the lease transfer ownership of the underlying asset?

No, ownership of the underlying asset does not automatically transfer to Lessee.

2. Does the lease provide an option to purchase the underlying asset that is reasonably certain to be exercised?

No, the lease does not contain a purchase option.

3. Does the lease cover a "major part" of the underlying asset's remaining economic life?

No. The lease term includes the noncancellable three-year term, as well as the two one-year options that Lessee is reasonably certain to exercise. The lease term of five years represents 71 percent of the underlying asset's economic life. Lessee concludes that the lease term does not represent a "major part" of the asset's remaining economic life, as described in ASC 842-10-55-2.

4. Does the consideration transferred to Lessor represent “substantially all” of the underlying asset’s fair value?

No. The present value of the lease payments plus Lessee’s guarantee of the underlying asset’s residual value equals \$226,490, which represents 85 percent of the underlying asset’s fair value. Lessee concludes that the present value of the lease payments plus the lessee’s residual value guarantee does not represent substantially all of the underlying asset’s fair value.

The lease payments total \$250,000, based on an annual fixed payment of \$50,000. No escalation of the lease payments is assumed, since the lease payments are calculated based on the index (CPI) as of the lease commencement date (that is, if CPI doesn’t change over the lease term, then the payments do not escalate). Using Lessee’s incremental borrowing rate of 7 percent, the present value of the lease payments at lease commencement is \$219,360, and the present value of Lessee’s guarantee of the residual value (\$10,000) is \$7,130.

5. Does the lease convey the right to use an underlying asset so specialized that it has no alternative use to the lessor after the lease term?

No, the equipment is not specialized.

Lessee determines the lease should be classified as an operating lease.

4.2 Additional lessor classification criteria

When a lease meets one of the five criteria described in Section 4.1, a lessor classifies the lease as a sales-type lease. When a lease does not meet any of those criteria, a lessor must evaluate two additional criteria described in 842-10-25-3(b):

- Whether the sum of the present values of (a) the lease payments, (b) any residual value guarantee not included in the lease payments, and (c) any residual value guaranteed by third parties, either equals or exceeds substantially all of the fair value of the underlying asset
- Whether it is probable that the lessor will collect the lease payments and the residual value guarantee(s)

If both of these criteria are met, then the lessor classifies the lease as a direct financing lease. If one or both of these criteria are not met, the lessor classifies the lease as an operating lease.



ASC 842-10-25-3

When none of the criteria in paragraph 842-10-25-2 are met:

- a. A lessee shall classify the lease as an operating lease.
- b. A lessor shall classify the lease as either a direct financing lease or an operating lease. A lessor shall classify the lease as an operating lease unless both of the following criteria are met, in which case the lessor shall classify the lease as a direct financing lease:
 1. The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments in accordance with paragraph 842-

10-30-5(f) and/or any other third party unrelated to the lessor equals or exceeds substantially all of the fair value of the underlying asset

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



Grant Thornton insights: Contracts with repurchase arrangements

Under ASC 606-10-55-68, a customer does not obtain control of an asset in a sales contract that contains a repurchase right that provides the seller with an obligation or the right to repurchase the asset sold. This is because the repurchase agreement prevents the customer from fully directing the use of the asset and obtaining substantially all of its remaining economic benefits. In certain cases, a seller is required to account for a contract with a customer that contains a repurchase right as a lease under ASC 842. (See Section 6.6.2 for more information about contracts with repurchase rights.)

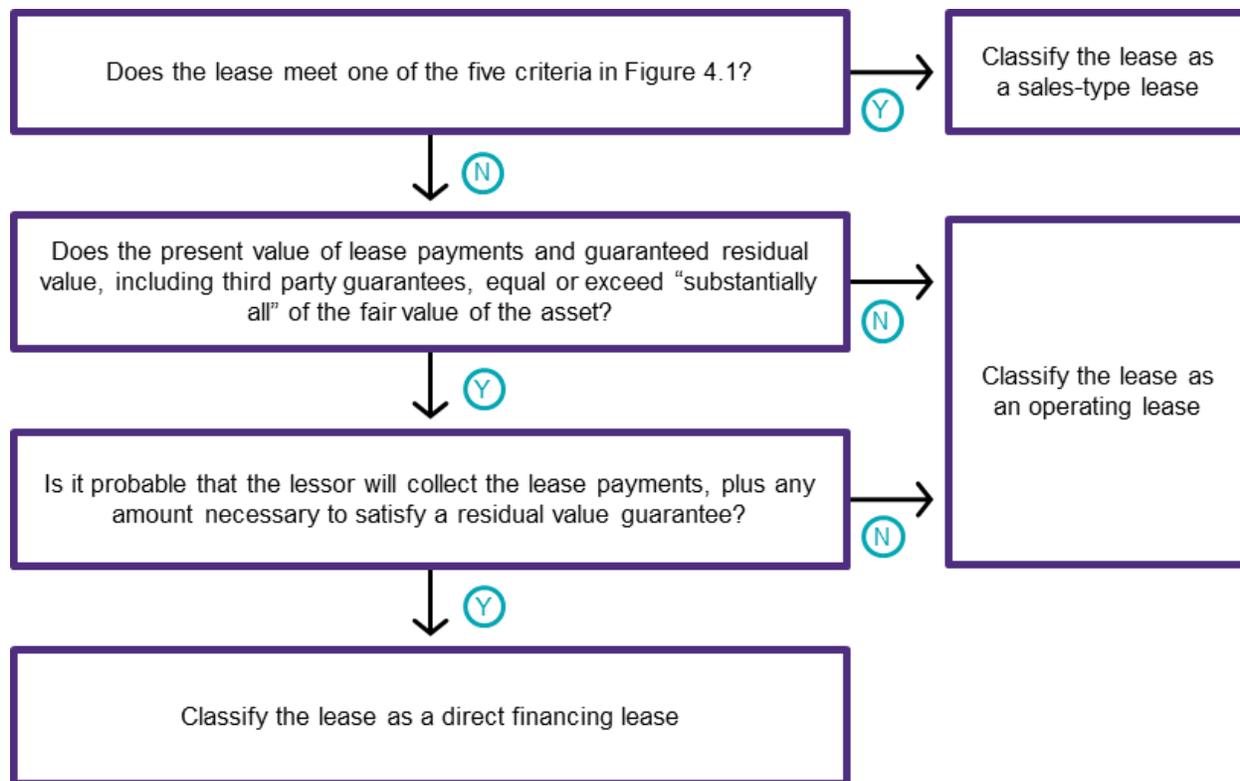
Contracts with customers that require lease accounting due to repurchase rights generally meet at least one of the five sales-type lease criteria. Therefore, even though a sale would not be recognized under ASC 606, a sales-type lease may be recognized under ASC 842.

For example, if the seller has the right, but not the obligation, to repurchase an asset, the lease term could be viewed as perpetual since the lessor's option to terminate the lease is not reflected in the lease term. Therefore, the lease term would cover a "major part" of the asset's remaining economic life.

Also, if the present value of the consideration paid by the customer approximates an asset's fair value, which is often the case in a contract with a customer, then the present value of the lease payments would equal or exceed substantially all of the asset's fair value.

Figure 4.2: Lessor classification

This figure illustrates the two additional criteria that a lessor must consider to determine whether a lease is classified as a direct financing or operating lease.



4.2.1 Present value of lease payments and guaranteed residual value

To distinguish between a direct financing lease and an operating lease, a lessor must essentially perform the same present value calculation required to assess whether the lease is a sales-type lease, except that the present value includes residual guarantees provided by parties other than the lessee, in addition to the present value of any lessee-guaranteed residual value.

The objective of the direct financing lease criteria is to identify contracts in which the lessor's risk is converted from *asset risk* (the risk inherent in owning an asset, which the lessor retains in an operating lease) to *credit risk* (the risk inherent in financing another entity's purchase of an asset). Accordingly, the lessor's efforts to offload asset risk to parties other than the lessee via a residual value guarantee must be considered as part of this analysis. If the sum of the present value of the lease payments and all residual value guarantees is not greater than or equal to substantially all of the asset's fair value, then the lessor must classify the lease as an operating lease.

4.2.2 Collectibility

A lessor must consider the collectibility of lease payments when assessing whether a lease is a direct financing lease. If it is not probable that the lessor will collect the lease payments plus any amount needed to satisfy a residual value guarantee, then the lessor's conversion of asset risk to credit risk is nonsubstantive. If collectibility is not probable, it would be inappropriate to classify the lease as a direct financing lease, and the lessor must instead classify the lease as an operating lease.



At the crossroads

Collectibility and lessor classification

Under legacy GAAP, if collectibility of the lease payments is not probable, then the lessor defaults to operating lease accounting. Under ASC 842, collectibility is evaluated differently depending on whether the lease meets any of the criteria for classification as a sales-type lease. Since the accounting for a sales-type lease is aligned with the accounting for sales to customers under ASC 606, the lessor must recognize any cash received from the lessee as a deposit liability if collectibility of the lease payments and lessee residual value guarantee is not probable in a sales-type lease. On the other hand, a direct financing lease is unlike a sale of an underlying asset, so there was no need for the Board to align the accounting for a direct financing lease with the revenue recognition guidance in ASC 606. Accordingly, if collectibility is not probable in a non-sales-type lease, then the lessor must apply operating lease accounting, similar to the legacy classification guidance under ASC 840.

Important uncertainties and lessor classification

Under legacy GAAP, a lessor classifies a lease as an operating lease if the lease includes important uncertainties related to the amount of unreimbursable costs incurred by the lessor. “Important uncertainties” include guarantees beyond a typical product warranty, such as committing to repair equipment throughout a three-year lease term when the standard warranty for the equipment covers only one year, or protection against an asset’s obsolescence.

ASC 842 does not carry forward a similar requirement with respect to “important uncertainties.” Therefore, leases that would have qualified as sales-type leases under ASC 840, except for the existence of important uncertainties, may now qualify as sales-type leases under ASC 842.



Lessor classification example

Lessor leases a piece of nonspecialized manufacturing equipment to Lessee. The noncancellable term is three years, with two one-year options to renew, both of which Lessor is reasonably certain Lessee will exercise. The annual lease payments start at \$50,000 at the beginning of year one, and increase each year based on the percentage increase in the consumer price index (CPI) each year.

Lessee guarantees Lessor that the residual value of the equipment will be at least \$10,000 at the end of the lease term. In addition, a third party guarantees to Lessor that the residual value of the equipment will be at least \$25,000 at the end of the lease term. For example, if the equipment is sold for \$18,000 at the end of the lease term, then Lessee would owe nothing under its residual value guarantee, and the third-party guarantor would owe Lessor \$7,000. If the equipment is sold for \$8,000 at the end of the lease term, then Lessee would owe \$2,000 under its residual value guarantee, and the third party guarantor would owe Lessor \$15,000.

The lease does not transfer ownership to Lessee or provide an option for Lessee to purchase the equipment. At the lease commencement date, the remaining economic life of the equipment is seven years, and its fair value is \$265,000. The rate implicit in the lease is 6 percent.

Lessor evaluates the five classification criteria as follows:

1. Does the lease transfer ownership of the underlying asset?

No, ownership of the underlying asset does not automatically transfer to Lessee.

2. Does the lease provide an option to purchase the underlying asset that is reasonably certain to be exercised?

No, the lease does not contain a purchase option.

3. Does the lease cover a “major part” of the underlying asset’s remaining economic life?

No. The lease term includes the noncancellable three-year term, as well as the two one-year options that Lessor is reasonably certain will be exercised. The lease term of five years represents 71 percent of the underlying asset’s economic life. Lessor concludes that the lease term does not represent a major part of the asset’s remaining economic life.

4. Does the consideration transferred to Lessor represent “substantially all” of the underlying asset’s fair value?

No. The present value of the lease payments plus Lessee’s guarantee of the underlying asset’s residual value equals \$230,728, which represents 87 percent of the underlying asset’s fair value. Lessor concludes that the present value of the lease payments plus the lessee’s residual value guarantee does not represent substantially all of the underlying asset’s fair value.

The lease payments total \$250,000, based on an annual fixed payment of \$50,000. No escalation of the lease payments is assumed, since the lease payments are calculated based on the index (CPI) as of the lease commencement date (that is, if CPI doesn’t change over the lease term, then the payments do not escalate). Using the rate of 6 percent implicit in the lease, the present value of the lease payments at lease commencement is \$223,255, and the present value of Lessee’s guarantee of the residual value (\$10,000) is \$7,473. I

5. Does the lease convey the right to use an underlying asset so specialized that it has no alternative use to the lessor after the lease term?

No, the equipment is not specialized.

Lessor determines the lease should not be classified as a sales-type lease.

Lessor next applies the two lessor-specific classification criteria to complete its classification analysis:

1. Does the combined present value of the lease payments plus the guaranteed residual value, including third-party guarantees, equal or exceed “substantially all” of the fair value of the underlying asset?

Yes. The present value of the lease payments plus all guarantees of the underlying asset’s residual value equals \$241,937, which represents 91 percent of the underlying asset’s fair value. Lessor concludes that the present value of the lease payments plus all guarantees of the underlying asset’s residual value represents substantially all of the underlying asset’s fair value.

The lease payments total \$250,000, based on an annual fixed payment of \$50,000. No escalation of the lease payments is assumed, since the lease payments are calculated based on the index (CPI) as of the lease commencement date (that is, if CPI doesn’t change over the lease term, then the payments do not escalate). Using the rate of 6 percent implicit in the lease, the present value of the lease payments at lease commencement is \$223,255, the present value of Lessee’s guarantee of

the residual value (\$10,000) is \$7,473, and the present value of the third-party guarantee of the residual value (\$15,000) is \$11,209.

2. Is it probable that Lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee?

Yes. Lessor assesses the creditworthiness of Lessee and the third-party guarantor, and deems it probable that it will collect the lease payments and residual value guarantees.

Lessor determines that the lease should be classified as a direct financing lease.

4.3 Other classification matters

ASC 842-10 contains additional guidance for reassessing lease classification, classifying related-party leases, lessee indemnification for environmental contamination, classification for leases of assets owned by a governmental unit or authority, and leases acquired in a business combination. These items are discussed in further detail in this section.

4.3.1 Reassessment of lease classification

Once a lease has been classified at lease commencement, its classification should be reassessed only under certain circumstances. For both lessors and lessees, if the lease is modified and that modification is not treated as a separate contract, then lease classification is reassessed as of the modification date. Lessees should also reassess the classification of a lease if either the lease term or its assessment of whether it is reasonably certain to exercise a purchase option changes. Other changes in circumstances do not warrant a classification reassessment, including a change in whether an underlying asset has no alternative use to the lessor at the end of the lease term or a change in a lessor's assessment of the collectibility of lease payments for reasons other than a contract modification.

When lease classification is reassessed, all inputs to the assessment must be updated as of the reassessment date. The reassessment date is the date of the execution of the lease amendment, if the reassessment is due to a modification of the lease. If there is a change in the likelihood that a lessee will exercise an option to extend or terminate a lease or an option to purchase the underlying asset, then the reassessment date is the date when this change is deemed to occur. Inputs to the reclassification assessment, including discount rate, fair value and expected life of the underlying asset, lease payments, and variable payments dependent on an index or rate, are all determined as of the reassessment date. Any other changes in the terms and conditions of the lease, or in the underlying facts and circumstances, should be considered by the entity in the classification reassessment.



ASC 842-10-25-9

If a lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8, the entity shall reassess the classification of the lease in accordance with paragraph 842-10-25-1 as of the effective date of the modification.

4.3.2 Related-party lease classification

The guidance in ASC 842-10-55 specifies that related-party leases should be evaluated using the same criteria used for leases between unrelated parties and should be classified based on legally enforceable

terms and conditions in the lease. The definition of “related parties” used in ASC 842 is the same definition used elsewhere in the Codification.



ASC 842-10-55-12

Leases between related parties should be classified in accordance with the lease classification criteria applicable to all other leases on the basis of the legally enforceable terms and conditions of the lease. In the separate financial statements of the related parties, the classification and accounting for the leases should be the same as for leases between unrelated parties.

Related Parties: Related parties include:

- a. Affiliates of the entity
- b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity
- c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
- d. Principal owners of the entity and members of their immediate families
- e. Management of the entity and members of their immediate families
- f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests
- g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.



Grant Thornton insights: Common control leases

The guidance in ASC 842-10-55-12 addresses the classification and accounting for leases between related parties, focusing on “legally enforceable terms and conditions of the lease.” Among related-party leases, leases between entities under common control often have less formal documentation of terms and conditions, which will challenge practitioners to determine what are the legally enforceable terms and conditions in these arrangements.

To identify the legally enforceable terms and conditions in related-party leases, an entity should first look to the written lease agreement, provided that a written agreement exists. If a related-party lease is documented in the same manner as leases containing similar assets with unrelated parties, and if the

terms and conditions of the agreement are legally enforceable, then the entity should analyze the lease similarly to its unrelated-party leases. However, if the facts and circumstances surrounding a related-party lease differ from leases involving similar assets with unrelated parties (such as the installation of long-term fixed assets in a space leased for less than one year) or if there is limited or no written documentation of the terms and conditions, then the entity should endeavor to understand the enforceable rights and obligations regarding the use of the underlying asset, taking into consideration the customary business practices between the parties. An entity may need to obtain input from legal counsel to understand the enforceability of any terms, conditions, and mutual understanding, whether or not they are documented. Once the legally enforceable terms and conditions are identified, the entity should base its lease assessment on those terms and conditions.



At the crossroads: Related-party leases

The guidance in ASC 842-10-55-12 requires entities to determine the classification of a related-party lease based on “legally enforceable terms and conditions,” which represents a departure from legacy GAAP where the objective is “to recognize economic substance rather than legal form.” This difference may result in a change in the way entities evaluate these leases, especially for those between entities under common control.

4.3.3 Lessee indemnification for environmental contamination

When a lease contains a provision that requires the lessee to indemnify the lessor for environmental contamination, whether preexisting or caused by the lessee’s use of the underlying asset during the lease term, that provision should *not* be considered when determining how to classify the lease. In other words, a lessor should not include any payments expected to be made by the lessee to satisfy an environmental contamination indemnification in the lease payments for purposes of determining whether the present value classification criterion is met.



ASC 842-10-55-15

A provision that requires lessee indemnification for environmental contamination, whether for environmental contamination caused by the lessee during its use of the underlying asset over the lease term or for preexisting environmental contamination, should not affect the classification of the lease.

4.3.4 Leases involving facilities owned by a government unit or authority

ASC 842 provides additional guidance for leases involving government owned-facilities, such as airports, bus terminals, and ports. These leases can be difficult to assess, as the remaining economic life and the fair value of the underlying asset is often difficult to determine. In these cases, if determining the fair value or remaining economic life is impractical, and if there is no automatic transfer of ownership or purchase option that the lessee is reasonably certain to exercise, then the lease should be classified as an operating lease.

There are six criteria that must all be met for a lease to be eligible for this guidance:

1. The underlying asset is owned by a governmental unit or authority.
2. The underlying asset is part of a larger facility operated on behalf of the lessor.
3. The underlying asset is a permanent structure that normally cannot be moved to a new location.
4. The lessor has the explicit right under the lease agreement or the applicable law to terminate the lease at any time during the lease term.
5. The lease neither transfers ownership nor allows the lessee to purchase or otherwise acquire ownership of the underlying asset.
6. The underlying asset or equivalent cannot be purchased or leased from a nongovernment unit or authority.

Leases not meeting these criteria are classified based on the five general classification criteria outlined in ASC 842-10-25-2.



ASC 842-10-55-13

Because of special provisions normally present in leases involving terminal space and other airport facilities owned by a governmental unit or authority, the economic life of such facilities for purposes of classifying a lease is essentially indeterminate. Likewise, it may not be practicable to determine the fair value of the underlying asset. If it is impracticable to determine the fair value of the underlying asset and such leases also do not provide for a transfer of ownership or a purchase option that the lessee is reasonably certain to exercise, they should be classified as operating leases. This guidance also applies to leases of other facilities owned by a governmental unit or authority in which the rights of the parties are essentially the same as in a lease of airport facilities. Examples of such leases may be those involving facilities at ports and bus terminals. The guidance in this paragraph is intended to apply to leases only if all of the following conditions are met:

- a. The underlying asset is owned by a governmental unit or authority.
- b. The underlying asset is part of a larger facility, such as an airport, operated by or on behalf of the lessor.
- c. The underlying asset is a permanent structure or a part of a permanent structure, such as a building, that normally could not be moved to a new location.
- d. The lessor, or in some circumstances a higher governmental authority, has the explicit right under the lease agreement or existing statutes or regulations applicable to the underlying asset to terminate the lease at any time during the lease term, such as by closing the facility containing the underlying asset or by taking possession of the facility.
- e. The lease neither transfers ownership of the underlying asset to the lessee nor allows the lessee to purchase or otherwise acquire ownership of the underlying asset.
- f. The underlying asset or equivalent asset in the same service area cannot be purchased or leased from a nongovernmental unit or authority. An equivalent asset in the same service area is an asset that would allow continuation of essentially the same service or activity as afforded by the underlying asset without any appreciable difference in economic results to the lessee.

ASC 842-10-55-14

Leases of underlying assets not meeting all of the conditions in paragraph 842-10-55-13 are subject to the same criteria for classifying leases under this Subtopic that are applicable to leases not involving government-owned property.

4.3.5 Leases acquired in a business combination

An entity that acquires a lease in a business combination should maintain the acquiree's lease classification, as determined based on the classification guidance in ASC 842. The acquirer should revisit the acquiree's original classification only if there is a lease modification in connection with the business combination that is not accounted for as a separate contract.

Although the classification of a lease acquired in a business combination is not reassessed, the acquired lease is measured at the acquisition date as if it were a new lease. In order to measure the lease, the acquirer must assess all of the following at the acquisition date:

- The lease term
- Options to purchase the underlying asset
- Lease payments, including amounts probable of being owed by the lessee under a residual value guarantee
- The discount rate

As discussed in paragraph BC415 of ASU 2016-02, for an acquiree that is a lessee, the lease liability is measured on the acquisition date at the present value of the remaining lease payments. An acquiree's right-of-use asset is measured at the amount of the lease liability adjusted for any off-market terms in the lease. Under ASC 805, only amounts that represent an asset or a liability are recorded in a business combination, and therefore prepaid or accrued rent are not recognized since they do not meet the definition of an asset or liability. However, the timing of lease payments could affect the determination of whether a lease is above or below market at the acquisition date. For example, a significant prepaid rent balance at the acquiree might indicate that the lease is below market (favorable) from the lessee's perspective at the acquisition date, based on the remaining lease payments.

**ASC 842-10-55-11**

In a business combination or an acquisition by a not-for-profit entity, the acquiring entity should retain the previous lease classification in accordance with this Subtopic unless there is a lease modification and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8.

5. Lessee accounting

5.1 General

Under ASC 842, lessees recognize most leases at the lease commencement date by recording a right-of-use asset and a lease liability on the statement of financial position. The right-of-use asset represents the lessee's right to use the asset, and the lease liability represents the lessee's obligation to make lease payments, over the lease term. Refer to Section 1.1 for information about determining the commencement date of the lease.



ASC 842-20-25-1

At the commencement date, a lessee shall recognize a right-of-use asset and a lease liability.

Right-of-Use Asset: An asset that represents a lessee's right to use an underlying asset for the lease term.

Lease Liability: A lessee's obligation to make the lease payments arising from a lease, measured on a discounted basis.

5.1.1 Short-term leases

Lessees may elect an accounting policy that allows them to forgo applying the recognition requirements in ASC 842 to short-term leases. A similar election is not available for lessors. A "short-term" lease is defined as a lease that, at commencement, (1) has a lease term of 12 months or less, and (2) does not contain an option to purchase the underlying asset that the lessee is reasonably certain to exercise. The lease term includes the noncancellable period; any periods subject to renewal or termination options that the lessee is reasonably certain to exercise or not to exercise, respectively; and any periods covered by lessor options to either extend or terminate the lease. As a result, a short-term lease is not required to have a maximum possible lease term of 12 months or less, and the existence of options to extend the lease term beyond 12 months from the lease commencement date does not preclude the lease from being a short-term lease if a lessee elects this accounting policy, as long as the lessee is not reasonably certain to exercise those options.

A lessee that designates a lease as "short-term" at the commencement date must reevaluate this conclusion any time there is a change in the lease term. A lease that does not meet the definition of a short-term lease at the commencement date cannot be subsequently accounted for as a short-term lease. For example, if a lease with an original term of five years has less than 12 months remaining as of the reporting date, the lessee may not elect to apply short-term lease accounting to that lease as of the reporting date.

Short-Term Lease: A lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

In paragraph BC381 of ASU 2016-02, the Board acknowledges that a potentially long-term lease could be structured to obtain short-term treatment. For example, a lease with a one-year noncancellable period that offers nine one-year renewal options could ultimately be extended for 10 years without ever being recognized on the lessee's statement of financial position. However, significant economic disincentives for both the lessee and lessor make it unlikely that many leases would be structured in such a way. In addition, it would be increasingly difficult to support that a lessee is not reasonably certain to exercise a renewal option after each successive renewal, which would likely lead to the lease ultimately being recorded on the lessee's statement of financial position.

A lessee that elects the short-term lease recognition exemption does not measure and record a right-of-use asset and a lease liability for short-term leases. Instead, the lessee recognizes the lease payments on a straight-line basis over the lease term and variable payments in the period when the corresponding obligation is incurred. A lessee is permitted to elect the short-term lease recognition exemption by asset class. For example, a lessee can apply the short-term lease recognition exemption to its equipment leases but not to its real estate leases, or vice versa. Although this election exempts a lessee from applying the recognition and measurement guidance in ASC 842 to short-term leases, it is nevertheless required to provide additional disclosures about its short-term leases.



ASC 842-20-25-2

As an accounting policy, a lessee may elect not to apply the recognition requirements in this Subtopic to short-term leases. Instead, a lessee may recognize the lease payments in profit or loss on a straight-line basis over the lease term and variable lease payments in the period in which the obligation for those payments is incurred (consistent with paragraphs 842-20-55-1 through 55-2). The accounting policy election for short-term leases shall be made by class of underlying asset to which the right of use relates.

Example 1 in ASC 842-20-55 shows how a lessee determines the lease term when applying the short-term lease recognition exemption.



Example 1 – Short-Term Lease

ASC 842-20-55-14

Lessee has made an accounting policy election not to recognize right-of-use assets and lease liabilities that arise from short-term leases for any class of underlying asset.

ASC 842-20-55-15

Lessee enters into a 12-month lease of a vehicle, with an option to extend for another 12 months. Lessee has considered all relevant factors and determined that it is not reasonably certain to exercise the option to extend. Because at lease commencement Lessee is not reasonably certain to exercise the option to extend, the lease term is 12 months.

ASC 842-20-55-16

The lease meets the definition of a short-term lease because the lease term is 12 months or less. Consequently, consistent with Lessee's accounting policy election, Lessee does not recognize the right-of-use asset and the lease liability arising from this lease.

A lessee must reconsider whether the short-term lease exemption still applies if there is a change in either the lease term or the likelihood that it will exercise a purchase option after the lessee initially applies the short-term lease exemption to a contract. If the change causes the lease term to extend more than 12 months beyond the end of the previous lease term, or if it becomes reasonably certain that the lessee will exercise a purchase option, the lessee must discontinue applying the short-term lease recognition exemption to that contract. Instead, the lessee must measure, classify, and recognize the lease under the general guidance in ASC 842 as of the date when either the lease term or the likelihood that it will exercise a purchase option changes.



ASC 842-20-25-3

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



Grant Thornton insights: Short-term leases with a nonconsecutive period of use

A lease may contain the right to use an asset for nonconsecutive periods over the contract term, such as a multiyear lease of seasonal retail space.

The definition of a "short-term" lease is a lease with a lease term of fewer than 12 months and without a purchase option that the lessee is reasonably certain to exercise. "Lease term" is defined as the sum of the periods, including nonconsecutive periods, during which the lessee has the right to use the underlying asset. Note that the definition of a short-term lease does not refer to the length of the *contract* term, but only the *lease* term. Therefore, we believe that a lease with a contract term of more than 12 months, but a lease term of fewer than 12 months, meets the definition of a short-term lease and that a lessee can apply the short-term lease exemption to this type of lease.

For example, Lessee enters into a three-year contract with Lessor to use retail space for three months each year during the holiday season. During the nine months of each year when Lessee is not using the retail space, Lessor may lease the space to other tenants. The contract term in this example is three years, but the period of use (and the lease term) is only nine months, which is the sum of the

nonconsecutive periods during which Lessee has the right to use the underlying asset during the term of the contract. This lease would qualify as a short-term lease, and Lessee may account for it off of the statement of financial position if it elects the short-term lease recognition exemption for the class of underlying assets that includes retail space.

5.2 Initial measurement

At the commencement date of the lease, a lessee measures and records a right-of-use asset and a lease liability. A lessee initially measures the right-of-use asset and lease liability in the same manner whether the lease is classified as an operating or a finance lease. However, the subsequent measurement and expense recognition patterns differ between the two lease classifications.

The table in Figure 5.1 below summarizes the initial measurement of the right-of-use asset and lease liability for lessees.

Figure 5.1: Initial measurement of right-of-use asset and lease liability

Right-of-use asset	Lease liability
Lease liability	Present value of lease payments
+ Payments made at or before commencement	
- Lease incentives received at or before commencement	
+ Initial direct costs	

5.2.1 Initial measurement of the lease liability

At the commencement date of the lease, a lessee initially measures the lease liability at the present value of the remaining lease payments. Lease payments include the following items:

- Fixed payments and in-substance fixed payments, less lease incentives paid or payable
- Variable payments that depend on a rate or an index
- The exercise price of a purchase option that is reasonably certain to be exercised
- The amount of any termination penalty if the lease term assumes the termination option will be exercised
- Structuring fees paid to special-purpose entity owners
- Amounts that the lessee is probable to owe under a residual value guarantee

The discount rate used in calculating the present value of the lease payments should be the rate implicit in the lease, if readily determinable, or the lessee's incremental borrowing rate if the rate implicit in the lease is not readily determinable. Nonpublic entities also have the option to use a risk-free rate as the

discount rate. Refer to Section 1.4 for details about lease payments and Section 1.8 for details about discount rates.



ASC 842-20-30-1

At the commencement date, a lessee shall measure both of the following:

- a. The lease liability at the present value of the lease payments not yet paid, discounted using the discount rate for the lease at lease commencement (as described in paragraphs 842-20-30-2 through 30-4)
- b. The right-of-use asset as described in paragraph 842-20-30-5.

5.2.2 Initial measurement of the right-of-use asset

The right-of-use asset is initially measured at the commencement date of the lease. To measure the right-of-use asset, a lessee takes the initial measurement of the lease liability and then (1) adds lease payments made at or before the commencement date, (2) subtracts lease incentives received from the lessor at or before the commencement date, and (3) adds any initial direct costs incurred by the lessee.



ASC 842-20-30-5

At the commencement date, the cost of the right-of-use asset shall consist of all of the following:

- a. The amount of the initial measurement of the lease liability
- b. Any lease payments made to the lessor at or before the commencement date, minus any lease incentives received
- c. Any initial direct costs incurred by the lessee (as described in paragraphs 842-10-30-9 through 30-10).

In paragraph BC220 of ASU 2016-02, the Board explains that it chose a cost-based measurement approach for the right-of-use asset, rather than a fair value approach, to enhance comparability between right-of-use assets and other nonfinancial assets, such as property, plant, and equipment, that are also measured on a cost basis.



Grant Thornton insights: Capitalization thresholds for operating leases

In paragraph BC122 of ASU 2016-02, the Board notes that entities will likely be able to adopt reasonable capitalization thresholds for determining which right-of-use assets and lease liabilities should be recognized. The Board observed that the practice of applying a capitalization threshold for leases may be consistent with an entity's accounting policies in other areas of GAAP, such as accounting for purchases of property, plant, and equipment.

We believe that a lessee should consider all relevant quantitative and qualitative factors impacting the financial statements and related disclosures before applying a capitalization threshold to right-of-use

assets and lease liabilities. A lessee should consider the impact of using a capitalization threshold on each financial statement line item, subtotals and totals, and disclosures, as well as on calculations that depend on amounts reported in the financial statements, such as loan covenants and commonly used financial ratios.

A lessee should separately evaluate the gross impact of omitting right-of-use assets and lease liabilities below a threshold in the financial statements, rather than evaluating the net balance-sheet effect. In our view, it would not be appropriate for a lessee to simply apply its current capitalization threshold for property, plant, and equipment to its right-of-use assets and lease liabilities without further analysis.



Lessee initial recognition

Lessee leases a machine to be used in its manufacturing facility. The lease term is five years, with no option to renew the lease or to purchase the underlying asset. Lease payments are fixed at \$50,000 due at the beginning of each year. Lessee incurs \$5,000 of initial direct costs, and receives a \$3,000 cash lease incentive from Lessor at the lease commencement date. Lessee cannot readily determine the rate implicit in the lease, and will use its incremental borrowing rate of 6 percent as the discount rate for purposes of calculating the lease liability.

Lessee measures the initial lease liability at \$223,255, which represents the present value of the \$50,000 annual payments over five years, discounted at 6 percent. Lessee measures the right-of-use asset at \$225,255, which is equal to the lease liability adjusted for lease incentives received and initial direct costs incurred ($\$223,255 - \$3,000 + \$5,000$).

Lessee's journal entry to initially record the lease is as follows (shown on a gross basis for illustrative purposes):

Dr. Right-of-use asset	\$223,255
Cr. Lease liability	\$223,255
Dr. Cash (incentive)	\$ 3,000
Cr. Right-of-use asset	\$ 3,000
Dr. Right-of-use asset	\$ 5,000
Cr. Cash (initial direct costs)	\$ 5,000



At the crossroads: Capping the initial measurement of the right-of-use asset

Under legacy GAAP, a lessee is required to recognize a capital lease asset and liability at the lower of the present value of the minimum lease payments or the fair value of the underlying asset at lease inception. ASC 842 does not include a similar requirement. As a result, it is possible, although improbable, that a right-of-use asset could be initially measured at an amount greater than the fair value of the underlying asset. If such circumstances arise, an entity should ensure that it has used the

appropriate discount rate to compute the present value of lease payments, and consider whether a triggering event has occurred that would require assessment of the right-of-use asset for impairment under ASC 360-10.

5.3 Finance lease subsequent measurement

For finance leases, a lessee must adjust the lease liability each period by increasing the liability to reflect interest expense recognized, and reducing the liability for any lease payments made, during each period.

The right-of-use asset in a finance lease is measured each period at cost, less accumulated amortization and, if applicable, impairment.

Both the liability and the right-of-use asset are subject to the remeasurement considerations in ASC 842-10-35-1 through 35-5, which are discussed in Section 5.8.



ASC 842-20-35-1

After the commencement date, for a finance lease, a lessee shall measure both of the following:

- a. The lease liability by increasing the carrying amount to reflect interest on the lease liability and reducing the carrying amount to reflect the lease payments made during the period. The lessee shall determine the interest on the lease liability in each period during the lease term as the amount that produces a constant periodic discount rate on the remaining balance of the liability, taking into consideration the reassessment requirements in paragraphs 842-10-35-1 through 35-5.
- b. The right-of-use asset at cost less any accumulated amortization and any accumulated impairment losses, taking into consideration the reassessment requirements in paragraphs 842-10-35-1 through 35-5.

A lessee amortizes the right-of-use asset in a finance lease from the commencement date of the lease to the earlier of (a) the end of the useful life of the right-of-use asset or (b) the end of the lease term. If the lease transfers ownership or contains an option to purchase the underlying asset that the lessee is reasonably certain to exercise, the right-of-use asset should be amortized over the useful life of the underlying asset.

Amortization of the right-of-use asset should be recognized on a straight-line basis, unless another systematic basis is more representative of the pattern in which the lessee expects to consume the asset's future economic benefits.

If the lease liability is remeasured due to changes in payments or other events, as discussed in Section 5.8, the right-of-use asset is likewise adjusted. After the adjustment, the amortization of the right-of-use asset is adjusted prospectively from the date of remeasurement to reflect a straight-line (or other systematic) amortization pattern of the right-of-use asset.



Amortization of the Right-of-Use Asset for a Finance Lease

ASC 842-20-35-7

A lessee shall amortize the right-of-use asset on a straight-line basis, unless another systematic basis is more representative of the pattern in which the lessee expects to consume the right-of-use asset's future economic benefits. When the lease liability is remeasured and the right-of-use asset is adjusted in accordance with paragraph 842-20-35-4, amortization of the right-of-use asset shall be adjusted prospectively from the date of remeasurement.

ASC 842-20-35-8

A lessee shall amortize the right-of-use asset from the commencement date to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term. However, if the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee shall amortize the right-of-use asset to the end of the useful life of the underlying asset.

For accounting purposes, the right to control the use of the underlying asset is the same as physically using the asset. Therefore, the extent of the lessee's actual use of the asset should not impact its pattern of amortization.



ASC 842-20-55-3

This Subtopic considers the right to control the use of the underlying asset as the equivalent of physical use. If the lessee controls the use of the underlying asset, recognition of lease cost in accordance with paragraph 842-20-25-6(a) or amortization of the right-of-use asset in accordance with paragraph 842-20-35-7 should not be affected by the extent to which the lessee uses the underlying asset.

5.3.1 Finance lease expense recognition

A lessee in a finance lease recognizes the following items in the statement of comprehensive income for each period, unless the costs must be capitalized under other guidance:

- Interest expense and amortization expense, calculated as discussed in this section.
- Variable lease payments that were not included in the lease liability (because they were not based on a rate or an index) as an expense in the period those obligations are incurred (see Section 1.4.3 for further discussion of recognizing variable lease payments)
- Any impairment of the right-of-use asset, as discussed in Section 5.6



Finance Leases

ASC 842-20-25-5

After the commencement date, a lessee shall recognize in profit or loss, unless the costs are included in the carrying amount of another asset in accordance with other Topics:

- a. Amortization of the right-of-use asset and interest on the lease liability
- b. Variable lease payments not included in the lease liability in the period in which the obligation for those payments is incurred (see paragraphs 842-20-55-1 through 55-2)
- c. Any impairment of the right-of-use asset determined in accordance with paragraph 842-20-35-9.

5.4 Operating lease subsequent measurement

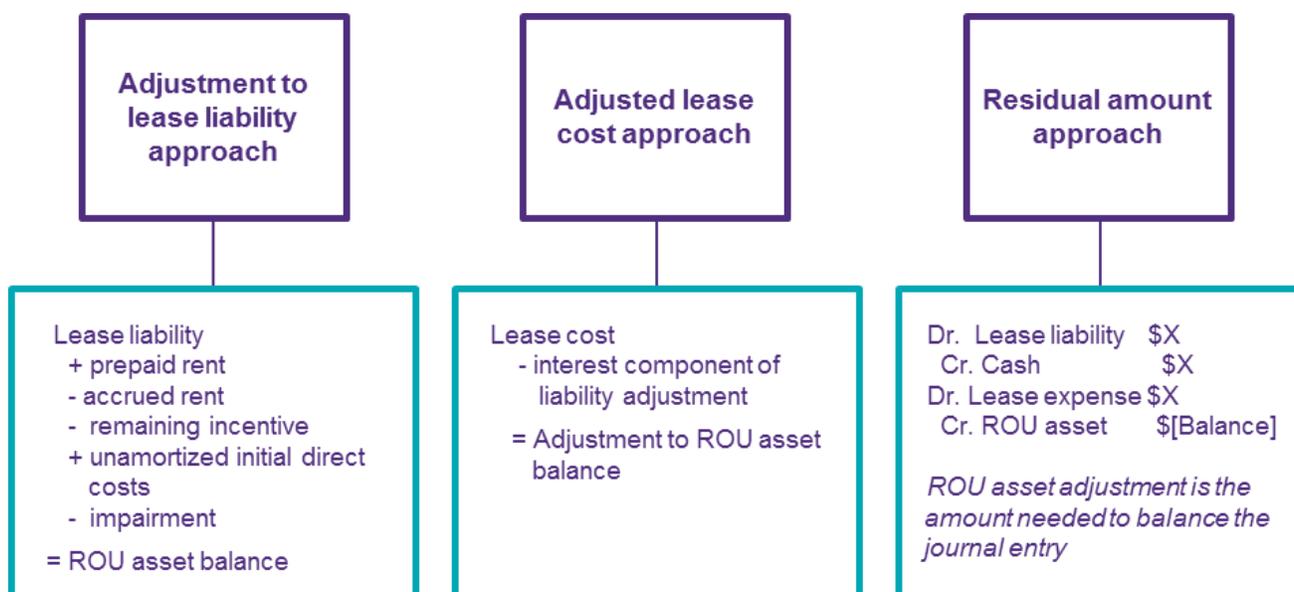
The lease liability associated with an operating lease is subsequently measured each period at the present value of the lease payments that are not yet paid. The present value is calculated using the discount rate determined at commencement date of the lease, unless the rate has been updated in accordance with ASC 842-20-35-5.

The right-of-use asset under an operating lease is subsequently measured based on the same methodology used for its initial measurement, unless the asset has been impaired. That is, the right-of-use asset is subsequently measured at the carrying amount of the lease liability, adjusted for (1) prepaid or accrued lease payments, (2) the remaining balance of lease incentives received, (3) unamortized initial direct costs, and (4) an impairment charge if the asset has not been previously impaired. This method is referred to as the “Adjustment to lease liability” approach in Figure 5.2.

A second way to subsequently measure the right-of-use asset is to reduce the previous carrying amount by subtracting the difference between the lease cost (that is, the straight-line lease expense recognized during the current period) and the interest component of the adjustment to the lease liability. This method is referred to as the “Adjusted lease cost” approach in Figure 5.2.

A third way to subsequently measure the right-of-use asset is to reduce the previous carrying amount by subtracting the amount necessary to reconcile the interest method-based adjustment to the lease liability, with the current-period cash paid and the straight-line expense recognized during the period. This method is referred to as the “Residual amount” approach in Figure 5.2.

The three methodologies for calculating subsequent adjustments to the right-of-use asset are summarized in Figure 5.2.

Figure 5.2: Operating lease right-of-use (ROU) asset remeasurement

For information about measuring a right-of-use asset that has been impaired, refer to Section 5.6.



At the crossroads: Operating lease expense recognition

If the description of how to subsequently measure the right-of-use asset in an operating lease seems complex, it's because the guidance was written in a way to allow the liability to be subsequently measured under the interest method, while retaining the straight-line expense recognition pattern for operating leases from legacy GAAP.

This operating lease accounting model is unconventional in that the amounts recognized on the lessee's statement of financial position and statement of comprehensive income are measured independently. In accounting jargon, the statement of financial position and the statement of comprehensive income accounts associated with operating leases do not "articulate" as they typically would under double-entry accrual accounting.

This feature of ASC 842's operating lease accounting model allows lessees to measure the lease liability as if it were debt, while following the straight-line recognition pattern of an executory contract for lease expense. This allowed the Board to satisfy its objective of requiring accounting on the statement of financial position for most leases while retaining the straight-line operating lease expense pattern that many stakeholders support.

**ASC 842-20-35-3**

After the commencement date, for an operating lease, a lessee shall measure both of the following:

- a. The lease liability at the present value of the lease payments not yet paid discounted using the discount rate for the lease established at the commencement date (unless the rate has been updated after the commencement date in accordance with paragraph 842-20-35-5, in which case that updated rate shall be used)
- b. The right-of-use asset at the amount of the lease liability, adjusted for the following, unless the right-of-use asset has been previously impaired, in which case the right-of-use asset is measured in accordance with paragraph 842-20-35-10 after the impairment:
 1. Prepaid or accrued lease payments
 2. The remaining balance of any lease incentives received, which is the amount of the gross lease incentives received net of amounts recognized previously as part of the single lease cost described in paragraph 842-20-25-6(a)
 3. Unamortized initial direct costs
 4. Impairment of the right-of-use asset.

5.4.1 Operating lease expense recognition

A lessee recognizes the cost of an operating lease on a straight-line basis, taking into account any impairment or other adjustments to the right-of-use asset. Each reporting period, lease cost is calculated in a manner that causes the remaining cost of the lease to be recognized on a straight-line basis over the remaining lease term. The “remaining cost of the lease” consists of (1) the total lease payments, paid and unpaid, reflecting any adjustment triggered by a remeasurement event or modification, plus (2) the total initial direct costs attributable to the lease, less (3) the periodic lease cost recognized in prior periods. A lessee also recognizes variable payments that were not included in the lease liability (because the payments were not based on a rate or an index) as expenses in the period the obligation for the payments is incurred. Additionally, if a right-of-use asset is determined to be impaired, the impairment charge is recognized in the period it is incurred. For guidance on the impairment of a right-of-use asset, see Section 5.6.

Lease cost is recognized in the statement of comprehensive income, unless the cost must be capitalized under other guidance.

**ASC 842-20-25-6**

After the commencement date, a lessee shall recognize all of the following in profit or loss, unless the costs are included in the carrying amount of another asset in accordance with other Topics:

- a. A single lease cost, calculated so that the remaining cost of the lease (as described in paragraph 842-20-25-8) is allocated over the remaining lease term on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the right to use the underlying asset (see paragraph 842-20-55-3),

unless the right-of-use asset has been impaired in accordance with paragraph 842-20-35-9, in which case the single lease cost is calculated in accordance with paragraph 842-20-25-7

- b. Variable lease payments not included in the lease liability in the period in which the obligation for those payments is incurred (see paragraphs 842-20-55-1 through 55-2)
- c. Any impairment of the right-of-use asset determined in accordance with paragraph 842-20-35-9.

ASC 842-20-25-8

Throughout the lease term, the remaining cost of an operating lease for which the right-of-use asset has not been impaired consists of the following:

- a. The total lease payments (including those paid and those not yet paid), reflecting any adjustment to that total amount resulting from either a remeasurement in accordance with paragraphs 842-10-35-4 through 35-5 or a lease modification; plus
- b. The total initial direct costs attributable to the lease; minus
- c. The periodic lease cost recognized in prior periods.

Example 4 in ASC 842-20-55 provides a comprehensive illustration of a lessee's accounting for an operating lease.



Example 4—Recognition and Initial and Subsequent Measurement by a Lessee in an Operating Lease

ASC 842-20-55-41

Lessee enters into a 10-year lease for 5,000 square feet of office space. The annual lease payment is \$10,000, paid in arrears, and increases 5 percent each year during the lease term. Lessee's incremental borrowing rate at lease commencement is 6 percent. Lessee classifies the lease as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3. Lessee incurs initial direct costs of \$5,000.

ASC 842-20-55-42

At the commencement date, Lessee receives a \$10,000 cash payment from Lessor that Lessee accounts for as a lease incentive. Lessee measures the lease liability at the present value of the 10 remaining lease payments (\$10,000 in Year 1, increasing by 5 percent each year thereafter), discounted at the rate of 6 percent, which is \$90,434. Lessee also measures a right-of-use asset of \$85,434 (the initial measurement of the lease liability + the initial direct costs of \$5,000 – the lease incentive of \$10,000).

ASC 842-20-55-43

During the first year of the lease, Lessee determines the remaining cost of the lease as the sum of the following:

- a. The total lease payments of \$115,779 (the sum of the 10 escalating payments to Lessor during the lease term of \$125,779 – the lease incentive paid to Lessee at the commencement date of \$10,000)
- b. The total initial direct costs attributable to the lease of \$5,000.

The amount of the remaining lease cost is therefore \$120,779 ($\$115,779 + \$5,000$). Consequently, Lessee determines that the single lease cost to be recognized every year throughout the lease term is \$12,078 ($\$120,779 \div 10$ years). This assumes that there are no remeasurements of the lease liability or modifications to the lease throughout the lease term.

ASC 842-20-55-44

At the end of Year 1, the carrying amount of the lease liability is \$85,860 (9 remaining lease payments, discounted at the rate of 6 percent), and the carrying amount of the right-of-use asset is the amount of the liability, adjusted for the following:

- a. Accrued lease payments of \$2,578 (the amount of payments to Lessor to be recognized as part of the single lease cost each year during the lease of \$12,578 [total payments to Lessor of \$125,779 \div 10 years] – the first year's lease payment of \$10,000)
- b. Unamortized initial direct costs of \$4,500 (gross initial direct costs of \$5,000 – amounts recognized previously as part of the single lease cost of \$500 [total initial direct costs of \$5,000 \div 10 years])
- c. The remaining balance of the lease incentive of \$9,000 (gross lease incentive of \$10,000 – amounts recognized previously as part of the single lease cost of \$1,000 [total lease incentives of \$10,000 \div 10 years]).

Therefore, at the end of Year 1, Lessee measures the right-of-use asset at the amount of \$78,782 ($\$85,860 - \$2,578 + \$4,500 - \$9,000$).

ASC 842-20-55-45

At the beginning of Year 2, Lessee determines the remaining cost of the lease to be \$108,701 (the total lease payments of \$115,779 + the total initial direct costs of \$5,000 – the single lease cost recognized in Year 1 of \$12,078). The single lease cost to be recognized in Year 2 is still \$12,078 ($\$108,701 \div 9$ years). For the purposes of the Example, only the first two years' determination of the single lease cost are shown. However, the single lease cost will be determined in the same way as in Years 1 and 2 for the remainder of the lease and, in this Example, will continue to equal \$12,078 every period for the remainder of the lease term assuming that there are no remeasurements of the lease liability or modifications to the lease.

ASC 842-20-55-46

At the end of Year 2, the carrying amount of the lease liability is \$80,511, and the carrying amount of the right-of-use asset is \$71,855 (the carrying amount of the lease liability of \$80,511 – the accrued lease payments of \$4,656 + the unamortized initial direct costs of \$4,000 – the remaining balance of the lease incentive received of \$8,000). For the purposes of the Example, the subsequent measurement of the lease liability and the subsequent measurement of the right-of-use asset are shown only for the first two years. However, Lessee will continue to measure the lease liability and the right-of-use asset for this lease in the same manner throughout the remainder of the lease term.

5.4.2 Lease incentives neither paid nor payable at commencement

Some lessors provide lease incentives to lessees that are paid after lease commencement and are not “payable” until a condition is satisfied. For example, in many real estate leases, the lessor agrees to reimburse the lessee for costs incurred to construct leasehold improvements up to a certain amount. The lessor might not contractually owe any amounts to the lessee until the lessee provides evidence that it has incurred qualifying expenditures.

In these cases, we believe it is acceptable for the lessee to treat the lease incentive as a reduction to the lease payments as of the commencement date, provided that the lessee is reasonably certain to incur qualifying expenditures up to the contractual reimbursement limit. Otherwise, we believe that upon incurring qualifying expenditures, the lessee should reduce its right-of-use asset and lease liability, and either (1) recognize the effect of the lease incentive prospectively or (2) recognize a cumulative catch-up adjustment to lease expense so that, prospectively, periodic lease expense is recognized as if the lease incentive was receivable as of the commencement date.



Lease incentives neither paid nor payable at commencement

Lessee leases retail space from Lessor for five years. The lease commences on January 1, 20X1. Lease payments include fixed annual payments of \$50,000, payable in arrears. Lessor agrees to reimburse Lessee for qualifying costs of constructing leasehold improvements, which are Lessee’s assets, up to \$20,000. Lessor is not obligated to reimburse Lessee until Lessee provides evidence that it has incurred qualifying costs. Lessee’s incremental borrowing rate at lease commencement is 5 percent.

Lessor reimburses Lessee for qualifying expenditures of \$20,000 on March 31, 20X1.

In the context of these facts, we will consider two scenarios.

Scenario 1: Lessee is reasonably certain to incur qualifying costs up to the threshold

If Lessee is reasonably certain, as of the commencement date, to incur qualifying costs of at least \$20,000, we believe it is acceptable for Lessee to include a \$20,000 lease incentive in its lease payments at the commencement date. Lessee expects the reimbursement to be paid on March 31, 20X1 and therefore includes a cash inflow in its schedule of future lease payments on that date.

At the commencement date, the lease payments are \$230,000 (\$50,000 fixed annual payments, totaling \$250,000, minus a lease incentive payable by Lessor of \$20,000). The present value of the lease payments at the commencement date, discounted at Lessee’s incremental borrowing rate, is \$196,156. This present value calculation assumes a cash inflow of \$20,000 on March 31, 20X1, and cash outflows of \$50,000 on December 31 of each year during the lease term. Lessee will recognize lease expense of \$46,000 per year ($\$230,000 \div 5$), or \$11,500 per quarter.

At the commencement date, Lessee records the following journal entry:

Dr. Right-of-use asset	\$196,156
Cr. Lease liability	\$196,156

On March 31, 20X1, Lessee records the following journal entry:

Dr. Lease expense	\$11,500
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Dr. Cash	\$20,000
Cr. Right-of-use asset	\$9,048
Cr. Lease liability	\$22,452

Scenario 2: Lessee is not reasonably certain to incur qualifying costs up to the threshold

Assume the same facts in Scenario 1 above, except that at the commencement date, Lessee is not reasonably certain to incur qualifying costs of at least \$20,000. Therefore, the reimbursement of qualifying costs is a contingent lease incentive that will be recognized when it becomes payable by Lessor. Lessee incurs qualifying costs of \$20,000 during the quarter ended March 31, 20X1, and Lessor reimburses Lessee for these costs on March 31, 20X1.

At the commencement date, the lease payments are \$250,000 (\$50,000 fixed annual payments over five years). The present value of the lease payments at the commencement date, discounted at Lessee's incremental borrowing rate, is \$216,474. This present value calculation assumes cash outflows of \$50,000 on December 31 of each year during the lease term. At the commencement date, Lessee calculates lease expense of \$50,000 per year ($\$250,000 \div 5$), or \$12,500 per quarter.

At the commencement date, Lessee records the following journal entry:

Dr. Right-of-use asset	\$216,474
Cr. Lease liability	\$216,474

Method 1

If Lessee chooses to recognize the effect of the lease incentive prospectively, then on March 31, 20X1, it records the following journal entry:

Dr. Lease expense	\$12,500
Dr. Cash	\$20,000
Cr. Right-of-use asset	\$30,366
Cr. Lease liability	\$2,134

Each quarter thereafter, Lessee recognizes lease expense of \$11,447 [$\$12,500 - (\$20,000 \div 19)$].

Method 2

If Lessee chooses to recognize a cumulative catch-up adjustment to lease expense so that, prospectively, periodic lease expense is recognized as if the lease incentive was payable by Lessor as of the commencement date, then on March 31, 20X1, it records the following journal entry:

Dr. Lease expense	\$11,500
Dr. Cash	\$20,000
Cr. Right-of-use asset	\$29,366
Cr. Lease liability	\$2,134

Each quarter thereafter, Lessee recognizes lease expense of \$11,500.

5.5 Amortization of leasehold improvements

A lessee capitalizes leasehold improvements as property, plant, and equipment. If the lease neither transfers ownership of the underlying asset to the lessee nor contains an option to purchase the underlying asset that the lessee is reasonably certain to exercise, a lessee must amortize leasehold improvements over the shorter of their useful lives or the remaining term of the lease. If the lease either transfers ownership of the underlying asset to the lessee or contains a purchase option that the lessee is reasonably certain to exercise, the leasehold improvements are amortized over their remaining useful lives. Similarly, leasehold improvements acquired in a business combination must be amortized over their remaining useful lives or the remaining lease term at the acquisition date, whichever is shorter.



ASC 842-20-35-12

Leasehold improvements shall be amortized over the shorter of the useful life of those leasehold improvements and the remaining lease term, unless the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, in which case the lessee shall amortize the leasehold improvements to the end of their useful life.

ASC 842-20-35-13

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

5.6 Lessee costs to place the underlying asset in service

A lessee may incur costs with a party other than the lessor to bring the underlying asset to the condition and location necessary for its intended use. For example, a lessee that leases manufacturing equipment might hire a third-party shipping company to pick up the equipment from the lessor's facility and transport the equipment to the lessee's facility, where the equipment will be installed. Generally, such costs do not qualify as initial direct costs, as defined in Section 2.1. However, if the lessee purchased the underlying asset instead of leasing it, such costs would be capitalized as part of the asset's initial carrying amount on the purchaser's statement of financial position, in accordance with ASC 360.

In a speech at the AICPA's 2018 Conference on Current SEC and PCAOB Developments, staff from the SEC's Office of the Chief Accountant [noted](#) that if costs incurred to place a leased asset into use do not fall within the scope of other GAAP they would not object to a lessee adopting an accounting policy to capitalize these costs by analogizing to the guidance in ASC 360, *Property, Plant, and Equipment*.

A lessee that makes a policy election to analogize to ASC 360 for costs to place a leased asset into use should apply the policy consistently and disclose it if it is material to the financial statements.

5.7 Impairment of the right-of-use asset

A lessee is required to evaluate the right-of-use asset for impairment using the guidance on the impairment or disposal of long-lived assets in ASC 360-10-35.

**ASC 842-20-35-9**

A lessee shall determine whether a right-of-use asset is impaired and shall recognize any impairment loss in accordance with Section 360-10-35 on impairment or disposal of long-lived assets.

ASC 842-20-35-10

If a right-of-use asset is impaired in accordance with paragraph 842-20-35-9, after the impairment, it shall be measured at its carrying amount immediately after the impairment less any accumulated amortization. A lessee shall amortize, in accordance with paragraph 842-20-25-7 (for an operating lease) or paragraph 842-20-35-7 (for a finance lease), the right-of-use asset from the date of the impairment to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term.

Under the guidance in ASC 360-10-35, a long-lived asset or asset group is tested for impairment when a triggering event occurs that indicates the carrying amount of the asset or asset group might not be recoverable. A right-of-use asset might be assessed for impairment individually or, if the cash flows related to the lease are not independent from the cash flows of other assets and liabilities, as part of an asset group.

Asset group: An asset group is the unit of accounting for a long-lived asset or assets to be held and used, which represents the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities.

ASC 360-10-35-21 includes examples of events that might cause a lessee to reassess whether the carrying amount of an asset or asset group is recoverable.

**ASC 360-10-35-21**

A long-lived asset (asset group) shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. The following are examples of such events or changes in circumstances:

- a. A significant decrease in the market price of a long-lived asset (asset group)
- b. A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition
- c. A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator
- d. An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group)

- e. A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group)
- f. A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life. The term more likely than not refers to a level of likelihood that is more than 50 percent.

If a lessee identifies a triggering event, it must evaluate the asset or asset group for impairment by determining whether (1) the carrying amount of the asset is recoverable, and (2) the carrying amount exceeds the fair value of the asset. To determine if the carrying amount of the asset is recoverable, the carrying amount is compared to the undiscounted cash flows expected from the use and eventual disposal of the asset. If the carrying amount exceeds the expected undiscounted cash flows, then the carrying amount is compared to the fair value of the asset. If the carrying amount exceeds the fair value, the impairment charge is equal to the difference between the carrying amount and the fair value. ASC 360-10-35 contains specific guidance about estimating expected cash flows and the fair value of an asset, as well as other considerations that are not addressed in this publication.



ASC 360-10-35-17

An impairment loss shall be recognized only if the carrying amount of a long-lived asset (asset group) is not recoverable and exceeds its fair value. The carrying amount of a long-lived asset (asset group) is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset (asset group). That assessment shall be based on the carrying amount of the asset (asset group) at the date it is tested for recoverability, whether in use (see paragraph 360-10-35-33) or under development (see paragraph 360-10-35-34). An impairment loss shall be measured as the amount by which the carrying amount of a long-lived asset (asset group) exceeds its fair value.



Grant Thornton insights: Undiscounted cash flow measurements for impairment on an operating lease

At its November 30, 2016 meeting, the FASB discussed several implementation issues associated with ASC 842, including evaluating the right-of-use asset for impairment under ASC 360. Two questions raised in the discussion were (1) whether the operating lease liability should be included in the asset group evaluated for impairment, and (2) whether it would be appropriate for a lessee to exclude the interest component of the remaining lease payments from its undiscounted cash flows associated with the first step of its impairment analysis.

There are two acceptable approaches a lessee could take with respect to operating lease liabilities in the context of its impairment analysis. Operating lease liabilities are characterized as operating liabilities rather than debt, as discussed in paragraph BC14 of 2016-02. Therefore, a lessee could include them in the asset group as operating liabilities. Alternatively, a lessee could analogize to the guidance in ASC 360 that requires an entity to exclude a liability for an asset retirement obligation from both the asset group and the future cash flows used in the recovery test, and therefore exclude the

operating lease liability from the asset group. If the lease liability is excluded from the asset group, the lease payments are also excluded from the future cash outflows used in the analysis.

If the lease liability is included in the asset group, the lessee must then determine whether the interest component of future lease payments should be excluded from the undiscounted cash flow analysis. Although the Board reached no conclusions about ASC 842 at the November 2016 meeting, multiple Board members indicated that they would not object to a lessee adopting an accounting policy to exclude the interest component of the remaining operating lease payments from the undiscounted cash flows for purposes of impairment analysis of ROU asset. Alternatively, a lessee should include all of the remaining lease payments in the undiscounted cash flows used in its impairment analysis, provided that it includes the operating lease liability in the asset group.

5.7.1 Post-impairment asset amortization – operating lease

Once a right-of-use asset related to an operating lease has been impaired, the asset is amortized on a straight-line or another systematic basis.

The single lease cost for an operating lease is calculated differently before and after impairment. Before impairment, the cost of the lease is generally allocated over the remaining lease term on a straight-line basis, which results in a back end–loaded amortization pattern for the right-of-use asset, assuming level payments throughout the lease term. After impairment of the right-of-use asset, lease expense is calculated as the sum of (1) the amortization of the remaining balance of the right-of-use asset on a straight-line or other rational, systematic basis, and (2) the accretion of the lease liability. The accretion of the lease liability is the amount that produces a constant periodic discount rate on the remaining lease liability. In other words, following an impairment, an operating lease is accounted for like a finance lease, except with a single lease cost rather than separate interest and amortization.



ASC 842-20-25-7

After a right-of-use asset has been impaired in accordance with paragraph 842-20-35-9, the single lease cost described in paragraph 842-20-25-6(a) shall be calculated as the sum of the following:

1. Amortization of the remaining balance of the right-of-use asset after the impairment on a straight-line basis, unless another systematic basis is more representative of the pattern in which the lessee expects to consume the remaining economic benefits from its right to use the underlying asset
2. Accretion of the lease liability, determined for each remaining period during the lease term as the amount that produces a constant periodic discount rate on the remaining balance of the liability.

5.7.2 Post-impairment asset amortization – finance lease

When the right-of use asset in a finance lease is impaired, the amortization for that asset both before and after impairment is calculated the same way—that is, on a straight-line or another rational, systematic basis.

5.7.3 Example of impairment of a right-of-use asset

Example 5 from ASC 842-20-55 shows how a lessee accounts for an operating lease with a right-of-use asset that becomes impaired during the lease term.



Example 5—Impairment of a Right-of-Use Asset in an Operating Lease

ASC 842-20-55-48

Lessee enters into a 10-year lease of a nonspecialized asset. Lease payments are \$10,000 per year, payable in arrears. The lease does not transfer ownership of the underlying asset or grant Lessee an option to purchase the underlying asset. At lease commencement, the remaining economic life of the underlying asset is 50 years, and the fair value of the underlying asset is \$600,000. Lessee does not incur any initial direct costs as a result of the lease. Lessee's incremental borrowing rate is 7 percent, which reflects the fixed rate at which Lessee could borrow the amount of the lease payments in the same currency, for the same term, and with similar collateral as in the lease at commencement. The lease is classified as an operating lease.

ASC 842-20-55-49

At the commencement date, Lessee recognizes the lease liability of \$70,236 (the present value of the 10 lease payments of \$10,000, discounted at the rate of 7 percent). Lessee also recognizes a right-of-use asset of \$70,236 (the initial measurement of the lease liability). Lessee determines the cost of the lease to be \$100,000 (the total lease payments for the lease term). The annual lease expense to be recognized is therefore \$10,000 ($\$100,000 \div 10$ years).

ASC 842-20-55-50

At the end of Year 3, when the carrying amount of the lease liability and the right-of-use asset are both \$53,893, Lessee determines that the right-of-use asset is impaired in accordance with Section 360-10-35 and recognizes an impairment loss of \$35,000. The right-of-use asset is part of an asset group that Lessee tested for recoverability because of a significant adverse change in the business climate that affects Lessee's ability to derive benefit from the assets within the asset group. The portion of the total impairment loss for the asset group allocated to the right-of-use asset in accordance with paragraph 360-10-35-28 is \$35,000. After the impairment charge, the carrying amount of the right-of-use asset at the end of Year 3 is \$18,893 ($\$53,893 - \$35,000$). Because of the impairment, the total expense recognized in Year 3 is \$45,000 ($\$10,000$ in lease expense + the $\$35,000$ impairment charge). Beginning in Year 4, and for the remainder of the lease term, the single lease cost recognized by Lessee in accordance with paragraphs 842-20-25-6(a) and 842-20-25-7 will equal the sum of the following:

- a. Amortization of the right-of-use asset remaining after the impairment ($\$18,893 \div 7$ years = \$2,699 per year)
- b. Accretion of the lease liability. For example, in Year 4, the accretion is \$3,773 ($\$53,893 \times 7\%$) and, in Year 5, the accretion is \$3,337 ($\$47,665 \times 7\%$).

ASC 842-20-55-51

Consequently, at the end of Year 4, the carrying amount of the lease liability is \$47,665 (that is, calculated as either the present value of the remaining lease payments, discounted at 7 percent, or the previous balance of $\$53,893 - \$10,000$ Year 4 lease payment + the $\$3,773$ accretion of the lease

liability). The carrying amount of the right-of-use asset is \$16,194 (the previous balance of \$18,893 – \$2,699 amortization). Lessee measures the lease liability and the right-of-use asset in this manner throughout the remainder of the lease term.

5.7.4 Lessee decision to abandon right-of-use asset

ASC 842 doesn't address the accounting if a lessee abandons a right-of-use asset.



Grant Thornton insights: Lessee decision to abandon right-of-use asset

A lessee might decide to abandon a right-of-use asset prior to the end of the lease term for various reasons. For example, a retailer might decide to close an underperforming store prior to the end of the lease term and, due to contractual restrictions, may not be permitted to sublease the space. We believe that it acceptable for a lessee to apply the abandonment guidance in ASC 360-10-35-47 through 35-48 to a right-of-use asset if the lessee decides to abandon the underlying asset. In the context of a lease, we believe “abandonment” means ceasing to use the underlying asset and lacking either the intent or the ability to sublease the underlying asset.

On the date a lessee decides to abandon a right-of-use asset, the lessee must first consider whether an impairment assessment is required under ASC 360 and if so, apply the relevant guidance to measure and recognize any impairment charge. After applying the impairment guidance, provided the right-of-use asset has not been entirely written-off, the lessee should shorten that asset's useful life so that it extends only up to the abandonment date. Accordingly, the right-of-use asset must be amortized to its salvage value, which will typically be zero, from the date the entity decides to abandon the asset to the date the asset is actually abandoned.

There is diversity in practice with respect to the subsequent measurement of an operating lease following the date the lessee decides to abandon the right-of-use asset. On one hand, the decision to abandon the right-of-use asset could be viewed as akin to impairment, in which case, the right-of-use asset is amortized on a straight-line basis from the date the decision is made to abandon the asset to the date the asset is actually abandoned, and the lease liability continues to be measured based on an effective interest method over the remaining lease term. Under this approach, straight-line recognition of lease expense is lost for an operating lease when a lessee decides to abandon the right-of-use asset.

On the other hand, the guidance in ASC 842 appears to require a shift from straight-line lease expense recognition for operating leases *only* if an impairment charge is recognized. Therefore, a straight-line lease expense recognition pattern should be preserved during the remainder of the lease term until the right-of-use asset is abandoned. Under this approach, straight-line recognition of lease expense is retained for an operating lease until the right-of-use asset is abandoned.

We believe that either of these amortization approaches is acceptable.

5.8 Lease modification

When any modification or amendment is made to a lease, a lessee must determine whether the modification should be treated as a separate contract or as a continuation of the existing contract.

To be accounted for as a separate contract under ASC 842, a lease modification must (1) grant the lessee an additional right of use not included in the original lease contract, and (2) increase the lease payments commensurate with the stand-alone price for the additional right of use. For the second criterion, the evaluation of the stand-alone price of the additional right of use takes into account any adjustments necessary for a particular lease, such as incremental costs that were avoided by leasing from the existing lessor rather than from a new lessor.



ASC 842-10-25-8

An entity shall account for a modification to a contract as a separate contract (that is, separate from the original contract) when both of the following conditions are present:

- a. The modification grants the lessee an additional right of use not included in the original lease (for example, the right to use an additional asset).
- b. The lease payments increase commensurate with the standalone price for the additional right of use, adjusted for the circumstances of the particular contract. For example, the standalone price for the lease of one floor of an office building in which the lessee already leases other floors in that building may be different from the standalone price of a similar floor in a different office building, because it was not necessary for a lessor to incur costs that it would have incurred for a new lessee.

5.8.1 Modification accounted for as a separate contract

A modification that is accounted for as a separate contract should be treated as a new lease and initially measured at the commencement date of the new lease based on the guidance in ASC 842. A modification treated as a separate lease has no impact on the accounting for the existing lease.

Example 15 from ASC 842-10-55 illustrates how a lessee accounts for a lease modification that is a separate contract.



Example 15—Modification Accounted for As a Separate Contract

ASC 842-10-55-160

Lessee enters into a 10-year lease for 10,000 square feet of office space. At the beginning of Year 6, Lessee and Lessor agree to modify the lease for the remaining 5 years to include an additional 10,000 square feet of office space in the same building. The increase in the lease payments is commensurate with the market rate at the date the modification is agreed for the additional 10,000 square feet of office space.

ASC 842-10-55-161

Lessee accounts for the modification as a new contract, separate from the original contract. This is because the modification grants Lessee an additional right of use as compared with the original contract, and the increase in the lease payments is commensurate with the standalone price of the additional right of use. Accordingly, from the effective date of the modification, Lessee would have 2 separate contracts, each of which contain a single lease component—the original, unmodified contract

for 10,000 square feet of office space and the new contract for 10,000 additional square feet of office space, respectively. Lessee would not make any adjustments to the accounting for the original lease as a result of this modification.

5.8.2 Modification accounted for as a continuation of the existing contract

A lease modification that does not meet both criteria to be considered a separate contract is accounted for as a continuation of the existing contract. In those circumstances, a lessee must reassess lease classification for the modified lease, taking into account all modified terms and conditions and measuring all inputs, including the discount rate, as of the effective date of the modification. The modification is effective on the date when it is approved by both the lessee and the lessor. Any other payments made in connection with the modified lease, such as initial direct costs or lease incentives, should be added to the right-of-use asset.

Effective Date of the Modification: The date that a lease modification is approved by both the lessee and the lessor.



ASC 842-10-25-9

If a lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8, the entity shall reassess the classification of the lease in accordance with paragraph 842-10-25-1 as of the effective date of the modification.

ASC 842-10-25-10

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

For a modification that is not accounted for as a separate contract, the lessee must reallocate the remaining consideration in the contract among the lease and nonlease components, and remeasure the lease liability based on the discount rate as of the effective date of the modification. The adjustment to the right-of-use asset depends on the terms of the modification. Under the guidance in ASC 842, a modification that is not accounted for as a new lease fits into one of four broad categories, as follows:

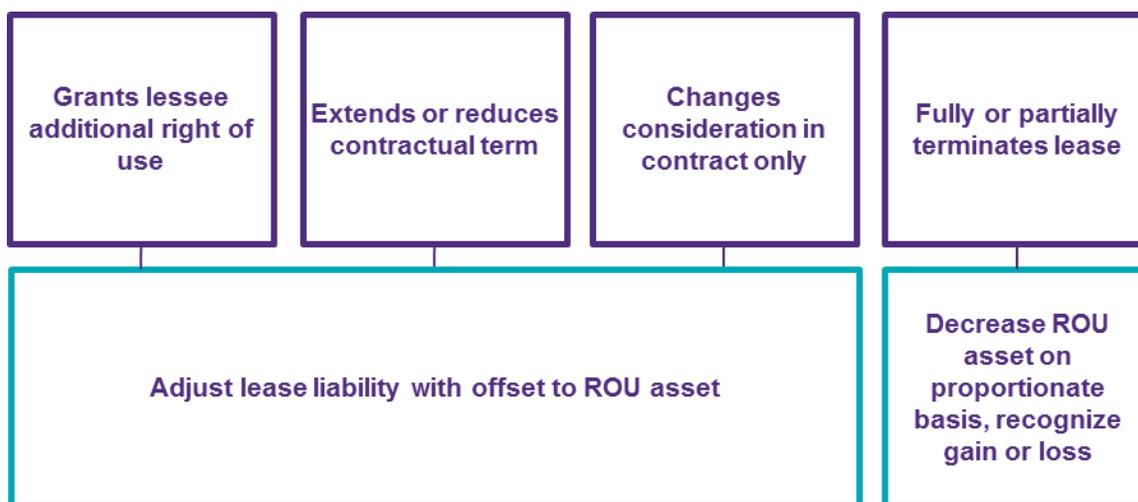
- It fully or partially terminates an existing lease.
- It grants an additional right of use.
- It extends or reduces the term of the existing lease, unless an existing option to extend or terminate the lease is exercised.
- It changes only the consideration in the contract.

For a modification that fully or partially terminates a lease, the lessee reduces the carrying amount of the right-of-use asset on a basis proportionate to the full or partial termination of the lease. Any difference between the adjustment to the right-of-use asset and the lease liability is recognized as a gain or loss in the current period.

For example, if a lessee modifies a lease of 10,000 square feet of office space so that it has the right to use only 5,000 square feet going forward, it could reduce both the right-of-use asset and the lease liability by 50 percent, with any difference recognized as a gain or loss in earnings. Then, the lessee would remeasure the lease liability, with the offset recognized as an adjustment to the right-of-use asset.

For any of the categories other than a full or partial termination of a lease, the lease liability is adjusted to reflect its remeasured amount, with an offset to the right-of-use asset. In paragraph BC175 of ASU 2016-02, the Board notes that if a lease is not fully or partially terminated, the modification changes only the cost of the right-of-use asset in the original lease, with no impact on profit or loss. In the same paragraph, the Board notes that a lease may be modified even if the contractual terms related to the lease component do not change. For example, a change in the consideration paid for a nonlease component may change the remaining lease payments, because the lessee must reallocate the amended consideration in the contract among the lease and nonlease components on the same basis as the original consideration in the contract was allocated.

Figure 5.3: Subsequent measurement for a modification not accounted for as a separate contract



ASC 842-10-25-11

A lessee shall reallocate the remaining consideration in the contract and remeasure the lease liability using a discount rate for the lease determined at the effective date of the modification if a contract modification does any of the following:

- a. Grants the lessee an additional right of use not included in the original contract (and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8)

- b. Extends or reduces the term of an existing lease (for example, changes the lease term from five to eight years or vice versa), other than through the exercise of a contractual option to extend or terminate the lease (as described in paragraph 842-20-35-5)
- c. Fully or partially terminates an existing lease (for example, reduces the assets subject to the lease)
- d. Changes the consideration in the contract only.

ASC 842-10-25-12

In the case of (a), (b), or (d) in paragraph 842-10-25-11 the lessee shall recognize the amount of the remeasurement of the lease liability for the modified lease as an adjustment to the corresponding right-of-use asset.

ASC 842-10-25-13

In the case of (c) in paragraph 842-10-25-11 the lessee shall decrease the carrying amount of the right-of-use asset on a basis proportionate to the full or partial termination of the existing lease. Any difference between the reduction in the lease liability and the proportionate reduction in the right-of-use asset shall be recognized as a gain or a loss at the effective date of the modification.

When there is a modification to a finance lease that is not accounted for as a separate contract and the classification changes from a finance lease to an operating lease, the lessee should first remeasure and adjust the carrying amounts of the lease liability and right-of-use asset using the applicable guidance in ASC 842. Next, the lessee should measure the difference between the adjusted carrying amount of the right-of-use asset and the initial carrying amount that would have been calculated for the right-of-use asset had the modification been treated as a new lease. The difference between these two amounts should be treated the same as a prepayment of rent or a lease incentive.



Lease modification – finance lease to operating lease

Lessee leases a machine to be used in its manufacturing facility. The noncancellable term of the lease is three years, with three one-year renewal options. Lessee is reasonably certain to exercise all three of the renewal options, so that the lease term is six years. The remaining economic life of the machine is seven years, and Lessee determines that the lease is classified as a finance lease.

The contract requires fixed payments of \$50,000 per year, payable annually in arrears. There are no lease incentives or initial direct costs associated with the lease. Lessee uses its incremental borrowing rate of 6 percent to measure the lease liability and the right-of-use asset at lease commencement.

At the beginning of year two, Lessee and Lessor agree to modify the lease, reducing the noncancellable term from three to two years and adding a one-year renewal option, so that the maximum possible lease term remains six years. Lessee and Lessor agree to increase the annual payments to \$55,000.

As of the modification date, Lessee's expectation about whether it is reasonably certain to exercise its renewal options has changed since the commencement date of the lease. Lessee believes it is reasonably certain to exercise only one of the renewal options, so the remaining lease term as of the modification date is two years. The remaining economic life of the machine as of the modification date is six years, and Lessee determines that the modified lease is classified as an operating lease.

On the modification date, the carrying amount of the right-of-use asset is \$196,693, and the carrying amount of the lease liability is \$210,618. Lessee's incremental borrowing rate at the modification date remains 6 percent.

On the modification date, Lessee remeasures the lease liability based on the modified remaining lease payments, the modified lease term, and its current incremental borrowing rate. The remeasured lease liability is \$100,837.

Therefore, Lessee records the following journal entry to adjust the lease liability on the modification date:

Dr. Lease liability	\$109,781
Cr. Right-of-use asset	\$109,781

Since the modification changed the lease classification from finance to operating, Lessee treats the difference between the new carrying amount of the right-of-use asset (\$86,912) and the carrying amount that results from applying the initial measurement guidance (\$100,837) the same as a lease incentive. This deemed lease incentive equals \$13,925.

At the end of year two, Lessee measures the lease liability at \$51,887, which is equal to the present value of the lease payments not yet paid, discounted using the discount rate established at the modification date. Lessee also measures the right-of-use asset at \$44,924, which is equal to the lease liability (\$51,887) adjusted for the remaining balance of the deemed lease incentive (\$6,963).

Lessee recognizes lease expense of \$48,038 in year two, which is equal to (a) the sum of the remaining lease payments as of the modification date of \$110,000, minus the deemed lease incentive of \$13,925, divided by (b) the remaining lease term as of the modification date of two years.



ASC 842-10-25-14

If a finance lease is modified and the modified lease is classified as an operating lease, any difference between the carrying amount of the right-of-use asset after recording the adjustment required by paragraph 842-10-25-12 or 842-10-25-13 and the carrying amount of the right-of-use asset that would result from applying the initial operating right-of-use asset measurement guidance in paragraph 842-20-30-5 to the modified lease shall be accounted for in the same manner as a rent prepayment or a lease incentive.

Examples 16, 17, 18, and 19 in ASC 842-10-55 illustrate a lessee's accounting for the four types of modifications not accounted for as a separate contract, as discussed in ASC 842-10-25-11.

Example 16 below shows how a lessee accounts for a modification that increases the lease term.



Example 16—Modification That Increases the Lease Term

Case A—No Change in Lease Classification

ASC 842-10-55-162

Lessee and Lessor enter into a 10-year lease for 10,000 square feet of office space in a building with a remaining economic life of 50 years. Annual payments are \$100,000, paid in arrears. Lessee's incremental borrowing rate at the commencement date is 6 percent. The lease is classified as an operating lease. At the beginning of Year 6, Lessee and Lessor agree to modify the lease such that the total lease term increases from 10 years to 15 years. The annual lease payments increase to \$110,000 per year for the remaining 10 years after the modification. Lessee's incremental borrowing rate is 7 percent at the date the modification is agreed to by the parties.

ASC 842-10-55-163

At the beginning of Year 6, Lessee's lease liability and its right-of-use asset both equal \$421,236 (that is, because the lease payments are made annually in arrears and because the lease payments are even throughout the lease term, the lease liability and right-of-use asset will be equal).

ASC 842-10-55-164

The modification does not grant an additional right of use to the lessee; rather, it changes (modifies) an attribute of the right to use the 10,000 square feet of office space Lessee already controls. That is, after the modification, Lessee still controls only a single right of use transferred to Lessee at the original lease commencement date.

ASC 842-10-55-165

Because the modification does not grant Lessee an additional right of use, the modification cannot be a separate contract. Therefore, at the effective date of the modification, Lessee reassesses classification of the lease (which does not change in this Example—see Case B [paragraphs 842-10-55-166 through 55-167] for a change in lease classification) and remeasures the lease liability on the basis of the 10-year remaining lease term, 10 remaining payments of \$110,000, and its incremental borrowing rate at the effective date of the modification of 7 percent. Consequently, the modified lease liability equals \$772,594. The increase to the lease liability of \$351,358 is recorded as an adjustment to the right-of-use asset (that is, there is no income or loss effect from the modification).

Case B—Change in Lease Classification

ASC 842-10-55-166

Assume the same facts as in Case A (paragraphs 842-10-55-162 through 55-165), except that the underlying asset is a piece of equipment with a 12-year remaining economic life at the effective date of the modification. Consequently, when the lessee reassesses classification of the lease in accordance with paragraph 842-10-25-1 as of the effective date of the modification based on the modified rights and obligations of the parties, the lessee classifies the modified lease as a finance lease (that is, because the remaining lease term of 10 years is for a major part of the 12-year remaining economic life of the equipment).

ASC 842-10-55-167

Consistent with Case A, at the effective date of the modification, the lessee remeasures its lease liability based on the 10-year remaining lease term, 10 remaining payments of \$110,000, and its incremental borrowing rate of 7 percent. Consequently, the modified lease liability equals \$772,594. The increase to the lease liability of \$351,358 is recorded as an adjustment to the right-of-use asset (that is, there is no income or loss effect from the modification). However, different from Case A, beginning on the effective date of the modification, Lessee accounts for the 10-year modified lease as a finance lease.

Example 17 in ASC 842-10-55 shows how a lessee accounts for a modification that grants an additional right of use.

**Example 17—Modification That Grants an Additional Right of Use****ASC 842-10-55-168**

Lessee enters into a 10-year lease for 10,000 square feet of office space. The lease payments are \$100,000 per year, paid in arrears. Lessee's incremental borrowing rate at lease commencement is 6 percent. At the beginning of Year 6, Lessee and Lessor agree to modify the contract to include an additional 10,000 square feet of office space on a different floor of the building for the final 4 years of the original 10-year lease term for a total annual fixed payment of \$150,000 for the 20,000 square feet.

ASC 842-10-55-169

The increase in the lease payments (of \$50,000 per year) is at a substantial discount to the market rate at the date the modification is agreed to for leases substantially similar to that for the new 10,000 square feet of office space that cannot be attributed solely to the circumstances of the contract. Consequently, Lessee does not account for the modification as a separate contract.

ASC 842-10-55-170

Instead, Lessee accounts for the modified contract, which contains 2 separate lease components — first, the original 10,000 square feet of office space and, second, the right to use the additional 10,000 square feet of office space for 4 years that commences 1 year after the effective date of the modification. There are no nonlease components of the modified contract. The total lease payments, after the modification, are \$700,000 (1 payment of \$100,000 + 4 payments of \$150,000).

ASC 842-10-55-171

Lessee allocates the lease payments in the modified contract to the 2 separate lease components on a relative standalone price basis, which, in this Example, results in the allocation of \$388,889 to the original space lease and \$311,111 to the additional space lease. The allocation is based on the remaining lease terms of each separate lease component (that is, 5 years for the original 10,000-square-foot lease and 4 years for the additional 10,000-square-foot lease). The remaining lease cost for each separate lease component is equal to the total payments, as allocated, which will be recognized on a straight-line basis over their respective lease terms. Lessee remeasures the lease

liability for the original space lease as of the effective date of the modification—the lease classification of which does not change as a result of the modification—on the basis of all of the following:

- a. A remaining lease term of 5 years
- b. Annual allocated lease payments of \$77,778 in Years 6 through 10 (see paragraph 842-10-55-173)
- c. Lessee's incremental borrowing rate at the effective date of the modification of 7 percent.

ASC 842-10-55-172

The remeasured lease liability for the original space lease equals \$318,904. Lessee recognizes the difference between the carrying amount of the modified lease liability and the carrying amount of the lease liability immediately before the modification of \$102,332 (\$421,236 – \$318,904) as an adjustment to the right-of-use asset.

ASC 842-10-55-173

During Year 6, Lessee recognizes lease cost of \$77,778. At the end of Year 6, Lessee makes its lease payment of \$100,000, of which \$77,778 is allocated to the lease of the original office space and \$22,222 is allocated to the lease of the additional office space as a prepayment of rent. Lessee allocates the lease payment in this manner to reflect even payments for the even use of the separate lease components over their respective lease terms.

ASC 842-10-55-174

At the commencement date of the separate lease component for the additional office space, which is 1 year after the effective date of the modification, Lessee measures and recognizes the lease liability at \$241,896 on the basis of all of the following:

- a. A lease term of 4 years
- b. Four allocated annual payments of \$72,222 ([allocated lease payments of \$311,111 – \$22,222 rent prepayment] ÷ 4 years)
- c. Lessee's incremental borrowing rate at the commencement date of the separate lease component for the additional office space of 7.5 percent.

ASC 842-10-55-175

At the commencement date, the right-of-use asset for the additional office space lease component is recognized and measured at \$264,118 (the sum of the lease liability of \$241,896 and the prepaid rent asset of \$22,222).

ASC 842-10-55-176

During Years 7–10, Lessee recognizes lease cost of \$77,778 each year for each separate lease component and allocates each \$150,000 annual lease payment of \$77,778 to the original office space lease and \$72,222 to the additional office space lease.

Example 18 in ASC 842-10-55 illustrates two ways that a lessee could account for a modification that decreases the scope of a lease. As noted in paragraph BC177 of ASU 2016-02, either of these methods would be acceptable.

Both methods measure and record the modified lease liability at the present value of the remaining lease payments at the effective date of the modification.

In the first method illustrated in Example 18 (Case A), the right-of-use asset is remeasured based on the change in the lease liability. The lessee first calculates the percentage change in the lease liability before and after the modification, and then decreases the carrying amount of the right-of-use asset based on the percentage change in the lease liability. The difference between the adjustment to the lease liability and the adjustment to the right-of-use asset is recognized as a gain or loss in current-period earnings.

In the second method illustrated in Example 18 (Case B), the right-of-use asset is remeasured based on the change in the lessee's remaining right of use. The lessee first calculates the percentage decrease in its right of use based on a relevant measure of utility, which in this example, is square feet of office space. The lessee adjusts both the pre-modification right-of-use asset and the pre-modification lease liability by the percentage decrease in its right of use. The difference between the adjustment to the right-of-use asset and the adjustment to the lease liability is recognized as a gain or loss in current-period earnings. Next, the lessee remeasures the lease liability in accordance with ASC 842-10-25-11 and adjusts the lease liability accordingly, with a corresponding adjustment to the right-of-use asset.

The two methods illustrated in Example 18 result in different amounts for the modified right-of-use asset and the gain or loss.



Example 18—Modification That Decreases the Scope of a Lease

ASC 842-10-55-177

Lessee enters into a 10-year lease for 10,000 square feet of office space. The annual lease payment is initially \$100,000, paid in arrears, and increases 5 percent each year during the lease term. Lessee's incremental borrowing rate at lease commencement is 6 percent. Lessee does not provide a residual value guarantee. The lease does not transfer ownership of the office space to Lessee or grant Lessee an option to purchase the space. The lease is an operating lease for all of the following reasons:

- a. The lease term is 10 years, while the office building has a remaining economic life of 40 years.
- b. The fair value of the office space is estimated to be significantly in excess of the present value of the lease payments.
- c. The office space is expected to have an alternative use to Lessor at the end of the lease term.

ASC 842-10-55-178

At the beginning of Year 6, Lessee and Lessor agree to modify the original lease for the remaining 5 years to reduce the lease to only 5,000 square feet of the original space and to reduce the annual lease payment to \$68,000. That amount will increase 5 percent each year thereafter of the remaining lease term.

ASC 842-10-55-179

The classification of the lease does not change as a result of the modification. It is clear based on the terms of the modified lease that it is not a finance lease because the modification reduces both the lease term and the lease payments. Lessee remeasures the lease liability for the modified lease at the effective date of the modification on the basis of all of the following:

- a. A remaining lease term of 5 years
- b. Lease payments of \$68,000 in the year of modification (Year 6), increasing by 5 percent each year thereafter
- c. Lessee's incremental borrowing rate at the effective date of the modification of 7 percent.

ASC 842-10-55-180

The remeasured lease liability equals \$306,098.

Case A—Remeasuring the Right-of-Use Asset Based on Change in Lease Liability

ASC 842-10-55-181

The difference between the premodification liability and the modified lease liability is \$284,669 ($\$590,767 - \$306,098$). That difference is 48.2 percent ($\$284,669 \div \$590,767$) of the premodification lease liability. The decrease in the lease liability reflects the early termination of the right to use 5,000 square feet of space (50 percent of the original leased space), the change in the lease payments, and the change in the discount rate.

ASC 842-10-55-182

Lessee decreases the carrying amount of the right-of-use asset to reflect the partial termination of the lease based on the adjustment to the carrying amount of the lease liability, with any difference recognized in profit or loss. The premodification right-of-use asset is \$514,436. Therefore, at the effective date of the modification, Lessee reduces the carrying amount of the right-of-use asset by \$247,888 ($48.2\% \times \$514,436$). Lessee recognizes the difference between the adjustment to the lease liability and the adjustment to the right-of-use asset ($\$284,669 - \$247,888 = \$36,781$) as a gain.

Case B—Remeasuring the Right-of-Use Asset Based on the Remaining Right of Use

ASC 842-10-55-183

Lessee determines the proportionate decrease in the carrying amount of the right-of-use asset based on the remaining right-of-use asset (that is, 5,000 square feet corresponding to 50 percent of the original right-of-use asset).

ASC 842-10-55-184

Fifty percent of the premodification right-of-use asset is \$257,218 ($50\% \times \$514,436$). Fifty percent of the premodification lease liability is \$295,384 ($50\% \times \$590,767$). Consequently, Lessee decreases the carrying amount of the right-of-use asset by \$257,218 and the carrying amount of the lease liability by \$295,384. At the effective date of the modification, Lessee recognizes the difference between the

decrease in the lease liability and the decrease in the right-of-use asset of \$38,166 ($\$295,384 - \$257,218$) as a gain.

ASC 842-10-55-185

Lessee recognizes the difference between the remaining lease liability of \$295,384 and the modified lease liability of \$306,098 (which equals \$10,714) as an adjustment to the right-of-use asset reflecting the change in the consideration paid for the lease and the revised discount rate.

Example 19 in ASC 842-10-55 shows how a lessee accounts for a modification that changes only the lease payments.



Example 19—Modification That Changes the Lease Payments Only

ASC 842-10-55-186

Lessee enters into a 10-year lease for 10,000 square feet of office space. The lease payments are \$95,000 in Year 1, paid in arrears, and increase by \$1,000 every year thereafter. The original discount rate for the lease is 6 percent. The lease is an operating lease. At the beginning of Year 6, Lessee and Lessor agree to modify the original lease for the remaining 5 years to reduce the lease payments by \$7,000 each year (that is, the lease payments will be \$93,000 in Year 6 and will continue to increase by \$1,000 every year thereafter). The modification only changes the lease payments and, therefore, cannot be accounted for as a separate contract. The classification of the lease does not change as a result of the modification.

ASC 842-10-55-187

Lessee remeasures the lease liability for the modified lease on the basis of all of the following:

- a. Remaining lease term of 5 years
- b. Payments of \$93,000 in Year 6, increasing by \$1,000 each year for the remainder of the lease term
- c. Lessee's incremental borrowing rate at the effective date of the modification of 7 percent.

ASC 842-10-55-188

The remeasured lease liability equals \$388,965. Lessee recognizes the difference between the carrying amount of the modified lease liability and the lease liability immediately before the effective date of the modification of \$40,206 ($\$429,171$ premodification lease liability – $\$388,965$ modified lease liability) as a corresponding reduction to the right-of-use asset. Therefore, the adjusted right-of-use asset equals \$376,465 as of the effective date of the modification. Lessee calculates its remaining lease cost as \$462,500 (the sum of the total lease payments, as adjusted for the effects of the lease modification, of \$960,000 reduced by the total lease cost recognized in prior periods of \$497,500), which it will recognize on a straight-line basis over the remaining lease term.

ASC 842-10-55-189

During Year 6, Lessee recognizes lease cost of \$92,500 (\$462,500 remaining lease cost ÷ 5 years). As of the end of Year 6, Lessee's lease liability equals \$323,193 (present value of the remaining lease payments, discounted at 7 percent), and its right-of-use asset equals \$311,193 (the balance of the lease liability – the remaining accrued rent balance of \$12,000). Lessee recognizes additional lease cost of \$92,500 each year of the remaining lease term and measures its lease liability and right-of-use asset in the same manner as at the end of Year 6 each remaining year of the lease term. The following are the balances of the lease liability and the right-of-use asset at the end of Years 7 through 10 of the lease.

	<u>Lease Liability</u>	<u>Right-of-Use Asset</u>
Year 7	\$ 251,816	\$ 241,316
Year 8	\$ 174,443	\$ 166,443
Year 9	\$ 90,654	\$ 86,154
Year 10	\$ -	\$ -

5.8.3 Lease modification in connection with refunding of tax-exempt debt

Certain projects to construct a facility that is then leased to a user of the facility are funded by tax-exempt debt. In these arrangements, the lease may be structured to collateralize the debt, with lease payments that match the debt payments with respect to amounts and timing. In these situations, if the lessor refunds the tax-exempt debt resulting in a lease modification, that modification should be accounted for in the same manner as any other lease modification.



ASC 842-10-55-16

In some situations, tax-exempt debt is issued to finance construction of a facility, such as a plant or hospital that is transferred to a user of the facility by lease. A lease may serve as collateral for the guarantee of payments equivalent to those required to service the tax-exempt debt. Payments required by the terms of the lease are essentially the same, as to both amount and timing, as those required by the tax-exempt debt. A lease modification resulting from a refunding by the lessor of tax-exempt debt (including an advance refunding) should be accounted for in the same manner (that is, in accordance with paragraphs 842-10-25-8 through 25-18) as any other lease modification. For example, if the perceived economic advantages of the refunding are passed through to the lessee in the form of reduced lease payments, the lessee should account for the modification in accordance with paragraph 842-10-25-12, while the lessor should account for the modification in accordance with the applicable guidance in paragraphs 842-10-25-15 through 25-17.

5.9 Remeasurement of the lease

A lessee should remeasure the lease liability and reallocate the consideration in the contract among the lease and nonlease components when certain events occur. Events that trigger a remeasurement of the lease payments (and, therefore, the lease liability) include (1) a modification that is not accounted for as a separate contract, as discussed in Section 5.7.2, (2) the resolution of a contingency associated with a variable payment that causes it to meet the definition of a lease payment, and (3) a change in either the lease term, the assessment of whether a lessee is reasonably certain to exercise an option to purchase

the underlying asset, or the amount probable of being owed by the lessee under a residual value guarantee.



ASC 842-10-35-4

A lessee shall remeasure the lease payments if any of the following occur:

- a. The lease is modified, and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8.
- b. A contingency upon which some or all of the variable lease payments that will be paid over the remainder of the lease term are based is resolved such that those payments now meet the definition of lease payments. For example, an event occurs that results in variable lease payments that were linked to the performance or use of the underlying asset becoming fixed payments for the remainder of the lease term. However, a change in a reference index or a rate upon which some or all of the variable lease payments in the contract are based does not constitute the resolution of a contingency subject to (b) (see paragraph 842-10-35-5 for guidance on the remeasurement of variable lease payments that depend on an index or a rate).
- c. There is a change in any of the following:
 1. The lease term, as described in paragraph 842-10-35-1. A lessee shall determine the revised lease payments on the basis of the revised lease term.
 2. The assessment of whether the lessee is reasonably certain to exercise or not to exercise an option to purchase the underlying asset, as described in paragraph 842-10-35-1. A lessee shall determine the revised lease payments to reflect the change in the assessment of the purchase option.
 3. Amounts probable of being owed by the lessee under residual value guarantees. A lessee shall determine the revised lease payments to reflect the change in amounts probable of being owed by the lessee under residual value guarantees.



Grant Thornton insights: Reassessment of variable lease payments that depend on an index or rate

The guidance in ASC 842-10-35-4(b) states that lease payments should be remeasured if a contingency on which some or all of the variable lease payments are based is resolved, such that the payments become fixed and meet the definition of lease payments. This paragraph also states that a lessee should not remeasure lease payments in connection with a change in an index or a rate which variable payments are based on. This principle is illustrated in Example 25 in ASC 842-10-55-231, where the guidance specifically states that the lease payments in the example should not be remeasured for a change in the Consumer Price Index.

Example 25 from ASC 842-10-55 shows how a lessee accounts for variable lease payments that depend on an index or a rate and for variable lease payments that are linked to performance.



Example 25—Variable Lease Payments That Depend on an Index or a Rate and Variable Lease Payments Linked to Performance

Case A—Variable Lease Payments That Depend on an Index or a Rate

ASC 842-10-55-226

Lessee enters into a 10-year lease of a building with annual lease payments of \$100,000, payable at the beginning of each year. The contract specifies that lease payments for each year will increase on the basis of the increase in the Consumer Price Index for the preceding 12 months. The Consumer Price Index at the commencement date is 125. This Example ignores any initial direct costs. The lease is classified as an operating lease.

ASC 842-10-55-227

The rate implicit in the lease is not readily determinable. Lessee's incremental borrowing rate is 8 percent, which reflects the rate at which Lessee could borrow an amount equal to the lease payment in the same currency, over a similar term, and with similar collateral as in the lease.

ASC 842-10-55-228

At the commencement date, Lessee makes the lease payment for the first year and measures the lease liability at \$624,689 (the present value of 9 payments of \$100,000 discounted at the rate of 8 percent). The right-of-use asset is equal to the lease liability plus the prepaid rent (\$724,689).

ASC 842-10-55-229

Lessee prepares financial statements on an annual basis. Lessee determines the cost of the lease to be \$1 million (the total lease payments for the lease term). The annual lease expense to be recognized is \$100,000 ($\$1 \text{ million} \div 10 \text{ years}$).

ASC 842-10-55-230

At the end of the first year of the lease, the Consumer Price Index is 128. Lessee calculates the payment for the second year, adjusted to the Consumer Price Index, to be \$102,400 ($\$100,000 \times 128 \div 125$).

ASC 842-10-55-231

Because Lessee has not remeasured the lease liability for another reason, Lessee does not make an adjustment to the lease liability to reflect the Consumer Price Index at the end of the reporting period; that is, the lease liability continues to reflect annual lease payments of \$100,000 (8 remaining annual payments of \$100,000, discounted at the rate of 8 percent is \$574,664). However, the Year 2 payment amount of \$102,400 (the \$100,000 annual fixed payment + \$2,400 variable lease payment) will be recognized in profit or loss for Year 2 of the lease and classified as cash flow from operations in Lessee's statement of cash flows. In its quantitative disclosures, Lessee will include \$100,000 of the \$102,400 in its disclosure of operating lease cost and \$2,400 in its disclosure of variable lease cost.

Case B—Variable Lease Payments Linked to Performance

ASC 842-10-55-232

Lessee enters into a 10-year lease of a building with annual lease payments of \$100,000, payable at the beginning of each year. The contract specifies that Lessee also is required to make variable lease payments each year of the lease, which are determined as 2 percent of Lessee's sales generated from the building.

ASC 842-10-55-233

At the commencement date, Lessee measures the lease liability and right-of-use asset at the same amounts as in Case A (paragraphs 842-10-55-226 through 55-231) because the 2 percent royalty that will be paid each year to Lessor under the lease is a variable lease payment, which means that payment is not included in the measurement of the lease liability (or the right-of-use asset) at any point during the lease.

ASC 842-10-55-234

During the first year of the lease, Lessee generates sales of \$1.2 million from the building and, therefore, recognizes total lease cost of \$124,000 ($\$100,000 + [2\% \times \$1.2 \text{ million}]$). In its quantitative disclosures, Lessee will include \$100,000 of the \$124,000 in its disclosure of operating lease cost and \$24,000 in its disclosure of variable lease cost.

5.9.1 Reassessment of lease term or option to purchase

There are four types of events that would cause a lessee to reassess the lease term and whether it is reasonably certain to exercise an option to purchase an underlying asset, which would trigger a remeasurement of the lease payments:

1. A significant event or change in circumstances occurs that is within the control of the lessee and directly affects whether the lessee is reasonably certain to exercise an option to either extend the lease or to purchase the underlying asset, or not to exercise an option to terminate the lease. For example, a lessee should reassess the lease term for manufacturing equipment, and whether it is reasonably certain to exercise an option to purchase the equipment, if it decides to discontinue manufacturing the product produced by the equipment. The concept of "within the control of the lessee" is meant to exclude external events, such as fluctuations in market rates to lease or buy similar assets.
2. The occurrence of an event specified in the contract obligates the lessee to exercise (or not to exercise) an option to extend or terminate the lease.
3. A lessee elects to exercise an option that the entity had previously determined it was not reasonably certain to exercise.
4. A lessee elects not to exercise an option that the entity had previously determined it was reasonably certain to exercise.

**ASC 842-10-35-1**

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

- a. There is a significant event or a significant change in circumstances that is within the control of the lessee that directly affects whether the lessee is reasonably certain to exercise or not to exercise an option to extend or terminate the lease or to purchase the underlying asset.
- b. There is an event that is written into the contract that obliges the lessee to exercise (or not to exercise) an option to extend or terminate the lease.
- c. The lessee elects to exercise an option even though the entity had previously determined that the lessee was not reasonably certain to do so.
- d. The lessee elects not to exercise an option even though the entity had previously determined that the lessee was reasonably certain to do so.

ASC 842-10-35-2

See paragraphs 842-10-55-28 through 55-29 for implementation guidance on reassessing the lease term and lessee options to purchase the underlying asset.

The implementation guidance in ASC 842-10-55-28 provides examples of events or changes in circumstances that should be considered when determining whether to reassess the lease term or the likelihood that a lessee will exercise a purchase option. These examples include constructing significant leasehold improvements that are expected to have significant value to the lessee when the option can be exercised, making significant modifications to the underlying asset, making business decisions relevant to the lessee's ability to exercise or not to exercise a renewal option, or subleasing the underlying asset for a period beyond the exercise date of a renewal option.

**ASC 842-10-55-28**

Examples of significant events or significant changes in circumstances that a lessee should consider in accordance with paragraph 842-10-35-1 include, but are not limited to, the following:

- a. Constructing significant leasehold improvements that are expected to have significant economic value for the lessee when the option becomes exercisable
- b. Making significant modifications or customizations to the underlying asset
- c. Making a business decision that is directly relevant to the lessee's ability to exercise or not to exercise an option (for example, extending the lease of a complementary asset or disposing of an alternative asset)
- d. Subleasing the underlying asset for a period beyond the exercise date of the option.

ASC 842-10-55-29

A change in market-based factors (such as market rates to lease or purchase a comparable asset) should not, in isolation, trigger reassessment of the lease term or a lessee option to purchase the underlying asset.

Example 3 from ASC 842-20-55 shows how a lessee accounts for a change in lease term.



Example 3—Initial and Subsequent Measurement by a Lessee and Accounting for a Change in the Lease Term

Case A—Initial and Subsequent Measurement of the Right-of-Use Asset and the Lease Liability

ASC 842-20-55-22

Lessee enters into a 10-year lease of an asset, with an option to extend for an additional 5 years. Lease payments are \$50,000 per year during the initial term and \$55,000 per year during the optional period, all payable at the beginning of each year. Lessee incurs initial direct costs of \$15,000.

ASC 842-20-55-23

At the commencement date, Lessee concludes that it is not reasonably certain to exercise the option to extend the lease and, therefore, determines the lease term to be 10 years.

ASC 842-20-55-24

The rate implicit in the lease is not readily determinable. Lessee's incremental borrowing rate is 5.87 percent, which reflects the fixed rate at which Lessee could borrow a similar amount in the same currency, for the same term, and with similar collateral as in the lease at the commencement date.

ASC 842-20-55-25

At the commencement date, Lessee makes the lease payment for the first year, incurs initial direct costs, and measures the lease liability at the present value of the remaining 9 payments of \$50,000, discounted at the rate of 5.87 percent, which is \$342,017. Lessee also measures a right-of-use asset of \$407,017 (the initial measurement of the lease liability plus the initial direct costs and the lease payment for the first year).

ASC 842-20-55-26

During the first year of the lease, Lessee recognizes lease expense depending on how the lease is classified. Paragraphs 842-20-55-27 through 55-30 illustrate the lease expense depending on whether the lease is classified as a finance lease or as an operating lease.

If the Lease Is Classified as a Finance Lease

ASC 842-20-55-27

Lessee depreciates its owned assets on a straight-line basis. Therefore, the right-of-use asset would be amortized on a straight-line basis over the 10-year lease term. The lease liability is increased to reflect the Year 1 interest on the lease liability in accordance with the interest method. As such, in

Year 1 of the lease, Lessee recognizes the amortization expense of \$40,702 ($\$407,017 \div 10$) and the interest expense of \$20,076 ($5.87\% \times \$342,017$).

ASC 842-20-55-28

At the end of the first year of the lease, the carrying amount of Lessee's lease liability is \$362,093 ($\$342,017 + \$20,076$), and the carrying amount of the right-of-use asset is \$366,315 ($\$407,017 - \$40,702$).

If the Lease Is Classified as an Operating Lease

ASC 842-20-55-29

Lessee determines the cost of the lease to be \$515,000 (sum of the lease payments for the lease term and initial direct costs incurred by Lessee). The annual lease expense to be recognized is therefore \$51,500 ($\$515,000 \div 10$ years).

ASC 842-20-55-30

At the end of the first year of the lease, the carrying amount of Lessee's lease liability is \$362,093 ($\$342,017 + \$20,076$), and the carrying amount of the right-of-use asset is \$375,593 (the carrying amount of the lease liability plus the remaining initial direct costs, which equal \$13,500).

Case B—Accounting for a Change in the Lease Term

ASC 842-20-55-31

At the end of Year 6 of the lease, Lessee makes significant leasehold improvements. Those improvements are expected to have significant economic value for Lessee at the end of the original lease term of 10 years. The improvements result in the underlying asset having greater utility to Lessee than alternative assets that could be leased for a similar amount and that are expected to have significant economic life beyond the original lease term. Consequently, construction of the leasehold improvements is deemed a significant event or significant change in circumstances that directly affects whether Lessee is reasonably certain to exercise the option to extend the lease and triggers a reassessment of the lease term. Upon reassessing the lease term, at the end of Year 6, Lessee concludes that it is reasonably certain to exercise the option to extend the lease for five years. Taking into consideration the extended remaining lease term, Lessee's incremental borrowing rate at the end of Year 6 is 7.83 percent. As a result of Lessee's remeasuring the remaining lease term to nine years, Lessee also would remeasure any variable lease payments that depend on an index or a rate; however, in this Example, there are no variable lease payments that depend on an index or a rate. In accordance with paragraph 842-10-25-1, Lessee reassesses the lease classification as a result of the change in the lease term. Assume for purposes of this Example that the reassessment does not change the classification of the lease from that determined at the commencement date.

ASC 842-20-55-32

At the end of Year 6, before accounting for the change in the lease term, the lease liability is \$183,973 (present value of 4 remaining payments of \$50,000, discounted at the rate of 5.87 percent). Lessee's right-of-use asset is \$162,807 if the lease is classified as a finance lease or \$189,973 if the lease is classified as an operating lease (the balance of the remeasured lease liability at the end of Year 6 plus the remaining initial direct costs of \$6,000).

ASC 842-20-55-33

Lessee remeasures the lease liability, which is now equal to the present value of 4 payments of \$50,000 followed by 5 payments of \$55,000, all discounted at the rate of 7.83 percent, which is \$355,189. Lessee increases the lease liability by \$171,216, representing the difference between the remeasured liability and its current carrying amount (\$355,189 – \$183,973). The corresponding adjustment is made to the right-of-use asset to reflect the cost of the additional rights.

ASC 842-20-55-34

Following the adjustment, the carrying amount of Lessee's right-of-use asset is \$334,023 if the lease is a finance lease (that is, \$162,807 + \$171,216) or \$361,189 if the lease is an operating lease (that is, \$189,973 + \$171,216).

ASC 842-20-55-35

Lessee then makes the \$50,000 lease payment for Year 7, reducing the lease liability to \$305,189 (\$355,189 – \$50,000), regardless of how the lease is classified.

ASC 842-20-55-36

Lessee recognizes lease expense in Year 7 as follows, depending on how the lease had been classified at the commencement date.

If the Lease Is Classified as a Finance Lease at the Commencement Date**ASC 842-20-55-37**

Lessee depreciates its owned assets on a straight-line basis. Therefore, the right-of-use asset will be amortized on a straight-line basis over the lease term. The lease liability will be reduced in accordance with the interest method. As such, in Year 7 (the first year following the remeasurement), Lessee recognizes amortization expense of \$37,114 ($\$334,023 \div 9$) and interest expense of \$23,896 ($7.83\% \times \$305,189$).

If the Lease Is Classified as an Operating Lease at the Commencement Date**ASC 842-20-55-38**

Lessee determines the remaining cost of the lease as the sum of the following:

- a. The total lease payments, as adjusted for the remeasurement, which is the sum of \$500,000 (10 payments of \$50,000 during the initial lease term) and \$275,000 (5 payments of \$55,000 during the term of the lease extension); plus
- b. The total initial direct costs attributable to the lease of \$15,000; minus
- c. The periodic lease cost recognized in prior periods of \$309,000.

ASC 842-20-55-39

The amount of the remaining cost of the lease is therefore \$481,000 ($\$775,000 + \$15,000 - \$309,000$). Consequently, Lessee determines that the annual expense to be recognized throughout the remainder of the lease term is \$53,444 ($\$481,000 \div$ the remaining lease term of 9 years).

5.9.2 Recognizing the remeasurement

When changes to the lease payments cause the lessee to remeasure the lease liability, the offset to the lease liability adjustment should be an adjustment to the right-of-use asset, and not to profit or loss. An exception is when the carrying amount of the right-of-use asset is reduced to zero, in which case, any remaining amount of the adjustment would be recognized in profit or loss. When a lessee remeasures the lease payments, it must also reallocate the consideration in the contract.



ASC 842-20-35-4

After the commencement date, a lessee shall remeasure the lease liability to reflect changes to the lease payments as described in paragraphs 842-10-35-4 through 35-5. A lessee shall recognize the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset. However, if the carrying amount of the right-of-use asset is reduced to zero, a lessee shall recognize any remaining amount of the remeasurement in profit or loss.

ASC 842-20-35-5

If there is a remeasurement of the lease liability in accordance with paragraph 842-20-35-4, the lessee shall update the discount rate for the lease at the date of remeasurement on the basis of the remaining lease term and the remaining lease payments unless the remeasurement of the lease liability is the result of one of the following:

- a. A change in the lease term or the assessment of whether the lessee will exercise an option to purchase the underlying asset and the discount rate for the lease already reflects that the lessee has an option to extend or terminate the lease or to purchase the underlying asset.
- b. A change in amounts probable of being owed by the lessee under a residual value guarantee (see paragraph 842-10-35-4(c)(3)).
- c. A change in the lease payments resulting from the resolution of a contingency upon which some or all of the variable lease payments that will be paid over the remainder of the lease term are based (see paragraph 842-10-35-4(b)).

In addition to updating other inputs to the measurement of the lease liability on remeasurement, the lessee should update the index or rate used to measure any variable payments included in lease payments to reflect the index or rate at the remeasurement date. Otherwise, absent a remeasurement event, a lessee should continue to use the index or rate from the commencement of the lease to measure the lease liability throughout the lease term.



ASC 842-10-35-5

When one or more of the events described in paragraph 842-10-35-4(a) or (c) occur or when a contingency unrelated to a change in a reference index or rate under paragraph 842-10-34(b) is resolved, variable lease payments that depend on an index or a rate shall be remeasured using the index or rate as of the date the reassessment is required.

5.10 Lease termination

When a lease is terminated before the end of the lease term, the lessee should account for the termination by removing the right-of-use asset and the lease liability from the statement of financial position and recording the difference to profit or loss.



ASC 842-20-40-1

A termination of a lease before the expiration of the lease term shall be accounted for by the lessee by removing the right-of-use asset and the lease liability, with profit or loss recognized for the difference.

The definition of a lease termination in ASC 842-20-40-1 excludes a termination caused when a lessee purchases an underlying asset. This termination is considered an integral part of the purchase of the underlying asset. When the lessee purchases the underlying asset, any difference between the purchase price of the asset and the carrying amount of the lease liability is recorded as an adjustment to the carrying amount of the asset. This guidance does not apply to assets acquired in a business combination, which are accounted for under ASC 805, *Business Combinations*.



ASC 842-20-40-2

The termination of a lease that results from the purchase of an underlying asset by the lessee is not the type of termination of a lease contemplated by paragraph 842-20-40-1 but, rather, is an integral part of the purchase of the underlying asset. If the lessee purchases the underlying asset, any difference between the purchase price and the carrying amount of the lease liability immediately before the purchase shall be recorded by the lessee as an adjustment of the carrying amount of the asset. However, this paragraph does not apply to underlying assets acquired in a business combination, which are initially measured at fair value in accordance with paragraph 805-20-30-1.



Lessee terminates lease through purchase of underlying asset

Lessee and Lessor agree that Lessee will purchase a piece of equipment it is leasing, effectively terminating the lease. A purchase option for the underlying asset was not previously included in the lease. At the time of the purchase, Lessee has recorded a right-of-use asset of \$105,000 and a lease liability of \$100,000. The purchase price of the asset is \$80,000.

Lessee records the difference between the lease liability of \$100,000 and the purchase price of the asset of \$80,000 as a \$20,000 reduction in the carrying amount of the asset. The resulting carrying amount of the asset is \$85,000, which is equal to the right-of-use asset carrying amount immediately preceding the purchase of \$105,000, less the \$20,000 reduction.

Lessee records the following journal entries to reflect its purchase of the underlying asset:

Dr. Lease liability	\$100,000
Dr. Equipment	\$ 85,000

Cr. Right-of-use asset	\$105,000
Cr. Cash	\$ 80,000

5.11 Leases denominated in a foreign currency

A lease liability is a monetary liability because it represents an obligation to pay an amount that can be determined without referring to future prices of specific goods and services. Under the guidance in ASC 830, *Foreign Currency Matters*, the lease liability, as a monetary liability, should be remeasured each period using the exchange rate at the end of each reporting period. In contrast, a right-of-use asset is a nonmonetary asset. A nonmonetary asset is not impacted by subsequent changes to the exchange rate, and is measured based on the exchange rate in effect at the date the asset is initially recognized, referred to as the historical rate. Therefore, entities with leases denominated in a foreign currency should remeasure the lease liability using the current exchange rate and remeasure the right-of-use asset using the historical exchange rate each period.

Monetary Liability: An obligation to pay a sum of money the amount of which is fixed or determinable without reference to future prices of specific goods and services.

Nonmonetary Assets and Liabilities: Nonmonetary assets and liabilities are assets and liabilities other than monetary ones. Examples are inventories; investments in common stocks; property, plant, and equipment; and liabilities for rent collected in advance.



ASC 842-20-55-10

The right-of-use asset is a nonmonetary asset while the lease liability is a monetary liability. Therefore, in accordance with Subtopic 830-10 on foreign currency matters, when accounting for a lease that is denominated in a foreign currency, if remeasurement into the lessee's functional currency is required, the lease liability is remeasured using the current exchange rate, while the right-of-use asset is remeasured using the exchange rate as of the commencement date.

5.11.1 Translation of periodic lease cost

The periodic lease cost of an operating lease is composed of two elements, even though it is recorded as a single cost:

- The amortization of the right-of-use asset, which is a nonmonetary asset, and
- Interest expense associated with the lease liability, which is a monetary liability.

Therefore, the lessee should use a blended rate consisting of the historical rate applied to amortize the right-of-use asset and a weighted-average exchange rate for the period applied to the interest expense for the lease liability.



Accounting for a foreign-currency-denominated operating lease

Lessee agrees to lease a piece of equipment from Lessor for five years. The lease is classified as an operating lease, commences on January 1, 20X1, and requires annual payments of €100, payable in arrears. Lessee's functional currency is the U.S. dollar, and its incremental borrowing rate on January 1, 20X1 is 5 percent. The exchange rates on January 1 and December 31, 20X1 are €0.83:US\$1.00 and €0.87:US\$1.00, respectively.

The following table summarizes Lessee's measurement of the right-of-use asset and lease liability during year one, denominated in euros.

Date	ROU asset amort.	ROU asset balance	Payment	Principal	Interest	Lease liability
1/1/X1		433				433
12/31/X1	78	355	100	78	22	355

On January 1, 20X1, Lessee records the following journal entry to recognize the right-of-use asset and lease liability, denominated in U.S. dollars. Both the right-of-use asset and the lease liability are translated at the spot exchange rate (€0.83:US\$1.00) on the commencement date of the lease.

Dr. Right-of-use asset	\$522
Cr. Lease liability	\$522

Although an operating lease has, pursuant to ASC 842-20-25-6, "a single lease cost," this amount can be separated into amortization of the right-of-use asset and interest expense incurred on the lease liability. Amortization of the right-of-use asset is translated at the lease commencement-date exchange rate, and interest expense is translated at the average exchange rate for the period, which in this example equals the average of the exchange rates at January 1 and December 31, 20X1, or €0.85:US\$1.00.

Amortization (€)	Rate	Amortization (US\$)	Interest (€)	Rate	Interest (US\$)	Lease expense
€78	0.83	\$94	€22	0.85	\$26	\$120

On December 31, 20X1, Lessee records the following journal entry to recognize the adjustment to the right-of-use asset and lease liability, the euro-denominated cash lease payment for year one, as well as lease expense and a transaction gain associated with the remeasurement of the lease liability at the spot exchange rate on December 31, 20X1.

Dr. Lease liability	\$114
Cr. Right-of-use asset	\$94
Dr. Lease expense	\$120

Cr. Cash	\$115
Cr. Transaction gain	\$25

5.11.2 Modification or remeasurement of a foreign-currency-denominated lease

ASC 842 does not address the application of the modification and remeasurement guidance to a lease denominated in a foreign currency. Practitioners have raised questions about how a lessee should remeasure the right-of-use asset associated with a foreign-currency-denominated lease when the lease is modified or remeasured. See Sections 5.7 and 5.8 for information about a lessee's accounting for lease modifications and remeasurements, respectively.

Based on discussions with the SEC staff, we believe that there are two acceptable approaches for remeasuring the right-of-use asset associated with a lease denominated in a foreign currency upon modification or remeasurement, and that a lessee should elect one of these two approaches as an accounting policy.

- *Remeasure the entire right-of-use asset at the current exchange rate:* Under this approach, a lessee remeasures the right-of-use asset based on the current exchange rate as of the remeasurement date. This approach applies to (1) modifications that are not accounted for as separate contracts and (2) remeasurements triggered by a change in either the lease term or the assessment of whether a lessee is reasonably certain to exercise an option to purchase the underlying asset. Applying this approach generates a foreign-exchange gain or loss upon remeasuring the right-of-use asset at the current exchange rate.
- *Measure only the incremental portion of the right-of-asset at the current exchange rate:* Under this approach, a lessee applies a "layering" approach to the right-of-use asset. The layer consisting of the right-of-use asset immediately prior to the modification or remeasurement event is still measured in the functional currency using the historical (lease commencement date) exchange rate. The layer consisting of the incremental right-of-use asset recognized upon the modification or remeasurement event is measured in the functional currency using the current exchange rate. In subsequent periods, the layers continue to be measured in the functional currency based on their respective historical exchange rates. Applying this approach does not generate a foreign-exchange gain or loss with respect to the right-of-use asset.



Remeasuring the right-of-use asset in a foreign-currency-denominated lease

Lessee agrees to lease a piece of equipment from Lessor for five years. The lease commences on January 1, 20X1 and requires annual payments of €100, payable in arrears. Lessee's functional currency is the U.S. dollar, and its incremental borrowing rate on January 1, 20X1 is 5 percent.

Lessee and Lessor modify the lease on June 30, 20X2 in a manner that does not require accounting for the modified lease as a separate contract. Specifically, Lessee and Lessor agree to extend the lease term by one year, and to increase the annual lease payments from €100 to €110 for the remainder of the lease term. The exchange rates on January 1 and December 31, 20X1 are €0.83:US\$1.00 and €0.87:US\$1.00, respectively. The exchange rate on June 30, 20X2 is €0.95:US\$1.00.

Immediately prior to the modification the carrying amounts of Lessee's right-of-use asset and lease liability are €314 and €364, respectively.

Assuming that Lessee's incremental borrowing rate remains 5 percent at June 30, 20X2, the remeasured euro-denominated lease liability at June 30, 20X2 is €487, requiring a credit to the lease liability of €123. Therefore, the right-of-use asset is debited by €123, resulting in a new carrying amount of €437.

Lessee's subsequent measurement of the right-of-use asset in its functional currency on the modification date, based on the two approaches described in this section, is as follows.

Remeasure the entire right-of use asset at the current exchange rate

The right-of-use asset of €437 is measured in Lessee's functional currency at the current exchange rate of €0.95:US\$1.00, which equals \$460. The lease liability of €487 is also measured at the current exchange rate, which yields a carrying amount of US\$513. The transaction loss is equal to the difference between the functional currency amounts of the right-of-use asset immediately prior to the modification based on the historical exchange rate (€0.83:US\$1.00) and the current exchange rate (€0.95:US\$1.00). In other words, the transaction loss is equal to $(€314 \div 0.83) - (€314 \div 0.95)$, or US\$48.

The remeasurement journal entry is as follows:

Dr. Right-of-use asset	\$82 [$\$460 - (€314 \div 0.95) - \48]
Dr. Transaction loss	\$48
Cr. Lease liability	\$130 [$€123 \div 0.95$]

Measure only the incremental portion of the right-of-use asset at the current exchange rate

The right-of-use asset of €437 consists of two layers. Layer one is the pre-modification balance of €314, and layer two is the incremental balance associated with the modification of €123. Lessee measures layer one at the historical exchange rate of €0.83:US\$1.00, and layer two at the current exchange rate of €0.95:US\$1.00. In Lessee's functional currency, layer one is equal to \$378, and layer two is equal to \$130. The functional currency right-of-use asset balance at June 30, 20X2 only requires an adjustment for the incremental amount added as a result of the modification, or layer two, of \$130.

The remeasurement journal entry is as follows:

Dr. Right-of-use asset	\$130
Cr. Lease liability	\$130

5.12 Maintenance deposits

Some lease agreements require the lessee to fund the repairs and maintenance of the leased asset for the duration of the lease. Some of these leases require lessees to deposit funds to cover future repairs and maintenance costs, which might be referred to as maintenance reserves or supplemental rent. Lessors are then required to reimburse the lessee's costs for required maintenance activities paid for with the deposit when these activities are performed.

Sometimes excess amounts remain on deposit with the lessor at the end of the lease term because the total maintenance costs were less than the deposit required in the agreement. Depending on the terms in the lease agreement, the lessor may be entitled to keep the excess amount or may be required to return it to the lessee.

A lessee must assess whether it is probable that it will recover the amount on deposit by performing maintenance activities. In determining whether recovery is probable, a lessee should determine if the event is likely to occur using the definition of “probable” in ASC 450, *Contingencies*.

At lease commencement, a lessee accounts for a maintenance deposit paid to a lessor that will be refunded when the lessee performs specified maintenance activities as a deposit asset, provided that it is probable the deposit will be used to reimburse the costs of maintenance activities paid for by the lessee. If the lessee determines that it is not probable that the deposit will be refunded, it recognizes these deposits as variable lease expense. Regardless of the probability that the deposit will be refunded, the lessee should record the costs as expense, or capitalize them in accordance with its accounting policy, when the underlying maintenance is performed.

If the lessee makes a payment to a lessor that is not “substantively and contractually related” to maintaining the leased asset, the guidance relating to contractual maintenance deposits does not apply.



ASC 842-20-55-4

Under certain leases (for example, certain equipment leases), a lessee is legally or contractually responsible for repair and maintenance of the underlying asset throughout the lease term. Additionally, certain lease agreements include provisions requiring the lessee to make deposits to the lessor to financially protect the lessor in the event the lessee does not properly maintain the underlying asset. Lease agreements often refer to these deposits as maintenance reserves or supplemental rent. However, the lessor is required to reimburse the deposits to the lessee on the completion of maintenance activities that the lessee is contractually required to perform under the lease agreement.

ASC 842-20-55-5

Under a typical arrangement, maintenance deposits are calculated on the basis of a performance measure, such as hours of use of the underlying asset, and are contractually required under the terms of the lease agreement to be used to reimburse the lessee for required maintenance of the underlying asset on the completion of that maintenance. The lessor is contractually required to reimburse the lessee for the maintenance costs paid by the lessee, to the extent of the amounts on deposit.

ASC 842-20-55-6

In some cases, the total cost of cumulative maintenance events over the term of the lease is less than the cumulative deposits, which results in excess amounts on deposit at the expiration of the lease. In those cases, some lease agreements provide that the lessor is entitled to retain such excess amounts, whereas other agreements specifically provide that, at the expiration of the lease agreement, such excess amounts are returned to the lessee (refundable maintenance deposit).

ASC 842-20-55-7

The guidance in paragraphs 842-20-55-8 through 55-9 does not apply to payments to a lessor that are not substantively and contractually related to maintenance of the leased asset. If at the commencement date a lessee determines that it is less than probable that the total amount of payments will be returned to the lessee as a reimbursement for maintenance activities, the lessee should consider that when determining the portion of each payment that is not addressed by the guidance in paragraphs 842-20-55-8 through 55-9.

ASC 842-20-55-8

Maintenance deposits paid by a lessee under an arrangement accounted for as a lease that are refunded only if the lessee performs specified maintenance activities should be accounted for as a deposit asset.

ASC 842-20-55-9

A lessee should evaluate whether it is probable that an amount on deposit recognized under paragraph 842-20-55-8 will be returned to reimburse the costs of the maintenance activities incurred by the lessee. When an amount on deposit is less than probable of being returned, it should be recognized in the same manner as variable lease expense. When the underlying maintenance is performed, the maintenance costs should be expensed or capitalized in accordance with the lessee's maintenance accounting policy.

6. Lessor accounting

The lessor accounting model under ASC 842 is based on the rights and obligations of the lessor in the lease contract. A lessor classifies a lease at commencement as one of the following types of lease:

- A sales-type lease
- A direct financing lease
- An operating lease

The accounting for each type of lease reflects a different set of rights and obligations. A sales-type lease has characteristics of a sale contract, and therefore the lessor derecognizes the underlying asset, recognizes profit or loss on the “sale,” and recognizes a financial asset for the consideration receivable. A direct financing lease has characteristics of a secured lending arrangement, whereby the lessor takes on credit risk, and therefore derecognizes the underlying asset and recognizes a financial asset on which it earns interest income. In an operating lease, the lessor retains substantial exposure to changes in the underlying asset’s value, unlike a sale or secured lending arrangement. Therefore, in an operating lease, the lessor does not derecognize the underlying asset, and recognizes income associated with providing the lessee the right to control the use of the asset ratably over the lease term.

The table in Figure 6.1 summarizes some of the key accounting concepts for a lessor in sales-type, direct financing, and operating leases.

Figure 6.1: Summary of lessor accounting

	Sales-type lease	Direct financing lease	Operating lease
Derecognize leased asset?	Yes	Yes	No
Record net investment in the lease?	Yes lease receivable + unguaranteed residual value	Yes lease receivable + unguaranteed residual value – any deferred selling profit	No
Defer initial direct costs?	Depends	Yes	Yes
Lease income recognition pattern	Gain or loss recognized up front, interest method applied prospectively	Loss recognized up front, interest method applied prospectively	Straight-line (or systematic and rational basis)

Variable payment recognition	As income in profit or loss in the period when the changes in facts and circumstances occur that trigger the variable lease payments
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At the crossroads: Lessor accounting model

As discussed in paragraph BC91 and BC92 of ASU 2016-02, the Board decided not to undertake a wholesale revision of the lessor accounting model under legacy GAAP. Certain changes to the definition of a lease under ASC 842 will impact lessors as well as lessees, and other changes to the lessor model are intended to align it with the revenue model in ASC 606. This alignment was necessary because leasing is a revenue-generating activity for lessors, and ASC 606 supersedes much of the legacy GAAP that the legacy lessor accounting model was based on.

6.1 Sales-type leases

A sales-type lease is a lease that meets one of the five classification criteria outlined in Section 4.1. This type of lease has characteristics of a sale, as the lessee effectively obtains control of the underlying asset. As a result, the lessor derecognizes the underlying asset, recognizes profit or loss as if it were selling the asset, and recognizes a net investment in the lease that includes a lease receivable representing the lessor's right to receive lease payments over the lease term. The lease payments reflected in the net investment in the lease include only those payments that meet the definition of "lease payments," as discussed in Section 1.4. The lessor recognizes interest income on the net investment in the lease over the lease term, calculated using the rate implicit in the lease, as discussed in Section 1.8.1. At the end of the lease, the lessor reclassifies the remaining net investment in the lease, which equals the asset's expected residual value, to the appropriate asset category and resumes accounting for it under the applicable guidance, including recognizing depreciation and assessing the asset for impairment.

6.1.1 Initial recognition and measurement

On the commencement date of the lease (as defined in Section 1.1), the lessor in a sales-type lease must

- Derecognize the underlying asset
- Recognize
 - The net investment in the lease
 - Selling profit or selling loss
- Initial direct costs either as an expense, if the fair value of the underlying asset differs from its carrying amount at commencement, or as a component of the lease's net investment, if the fair value of the underlying asset is the same as its carrying amount at commencement



ASC 842-30-25-1

At the commencement date, a lessor shall recognize each of the following and derecognize the underlying asset in accordance with paragraph 842-30-40-1:

- a. A net investment in the lease, measured in accordance with paragraph 842-30-30-1
- b. Selling profit or selling loss arising from the lease
- c. Initial direct costs as an expense if, at the commencement date, the fair value of the underlying asset is different from its carrying amount. If the fair value of the underlying asset equals its carrying amount, initial direct costs (see paragraphs 842-10-30-9 through 30-10) are deferred at the commencement date and included in the measurement of the net investment in the lease. The rate implicit in the lease is defined in such a way that those initial direct costs eligible for deferral are included automatically in the net investment in the lease; there is no need to add them separately.

Derecognition of the leased asset

At the commencement date of a sales-type lease, the lessor first derecognizes the carrying amount of the underlying asset, as if it had sold the asset.

If the collectibility of lease payments is not probable at the commencement date, the lessor cannot derecognize the asset. Instead, any lease payments received are recognized as a deposit liability until collectibility is probable. (Refer to Section 4.2.2 for more information about assessing collectibility.)

According to ASC 842-30-25-6, a lessor does not subsequently reassess collectibility if collectibility of the lease payments is considered probable at lease commencement. Any subsequent changes to the lessee's credit risk are evaluated under the guidance for impairment of the net investment in the lease, as discussed in Section 6.8.



ASC 842-30-40-1

At the commencement date, a lessor shall derecognize the carrying amount of the underlying asset (if previously recognized) unless the lease is a sales-type lease and collectibility of the lease payments is not probable (see paragraph 842-30-25-3).

Net investment in the lease

At the commencement date of a sales-type lease, the lessor measures and recognizes the net investment in the lease. The net investment in the lease consists of the following components:

- The lease receivable, measured at the present value and discounted using the rate implicit in the lease, comprising:
 - Lease payments not yet received by the lessor
 - The amount the lessor expects to receive from a residual value guarantee from the lessee or a third party
- The present value of the unguaranteed residual asset, discounted using the rate implicit in the lease. The unguaranteed residual asset represents the amount the lessor expects to derive from the underlying asset after the lease expires that is not guaranteed by the lessee or a third party. When the underlying asset is land, the residual value of the land should not exceed the land's fair value at the commencement date.

While the lessor is not required to present these components separately in the financial statements, they must be disclosed separately in the notes.

Lease Receivable: A lessor's right to receive lease payments arising from a sales-type lease or a direct financing lease plus any amount that a lessor expects to derive from the underlying asset following the end of the lease term to the extent that it is guaranteed by the lessee or any other third party unrelated to the lessor, measured on a discounted basis.



ASC 842-30-30-1

At the commencement date, for a sales-type lease, a lessor shall measure the net investment in the lease to include both of the following:

- a. The lease receivable, which is measured at the present value, discounted using the rate implicit in the lease, of:
 1. The lease payments (as described in paragraph 842-10-30-5) not yet received by the lessor
 2. The amount the lessor expects to derive from the underlying asset following the end of the lease term that is guaranteed by the lessee or any other third party unrelated to the lessor
- b. The unguaranteed residual asset at the present value of the amount the lessor expects to derive from the underlying asset following the end of the lease term that is not guaranteed by the lessee or any other third party unrelated to the lessor, discounted using the rate implicit in the lease.



Grant Thornton insights: Residual value in long-term land lease

For sales-type and direct financing leases, a lessor is required to include the expected residual value of the underlying asset at the end of the lease term in its initial measurement of the net investment in the lease. Unlike equipment, the expected residual value of land might be greater than its fair value at the lease commencement date.

It is our view that a lessor should cap its expected residual value for land at the land's fair value on the lease commencement date. This policy is consistent with a prior FASB staff view on FASB Statement 13, *Accounting for Leases*. Since the FASB's objective in ASC 842 is to substantially retain the model for lessor accounting used in previous GAAP, we believe this interpretation is still appropriate.

Initial direct costs

Initial direct costs are the direct, incremental costs of obtaining a lease, as defined in Section 1.2. The accounting for initial direct costs in a sales-type lease depends on the relationship of the fair value of the asset to its carrying amount. If the fair value of the underlying asset is different than its carrying amount, the initial direct costs are expensed as incurred. However, if the carrying amount and the fair value of the

underlying asset are equal in a sales-type lease, the lessor defers the initial direct costs of the lease and recognizes them over the lease term. Initial direct costs are automatically included in the measurement of the lease, based on how the rate implicit in the lease is defined. Therefore, deferred initial direct costs are reflected in the net investment in the lease. For further discussion about the relationship between initial direct costs and the rate implicit in the lease, please refer to Section 1.8.1

Selling profit or loss

At the commencement date, the lessor in a sales-type lease recognizes selling profit or selling loss in the statement of comprehensive income. Selling profit or loss is equal to the difference between (1) the lower of the fair value of the underlying asset or the sum of the lease receivable and any lease payments prepaid by the lessee, and (2) the carrying amount of the underlying asset net of any unguaranteed residual asset, minus any deferred initial direct costs of the lessor. Initial direct costs that are eligible for deferral in a sales-type lease are automatically deferred based on how the rate implicit in the lease is calculated, meaning that the lease receivable reflects the deferred initial direct costs. Therefore, computing the selling profit or loss without subtracting the deferred initial direct costs would overstate the selling profit or loss, as discussed in paragraph BC302 of ASU 2016-02.

The selling profit or loss can be presented either gross or net, based on the lessor's business model. A lessor that uses leasing as an alternative to selling goods to customers should present its selling profit or loss on a gross basis, meaning that it would recognize revenue and cost of goods sold for the leasing transaction. A lessor that presents its selling profit or loss on a gross basis recognizes revenue as the lesser of (1) the fair value of the underlying asset at commencement date or (2) the sum of the lease receivable and any lease payments prepaid by the lessee. Cost of goods sold equals the carrying amount of the underlying asset at the commencement date less the unguaranteed residual asset.

On the other hand, a lessor that uses leasing as a means of providing financing should present selling profit or loss as a net amount in a single line item. Refer to Section 10.2.2 for the guidance and a further discussion of a lessor's presentation in the statement of comprehensive income.

Selling Profit or Selling Loss: At the commencement date, selling profit or selling loss equals:

- a. The fair value of the underlying asset or the sum of (1) the lease receivable and (2) any lease payments prepaid by the lessee, if lower; minus
- b. The carrying amount of the underlying asset net of any unguaranteed residual asset; minus
- c. Any deferred initial direct costs of the lessor.

6.1.2 Subsequent recognition and measurement

In each reporting period during the term of a sales-type lease, a lessor must recognize

- Interest income on the net investment in the lease
- Variable lease payments that are not included in the net investment in the lease as income if the changes that trigger the variable payments have occurred during the reporting period
- Impairment of the net investment in the lease

Interest income is calculated by multiplying the rate implicit in the lease by the balance of the net investment in the lease at the beginning of the reporting period. In other words, the net investment in the lease is subsequently accreted using the interest method, so that the adjustment produces a constant periodic interest rate equal to the rate implicit in the lease.

Variable lease payments that are not included in the net investment in the lease are recognized when the changes that trigger the variable payments occur. For example, variable lease payments that are based on the lessee's sales during a reporting period are recognized by the lessor in that reporting period's income based on the lessee's actual sales during that reporting period.

See Section 6.8 for information about assessing the net investment in the lease for impairment.



ASC 842-30-25-2

After the commencement date, a lessor shall recognize all of the following:

- a. Interest income on the net investment in the lease, measured in accordance with paragraph 842-30-35-1(a).
- b. Variable lease payments that are not included in the net investment in the lease as income in profit or loss in the period when the changes in facts and circumstances on which the variable lease payments are based occur.
- c. Impairment of the net investment in the lease (as described in paragraph 842-30-35-3).

Subsequent measurement of net investment in a lease

The net investment in the lease is subsequently measured by (1) increasing the carrying amount for interest income recognized during the period, and (2) reducing the carrying amount for lease payments received during the period, except for variable payments that were excluded from lease payments and were in turn excluded from the initial measurement of the net investment in the lease). The net investment in the lease is not remeasured unless the lease is modified and the modification does not qualify as a separate contract. See Section 6.9 for discussion of lease modifications.



ASC 842-30-35-1

After the commencement date, a lessor shall measure the net investment in the lease by doing both of the following:

- a. Increasing the carrying amount to reflect the interest income on the net investment in the lease. A lessor shall determine the interest income on the net investment in the lease in each period during the lease term as the amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease.
- b. Reducing the carrying amount to reflect the lease payments collected during the period.

ASC 842-30-35-2

After the commencement date, a lessor shall not remeasure the net investment in the lease unless the lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8.



Sales-type lease with fixed payments

Lessor and Lessee enter into a five-year equipment lease with annual payments of \$12,000 payable in arrears. Lessee provides a residual value guarantee of \$15,000. Lessor concludes that collectibility of both the annual payments and any residual value guarantee is probable. The equipment has a ten-year remaining economic life, a net carrying amount of \$50,000, and a fair value of \$70,000 as of the lease commencement date. Lessor expects the asset to have a residual value at the end of the lease term of \$20,000. Lessor incurs \$2,500 in initial direct costs. Lessor uses leases as an alternative means of realizing value from the goods it otherwise sells.

Lessor computes a rate implicit in the lease of 3.9392 percent, which is the discount rate that equates the present value of the \$12,000 lease payments plus the expected residual value of \$20,000 with the fair value of \$70,000. Since the asset's carrying amount differs from its fair value at the lease commencement date, Lessor excludes initial direct costs from its calculation of the rate implicit in the lease (that is, Lessor does not add the initial direct costs to the fair value of the underlying asset when calculating the rate implicit in the lease).

Lessor classifies the lease as a sales-type lease because the sum of the present values of the lease payments and the residual value guaranteed by Lessee, discounted at the rate implicit in the lease, is equal to substantially all of the asset's fair value at the lease commencement date.

Lessor measures the net investment in the lease at \$70,000, which represents the sum of (1) the present value of the \$12,000 annual payments over five years, (2) the present value of Lessee's \$15,000 residual value guarantee, and (3) the present value of the \$5,000 unguaranteed residual asset (the difference between the expected residual value of \$20,000 and the guaranteed residual value of \$15,000). All present values are calculated using a discount rate equal to the rate implicit in the lease, which is 3.9392 percent.

Since Lessor uses leasing as an alternative to selling its goods, it presents selling profit on a gross rather than net basis. Therefore, Lessor measures the selling profit at \$20,000, which is equal to the difference between revenue of \$65,878 (calculated as the lesser of the fair value of the underlying asset (\$70,000) and the lease receivable plus any prepaid lease payments (\$65,878)), and cost of goods sold of \$45,878 (calculated as the carrying amount of the underlying asset (\$50,000) net of the present value of the unguaranteed residual asset (\$4,122)).

At the lease commencement date, Lessor records the following journal entries:

Dr.	Net investment in lease	\$70,000
Dr.	Cost of goods sold	\$45,878
Cr.	PP&E	\$50,000
Cr.	Revenue	\$65,878
Dr.	Expense	\$ 2,500

Cr.	Cash	\$2,500
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At the end of year one, Lessor records the receipt of cash, interest income, and an adjustment to the net investment in the lease. Lessor calculates interest income as the beginning balance of the net investment in the lease multiplied by the rate implicit in the lease ($\$70,000 \times 3.9392\% = \$2,757$). The net investment in the lease is decreased for the cash received and increased for the interest income, resulting in a net decrease of \$9,243. Lessor records the following journal entries:

Dr.	Cash	\$12,000
	Cr. Net investment in lease	\$12,000
Dr.	Net investment in lease	\$ 2,757
	Cr. Interest income	\$ 2,757

6.1.3 Sales-type leases with significant variable payments

In certain cases, a lessor enters into a lease with a significant amount of variable payments. For example, a lessor provides a customer with medical testing equipment for no additional consideration, along with the right to purchase consumables used in operating the testing equipment for a fixed period of time, with no minimum purchase required. Since variable payments that are not based on an index or rate are excluded from lease payments, this type of lease could result in a day-one loss for the lessor if it is determined to be sales-type lease, because the present value of the lease payments is less than the fair value of the underlying asset.



Grant Thornton insights: Determining the rate implicit in a lease with significant variable payments

The Master Glossary definition of “rate implicit in the lease” specifies that a lessor should use zero as the rate implicit in the lease if the rate calculated is less than zero because the sum of the lease payments and the expected residual value is less than the sum of the asset’s fair value and deferred initial direct costs. Using a rate that is less than zero as the rate implicit in the lease is not appropriate.



Sales-type lease with significant variable payments

Lessor enters into a 20-year lease of solar panels, with monthly payments based on a fixed rate per kilowatt hour multiplied by the number of kilowatt hours of electricity produced by the panels each month. Lessee does not provide a residual value guarantee. The solar panels have a 25-year remaining economic life, and the net carrying amount of the panels is equal to their fair value of \$20,000 as of the lease commencement date. Lessor expects the asset to have a residual value of \$5,000 at the end of the lease. Lessor incurs \$2,500 in initial direct costs.

Lessor computes a rate implicit in the lease of -7.2446 percent, which is the discount rate that equates the present value of the expected residual value of \$5,000 with the sum of the fair value of \$20,000 plus deferred initial direct costs of \$2,500. Since Lessor is not permitted to use a negative discount rate, the rate implicit in the lease is assumed to be zero. The lease payments, as defined in ASC 842, are zero,

since the payments are entirely variable based on the volume of electricity produced by the panels and are not based on an index or rate.

Lessor classifies the lease as a sales-type lease because, at the lease commencement date, the lease term is equal to a major part of the asset's economic life.

At the commencement date, Lessor records the net investment in the lease, which is the present value of the residual value of the underlying asset of \$5,000 discounted at a rate of zero, plus initial direct costs of \$2,500. Lessor derecognizes the equipment and recognizes the cash paid and the loss in the following journal entries:

Dr.	Net investment in lease	\$ 7,500
	Cr.	Property, plant, and equipment
		\$20,000
Dr.	Loss	\$15,000
	Cr.	Cash
		\$ 2,500

The first year's actual payments equal \$1,000 and Lessor records the following journal entries in year one:

Dr.	Cash	\$1,000
	Cr.	Net investment in lease
		\$125
	Cr.	Interest income
		\$875

Since the rate implicit in the lease is zero, Lessor amortizes the net investment in the lease to the asset's unguaranteed residual value of \$5,000 on a straight-line (or another systematic and rational) basis over the 20-year lease term.

6.1.4 Derecognition

At the end of the lease term, the lessor in a sales-type lease reclassifies the net investment in the lease to the appropriate asset category, and subsequently accounts for the asset using other applicable guidance, such as ASC 360-10.



ASC 842-30-35-5

At the end of the lease term, a lessor shall reclassify the net investment in the lease to the appropriate category of asset (for example, property, plant, and equipment) in accordance with other Topics, measured at the carrying amount of the net investment in the lease. The lessor shall account for the underlying asset that was the subject of a lease in accordance with other Topics.

6.1.5 Sales-type lease example

The following example from ASC 842-30-55 illustrates a lessor's accounting for a sales-type lease.



Example 1—Lessor Accounting Example

Case A—Lessor Accounting—Sales-Type Lease

ASC 842-30-55-19

Lessor enters into a 6-year lease of equipment with Lessee, receiving annual lease payments of \$9,500, payable at the end of each year. Lessee provides a residual value guarantee of \$13,000. Lessor concludes that it is probable it will collect the lease payments and any amount necessary to satisfy the residual value guarantee provided by Lessee. The equipment has a 9-year estimated remaining economic life, a carrying amount of \$54,000, and a fair value of \$62,000 at the commencement date. Lessor expects the residual value of the equipment to be \$20,000 at the end of the 6-year lease term. The lease does not transfer ownership of the underlying asset to Lessee or contain an option for Lessee to purchase the underlying asset. Lessor incurs \$2,000 in initial direct costs in connection with obtaining the lease, and no amounts are prepaid by Lessee to Lessor. The rate implicit in the lease is 5.4839 percent.

ASC 842-30-55-20

Lessor classifies the lease as a sales-type lease because the sum of the present value of the lease payments and the present value of the residual value guaranteed by the lessee amounts to substantially all of the fair value of the equipment. None of the other criteria to be classified as a sales-type lease are met. In accordance with paragraph 842-10-25-4, the discount rate used to determine the present value of the lease payments and the present value of the residual value guaranteed by Lessee (5.4839 percent) for purposes of assessing whether the lease is a sales-type lease under the criterion in paragraph 842-10-25-2(d) assumes that no initial direct costs will be capitalized because the fair value of the equipment is different from its carrying amount.

ASC 842-30-55-21

Lessor measures the net investment in the lease at \$62,000 at lease commencement, which is equal to the fair value of the equipment. The net investment in the lease consists of the lease receivable (which includes the 6 annual payments of \$9,500 and the residual value guarantee of \$13,000, both discounted at the rate implicit in the lease, which equals \$56,920) and the present value of the unguaranteed residual value (the present value of the difference between the expected residual value of \$20,000 and the residual value guarantee of \$13,000, which equals \$5,080). Lessor calculates the selling profit on the lease as \$8,000, which is the difference between the lease receivable (\$56,920) and the carrying amount of the equipment net of the unguaranteed residual asset ($\$54,000 - \$5,080 = \$48,920$). The initial direct costs do not factor into the calculation of the selling profit in this Example because they are not eligible for deferral on the basis of the guidance in paragraph 842-30-25-1(c) (that is, because the fair value of the underlying asset is different from its carrying amount at the commencement date).

ASC 842-30-55-22

At the commencement date, Lessor derecognizes the equipment (carrying amount of \$54,000) and recognizes the net investment in the lease of \$62,000 and the selling profit of \$8,000. Lessor also pays and recognizes the initial direct costs of \$2,000 as an expense.

ASC 842-30-55-23

At the end of Year 1, Lessor recognizes the receipt of a lease payment of \$9,500 and interest on the net investment in the lease (the beginning balance of the net investment in the lease of \$62,000 \times the rate implicit in the lease of 5.4839% = \$3,400), resulting in a balance in the net investment of the lease of \$55,900. For disclosure purposes, Lessor also calculates the separate components of the net investment in the lease: the lease receivable and the unguaranteed residual asset. The lease receivable equals \$50,541 (the beginning balance of the lease receivable of \$56,920 – the annual lease payment received of \$9,500 + the amount of interest income on the lease receivable during Year 1 of \$3,121, which is \$56,920 \times 5.4839%). The unguaranteed residual asset equals \$5,360 (the beginning balance of the unguaranteed residual asset of \$5,081 + the interest income on the unguaranteed residual asset during Year 1 of \$279, which is \$5,081 \times 5.4839%).

ASC 842-30-55-24

At the end of Year 6, Lessor reclassifies the net investment in the lease, then equal to the estimated residual value of the underlying asset of \$20,000, as equipment.

6.2 Direct financing leases

A lease that does not meet any one of the five general classification criteria in Section 4.1, but instead meets the two lessor-specific criteria in Section 4.2, is classified as a direct financing lease by the lessor. A direct financing lease converts the lessor's risk from asset risk to credit risk. In other words, rather than being exposed to fluctuations in the underlying asset's fair value during the lease term as an owner of the asset, the lessor assumes credit risk based on the lessee's ability to fulfill its payment obligations in a direct financing lease. Accordingly, the lessor in a direct financing lease derecognizes the underlying asset, recognizes any loss or defers any profit associated with derecognizing the asset, and recognizes a net investment in the lease, which includes a lease receivable for the payments owed by the lessee for using the asset over the lease term. The payments reflected in the lease's net investment include only those payments that meet the definition of lease payments, as discussed in Section 1.4. During the lease term, the lessor recognizes interest income on the net investment in the lease. At the end of the lease, the lessor reclassifies the net investment in the lease to the appropriate asset category, and subsequently accounts for that asset using the relevant accounting guidance, such as ASC 360-10.

6.2.1 Initial recognition and measurement

On the commencement date of a direct financing lease, the lessor must derecognize the underlying asset, and recognize net investment in the lease and any selling loss. Any selling profit is deferred and recognized over the term of the lease.



ASC 842-30-25-7

At the commencement date, a lessor shall recognize both of the following and derecognize the underlying asset in accordance with paragraph 842-30-40-1:

- a. A net investment in the lease, measured in accordance with paragraph 842-30-30-2.
- b. Selling loss arising from the lease, if applicable.

Derecognition of the leased asset

At the commencement date of a direct financing lease, the lessor derecognizes the carrying amount of the underlying asset using the guidance in ASC 842-30-40-1.

Net investment in the lease

At the commencement date of a direct financing lease, the lessor measures and recognizes the net investment in the lease, which comprises the following components:

- The lease receivable, measured at the present value and discounted using the rate implicit in the lease, which consists of
 - Lease payments not yet received by the lessor
 - The amount the lessor expects to receive from a residual value guarantee from the lessee or a third party
- The present value of the unguaranteed residual asset, discounted using the rate implicit in the lease. The unguaranteed residual asset represents the amount the lessor expects to derive from the underlying asset after the lease ends that is not guaranteed by the lessee or a third party. When the underlying asset is land, the residual value of the land should not exceed the land's fair value at the commencement date (see discussion in Section 1.4.7).
- Deferred profit on the lease, if any

While the lessor is not required to present these components separately in the financial statements, they must be disclosed separately in the notes.

For a discussion of the residual value in a long-term land lease, see Section 6.1.1.



ASC 842-30-30-2

At the commencement date, for a direct financing lease, a lessor shall measure the net investment in the lease to include the items in paragraph 842-30-30-1(a) through (b), reduced by the amount of any selling profit.

ASC 842-30-25-8

Selling profit and initial direct costs (see paragraphs 842-10-30-9 through 30-10) are deferred at the commencement date and included in the measurement of the net investment in the lease. The rate implicit in the lease is defined in such a way that initial direct costs deferred in accordance with this paragraph are included automatically in the net investment in the lease; there is no need to add them separately.

Initial direct costs

Initial direct costs are the incremental costs of obtaining a lease, as defined in Section 1.2. The initial direct costs are reflected in the initial measurement of the net investment in the lease, based on how the rate implicit in the lease is calculated. For further discussion about the relationship between initial direct costs and the rate implicit in the lease, please refer to Section 1.8.1

Selling profit or loss

At the lease commencement date, the lessor in a direct financing lease must determine whether there is selling profit or loss. If there is a selling loss, the lessor recognizes that amount in the statement of comprehensive income at the commencement date. If there is a selling profit, the lessor defers and recognizes that amount over the lease term. Recognizing profit over the lease term is consistent with the economic substance of a direct financing lease, which is that of a lending arrangement, in that the profit represents the lessor's credit-based return on its net investment. If instead the lessor were to defer any selling profit to be recognized in full at the end of the lease term (rather than recognized over the lease term), it might recognize a loss on the sale of the residual asset, which would not reflect the economic substance of the leasing transaction, as discussed in paragraph BC97 of ASU 2016-02.

Selling profit or loss is equal to the difference between (1) the lower of the fair value of the underlying asset or the sum of the lease receivable plus any lease payments prepaid by the lessee, and (2) the carrying amount of the underlying asset net of any unguaranteed residual asset, minus the lessor's deferred initial direct costs. Initial direct costs in a direct financing lease are automatically deferred based on how the rate implicit in the lease is calculated, meaning that the lease receivable reflects the deferred initial direct costs. Therefore, computing the selling profit or loss without subtracting the deferred initial direct costs would overstate the selling profit or loss, as discussed in paragraph BC302 of ASU 2016-02.

Selling Profit or Selling Loss: At the commencement date, selling profit or selling loss equals:

- a. The fair value of the underlying asset or the sum of (1) the lease receivable and (2) any lease payments prepaid by the lessee, if lower; minus
- b. The carrying amount of the underlying asset net of any unguaranteed residual asset; minus
- c. Any deferred initial direct costs of the lessor.

6.2.2 Subsequent recognition and measurement

A lessor in a direct financing lease must recognize the following items for each reporting period that occurs during the lease term:

- Interest income on the net investment in the lease
- Variable lease payments that are excluded from the lease's net investment as income if the changes that trigger the variable payments have occurred during the reporting period
- Impairment of the net investment in the lease

See Section 6.8 for information about assessing the net investment in the lease for impairment.



ASC 842-30-25-9

After the commencement date, a lessor shall recognize all of the following:

- a. Interest income on the net investment in the lease, measured in accordance with paragraph 842-30-35-1(a).
- b. Variable lease payments that are not included in the net investment in the lease as income in profit or loss in the period when the changes in facts and circumstances on which the variable lease payments are based occur.
- c. Impairment of the net investment in the lease (as described in paragraph 842-30-35-3).



Direct financing lease

Lessor and Lessee enter into a five-year lease of equipment with annual payments of \$12,000, payable in arrears. A third party provides a residual value guarantee of \$15,000. The equipment has a ten-year remaining economic life, a net carrying amount of \$50,000, and a fair value of \$70,000 as of the lease commencement date. Lessor expects the asset to have a residual value of \$20,000 at the end of the lease term. Lessor incurs \$2,500 in initial direct costs.

Lessor first evaluates the lease to determine whether it is a sales-type lease. Lessor computes an implicit rate (3.9392 percent) (see the “Sales-type lease with fixed payments” example, in Section 6.1.3, for information about how this rate is computed). The present value of the lease payments plus the residual value guaranteed by Lessee (which is zero in this example) is equal to 76 percent of the asset’s fair value, which is less than substantially all of the underlying asset’s fair value. Since the lease does not meet any of the general classification criteria in Section 4.1, Lessor determines that the lease is not a sales-type lease.

Next, Lessor evaluates the lease to determine whether it is a direct financing lease. Lessor computes a rate implicit in the lease of 2.8793 percent, which is the discount rate that equates the present value of the \$12,000 lease payments and the expected residual value of \$20,000, with the sum of the fair value of \$70,000 plus \$2,500 in deferred initial direct costs.

Lessor classifies the lease as a direct financing lease because the sum of the present values of the lease payments and the guaranteed residual value, discounted at the rate implicit in the lease (2.8793 percent), is equal to substantially all of the asset’s fair value at the lease commencement date, and collectibility of the lease payments is probable.

Lessor initially measures the net investment in the lease at \$52,500, which represents the sum of (1) the present value of the \$12,000 annual payments over five years, (2) the present value of the \$15,000 residual value guarantee, and (3) the present value of the \$5,000 unguaranteed residual asset (the difference between the expected residual value of \$20,000 and the guaranteed residual value of \$15,000), minus the deferred profit of \$20,000. The deferred profit is equal to (1) the lesser of the fair value of the underlying asset (\$70,000) and the lease receivable plus any prepaid lease payments (\$68,162), minus (2) the carrying amount of the underlying asset (\$50,000) net of the present value of the unguaranteed residual asset (\$4,338), minus deferred initial direct costs of \$2,500.

At the lease commencement date, Lessor records the following journal entries:

Dr.	Net investment in lease	\$52,500
	Cr. Property plant and equipment	\$50,000
	Cr. Cash	\$ 2,500

At the end of year one, Lessor recognizes \$12,000 for the first payment received. Lessor also recognizes interest income of \$7,022, calculated by multiplying the net investment in the lease by the rate necessary to amortize the value of the net investment to the expected residual value of the underlying asset at the end of the lease term ($\$52,500 \times 13.3752$ percent = \$7,022). Lessor recognizes a decrease of \$4,987 in the lease's net investment, which is calculated as the difference between the cash payment and the interest income ($\$12,000 - \$7,022 = \$4,978$). Accordingly, at the end of year one, Lessor records the following journal entries:

Dr.	Cash	\$12,000
	Cr. Net investment in lease	\$4,978
	Cr. Interest income	\$7,022

6.2.3 Derecognition

At the end of the lease term, the lessor in a direct financing lease reclassifies the net investment in the lease to the appropriate asset category, and subsequently accounts for the asset using other guidance, such as ASC 360-10.

6.2.4 Direct financing lease example

The following example from ASC 842-30-55 illustrates how a lessor accounts for a direct financing lease. The facts and circumstances from Case A are included in the example below, since Case C is based on those same facts and circumstances.



Example 1—Lessor Accounting Example

[Excerpt from Case A—Lessor Accounting—Sales-Type Lease included for reference]

ASC 842-30-55-19

Lessor enters into a 6-year lease of equipment with Lessee, receiving annual lease payments of \$9,500, payable at the end of each year. Lessee provides a residual value guarantee of \$13,000. Lessor concludes that it is probable it will collect the lease payments and any amount necessary to satisfy the residual value guarantee provided by Lessee. The equipment has a 9-year estimated remaining economic life, a carrying amount of \$54,000, and a fair value of \$62,000 at the commencement date. Lessor expects the residual value of the equipment to be \$20,000 at the end of the 6-year lease term. The lease does not transfer ownership of the underlying asset to Lessee or contain an option for Lessee to purchase the underlying asset. Lessor incurs \$2,000 in initial direct costs in connection with obtaining the lease, and no amounts are prepaid by Lessee to Lessor. The rate implicit in the lease is 5.4839 percent.

Case C—Lessor Accounting—Direct Financing Lease**ASC 842-30-55-31**

Assume the same facts and circumstances as in Case A (paragraphs 842-30-55-19 through 55-24), except that the \$13,000 residual value guarantee is provided by a third party, not by Lessee. Collectibility of the lease payments and any amount necessary to satisfy the third party residual value guarantee is probable.

ASC 842-30-55-32

None of the criteria in paragraph 842-10-25-2 to be classified as a sales-type lease are met. In accordance with paragraph 842-10-25-4, the discount rate used to determine the present value of the lease payments (5.4839 percent) for purposes of assessing whether the lease is a sales-type lease under the criterion in paragraph 842-10-25-2(d) assumes that no initial direct costs will be capitalized because the fair value of the equipment is different from its carrying amount.

ASC 842-30-55-32A

Rather, Lessor classifies the lease as a direct financing lease because the sum of the present value of the lease payments and the present value of the residual value guaranteed by the third party amounts to substantially all of the fair value of the equipment, and it is probable that Lessor will collect the lease payments plus any amount necessary to satisfy the third-party residual value guarantee. The discount rate used to determine the present value of the lease payments and the present value of the third-party residual value guarantee for purposes of assessing whether the lease meets the criterion in paragraph 842-10-25-3(b)(1) to be classified as a direct financing lease is the rate implicit in the lease of 4.646 percent, which includes the initial direct costs of \$2,000 that Lessor incurred.

ASC 842-30-55-33

At the commencement date, Lessor derecognizes the equipment and recognizes a net investment in the lease of \$56,000, which is equal to the carrying amount of the underlying asset of \$54,000 plus the initial direct costs of \$2,000 that are included in the measurement of the net investment in the lease in accordance with paragraph 842-30-25-8 (that is, because the lease is classified as a direct financing lease). The net investment in the lease includes a lease receivable of \$58,669 (the present value of the 6 annual lease payments of \$9,500 and the third-party residual value guarantee of \$13,000, discounted at the rate implicit in the lease of 4.646 percent), an unguaranteed residual asset of \$5,331 (the present value of the difference between the estimated residual value of \$20,000 and the third-party residual value guarantee of \$13,000, discounted at 4.646 percent), and deferred selling profit of \$8,000.

ASC 842-30-55-34

Lessor calculates the deferred selling profit of \$8,000 in this Example as follows:

- a. The lease receivable (\$58,669); minus
- b. The carrying amount of the equipment (\$54,000), net of the unguaranteed residual asset (\$5,331), which equals \$48,669; minus
- c. The initial direct costs included in the measurement of the net investment in the lease (\$2,000).

ASC 842-30-55-35

At the end of Year 1, Lessor recognizes the receipt of the lease payment of \$9,500 and interest on the net investment in the lease of \$4,624 (the beginning balance of the net investment in the lease of \$56,000 \times the discount rate that, at the commencement date, would have resulted in the sum of the lease receivable and the unguaranteed residual asset equaling \$56,000, which is 8.258 percent), resulting in a balance in the net investment of the lease of \$51,124.

ASC 842-30-55-36

Also at the end of Year 1, Lessor calculates, for disclosure purposes, the separate components of the net investment in the lease: the lease receivable, the unguaranteed residual asset, and the deferred selling profit. The lease receivable equals \$51,895 (the beginning balance of the lease receivable of \$58,669 – the annual lease payment received of \$9,500 + the amount of interest income on the lease receivable during Year 1 of \$2,726, which is \$58,669 \times 4.646%). The unguaranteed residual asset equals \$5,578 (the beginning balance of the unguaranteed residual asset of \$5,331 + the interest income on the unguaranteed residual asset during Year 1 of \$247, which is \$5,331 \times 4.646%). The deferred selling profit equals \$6,349 (the initial deferred selling profit of \$8,000 – \$1,651 recognized during Year 1 [the \$1,651 is the difference between the interest income recognized on the net investment in the lease during Year 1 of \$4,624 calculated in paragraph 842-30-55-35 and the sum of the interest income earned on the lease receivable and the unguaranteed residual asset during Year 1]).

ASC 842-30-55-37

At the end of Year 2, Lessor recognizes the receipt of the lease payment of \$9,500 and interest on the net investment in the lease (the beginning of Year 2 balance of the net investment in the lease of \$51,124 \times 8.258%, which is \$4,222), resulting in a carrying amount of the net investment in the lease of \$45,846.

ASC 842-30-55-38

Also at the end of Year 2, Lessor calculates the separate components of the net investment in the lease. The lease receivable equals \$44,806 (the beginning of Year 2 balance of \$51,895 – the annual lease payment received of \$9,500 + the interest income earned on the lease receivable during Year 2 of \$2,411, which is \$51,895 \times 4.646%). The unguaranteed residual asset equals \$5,837 (the beginning of Year 2 balance of the unguaranteed residual asset of \$5,578 + the interest income earned on the unguaranteed residual asset during Year 2 of \$259, which is \$5,578 \times 4.646%). The deferred selling profit equals \$4,797 (the beginning of Year 2 balance of deferred selling profit of \$6,349 – \$1,552 recognized during Year 2 [the \$1,552 is the difference between the interest income recognized on the net investment in the lease during Year 2 of \$4,222 and the sum of the interest income earned on the lease receivable and the unguaranteed residual asset during Year 2]).

ASC 842-30-55-39

At the end of Year 6, Lessor reclassifies the net investment in the lease, then equal to the estimated residual value of the underlying asset of \$20,000, as equipment.

6.3 Operating leases

Unlike in a sales-type or a direct financing lease, the lessor in an operating lease remains exposed to risk by way of future changes in the fair value of the underlying asset (asset risk). Therefore, the lessor continues to recognize the underlying asset on its statement of financial position, does not recognize a net investment in the lease or any selling profit or loss, and recognizes income generally on a straight-line basis over the lease term.

6.3.1 Initial recognition and measurement

At the commencement date of an operating lease, the lessor does not derecognize the underlying asset. The lessor continues depreciating the asset over the lease term and assessing it for impairment when appropriate.



ASC 842-30-30-4

A lessor shall continue to measure the underlying asset subject to an operating lease in accordance with other Topics.

ASC 842-30-35-6

A lessor shall continue to measure, including testing for impairment in accordance with Section 360-10-35 on impairment or disposal of long-lived assets, the underlying asset subject to an operating lease in accordance with other Topics.

If, at the commencement of an operating lease, a lessor determines that collectibility of lease payments and any amount needed to satisfy a residual value guarantee is not probable, then lease income is limited to the lesser of either (1) the amount that would have been recognized on a straight-line or other systematic and rational basis had collectibility been probable, or (2) the amount that has actually been collected from the lessee. Refer to Section 6.4.3 for further discussion of how a lessor considers collectibility for an operating lease.

Initial direct costs

A lessor defers and expenses initial direct costs in an operating lease over the lease term. Refer to Section 1.2 for more information about initial direct costs.



ASC 842-30-25-10

At the commencement date, a lessor shall defer initial direct costs.

6.3.2 Subsequent recognition and measurement

After the commencement date of an operating lease, the lessor recognizes the following:

- Lease payments as income over the lease term on a straight-line or other systematic and rational basis

- Variable lease payments as income in the period when the changes that trigger the variable lease payments occur
- Initial direct costs as expense over the lease term on the same basis as lease income

**ASC 842-30-25-11**

After the commencement date, a lessor shall recognize all of the following:

- a. The lease payments as income in profit or loss over the lease term on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the use of the underlying asset, subject to paragraph 842-30-25-12.
- b. Variable lease payments as income in profit or loss in the period in which the changes in facts and circumstances on which the variable lease payments are based occur.
- c. Initial direct costs as an expense over the lease term on the same basis as lease income (as described in (a)).

The implementation guidance in ASC 842-30-55 states that when considering how to recognize lease payments in an operating lease, lessors should treat the right to control the use of the asset the same as the physical use of the asset. Therefore, the extent to which a lessee uses the underlying asset should not impact how the lessor recognizes income.

**ASC 842-30-55-17**

This Subtopic considers the right to control the use of the underlying asset as the equivalent of physical use. If the lessee controls the use of the underlying asset, recognition of lease income in accordance with paragraph 842-30-25-11(a) should not be affected by the extent to which the lessee uses the underlying asset.

Lease payments recognized as income

A lessor recognizes lease payments from an operating lease as income in profit or loss generally on a straight-line basis over the lease term. However, the Board noted in paragraph BC327 in ASU 2016-02 that a lessor might depart from using a straight-line basis to recognize income from an operating lease if doing so better represents how the underlying asset is being used. The Board clarified that a lessor is still expected to recognize fixed payments on a straight-line basis when payments are uneven for reasons other than to reflect or compensate for market rentals or market conditions. For example, the Board expects a lessor to recognize lease income on a straight-line basis if there is significant front-loading or back-loading of payments or if a lease contains rent-free periods.



At the crossroads: Lessor's recognition of operating lease income

Based on discussion with the FASB staff, it is our understanding that the Board did not intend the discussion in paragraph BC327 to change how lessors recognize operating lease income under legacy GAAP. Specifically, under ASC 842, lessors are not required to evaluate uneven operating lease payment patterns to determine whether the pattern corresponds to expectations about changes in market rentals or market conditions. Further, the guidance in paragraphs ASC 842-30-25-11(a) and ASC 842-30-55-17 are authoritative guidance, which take precedence over the discussion in the Basis for Conclusions. Accordingly, we expect that most operating leases will continue to be recognized on a straight-line basis under ASC 842.



ASU 2016-02 BC327

Although in the Board's view, recognizing rental income on a straight-line basis often will reflect the pattern in which income is earned from the underlying asset, it noted, consistent with previous GAAP, that will not always be the case. For example, the Board concluded that it would be simpler and more consistent with its proposals on variable lease payments to recognize lease income arising from variable lease payments for operating leases in the period in which the changes in facts and circumstances on which the payments are based occur, rather than on a straight-line basis. Consequently, the Board decided that a lessor should recognize rental income on a systematic basis that is not straight line if that basis was more representative of the pattern in which income is earned from the underlying asset. Nonetheless, a lessor is expected to recognize uneven fixed lease payments on a straight-line basis when the payments are uneven for reasons other than to reflect or compensate for market rentals or market conditions (for example, when there is significant front-loading or back-loading of payments or when rent-free periods exist in a lease).

Variable lease payments

Variable lease payments are recognized as income in the period when the changes in facts and circumstances that triggered the variable payments occur. In this regard, a lessor's accounting for an operating lease should mirror its accounting for sales-type and direct financing leases.

Initial direct costs

Initial direct costs incurred by a lessor in connection with an operating lease must be deferred at the commencement date of the lease and subsequently recognized as expense on the same basis as the lease payments (generally a straight-line basis) over the term of the lease.

6.4 Collectibility

At the commencement date of the lease, the lessor assesses whether it is probable that it will collect the lease payments and any residual value guarantee from the lessee. The definition of "probable" used in this assessment means that the collection of payments is "likely to occur" in line with the definition of probable in other areas of U.S. GAAP. For further discussion on collectibility, refer to Section 4.2.2.

6.4.1 Sales-type leases and collectibility

If the collectibility of payments from the lessee is not probable in a sales-type lease, the lessor neither derecognizes the underlying asset nor recognizes a net investment in the lease. Instead, the lessor recognizes the lease payments received, including variable payments, as a deposit liability until one of the following events occurs:

- Collectibility becomes probable.
- The contract is terminated and the lease payments are nonrefundable.
- The lessor has repossessed the underlying asset, has no further obligation under the contract to the lessee, and the lease payments received are nonrefundable.



ASC 842-30-40-1

At the commencement date, a lessor shall derecognize the carrying amount of the underlying asset (if previously recognized) unless the lease is a sales-type lease and collectibility of the lease payments is not probable (see paragraph 842-30-25-3).

ASC 842-30-25-3

The guidance in paragraphs 842-30-25-1 through 25-2 notwithstanding, if collectibility of the lease payments, plus any amount necessary to satisfy a residual value guarantee provided by the lessee, is not probable at the commencement date, the lessor shall not derecognize the underlying asset but shall recognize lease payments received—including variable lease payments—as a deposit liability until the earlier of either of the following:

- a. Collectibility of the lease payments, plus any amount necessary to satisfy a residual value guarantee provided by the lessee, becomes probable. If collectibility is not probable at the commencement date, a lessor shall continue to assess collectibility to determine whether the lease payments and any amount necessary to satisfy a residual value guarantee are probable of collection.
- b. Either of the following events occurs:
 1. The contract has been terminated, and the lease payments received from the lessee are nonrefundable.
 2. The lessor has repossessed the underlying asset, it has no further obligation under the contract to the lessee, and the lease payments received from the lessee are nonrefundable.

If collectibility is not probable at lease commencement for a sales-type lease, a lessor should reassess collectibility until collectibility is probable or the lease is terminated. If collectibility becomes probable during the term of the lease, the lessor must

- Derecognize the carrying amount of the underlying asset
- Derecognize the amount of any deposit liability recognized based on payments received
- Recognize a net investment in the lease on the basis of the remaining lease payments discounted at the rate implicit in the lease determined at the commencement date

- Recognize selling profit or selling loss, based on
 - The lease receivable plus the carrying amount of the deposit liability, minus
 - The carrying amount of the underlying asset (net of the unguaranteed residual asset)

**ASC 842-30-25-4**

When collectibility is not probable at the commencement date, at the date the criterion in paragraph 842-30-25-3(a) is met (that is, the date at which collectibility of the lease payments plus any amount necessary to satisfy a residual value guarantee provided by the lessee is assessed as probable), the lessor shall do all of the following:

- a. Derecognize the carrying amount of the underlying asset.
- b. Derecognize the carrying amount of any deposit liability recognized in accordance with paragraph 842-30-25-3.
- c. Recognize a net investment in the lease on the basis of the remaining lease payments and remaining lease term, using the rate implicit in the lease determined at the commencement date.
- d. Recognize selling profit or selling loss calculated as:
 1. The lease receivable; plus
 2. The carrying amount of the deposit liability; minus
 3. The carrying amount of the underlying asset, net of the unguaranteed residual asset.

ASC 842-30-25-5

When collectibility is not probable at the commencement date, at the date the criterion in paragraph 842-30-25-3(b) is met, the lessor shall derecognize the carrying amount of any deposit liability recognized in accordance with paragraph 842-30-25-3, with the corresponding amount recognized as lease income.

ASC 842-30-25-6

If collectibility is probable at the commencement date for a sales-type lease or for a direct financing lease, a lessor shall not reassess whether collectibility is probable. Subsequent changes in the credit risk of the lessee shall be accounted for in accordance with the impairment guidance applicable to the net investment in the lease in paragraph 842-30-35-3.

Example 1, Case B from ASC 842-30-55, shows how the lessor accounts for a sales-type lease if collectibility is not probable at the lease commencement date. The facts and circumstances from Case A are repeated in the example below, because Case B is based on those same facts and circumstances.



Example 1—Lessor Accounting Example

[Excerpt from Case A—Lessor Accounting—Sales-Type Lease included for reference]

ASC 842-30-55-19

Lessor enters into a 6-year lease of equipment with Lessee, receiving annual lease payments of \$9,500, payable at the end of each year. Lessee provides a residual value guarantee of \$13,000. Lessor concludes that it is probable it will collect the lease payments and any amount necessary to satisfy the residual value guarantee provided by Lessee. The equipment has a 9-year estimated remaining economic life, a carrying amount of \$54,000, and a fair value of \$62,000 at the commencement date. Lessor expects the residual value of the equipment to be \$20,000 at the end of the 6-year lease term. The lease does not transfer ownership of the underlying asset to Lessee or contain an option for Lessee to purchase the underlying asset. Lessor incurs \$2,000 in initial direct costs in connection with obtaining the lease, and no amounts are prepaid by Lessee to Lessor. The rate implicit in the lease is 5.4839 percent.

Case B—Lessor Accounting—Sales-Type Lease—Collectibility of the Lease Payments Is Not Probable

ASC 842-30-55-25

Assume the same facts and circumstances as in Case A (paragraphs 842-30-55-19 through 55-24), except that it is not probable Lessor will collect the lease payments and any amount necessary to satisfy the residual value guarantee provided by Lessee. In reaching this conclusion, the entity observes that Lessee's ability and intention to pay may be in doubt because of the following factors:

- a. Lessee intends to make the lease payments primarily from income derived from its business in which the equipment will be used (which is a business facing significant risks because of high competition in the industry and Lessee's limited experience)
- b. Lessee has limited credit history and no significant other income or assets with which to make the payments if the business is not successful.

ASC 842-30-55-26

In accordance with paragraph 842-30-25-3, Lessor does not derecognize the equipment and does not recognize a net investment in the lease or any selling profit or selling loss. However, consistent with Case A, Lessor pays and recognizes the initial direct costs of \$2,000 as an expense at the commencement date.

ASC 842-30-55-27

At the end of Year 1, Lessor reassesses whether it is probable it will collect the lease payments and any amount necessary to satisfy the residual value guarantee provided by Lessee and concludes that it is not probable. In addition, neither of the events in paragraph 842-30-25-3(b) has occurred. The contract has not been terminated and Lessor has not repossessed the equipment because Lessee is fulfilling the terms of the contract. Consequently, Lessor accounts for the \$9,500 Year 1 lease payment

as a deposit liability in accordance with paragraph 842-30-25-3. Lessor recognizes depreciation expense on the equipment of \$7,714 ($\$54,000 \text{ carrying value} \div 7\text{-year useful life}$).

ASC 842-30-55-28

Lessor's accounting in Years 2 and 3 is the same as in Year 1. At the end of Year 4, Lessee makes the fourth \$9,500 annual lease payment such that the deposit liability equals \$38,000. Lessor concludes that collectibility of the lease payments and any amount necessary to satisfy the residual value guarantee provided by Lessee is now probable on the basis of Lessee's payment history under the contract and the fact that Lessee has been successfully operating its business for four years. Lessor does not reassess the classification of the lease as a sales-type lease.

ASC 842-30-55-29

Consequently, at the end of Year 4, Lessor derecognizes the equipment, which has a carrying amount of \$23,143, and recognizes a net investment in the lease of \$35,519. The net investment in the lease consists of the lease receivable (the sum of the 2 remaining annual payments of \$9,500 and the residual value guarantee of \$13,000, discounted at the rate implicit in the lease of 5.4839 percent determined at the commencement date, which equals \$29,228) and the unguaranteed residual asset (the present value of the difference between the expected residual value of \$20,000 and the residual value guarantee of \$13,000, which equals \$6,291). Lessor recognizes selling profit of \$50,376, the difference between (a) the sum of the lease receivable and the carrying amount of the deposit liability ($\$29,228 \text{ lease receivable} + \$38,000 \text{ in lease payments already made} = \$67,228$) and (b) the carrying amount of the equipment, net of the unguaranteed residual asset ($\$23,143 - \$6,291 = \$16,852$).

ASC 842-30-55-30

After the end of Year 4, Lessor accounts for the remaining two years of the lease in the same manner as any other sales-type lease. Consistent with Case A, at the end of Year 6, Lessor reclassifies the net investment in the lease, then equal to the estimated residual value of the underlying asset of \$20,000, as equipment.

6.4.2 Direct financing leases and collectibility

A lease that is not a sales-type lease is only classified as a direct financing lease if collectibility of the lease payments and any amount necessary to satisfy a residual value guarantee is probable at lease commencement. If collectibility is not probable, the lease would not meet the criteria to be classified as a direct financing lease and would instead be classified as an operating lease.

6.4.3 Operating leases and collectibility

A lease is classified as an operating lease if it does not qualify as a sales-type lease and the lessor decides at lease commencement that collectibility of the lease payments and any amount necessary to satisfy a residual guarantee is not probable. In this case, the lessor's lease income is limited to the lesser of (1) the lease income that would have been recognized had collectibility been probable, or (2) the lease payments collected from the lessee to date, including any variable lease payments.

A lessor must continuously monitor collectibility for an operating lease. If the lessor's assessment of collectibility changes from probable to not probable, or vice versa, during the lease term, it must recognize an adjustment to lease income in the period in which its collectibility assessment changes, so that the cumulative lease income recognized is equal to the lesser of either (1) the amount that would

have been recognized on a straight-line or other systematic and rational basis had collectibility been probable, or (2) the amount that has actually been collected from the lessee.



ASC 842-30-25-12

If collectibility of the lease payments plus any amount necessary to satisfy a residual value guarantee (provided by the lessee or any other unrelated third party) is not probable at the commencement date, lease income shall be limited to the lesser of the income that would be recognized in accordance with paragraph 842-30-25-11(a) through (b) or the lease payments, including variable lease payments, that have been collected from the lessee.

ASC 842-30-25-13

If the assessment of collectibility changes after the commencement date, any difference between the lease income that would have been recognized in accordance with paragraph 842-30-25-11(a) through (b) and the lease payments, including variable lease payments, that have been collected from the lessee shall be recognized as a current-period adjustment to lease income.

Example 1, Case B, in ASC 842-30-55 illustrates a lessor's accounting for a direct financing lease when collectibility is not probable at the commencement date of the lease, but is later deemed probable. The facts and circumstances used in Case A and Case C are repeated here since they also apply to Case D.



Example 1—Lessor Accounting Example

[Excerpt from Case A—Lessor Accounting—Sales-Type Lease and Case C—Lessor Accounting—Direct Financing Lease included for reference]

ASC 842-30-55-19

Lessor enters into a 6-year lease of equipment with Lessee, receiving annual lease payments of \$9,500, payable at the end of each year. Lessee provides a residual value guarantee of \$13,000. Lessor concludes that it is probable it will collect the lease payments and any amount necessary to satisfy the residual value guarantee provided by Lessee. The equipment has a 9-year estimated remaining economic life, a carrying amount of \$54,000, and a fair value of \$62,000 at the commencement date. Lessor expects the residual value of the equipment to be \$20,000 at the end of the 6-year lease term. The lease does not transfer ownership of the underlying asset to Lessee or contain an option for Lessee to purchase the underlying asset. Lessor incurs \$2,000 in initial direct costs in connection with obtaining the lease, and no amounts are prepaid by Lessee to Lessor. The rate implicit in the lease is 5.4839 percent.

ASC 842-30-55-31

Assume the same facts and circumstances as in Case A (paragraphs 842-30-55-19 through 55-24), except that the \$13,000 residual value guarantee is provided by a third party, not by Lessee. Collectibility of the lease payments and any amount necessary to satisfy the third party residual value guarantee is probable.

Case D—Lessor Accounting—Collectibility is Not Probable

ASC 842-30-55-40

Assume the same facts and circumstances as Case C (paragraphs 842-30-55-31 through 55-39), except that collectibility of the lease payments and any amount necessary to satisfy the residual value guarantee provided by the third party is not probable and the lease payments escalate every year over the lease term. Specifically, the lease payment due at the end of Year 1 is \$7,000, and subsequent payments increase by \$1,000 every year for the remainder of the lease term. Because it is not probable that Lessor will collect the lease payments and any amount necessary to satisfy the residual value guarantee provided by the third party in accordance with paragraph 842-10-25-3, Lessor classifies the lease as an operating lease.

ASC 842-30-55-41

Lessor continues to measure the equipment in accordance with Topic 360 on property, plant, and equipment.

ASC 842-30-55-42

Because collectibility of the lease payments is not probable, Lessor recognizes lease income only when Lessee makes the lease payments, and in the amount of those lease payments. Therefore, Lessor only recognizes lease income of \$7,000 at the point in time Lessee makes the end of Year 1 payment for that amount.

ASC 842-30-55-43

At the end of Year 2, Lessor concludes that collectibility of the remaining lease payments and any amount necessary to satisfy the residual value guarantee provided by the third party is probable; therefore, Lessor recognizes lease income of \$12,000. The amount of \$12,000 is the difference between lease income that would have been recognized through the end of Year 2 (\$57,000 in total lease payments ÷ 6 years = \$9,500 per year × 2 years = \$19,000) and the \$7,000 in lease income previously recognized. Collectibility of the remaining lease payments remains probable throughout the remainder of the lease term; therefore, Lessor continues to recognize lease income of \$9,500 each year.

6.5 Lessor costs to fulfil lease obligations

A lessor may incur costs to fulfill its obligations under a lease, such as costs to transport the underlying asset to the lessee's facility. Generally these costs do not qualify as initial direct costs, as defined in Section 2.1. However, if the lessor were to sell rather than lease the underlying asset, such costs might qualify for deferral, in accordance with ASC 340-40, *Other Assets and Deferred Costs: Contracts with Customers*.

In a speech at the AICPA's 2018 Conference on Current SEC and PCAOB Developments, a staff member from the SEC's Office of the Chief Accountant [noted](#) that if costs incurred to fulfill a lessor's lease obligation are not within the scope of other GAAP and would qualify for deferral if the arrangement were within the scope of ASC 606, the SEC staff would not object to a lessor capitalizing and amortizing these costs by analogy to the guidance in ASC 340-40.

A lessor that makes a policy election to analogize to ASC 340-40 for costs to fulfill lease obligations should apply the policy consistently and disclose it if it is material to the financial statements.

6.6 Sale of the lease receivable

If a lessor in a sales-type or direct financing lease sells the lease receivable, the derecognition requirements for financial assets in ASC 860, *Transfers and Servicing*, should be applied to the transaction. In paragraph BC317 of ASU 2016-02, the Board notes that a lease receivable has no particular features that would prevent it from being derecognized as a financial instrument. In addition, the Board discussed in paragraph BC316 of ASU 2016-02 that lessors are not permitted to measure lease receivables held for sale at fair value.

If the lessor retains an interest in the unguaranteed residual asset underlying the lease receivable that is sold, it does not continue to accrete the unguaranteed residual asset to its estimated value over the remaining lease term. Instead, the lessor continues to recognize the unguaranteed residual asset at its carrying amount as of the date when the lease receivable is sold. The lessor also assesses the unguaranteed residual asset for impairment in accordance with ASC 360, *Property, Plant, and Equipment*.



ASC 842-30-35-4

If a lessor sells substantially all of the lease receivable associated with a sales-type lease or a direct financing lease and retains an interest in the unguaranteed residual asset, the lessor shall not continue to accrete the unguaranteed residual asset to its estimated value over the remaining lease term. The lessor shall report any remaining unguaranteed residual asset thereafter at its carrying amount at the date of the sale of the lease receivable and apply Topic 360 on property, plant, and equipment to determine whether the unguaranteed residual asset is impaired.

6.7 Sales of equipment with guaranteed minimum resale amount

If a seller guarantees that a customer that is the end user of equipment will receive, either from the seller or a third party, a minimum resale value of a piece of equipment as a sales incentive, one possible outcome is that the seller would account for the transaction as a lease instead of a sale. The guarantee might require the seller to repurchase the equipment at a guaranteed price within a specific time period as a means to facilitate the resale of the equipment, or the seller might pay the customer for the difference between the proceeds from the resale and the guaranteed minimum resale value. In some circumstances a dealer or distributor may be involved in the sale transaction.



Sales of Equipment with Guaranteed Minimum Resale Amount

ASC 842-30-55-1

This implementation guidance addresses the application of the provisions of this Subtopic in the following circumstances. A manufacturer sells equipment with an expected useful life of several years to end users (purchasers) utilizing various sales incentive programs. Under one such sales incentive program, the manufacturer contractually guarantees that the purchaser will receive a minimum resale amount at the time the equipment is disposed of, contingent on certain requirements.

ASC 842-30-55-2

The manufacturer provides the guarantee by agreeing to do either of the following:

- a. Reacquire the equipment at a guaranteed price at specified time periods as a means to facilitate its resale
- b. Pay the purchaser for the deficiency, if any, between the sales proceeds received for the equipment and the guaranteed minimum resale value.

There may be dealer involvement in these types of transactions, but the minimum resale guarantee is the responsibility of the manufacturer.

6.7.1 Guarantee payment

One type of sales incentive program is structured so that the seller contractually guarantees that it will pay the customer that is a reseller for the shortfall if the proceeds received for reselling the asset is less than the asset's guaranteed minimum resale value. In this case, the seller accounts for the guarantee in accordance with ASC 460 and ASC 606.

**Sales of Equipment with Guaranteed Minimum Resale Amount (continued)****ASC 842-30-55-4**

A sales incentive program in which an entity (for example, a manufacturer) contractually guarantees that it will pay a purchaser for the deficiency, if any, between the sales proceeds received for the equipment and the guaranteed minimum resale value should be accounted for in accordance with Topic 460 on guarantees and Topic 606 on revenue from contracts with customers.

6.7.2 Repurchase right

In another type of sales incentive program, the seller guarantees that it has either the right or the obligation to reacquire the asset at a guaranteed price within a specified time period as a means to facilitate the asset's resale. This type of sales incentive should be evaluated using the guidance on satisfying performance obligations in ASC 606-10-25-30 and the guidance on repurchase agreements in ASC 606-10-55-66 through 55-78 to determine whether the contract is a lease. If the contract qualifies as a lease, it is accounted for under the guidance in ASC 842.

**Sales of Equipment with Guaranteed Minimum Resale Amount (continued)****ASC 842-30-55-3**

A sales incentive program in which an entity (for example, a manufacturer) contractually guarantees that it has either a right or an obligation to reacquire the equipment at a guaranteed price (or prices) at a specified time (or specified time periods) as a means to facilitate its resale should be evaluated in accordance with the guidance on satisfaction of performance obligations in paragraph 606-10-25-30 and the guidance on repurchase agreements in paragraphs 606-10-55-66 through 55-78. If that

evaluation results in a lease, the manufacturer should account for the transaction as a lease using the principles of lease accounting in Subtopic 842-10 and in this Subtopic.

If a seller concludes, after analyzing a contract under ASC 606, that the transaction should be accounted for as a lease, it must determine how to classify the lease. Lease payments used in this determination generally equal the difference between the proceeds the seller receives from the purchaser when the equipment is initially transferred and the amount of the residual value guarantee to the purchaser as of the first exercise date of the guarantee.



ASC 842-30-55-5

The lease payments used as part of the determination of whether the transaction should be classified as an operating lease, a direct financing lease, or a sales-type lease generally will be the difference between the proceeds upon the equipment's initial transfer and the amount of the residual value guarantee to the purchaser as of the first exercise date of the guarantee.

6.7.3 Contract with repurchase rights classified as an operating lease

If a transaction that otherwise would be accounted for as a sale under ASC 606, except that it involves a repurchase right that causes it to be accounted for as a lease, is classified as an operating lease, the net proceeds from the equipment's initial transfer to the lessee should be recognized as a liability in the seller's statement of financial position. The liability is reduced to the amount of the guaranteed residual value on a pro rata basis over the period covered by the guarantee, up to the first date when the guarantee can be exercised. Revenue is recognized on the transferred underlying asset as an offset to the reduction in the liability. The asset is not derecognized at the time of the transaction, but instead remains on the seller's statement of financial position, is depreciated in line with the seller's accounting policy, and is evaluated for impairment under the appropriate guidance.



Sales of Equipment with Guaranteed Minimum Resale Amount (continued)

ASC 842-30-55-6

If the transaction qualifies as an operating lease, the net proceeds upon the equipment's initial transfer should be recorded as a liability in the manufacturer's balance sheet.

ASC 842-30-55-7

The liability is then subsequently reduced on a pro rata basis over the period to the first exercise date of the guarantee to the amount of the guaranteed residual value at that date with corresponding credits to revenue in the manufacturer's income statement. Any further reduction in the guaranteed residual value resulting from the purchaser's decision to continue to use the equipment should be recognized in a similar manner.

ASC 842-30-55-8

The equipment should be included in the manufacturer's balance sheet and depreciated following the manufacturer's normal depreciation policy.

ASC 842-30-55-9

The Impairment or Disposal of Long-Lived Assets Subsections of Subtopic 360-10 on property, plant, and equipment provide guidance on the accounting for any potential impairment of the equipment.

6.7.4 Customer's exercise of residual value guarantee

When the customer exercises a residual value guarantee by selling equipment to another party, the liability on the seller's books is reduced by the amount paid to the customer. At that time, the remaining undepreciated carrying amount of the equipment, and any remaining liability, are removed from the seller's statement of financial position. This derecognition affects the determination of income in the period the equipment is sold.

If the customer exercises the residual value guarantee by selling the equipment back to the seller at the guaranteed price, the seller reduces its liability by the amount it pays to the customer. If there is any remaining liability after that reduction, the seller includes it in the determination of income for the period in which the guarantee is exercised.



ASC 842-30-55-10

At the time the purchaser elects to exercise the residual value guarantee by selling the equipment to another party, the liability should be reduced by the amount, if any, paid to the purchaser. The remaining undepreciated carrying amount of the equipment and any remaining liability should be removed from the balance sheet and included in the determination of income of the period of the equipment's sale.

ASC 842-30-55-11

Alternatively, if the purchaser exercises the residual value guarantee by selling the equipment to the manufacturer at the guaranteed price, the liability should be reduced by the amount paid to the purchaser. Any remaining liability should be included in the determination of income of the period of the exercise of the guarantee.

6.7.5 Minimum resale value guarantees not in scope of derivative or guarantee guidance

A minimum resale value guarantee is not within the scope of the guidance in ASC 815. Specifically, the embedded guarantee feature discussed in this section qualifies for a scope exception from derivative accounting because (1) it is not traded on an exchange, and (2) its underlying is based on the price of a nonfinancial asset (the asset underlying the lease) of one of the parties to the contract and is not readily convertible to cash.

**ASC 842-30-55-12**

The accounting for a guaranteed minimum resale value is not in the scope of Topic 815 on derivatives and hedging. In the transaction described, the embedded guarantee feature is not an embedded derivative instrument that must be accounted for separately from the lease because it does not meet the criterion in paragraph 815-15-25-1(c).

ASC 842-30-55-13

Specifically, if freestanding, the guarantee feature would be excluded from the scope of paragraph 815-10-15-59(b) because of both of the following conditions:

- a. It is not exchange traded.
- b. The underlying on which settlement is based is the price of a nonfinancial asset of one of the parties, and that asset is not readily convertible to cash. It is assumed that the equipment is not readily convertible to cash, as that phrase is used in Topic 815.

ASC 842-30-55-14

Paragraph 815-10-15-59(b)(2) states that the related exception applies only if the nonfinancial asset related to the underlying is owned by the party that would not benefit under the contract from an increase in the price or value of the nonfinancial asset. (In some circumstances, the exclusion in paragraph 815-10-15-63 also would apply.)

The relevant paragraphs of ASC 815, referred to in the excerpt from ASC 842 above, are included below for reference.

**ASC 815-15-25-1**

An embedded derivative shall be separated from the host contract and accounted for as a derivative instrument pursuant to Subtopic 815-10 if and only if all of the following criteria are met:

- a. The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.
- b. The hybrid instrument is not remeasured at fair value under otherwise applicable generally accepted accounting principles (GAAP) with changes in fair value reported in earnings as they occur.

A separate instrument with the same terms as the embedded derivative would, pursuant to Section 815-10-15, be a derivative instrument subject to the requirements of this Subtopic. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

ASC 815-10-15-59

Contracts that are not exchange-traded are not subject to the requirements of this Subtopic if the underlying on which the settlement is based is any one of the following:

- a. A climatic or geological variable or other physical variable. Climatic, geological, and other physical variables include things like the number of inches of rainfall or snow in a particular area and the severity of an earthquake as measured by the Richter scale. (See Example 13 [paragraph 815-10-55-135].)
- b. The price or value of a nonfinancial asset of one of the parties to the contract provided that the asset is not readily convertible to cash. This scope exception applies only if both of the following are true:
 1. The nonfinancial assets are unique.
 2. The nonfinancial asset related to the underlying is owned by the party that would not benefit under the contract from an increase in the fair value of the nonfinancial asset. (If the contract is a call option, the scope exception applies only if that nonfinancial asset is owned by the party that would not benefit under the contract from an increase in the fair value of the nonfinancial asset above the option's strike price.)
- c. The fair value of a nonfinancial liability of one of the parties to the contract provided that the liability does not require delivery of an asset that is readily convertible to cash.
- d. Specified volumes of sales or service revenues of one of the parties to the contract. (This scope exception applies to contracts with settlements based on the volume of items sold or services rendered, for example, royalty agreements. This scope exception does not apply to contracts based on changes in sales or revenues due to changes in market prices.)

ASC 815-10-15-63

A derivative instrument (whether freestanding or embedded in another contract) whose existence serves as an impediment to recognizing a related contract as a sale by one party or a purchase by the counterparty is not subject to this Subtopic. For example, the existence of a guarantee of the residual value of a leased asset by the lessor may be an impediment to treating a contract as a sales-type lease, in which case the contract would be treated by the lessor as an operating lease. Another example is the existence of a call option enabling a transferor to repurchase transferred assets that is an impediment to sales accounting under Topic 860. Such a call option on transferred financial assets that are not readily obtainable would prevent accounting for that transfer as a sale. The consequence is that to recognize the call option would be to count the same thing twice. The holder of the option already recognizes in its financial statements the assets that it has the option to purchase.

The guidance on guarantees in ASC 460, which excludes guarantees if the guarantor owns the asset related to the underlying, does not apply if a lessor guarantees a minimum resale value for an asset underlying a sales-type or operating lease. Specifically, in a sales-type lease, the residual value of the asset is included in the lessor's measurement of the net investment of the lease, and in an operating lease, the lessor does not derecognize the underlying asset.



ASC 842-30-55-15

Lastly, Topic 460 on guarantees does not affect the guarantor's accounting for the guarantee because that Topic does not apply to a guarantee for which the underlying is related to an asset of the guarantor. Because the manufacturer continues to recognize the residual value of the equipment guaranteed by the manufacturer as an asset (included in the seller-lessor's net investment in the lease)

if recording a sales-type lease, that guarantee does not meet the characteristics in paragraph 460-10-15-4 and is, therefore, not subject to the guidance in Topic 460. Additionally, if the lease is classified as an operating lease, the manufacturer does not remove the asset from its books, and its guarantee would be a market value guarantee of its own asset. A market value guarantee of the guarantor's own asset is not within the scope of Topic 460, and the guidance in paragraphs 842-10-55-32 through 55-33 for an operating lease is not affected. As a result, the guarantor's accounting for the guarantee is unaffected by Topic 460.

[The relevant paragraph of ASC 460, referred to in the guidance above, is included below for reference.]

ASC 460-10-15-4

Except as provided in paragraph 460-10-15-7, the provisions of this Topic apply to the following types of guarantee contracts:

- a. Contracts that contingently require a guarantor to make payments (as described in the following paragraph) to a guaranteed party based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party. For related implementation guidance, see paragraph 460-10-55-2.
- b. Contracts that contingently require a guarantor to make payments (as described in the following paragraph) to a guaranteed party based on another entity's failure to perform under an obligating agreement (performance guarantees). For related implementation guidance, see paragraph 460-10-55-12.
- c. Indemnification agreements (contracts) that contingently require an indemnifying party (guarantor) to make payments to an indemnified party (guaranteed party) based on changes in an underlying that is related to an asset, a liability, or an equity security of the indemnified party.
- d. Indirect guarantees of the indebtedness of others, even though the payment to the guaranteed party may not be based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party.

6.8 Indemnification payments related to tax effects

The lessor must reflect in income payments received from the lessee related to tax effects other than the investment tax credit in a manner consistent with how the lease is classified. For instance, the lessor accounts for tax indemnification payments in a sales-type or a direct financing lease as an adjustment to the lessor's net investment in the lease. Tax indemnification payments received by a lessor in an operating lease are recognized ratably over the lease term.



ASC 842-30-55-16

Indemnification payments related to tax effects other than the investment tax credit should be reflected by the lessor in income consistent with the classification of the lease. That is, the payments should be accounted for as an adjustment of the lessor's net investment in the lease if the lease is a sales-type lease or a direct financing lease or recognized ratably over the lease term if the lease is an operating lease.

6.9 Impairment of the net investment in the lease

A lessor that has not yet adopted the guidance in ASU 2016-13 *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, which is effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2019 for public business entities that are Securities and Exchange Commission (SEC) filers or December 15, 2020 for all other public business entities. For all other entities it is effective for fiscal years beginning after December 15, 2020 and interim periods within fiscal years beginning after December 15, 2021, must apply the impairment guidance in ASC 310, *Receivables*, to the net investment in the lease. After adopting the guidance in ASU 2016-13, a lessor must apply the impairment guidance in ASC 326, *Financial Instruments—Credit Losses* to the lease's net investment. Although the net investment in the lease comprises both a financial asset (lease receivable) and a nonfinancial asset (unguaranteed residual asset), the Board decided that lessors should apply a single financial asset impairment model to the net investment in the lease, rather than an "overly complex" model in which the financial and nonfinancial components are evaluated separately for impairment using different criteria.

The guidance in ASC 310 requires a creditor to determine whether it is probable that it will be unable to collect all amounts due under the terms of an agreement, as described in ASC 310-10-35-16. If it is probable that the creditor will be unable to collect these amounts, the impairment is measured based on the present value of expected future cash flows from both the lease receivable and unguaranteed residual asset, discounted at the effective interest rate in the agreement and subject to a practical expedient for collateral-dependent instruments. A lessor must consider the collateral underlying the net investment in the lease when estimating future cash flows as part of its impairment analysis. The collateral represents the cash flows the lessor expects to receive from the underlying asset during the lease term, as well as cash flows it expects to derive from the collateral after the lease ends, such as from re-leasing the asset to a new lessee.



ASC 842-30-35-3

A lessor shall determine impairment related to the net investment in the lease and shall recognize any impairment in accordance with Topic 310 on receivables (as described in paragraphs 310-10-35-16 through 35-30). When determining the loss allowance for a net investment in the lease, a lessor shall take into consideration the collateral relating to the net investment in the lease. The collateral relating to the net investment in the lease represents the cash flows that the lessor would expect to receive (or derive) from the lease receivable and the unguaranteed residual asset during and following the end of the remaining lease term.

6.10 Modifications

If a lease is modified to provide a lessee with an additional right of use, and the lease payments are increased commensurate with that additional right, then a lessor must account for the modification as a new lease. The lessor's accounting for the original lease would not be affected by this type of modification.

If a lease modification does not qualify as a new, separate lease, then the lessor must reassess the lease's classification as of the effective date of the modification. The modification is effective on the date when it is approved by both the lessee and the lessor. A lessor should not remeasure the net investment in the lease or lease payments unless a lease is modified. Subsequent accounting for the modified lease depends on how the original and modified leases are classified. The following sections discuss the impact of modifying the three types of leases.



ASC 842-30-35-2

After the commencement date, a lessor shall not remeasure the net investment in the lease unless the lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8.

ASC 842-10-35-3

A lessor shall not reassess the lease term or a lessee option to purchase the underlying asset unless the lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8. When a lessee exercises an option to extend the lease or purchase the underlying asset that the lessor previously determined the lessee was not reasonably certain to exercise or exercise an option to terminate the lease that the lessor previously determined the lessee was reasonably certain to exercise, the lessor shall account for the exercise of that option in the same manner as a lease modification.

ASC 842-10-35-6

A lessor shall not remeasure the lease payments unless the lease is modified and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8.

Effective Date of the Modification: The date that a lease modification is approved by both the lessee and the lessor.

This figure summarizes how a lessor accounts for modifications for each type of lease classification.

Figure 6.2: Summary of accounting for lease modifications for lessors

Original lease classification	Modified lease classification		
	Sales-type	Direct financing	Operating
Sales-type	Adjust the discount rate of the modified lease so the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease immediately before the effective date of the modification.		Reclassify the net investment in the lease to the appropriate class of property, plant, and equipment.

Direct financing	Follow guidance applicable to new sales-type leases, using the modification effective date as the commencement date. Calculate selling profit or loss using the fair value of the asset at the modification effective date, and the carrying amount of the net investment in the original lease as the carrying value of the underlying asset.	Adjust the discount rate of the modified lease so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease immediately before the effective date of the modification.	
Operating	Derecognize any deferred rent liability or accrued rent asset and adjust the selling profit or selling loss accordingly.	Consider any prepaid or accrued lease rentals relating to the original lease as a part of the lease payments for the modified lease.	

6.10.1 Modification of a sales-type lease

When a sales-type lease is modified in a way that does not create a separate contract, the lessor reassesses the classification of the modified lease as of the date the modification takes effect. If the modified lease is classified as a sales-type or direct financing lease, the lessor adjusts the discount rate for the modified lease so that the initial net investment in the modified lease is equal to the carrying amount of the net investment in the original sales-type lease immediately before the effective date of the modification. See ASC 842-10-55-205 in Example 22 in Section 6.9.2 for an illustration of this calculation.

If the modified lease is classified as an operating lease, the lessor derecognizes the net investment in the lease and recognizes the underlying asset. The carrying value of the underlying asset recognized equals the net investment in the original sales-type lease immediately before the effective date of the modification. The lessor then depreciates the underlying asset according to its accounting policy for depreciating capital assets. Lease payments are then recognized on a straight-line basis using the guidance on recognizing lease income for operating leases.



ASC 842-10-25-17

If a sales-type lease is modified and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8, the lessor shall account for the modified lease as follows:

- a. If the modified lease is classified as a sales-type or a direct financing lease, in the same manner as described in paragraph 842-10-25-16(a)

- b. If the modified lease is classified as an operating lease, in the same manner as described in paragraph 842-10-25-16(c).



Modification of a sales-type lease with significant variable payments

Lessor enters into a five-year contract with Lessee to provide medical testing equipment and consumables that are used with the equipment to perform medical tests. Lessee must purchase at least 1,000 units of consumables at the list price in each year of the contract. Lessee is not required to make any other payments under the contract except those related to consumables purchases.

The contract contains a lease component related to the right to use the equipment and a nonlease component related to the sale of consumables. Title to the equipment automatically transfers to Lessee at the end of the lease term.

At the commencement date, Lessor's carrying amount of the equipment is \$10,000. The stand-alone selling price of the lease component is \$100 per month, and the stand-alone selling price of the nonlease component is \$415 per month (\$25,000 for the lease term), based on a stand-alone selling price per unit of consumable of \$5 (which is equal to the current list price) and a monthly purchase requirement of 83 units (1,000 per year divided by 12). For purposes of this example, we have used monthly stand-alone selling prices to compute the allocation ratios, but in practice, preparers may use stand-alone selling prices based on other periods of time (for example, annually) depending on what information is available.

Lessor determines that the lease is a sales-type lease, and that the rate implicit in the lease is negative. Accordingly, Lessor uses a discount rate of zero to initially and subsequently measure its net investment in the lease, which is \$4,750 ($\$25,000 \times 19$ percent) at the commencement date of the lease. 19 percent is the quotient of the stand-alone selling price of the lease component (\$100 per month) and the sum of the stand-alone selling prices of the lease and nonlease components (\$515 per month).

At the commencement date, Lessor recognizes the following journal entry:

Dr. Net investment in lease	\$4,750
Cr. Revenue	\$4,750
Dr. Cost of goods sold	\$10,000
Cr. Equipment	\$10,000

The amortization schedule for the net investment in the lease as of the commencement date is as follows.

Year	Payment	Amortization	Interest	Balance
Y0				\$4,750
Y1	\$950	\$950	\$ -	\$3,800

Y2	\$950	\$950	\$ -	\$2,850
Y3	\$950	\$950	\$ -	\$1,900
Y4	\$950	\$950	\$ -	\$ 950
Y5	\$950	\$950	\$ -	\$ -

At the beginning of year three, Lessor and Lessee agree to amend the terms of the contract. Under the amended agreement Lessor transfers to Lessee one additional piece of testing equipment, extends the term of the contract by two years, and increases the minimum annual consumable purchase requirement to 2,200 units. The stand-alone selling price of each lease component is \$110 per month, and the stand-alone selling price of the nonlease component is \$1,098 per month, based on the stand-alone selling price of \$6 per unit of consumable (which is equal to the current list price) and a monthly purchase requirement of 183 units (2,200 per year ÷ by 12).

After the modification, both lease components are classified as sales-type leases because title to both pieces of equipment automatically transfers to Lessee at the end of the lease term. According to ASC 842-10-25-16 through 25-17, if a sales-type lease is modified and remains a sales-type lease, a lessor must adjust the discount rate for the modified lease so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease immediately before the effective date of the modification.

Lessor's carrying amount of the net investment in the original lease immediately before the effective date of the modification is \$2,850, and the modified lease payments attributable to the original lease component are \$1,056 per year for the remaining six years of the modified lease term. The discount rate to reconcile the new lease payments to the carrying amount of the net investment in the original lease is 29 percent.

Even though the original rate implicit in the lease is negative, once a loss is recognized upon commencement of the original lease equal to the difference between the carrying amount of the underlying asset and the present value of the lease payments (discounted at a rate of zero), the relevant basis for computing any prospective changes to the discount rate becomes the net investment in the lease. Therefore, the discount rate for the original lease component goes from zero to 29 percent as a result of the modification.

The modified amortization schedule for the net investment in the **original lease component** as of the modification date is as follows.

Year	Payment	Amortization	Interest	Balance
Y2				\$2,850
Y3	\$1,056	\$229	\$827	\$2,621
Y4	\$1,056	\$295	\$761	\$2,326

Y5	\$1,056	\$381	\$675	\$1,945
Y6	\$1,056	\$492	\$564	\$1,453
Y7	\$1,056	\$634	\$422	\$ 819
Y8	\$1,056	\$819	\$237	\$ -

The amortization schedule for the net investment in the new lease component as of the modification date is as follows.

Year	Payment	Amortization	Interest	Balance
Y2				\$6,336
Y3	\$1,056	\$1,056	\$ -	\$5,280
Y4	\$1,056	\$1,056	\$ -	\$4,224
Y5	\$1,056	\$1,056	\$ -	\$3,168
Y6	\$1,056	\$1,056	\$ -	\$2,112
Y7	\$1,056	\$1,056	\$ -	\$1,056
Y8	\$1,056	\$1,056	\$ -	\$ -

6.10.2 Modification of a direct financing lease

When a direct financing lease is modified in a way that does not create a separate contract, the lessor reassesses the classification of the modified lease as of the date when the modification takes effect. If the modified lease is classified as a direct financing lease, the lessor adjusts the discount rate of the modified lease so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease immediately before the effective date of the modification. See ASC 842-10-55-205 in Example 22 in this section for an illustration of this calculation.

If the modified lease is classified as a sales-type lease, the lessor accounts for the lease as a new sales-type lease by recognizing a net investment in the lease and selling profit or loss. In calculating selling profit or loss, the lessor uses the fair value of the underlying asset at the modification date and the carrying amount of the net investment in the lease at the modification date to calculate the selling profit or loss.

If the modified lease is classified as an operating lease, the lessor derecognizes the net investment in the lease and recognizes the underlying asset. The carrying value of the underlying asset recognized equals

the net investment in the original direct financing lease immediately before the effective date of the modification. The lessor then depreciates the underlying asset according to its accounting policy for depreciating capital assets. Lease payments are then recognized on a straight-line basis using the guidance on recognizing lease income for operating leases.



ASC 842-10-25-16

If a direct financing lease is modified and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8, the lessor shall account for the modified lease as follows:

- a. If the modified lease is classified as a direct financing lease, the lessor shall adjust the discount rate for the modified lease so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease immediately before the effective date of the modification.
- b. If the modified lease is classified as a sales-type lease, the lessor shall account for the modified lease in accordance with the guidance applicable to sales-type leases in Subtopic 842-30 with the commencement date of the modified lease being the effective date of the modification. In calculating the selling profit or selling loss on the lease, the fair value of the underlying asset is its fair value at the effective date of the modification and its carrying amount is the carrying amount of the net investment in the original lease immediately before the effective date of the modification.
- c. If the modified lease is classified as an operating lease, the carrying amount of the underlying asset equals the net investment in the original lease immediately before the effective date of the modification.

Example 22 from ASC 842-10-55 illustrates how a lessor accounts for a modification of a direct financing lease.



Example 22—Modification of a Direct Financing Lease

ASC 842-10-55-201

Lessor enters into a six-year lease of a piece of new, nonspecialized equipment with a nine-year economic life. The annual lease payments are \$11,000, payable in arrears. The estimated residual value of the equipment is \$21,000, of which \$15,000 is guaranteed by a third-party unrelated to Lessee or Lessor. The lease does not contain an option for Lessee to purchase the equipment, and the title does not transfer to Lessee as a consequence of the lease. The fair value of the equipment at lease commencement is \$65,240, which is equal to its cost (and carrying amount). Lessor incurs no initial direct costs in connection with the lease. The rate implicit in the lease is 7.5 percent such that the present value of the lease payments is \$51,632 and does not amount to substantially all of the fair value of the equipment.

ASC 842-10-55-202

The Lessor concludes that the lease is not a sales-type lease because none of the criteria in paragraph 842-10-25-2 are met. However, the sum of the present value of the lease payments and the present value of the residual value of the underlying asset guaranteed by the third-party guarantor is \$61,352,

which is substantially all of the fair value of the equipment, and collectibility of the lease payments is probable. Consequently, the lease is classified as a direct financing lease. Lessor recognizes the net investment in the lease of \$65,240 (which includes the lease receivable of \$61,352 and the present value of the unguaranteed residual value of \$3,888 [the present value of the difference between the expected residual value of \$21,000 and the guaranteed residual value of \$15,000]) and derecognizes the equipment with a carrying amount of \$65,240.

ASC 842-10-55-203

At the end of Year 1, Lessor receives a lease payment of \$11,000 from Lessee and recognizes interest income of \$4,893 ($\$65,240 \times 7.5\%$). Therefore, the carrying amount of the net investment in the lease is \$59,133 ($\$65,240 + \$4,893 - \$11,000$).

Case A—Direct Financing Lease to Direct Financing Lease

ASC 842-10-55-204

At the end of Year 1, the lease term is reduced by 1 year and the annual lease payment is reduced to \$10,000 for the remaining 4 years of the modified lease term. The estimated residual value of the equipment at the end of the modified lease term is \$33,000, of which \$30,000 is guaranteed by the unrelated third party, while the fair value of the equipment is \$56,000. The remaining economic life of the equipment is 8 years, and the present value of the remaining lease payments, discounted using the rate implicit in the modified lease of 8.857 percent, is \$32,499. Lessor concludes that the modified lease is not a sales-type lease because none of the criteria in paragraph 842-10-25-2 are met. However, the sum of the present value of the lease payments and the present value of the residual value of the underlying asset guaranteed by the third-party guarantor, discounted using the rate implicit in the modified lease of 8.857 percent, is \$53,864, which is substantially all of the fair value of the equipment, and collectibility of the lease payments is probable. As such, the modified lease is classified as a direct financing lease.

ASC 842-10-55-205

In accounting for the modification in accordance with paragraph 842-10-25-16(a), Lessor carries forward the balance of the net investment in the lease of \$59,133 immediately before the effective date of the modification as the opening balance of the net investment in the modified lease. To retain the same net investment in the lease even while the lease payments, the lease term, and the estimated residual value have all changed, Lessor adjusts the discount rate for the lease from the rate implicit in the modified lease of 8.857 percent to 6.95 percent. This discount rate is used to calculate interest income on the net investment in the lease throughout the remaining term of the modified lease and will result, at the end of the modified lease term, in a net investment balance that equals the estimated residual value of the underlying asset of \$33,000.

Case B—Direct Financing Lease to Sales-Type Lease

ASC 842-10-55-206

At the end of Year 1, the lease term is extended for two years. The lease payments remain \$11,000 annually, paid in arrears, for the remainder of the lease term. The estimated residual value is \$6,500, of which none is guaranteed. The rate implicit in the modified lease is 7.58 percent. At the effective date of the modification, the remaining economic life of the equipment is 8 years, and the fair value of the

equipment is \$62,000. Because the modified lease term is now for the major part of the remaining economic life of the equipment, the modified lease is classified as a sales-type lease.

ASC 842-10-55-207

On the effective date of the modification, Lessor recognizes a net investment in the sales-type lease of \$62,000, which is equal to the fair value of the equipment at the effective date of the modification, and derecognizes the carrying amount of the net investment in the original direct financing lease of \$59,133. The difference of \$2,867 is the selling profit on the modified lease. After the effective date of the modification, Lessor accounts for the sales-type lease in the same manner as any other sales-type lease in accordance with Subtopic 842-30.

Case C—Direct Financing Lease to Operating Lease

ASC 842-10-55-208

At the end of Year 1, the lease term is reduced by 2 years, and the lease payments are reduced to \$9,000 per year for the remaining 3-year lease term. The estimated residual value is revised to \$33,000, of which only \$13,000 is guaranteed by an unrelated third party. The fair value of the equipment at the effective date of the modification is \$56,000. The modified lease does not transfer the title of the equipment to Lessee or grant Lessee an option to purchase the equipment. The modified lease is classified as an operating lease because it does not meet any of the criteria to be classified as a sales-type lease or as a direct financing lease.

ASC 842-10-55-209

Therefore, at the effective date of the modification, Lessor derecognizes the net investment in the lease, which has a carrying amount of \$59,133, and recognizes the equipment at that amount. Collectibility of the lease payments is probable; therefore, Lessor will recognize the \$27,000 ($\$9,000 \times 3$ years) in lease payments on a straight-line basis over the 3-year modified lease term, as well as depreciation on the rerecognized equipment.

6.10.3 Modification of an operating lease

When an operating lease is modified but does not result in a separate contract, the lessor accounts for the modification as a termination of the existing lease and the creation of a new lease, starting on the effective date of the modification. If the modified lease remains an operating lease, the lessor considers any prepaid or accrued rent associated with the original lease to be part of the lease payments under the modified lease.

If the modified lease is classified as a sales-type or a direct financing lease, the lessor records the net investment in the lease and derecognizes the underlying asset. The lessor also derecognizes any prepaid or accrued rent, and reflects this adjustment in calculating selling profit or loss. Selling profit or loss is recognized in current-period net income or is deferred, based on the applicable guidance for a sales-type or a direct financing lease.

**ASC 842-10-25-15**

If an operating lease is modified and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8, the lessor shall account for the modification as if it were a termination of the existing lease and the creation of a new lease that commences on the effective date of the modification as follows:

- a. If the modified lease is classified as an operating lease, the lessor shall consider any prepaid or accrued lease rentals relating to the original lease as a part of the lease payments for the modified lease.
- b. If the modified lease is classified as a direct financing lease or a sales-type lease, the lessor shall derecognize any deferred rent liability or accrued rent asset and adjust the selling profit or selling loss accordingly.

Examples 20 and 21 from ASC 842-10-55 show how a lessor accounts for an operating lease that has been modified. Example 20 illustrates the accounting when the modification does not change the lease classification, while Example 21 illustrates the accounting when the modification changes the lease classification.

**Example 20—Modification of an Operating Lease That Does Not Change Lease Classification****ASC 842-10-55-190**

Lessor enters into a 10-year lease with Lessee for 10,000 square feet of office space. The annual lease payments are \$100,000 in the first year, increasing by 5 percent each year thereafter, payable in arrears. The lease term is not for a major part of the remaining economic life of the office space (40 years), and the present value of the lease payments is not substantially all of the fair value of the office space. Furthermore, the title does not transfer to Lessee as a consequence of the lease, the lease does not contain an option for Lessee to purchase the office space, and the asset is not specialized such that it clearly has an alternative use to Lessor at the end of the lease term. Consequently, the lease is classified as an operating lease.

ASC 842-10-55-191

At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining 5 years to include an additional 10,000 square feet of office space in the same building for a total annual fixed payment of \$150,000. The increase in total consideration is at a discount both to the current market rate for the new 10,000 square feet of office space and in the context of that particular contract. The modified lease continues to be classified as an operating lease.

ASC 842-10-55-192

At the effective date of the modification (at the beginning of Year 6), Lessor has an accrued lease rental asset of \$76,331 (rental income recognized on a straight-line basis for the first 5 years of the lease of \$628,895 [$\$1,257,789 \div 10 \text{ years} = \$125,779 \text{ per year}$] less lease payments for the first

5 years of \$552,564 [that is, \$100,000 in Year 1, \$105,000 in Year 2, \$110,250 in Year 3, \$115,763 in Year 4, and \$121,551 in Year 5]).

ASC 842-10-55-193

Because the change in pricing of the lease is not commensurate with the standalone price for the additional right-of-use asset, Lessor does not account for the modification as a new lease, separate from the original 10-year lease. Instead, Lessor accounts for the modified lease prospectively from the effective date of the modification, recognizing the lease payments to be made under the modified lease of \$750,000 ($\$150,000 \times 5$ years), net of Lessor's accrued rent asset of \$76,331, on a straight-line basis over the remaining 5-year lease term ($\$673,669 \div 5$ years = \$134,734 per year). At the end of the lease, Lessor will have recognized as lease income the \$1,302,564 in lease payments it receives from Lessee during the 10-year lease term.

Example 21—Modification of an Operating Lease That Changes Lease Classification

Case A—Operating Lease to Sales-Type Lease

ASC 842-10-55-194

Lessor enters into a four-year lease of a piece of nonspecialized equipment. The annual lease payments are \$81,000 in the first year, increasing by 5 percent each year thereafter, payable in arrears. The estimated residual value of the equipment is \$90,000, of which none is guaranteed. The remaining economic life of the equipment at lease commencement is seven years. The carrying amount of the equipment and its fair value are both \$425,000 at the commencement date. The lease is not for a major part of the remaining economic life of the equipment, and the present value of the lease payments is not substantially all of the fair value of the equipment. Furthermore, title does not transfer to Lessee as a result of the lease, the lease does not contain an option for Lessee to purchase the underlying asset, and because the asset is nonspecialized, it is expected to have an alternative use to Lessor at the end of the lease term. Consequently, the lease is classified as an operating lease.

ASC 842-10-55-195

At the beginning of Year 3, Lessee and Lessor agree to extend the lease term by two years. That is, the modified lease is now a six-year lease, as compared with the original four-year lease. The additional two years were not an option when the original lease was negotiated. The modification alters the Lessee's right to use the equipment; it does not grant Lessee an additional right of use. Therefore, Lessor does not account for the modification as a separate contract from the original four-year lease contract.

ASC 842-10-55-196

On the effective date of the modification, the fair value of the equipment is \$346,250, and the remaining economic life of the equipment is 5 years. The estimated residual value of the equipment is \$35,000, of which none is guaranteed. The modified lease is for a major part of the remaining economic life of the equipment at the effective date of the modification (four years out of the five-year-remaining economic life of the equipment). Consequently, the modified lease is classified as a sales-type lease.

ASC 842-10-55-197

In accounting for the modification, Lessor determines the discount rate for the modified lease (that is, the rate implicit in the modified lease) to be 7.6 percent. Lessor recognizes the net investment in the modified lease of \$346,250 and derecognizes both the accrued rent and the equipment at the effective date of the modification. Lessor also recognizes, in accordance with paragraph 842-10-25-15(b), selling profit of \$34,169 ($\$320,139$ lease receivable – $\$8,510$ accrued rent balance – the $\$277,460$ carrying amount of the equipment derecognized, net of the unguaranteed residual asset [$\$277,460 = \$303,571 - \$26,111$]). After the effective date of the modification, Lessor accounts for the modified lease in the same manner as any other sales-type lease in accordance with Subtopic 842-30.

Case B—Operating Lease to Direct Financing Lease

ASC 842-10-55-198

At the beginning of Year 3, Lessee and Lessor enter into a modification to extend the lease term by 1 year, and Lessee agrees to make lease payments of \$108,000 per year for each of the remaining 3 years of the modified lease. No other terms of the contract are modified. Concurrent with the execution of the modification, Lessor obtains a residual value guarantee from an unrelated third party for \$40,000. Consistent with Case A (paragraphs 842-10-55-194 through 55-197), at the effective date of the modification the fair value of the equipment is \$346,250, the carrying amount of the equipment is \$303,571, and Lessor's accrued rent balance is \$8,510. The estimated residual value at the end of the modified lease term is \$80,000. The discount rate for the modified lease is 7.356 percent.

ASC 842-10-55-199

Lessor reassesses the lease classification as of the effective date of the modification and concludes that the modified lease is a direct financing lease because none of the criteria in paragraph 842-10-25-2 and both criteria in paragraph 842-10-25-3(b) are met.

ASC 842-10-55-200

Therefore, at the effective date of the modification, Lessor recognizes a net investment in the modified lease of \$312,081, which is the fair value of the equipment ($\$346,250$) less the selling profit on the lease ($\$34,169 = \$313,922$ lease receivable – $\$8,510$ accrued rent balance – the $\$271,243$ carrying amount of the equipment derecognized, net of the unguaranteed residual asset [$\$271,243 = \$303,571 - \$32,328$]), which is deferred as part of the net investment in the lease. After the effective date of the modification, Lessor accounts for the modified lease in the same manner as any other direct financing lease in accordance with Subtopic 842-30.

6.11 Terminations

If a sales-type or a direct financing lease is terminated before the end of the lease term, the lessor must follow these steps:

- Test the net investment in the lease for impairment following the guidance in ASC 310 and recognize any impairment loss at the termination date.
- Reclassify the net investment in the lease to the appropriate asset category, measured as the sum of the carrying amount of the lease receivable (less any amounts the lessor still expects to receive from the lessee, which are accounted for separately as a receivable) and the residual asset.
- Account for the underlying asset prospectively in accordance with other Codification guidance.

**ASC 842-30-40-2**

If a sales-type lease or a direct financing lease is terminated before the end of the lease term, a lessor shall do all of the following:

- a. Test the net investment in the lease for impairment in accordance with Topic 310 on receivables and recognize any impairment loss identified.
- b. Reclassify the net investment in the lease to the appropriate category of asset in accordance with other Topics, measured at the sum of the carrying amounts of the lease receivable (less any amounts still expected to be received by the lessor) and the residual asset
- c. Account for the underlying asset that was the subject of the lease in accordance with other Topics.

7. Sale-leaseback accounting

A sale and leaseback transaction is the sale of an asset to a buyer-lessor, often a specialized financing entity, and the lease of some or all of the asset for some or all of its remaining economic life back to a seller-lessee. A sale and leaseback transaction may offer advantages from a cash flow, financing, and tax perspective.

7.1 Determining if a transaction is within the scope of sale-leaseback guidance

A sale-leaseback is a transaction in which an entity transfers an asset to another entity, and then leases the same asset back from that entity. The entity that sells and leases back the asset is referred to as the seller-lessee, and the entity that buys the asset and leases it back to the seller is referred to as the buyer-lessor. The scope of the sale-leaseback subtopic in ASC 842 is the same as other subtopics in ASC 842, as described in ASC 842-10-15.



ASC 842-40-15-1

This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic; see Section 842-10-15.

ASC 842-40-15-2

If an entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) and leases that asset back from the buyer-lessor, both the seller-lessee and the buyer-lessor shall account for the transfer contract and the lease in accordance with Sections 842-40-25, 842-40-30, and 842-40-50.

There are, however, other circumstances in which an entity must consider whether a transaction should be accounted for under the sale and leaseback guidance in ASC 842-40, including the following situations:

- The lessee controls the underlying asset before the lease commences.
- The lessee incurs costs related to the construction or design of the underlying asset before the lease commences.
- The lessee indemnifies the lessor for preexisting environmental contamination.
- The lessee sells an interest in the underlying asset.

These topics are discussed in greater detail in this section.



At the crossroads: Sale and leaseback of real estate versus other assets

The legacy sale and leaseback guidance contains separate provisions for sales and leasebacks of real estate and other assets. The legacy guidance on sales and leasebacks of real estate is complex, and includes a number of “traps” that often cause transactions involving real estate to “fail” to achieve sale and leaseback accounting, meaning that they are accounted for as secured financing arrangements.

ASC 842 does not differentiate between real estate assets and other assets for the purposes of applying the sale and leaseback guidance, and eliminates many of the onerous provisions related to sale and leasebacks for real estate under legacy GAAP. Therefore, we expect that more transactions involving real estate will qualify for sale and leaseback accounting under ASC 842 than under legacy GAAP.

7.1.1 Lessee controls the underlying asset before the lease commencement date

In some transactions, a lessee obtains legal title to an underlying asset before the title is transferred to the lessor and the asset is leased to the lessee. In these situations, the parties must determine whether the lessee obtains control of the underlying asset, rather than just title to the asset, before the asset is transferred to the lessor. Under ASC 842, the lessee obtains control of the asset if it (a) directs its use and (b) obtains substantially all of its remaining economic benefits. If the lessee obtains control of the underlying asset before it is transferred to the lessor, then the transaction is accounted for as a sale and leaseback transaction under ASC 842-40.



ASC 842-40-55-1

A lessee may obtain legal title to the underlying asset before that legal title is transferred to the lessor and the asset is leased to the lessee. If the lessee controls the underlying asset (that is, it can direct its use and obtain substantially all of its remaining benefits) before the asset is transferred to the lessor, the transaction is a sale and leaseback transaction that is accounted for in accordance with this Subtopic.

If the lessee obtains legal title to an underlying asset, but does not control the underlying asset before the title is transferred to the lessor, the transaction is not within the scope of the sale and leaseback guidance, and is instead treated as a lease in line with the general guidance in ASC 842. This situation could occur, for instance, if a lessor purchases an asset from a third party, but for tax or other reasons, the lessee briefly legally owns the asset. In this case, the lessor should account for its purchase of the underlying asset, and both the lessor and lessee should account for the lease, in accordance with the relevant guidance in ASC 842.

**ASC 842-40-55-2**

If the lessee obtains legal title, but does not obtain control of the underlying asset before the asset is transferred to the lessor, the transaction is not a sale and leaseback transaction. For example, this may be the case if a manufacturer, a lessor, and a lessee negotiate a transaction for the purchase of an asset from the manufacturer by the lessor, which in turn is leased to the lessee. For tax or other reasons, the lessee might obtain legal title to the underlying asset momentarily before legal title transfers to the lessor. In this case, if the lessee obtains legal title to the asset but does not control the asset before it is transferred to the lessor, the transaction is accounted for as a purchase of the asset by the lessor and a lease between the lessor and the lessee.

7.1.2 Lessee incurs construction or design costs before lease commencement

Two parties may enter into a contract to lease an underlying asset that is not yet ready to be used by the lessee, such as when an asset needs to be constructed or redesigned to fit the lessee's requirements. Depending on the terms and conditions of the contract, the lessee may be required to make payments related to the asset's construction or design.

**ASC 842-40-55-3**

An entity may negotiate a lease before the underlying asset is available for use by the lessee. For some leases, the underlying asset may need to be constructed or redesigned for use by the lessee. Depending on the terms and conditions of the contract, a lessee may be required to make payments relating to the construction or design of the asset.

If the lessee incurs costs related to the construction or design of the underlying asset before lease commencement, the lessee should account for those costs under the guidance in other Codification Topics, such as ASC 330 or ASC 360. Costs related to the underlying asset's construction or design exclude payments made by the lessee for the right to use the underlying asset. Payments for the right to use the underlying asset are accounted for as lease payments, regardless of their timing or form.

**ASC 842-40-55-4**

If a lessee incurs costs relating to the construction or design of an underlying asset before the commencement date, the lessee should account for those costs in accordance with other Topics, for example, Topic 330 on inventory or Topic 360 on property, plant, and equipment. Costs relating to the construction or design of an underlying asset do not include payments made by the lessee for the right to use the underlying asset. Payments for the right to use the underlying asset are lease payments, regardless of the timing of those payments or the form of those payments (for example, a lessee might contribute construction materials for the asset under construction).

If, before lease commencement, the lessee controls the underlying asset being constructed, the transaction is accounted for as a sale and leaseback transaction. Any one of the following criteria, which are not all inclusive, would indicate that the lessee controls the asset during the construction period:

- The lessee has the right to obtain the partially constructed asset at any point during the construction period.
- The lessor has an enforceable right to payment for its performance to date, and the asset does not have an alternative use to the owner-lessor. When evaluating whether the asset has an alternative use, an entity considers the characteristics of the asset that will ultimately be leased rather than those of the in-process construction project.
- The lessee legally owns both the land and the property improvements (if the underlying asset is real estate) or other types of assets under construction.
- The lessee controls the land where property improvements will be made.
- The lessee is leasing the land where property improvements will be made for a term that, including lessee renewal options, is greater than or equal to substantially all of the economic life of the property improvements. In addition, the lessee does not enter into a sublease before construction begins for a term that, including renewal options, allows the lessor or another party to sublease the land for substantially all of the economic life of the property improvements.



ASC 842-40-55-5

If the lessee controls the underlying asset being constructed before the commencement date, the transaction is accounted for in accordance with this Subtopic. Any one (or more) of the following would demonstrate that the lessee controls an underlying asset that is under construction before the commencement date:

- a. The lessee has the right to obtain the partially constructed underlying asset at any point during the construction period (for example, by making a payment to the lessor).
- b. The lessor has an enforceable right to payment for its performance to date, and the asset does not have an alternative use (see paragraph 842-10-55-7) to the owner-lessor. In evaluating whether the asset has an alternative use to the owner-lessor, an entity should consider the characteristics of the asset that will ultimately be leased.
- c. The lessee legally owns either:
 1. Both the land and the property improvements (for example, a building) that are under construction
 2. The non-real-estate asset (for example, a ship or an airplane) that is under construction.
- d. The lessee controls the land that property improvements will be constructed upon (this includes where the lessee enters into a transaction to transfer the land to the lessor, but the transfer does not qualify as a sale in accordance with paragraphs 842-40-25-1 through 25-3) and does not enter into a lease of the land before the beginning of construction that, together with renewal options, permits the lessor or another unrelated third party to lease the land for substantially all of the economic life of the property improvements.

- e. The lessee is leasing the land that property improvements will be constructed upon, the term of which, together with lessee renewal options, is for substantially all of the economic life of the property improvements, and does not enter into a sublease of the land before the beginning of construction that, together with renewal options, permits the lessor or another unrelated third party to sublease the land for substantially all of the economic life of the property improvements.

The list of circumstances above in which a lessee controls an underlying asset that is under construction before the commencement date is not all inclusive. There may be other circumstances that individually or in combination demonstrate that a lessee controls an underlying asset that is under construction before the commencement date.



Grant Thornton insights: Call and put options related to an asset under construction

Lessee call options

According to ASC 842-40-55-5(a), a lessee controls an asset under construction if it has the right to obtain the asset “at any point” during the construction period. Practitioners have questioned whether “at any point” means the same thing as “at all points” during the construction period. In other words, would a lessee call option to purchase the asset at a single point during the construction period indicate that the lessee controls the asset while it is under construction?

We believe that “at any point” does *not* mean “at all points” during the construction period. Rather, it is our view that if the only condition related to exercising a lessee purchase option is the passage of time, then the existence of that purchase option indicates that the lessee controls the asset while it is under construction. For example, if a construction project begins on January 1, and the lessee has an option to purchase the asset under construction at any time after March 31, then we believe the lessee controls the asset under construction as of January 1 based on the guidance in ASC 842-40-55-5(a).

If exercising a lessee purchase option is subject to any condition that is outside the lessee’s control other than the passage of time, then it is our view that the lessee does not control the asset under construction until the condition is resolved. For example, if a construction project begins on January 1, and the lessee has an option to purchase the asset under construction at any time after March 31 provided that the local government grants a permit, then we believe the lessee controls the asset under construction when the permit is granted, even if that date precedes March 31.

Lessor put options

The indicators listed in ASC 842-40-55-5 do not explain how an entity should consider a lessor’s option to put the asset under construction to the lessee during the construction period. We believe that entities should evaluate these options using the guidance in ASC 606 on customer put options.

Under ASC 606, if a customer has the right to require a seller to repurchase the asset at a price that is lower than the original selling price, an entity must assess whether the customer has a significant economic incentive to exercise its right. If the customer has a significant economic incentive to exercise a put option, then the seller did not transfer control of the asset to the customer. This “economic incentive” assessment takes into consideration various factors, including the relationship between the repurchase price and the expected market value of the asset at the date of repurchase. If the repurchase price is expected to significantly exceed market value, then a significant economic incentive exists.

Accordingly, if the lessor has a significant economic incentive to exercise during construction a put option related to an asset under construction, then we believe the lessee has obtained control of the asset under construction.

The guidance in ASC 842-40-55 states that if a lessee controls the underlying asset before the commencement date of the lease (a “build-to-suit” transaction), the transaction should be accounted for as a sale and leaseback transaction. The following discussion focuses on whether this guidance also applies to a lessor.



Grant Thornton insights: Lessor accounting for build-to-suit transaction

While the guidance in ASC 842-40 clearly requires the lessee to account for a build-to-suit transaction, practitioners have questioned whether a similar requirement applies to the lessor in a build-to-suit transaction.

The Board explains in paragraph BC371 of ASU 2016-02 that it intended the seller-lessee’s and the buyer-lessor’s accounting for a “failed” sale and leaseback to be symmetrical, meaning that the seller-lessee would continue to recognize the underlying asset and a financing obligation, and the buyer-lessor would recognize a loan receivable. The Board further notes that a buyer-lessor should not recognize an asset it does not control because doing so would be inconsistent with the definition of an asset under FASB Concepts Statement 6, and would result in both the seller-lessee and the buyer-lessor recognizing the same asset concurrently. What’s more, in response to a technical inquiry, the FASB staff said that the lessor’s accounting for a build-to-suit transaction should be symmetrical to the lessee’s.

Therefore, we believe that a lessor should perform the same analysis as a lessee in determining whether the lessee controls the asset under construction. If the analysis concludes that the lessee controls the asset under construction, then the lessor would account for its expenditures related to the construction project as a loan receivable from the lessee during the construction period.

When construction is completed, the lessor would assess whether the transaction qualifies as a sale and leaseback, in which case, it would de-recognize the loan receivable and recognize the underlying asset along with the leaseback. If the transaction does not qualify (it is a “failed” sale-leaseback), then the lessor would continue to recognize the loan receivable, which would be serviced via the lessee’s payments under the leaseback.



At the crossroads: Build-to-suit arrangements

The guidance for build-to-suit arrangements in ASC 842 requires both the lessor and lessee to evaluate whether the lessee controls the asset during the construction period based on guidance similar to ASC 606-10-25-27, which explains how to determine whether a performance obligation in a revenue arrangement is satisfied over time.

The Board acknowledges in paragraph BC400(b) of ASU 2016-02 that this guidance represents a departure from legacy GAAP and could result in different accounting treatment under ASC 842. The

legacy build-to-suit guidance is complex and often results in the lessee being identified as the owner of the construction project. For example, under legacy guidance, if the lessee provides any supplies or other components related to the construction project (referred to as “hard costs”) for which it is entitled to reimbursement other than those purchased after lease inception, the lessee is considered to be the deemed owner of the construction project, regardless of the dollar-value of the hard costs incurred.

We expect that a model based on “indicators” of control will make the build-to-suit guidance easier for entities to apply, and will provide accounting results that are better aligned with the economic substance of the lessee’s involvement with the construction of the underlying asset.

Example 3 from ASC 842-40-55 illustrates circumstances in which the lessee controls and does not control an asset under construction.



Example 3—Lessee Control over an Asset under Construction

ASC 842-40-55-40

Lessee and Lessor enter into a contract whereby Lessor will construct (whether itself or using subcontractors) a building to Lessee’s specifications and lease that building to Lessee for a period of 20 years once construction is completed for an annual lease payment of \$1,000,000, increasing by 5 percent per year, plus a percentage of any overruns above the budgeted cost to construct the building. The building is expected to have an economic life of 50 years once it is constructed. Lessee does not legally own the building and does not have a right under the contract to obtain the building while it is under construction (for example, a right to purchase the construction in process from Lessor). In addition, while the building is being developed to Lessee’s specifications, those specifications are not so specialized that the asset does not have an alternative use to Lessor.

Case A—Lessee Does Not Control the Asset under Construction

ASC 842-40-55-41

Assume Lessee controls (that is, Lessee is the owner for accounting purposes) the land upon which the building will be constructed and, as part of the contract, Lessee agrees to lease the underlying land to Lessor for an initial period of 25 years. Lessor also is granted a series of six 5-year renewal options for the land lease.

ASC 842-40-55-42

None of the circumstances in paragraph 842-40-55-5 exist. Even though Lessee owns the land (whether legally or for accounting purposes only) upon which the building will be constructed, Lessor legally owns the property improvements and has rights to use the underlying land for at least substantially all of the economic life of the building. Lessee does not own the building and does not have a right under the contract to obtain the building (for example, a right to purchase the building from Lessor). In addition, the building has an alternative use to Lessor. Therefore, Lessee does not control the building under construction. Consequently, the arrangement is not within the scope of this Subtopic. Lessee and Lessor will account for the lease of the building in accordance with Subtopics 842-20 and 842-30, respectively. If Lessee incurs costs related to the construction or design of the building (for example, architectural services in developing the specifications of the building), it will account for those

costs as lease payments unless the costs are for goods or services provided to Lessee, in which case Lessee will account for those costs in accordance with other Topics.

Case B—Lessee Controls the Asset under Construction

ASC 842-40-55-43

Assume Lessee leases, rather than owns, the land upon which the building will be constructed. Lessee has a 20-year lease of the underlying land and five 10-year renewal options. Therefore, Lessee's lease of the underlying land, together with the renewal options, is for at least substantially all of the economic life of the building under construction. Lessee enters into a sublease with Lessor for the right to use the underlying land for 20 years that commences upon completion of the building. The sublease has a single 10-year renewal option available to Lessor.

ASC 842-40-55-44

Lessee controls the building during the construction period and, therefore, the arrangement is within the scope of this Subtopic. Lessee and Lessor will apply the guidance in this Subtopic to determine whether this arrangement qualifies as a sale and a leaseback or whether this arrangement is, instead, a financing arrangement. Lessee controls the building during the construction period because, in accordance with paragraph 842-40-55-5(e), Lessee controls the use of the land upon which the building will be constructed for a period that is at least substantially all of the economic life of the building and the sublease entered into with Lessor does not both (a) grant Lessor the right to use the land before the beginning of construction and (b) permit Lessor to use the land for substantially all the economic life of the building (that is, the sublease, including Lessor renewal options, only is for 30 years as compared with the 50-year economic life of the building).



Grant Thornton insights: A lessee's sale or transfer of a purchase option

A lease may provide the lessee with an option to purchase the underlying asset before, during, or at the end of the lease term. For example, a lessee that is involved with the construction of an underlying asset might have an option to purchase the asset during the construction period. Or, a lessee might enter into a forward-starting lease (that is, a lease for which there is a period of time between the inception and commencement dates) including a purchase option that can be exercised upon lease commencement.

If the lessee sells the purchase option to a third party on condition that the third party must exercise the option and lease the underlying asset back to the lessee, practitioners have questioned whether the transaction should be accounted for under the sale and leaseback guidance in ASC 842-40.

In this situation, we believe that the lessee must account for the transfer of the purchase option under the sale and leaseback guidance in ASC 842-40. Our view is based on the guidance in ASC 842-40-55-5(a) that stipulates a lessee controls an underlying asset that is under construction before the commencement date of a lease if the lessee has the right to obtain the partially constructed underlying asset at any point during the construction period.

Therefore, if the lessee has an option to purchase an underlying asset that is under construction, the lessee controls the underlying asset and should recognize the construction-in-progress in its statement of financial position, as required under ASC 842-40. When it transfers the option to a third party, the

lessee should assess whether it must derecognize the asset based on the sale and leaseback guidance.

If the lessee has an option to purchase an asset that is no longer under construction (that is, construction has been completed), and it transfers that option to a third party on condition that the third party must exercise the option and lease the asset back to the lessee, then it is our view that, by virtue of transferring an “encumbered” purchase option (meaning the option must be exercised and the asset leased to the lessee), the lessee has obtained control of the underlying asset and therefore must assess the transaction under the sale and leaseback guidance in ASC 842-40. In substance, this arrangement is no different than a transaction in which the lessee exercises its option, obtains control of the underlying asset, and then sells and leases back the underlying asset from a third party buyer-lessor.

7.1.3 Lessee indemnification for environmental contamination

A lease would not fall within the scope of the sale and leaseback guidance based solely on the lessee providing indemnification for preexisting environmental contamination. This type of provision does not, on its own, mean that the lessee controlled the underlying asset before the lease began, regardless of the likelihood of loss resulting from the indemnity.



ASC 842-40-55-7

A provision that requires lessee indemnifications for preexisting environmental contamination does not, on its own, mean that the lessee controlled the underlying asset before the lease commenced regardless of the likelihood of loss resulting from the indemnity. Consequently, the presence of such a provision does not mean the transaction is in the scope of this Subtopic.

7.1.4 Sale subject to a preexisting lease

In some circumstances, an entity may hold an ownership interest in an investee or an undivided interest in a property, and may also be a lessee with respect to the investee or the property under a preexisting lease. If the entity sells its ownership or undivided interest, or if the investee sells the underlying asset, practitioners have questioned whether the transaction is subject to the sale and leaseback guidance in ASC 842-40. According to ASC 842-40-55-8 through 55-10, such a transaction would be subject to analysis under the sale and leaseback guidance if, in connection with the transfer, either the scope or the price of the preexisting lease is modified. Otherwise, the transaction should be accounted for based on other relevant Codification Topics.

ASC 842 specifies that a lease between entities under common control is not considered a preexisting lease.



ASC 842-40-55-8

An entity owns an interest in an underlying asset and also is a lessee under an operating lease for all or a portion of the underlying asset. Acquisition of an ownership interest in the underlying asset and consummation of the lease occurred at or near the same time. This owner-lessee relationship can

occur, for example, when the entity has an investment in a partnership that owns the underlying asset (or a larger asset of which the underlying asset is a distinct portion). The entity subsequently sells its interest or the partnership sells the underlying asset to an independent third party, and the entity continues to lease the underlying asset under the preexisting operating lease.

ASC 842-40-55-9

A transaction should be subject to the guidance in this Subtopic if the scope or price of the preexisting lease is modified in connection with the sale. If the scope or the price of the preexisting lease is not modified in conjunction with the sale, the sale should be accounted for in accordance with other Topics.

ASC 842-40-55-10

A lease between parties under common control should not be considered a preexisting lease. Accordingly, the guidance in this Subtopic should be applied to transactions that include nonfinancial assets within its scope, except if Topic 980 on regulated operations applies. That is, if one of the parties under common control is a regulated entity with a lease that has been approved by the appropriate regulatory agency, that lease should be considered a preexisting lease.

7.2 Determining whether the transfer of an asset is a sale

Once an entity determines that a transaction is within the scope of the sale and leaseback guidance in ASC 842-40, it must assess whether the transfer of the asset meets the requirements to be accounted for as a sale. To make this determination, an entity applies the guidance in ASC 606 to determine whether (a) a contract exists, and (b) control of the asset transferred from the seller-lessee to the buyer-lessor. Both the buyer-lessor and the seller-lessee must make this assessment.

A sale cannot occur if a contract does not exist between the parties. An entity must apply the guidance in ASC 606-10-25-1 through 25-8, which outlines the five criteria that indicate a contract exists:

- a. The parties have approved the contract.
- b. The entity can identify each party's rights for the goods or services to be transferred.
- c. The entity can identify the payment terms for the goods or services to be transferred.
- d. The contract has commercial substance.
- e. It is probable that the seller will collect substantially all of the consideration it is entitled to in exchange for transferring the goods or services to the customer.

Unless all of these criteria are met, a contract does not exist, and the transaction cannot be accounted for as a sale and leaseback. For more information about the specific guidance in ASC 606, refer to Grant Thornton's Revenue Guide.

If an entity determines that a contract exists, then it must next apply the guidance on whether a performance obligation is satisfied by transferring control of an asset in ASC 606-10-25-30. This guidance specifies five indicators that control has transferred:

- a. The seller has the present right to payment.
- b. The customer has legal title to the asset.
- c. The seller has transferred physical possession of the asset.
- d. The customer has the significant risks and rewards of ownership.

e. The customer has accepted the asset.

None of these indicators alone can determine whether control has transferred to the customer. An entity must consider all of the indicators collectively to make this determination.

The existence of a leaseback in the contract does not, on its own, prevent the buyer-lessor from obtaining control of the asset. As the Board noted in paragraph BC352(a) of ASU 2016-02, a sale transfers *control* of the asset, whereas a lease transfers the *right to control the use* of the asset. Granting the seller-lessee the right to control the *use of* the asset does not preclude the buyer-lessor from obtaining control of the *asset*.

However, the buyer-lessor does not obtain control of the asset if the leaseback is classified as a sales-type lease (from the buyer-lessor's perspective) or as a finance lease (from the seller-lessee's perspective). As the Board notes in paragraph BC352(b) of ASU 2016-02, in a finance lease or a sales-type lease, the lessee obtains the ability to direct the use of, and to obtain substantially all of the remaining economic benefits from, the underlying asset. Accounting for a sale and a concurrent finance leaseback would imply that the seller-lessee has transferred and concurrently reacquired control of the underlying asset, which the Board views as an inappropriate outcome of the sale and leaseback accounting model.

As noted in Section 7.2.2, the existence of a residual value guarantee should be considered when evaluating whether control of the underlying asset has transferred to the buyer-lessor.



ASC 842-40-25-1

An entity shall apply the following requirements in Topic 606 on revenue from contracts with customers when determining whether the transfer of an asset shall be accounted for as a sale of the asset:

- a. Paragraphs 606-10-25-1 through 25-8 on the existence of a contract
- b. Paragraph 606-10-25-30 on when an entity satisfies a performance obligation by transferring control of an asset.

ASC 842-40-25-2

The existence of a leaseback (that is, a seller-lessee's right to use the underlying asset for a period of time) does not, in isolation, prevent the buyer-lessor from obtaining control of the asset. However, the buyer-lessor is not considered to have obtained control of the asset in accordance with the guidance on when an entity satisfies a performance obligation by transferring control of an asset in Topic 606 if the leaseback would be classified as a finance lease or a sales-type lease.



At the crossroads: Sale leaseback accounting for capital/finance leases

Under legacy GAAP, sale and leaseback accounting is not precluded if a leaseback is classified as a capital lease. Accordingly, under ASC 840, it is possible for a seller-lessee to derecognize the underlying asset (that is, account for the sale of the asset) and to concurrently recognize a capital lease asset and obligation.

Under ASC 842, the parties to a contract would be precluded from accounting for the transaction as a sale and leaseback if the leaseback would be classified as a finance lease or a sales-type lease. Instead, the transaction would be accounted for as a secured borrowing arrangement.

7.2.1 Repurchase option

If the seller-lessee has an option to repurchase the underlying asset, the parties cannot account for the transaction as a sale unless both of the following criteria under ASC 842-40-25-3 are met:

- The exercise price of the option is equal to the fair value of the asset when the option is exercised.
- Alternative assets that are substantially the same as the transferred asset are readily available in the marketplace.

A fixed-price option to repurchase the underlying asset precludes sale accounting under ASC 842.



ASC 842-40-25-3

An option for the seller-lessee to repurchase the asset would preclude accounting for the transfer of the asset as a sale of the asset unless both of the following criteria are met:

- a. The exercise price of the option is the fair value of the asset at the time the option is exercised.
- b. There are alternative assets, substantially the same as the transferred asset, readily available in the marketplace.



Grant Thornton insights: Options to repurchase real estate

In paragraph BC352(c) of ASU 2016-02, the Board addresses the two criteria specified in ASC 842-40-25-3 that require a seller-lessee to apply sale and leaseback accounting to an arrangement containing an option to repurchase the underlying asset. In the Board's view, an option to purchase an asset when alternative assets exist in the marketplace at a price equal to the asset's current fair value does not preclude the buyer from controlling the asset, since the buyer could simply use the proceeds from exercising the option to purchase an alternative asset.

However, the Board noted that real estate is a unique type of asset because no two units of real estate are "substantially the same." This conclusion is based on the fact that no two pieces of land can occupy the same space. Therefore, a sale-leaseback of real estate that includes a seller-lessee repurchase option will never qualify for sale and leaseback accounting treatment under ASC 842-40, but will be accounted for as a secured borrowing arrangement.



Grant Thornton insights: Fixed-price renewal periods

Under legacy GAAP, a leaseback of real estate with renewal periods at fixed rental rates covering a substantial portion of the underlying asset's remaining useful life would prevent an entity from applying sale and leaseback accounting (a "failed" sale-leaseback). The seller-lessee's ability to continue to use the underlying asset for substantially all of its remaining useful life at a fixed price allows it to participate in future profit from the property, which is a form of continuing involvement that precludes sale accounting under legacy GAAP.

In contrast, under ASC 842, an entity determines whether a sale occurs based on the revenue guidance in ASC 606, which is a control-based model. ASC 606-10-25-30 lays out five indicators that control of the underlying asset has transferred to the customer.

We believe that under ASC 842-40, the seller-lessee's ability to continue to use the underlying asset for substantially all of its remaining economic life at a fixed price does not stipulate that control of the asset has not transferred. Rather, we believe that an entity should consider all relevant facts and circumstances in weighing the various indicators that control has transferred.

Also, an entity must assess any renewal periods to determine whether they are part of the lease term, which might cause the lease to meet the "major part of the asset's remaining economic life" criterion for classification as a finance lease. In a situation where a seller-lessee has the ability to continue to use the underlying asset for substantially all of its remaining economic life, and there is an economic incentive for the seller-lessee to do so, sale and leaseback accounting would be precluded based on the leaseback's classification as a finance lease.

7.2.2 Seller-lessee guarantee of the residual value

Although the presence of a residual value guarantee on its own does not prevent accounting for a transaction as a sale and leaseback, the guarantee must be considered when evaluating whether control of the asset has transferred to the buyer-lessor. In general, the more significant the residual value guarantee, the more likely that its existence precludes transferring control of the underlying asset from the seller-lessee to the buyer-lessor.

If the seller-lessee guarantees the buyer-lessor that the underlying asset's residual value will be a certain amount at the end of the lease term, and the transaction qualifies for sale and leaseback accounting under ASC 842-40, the residual value guarantee is accounted for in the same manner as any other residual value guarantee provided by a lessee.



ASC 842-40-55-20

The seller-lessee may guarantee to the lessor that the residual value will be a stipulated amount at the end of the lease term. If the transfer of the asset is a sale in accordance with paragraphs 842-40-25-1 through 25-3, the seller-lessee residual value guarantee should be accounted for in the same manner as any other residual value guarantee provided by a lessee.

ASC 842-40-55-21

The residual value guarantee does not, on its own, preclude accounting for the transaction as a sale and leaseback, but should be considered in evaluating whether control of the asset has transferred to the buyer-lessor in accordance with paragraph 606-10-25-30. For example, a significant residual value guarantee by the seller-lessee may affect an entity's consideration of the transfer of control indicator in paragraph 606-10-25-30(d).

7.2.3 Transfer of tax benefits

When entities enter into an arrangement to transfer the tax benefits associated with an asset so that two or more entities have a tax basis in the same asset, the transaction must be analyzed to determine whether the transfer should be accounted for as a sale and leaseback under ASC 842-40.

ASC 842-40-55-11 through 55-14 describes a scenario in which a U.S. entity and a foreign investor enter into a transaction to transfer certain tax benefits associated with an asset.



ASC 842-40-55-11

A U.S. entity purchases an asset and enters into a contract with a foreign investor that provides that foreign investor with an ownership right in, but not necessarily title to, the asset. That ownership right enables the foreign investor to claim certain benefits of ownership of the asset for tax purposes in the foreign tax jurisdiction.

ASC 842-40-55-12

The U.S. entity also enters into a contract in the form of a leaseback for the ownership right with the foreign investor. The contract contains a purchase option for the U.S. entity to acquire the foreign investor's ownership right in the asset at the end of the lease term.

ASC 842-40-55-13

The foreign investor pays the U.S. entity an amount of cash on the basis of an appraised value of the asset. The U.S. entity immediately transfers a portion of that cash to a third party, and that third party assumes the U.S. entity's obligation to make the future lease payments, including the purchase option payment. The cash retained by the U.S. entity is consideration for the tax benefits to be obtained by the foreign investor in the foreign tax jurisdiction. The U.S. entity may agree to indemnify the foreign investor against certain future events that would reduce the availability of tax benefits to the foreign investor. The U.S. entity also may agree to indemnify the third-party trustee against certain future events.

ASC 842-40-55-14

The result of the transaction is that both the U.S. entity and the foreign investor have a tax basis in the same depreciable asset.

For this type of transaction, an entity should determine whether the transfer of the ownership right constitutes a sale and leaseback of the underlying asset. If the leaseback of the ownership right would be classified as a finance lease, or if the U.S. entity has the option to repurchase the ownership right at a price other than fair value, treating the transaction as a sale is not permitted. If the U.S. entity determines

that the transfer of the ownership right is not a sale, it should account for the cash received from the foreign investor as a financial liability under other applicable GAAP. If the transfer of ownership qualifies for sale accounting, the U.S. entity should recognize income based on the facts and circumstances of the transaction. For example, it would not be appropriate for the U.S. entity to recognize income immediately if there is a more than a remote possibility of a loss in the cash consideration in the future based on indemnification or other contingencies in the contract.

The total consideration the U.S. entity receives is compensation for both the tax benefits and indemnification of the foreign investor or another third-party trustee. The U.S. entity should recognize a liability for an indemnification agreement at contract inception in accordance with ASC 460. This liability would reduce the amount of income allocated to the tax benefits.



ASC 842-40-55-15

An entity should determine whether the transfer of the ownership right is a sale based on the guidance in paragraphs 842-40-25-1 through 25-3. Consistent with paragraphs 842-40-25-2 through 25-3, if the leaseback for the ownership right is a finance lease or if the U.S. entity has an option to repurchase the ownership right at any exercise price other than the fair value of that right on the exercise date, there is no sale. If the transfer of the ownership right is not a sale, consistent with the guidance in paragraph 842-40-25-5, the entity should account for the cash received from the foreign investor as a financial liability in accordance with other Topics.

ASC 842-40-55-16

If the transfer of the ownership right is a sale, income recognition for the cash received should be determined on the basis of individual facts and circumstances. Immediate income recognition is not appropriate if there is more than a remote possibility of loss of the cash consideration received because of indemnification or other contingencies.

ASC 842-40-55-17

The total consideration received by the U.S. entity is compensation for both the tax benefits and the indemnification of the foreign investor or other third-party trustee. The recognition of a liability for the indemnification agreement at inception in accordance with the guidance in Topic 460 on guarantees would reduce the amount of income related to the tax benefits that the seller-lessee would recognize immediately when the possibility of loss is remote.

7.3 Accounting for a transfer of assets that is a sale

If the transfer of an asset qualifies as a sale, the seller-lessee should (1) recognize the transaction price for the sale when control of the asset transfers, (2) derecognize the carrying amount of the asset, and (3) account for the lease in accordance with the guidance in ASC 842-20. Profit or loss should be recognized when control of the underlying asset transfers based on the difference between the transaction price and the carrying amount of the asset, adjusted for any off-market terms.

The buyer-lessor accounts for the purchase in accordance with other applicable guidance, and the lease in accordance with the guidance for lessors in ASC 842-30.

**ASC 842-40-25-4**

If the transfer of the asset is a sale in accordance with paragraphs 842-40-25-1 through 25-3, both of the following apply:

- a. The seller-lessee shall:
 1. Recognize the transaction price for the sale at the point in time the buyer-lessor obtains control of the asset in accordance with paragraph 606-10-25-30 in accordance with the guidance on determining the transaction price in paragraphs 606-10-32-2 through 32-27
 2. Derecognize the carrying amount of the underlying asset
 3. Account for the lease in accordance with Subtopic 842-20.
- b. The buyer-lessor shall account for the purchase in accordance with other Topics and for the lease in accordance with Subtopic 842-30.

7.3.1 Determining the transaction price

The seller-lessee determines the transaction price based on the guidance in ASC 606-10-32-2 through 32-27. The ASC Master Glossary defines “transaction price” as the amount of consideration that an entity expects to be entitled to in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties. ASC 606 describes four additional components that an entity must consider as inputs to the transaction price:

- Variable consideration, which should be estimated and constrained to the amount at which it is probable that a significant reversal of revenue recognized in the contract will not occur
- Consideration payable to the customer that is not exchanged for a distinct good or service
- Significant financing components, to recognize any explicit or implicit financing in the contract
- Noncash consideration, such as goods or services, common stock, or other equity instruments

For further information on the guidance in ASC 606 regarding the transaction price, refer to Grant Thornton’s Revenue Guide.

Transaction Price: The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

7.3.2 Determining if the sale and leaseback is at fair value

Once the seller-lessee determines the transaction price, it must determine whether the transaction is at fair value by comparing either (1) the sale price of the asset and its fair value, or (2) the present value of the lease payments and the present value of at-market rental payments. The entity may use either

technique, depending on which one yields information that is more readily determinable and maximizes the use of observable prices and other information.

A variable component in a sale and leaseback transaction does not, on its own, cause the transaction to be off-market. If an entity uses lease payments to determine whether the transaction is at-market, then it must measure any variable payments based on the guidance for consideration in a contract in ASC 606 rather than on the definition of lease payments in ASC 842. This distinction is important because, under ASC 842, an entity does not include variable payments in its measurement of lease payments unless they are based on an index or a rate, whereas under ASC 606, an entity estimates the amount of variable payments in a contract, subject to the constraint based on whether a subsequent reversal of revenue is probable. An entity's assessment of variable payments in a sale-leaseback transaction should be based on all available historical, current, and forecast information.



ASC 842-40-30-1

An entity shall determine whether a sale and leaseback transaction is at fair value on the basis of the difference between either of the following, whichever is more readily determinable:

- a. The sale price of the asset and the fair value of the asset
- b. The present value of the lease payments and the present value of market rental payments.

ASC 842-40-30-3

A sale and leaseback transaction is not off market solely because the sale price or the lease payments include a variable component. In determining whether the sale and leaseback transaction is at fair value, the entity should consider those variable payments it reasonably expects to be entitled to (or to make) on the basis of all of the information (historical, current, and forecast) that is reasonably available to the entity. For a seller-lessee, this would include estimating any variable consideration to which it expects to be entitled in accordance with paragraphs 606-10-32-5 through 32-9.



At the crossroads: Recognizing a gain on a sale and leaseback transaction

Under legacy GAAP, there are specific requirements for recognizing a gain or loss resulting from the sale of an asset in a sale and leaseback transaction, which generally causes a seller-lessee to defer any gain on the sale of the asset and to recognize it over the term of the leaseback.

Under ASC 842, if a transaction qualifies for sale and leaseback accounting, then the sale portion of the transaction is accounted for like any other sale, meaning that any profit or loss on the sale is recognized when control of the underlying asset is transferred to the buyer.

The transaction is at fair value

If the sale and leaseback is at-market, then the sale is recorded like a sale that doesn't involve a leaseback. The seller-lessee recognizes the consideration received, derecognizes the underlying asset, and recognizes a gain or loss for the difference between the transaction price and the carrying amount of the underlying asset.

The transaction is not at fair value

If the sale and leaseback is off-market, then any difference between the transaction price and the fair value of the underlying asset is recognized as a financing asset or liability. An entity must adjust the sale price of the asset applying the same information used to determine that the transaction was not at fair value. For example, if an entity determines that the transaction is off-market based on the difference between the selling price and the fair value of the underlying asset, then the adjustment to the selling price would also be based on the difference between the selling price and the fair value of the underlying asset. Depending on whether this analysis indicates the transaction is above or below market, an entity should make an adjustment as follows:

- If the asset's sale price is less than its fair value, the entity would make an adjustment to increase the sales price to match the fair value, and would recognize the difference as prepaid rent. The seller-lessee would recognize this prepaid rent as an adjustment to the right-of-use asset associated with the leaseback.
- If the asset's sale price is greater than its fair value, the entity would make an adjustment to reduce the sales price to match the fair value, and would recognize the difference as additional financing. As discussed in paragraph BC361(b), the Board decided that a buyer-lessor paying more than fair value for an asset is not economically different than a buyer-lessor paying fair value to purchase an asset and also providing a loan to the seller-lessee.

If the transaction is executed between related parties, an entity does not make the adjustments described above, but instead provides the required related-party disclosures under ASC 850, *Related Party Disclosures*.



ASC 842-40-30-2

If the sale and leaseback transaction is not at fair value, the entity shall adjust the sale price of the asset on the same basis the entity used to determine that the transaction was not at fair value in accordance with paragraph 842-40-30-1. The entity shall account for both of the following:

- a. Any increase to the sale price of the asset as a prepayment of rent
- b. Any reduction of the sale price of the asset as additional financing provided by the buyer-lessor to the seller-lessee. The seller-lessee and the buyer-lessor shall account for the additional financing in accordance with other Topics.

ASC 842-40-30-4

If the transaction is a related party lease, an entity shall not make the adjustments required in paragraph 842-40-30-2, but shall provide the required disclosures as discussed in paragraphs 842-20-50-7 and 842-30-50-4.

Example 1 from ASC 842-40-55 illustrates the accounting for a sale and leaseback transaction for both the seller-lessee and the buyer-lessor.



Example 1—Sale and Leaseback Transaction

ASC 842-40-55-23

An entity (Seller) sells a piece of land to an unrelated entity (Buyer) for cash of \$2 million. Immediately before the transaction, the land has a carrying amount of \$1 million. At the same time, Seller enters into a contract with Buyer for the right to use the land for 10 years (the leaseback), with annual payments of \$120,000 payable in arrears. This Example ignores any initial direct costs associated with the transaction. The terms and conditions of the transaction are such that Buyer obtains substantially all the remaining benefits of the land on the basis of the combination of the cash flows it will receive from Seller during the leaseback and the benefits that will be derived from the land at the end of the lease term. In determining that a sale occurs at commencement of the leaseback, Seller considers that, at that date, all of the following apply:

- a. Seller has a present right to payment of the sales price of \$2 million.
- b. Buyer obtains legal title to the land.
- c. Buyer has the significant risks and rewards of ownership of the land because, for example, Buyer has the ability to sell the land if the property value increases and also must absorb any losses, realized or unrealized, if the property value declines.

ASC 842-40-55-24

The observable fair value of the land at the date of sale is \$1.4 million. Because the fair value of the land is observable, both Seller and Buyer utilize that benchmark in evaluating whether the sale is at market term. Because the sale is not at fair value (that is, the sales price is significantly in excess of the fair value of the land), both Seller and Buyer adjust for the off-market terms in accounting for the transaction. Seller recognizes a gain of \$400,000 (\$1.4 million – \$1 million) on the sale of the land. The amount of the excess sale price of \$600,000 (\$2 million – \$1.4 million) is recognized as additional financing from Buyer to Seller (that is, Seller is receiving the additional benefit of financing from Buyer). Seller's incremental borrowing rate is 6 percent. The leaseback is classified as an operating lease.

ASC 842-40-55-25

At the commencement date, Seller derecognizes the land with a carrying amount of \$1 million. Seller recognizes the cash received of \$2 million, a financial liability for the additional financing obtained from Buyer of \$600,000, and a gain on sale of the land of \$400,000. Seller also recognizes a lease liability for the leaseback at the present value of the portion of the 10 contractual leaseback payments attributable to the lease of \$38,479 (\$120,000 contractual lease payment – \$81,521 of that lease payment that is attributable to the additional Buyer financing), discounted at the rate of 6 percent, which is \$283,210, and a corresponding right-of-use asset of \$283,210. The amount of \$81,521 is the amount of each \$120,000 annual payment that must be attributed to repayment of the principal of the financial liability for that financial liability to reduce to zero by the end of the lease term.

ASC 842-40-55-26

After initial recognition and measurement, at each period of the lease term, Seller will do both of the following:

- a. Decrease the financing obligation for the amount of each lease payment allocated to that obligation (that is, \$81,521) and increase the carrying amount of the obligation for interest accrued using Seller's incremental borrowing rate of 6 percent. For example, at the end of Year 1, the balance of the financial obligation is \$554,479 ($\$600,000 - \$81,521 + \$36,000$).
- b. Recognize the interest expense on the financing obligation (for example, \$36,000 in Year 1) and \$38,479 in operating lease expense.

ASC 842-40-55-27

At the end of the lease term, the financing obligation and the lease liability equal \$0.

ASC 842-40-55-28

Also, at the commencement date, Buyer recognizes the land at a cost of \$1.4 million and a financial asset for the additional financing provided to Seller of \$600,000. Because the lease is an operating lease, at the date of sale Buyer does not do any accounting for the lease.

ASC 842-40-55-29

In accounting for the additional financing to Seller, Buyer uses 6 percent as the applicable discount rate, which it determined in accordance with paragraphs 835-30-25-12 through 25-13. Therefore, Buyer will allocate \$81,521 of each lease payment to Buyer's financial asset and allocate the remaining \$38,479 to lease income. After initial recognition and measurement at each period of the lease term, Buyer will do both of the following:

- a. Decrease the financial asset for the amount of each lease payment received that is allocated to that obligation (that is, \$81,521) and increase the carrying amount of the obligation for interest accrued on the financial asset using Seller's incremental borrowing rate of 6 percent. Consistent with Seller's accounting, at the end of Year 1, the carrying amount of the financial asset is \$554,479 ($\$600,000 - \$81,521 + \$36,000$).
- b. Recognize the interest income on the financing obligation (for example, \$33,269 in Year 2) and \$38,479 in operating lease income.

ASC 842-40-55-30

At the end of the lease term, the carrying amount of the financial asset is \$0, and Buyer continues to recognize the land.

7.4 Accounting for a transfer of assets that is not a sale

If the parties to a sale-leaseback transaction determine that the transfer does not meet the sale criteria in ASC 606, then the transaction is accounted for as a "failed sale-leaseback."

The seller-lessee in a failed sale-leaseback transaction does not derecognize the transferred asset. Any amounts received by the seller-lessee are recognized as a financial liability in accordance with other applicable guidance. The seller-lessee recognizes interest expense on the financial liability, and reduces that liability as it makes lease payments.

The buyer-lessor in a failed sale and leaseback transaction does not recognize the transferred asset. Instead, the buyer-lessor accounts for the sale price of the asset as a financial asset in accordance with other applicable guidance. The buyer-lessor recognizes interest income on the financial asset, and reduces the financial asset as the seller-lessee makes lease payments.

**ASC 842-40-25-5**

If the transfer of the asset is not a sale in accordance with paragraphs 842-40-25-1 through 25-3, both of the following apply:

- a. The seller-lessee shall not derecognize the transferred asset and shall account for any amounts received as a financial liability in accordance with other Topics.
- b. The buyer-lessor shall not recognize the transferred asset and shall account for the amounts paid as a receivable in accordance with other Topics.

When a transfer does not qualify as a sale, the seller-lessee must adjust the interest rate on its financial liability such that two conditions are satisfied.

- First, interest expense recognized on the financial liability may not exceed the principal payments over the shorter of the lease term and the financing term. In other words, the liability cannot exhibit “negative amortization,” whereby the principal balance grows during its term. The term of the financing may be shorter than the lease term because a failed sale leaseback might subsequently qualify for sale and leaseback accounting before the end of the lease term, as discussed in Section 7.4.2.
- Second, the carrying amount of the asset cannot exceed the carrying amount of the financial liability at the earlier of the end of the lease term or when control of the asset transfers to the buyer-lessor. In other words, the arrangement cannot contain a “built-in loss,” whereby the seller-lessee would recognize a loss at the end of the financing term because the asset balance exceeds the liability balance on that date.

**ASC 842-40-30-6**

The guidance in paragraph 842-40-25-5 notwithstanding, the seller-lessee shall adjust the interest rate on its financial liability as necessary to ensure that both of the following apply:

- a. Interest on the financial liability is not greater than the principal payments on the financial liability over the shorter of the lease term and the term of the financing. The term of the financing may be shorter than the lease term because the transfer of an asset that does not qualify as a sale initially may qualify as a sale at a point in time before the end of the lease term.
- b. The carrying amount of the asset does not exceed the carrying amount of the financial liability at the earlier of the end of the lease term or the date at which control of the asset will transfer to the buyer-lessor (for example, the date at which a repurchase option expires if that date is earlier than the end of the lease term).



At the crossroads: Buyer-lessor accounting for a failed sale leaseback

Legacy GAAP does not require a buyer-lessor to account for a sale and leaseback transaction that does not meet the sale criteria as a failed sale and leaseback transaction. However, under ASC 842, the Board determined that the accounting for build-to-suit and sale-leaseback arrangements should be symmetrical for the seller-lessee and the buyer-lessor. For buyer-lessors, the requirement to assess these transactions to determine whether they qualify for, or fail to achieve, sale-leaseback accounting might require new processes and controls.

The following example illustrates a seller-lessee's calculation of the interest rate used in a failed sale and leaseback transaction.



Seller-lessee's calculation of interest rate in a failed sale and leaseback transaction

Seller sells an asset to Buyer, an unrelated entity, for \$1 million. On the transaction date, the underlying asset's carrying value is \$900,000, its remaining economic life is 12 years, and its fair value is \$950,000. Seller concurrently leases the asset back from Buyer for five years, with annual payments of \$150,000, payable in arrears. The lease includes a repurchase option that allows Seller to repurchase the asset for \$650,000 at the end of year three, after which the option expires. Seller's incremental borrowing rate is 4.25 percent. Seller evaluates classification of the leaseback at the commencement date and determines that it is an operating lease. As of the transaction date, Seller is not reasonably certain to exercise the repurchase option, and the lease term is five years.

The transaction is a failed sale leaseback due to the fixed-price repurchase option. Therefore, Seller does not derecognize the underlying asset and recognizes a financial liability equal to the cash received from Buyer. The term of the financing is three years – if the lease continues after year three, it will no longer contain a repurchase option and will then qualify for sale and leaseback accounting.

Seller must ensure that the interest rate used to account for its financial liability does not cause negative amortization over the shorter of the lease term and the term of the financing, or a built-in loss at the earlier of the end of the lease term or the date at which control of the asset transfers to Buyer. In other words, in Seller's amortization table, the carrying amount of its financial liability at the end of year three cannot be greater than the carrying amount at the transaction date, and the carrying amount of the asset at the end of year three must not exceed the carrying amount of the financial liability on that date.

Seller first prepares an amortization schedule based on its incremental borrowing rate of 4.25 percent. The "negative amortization" condition is satisfied, since the carrying amount of its financial liability at the end of year three is less than the carrying amount at the transaction date. However, the "built-in loss" condition is not satisfied, because the carrying amount of the asset at the end of year three is \$675,000, which exceeds the balance of the financial liability on that date.

	Financial liability	Underlying asset
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Year	Beginning balance	Interest at 4.25%	Payment	Ending balance	Beginning carrying amount	Depreciation	Ending carrying amount
1	\$1,000,000	\$42,500	(\$150,000)	\$892,500	\$900,000	\$75,000	\$825,000
2	892,500	37,931	(150,000)	780,431	825,000	75,000	750,000
3	780,431	33,168	(150,000)	663,600	750,000	75,000	675,000

Seller increases the interest rate until it identifies a rate that satisfies both the “negative amortization” and the “built-in loss” conditions, which it determines to be 4.66 percent. Seller updates its amortization table to reflect the change in interest rate as shown below. Seller will use this adjusted table to account for the failed sale leaseback as a financing arrangement.

Year	Financial liability				Underlying asset		
	Beginning balance	Interest at 4.66%	Payment	Ending balance	Beginning carrying amount	Depreciation	Ending carrying amount
1	\$1,000,000	\$46,600	(\$150,000)	\$896,600	\$900,000	\$75,000	\$825,000
2	896,600	41,782	(150,000)	788,382	825,000	75,000	750,000
3	788,382	36,739	(150,000)	675,120	750,000	75,000	675,000

7.4.1 Accounting by a seller-lessee reasonably certain to exercise a repurchase option

In a failed sale-leaseback that involves a repurchase option, the seller-lessee must determine whether it is reasonably certain to exercise the repurchase option. If the seller-lessee is reasonably certain to exercise the repurchase option, then it must amortize the financial liability using an imputed interest rate that causes the financial liability to be equal to the exercise price of the repurchase option at its expected exercise date, such that it will not recognize a gain or loss on extinguishment of the financial liability.

To recognize its exercise of the repurchase option, the seller-lessee derecognizes the financial liability and recognizes the cash paid to the buyer-lessor. There is no accounting adjustment necessary for the underlying asset - it remains on the seller-lessee’s statement of financial position at its amortized cost basis.



Example: Exercise of a repurchase option in a failed sale-leaseback is reasonably certain

Assume the same facts from the example in Section 7.4, except that Seller determines at the original transaction date that it is reasonably certain to exercise the repurchase option at the end of year three. In this case, Seller must ensure that both the “negative amortization” and “built-in loss” conditions are satisfied based on an amortization schedule in which the financial liability’s balance is equal to the exercise price of the repurchase option on the date the option is reasonably certain to be exercised. Seller determines this rate to be 3.76 percent, and updates its amortization table accordingly.

Year	Financial liability				Underlying asset		
	Beginning balance	Interest at 3.76%	Payment	Ending balance	Beginning carrying amount	Depreciation	Ending carrying amount
1	(\$1,000,000)	(\$37,614)	150,000	(\$887,614)	\$900,000	\$75,000	\$825,000
2	(\$887,614)	(\$33,386)	150,000	(\$771,000)	825,000	75,000	750,000
3	(\$771,000)	(\$29,000)	150,000	(\$650,000)	750,000	75,000	675,000

At the end of year three, Seller exercises its repurchase option. Seller derecognizes the liability of \$650,000 and recognizes the cash payment of \$650,000. The journal entry to record the repurchase is as follows:

Dr. Financial liability	\$650,000
Cr. Cash	\$650,000

7.4.2 Failed sale-leaseback subsequently meets the sale-leaseback criteria

Although a sale-leaseback might initially fail to qualify for sale-leaseback accounting, at some point during the term of the leaseback the transaction could meet the criteria for sale-leaseback accounting. For example, a ten year leaseback of real estate contains a repurchase option exercisable through year five of the leaseback. If the seller-lessee does not exercise the repurchase option, then it expires at the end of year five, and the sale-leaseback would qualify for sale-leaseback accounting at that time.

As discussed in paragraph BC369, if a failed sale-leaseback subsequently meets the criteria for sale accounting, whether before or at the end of the leaseback term, the parties should account for the sale as follows:

- The buyer-lessor should derecognize the financial asset at its current carrying value and recognize the purchased asset at the same amount.
- The seller-lessee should derecognize the financial liability and the carrying amount of the sold asset, and recognize a gain for the difference between the two.

If the lessee and lessor qualify to derecognize or recognize, respectively, the underlying asset before the end of the leaseback term, then the leaseback is accounted for as described in Section 7.3.



Example: Failed sale-leaseback that subsequently meets the sale-leaseback criteria

Continuing the example in Section 7.4, assume that Seller's repurchase option expires unexercised at the end of year three. Since the fixed price purchase option was the only term preventing the transaction from being accounted for as a sale-leaseback, Seller recognizes the sale and leaseback on the date that the purchase option expires. At that time the asset has a carrying value of \$675,000 and the financial liability has a carrying value of \$675,120. The difference between the asset and liability, \$120, is recorded as a gain. Seller's journal entry to record the sale is as follows:

Dr. Liability	\$675,120
Cr. Asset	\$675,000
Cr. Gain on sale	\$ 120

Seller then records the leaseback based on the lessee guidance in ASC 842-20 for the two remaining years of the original five year term. Seller assessed the lease classification at the initial transaction date and determined that the lease was an operating lease.

Seller uses its incremental borrowing rate of 4.25% that was in place at the initial transaction date to calculate the present value of the two remaining lease payments of \$150,000, for a total of \$281,904. This methodology is consistent with Example 2 in ASC 842-40-55. Seller records a lease liability of \$281,904 and a ROU asset for the same amount, as there are no prepaid lease payments, lease incentives, or initial direct costs to record. Seller recognizes the total remaining lease payments on a straight-line basis over the lease term.

Example 2 from ASC 842-40-55 illustrates the accounting for a sale and leaseback transaction where the transfer of the asset does not meet the definition of a sale.



Example 2—Accounting for a Failed Sale and Leaseback Transaction

ASC 842-40-55-31

An entity (Seller) sells an asset to an unrelated entity (Buyer) for cash of \$2 million. Immediately before the transaction, the asset has a carrying amount of \$1.8 million and has a remaining useful life of 21 years. At the same time, Seller enters into a contract with Buyer for the right to use the asset for 8 years with annual payments of \$200,000 payable at the end of each year and no renewal options. Seller's incremental borrowing rate at the date of the transaction is 4 percent. The contract includes an option to repurchase the asset at the end of Year 5 for \$800,000.

ASC 842-40-55-32

The exercise price of the repurchase option is fixed and, therefore, is not the fair value of the asset on the exercise date of the option. Consequently, the repurchase option precludes accounting for the

transfer of the asset as a sale. Absent the repurchase option, there are no other factors that would preclude accounting for the transfer of the asset as a sale.

ASC 842-40-55-33

Therefore, at the commencement date, Seller accounts for the proceeds of \$2 million as a financial liability and continues to account for the asset. Buyer accounts for the payment of \$2 million as a financial asset and does not recognize the transferred asset. Seller accounts for its financing obligation, and Buyer accounts for its financial asset in accordance with other Topics, except that, in accordance with paragraph 842-40-30-6, Seller imputes an interest rate (4.23 percent) to ensure that interest on the financial liability is not greater than the payments on the financial liability over the shorter of the lease term and the term of the financing and that the carrying amount of the asset will not exceed the financial liability at the point in time the repurchase option expires (that is, at the point in time Buyer will obtain control of the asset in accordance with the guidance on satisfying performance obligations in Topic 606). Paragraph 842-40-30-6 does not apply to the buyer-lessor; therefore, Buyer recognizes interest income on its financial asset on the basis of the imputed interest rate determined in accordance with paragraphs 835-30-25-12 through 25-13, which in this case Buyer determines to be 4 percent.

ASC 842-40-55-34

During Year 1, Seller recognizes interest expense of \$84,600 ($4.23\% \times \2 million) and recognizes the payment of \$200,000 as a reduction of the financial liability. Seller also recognizes depreciation expense of \$85,714 ($\1.8 million \div 21 years). Buyer recognizes interest income of \$80,000 ($4\% \times \2 million) and recognizes the payment of \$200,000 as a reduction of its financial asset.

ASC 842-40-55-35

At the end of Year 1, the carrying amount of Seller's financial liability is \$1,884,600 ($\2 million + \$84,600 – \$200,000), and the carrying amount of the underlying asset is \$1,714,286 ($\1.8 million – \$85,714). The carrying amount of Buyer's financial asset is \$1,880,000 ($\2 million + \$80,000 – \$200,000).

ASC 842-40-55-36

At the end of Year 5, the option to repurchase the asset expires, unexercised by Seller. The repurchase option was the only feature of the arrangement that precluded accounting for the transfer of the asset as a sale. Therefore, upon expiration of the repurchase option, Seller recognizes the sale of the asset by derecognizing the carrying amount of the financial liability of \$1,372,077, derecognizing the carrying amount of the underlying asset of \$1,371,429, and recognizing a gain of \$648. Buyer recognizes the purchase of the asset by derecognizing the carrying amount of its financial asset of \$1,350,041 and recognizes the transferred asset at that same amount. The date of sale also is the commencement date of the leaseback for accounting purposes. The lease term is 3 years (8 year contractual leaseback term – 5 years already passed at the commencement date). Therefore, Seller recognizes a lease liability at the present value of the 3 remaining contractual leaseback payments of \$200,000, discounted at Seller's incremental borrowing rate at the contractually stated commencement date of 4 percent, which is \$555,018, and a corresponding right-of-use asset of \$555,018. Seller uses the incremental borrowing rate as of the contractual commencement date because that rate more closely reflects the interest rate that would have been considered by Buyer in pricing the lease.

ASC 842-40-55-37

The lease is classified as an operating lease by both Seller and Buyer. Consequently, in Year 6 and each year thereafter, Seller recognizes a single lease cost of \$200,000, while Buyer recognizes lease income of \$200,000 and depreciation expense of \$84,378 on the underlying asset ($\$1,350,041 \div 16$ years remaining useful life).

ASC 842-40-55-38

At the end of Year 6 and at each reporting date thereafter, Seller calculates the lease liability at the present value of the remaining lease payments of \$200,000, discounted at Seller's incremental borrowing rate of 4 percent. Because Seller does not incur any initial direct costs and there are no prepaid or accrued lease payments, Seller measures the right-of-use asset at an amount equal to the lease liability at each reporting date for the remainder of the lease term.

7.5 Sale-leaseback-sublease transactions

A sale-leaseback-sublease transaction occurs if an entity enters into a sale and leaseback transaction and either (1) the underlying asset is already subject to an operating lease, or (2) the underlying asset is subleased or the seller-lessee intends to sublease the asset to another party under an operating lease.

A sale-leaseback-sublease transaction is within the scope of ASC 842-40. The existence of the sublease does not, on its own, prevent the buyer-lessor from obtaining control of the underlying asset. The existence of the sublease also does not prevent the seller-lessee from controlling the asset before it is transferred to the buyer-lessor. The seller-lessee must determine whether the transfer of the asset is a sale without considering the sublease.



ASC 842-40-55-18

An entity enters into a sale and leaseback of an asset that meets either of the following criteria:

- a. The asset is subject to an operating lease.
- b. The asset is subleased or intended to be subleased by the seller-lessee to another party under an operating lease.

ASC 842-40-55-19

A sale-leaseback-sublease transaction is within the scope of this Subtopic. The existence of the sublease (that is, the operating lease in paragraph 842-40-55-18(a) or (b)) does not, in isolation, prevent the buyer-lessor from obtaining control of the asset in accordance with paragraphs 842-40-25-1 through 25-3, nor does it prevent the seller-lessee from controlling the asset before its transfer to the buyer-lessor (that is, the seller-lessee is subject to the same requirements for determining whether the transfer of the asset is a sale as it would be without the sublease). All facts and circumstances should be considered in determining whether the buyer-lessor obtains control of the underlying asset from the seller-lessee in a sale-leaseback-sublease transaction.



At the crossroads: No requirement for a leaseback to be 'normal'

Under legacy GAAP, one of the criteria for sale and leaseback accounting for real estate is that the leaseback must be “normal,” meaning that the seller-lessee will actively use, rather than sublease, the underlying asset.

ASC 842 eliminates the requirement for real estate sale-leasebacks to involve a “normal” leaseback, so that a sale-leaseback-sublease transaction might qualify for sale-leaseback accounting, regardless of the type of underlying asset.

8. Leveraged leases

8.1 Overview

ASC 842 defines a leveraged lease as a lease that was classified as a leveraged lease under legacy GAAP which commenced before the effective date of ASC 842. After the effective date of ASC 842, a lessor can no longer classify new or modified leases as leveraged leases. Instead, a lessor will classify all new or modified leases as sales-type, direct financing, or operating leases, based on the criteria discussed in Sections 4.1 and 4.2. According to paragraph BC397 of ASU 2016-02, the Board decided that the accounting model for lessors under ASC 842 should be consistent across all lease types, and should no longer contain specialized guidance for transactions with specific characteristics, such as leveraged leases under legacy GAAP. Therefore, the Board did not retain the accounting model for leveraged leases that existed in legacy GAAP, opting instead for a classification and accounting model that applies consistently to all leases.

Leveraged Lease (ASC 842): From the perspective of a lessor, a lease that was classified as a leveraged lease in accordance with the leases guidance in effect before the effective date and for which the commencement date is before the effective date.

ASC 842 grandfathers the classification of, and the accounting for, leveraged leases commencing before the effective date of ASC 842. The Board decided to retain leveraged lease accounting for legacy transactions because it would be unnecessarily complex for entities to unwind and derecognize leveraged leases existing at the effective date of ASC 842. Therefore, the guidance in ASC 842-50 carries forward the leveraged leasing guidance in legacy GAAP, which applies only to these grandfathered leases.

If a leveraged lease is modified on or after the effective date of ASC 842, it is accounted for as a new lease on the date when the modification takes effect. Therefore, a leveraged lease modified after the effective date of ASC 842 loses its grandfathered status, and will thereafter be classified and accounted for as either a sales-type, direct financing, or operating lease.

In addition, if a lessee exercises an option to extend the lease term of a leveraged lease, but the lessor previously had determined it was not reasonably assured that the lessee would exercise that option, then exercising the option would be treated as a modification of the lease under ASC 842. In this scenario, the modification results in the extended lease being accounted for as a new lease under ASC 842, which means it loses its grandfathered classification as a leveraged lease.



At the crossroads: Leveraged leases under legacy GAAP

Under legacy GAAP (ASC 840-10-25-43(c)), a lessor classifies a lease as a leveraged lease if it meets all of the following conditions:

- The lease meets the criteria in ASC 840 to be classified as a direct financing lease (in other words, it was not a sales-type or an operating lease).
- The lease involves at least three distinct parties: a lessee, a long-term creditor, and a lessor.
- The financing that the creditor provides is nonrecourse to the lessor's general credit, although there could be recourse to the underlying asset or to the lease payments themselves. The amount of the financing has to be sufficient so that the lessor achieves "substantial leverage."
- The lessor's net investment in the lease declines during the early years once the investment was completed and rises during the later years of the lease before its final elimination. This decrease and increase might occur more than one time during the life of the leveraged lease

Leveraged Lease (ASC 840): From the perspective of a lessor, a lease that meets all of the conditions in paragraph 840-10-25-43(c).



Grant Thornton insights: Leveraged lease acquired in a business combination after the effective date of ASC 842

The transition guidance in ASC 842-10-65-1(z)(1), states that "A lessor shall apply the pending content that links to this paragraph to a leveraged lease that meets the criteria in (z) that is acquired in a business combination or an acquisition by a not-for-profit entity on or after the effective date." A question arises whether this transition guidance indicates that leveraged leases acquired in a business combination should be accounted for under the pending content in ASC 842-10 and ASC 842-30 as either a sales-type, direct financing, or operating lease, or whether the "pending content" referred to is the guidance in ASC 842-50, in which case, these leases would continue to be accounted for as leveraged leases.

We believe that the pending content referred to is the pending content that allows a leveraged lease that commenced before the effective date of the ASC 842 to retain its leveraged lease classification as long as it's not subsequently modified, as discussed earlier in this section. The guidance in ASC 842-50-25-2 clearly states that an acquirer retains the leveraged lease classification in a business combination. Further, ASC 842-10-55-11 states that in a business combination, the acquirer must retain the acquiree's lease classification, unless the lease is modified and is not accounted for as a separate contract.

Accordingly, leveraged leases acquired in a business combination after ASC 842's effective date retain their leveraged lease classification as long as the lease is not modified.

8.2 Guidance

Since the leveraged leasing guidance applies only to leases executed prior to adopting ASC 842, we have neither reproduced the relevant guidance nor provided commentary with respect to that guidance in this guide. For more information about accounting for leveraged leases, refer to ASC 842-50.

9. Subleases

9.1 Sublease

A sublease is a transaction in which a lessee agrees to lease to a third party all or a portion of the underlying asset that the lessee is leasing from a lessor. In a sublease, the original lessee is often called the *intermediate lessor* or *sublessor*, the original lease is called the *head lease*, and the third party leasing the asset from the sublessor is called the *sublessee*. A sublease is essentially the lease of a right-of-use asset, and should therefore be accounted for in the same manner as other leases.

Sublease: A transaction in which an underlying asset is re-leased by the lessee (or intermediate lessor) to a third party (the sublessee) and the original (or head) lease between the lessor and the lessee remains in effect.

Under ASC 842, a sublessor accounts for the head lease and the sublease as two separate contracts, unless they must be combined under the contract combination guidance discussed in Section 3.1.7. A sublessor should not classify the right-of-use asset associated with the head lease as an asset held-for-sale. As the Board stated in paragraph BC115 of ASU 2016-02, head leases and subleases are generally negotiated separately and involve different counterparties. A sublessor's obligations under a head lease are generally not relieved or extinguished by entering into a sublease transaction, and, if they are, the sublessor should account for this as a termination of the head lease (see Section 5.9).

9.2 Sublease classification

A sublease is classified based on the underlying asset rather than on the right-of-use asset associated with the head lease. In paragraph BC116 of ASU 2016-02, the Board notes that classifying a sublease based on the right-of-use asset would be inappropriate because (1) the sublessee might not know the terms of the head lease, and (2) doing so could result in a sublessor accounting for leases in which it is the intermediate lessor differently from leases in which it is the lessor of an asset it owns.

Refer to Section 1.5.2 for a discussion of the impact of renewal options in a sublease on the determination of the lease term in the head lease.



ASC 842-10-25-6

When classifying a sublease, an entity shall classify the sublease with reference to the underlying asset (for example, the item of property, plant, or equipment that is the subject of the lease) rather than with reference to the right-of-use asset.

9.3 Sublessor's initial and subsequent measurement of a sublease

A sublease may or may not relieve the original lessee of its primary obligation under the original lease. If the original lessee is relieved of its primary obligation when it subleases the underlying asset, then it must account for the sublease transaction as the termination of the original lease.

Despite being relieved of its primary obligation, the original lessee may be secondarily obligated under the original or amended lease if it, in effect, guarantees the third-party lessee's performance. If the original lessee becomes secondarily obligated to perform under the original lease, it must recognize its guarantee obligation in accordance with ASC 405-20-40-2, *Liabilities: Extinguishments of Liabilities*.

If the original lessee is not relieved of its primary obligation under the head lease, then it must continue to account for the original lease as a lessee, and must account for the sublease as a lessor. Under ASC 842, the sublessor is not permitted to present amounts associated with the head lease on a net basis with amounts associated with the sublease in the statement of financial position. Regarding net presentation in the statement of comprehensive income, ASC 842 does not contain explicit guidance either permitting or prohibiting such presentation. However, we believe that consistent with presentation on the statement of financial position, generally an entity should not present lease expense and sublease income on a net basis in the statement of comprehensive income.

Like other leases under ASC 842, classification determines how the sublessor should account for the head lease and the sublease, as described in the table in Figure 9.1.

Figure 9.1: Sublessor's accounting for head lease and sublease

Sublease classification	
Sales-type or direct financing	Operating
<ul style="list-style-type: none"> • Derecognize the right-of-use asset associated with the head lease • Recognize net investment in the sublease, and assess it for impairment, based on the guidance in ASC 310-10 (ASC 326-20 after adoption of ASU 2016-13). • Account for the head lease liability in the same manner as a liability associated with a finance lease, as follows: <ul style="list-style-type: none"> – <i>If the head lease is classified as a finance lease:</i> Continue the pre-sublease accounting. – <i>If the head lease is classified as an operating lease:</i> Apply the subsequent measurement guidance for finance leases 	<ul style="list-style-type: none"> • Account for the right-of-use asset and lease liability in the same manner as before the sublease commenced. • If lease cost for the term of the sublease exceeds the anticipated sublease income, treat this as an indicator that the right-of-use asset may not be recoverable in accordance with ASC 360-10-35-21.

to the lease liability prospectively from the commencement date of the sublease.



ASC 842-20-35-14

If the nature of a sublease is such that the original lessee is not relieved of the primary obligation under the original lease, the original lessee (as sublessor) shall continue to account for the original lease in one of the following ways:

- a. If the sublease is classified as an operating lease, the original lessee shall continue to account for the original lease as it did before commencement of the sublease. If the lease cost for the term of the sublease exceeds the anticipated sublease income for that same period, the original lessee shall treat that circumstance as an indicator that the carrying amount of the right-of-use asset associated with the original lease may not be recoverable in accordance with paragraph 360-10-35-21.
- b. If the original lease is classified as a finance lease and the sublease is classified as a sales-type lease or a direct financing lease, the original lessee shall derecognize the original right-of-use asset in accordance with paragraph 842-30-40-1 and continue to account for the original lease liability as it did before commencement of the sublease. The original lessee shall evaluate its investment in the sublease for impairment in accordance with paragraph 842-30-35-3.
- c. If the original lease is classified as an operating lease and the sublease is classified as a sales-type lease or a direct financing lease, the original lessee shall derecognize the original right-of-use asset in accordance with paragraph 842-30-40-1 and, from the sublease commencement date, account for the original lease liability in accordance with paragraphs 842-20-35-1 through 35-2. The original lessee shall evaluate its investment in the sublease for impairment in accordance with paragraph 842-30-35-3.



At the crossroads: Recognizing a loss on a sublease

Under legacy GAAP, a sublessor is required to recognize a loss on a sublease if the costs it expects to incur exceed the anticipated sublease income.

Under ASC 842, a sublessor is no longer required to recognize a loss in this manner. Instead, a sublessor must evaluate its right-of-use asset or its net investment in the sublease to determine if it can be recovered. If the sublease is classified as an operating lease, the sublessor evaluates the right-of-use asset to determine if it can be recovered under ASC 360. Otherwise, the sublessor evaluates its net investment in the sublease for recoverability under the guidance in ASC 310-10 (ASC 326-20 after adoption of ASU 2016-13).

9.3.1 Sublease of a portion of a leased asset

The sublessor may lease to the sublessee all or only a portion of the right to control the use of the underlying asset that it is leasing from the head lessor. If the sublessor leases to the sublessee only a

portion of the right to use an underlying asset, the sublessor must pay careful attention to the unit of account when determining the accounting for the sublease.



Grant Thornton insights: Subleasing a portion of the leased asset

A sublessor might sublease only a portion of the underlying asset it has the right to use under the head lease. For example, a sublessor might lease an entire 10-floor office building from a head lessor, and in turn sublease a single floor in that building to a sublessee. A question arises whether, in such circumstances, the sublessor should disaggregate the right-of-use asset associated with the head lease into components that either are or are not subject to the sublease for purposes of applying the asset impairment model in ASC 360. In other words, should a sublessor be able to assign portions of a right-of-use asset that are and are not subleased to different asset groups for impairment testing purposes?

We believe that the answer depends on the unit-of-account associated with the head lease. A sublessor must keep in mind that the guidance in ASC 842 is applied to separate lease components, as described in ASC 842-10-15. For example, a contract to lease a 10-floor office building might contain 10 individual lease components, one pertaining to the right to use each floor, if the right to use each floor satisfies the criteria in ASC 842-10-15-28. Although the lessee in this example might not have considered the right-of-use on a disaggregated basis for practical reasons, each one of the 10 separate lease components could potentially be assigned to a different asset group for impairment testing purposes.

For example, assume that a contract to lease a 10-floor office building originally contains a single lease component. But, in order to sublease one of the floors, the sublessor modifies the space so that one floor can be used on its own, which meets the criteria to be a separate lease component. In this case, we believe that the sublessor should disaggregate the right-of-use asset upon modifying the leased space, so that each lease component may be assigned to a different asset group for impairment testing purposes. In these circumstances, both the sublessor and the head lessor should consider whether a lease modification has occurred and, if so, apply the appropriate guidance under ASC 842.

9.3.2 Sublessor discount rate

The original lessee in a sublease transaction (the sublessor) should use the rate implicit in the sublease to determine how to classify the sublease, and to measure the net investment in the sublease if it is classified as a sales-type or a direct financing lease. If the rate implicit in the sublease cannot be readily determined, the sublessor may use the discount rate used for the head lease.



ASC 842-20-35-15

The original lessee (as sublessor) in a sublease shall use the rate implicit in the lease to determine the classification of the sublease and to measure the net investment in the sublease if the sublease is classified as a sales-type or a direct financing lease unless that rate cannot be readily determined. If the rate implicit in the lease cannot be readily determined, the original lessee may use the discount rate for the lease established for the original (or head) lease.

9.3.3 Sublessor derecognition

If the sublessor in a sublease arrangement is relieved of its primary obligation under the original lease, the transaction is considered a termination of the original lease and the creation of a new lease between head lessor and sublessee.

Any consideration that the sublessor pays or receives when the original lease is terminated that was not already included in the lease payments (for example, a termination payment that was not included in the lease payments based on the lease term) should be included when the sublessor determines profit or loss resulting from the lease termination. ASC 842-20-40-1 requires a lessee to account for a lease termination that occurs before the end of the lease term by derecognizing both the right-of-use asset and the lease liability, with the difference between the two recognized as profit or loss.

If the sublessor is secondarily liable to the original lessor under the sublease, its obligation is treated as a guarantee and recognized under ASC 405-20-40-2. The guarantee obligation is initially measured at fair value and either reduces the gain, or increases the loss, associated with terminating the original lease.



ASC 842-20-40-3

If the nature of a sublease is such that the original lessee is relieved of the primary obligation under the original lease, the transaction shall be considered a termination of the original lease. Paragraph 842-20-35-14 addresses subleases in which the original lessee is not relieved of the primary obligation under the original lease. Any consideration paid or received upon termination that was not already included in the lease payments (for example, a termination payment that was not included in the lease payments based on the lease term) shall be included in the determination of profit or loss to be recognized in accordance with paragraph 842-20-40-1. If a sublease is a termination of the original lease and the original lessee is secondarily liable, the guarantee obligation shall be recognized by the lessee in accordance with paragraph 405-20-40-2.

ASC 405-20-40-2

If a creditor releases a debtor from primary obligation on the condition that a third party assumes the obligation and that the original debtor becomes secondarily liable, that release extinguishes the original debtor's liability. However, in those circumstances, whether or not explicit consideration was paid for that guarantee, the original debtor becomes a guarantor. As a guarantor, it shall recognize a guarantee obligation in the same manner as would a guarantor that had never been primarily liable to that creditor, with due regard for the likelihood that the third party will carry out its obligations. The guarantee obligation shall be initially measured at fair value, and that amount reduces the gain or increases the loss recognized on extinguishment. See Topic 460 for accounting guidance related to guarantees.

9.4 Original lessor's accounting for a sublease

A lessor's accounting is not affected when a lessee enters into a sublease agreement or transfers the lease to a third party, unless the original lease agreement is modified or replaced by a new agreement. If the lessor enters into a new or modified agreement with the new lessee, the lessor accounts for the termination of the original lease following the derecognition guidance in ASC 842-30-40, as discussed in Section 6.10.

If the residual value of the underlying asset is acquired by a third party, the lessor accounts for this transaction in accordance with ASC 360-10-25-2.



ASC 842-30-35-7

If the original lessee enters into a sublease or the original lease agreement is sold or transferred by the original lessee to a third party, the original lessor shall continue to account for the lease as it did before.

ASC 842-30-40-3

If the original lease agreement is replaced by a new agreement with a new lessee, the lessor shall account for the termination of the original lease as provided in paragraph 842-30-40-2 and shall classify and account for the new lease as a separate transaction.

ASC 842-30-40-4

For guidance on the acquisition of the residual value of an underlying asset by a third party, see paragraph 360-10-25-2.

9.5 Sublessee

The sublessee's accounting is not affected by the fact that a lease is a sublease. The lessee in a sublease agreement accounts for the lease in accordance with the general lessee guidance ASC 842, as discussed in Section 5.

10. Presentation and disclosure

10.1 Lessee presentation

A lessee must present the assets and liabilities related to its operating and finance leases separately on the statement of financial position or in the notes to the financial statements. In its statement of comprehensive income, a lessee must present the single lease cost related to its operating leases within income from continuing operations, and the amortization and interest expenses related to its finance leases in a manner consistent with how it presents other interest and amortization items. In the statement of cash flows, a lessee must present cash flows associated with operating leases in the operating activities section. For finance leases, cash flows that amortize the lease liability should be classified as financing activities, and cash flows associated with interest are classified as operating activities.

10.1.1 Statement of financial position

Under the guidance in ASC 842, a lessee may choose to present its right-of-use assets and lease liabilities for both operating and finance leases either as separate line items or within other line items in the statement of financial position. If these assets and liabilities are not separately presented from other assets and liabilities in the statement of financial position, the disclosures in the notes to the financial statements must indicate the line items where they have been included in the statement of financial position.

A lessee is prohibited from combining right-of-use assets and lease liabilities for operating and finance leases in the same financial statement line item. The Board did not stipulate in which financial statement line item(s) the right-of-use assets and lease liabilities should be reported when they are not presented separately from other assets and liabilities. However, it would be inappropriate to present operating right-of-use assets together with owned assets in property, plant, and equipment, as the lessee's risk associated with the asset underlying an operating lease is substantially different than the risk associated with owned property, plant, and equipment, as noted in paragraph BC265 of ASU 2016-02.

The classification of right-of-use assets and lease liabilities as current or noncurrent follows the same considerations as other nonfinancial assets and financial liabilities.



ASC 842-20-45-1

A lessee shall either present in the statement of financial position or disclose in the notes all of the following:

- a. Finance lease right-of-use assets and operating lease right-of-use assets separately from each other and from other assets
- b. Finance lease liabilities and operating lease liabilities separately from each other and from other liabilities.

Right-of-use assets and lease liabilities shall be subject to the same considerations as other nonfinancial assets and financial liabilities in classifying them as current and noncurrent in classified statements of financial position.

ASC 842-20-45-2

If a lessee does not present finance lease and operating lease right-of-use assets and lease liabilities separately in the statement of financial position, the lessee shall disclose which line items in the statement of financial position include those right-of-use assets and lease liabilities.

ASC 842-20-45-3

In the statement of financial position, a lessee is prohibited from presenting both of the following:

- a. Finance lease right-of-use assets in the same line item as operating lease right-of-use assets
- b. Finance lease liabilities in the same line item as operating lease liabilities.

10.1.2 Statement of comprehensive income

Under ASC 842, a lessee is required to present activities related to finance leases separately from activities related to operating leases in the statement of comprehensive income.

A lessee recognizes the lease expense associated with an operating lease in income from continuing operations in the statement of comprehensive income. ASC 842 distinguishes between the terms “lease cost” and “lease expense.” Lease cost refers to the periodic recognition of lease payments and initial direct costs, and may be recognized either in the statement of comprehensive income as lease expense, or capitalized in the statement of financial position as, for example, project costs subject to ASC 970-360, *Real Estate – General: Property, Plant, and Equipment*, or inventory subject to ASC 330. On the other hand, lease expense refers to lease cost that is recognized in the statement of comprehensive income.

For finance leases, lessees are not required to present interest expense associated with the lease liability, or amortization expense associated with the right-of-use asset, separately from other similarly characterized activities in the statement of comprehensive income. Rather, a lessee presents interest expense associated with finance leases in a manner consistent with how it presents other interest expense, and amortization expense associated with finance leases in a manner consistent with how it presents other depreciation or amortization expense.

**ASC 842-20-45-4**

In the statement of comprehensive income, a lessee shall present both of the following:

- a. For finance leases, the interest expense on the lease liability and amortization of the right-of-use asset are not required to be presented as separate line items and shall be presented in a manner consistent with how the entity presents other interest expense and depreciation or amortization of similar assets, respectively
- b. For operating leases, lease expense shall be included in the lessee’s income from continuing operations.



Grant Thornton insights: Lessee presentation of variable payments for a finance lease

Under ASC 842, variable lease payments that are not based on an index or a rate are excluded from the definition of lease payments and are not included in the measurement of either the lease liability or the right-of-use asset. A lessee recognizes these variable lease payments in the period in which the changes occur that trigger the variable payments.

ASC 842 does not specify how variable payments associated with a finance lease should be presented in a lessee's statement of comprehensive income. We believe that a lessee has the option to present variable payments associated with a finance lease either as interest expense or as a separate component of income from continuing operations, such as rental expense. A lessee should disclose its policy for presenting these variable lease payments.

10.1.3 Statement of cash flows

The presentation of cash outflows associated with leases in the statement of cash flows is linked to the presentation of expenses associated with leases in the statement of comprehensive income, as the Board noted in paragraph BC269 of ASU 2016-02.

For operating leases, a lessee classifies lease payments in the operating activities section of the statement of cash flows, except for payments that are used to bring an asset to the condition and location necessary for its intended use, which are classified as investing activities.

For finance leases, a lessee classifies the portion of the lease cost that amortizes the lease liability under financing activities in the statement of cash flows. The interest portion is separately presented within the section for cash flows from operating activities, consistent with the presentation guidance for interest payments in ASC 230, *Statement of Cash Flows*.

A lessee's variable lease payments under either a finance or an operating lease that are not included in the definition of "lease payments" because they are not based on an index or rate are classified in the operating activities section of the statement of cash flows when paid.

Payments related to short-term leases for which the lessee elects the short-term lease exemption (see Section 5.1.1) are classified in operating activities in the statement of cash flows.

The Board noted in paragraph BC271 of ASU 2016-02 that operating lease payments that are capitalized as part of the cost of another asset, such as inventory or property, plant, and equipment, must be classified in the statement of cash flows in the same manner as other payments associated with that type of asset. For example, an entity might enter into an operating lease for a truck to transport a new piece of machinery to its factory for installation. If the lease payments for the truck are capitalized as part of the cost basis of the machinery, the payments would be presented in the investing section of the statement of cash flows, consistent with the cash flow associated with purchasing the asset.

**ASC 842-20-45-5**

In the statement of cash flows, a lessee shall classify all of the following:

- a. Repayments of the principal portion of the lease liability arising from finance leases within financing activities
- b. Interest on the lease liability arising from finance leases in accordance with the requirements relating to interest paid in Topic 230 on cash flows
- c. Payments arising from operating leases within operating activities, except to the extent that those payments represent costs to bring another asset to the condition and location necessary for its intended use, which should be classified within investing activities
- d. Variable lease payments and short-term lease payments not included in the lease liability within operating activities.

10.2 Lessor presentation

A lessor must present its net investment in sales-type and direct financing leases separately from other assets, and present the assets underlying operating leases consistent with other property, plant, and equipment, in the statement of financial position.

Because leasing is a revenue-generating activity for lessors, they must present leasing activities in the statement of comprehensive income either as interest income for sales-type or direct financing leases or rental income for operating leases. For variable payments associated with a sales-type or direct financing lease, see the “Grant Thornton insights” discussion in Section 10.2.2. Cash receipts associated with all leases are classified as cash flows from operating activities in the statement of cash flows.

10.2.1 Statement of financial position

A lessor must present its net investment in sales-type and direct financing leases combined as a single item on the statement of financial position, separately from other assets. A lessor must classify its net investment in leases as current or noncurrent on the same basis used to classify other assets when a classified statement of financial position is presented.

While a lessor is not required to separately present the components of its net investment in leases (that is, lease receivables, unguaranteed residual assets, and deferred profit for direct financing leases), it is required to disclose these components in the notes to the financial statements.

**ASC 842-30-45-1**

A lessor shall present lease assets (that is, the aggregate of the lessor’s net investment in sales-type leases and direct financing leases) separately from other assets in the statement of financial position.

ASC 842-30-45-2

Lease assets shall be subject to the same considerations as other assets in classification as current or noncurrent assets in a classified balance sheet.

For an operating lease, a lessor must continue to recognize the underlying asset in the statement of financial position and must continue to present and disclose the asset using other applicable guidance, such as ASC 360. The disclosures required under ASC 360 must be made separately for underlying assets subject to operating leases and for owned assets.

**ASC 842-30-45-6**

A lessor shall present the underlying asset subject to an operating lease in accordance with other Topics.

10.2.2 Statement of comprehensive income

A lessor presents income from leases separately either in the statement of comprehensive income or in the notes to the financial statements. If a lessor chooses not to separately present lease income in the statement of comprehensive income, it must disclose in the notes which line item includes lease income.

**ASC 842-30-45-3**

A lessor shall either present in the statement of comprehensive income or disclose in the notes income arising from leases. If a lessor does not separately present lease income in the statement of comprehensive income, the lessor shall disclose which line items include lease income in the statement of comprehensive income.

Sales-type and direct financing leases

A lessor in a sales-type or direct financing lease presents profit or loss recognized at commencement, either gross or net in the manner that corresponds to the lessor's business model. As the Board discussed in paragraph BC334 of ASU 2016-02, a lessor might use leasing solely as a means to provide financing to lessees or as a mechanism to receive value from assets that it also sells. In recognition of these different business models, ASC 842 permits a lessor to present profit recognized at the lease commencement date either on a gross basis, as the difference between revenue and cost of goods sold, or on a net basis, as leasing profit or loss, to reflect how the lessor generates its income. A lessor that primarily provides financing would present selling profit or loss on a net basis, and a lessor that uses leasing as an alternative to selling the underlying asset to its customers would present selling profit or loss on a gross basis. For further discussion of calculation of selling profit or loss see Section 6.1.1 for a sales-type lease and Section 6.2.1 for a direct financing lease.

**ASC 842-30-45-4**

A lessor shall present any profit or loss on the lease recognized at the commencement date in a manner that best reflects the lessor's business model(s). Examples of presentation include the following:

- a. If a lessor uses leases as an alternative means of realizing value from the goods that it would otherwise sell, the lessor shall present revenue and cost of goods sold relating to its leasing activities in separate line items so that income and expenses from sold and leased items are presented consistently. Revenue recognized is the lesser of:
 1. The fair value of the underlying asset at the commencement date
 2. The sum of the lease receivable and any lease payments prepaid by the lessee.

Cost of goods sold is the carrying amount of the underlying asset at the commencement date minus the unguaranteed residual asset.

- b. If a lessor uses leases for the purposes of providing finance, the lessor shall present the profit or loss in a single line item.

A lessor in a sales-type or direct financing lease must recognize interest income on the net investment in the lease over the lease term, and present that amount separately in the statement of comprehensive income.



Grant Thornton insights: Lessor presentation of variable payments for a sales-type or direct financing lease

Variable lease payments that are not based on an index or a rate are excluded from the definition of lease payments, and are not included in the measurement of the net investment in the lease. A lessor recognizes variable payments related to a lease component as income in the period when the changes occur that trigger the variable payments.

When variable payments are recognized, we believe that the lessor has the option to present them either as interest income, along with the interest income recognized on the net investment in the lease, or as a component of income from continuing operations, such as rental income. A lessor should disclose its policy for presenting variable lease payments.

Operating leases

ASC 842-30 lacks specific guidance about how lessors should present activities related to operating leases in the statement of comprehensive income. However, consistent with the presentation guidance for sales-type and direct financing leases, we believe that lessors should either (1) present income related to operating leases separately in the statement of comprehensive income, or (2) include income related to operating leases in another line item in the statement of comprehensive income and disclose in the notes the amount of operating lease income and where it is located in the statement of comprehensive income.



Grant Thornton insights: Lessor presentation and disclosure of CAM

Unless a lessor elects and qualifies to apply the expedient to combine lease and nonlease components (as discussed in Section 3.1.6), it should account for revenue from providing common area maintenance (CAM) services under a real estate lease as a nonlease component, since these services

do not give the lessee the right to use an underlying asset, as discussed in Section 3.1.2). Income associated with CAM services should be presented or disclosed separately from lease income, even if both the lease component and the CAM services are recognized on a similar basis, such as straight-line, over the lease term.

The expedient to combine lease and nonlease components is applied by class of underlying asset, and does not consider the type of lease arrangement, whether gross or net. Therefore a lessor that enters into gross and net leases involving underlying assets of the same asset class, such as real estate, is not permitted to elect the expedient to combine lease and nonlease components for its gross leases but not for its net leases.

In a gross lease, the lessee makes a single fixed payment to the lessor to cover both the lease and nonlease components in the contract, and in a net lease, the lessee makes a fixed or variable payment for the lease component, and makes variable payments for nonlease components, generally based on the actual costs incurred by the lessor in delivering nonlease services such as CAM. Therefore, a lessor that elects the expedient for its real estate leases would recognize the fixed payments for its gross leases as lease income, and would recognize the fixed and variable payments for all of the lease and nonlease components combined pursuant to the expedient as lease income.

10.2.3 Statement of cash flows

A lessor must classify cash flows from sales-type, direct financing, and operating leases in the operating activities section in the statement of cash flows.

A lessor that is a depository or lending institution within the scope of ASC 942 *Financial Services—Depository and Lending*, must apply the guidance in ASC 942 for presenting cash flows received for principal payments on leases. That guidance requires lessors to include principal payments received from lessees for sales-type or direct financing leases in the investing activities section on the statement of cash flows.



ASC 842-30-45-5

In the statement of cash flows, a lessor shall classify cash receipts from leases within operating activities. However, if the lessor is within the scope of Topic 942 on financial services—depository and lending, it shall follow the guidance in paragraph 942-230-45-4 for the presentation of principal payments received from leases.

ASC 842-30-45-7

In the statement of cash flows, a lessor shall classify cash receipts from [operating] leases within operating activities.

ASC 942-230-45-4

Entities within the scope of this Subtopic shall classify principal payments received under sales-type leases and direct financing leases within investing activities.

10.3 Overall disclosures

The disclosure requirements in ASC 842 are intended to provide information that allows financial statement users to assess the amount, timing, and uncertainty of cash flows arising from a lease. This overall objective applies to disclosures provided by both lessees and lessors. These disclosures include qualitative and quantitative information about

- The leases themselves
- Significant judgments made by the entity in applying ASC 842
- Amounts recognized in the financial statements under ASC 842

The guidance in ASC 842 does not specify the level of detail for these disclosures. As a result, entities should disclose sufficient details to fulfill the disclosure objective. Information should be aggregated or disaggregated in a way so that useful information is not obscured.



Grant Thornton insights: Additional disclosures to meet disclosure objective

Entities may need to disclose information beyond what is specifically required under ASC 842 to meet the overall disclosure objective, which is to enable financial statement users to assess the timing, amount, and uncertainty of cash flows arising from leasing activities. For example, although ASC 842 does not specifically require disclosures about lease modifications or reassessments of lease terms, an entity may need to disclose this information to meet the disclosure objective.

The Board did not include an explicit statement about materiality with respect to applying the disclosure guidance in ASC 842, nor did the Board indicate that certain circumstances might permit an entity to omit certain disclosures. In paragraphs BC275 and BC276 of ASU 2016-02, however, the Board did state that it is implicit in the overall disclosure objective that the level of detail should correspond to the significance of an entity's leasing activity.



ASC 842-20-50-1 [Lessee]

The objective of the disclosure requirements is to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. To achieve that objective, a lessee shall disclose qualitative and quantitative information about all of the following:

- a. Its leases (as described in paragraphs 842-20-50-3(a) through (b) and 842-20-50-7 through 50-8)
- b. The significant judgments made in applying the requirements in this Topic to those leases (as described in paragraph 842-20-50-3(c))
- c. The amounts recognized in the financial statements relating to those leases (as described in paragraphs 842-20-50-4 and 842-20-50-6).

ASC 842-20-50-2

A lessee shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. A lessee shall aggregate or disaggregate disclosures so that useful information is not obscured by including a large amount of insignificant detail or by aggregating items that have different characteristics.

ASC 842-30-50-1 [Lessor]

The objective of the disclosure requirements is to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. To achieve that objective, a lessor shall disclose qualitative and quantitative information about all of the following:

- a. Its leases (as described in paragraphs 842-30-50-3(a), 842-30-50-4, and 842-30-50-7)
- b. The significant judgments made in applying the requirements in this Topic to those leases (as described in paragraph 842-30-50-3(b))
- c. The amounts recognized in the financial statements relating to those leases (as described in paragraphs 842-30-50-5 through 50-6 and 842-30-50-8 through 50-13).

ASC 842-30-50-2

A lessor shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. A lessor shall aggregate or disaggregate disclosures so that useful information is not obscured by including a large amount of insignificant detail or by aggregating items that have different characteristics.



Grant Thornton insights: Disclosures in interim periods

ASC 842 does not specify which disclosure requirements apply to interim versus annual reporting periods. ASU 2016-02 added paragraph 6A to ASC 270-10-50, *Interim Reporting*, requiring lessors to disclose a table of all lease-related income items in their interim financial statements. Except for this explicit guidance for lessors, ASC 270 does not include specific interim disclosure requirements related to leases.

Entities are not required to provide all of the disclosures described in ASC 842 in financial statements prepared as of an interim reporting date.

However, for interim periods within the annual period in which ASC 842 is first applied, public business entities must provide all of the disclosures described in ASC 842. According to Article 10 of SEC Regulation S-X, a reporting entity must disclose information related to significant changes that occur after the most recently completed fiscal year-end, including changes in accounting principles and practices. Therefore, all of the disclosure requirements in ASC 842 should be met for interim reporting purposes within the first annual period in which ASC 842 is applied.

10.3.1 Lessee disclosures

ASC 842 requires lessees to disclose certain qualitative and quantitative information in addition to the overall disclosure requirements discussed in Section 10.3. This information is summarized in Figure 10.1 below.

Figure 10.1: Summary of lessee disclosure requirements

Disclosure area	Summary of requirements
Information about leases (including subleases)	<ul style="list-style-type: none"> • General description of leases • How variable payments are determined • Information about renewal and termination options • Information about residual value guarantees • Covenants and restrictions imposed by leases
Leases not yet commenced	<ul style="list-style-type: none"> • Information about significant leases not yet commenced • Description of any involvement with construction or design of the asset
Significant assumptions and judgments	<ul style="list-style-type: none"> • How the lessee determined that a contract contains a lease • How consideration is allocated among components • How the discount rate is determined
Lease cost	<ul style="list-style-type: none"> • Finance lease cost • Operating lease cost • Short-term lease cost • Variable lease cost • Sublease income • Net gain or loss on sale and leaseback transactions
Maturity analysis	<ul style="list-style-type: none"> • Undiscounted cash flows for each of the first five years and a total amount for subsequent years, presented separately for operating and finance leases • Reconciliation of undiscounted cash flows to operating and finance lease liabilities presented in the statement of financial position
Related parties	<ul style="list-style-type: none"> • Disclosures required under ASC 850, <i>Related Party Disclosures</i>, paragraphs 850-10-50-1 through 50-6
Accounting policy elections	<ul style="list-style-type: none"> • The fact that the short-term lease expedient has been elected, and information about short-term lease commitments if not reasonably reflected by the current period's short-term lease expense

Disclosure area	Summary of requirements
	<ul style="list-style-type: none"> The fact that the expedient to forgo separating lease and nonlease components has been elected, and class(es) of assets it applies to
Other information, separately for operating and finance leases	<ul style="list-style-type: none"> Cash and noncash information about increases and decreases in lease liabilities and right-of-use assets Weighted-average remaining lease term Weighted-average discount rate



At the crossroads: New lessee disclosures

A lessee must disclose information under ASC 842 that is not disclosed under legacy GAAP. For example, ASC 842 requires a lessee to disclose significant assumptions and judgments made in identifying leases, allocating consideration, and determining the lease term and the discount rate, unlike under legacy GAAP. In addition, ASC 842 requires a lessee to disclose new information, such as the weighted-average remaining lease term and the weighted-average discount rate.

The maturity analysis for operating and finance leases required under ASC 842 is similar to the requirement to disclose the future minimum rental payments under legacy GAAP. But, unlike legacy GAAP, ASC 842 requires entities to disclose a reconciliation of the undiscounted cash flows to the operating and finance lease liabilities.

As lessees transition to ASC 842, it is critical that they capture the data needed to make these disclosures as of the date when they apply the new leasing guidance.

Calculating the weighted-average remaining lease term

The weighted-average remaining lease term required to be disclosed under ASC 842-20-50-4(g)(3) is calculated using the remaining lease term and the carrying amount of the lease liability for each lease as of the reporting date. In other words, the remaining lease terms are “weighted” based on the corresponding lease liabilities. A separate weighted-average must be calculated for operating and finance leases.



Example of weighted-average remaining lease term

Lessee has four operating leases at the reporting date, with lease liabilities and remaining lease terms as shown in the table below. The lease liabilities are equal to the present value of the remaining lease payments associated with each lease. Lessee calculates the weighted-average remaining lease term by dividing each individual lease liability by the total lease liability, multiplying the quotient by each lease’s remaining term, and adding the results.

Lessee calculates a weighted-average remaining lease term of 3.72 years for its operating leases. Lessee must separately calculate and disclose the weighted-average lease term for its finance leases.

Operating lease	Lease liability	Remaining lease term	Weighted-average remaining lease term
1	\$238,363	3	1.67
2	29,019	2	0.14
3	89,275	6	1.25
4	<u>70,383</u>	4	<u>0.66</u>
Totals	<u>\$427,040</u>		<u>3.72</u>

Calculating the weighted-average discount rate

The weighted-average discount rate required to be disclosed under ASC 842-20-50-4(g)(4) is calculated using the same discount rate used to calculate the lease liability and the remaining lease payments for each lease as of the reporting date. In other words, the discount rates are “weighted” based on the corresponding remaining lease payments. A lessee must calculate separate weighted-averages for both operating and finance leases.



Example of weighted-average discount rate

Lessee has four operating leases at the reporting date, with undiscounted remaining lease payments and discount rates as shown in the table below. Lessee calculates the weighted-average discount rate by dividing each individual lease’s remaining payments by the total remaining lease payments, multiplying the quotient by each lease’s discount rate, and adding the results.

Lessee calculates a weighted-average discount rate of 6.1 percent for its operating leases and must separately calculate and disclose the weighted-average discount rate for any finance leases.

Operating lease	Lease payments	Discount rate	Weighted-average discount rate
1	\$270,000	6.5%	3.65%
2	30,000	7.0%	0.44%

3	96,000	3.0%	0.60%
4	<u>85,000</u>	8.0%	<u>1.41%</u>
Totals	<u>\$481,000</u>		<u>6.10%</u>

Lessees should disclose the following information under ASC 842.



ASC 842-20-50-3

A lessee shall disclose all of the following:

- a. Information about the nature of its leases, including:
 1. A general description of those leases.
 2. The basis and terms and conditions on which variable lease payments are determined.
 3. The existence and terms and conditions of options to extend or terminate the lease. A lessee should provide narrative disclosure about the options that are recognized as part of its right-of-use assets and lease liabilities and those that are not.
 4. The existence and terms and conditions of residual value guarantees provided by the lessee.
 5. The restrictions or covenants imposed by leases, for example, those relating to dividends or incurring additional financial obligations.

A lessee should identify the information relating to subleases included in the disclosures provided in (1) through (5), as applicable.

- b. Information about leases that have not yet commenced but that create significant rights and obligations for the lessee, including the nature of any involvement with the construction or design of the underlying asset.
- c. Information about significant assumptions and judgments made in applying the requirements of this Topic, which may include the following:
 1. The determination of whether a contract contains a lease (as described in paragraphs 842-10-15-2 through 15-27)
 2. The allocation of the consideration in a contract between lease and nonlease components (as described in paragraphs 842-10-15-28 through 15-32)
 3. The determination of the discount rate for the lease (as described in paragraphs 842-20-30-2 through 30-4).

ASC 842-20-50-4

For each period presented in the financial statements, a lessee shall disclose the following amounts relating to a lessee's total lease cost, which includes both amounts recognized in profit or loss during

the period and any amounts capitalized as part of the cost of another asset in accordance with other Topics, and the cash flows arising from lease transactions:

- a. Finance lease cost, segregated between the amortization of the right-of-use assets and interest on the lease liabilities.
- b. Operating lease cost determined in accordance with paragraphs 842-20-25-6(a) and 842-20-25-7.
- c. Short-term lease cost, excluding expenses relating to leases with a lease term of one month or less, determined in accordance with paragraph 842-20-25-2.
- d. Variable lease cost determined in accordance with paragraphs 842-20-25-5(b) and 842-20-25-6(b).
- e. Sublease income, disclosed on a gross basis, separate from the finance or operating lease expense.
- f. Net gain or loss recognized from sale and leaseback transactions in accordance with paragraph 842-40-25-4.
- g. Amounts segregated between those for finance and operating leases for the following items:
 1. Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows
 2. Supplemental noncash information on lease liabilities arising from obtaining right-of-use assets
 3. Weighted-average remaining lease term
 4. Weighted-average discount rate.

ASC 842-20-50-5

See paragraphs 842-20-55-11 through 55-12 for implementation guidance on preparing the weighted-average remaining lease term and the weighted-average discount rate disclosures. See Example 6 (paragraphs 842-20-55-52 through 55-53) for an illustration of the lessee quantitative disclosure requirements in paragraph 842-20-50-4.

ASC 842-20-50-6

A lessee shall disclose a maturity analysis of its finance lease liabilities and its operating lease liabilities separately, showing the undiscounted cash flows on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessee shall disclose a reconciliation of the undiscounted cash flows to the finance lease liabilities and operating lease liabilities recognized in the statement of financial position.

ASC 842-20-50-7

A lessee shall disclose lease transactions between related parties in accordance with paragraphs 850-10-50-1 through 50-6.

ASC 842-20-50-8

A lessee that accounts for short-term leases in accordance with paragraph 842-20-25-2 shall disclose that fact. If the short-term lease expense for the period does not reasonably reflect the lessee's short-

term lease commitments, a lessee shall disclose that fact and the amount of its short-term lease commitments.

ASC 842-20-50-9

A lessee that elects the practical expedient on not separating lease components from nonlease components in paragraph 842-10-15-37 shall disclose its accounting policy election and which class or classes of underlying assets it has elected to apply the practical expedient.

ASC 842-20-55-11

The lessee should calculate the weighted-average remaining lease term on the basis of the remaining lease term and the lease liability balance for each lease as of the reporting date.

ASC 842-20-55-12

The lessee should calculate the weighted-average discount rate on the basis of both of the following:

- a. The discount rate for the lease that was used to calculate the lease liability balance for each lease as of the reporting date
- b. The remaining balance of the lease payments for each lease as of the reporting date.

Example 6 in ASC 842-20-55 shows an acceptable format that a lessee might use to make the required quantitative disclosures. Note that the disclosures are required for all periods presented.



ASC 842-20-55-53

Example 6—Lessee Quantitative Disclosure Requirements in Paragraph 842-20-50-4

The following Example illustrates how a lessee may meet the quantitative disclosure requirements in paragraph 842-20-50-4.

	Year Ending December 31,	
	20X2	20X1
Lease cost		
Finance lease cost:	\$XXX	\$XXX
Amortization of right-of-use assets	XXX	XXX
Interest on lease liabilities	XXX	XXX
Operating lease cost	XXX	XXX
Short-term lease cost	XXX	XXX
Variable lease cost	XXX	XXX

Sublease income	(XXX)	(XXX)
Total lease cost	<u>XXX</u>	<u>XXX</u>
	<u>XXX</u>	<u>XXX</u>
Other information		
(Gains) and losses on sale and leaseback transactions, net	\$(XXX)	\$XXX
Cash paid for amounts included in the measurement of lease liabilities	XXX	XXX
Operating cash flows from finance leases	XXX	XXX
Operating cash flows from operating leases	XXX	XXX
Financing cash flows from finance leases	XXX	XXX
Right-of-use assets obtained in exchange for new finance lease liabilities	XXX	XXX
Right-of-use assets obtained in exchange for new operating lease liabilities	XXX	XXX
Weighted-average remaining lease term—finance leases	X.X years	X.X years
Weighted-average remaining lease term—operating leases	X.X years	X.X years
Weighted-average discount rate—finance leases	X.X%	X.X%
Weighted-average discount rate—operating leases	X.X%	X.X%

10.3.2 Lessor disclosures

ASC 842 requires lessors to disclose certain qualitative and quantitative information in addition to the overall disclosure requirements discussed in Section 10.3. This information is summarized in Figure 10.2. Lessor disclosure requirements under ASC 842 for leveraged leases are discussed in Section 10.5.

Figure 10.2: Summary of lessor disclosure requirements

Disclosure area	Summary of requirements
Information about leases	<ul style="list-style-type: none"> • General description of leases • How variable payments are determined • Information about renewal and termination options • Information about lessee options to purchase the underlying asset
Significant assumptions and judgments	<ul style="list-style-type: none"> • How the lessor determined that a contract contains a lease • How consideration is allocated between components • How the expected residual value of the underlying asset is determined
Practical expedients	<ul style="list-style-type: none"> • Practical expedient not to separate components <ul style="list-style-type: none"> – Description of accounting policy election and class or classes of assets to which it applies – Nature of combined lease and nonlease components – Nature of nonqualifying nonlease components (that is, components that are not combined) – Topic applied to combined component (ASC 842 or ASC 606) • Disclosure of election to exclude certain taxes from recognition in the statement of comprehensive income
Lease income	<ul style="list-style-type: none"> • For sales-type and direct financing leases: <ul style="list-style-type: none"> – Profit or loss recognized at lease commencement date – Interest income • Lease income related to operating lease payments • Lease income related to variable lease payments that were not included in the lease receivable
Related parties	<ul style="list-style-type: none"> • Disclosures required under ASC 850-10-50-1 through 50-6

Disclosure area	Summary of requirements
Residual asset risk	<ul style="list-style-type: none"> • The strategy for managing risk associated with the residual value of underlying assets • Carrying amount of residual assets covered by residual value guarantees • Any other methods used to reduce residual asset risk
Sales-type and direct financing leases	<ul style="list-style-type: none"> • The components of the net investment in the lease • Explanation of significant change in the balance of unguaranteed residual assets • Explanation of significant change in any deferred selling profit for direct financing leases • Undiscounted cash flows associated with lease receivables for each of the first five years and a total amount for subsequent years • Reconciliation of undiscounted cash flows to lease receivables
Operating leases	<ul style="list-style-type: none"> • Undiscounted cash flows for each of the first five years and a total amount for subsequent years • Disclosures required under ASC 360-10-50 for underlying assets

Residual asset risk

As the Board noted in paragraph BC340 of ASU 2016-02, uncertainty about the residual value of the underlying asset at the end of the lease is a significant risk for a lessor. A greater than expected decline in the market value of the underlying asset over the lease term would negatively impact the return the lessor earns on the lease. Factors that could have an impact on the lessor's realization of residual value at the end of the lease include rapid technological obsolescence, unusual wear and tear, excess use, and manufacturers' warranties.



At the crossroads: Residual asset risk disclosures

Legacy GAAP does not require a lessor to make disclosures about residual asset risk for the assets underlying its leases. As discussed in paragraph BC340 of ASU 2016-02, the Board added such disclosure requirements based on feedback received from financial statement users indicating that additional information would be helpful to aid in understanding a lessor's residual asset risk and how it manages that risk.

It is important for lessors to ensure that their systems capture the necessary information to satisfy these new disclosure requirements as they implement ASC 842.

Assets underlying operating leases

A lessor with operating leases should treat the underlying assets as a separate major class of depreciable assets, and further divide these major asset classes by significant class of underlying asset (buildings and equipment, for example), as discussed in paragraph BC341 of ASU 2016-02. A lessor must disclose the information required under ASC 360 for these assets separately from assets owned by the lessor that are held and used.

Lessors should disclose the following information under ASC 842.



ASC 842-30-50-3

A lessor shall disclose both of the following:

- a. Information about the nature of its leases, including:
 1. A general description of those leases
 2. The basis and terms and conditions on which variable lease payments are determined
 3. The existence and terms and conditions of options to extend or terminate the lease
 4. The existence and terms and conditions of options for a lessee to purchase the underlying asset
- b. Information about significant assumptions and judgments made in applying the requirements of this Topic, which may include the following:
 1. The determination of whether a contract contains a lease (as described in paragraphs 842-10-15-2 through 15-27)
 2. The allocation of the consideration in a contract between lease and nonlease components (as described in paragraphs 842-10-15-28 through 15-32)
 3. The determination of the amount the lessor expects to derive from the underlying asset following the end of the lease term.

ASC 842-30-50-3A

A lessor that elects the practical expedient in paragraph 842-10-15-42A on not separating nonlease components from associated lease components shall disclose the following:

- a. Its accounting policy election and the class or classes of underlying assets for which it has elected to apply the practical expedient
- b. The nature of:
 1. The lease component and nonlease components included within the combined component
 2. The nonlease component(s), if any, that are accounted for separate from the combined component because they do not qualify for the practical expedient.
- c. Which Topic the entity applies to the combined component (this Topic or Topic 606).

ASC 842-30-50-4

A lessor shall disclose any lease transactions between related parties (see Topic 850 on related party disclosures).

ASC 842-30-50-5

A lessor shall disclose lease income recognized in each annual and interim reporting period, in a tabular format, to include the following:

- a. For sales-type leases and direct financing leases:
 1. Profit or loss recognized at the commencement date (disclosed on a gross basis or a net basis consistent with paragraph 842-30-45-4).
 2. Interest income either in aggregate or separated by components of the net investment in the lease.
- b. For operating leases, lease income relating to lease payments.
- c. Lease income relating to variable lease payments not included in the measurement of the lease receivable.

ASC 842-30-50-6

A lessor shall disclose in the notes the components of its aggregate net investment in sales-type and direct financing leases (that is, the carrying amount of its lease receivables, its unguaranteed residual assets, and any deferred selling profit on direct financing leases).

ASC 842-30-50-7

A lessor shall disclose information about how it manages its risk associated with the residual value of its leased assets. In particular, a lessor should disclose all of the following:

- a. Its risk management strategy for residual assets
- b. The carrying amount of residual assets covered by residual value guarantees (excluding guarantees considered to be lease payments for the lessor, as described in paragraph 842-30-30-1(a)(2))
- c. Any other means by which the lessor reduces its residual asset risk (for example, buyback agreements or variable lease payments for use in excess of specified limits).

ASC 842-30-50-8

In addition to the disclosures required by paragraphs 842-30-50-3 through 50-7, a lessor also shall provide the disclosures in paragraphs 842-30-50-9 through 50-10 for sales-type leases and direct financing leases.

ASC 842-30-50-9

A lessor shall explain significant changes in the balance of its unguaranteed residual assets and deferred selling profit on direct financing leases.

ASC 842-30-50-10

A lessor shall disclose a maturity analysis of its lease receivables, showing the undiscounted cash flows to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessor shall disclose a reconciliation of the undiscounted cash flows to the lease receivables recognized in the statement of financial position (or disclosed separately in the notes).

ASC 842-30-50-11

In addition to the disclosures required by paragraphs 842-30-50-3 through 50-7, a lessor also shall provide the disclosures in paragraphs 842-30-50-12 through 50-13 for operating leases.

ASC 842-30-50-12

A lessor shall disclose a maturity analysis of lease payments, showing the undiscounted cash flows to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessor shall present that maturity analysis separately from the maturity analysis required by paragraph 842-30-50-10 for sales-type leases and direct financing leases.

ASC 842-30-50-13

A lessor shall provide disclosures required by Topic 360 on property, plant, and equipment separately for underlying assets under operating leases from owned assets.

ASC 842-30-50-14

A lessor that makes the accounting policy election in paragraph 842-10-15-39A shall disclose its accounting policy election and comply with the disclosure requirements in paragraphs 235-10-50-1 through 50-6.

10.4 Sale and leaseback transactions

Entities that enter into sale-leaseback transactions are required to provide the lessee or lessor disclosures for the leaseback portion of the transaction, as discussed in Section 10.3. Seller-lessees are also required to make additional disclosures about the transaction's main terms and conditions and about the resulting gains or losses.



ASC 842-40-50-1

If a seller-lessee or a buyer-lessor enters into a sale and leaseback transaction that is accounted for in accordance with paragraphs 842-40-25-4 and 842-40-30-1 through 30-3, it shall provide the disclosures required in paragraphs 842-20-50-1 through 50-9 for a seller-lessee or paragraphs 842-30-50-1 through 50-13 for a buyer-lessor.

ASC 842-40-50-2

In addition to the disclosures required by paragraphs 842-20-50-1 through 50-9, a seller-lessee that enters into a sale and leaseback transaction shall disclose both of the following:

- a. The main terms and conditions of that transaction

- b. Any gains or losses arising from the transaction separately from gains or losses on disposal of other assets.

10.5 Leveraged leases

Under ASC 842, lessors will no longer classify new or modified leases as leveraged leases. ASC 842 requires lessors to continue using legacy GAAP to account for leveraged leases that exist on the date when ASC 842 is initially applied. The presentation and disclosure requirements for legacy leveraged leases are unchanged from legacy GAAP. See Section 8 for a further discussion of leveraged leases.



ASC 842-50-45-1

For purposes of presenting the investment in a leveraged lease in the lessor's balance sheet, the amount of related deferred taxes shall be presented separately (from the remainder of the net investment). In the income statement or the notes to that statement, separate presentation (from each other) shall be made of pretax income from the leveraged lease, the tax effect of pretax income, and the amount of investment tax credit recognized as income during the period.

ASC 842-50-45-2

Integration of the results of income tax accounting for leveraged leases with the other results of accounting for income taxes under Topic 740 on income taxes is required if deferred tax credits related to leveraged leases are the only source (see paragraph 740-10-30-18) for recognition of a tax benefit for deductible temporary differences and carryforwards not related to leveraged leases. A valuation allowance is not necessary if deductible temporary differences and carryforwards will offset taxable amounts from future recovery of the net investment in the leveraged lease. However, to the extent that the amount of deferred tax credits for a leveraged lease as determined in accordance with this Subtopic differs from the amount of the deferred tax liability related to the leveraged lease that would otherwise result from applying the guidance in Topic 740, that difference is preserved and is not a source of taxable income for recognition of the tax benefit of deductible temporary differences and operating loss or tax credit carryforwards.

ASC 842-50-45-3

This Subtopic requires that the tax effect of any difference between the assigned value and the tax basis of a leveraged lease at the date of a business combination or an acquisition by a not-for-profit entity shall not be accounted for as a deferred tax credit. Any tax effects included in unearned and deferred income as required by this Subtopic shall not be offset by the deferred tax consequences of other temporary differences or by the tax benefit of operating loss or tax credit carryforwards. However, deferred tax credits that arise after the date of a combination shall be accounted for in the same manner as for leveraged leases that were not acquired in a combination.

ASC 842-50-50-1

If leveraged leasing is a significant part of the lessor's business activities in terms of revenue, net income, or assets, the components of the net investment balance in leveraged leases as set forth in paragraph 842-50-25-1 shall be disclosed in the notes to financial statements.

ASC 842-50-50-2

For guidance on disclosures about financing receivables, which include receivables relating to a lessor's rights to payments from leveraged leases, see the guidance beginning in paragraphs 310-10-50-5A, 310-10-50-27, and 310-10-50-31.

ASC 842-50-50-3

If accounting for the effect on leveraged leases of the change in tax rates results in a significant variation from the customary relationship between income tax expense and pretax accounting income and the reason for that variation is not otherwise apparent, the lessor shall disclose the reason for that variation.

11. Transition

11.1 Effective date

For public business entities (PBEs); not-for-profit entities that are conduit bond obligors for securities that are traded, listed, or quoted on an exchange or over-the-counter market; and employee benefit plans that file or furnish statements with or to the SEC, the guidance in ASC 842 is effective for financial statements issued for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

For all other entities, ASC 842 is effective for financial statements issued for fiscal years beginning after December 15, 2019 and for interim periods within fiscal years beginning after December 15, 2020.

All entities are permitted to early adopt ASC 842.



Grant Thornton insights: Early adoption of ASC 842

All entities are permitted to early adopt ASC 842, but certain entities might especially benefit from early adoption. For instance, early adoption would allow lessors to align their accounting for leases with their accounting for other revenue contracts under ASC 606. In addition, early adoption would allow lessees with assets on their statements of financial position from certain failed build-to-suit arrangements (projects where construction is completed prior to the effective date) to derecognize those assets upon transition to ASC 842. See the Section 11.8 for more information.



ASC 842-10-65-1 (excerpt)

The following represents the transition and effective date information related to Accounting Standards Updates No. 2016-02, Leases (Topic 842), No. 2018-01, Leases (Topic 842): *Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, and No. 2018-11, *Leases (Topic 842): Targeted Improvements* [Note: See paragraph 842-10-S65-1 for an SEC Staff Announcement on transition related to Update 2016-02.]

- a. A public business entity, a not-for-profit entity that has issued or is a conduit bond obligor for securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files or furnishes financial statements with or to the U.S. Securities and Exchange Commission shall apply the pending content that links to this paragraph for financial statements issued for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Earlier application is permitted.
- b. All other entities shall apply the pending content that links to this paragraph for financial statements issued for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Earlier application is permitted.

ASC Master Glossary

Public Business Entity: A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

- a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
- b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
- c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
- d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
- e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

11.1.1 SEC staff announcement on the definition of 'public business entity'

The SEC staff issued an announcement allowing an entity that meets the definition of a PBE solely because it is required to include its financial statements or financial information in another entity's SEC filing to use the non-PBE effective date (fiscal years beginning after December 15, 2019) to adopt ASC 842. These entities may still elect to adopt ASC 842 at an earlier date.

The SEC staff announcement does not apply to entities that are PBEs as described in ASC 842 for any other reason.



ASC 842-10-S65-1

The following is the text of SEC Staff Announcement: *Transition Related to Accounting Standards Updates No. 2014-09 and 2016-02.*

FASB Accounting Standards Updates No. 2014-09, Revenue from Contracts with Customers (Topic 606), issued in May 2014 and codified in ASC Topic 606, Revenue from Contracts with Customers, and No. 2016-02, Leases (Topic 842), issued in February 2016 and codified in ASC Topic 842, Leases, provide effective dates that differ for (1) public business entities and certain other specified entities and (2) all other entities. The SEC staff has received inquiries from stakeholders regarding the application

of the effective dates of ASC Topic 606 and ASC Topic 842 for a public business entity¹ that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filing with the SEC.

The transition provisions in ASC Topic 606 require that a public business entity and certain other specified entities adopt ASC Topic 606 for annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period.² All other entities are required to adopt ASC Topic 606 for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019.

The transition provisions in ASC Topic 842 require that a public business entity and certain other specified entities adopt ASC Topic 842 for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years.³ All other entities are required to adopt ASC Topic 842 for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.

In response to the stakeholder inquiries outlined above, the SEC staff would not object to a public business entity that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filing with the SEC adopting (1) ASC Topic 606 for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019, and (2) ASC Topic 842 for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.

A public business entity that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filing with the SEC may still elect to adopt ASC Topic 606 and ASC Topic 842 according to the public business entity effective dates outlined above.

This announcement is applicable only to public business entities that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filing with the SEC. This announcement is not applicable to other public business entities.

¹ The definition of Public Business Entity in the FASB's ASC Master Glossary states, in part, the following:

A public business entity is a business entity meeting any one of the criteria below . . .

- a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing) . . .

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

² Early adoption of ASC Topic 606 is permitted for public business entities and certain other specified entities only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

³ Early adoption of ASC Topic 842 is permitted for public business entities and certain other specified entities, as well as for all other entities.

Private company parent with a PBE subsidiary

Some stakeholders have asked how a private company parent should account for a PBE subsidiary in its consolidated financial statements during the period between the PBE effective date and the private company effective date for ASC 842. For example, assume that a private company parent plans to adopt ASC 842 on January 1, 2020, and its PBE subsidiary plans to adopt ASC 842 on January 1, 2019. Would the earlier adoption by the PBE subsidiary require the private company parent to accelerate its adoption to January 1, 2019 in the consolidated financial statements?

In paragraph BC34 of ASU 2013-12, *Definition of a Public Business Entity*, the FASB explained that a private company that controls and consolidates a U.S. public company should not be considered a PBE. Therefore, a private company parent would not be required to follow the PBE effective dates simply because it consolidates a PBE subsidiary.



Grant Thornton insights: Effective date for a private company parent with a PBE subsidiary

During deliberations leading to the issuance of ASU 2013-12, the Board did not address whether a private company parent would need to “unwind” the effects of a standard adopted by a PBE subsidiary before the parent’s adoption date. We believe that in the previous example, it would be acceptable for the parent to include the PBE subsidiary’s financial statement amounts in the private company’s consolidated financial statements either by using the subsidiary’s figures reported in accordance with ASC 842 or by “unwinding” the subsidiary’s ASC 842 adoption and including its financial statement amounts measured in accordance with legacy GAAP.

11.1.2 Early adoption

Entities are permitted to early adopt the guidance in ASC 842. If an entity has or is planning to early adopt ASC 842, it should be aware of the transition guidance for amendments to ASC 842 that were codified after the issuance of ASU 2016-02.

In addition to the transition guidance in ASC 842-10-65-1, which is explained throughout this section, the Board provided specific transition guidance in ASC 842-10-65-2 through 65-4 related to the guidance codified by ASU 2018-11, *Leases (Topic 842): Targeted Improvements*; ASU 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*; and ASU 2019-01, *Leases (Topic 842): Codification Improvements*, respectively.



ASC 842-10-65-2

The following represents the transition and effective date information related to Accounting Standards Update No. 2018-11, *Leases (Topic 842): Targeted Improvements*:

- a. An entity that has not yet adopted the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to paragraph 842-10-65-2, by class of underlying asset, to all new and existing leases when the entity first applies the pending content that links to paragraph 842-10-65-1 and shall apply the same transition method elected for the pending content that links to paragraph 842-10-65-1.
- b. An entity that has adopted the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to this paragraph, by class of underlying asset, to all new and existing leases either:
 1. In the first reporting period following the issuance of the pending content that links to paragraph 842-10-65-2
 2. At the original effective date of this Topic for that entity as determined in paragraph 842-10-65-1(a) and (b).
- c. An entity that has adopted the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to this paragraph, by class of underlying asset, to all new and existing leases either:
 1. Retrospectively to all prior periods beginning with the fiscal years in which the pending content that links to paragraph 842-10-65-1 was initially applied
 2. Prospectively.

ASC 842-10-65-3

The following represents the transition and effective date information related to Accounting Standards Update No. 2018-20, Leases (Topic 842): Narrow-Scope Improvements for Lessors:

- a. An entity that has not yet adopted the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to this paragraph to all new and existing leases when the entity first applies the pending content that links to paragraph 842-10-65-1 and shall apply the same transition method elected for the pending content that links to paragraph 842-10-65-1.
- b. An entity that has adopted the pending content that links to paragraph 842-10-65-1 before the issuance of the pending content that links to this paragraph shall adopt the pending content that links to this paragraph to all new and existing leases at the original effective date of this Topic for that entity as determined in paragraph 842-10-65-1(a) through (b). Alternatively, an entity that has adopted the pending content that links to paragraph 842-10-65-1 may adopt the pending content that links to this paragraph to all new and existing leases either:
 1. In the first reporting period ending after the issuance of the pending content that links to this paragraph
 2. In the first reporting period beginning after the issuance of the pending content that links to this paragraph.
- c. An entity that has adopted the pending content that links to paragraph 842-10-65-1 before the issuance of the pending content that links to this paragraph shall apply the pending content that links to this paragraph to all new and existing leases either:
 1. Retrospectively to all prior periods beginning with the fiscal years in which the pending content that links to paragraph 842-10-65-1 was initially applied

2. Prospectively.

ASC 842-10-65-4

The following represents the transition and effective date information related to Accounting Standards Update No. 2019-01, Leases (Topic 842): Codification Improvements:

- a. All entities within the scope of paragraph 842-10-65-1(a) shall apply the pending content that links to this paragraph for financial statements issued for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. All other entities shall apply the pending content that links to this paragraph for financial statements issued for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early application is permitted.
- b. An entity shall apply the pending content that links to this paragraph as of the date that it first applied the pending content that links to paragraph 842-10-65-1 and shall apply the same transition method elected for the pending content that links to paragraph 842-10-65-1 in accordance with paragraph 842-10-65-1(c).

11.2 Transition methods

There are two methods by which an entity may transition to ASC 842. Under the first method, which we will refer to as the “modified retrospective method,” an entity applies the transition guidance in ASC 842 as of the beginning of the earliest period presented in the financial statements in which it adopts ASC 842. Under this method, a cumulative-effect adjustment is recorded to retained earnings as of the beginning of the earliest period presented.

Under the second method, which we will refer to as the “current-period adjustment method,” an entity applies ASC 842 as of the beginning of the period in which it adopts ASC 842. Under this method, a cumulative-effect adjustment is recorded to retained earnings as of the beginning of the period in which ASC 842 is adopted.



ASC 842-10-65-1 (excerpt)

- c. In the financial statements in which an entity first applies the pending content that links to this paragraph, the entity shall recognize and measure leases within the scope of the pending content that links to this paragraph that exist at the application date, as determined by the transition method that the entity elects. An entity shall apply the pending content that links to this paragraph using one of the following two methods:
 1. Retrospectively to each prior reporting period presented in the financial statements with the cumulative effect of initially applying the pending content that links to this paragraph recognized at the beginning of the earliest comparative period presented, subject to the guidance in (d) through (gg). Under this transition method, the application date shall be the later of the beginning of the earliest period presented in the financial statements and the commencement date of the lease.
 2. Retrospectively at the beginning of the period of adoption through a cumulative-effect adjustment, subject to the guidance in (d) through (gg). Under this transition method, the

application date shall be the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph.

- d. An entity shall adjust equity and, if the entity elects the transition method in (c)(1), the other comparative amounts disclosed for each prior period presented in the financial statements, as if the pending content that links to this paragraph had always been applied, subject to the requirements in (e) through (gg).

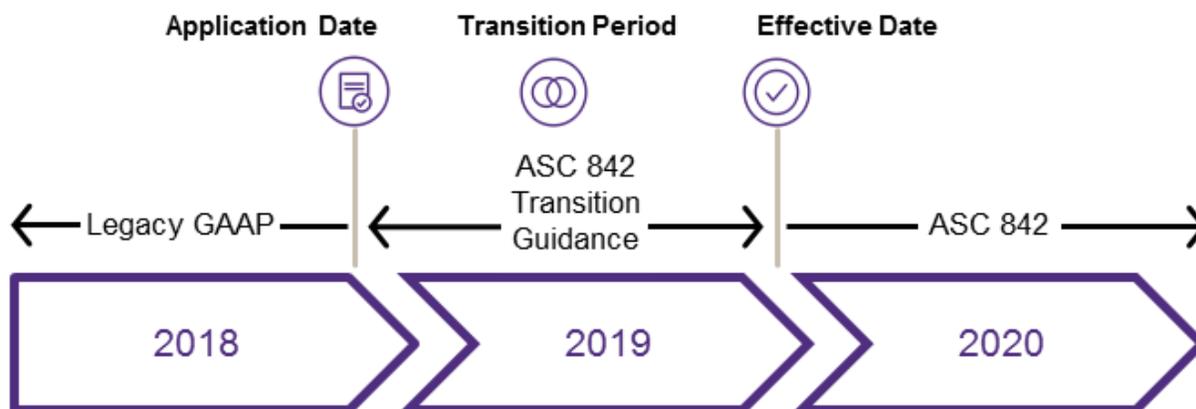
11.2.1 Modified retrospective method

The application date for an entity applying the modified retrospective method is the later of (a) the beginning of the earliest period presented in the comparative financial statements that include the period in which ASC 842 is first effective, and (b) the commencement date of the lease. Under the modified retrospective method, an entity applies the transition measurement requirements discussed in Sections 11.6 and 11.7 to all leases existing at, or commencing after, the beginning of the earliest period presented in the financial statements, and records any necessary adjustment to equity at the beginning of the earliest period presented. The transition period is the time between the beginning of the earliest period presented and the effective date of ASC 842, which will be a two-year period for PBEs and a one-year period for most other entities. Leases commencing during the transition period (that is, after the application date and before the effective date of ASC 842) are remeasured under the transition guidance discussed in Sections 11.6 and 11.7.

The timeline below illustrates the application date, transition period, and effective date under the modified retrospective method for a calendar-year PBE that has not early adopted ASC 842.



This timeline illustrates the application date, transition period, and effective date under the modified retrospective method for a typical calendar-year non-PBE that has not early adopted ASC 842.



Effective date falls between lease inception and commencement dates

Under ASC 842, leases are classified and measured at the lease's commencement date, whereas under legacy GAAP, leases are classified and measured at the lease's inception date. Refer to Section 1.1 for information about the inception and commencement dates of a lease.

In transition, an entity might have a lease with an inception date before, and a commencement date after, the effective date of ASC 842. Some stakeholders have questioned whether an entity should account for such leases similarly to leases that commenced before the effective date, or similarly to leases with an inception and commencement date occurring after the effective date.



Effective date falls between lease inception and commencement dates

Scenario 1

Lessee is a PBE for which ASC 842 is effective January 1, 2019, and Lessee uses the modified retrospective method to transition to the new guidance. Lessee enters into a lease on June 1, 2018 that commences on January 5, 2019. There are no modifications or other events between the inception date and the commencement date that would cause the lease to be remeasured.

Although the inception date of the lease precedes the effective date of ASC 842, the transition guidance applies only to leases that commence before the effective date, regardless of whether an inception date has occurred. Because the lease in this example had not yet commenced as of the effective date of ASC 842, it will be classified, measured, and recorded on its commencement date under ASC 842.

Scenario 2

Lessee has a lease with an initial 10-year term that commenced on January 1, 2016 and is classified as a capital lease under legacy GAAP. On July 1, 2018, Lessee negotiates with the lessor to extend the lease term by three years, so that the lease will terminate on December 31, 2028. In accordance with the guidance in ASC 840, Lessee continues to account for its original capital lease and will separately account for the extension as an operating lease when it commences in 2026.

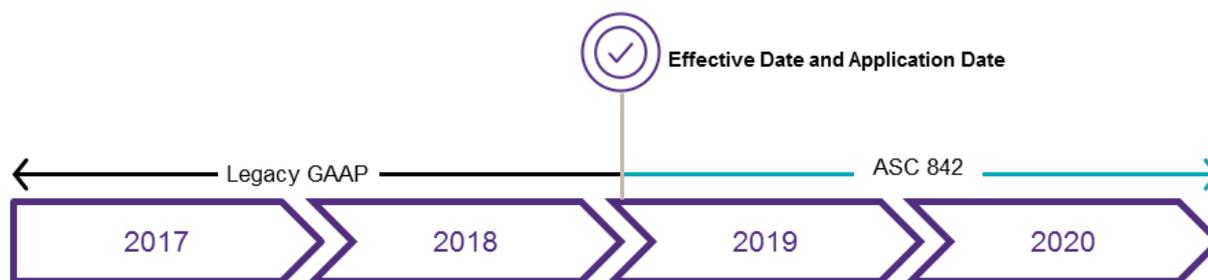
On the effective date, Lessee elects the package of practical expedients offered under ASC 842 that allows it to forgo reassessing the classification for leases that have already commenced. As a result,

Lessee classifies the lease terminating on December 31, 2025 as a finance lease. Lessee effectively “runs off” this lease based on the legacy capital lease guidance. However, Lessee cannot make this election for the new forward-starting three-year lease, which commences on January 1, 2026 and terminates on December 31, 2028, because the lease had not commenced as of the effective date of ASC 842. Therefore, Lessee will apply the guidance in ASC 842 to the forward-starting lease when it commences in 2026.

11.2.2 Current period adjustment method

The application date for an entity applying the current-period adjustment method is the same as the effective date of ASC 842. Therefore, there is no transition period between the application date and the effective date under the current-period adjustment method, unlike the modified retrospective method. Any adjustment necessary under the transition requirements described in Sections 11.6 and 11.7 is recorded at the application date. Prior comparative periods are presented under legacy GAAP, including disclosures in the notes to the financial statements.

The timeline below illustrates the application date and effective date under the current-period adjustment method for a calendar-year PBE that has not early adopted ASC 842.



The timeline below illustrates the application date and effective date under the current-period adjustment method for a typical calendar-year non-PBE that has not early adopted ASC 842.



11.2.3 Transition for short-term leases

A lessee may make an accounting policy election to forgo applying the guidance in ASC 842 to short-term leases. A short-term lease has a term of 12 or fewer months at commencement and does not have a purchase option that the lessee is reasonably certain to exercise, as discussed in Section 5.1.1. If a lessee makes this accounting policy election, no transition adjustment is required for short-term leases because short-term leases under ASC 842 are accounted for in the same manner as under legacy GAAP.



ASC 842-10-65-1 (excerpt)

- e. If a lessee elects not to apply the recognition and measurement requirements in the pending content that links to this paragraph to short-term leases, the lessee shall not apply the approach described in (k) through (t) to short-term leases.

11.3 Practical expedients

The Board made the following practical expedients available to all entities to aid their transition from legacy GAAP to ASC 842

- A package of expedients that must be elected together allowing an entity to forgo reassessing (1) whether a contract contains a lease, (2) classification of leases, and (3) whether capitalized costs associated with a lease meet the definition of “initial direct costs” in ASC 842
- An expedient allowing an entity to use hindsight to determine the lease term and impairment of right-of-use assets
- An expedient allowing an entity to continue applying legacy GAAP to land easements not previously accounted for under the legacy leasing guidance in ASC 840

An entity may elect these expedients or not, in any combination it chooses.

11.3.1 Package of practical expedients

A lessee or lessor may elect a package of transition expedients that allows an entity to forgo reassessing certain conclusions reached under legacy GAAP. All expedients in this package must be applied together for all leases that commence before the effective date of ASC 842. In transitioning to ASC 842, an entity electing this package of practical expedients would not need to assess

- Whether any expired or existing contracts are leases or contain leases under ASC 842
- Classification of any expired or existing leases under ASC 842
- Whether unamortized initial direct costs for existing leases meet the definition of initial direct costs under ASC 842

This package of expedients effectively allows an entity to “run off” existing leases, meaning an entity can continue to account for existing leases based on judgments made under legacy GAAP. As the Board notes in paragraph BC393(a) of ASU 2016-02, the expedients are not intended to grandfather incorrect assessments made under legacy GAAP. Therefore, if an entity identifies an error made under legacy GAAP, it should be corrected in accordance with ASC 250, *Accounting Changes and Error Corrections*.



ASC 842-10-65-1 (excerpt)

- f. An entity may elect the following practical expedients, which must be elected as a package and applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a lessor), when applying the pending content that links to this paragraph to leases that commenced before the effective date:

1. An entity need not reassess whether any expired or existing contracts are or contain leases.
2. An entity need not reassess the lease classification for any expired or existing leases (for example, all existing leases that were classified as operating leases in accordance with Topic 840 will be classified as operating leases, and all existing leases that were classified as capital leases in accordance with Topic 840 will be classified as finance leases).
3. An entity need not reassess initial direct costs for any existing leases.

Reassessing lease classification

If an entity does not elect the package of practical expedients that would allow it to forgo reassessing lease classification, a question arises about which date should be used to reassess lease classification when transitioning to ASC 842.



Grant Thornton insights: Reassessing lease classification

We believe an entity that does not elect the package of practical expedients should reassess lease classification under ASC 842 as of either the most recent date that it was required to reassess lease classification under legacy GAAP or the lease commencement date if the entity was never required to reassess classification under legacy guidance.



Example: Reassessing lease classification

Lessee, a PBE, signed a lease on November 15, 2015, which commenced on January 1, 2016. Lessee modified the lease on November 30, 2016. ASC 842 is effective for Lessee on January 1, 2019, and Lessee applies the modified retrospective method for transition. As Lessee presents two prior comparative periods in its financial statements, its application date for ASC 842 is January 1, 2017.

Lessee does not elect the package of practical expedients, and therefore must reassess the classification of its lease when transitioning to ASC 842. Since Lessee was required under legacy GAAP to reassess lease classification as of November 30, 2016, the most recent modification date, Lessee must assess the lease's classification under ASC 842 as of November 30, 2016.

11.3.2 Hindsight practical expedient

ASC 842 offers a practical expedient that allows an entity to use hindsight in determining the lease term and assessing impairment of right-of-use assets when transitioning to ASC 842. An entity electing this expedient may use its actual knowledge or current expectation as of the effective date, instead of its knowledge and expectations as of the latest date when it assessed lease classification under legacy GAAP, in assessing the likelihood that a lessee will exercise its option to extend or terminate a lease or to purchase the underlying asset. An entity electing this expedient may also use its most up-to-date information as of the effective date to evaluate impairment of its right-of-use assets in the transition period.



ASC 842-10-65-1 (excerpt)

- g. An entity also may elect a practical expedient, which must be applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a lessor) to use hindsight in determining the lease term (that is, when considering lessee options to extend or terminate the lease and to purchase the underlying asset) and in assessing impairment of the entity's right-of-use assets. This practical expedient may be elected separately or in conjunction with either one or both of the practical expedients in (f) and (gg).



Grant Thornton insights: Use caution when considering the hindsight practical expedient

When an entity applies the hindsight practical expedient to assess the term of a lease, it must undertake a “fresh” assessment of the facts and circumstances as of the effective date of ASC 842. The entity not only uses hindsight to incorporate actual decisions to extend or terminate a lease that were made during the transition period into the measurement of the lease term on the application date of ASC 842, but it must also reassess the lease term of each lease based on the guidance for establishing the lease term of a new lease under ASC 842.

Therefore, for all leases, an entity that elects the hindsight practical expedient must consider contract-based, asset-based, market-based, and entity-based factors as of the effective date to assess the lease term as of the application date. We believe this could be a significant undertaking for entities with large lease portfolios, which could be avoided by choosing not to elect the hindsight practical expedient.

For entities that choose to elect the hindsight practical expedient, there are a couple of limitations to keep in mind.

First, hindsight is applied only up to the effective date of ASC 842. For example, a change in circumstances that occurs after the effective date, such as a change in market rental rates that causes an entity to determine that a renewal option is reasonably certain to be exercised, would not be reflected in the entity's assessment of the lease term, despite the election of the hindsight practical expedient.

Second, an entity would not apply the hindsight practical expedient to retrospectively reflect the terms of a contract modification in its initial accounting for a lease under the ASC 842 transition provisions. Only options that were part of the contract as of the application date of ASC 842 should be assessed under this expedient.

Hindsight practical expedient and impairment of the right-of-use asset

In response to technical inquiries, the Board has stated that entities should not reallocate impairment losses among assets in an asset group in transition periods. Therefore, it is unclear how the use of hindsight would allow an entity to recognize impairment of a right-of-use asset during the transition period.

For example, if an entity using the modified retrospective method to apply ASC 842 as of January 1, 2017 determined that an asset group was impaired as of June 30, 2017, the entity could not, based on the Board's comments, use hindsight to recognize the effect of the June 30, 2017 impairment on the right-of-use asset that becomes part of the impaired asset group upon the initial application of ASC 842, since that would require a reallocation of the impairment loss among the assets in that asset group.



Grant Thornton insights: Hindsight practical expedient and impairment of the right-of-use asset

While the hindsight practical expedient allows entities to use hindsight in determining both the lease term and right-of-use asset impairment, we believe the expedient effectively applies only to evaluations of the lease term.

Accordingly, with respect to the above example, we believe that any impairment of the right-of-use asset during the transition period would be recognized at the effective date.

11.3.3 Land easement practical expedient

ASC 842 provides a transition-related practical expedient under which entities with existing or expired land easements not previously accounted for under legacy leasing GAAP may forgo assessing whether those contracts contain leases under ASC 842. This practical expedient allows entities that did not account for land easements as leases under legacy GAAP to carry forward that treatment for existing or expired land easements as of the effective date of ASC 842.

A land easement is a contract that provides a right to use, access, or cross another entity's land for a specified purpose, and is often used for railroad tracks or pipelines crossing over land not owned by the railroad or pipeline company. For further discussion of accounting for land easements under ASC 842, see Section 2.4.1. There was diversity in practice under legacy GAAP, whereby some entities accounted for land easements as leases, and others accounted for them as intangible assets based on an interpretation of Example 10 in ASC 350-30-55, *Intangibles – Goodwill and Other*, which described perpetual easements as intangible assets.

Any land easements entered into or modified after the effective date of ASC 842 must be assessed under ASC 842 to determine whether they contain a lease.



ASC 842-10-65-1 (excerpt)

- h. An entity also may elect a practical expedient to not assess whether existing or expired land easements that were not previously accounted for as leases under Topic 840 are or contain a lease under this Topic. For purposes of (gg), a land easement (also commonly referred to as a right of way) refers to a right to use, access, or cross another entity's land for a specified purpose. This practical expedient shall be applied consistently by an entity to all its existing and expired land easements that were not previously accounted for as leases under Topic 840. This practical expedient may be elected separately or in conjunction with either one or both of the practical expedients in (f) and (g). An entity that elects this practical expedient for existing or expired land easements shall apply the pending content that links to this paragraph to land easements entered into (or modified) on or after the date that the entity first applies the pending content that links to

this paragraph as described in (a) and (b). An entity that previously accounted for existing or expired land easements as leases under Topic 840 shall not be eligible for this practical expedient for those land easements.

11.3.4 Combining lease and nonlease components in transition

Under ASC 842, lessees and lessors must separately account for lease components and nonlease components within a contract. However, the guidance includes practical expedients that lessees and lessors may elect, allowing them to combine lease and associated nonlease components. The lessee expedient is discussed in Section 3.1.5 and the lessor expedient is discussed in Section 3.1.6. ASC 842's transition guidance does not specifically address whether entities can apply these practical expedients to combine lease and nonlease components during the transition period.



Grant Thornton insights: Combining lease and nonlease components in transition

Lessees may make an accounting policy election to combine lease components and associated nonlease components by class of underlying asset.

We believe that a lessee may apply the practical expedient to combine lease and nonlease components during the transition period, even though the transition guidance does not specifically address the issue. However, we believe that a lessee may only apply the expedient during the transition period if it will continue to apply the expedient after the effective date of ASC 842.

11.4 Amounts previously recognized in business combinations

An entity may have recognized an asset or liability for a favorable or unfavorable lease under ASC 805. When transitioning to ASC 842, all entities, except for lessors with respect to operating leases, should derecognize assets and liabilities for favorable or unfavorable leases acquired in a business combination.

When derecognizing a favorable or unfavorable lease asset or liability in transition, a lessee should reflect the offsetting debit or credit as an adjustment to the right-of-use asset associated with that lease. A lessor in a sales-type lease or a direct financing lease should reflect the offsetting debit or credit as an adjustment to equity at the beginning of the earliest comparative period presented or the effective date, depending on whether the lessor applies the modified retrospective or current-period adjustment transition method, respectively.

A lessor that previously recognized an asset or liability for a favorable or unfavorable operating lease in a business combination under ASC 840 should continue to recognize that asset or liability after adopting ASC 842.



ASC 842-10-65-1 (excerpt)

- h. If an entity has previously recognized an asset or a liability in accordance with Topic 805 on business combinations relating to favorable or unfavorable terms of an operating lease acquired as part of a business combination, the entity shall do all of the following:

1. Derecognize that asset and liability (except for those arising from leases that are classified as operating leases in accordance with Topic 842 for which the entity is a lessor).
2. Adjust the carrying amount of the right-of-use asset by a corresponding amount if the entity is a lessee.
3. Make a corresponding adjustment to equity if assets or liabilities arise from leases that are classified as sales-type leases or direct financing leases in accordance with Topic 842 for which the entity is a lessor. Also see (w).

11.5 Disclosures

In the financial statements in which it first applies ASC 842, an entity must provide the disclosures required for a change in accounting principle in accordance with ASC 250, with one exception: An entity is not required to disclose, in either its annual or interim financial statements, the effect of the change on each financial statement line item and per-share amount presented for the current period or for prior periods that are retrospectively adjusted. For example, an entity adopting ASC 842 on January 1, 2019 would not be required to disclose what the results in 2019 would have been under legacy GAAP, or the incremental impact of applying ASC 842 to the prior comparative periods, if the entity is using the modified retrospective method. An entity using the current-period adjustment method for transition should disclose the cumulative effect of the change in retained earnings as of the beginning of the period of adoption instead of the beginning of the earliest period presented as required by ASC 250-10-50-1(b)(3).

If an entity issues interim financial statements, it must provide the required ASC 250 disclosures in the financial statements of both the interim and annual periods of the change.



ASC 842-10-65-1 (excerpt)

- i. An entity shall provide the transition disclosures required by Topic 250 on accounting changes and error corrections, except for the requirements in paragraph 250-10-50-1(b)(2) and paragraph 250-10-50-3. An entity that elects the transition method in (c)(2) shall provide the transition disclosures in paragraph 250-10-50-1(b)(3) as of the beginning of the period of adoption rather than at the beginning of the earliest period presented.

Note: See paragraph 250-10-S99-6 on disclosure of the impact that recently issued accounting standards will have on the financial statements of a registrant.

ASC 250-10-50-1

An entity shall disclose all of the following in the fiscal period in which a change in accounting principle is made:

- a. The nature of and reason for the change in accounting principle, including an explanation of why the newly adopted accounting principle is preferable.
- b. The method of applying the change, including all of the following:
 1. A description of the prior-period information that has been retrospectively adjusted, if any.
 2. The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for the current

period and any prior periods retrospectively adjusted. Presentation of the effect on financial statement subtotals and totals other than income from continuing operations and net income (or other appropriate captions of changes in the applicable net assets or performance indicator) is not required.

3. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.
 4. If retrospective application to all prior periods is impracticable, disclosure of the reasons therefore, and a description of the alternative method used to report the change (see paragraphs 250-10-45-5 through 45-7).
- c. If indirect effects of a change in accounting principle are recognized both of the following shall be disclosed:
1. A description of the indirect effects of a change in accounting principle, including the amounts that have been recognized in the current period, and the related per-share amounts, if applicable
 2. Unless impracticable, the amount of the total recognized indirect effects of the accounting change and the related per-share amounts, if applicable, that are attributable to each prior period presented. Compliance with this disclosure requirement is practicable unless an entity cannot comply with it after making every reasonable effort to do so.

Financial statements of subsequent periods need not repeat the disclosures required by this paragraph. If a change in accounting principle has no material effect in the period of change but is reasonably certain to have a material effect in later periods, the disclosures required by (a) shall be provided whenever the financial statements of the period of change are presented.

ASC 250-10-50-2

An entity that issues interim financial statements shall provide the required disclosures in the financial statements of both the interim period of the change and the annual period of the change.

ASC 250-10-50-3

In the fiscal year in which a new accounting principle is adopted, financial information reported for interim periods after the date of adoption shall disclose the effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), and related per-share amounts, if applicable, for those post-change interim periods.

11.5.1 Prior-period disclosures under the current-period adjustment transition method

An entity electing the current-period adjustment method should apply the full guidance in ASC 842 beginning on the application date (that is, January 1, 2019 for a calendar-year PBE). Comparative periods presented in the financial statements for the period of adoption should be prepared and presented under legacy GAAP, including all required disclosures. This includes the future minimum rental payments for operating leases required under ASC 840-20-50-2.



ASC 842-10-65-1 (excerpt)

- jj. An entity electing the transition method in (c)(2) shall provide the required Topic 840 disclosures for all periods that continue to be in accordance with Topic 840.

11.5.2 Disclosure of election of practical expedients

An entity that uses any of the practical expedients is required to disclose its election of those expedients in the notes to the financial statements.



ASC 842-10-65-1 (excerpt)

- j. If an entity uses one or more of the practical expedients in (f), (g), and (gg), it shall disclose that fact.

11.5.3 SEC reporting and transition

SEC Staff Accounting Bulletin (SAB) Topic 11.M, *Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period*, explains that a registrant should evaluate ASUs that have not yet been adopted and disclose information to assist the financial statement user in assessing the impact that the guidance will have on the registrant's financial statements once adopted.

At the September 2016 EITF meeting, the SEC observer reminded registrants that when a registrant does not know, or cannot reasonably estimate, the impact of adopting a new standard, it should

- Make a statement indicating this fact
- Consider additional qualitative disclosures to help users assess the impact of the new guidance on the financial statements when adopted, including a description of
 - The effect of the accounting policies that the registrant expects to apply, if determined, and a comparison to the registrant's current accounting policies
 - The status of its process to implement the new standards
 - The significant implementation matters yet to be addressed

SAB Topic 11.M also provides SEC staff views on disclosures that registrants should consider including in both Management's Discussion & Analysis (MD&A) and the notes to the financial statements. These discussions in MD&A may include cross-references to the disclosures in the notes to the financial statements.

At the 2017 AICPA National Conference on Current and PCAOB Developments, SEC Chief Accountant Wesley R. Bricker reminded financial statement preparers of the importance of robust disclosures about the effect of recently issued accounting standards required by SAB Topic 11.M. He emphasized the need for companies to inform the marketplace about the anticipated effect of new accounting standards so that investors have sufficient time to absorb the information prior to the standard's adoption.

**ASC 250-10-S99-6**

The following is the text of SEC Staff Announcement: *Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of a Registrant When Such Standards Are Adopted in a Future Period (in accordance with Staff Accounting Bulletin [SAB] Topic 11.M).*

This announcement applies to Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers* (Topic 606); ASU No. 2016-02, *Leases* (Topic 842); and ASU No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*.¹

SAB Topic 11.M provides the SEC staff view that a registrant should evaluate ASUs that have not yet been adopted to determine the appropriate financial statement disclosures² about the potential material effects of those ASUs on the financial statements when adopted. Consistent with Topic 11.M, if a registrant does not know or cannot reasonably estimate the impact that adoption of the ASUs referenced in this announcement is expected to have on the financial statements, then in addition to making a statement to that effect, that registrant should consider additional qualitative financial statement disclosures to assist the reader in assessing the significance of the impact that the standard will have on the financial statements of the registrant when adopted. In this regard, the SEC staff expects the additional qualitative disclosures to include a description of the effect of the accounting policies that the registrant expects to apply, if determined, and a comparison to the registrant's current accounting policies. Also, a registrant should describe the status of its process to implement the new standards and the significant implementation matters yet to be addressed.

¹ This announcement also applies to any subsequent amendments to guidance in the ASUs that are issued prior to a registrant's adoption of the aforementioned ASUs.

² Topic 11.M provides SEC staff views on disclosures that registrants should consider in both Management's Discussion & Analysis (MD&A) and the notes to the financial statements. MD&A may contain cross references to these disclosures that appear within the notes to the financial statements.

11.6 Lessee transition

The transition guidance for lessees adopting ASC 842 is based on the classification of each lease under legacy GAAP and, if the lessee does not elect the package of practical expedients, the classification of each lease under ASC 842. Figure 11.1 below summarizes the transition accounting for lessees. See Section 4 for a discussion of lease classification under ASC 842.

Figure 11.1: Summary of lessee transition accounting

Classification	ASC 842 operating lease	ASC 842 finance lease
Legacy operating lease	<p>Recognize a lease liability at the present value of</p> <ul style="list-style-type: none"> • Remaining minimum rental payments • Amount probable of being owed under residual value guarantee <p>Recognize a right-of-use asset equal to the lease liability adjusted for</p> <ul style="list-style-type: none"> • Prepaid or accrued lease payments • Remaining balance of lease incentives • Unamortized initial direct costs • ASC 420 liability • Asset or liability for a favorable or unfavorable lease recognized under ASC 805 	<p>Recognize a lease liability at the present value of</p> <ul style="list-style-type: none"> • Remaining minimum rental payments • Amount probable of being owed under residual value guarantee <p>Recognize a right-of-use asset at the proportionate amount, based on lease term, of the liability at commencement, adjusted for</p> <ul style="list-style-type: none"> • Prepaid or accrued lease payments • ASC 420 liability • Asset or liability for a favorable or unfavorable lease recognized under ASC 805
Legacy capital lease	<p>Derecognize capital lease asset and liability</p> <p>Recognize right-of-use asset and lease liability based on ASC 842 initial or subsequent measurement guidance, depending on whether the lease commenced before or after the application date</p>	<p>Bring forward the previous capital lease asset and capital lease liability carrying amounts as the right-of-use asset and lease liability, respectively</p>

11.6.1 Leases classified as operating leases under legacy GAAP

Under legacy GAAP, lessees do not recognize right-of-use assets and lease liabilities for operating leases, but will be required to do so during the transition period to ASC 842 (if using the modified retrospective transition method) and thereafter. When transitioning its operating lease accounting to ASC 842, a lessee recognizes a lease liability measured at the present value of the remaining minimum rental payments, as described under legacy GAAP, plus any amount probable of being owed under a residual value guarantee, as of the later of the application date or the commencement date of the lease. The right-of-use asset is measured based on this liability, and is calculated differently depending on the classification of the lease under ASC 842.

Lease liability measurement

On the application date of ASC 842, the lease liability is measured at the present value of (1) the remaining minimum rental payments, as described under legacy GAAP, and (2) any amount probable of being owed by the lessee under a residual value guarantee. The discount rate used in the present value calculation should be established as of the same date that the lease liability is measured—that is, the later of the application date or the commencement date of the lease. As a reminder, for an entity using the modified retrospective transition method, the application date is the beginning of the earliest period presented, and for an entity using the current-period adjustment method, the application date and the effective date are the same.

On or after the effective date of ASC 842, if a lease is modified and the modification is not accounted for as a separate contract, or if the lease must otherwise be remeasured, the modification or remeasurement should be accounted for under ASC 842.



ASC 842-10-65-1 (excerpt)

- k. A lessee shall initially recognize a right-of-use asset and a lease liability at the application date as determined in (c).
- l. Unless, on or after the effective date, the lease is modified (and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8) or the lease liability is required to be remeasured in accordance with paragraph 842-20-35-4, a lessee shall measure the lease liability at the present value of the sum of the following, using a discount rate for the lease (which, for entities that are not public business entities, can be a risk-free rate determined in accordance with paragraph 842-20-30-3) established at the application date as determined in (c):
 - 1. The remaining minimum rental payments (as defined under Topic 840).
 - 2. Any amounts probable of being owed by the lessee under a residual value guarantee.

Variable payments based on an index or a rate

Under ASC 842, variable payments based on an index or a rate are included in lease payments based on the index or rate in effect at the commencement date of the lease. At the application date of ASC 842, if a legacy operating lease continues to be classified as an operating lease under ASC 842, the lessee should use the index or rate in effect at the commencement of the lease to measure its lease liability. This index or rate would be the same as the index or rate that was used under legacy GAAP to calculate the minimum rental payments for disclosure purposes.

Determining the incremental borrowing rate in transition

When measuring the lease liability in transition, a lessee should use its incremental borrowing rate to discount the lease payments, unless it can readily determine the rate implicit in the lease. The incremental borrowing rate used should be a collateralized rate for a term similar to the lease term. The transition guidance does not provide guidance on whether a lessee should determine its incremental borrowing rate based either on the initial term of the lease at lease commencement or on the remaining lease term as of the date ASC 842 is initially applied.



Grant Thornton insights: Determining the incremental borrowing rate in transition

Based on a discussion with the FASB staff, we believe a lessee could determine its incremental borrowing rate based either on the initial term of the lease at lease commencement or on the remaining lease term as of the date ASC 842 is initially applied when transitioning to ASC 842. For example, assume that Lessee enters into a 10-year lease that commences on January 1, 2016. Lessee applies the current-period transition approach, and its ASC 842 application date is January 1, 2019. Lessee could estimate its incremental borrowing rate for purposes of measuring this lease liability by referencing the rate at which it could borrow an amount equal to the sum of the remaining lease payments for either 7 years, the remaining lease term at the application date, or 10 years, the lease term at commencement, on the application date. Whatever policy Lessee elects should be consistently applied to all of its leases in transition.

Right-of-use asset measurement for leases classified as operating leases under ASC 842

To measure the right-of-use asset for a lease classified as an operating lease under legacy GAAP that is still classified as an operating lease under ASC 842, the lessee adjusts the amount assigned to the lease liability for the following items

- The items in paragraph 842-20-35-3(b), which consist of the following
 - Prepaid or accrued lease payments
 - The remaining balance of any lease incentives received, calculated as the gross lease incentives received net of amounts recognized previously as part of the single lease cost under legacy GAAP
 - Unamortized initial direct costs
 - Impairment of the right-of-use asset
- The carrying amount of any liability recognized under legacy GAAP in accordance with ASC 420 for exit or disposal costs associated with the lease

If the initial measurement of the right-of-use asset is adjusted for the carrying amount of a liability recognized under ASC 420, the lessee should apply the recognition and subsequent measurement guidance for a right-of-use asset that is impaired, as described in ASC 842-20-25-7 and ASC 842-20-35-10. That guidance requires a lessee to subsequently measure an impaired operating lease as if it were a finance lease as discussed in Section 5.3. In other words, the right-of-use asset is amortized, generally on a straight-line basis, over the lease term; the liability is decreased for payments and increased for interest; and lease cost is recognized equal to the sum of interest and amortization expense.



ASC 842-10-65-1 (excerpt)

- m. For each lease classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3, a lessee shall initially measure the right-of-use asset at the initial measurement of the lease liability adjusted for both of the following:
 1. The items in paragraph 842-20-35-3(b), as applicable.

2. The carrying amount of any liability recognized in accordance with Topic 420 on exit or disposal cost obligations for the lease.
- n. For each lease classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3, a lessee shall subsequently measure the right-of-use asset throughout the remaining lease term in accordance with paragraph 842-20-35-3(b). If the initial measurement of the right-of-use asset in (m) is adjusted for the carrying amount of a liability recognized in accordance with Topic 420 on exit or disposal cost obligations for the lease, the lessee shall apply the recognition and subsequent measurement guidance in Sections 842-20-25 and 842-20-35, respectively, when the right-of-use asset has been impaired.

11.6.2 Operating lease impairment model

The impairment model in ASC 360 applies to right-of-use assets under ASC 842. In response to inquiries about the impairment of right-of-use assets during the transition period, the Board clarified that a lessee should not reallocate an impairment loss recognized during the transition period among an asset group that contains a right-of-use asset under an operating lease.



Grant Thornton insights: Operating lease impairment model

We believe that the impairment model in ASC 360 effectively applies to operating lease right-of-use assets only after the effective date of ASC 842. However, we believe that these right-of-use assets should be assessed for impairment during the transition period based on ASC 420, similar to how operating leases are assessed for impairment based on the occurrence of a cease-use date under legacy GAAP.

11.6.3 Lessee transition example

The following example illustrates the application of the transition guidance for a legacy operating lease that is classified as an operating lease under ASC 842.



Example: Lessee transition – operating lease to operating lease

Lessee enters into a five-year lease of equipment that commences on January 1, 2016. The lease payments start at \$100,000 in year one, payable annually in arrears, and increase by \$50,000 each year of the lease. Lessee records initial direct costs of \$25,000 in connection with entering into the lease. The lease is classified as an operating lease at lease inception under legacy GAAP.

Lessee, a PBE, adopts ASC 842 on January 1, 2019 and presents two comparative periods in its financial statements for the year ended December 31, 2019. Therefore, the beginning of the earliest period presented is January 1, 2017. Lessee adopts ASC 842 using the modified retrospective method. Since the later of the commencement date of the lease and the application date of ASC 842 is January 1, 2017, this date will be used as the measurement date for the right-of-use asset and lease liability. Lessee also elects to apply the package of practical expedients, which allows the entity to forgo

reassessing both classification of the lease and whether previously deferred initial direct costs continue to qualify for deferral. The discount rate associated with the lease on January 1, 2017 is 5 percent.

Lessee measures the lease liability at the present value of the remaining minimum rental payments at January 1, 2017 (as calculated under legacy GAAP), which is \$787,033.¹ Lessee then calculates the right-of-use asset starting with the value of the lease liability, subtracting accrued rent as of January 1, 2017 (\$100,000) and adding the unamortized initial direct costs as of January 1, 2017 (\$20,000), to arrive at a right-of-use asset carrying amount of \$707,033. Lessee records the following journal entry as of January 1, 2017 to recognize the right-of-use asset and lease liability, and to derecognize the accrued rent and deferred initial direct costs that were recorded under legacy GAAP:

Dr. Right-of-use asset	\$707,033
Dr. Accrued rent	\$100,000
Cr. Lease liability	\$787,033
Cr. Deferred initial direct costs	\$ 20,000

If Lessee had chosen the current-period adjustment method for transition, the right-of-use asset and lease liability would be measured as of January 1, 2019. The discount rate associated with the lease on January 1, 2019 is 5 percent. As of that date, Lessee measures the lease liability at the present value of the remaining minimum rental payments, as calculated under legacy GAAP, which is \$510,204.² Lessee then calculates the right-of-use asset starting with the value of the lease liability, subtracting accrued rent as of January 1, 2019 (\$150,000) and adding the unamortized initial direct costs as of January 1, 2019 (\$10,000), to arrive at a right-of-use asset carrying amount of \$370,204. Lessee records the following journal entry as of January 1, 2019 to recognize the right-of-use asset and lease liability, and to derecognize the accrued rent and deferred initial direct costs that were recorded under legacy GAAP:

Dr. Right-of-use asset	\$370,204
Dr. Accrued rent	\$150,000
Cr. Lease liability	\$510,204
Cr. Deferred initial direct costs	\$ 10,000

¹ Calculated as the present value of the remaining minimum rental payments at January 1, 2017 using a discount rate of 5 percent:

Year	Payment	Present value at 5%
2	\$150,000	\$142,857
3	200,000	181,406
4	250,000	215,959

5	300,000	<u>246,811</u>
Total		<u>\$787,033</u>

² Calculated as the present value of the remaining minimum rental payments at January 1, 2019 using a discount rate of 5 percent:

Year	Payments	Present value at 5%
4	\$250,000	\$238,095
5	300,000	<u>272,109</u>
Total		<u>\$510,204</u>

The following example from the Codification illustrates the application of the transition guidance for a legacy operating lease that is classified as an operating lease under ASC 842.



Example 29—Lessee Transition—Existing Operating Lease

ASC 842-10-55-249

The effective date of the guidance in this Topic for Lessee is January 1, 20X4. Lessee enters into a five-year lease of an asset on January 1, 20X1, with annual lease payments payable at the end of each year. Lessee accounts for the lease as an operating lease. At lease commencement, Lessee defers initial direct costs of \$500, which will be amortized over the lease term. On January 1, 20X2 (and before transition adjustments), Lessee has an accrued rent liability of \$1,200 for the lease, reflecting rent that was previously recognized as an expense but was not yet paid as of that date. Four lease payments (1 payment of \$31,000 followed by 3 payments of \$33,000) and unamortized initial direct costs of \$400 remain.

ASC 842-10-55-250

January 1, 20X2 is the beginning of the earliest comparative period presented in the financial statements in which Lessee first applies the guidance in this Topic. On January 1, 20X2, Lessee's incremental borrowing rate is 6 percent. Lessee has elected the package of practical expedients in paragraph 842-10-65-1(f). As such, Lessee accounts for the lease as an operating lease, without reassessing whether the contract contains a lease or whether classification of the lease would be different in accordance with this Topic. Lessee also does not reassess whether the unamortized initial

direct costs on January 1, 20X2, would have met the definition of initial direct costs in this Topic at lease commencement.

ASC 842-10-55-251

On January 1, 20X2, Lessee measures the lease liability at \$112,462, which is the present value of 1 payment of \$31,000 and 3 payments of \$33,000 discounted using the rate of 6 percent. The right-of-use asset is equal to the lease liability before adjustment for accrued rent and unamortized initial direct costs, which were not reassessed because Lessee elected the practical expedients in paragraph 842-10-65-1(f).

ASC 842-10-55-252

On January 1, 20X2, Lessee recognizes a lease liability of \$112,462 and a right-of-use asset of \$111,662 ($\$112,462 - \$1,200 + \400).

ASC 842-10-55-253

From the transition date (January 1, 20X2) on, Lessee will continue to measure and recognize the lease liability at the present value of the sum of the remaining minimum rental payments (as that term was applied under Topic 840) and the right-of-use asset in accordance with this Topic.

ASC 842-10-55-254

Beginning on the effective date of January 1, 20X4, Lessee applies the subsequent measurement guidance in Section 842-20-35, including the reassessment requirements.

11.6.4 Foreign-currency-denominated leases in transition

Lessees transitioning to ASC 842 under the modified retrospective method with leases denominated in foreign currencies must consider the appropriate exchange rate to use in remeasuring the right-of-use asset and lease liability into the lessee's functional currency in the comparative periods presented, as well as the appropriate rates to use in translating lease expense incurred during the comparative periods.

ASC 842-20-55-10 explains that prospectively, for a foreign-currency-denominated lease, the right-of-use asset is remeasured into the lessee's functional currency based on the exchange rate in place at the commencement date of the lease, and the lease liability is remeasured using the current exchange rate at each reporting date.



Grant Thornton insights: Foreign-currency-denominated leases in transition

The guidance in ASC 842 does not specifically address the translation of lease cost, but we believe that for both operating and finance leases, a lessee must translate (1) the interest component of lease cost using the average exchange rate during the period, and (2) the amortization component of lease cost using the historical exchange rate used to translate the right-of-use asset. This methodology is necessary even for operating leases for which a single lease cost is presented, so that the right-of-use asset is amortized to zero by the end of the lease term.

There are no specific transition requirements in ASC 842 related to foreign-currency-denominated leases. Therefore, we believe a lessee should follow the general transition guidance in ASC 842-10-65-1(d). This guidance requires that after the application date, entities should reflect leasing activities in the financial statements as if they had always been accounted for under ASC 842. Therefore, the statement(s) of comprehensive income during the transition period should reflect the impact of the changes in foreign exchange rates on the measurement of the entity's right-of-use assets and lease liabilities.

A lessee recognizing a foreign-currency-denominated lease should translate the right-of-use asset using the exchange rate on either the initial application date of ASC 842 or the commencement date of the lease, whichever is later. This treatment is consistent with ASC 830-20-30-1, which states that

At the date a foreign currency transaction is recognized, each asset, liability, revenue, expense, gain, or loss arising from the transaction shall be measured initially in the functional currency of the recording entity by use of the exchange rate in effect at that date.

Since the date when the right-of-use asset is first recognized is the later of the application date of ASC 842 or the commencement date of the lease, the rate in place at that date should be used to initially and subsequently measure a right-of-use asset in the lessee's functional currency during the transition period.

As a monetary liability, the lease liability must be remeasured at the current exchange rate each period. Therefore, the current exchange rate at the later of the application date of ASC 842 or the commencement date of the lease should be used to initially measure a lease liability in the lessee's functional currency, and that rate should be updated to the then-current exchange rate at each subsequent measurement date.



Example: Foreign-currency-denominated leases in transition

Lessee, a U.S. based PBE, enters into an operating lease for office space in London that commences on January 1, 2016. The lease is denominated in British pounds (GBP), while the functional currency of Lessee is U.S. dollars (USD). The lease has a six-year term, which includes two years under a renewal option that Lessee deems it is reasonably certain to exercise. The lease requires annual payments of £25,000 at the beginning of each year.

ASC 842 is effective for Lessee on January 1, 2019, and Lessee uses the modified retrospective transition method, so that the application date is January 1, 2017, the beginning of the earliest period presented in Lessee's 2019 financial statements.

At the application date of ASC 842, Lessee measures the lease liability at the present value of the five remaining £25,000 payments using a discount rate of 5 percent, and calculates a lease liability of £113,649, which equals the right-of-use asset.

Lessee applies the guidance in ASC 830 to measure this transaction in its functional currency. Following the guidance in ASC 830-20-30-1, Lessee uses the exchange rate in effect on the date when the transaction is recognized, which is the application date of January 1, 2017. At that date, 1 GBP was equal to 1.23 USD. Therefore, Lessee initially measures the lease liability and the right-of-use asset at \$139,788.

At each reporting date thereafter, the right-of-use asset will continue to be remeasured using an exchange rate of 1 GBP to 1.23 USD, while the lease liability will be remeasured using the current exchange rate at the reporting date.

Right-of-use asset measurement for leases classified as finance leases under ASC 842

To measure the right-of-use asset for a lease classified as an operating lease under legacy GAAP that is classified as a finance lease under ASC 842, a lessee must calculate the “applicable proportion” of the lease liability at the commencement date. The “applicable proportion” is measured as the remaining lease term at the application date, divided by the total lease term. The lessee recognizes a right-of-use asset equal to the product of the applicable proportion and the commencement-date lease liability. The right-of-use asset is also adjusted by the carrying amount of any prepaid or accrued lease payments as well as the carrying amount of any liability recognized under ASC 420.

The commencement-date lease liability can be imputed based on the liability measured as of the application date of ASC 842. To impute the commencement-date lease liability, the lessee should divide the total remaining minimum rental payments at the application date by the lease term as of the commencement date. That quotient is the imputed periodic minimum rental payment, which can be present valued as if it were incurred on a straight-line basis over the commencement-date lease term, using the discount rate determined as of the ASC 842 application date. See “Example: Lessee transition – operating lease to finance lease” below for an illustration of imputing the commencement-date lease liability.



ASC 842-10-65-1 (excerpt)

- o. For each lease classified as a finance lease in accordance with paragraph 842-10-25-2, a lessee shall measure the right-of-use asset as the applicable proportion of the lease liability at the commencement date, which can be imputed from the lease liability determined in accordance with (l). The applicable proportion is the remaining lease term at the application date as determined in (c) relative to the total lease term. A lessee shall adjust the right-of-use asset recognized by the carrying amount of any prepaid or accrued lease payments and the carrying amount of any liability recognized in accordance with Topic 420 for the lease.

The following example illustrates the application of the transition guidance for a legacy operating lease that is classified as a finance lease under ASC 842.



Example: Lessee transition – operating lease to finance lease

Lessee enters into a five-year lease of equipment, which commences on January 1, 2018. The lease payments start at \$50,000 a year, payable in arrears, and escalate by \$10,000 each year of the lease. Lessee has provided a guarantee to the lessor that the residual value of the underlying asset will be \$15,000 at the end of the lease term. As of the application date of ASC 842, Lessee determines it is probable that it will owe \$5,000 under the residual value guarantee at the end of the lease term. The lease is classified as an operating lease at lease inception under legacy GAAP.

Lessee, a PBE, adopts ASC 842 on January 1, 2019 using the current-period adjustment method and presents two comparative periods in its financial statements for the year ended December 31, 2019. Since the later of the commencement date of the lease and the application date of ASC 842 is January 1, 2019, this date will be the measurement date for the right-of-use asset and the lease liability. Lessee does not elect the package of practical expedients that would allow it to forgo reassessing classification of the lease, and therefore must reassess lease classification as of the lease's commencement date. Lessee determines that the lease would be classified as a finance lease under ASC 842. The discount rate associated with the lease on January 1, 2019 is 6 percent.

Lessee measures the lease liability at the present value of the remaining minimum rental payments at January 1, 2019 (as calculated under legacy GAAP) and the amount it is probable to owe under its residual value guarantee, which total \$261,323.¹

Lessee measures the right-of-use asset based on the applicable proportion of the lease liability as measured at the commencement of the lease (rather than at the application date of ASC 842). As the remaining lease term at the application date is four years and the total lease term is five years, the applicable proportion is 80 percent (4 years ÷ 5 years).

Lessee measures the commencement-date lease liability based on imputed lease payments over the full term of the lease. The lease payments are imputed by dividing the total remaining minimum rental payments by the remaining lease term as of the application date, which is January 1, 2019. The imputed annual lease payments are \$75,000 per year.² These payments, along with the amount Lessee is probable to owe under the residual value guarantee, are discounted to the lease commencement date using the January 1, 2019 discount rate of 6 percent, generating a commencement-date lease liability of \$319,664.²

Therefore, the right-of-use asset at the application date is \$255,731 (\$319,664 x 80 percent).

The difference between the right-of-use asset and the lease liability is recorded as a transition adjustment to retained earnings at the application date.

Lessee records the following journal entry to recognize the right-of-use asset and lease liability:

Dr. Right-of-use asset	\$255,731
Dr. Retained earnings	\$ 5,592
Cr. Lease liability	\$261,323

¹ Calculated as the sum of the present value of the remaining minimum rental payments at January 1, 2019 and the present value of the amount probable of being owed under the residual value guarantee using a discount rate of 6 percent:

Year	Payment	Residual value guarantee	Total	Present value at 6%
2	\$ 60,000	\$ –	\$ 60,000	\$ 56,604
3	70,000	–	70,000	62,300

4	80,000	–	80,000	67,170
5	90,000	5,000	95,000	<u>75,249</u>
Total				<u>\$261,323</u>

² Calculated as the sum of the present value of the imputed minimum rental payments ($[\$60,000 + \$70,000 + \$80,000 + \$90,000] \div 4$) at January 1, 2018 and the present value of the amount probable of being owed under the residual value guarantee using a discount rate of 6 percent:

Year	Payment	Residual value guarantee	Total	Present value at 6%
1	\$ 75,000	\$ –	\$ 75,000	\$ 70,755
2	75,000	–	75,000	66,750
3	75,000	–	75,000	62,971
4	75,000	–	75,000	59,407
5	75,000	5,000	80,000	<u>59,781</u>
Total				<u>\$319,664</u>

Initial direct costs

If a lessee has elected the package of practical expedients under ASC 842, allowing it to forgo the reassessment of unamortized initial direct costs, or if the lessee has not elected the package of practical expedients but has determined that its deferred costs continue to meet the definition of initial direct costs under ASC 842, those costs remain capitalized and will continue to be amortized in line with the requirements in ASC 842. If a lessee does not elect the package of practical expedients and determines that some of its deferred costs do not meet the definition of initial direct costs under ASC 842, those costs must be written off. If the lease commenced before the application date of ASC 842, the costs are written off as an adjustment to equity as of the application date. If the costs relate to a lease that commenced during the transition period, they are written off as an adjustment to earnings in the period in which they were incurred.

**ASC 842-10-65-1 (excerpt)**

- p. If a lessee does not elect the practical expedients described in (f), any unamortized initial direct costs that do not meet the definition of initial direct costs in this Topic shall be written off as an adjustment to equity unless the entity elects the transition method in (c)(1) and the costs were incurred after the beginning of the earliest period presented, in which case those costs shall be written off as an adjustment to earnings in the period the costs were incurred.

11.6.5 Leases classified as capital leases under legacy GAAP

When transitioning capital leases to ASC 842, a lessee should derecognize its legacy capital lease assets and capital lease liabilities, and should recognize right-of-use assets and lease liabilities measured based on each lease's classification under ASC 842.

Leases classified as finance leases under ASC 842

A lessee with a lease classified as a capital lease under legacy GAAP that is classified as a finance lease under ASC 842 should account for the lease in transition as follows

- The lessee recognizes a right-of-use asset and a lease liability at the carrying amount of the capital lease asset and the capital lease liability, respectively, under legacy GAAP at the application date.
- The lessee includes any unamortized initial direct costs that meet the definition of initial direct costs under ASC 842 in the measurement of the right-of-use asset. If the lessee has elected the package of practical expedients, then the lessee includes all unamortized initial direct costs in the measurement of the right-of-use asset.
- If the lessee has not elected the package of practical expedients, any unamortized initial direct costs that do not meet the definition of initial direct costs under ASC 842 are written off. Refer to the "Initial direct costs" section above for a discussion of accounting for initial direct costs in transition.
- Under the modified retrospective transition method, the lessee applies the subsequent measurement guidance for capital leases under ASC 840-30-35 to remeasure the right-of-use asset and the lease liability before the effective date of ASC 842.
- After the effective date of ASC 842, the lessee applies the subsequent measurement guidance in ASC 842-20-35 to remeasure the right-of-use asset and lease liability. When applying the remeasurement guidance for a lease liability in ASC 842-20-35-4, a lessee does not apply the requirement to remeasure the lease payments due to changes in amounts probable of being owed under residual value guarantees.
- For presentation and disclosure purposes, the assets and liabilities associated with capital leases under legacy GAAP should be classified as right-of-use assets and lease liabilities arising from a finance lease.



ASC 842-10-65-1 (excerpt)

- r. For each lease classified as a finance lease in accordance with this Topic, a lessee shall do all of the following:
1. Recognize a right-of-use asset and a lease liability at the carrying amount of the lease asset and the capital lease obligation in accordance with Topic 840 at the application date as determined in (c).
 2. Include any unamortized initial direct costs that meet the definition of initial direct costs in this Topic in the measurement of the right-of-use asset established in (r)(1).
 3. If a lessee does not elect the practical expedients described in (f), write off any unamortized initial direct costs that do not meet the definition of initial direct costs in this Topic and that are not included in the measurement of the capital lease asset under Topic 840 as an adjustment to equity unless the entity elects the transition method in (c)(1) and the costs were incurred after the beginning of the earliest period presented, in which case those costs shall be written off as an adjustment to earnings in the period the costs were incurred.
 4. If an entity elects the transition method in (c)(1), subsequently measure the right-of-use asset and the lease liability in accordance with Section 840-30-35 before the effective date.
 5. Regardless of the transition method selected in (c), apply the subsequent measurement guidance in paragraphs 842-20-35-4 through 35-5 and 842-20-35-8 after the effective date. However, when applying the pending content in paragraph 842-20-35-4, a lessee shall not remeasure the lease payments for amounts probable of being owed under residual value guarantees in accordance with paragraph 842-10-35-4(c)(3).
 6. Classify the assets and liabilities held under capital leases as right-of-use assets and lease liabilities arising from finance leases for the purposes of presentation and disclosure.

The following example from the Codification illustrates the application of the transition guidance for a legacy capital lease classified as a finance lease under ASC 842.



Example 28—Lessee Transition—Existing Capital Lease

ASC 842-10-55-244

The effective date of the guidance in this Topic for Lessee is January 1, 20X4. Lessee enters into a 7-year lease of an asset on January 1, 20X1, with annual lease payments of \$25,000 payable at the end of each year. The lease includes a residual value guarantee by Lessee of \$8,190. Lessee's incremental borrowing rate on the date of commencement was 6 percent. Lessee accounts for the lease as a capital lease. At lease commencement, Lessee defers initial direct costs of \$2,800, which will be amortized over the lease term. On January 1, 20X2 (and before transition adjustments), Lessee has a lease liability of \$128,707, a lease asset of \$124,434, and unamortized initial direct costs of \$2,400.

ASC 842-10-55-245

January 1, 20X2 is the beginning of the earliest comparative period presented in the financial statements in which Lessee first applies the guidance in this Topic. Lessee has elected the package of practical expedients in paragraph 842-10-65-1(f). As such, Lessee accounts for the lease as a finance lease, without reassessing whether the contract contains a lease or whether classification of the lease would be different in accordance with this Topic. Lessee also does not reassess whether the unamortized initial direct costs on January 1, 20X2, would have met the definition of initial direct costs in this Topic at lease commencement.

ASC 842-10-55-246

On January 1, 20X2, Lessee recognizes a lease liability at the carrying amount of the capital lease obligation on December 31, 20X1, of \$128,707 and a right-of-use asset at the carrying amount of the capital lease asset of \$126,834 (which includes unamortized initial direct costs of \$2,400 that were included in the capital lease asset). Lessee subsequently measures the lease liability and the right-of-use asset in accordance with Subtopic 840-30 until the effective date.

ASC 842-10-55-247

Beginning on the effective date, Lessee applies the subsequent measurement guidance in Section 842-20-35, including the reassessment requirements, except for the requirement to reassess amounts probable of being owed under residual value guarantees. Such amounts will only be reassessed if there is a remeasurement of the lease liability for another reason, including as a result of a lease modification (that is, not accounted for as a separate contract).

Leases classified as operating leases under ASC 842

A lessee with a lease classified as a capital lease under legacy GAAP that is classified as an operating lease under ASC 842 should account for the lease in transition as follows:

- The lessee derecognizes the capital lease asset and the capital lease liability at the application date, and records any difference between the asset and liability in the same manner as prepaid or accrued rent.
- If the lease commenced before the application date, the lessee recognizes a right-of-use asset and a lease liability at the application date in accordance with the subsequent measurement guidance for operating leases in ASC 842-20-35-3. This guidance requires measuring a lease liability at the present value of unpaid lease payments and measuring the right-of-use asset at the amount of the lease liability, adjusted for prepaid or accrued lease payments, the remaining balance of lease incentives received, unamortized initial direct costs, and any impairment of the right-of-use asset.
- If the lessee applies the modified retrospective transition method and the lease commenced after the beginning of the earliest period presented but before the effective date, the lessee recognizes a right-of-use asset and a lease liability in accordance with ASC 842-20-30-1 at the commencement date of the lease.
- The lessee subsequently measures the right-of-use asset and the lease liability using the subsequent measurement guidance for operating leases in ASC 842-20-35.
- If the lessee has not elected the package of practical expedients, any unamortized initial direct costs that do not meet the definition of initial direct costs under ASC 842 are written off. Refer to the "Initial direct costs" section above for a discussion of accounting for initial direct costs in transition.

**ASC 842-10-65-1 (excerpt)**

- s. For each lease classified as an operating lease in accordance with this Topic, a lessee shall do the following:
1. Derecognize the carrying amount of any capital lease asset and capital lease obligation in accordance with Topic 840 at the application date as determined in (c). Any difference between the carrying amount of the capital lease asset and the capital lease obligation shall be accounted for in the same manner as prepaid or accrued rent.
 2. If an entity elects the transition method in (c)(1) and the lease commenced before the beginning of the earliest period presented in the financial statements or if the entity elects the transition method in (c)(2), recognize a right-of-use asset and a lease liability in accordance with paragraph 842-20-35-3 at the application date as determined in (c).
 3. If an entity elects the transition method in (c)(1) and the lease commenced after the beginning of the earliest period presented in the financial statements, recognize a right-of-use asset and a lease liability in accordance with paragraph 842-20-30-1 at the commencement date of the lease.
 4. Account for the operating lease in accordance with the guidance in Subtopic 842-20 after initial recognition in accordance with (s)(2) or (s)(3).
 5. Write off any unamortized initial direct costs that do not meet the definition of initial direct costs in this Topic as an adjustment to equity unless the entity elects the transition method in (c)(1) and the costs were incurred after the beginning of the earliest period presented, in which case those costs shall be written off as an adjustment to earnings in the period the costs were incurred.

11.6.6 Lessee modifications in transition

A lease that is modified on or after the effective date of ASC 842 in a manner that does not result in a new contract for accounting purposes, or a lease that is remeasured for any reason, is accounted for under the guidance in ASC 842 from the modification or remeasurement date. For an entity using the modified retrospective transition approach, the accounting for a modification that occurs during the transition period is not specified in the transition guidance. See Section 5.7 for a discussion of lease modification for a lessee, and Section 5.8 for a discussion of lease remeasurement for a lessee.

**ASC 842-10-65-1 (excerpt)**

- q. If a modification to the contractual terms and conditions occurs on or after the effective date, and the modification does not result in a separate contract in accordance with paragraph 842-10-25-8, or the lessee is required to remeasure the lease liability for any reason (see paragraphs 842-20-35-4 through 35-5), the lessee shall follow the requirements in this Topic from the effective date of the modification or the remeasurement date.
- t. If a modification to the contractual terms and conditions occurs on or after the effective date, and the modification does not result in a separate contract in accordance with paragraph 842-10-25-8, or the lessee is required to remeasure the lease liability in accordance with paragraph 842-20-35-4,

the lessee shall subsequently account for the lease in accordance with the requirements in this Topic beginning on the effective date of the modification or the remeasurement date.



Grant Thornton insights: Accounting for lease modifications in transition

We believe that a lessee using the modified retrospective transition method should account for lease modifications that occur during the transition period based on (1) the lease's classification under legacy GAAP and (2) whether lease classification changes in transition.

A lease modification that occurs during the transition period and does not change the lease's classification should be accounted for using the modification provisions of legacy GAAP. However, legacy GAAP does not address how to account for the effect of a modification on the right-of-use asset and lease liability associated with an operating lease, as operating leases are accounted for "off-balance sheet" under legacy GAAP. Therefore, we believe a lessee that modifies a lease during the transition period that is classified as an operating lease both before and after the application of ASC 842 should apply legacy GAAP to determine how to account for the modification, and ASC 842 to determine how to adjust the right-of-use asset and lease liability.

If a lessee does not apply the package of practical expedients and if the lease classification changes in transition, the modification guidance in ASC 842 should be applied during the transition period.

11.6.7 Build-to-suit arrangements

Under legacy GAAP, a lessee involved in the construction of an asset that it will lease must evaluate whether its involvement causes it to bear substantially all of the construction-period risks. These types of arrangements are referred to as "build-to-suit" arrangements. If it is determined under legacy GAAP that the lessee is subject to substantially all of the construction-period risks, then the lessee is deemed to be the owner of the construction project and must capitalize the construction project in accordance with ASC 360. When construction is completed, the lessee must apply the sale-leaseback guidance under legacy GAAP to determine whether it should derecognize the constructed asset. If a lessee does not qualify to derecognize the constructed asset, the arrangement is referred to as a "failed build-to-suit," and the lessee accounts for the arrangement as a financing.

ASC 842 does not carry forward this guidance and establishes a control-based model for assessing build-to-suit arrangements. A lessee that accounts for a failed build-to-suit arrangement as a financing under legacy GAAP should derecognize those assets and liabilities when it transitions to ASC 842.

A lessee that applies the modified retrospective transition method should derecognize the assets and liabilities associated with a legacy failed build-to-suit arrangement at the later of (1) the beginning of the earliest period presented, or (2) the date when the lessee was determined to be the accounting owner of the assets in accordance with legacy GAAP. A lessee using the current-period adjustment transition method should derecognize the assets and liabilities at the beginning of the reporting period in which the lessee first applies ASC 842. Any difference between the assets and liabilities derecognized would be recorded as an adjustment to equity at the derecognition date. The lessee then applies the general transition requirements of ASC 842 to the lease. ASC 842 does not specifically address the transition for build-to-suit arrangements if construction is incomplete at the effective date.

A lessee with a build-to-suit lease for which the construction period ended before the ASC 842 application date that was accounted for as a sale-leaseback transaction under legacy GAAP should follow the general lessee transition requirements.



ASC 842-10-65-1 (excerpt)

- u. A lessee shall apply a modified retrospective transition approach for leases accounted for as build-to-suit arrangements under Topic 840 that are existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements (if an entity elects the transition method in (c)(1)) or that are existing at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph (if an entity elects the transition method in (c)(2)) as follows:
 - 1. If an entity has recognized assets and liabilities solely as a result of a transaction's build-to-suit designation in accordance with Topic 840, the entity shall do the following:
 - i. If an entity elects the transition method in (c)(1), the entity shall derecognize those assets and liabilities at the later of the beginning of the earliest comparative period presented in the financial statements and the date that the lessee is determined to be the accounting owner of the asset in accordance with Topic 840.
 - ii. If an entity elects the transition method in (c)(2), the entity shall derecognize those assets and liabilities at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph.
 - iii. Any difference in (i) or (ii) shall be recorded as an adjustment to equity at the date that those assets and liabilities were derecognized in accordance with (u)(1)(i) or (ii).
 - iv. The lessee shall apply the lessee transition requirements in (k) through (t) to the lease.
 - 2. If the construction period of the build-to-suit lease concluded before the beginning of the earliest comparative period presented in the financial statements (if the entity elects the transition method in (c)(1)) or if it concluded before the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph (if the entity elects the transition method in (c)(2)), and the transaction qualified as a sale and leaseback transaction in accordance with Subtopic 840-40 before that date, the entity shall follow the general lessee transition requirements for the lease.



Grant Thornton insights: Build-to-suit arrangements in transition

Under the build-to-suit guidance in legacy GAAP, a lessee involved in the construction of an asset may be required to recognize that asset as if it were the owner. However, in transition, when the construction of the asset in a build-to-suit arrangement is completed before the effective date of ASC 842, a lessee must derecognize the asset even if it concludes that it would continue to recognize the asset after construction is completed under legacy GAAP.

If a lessee is not deemed to be the owner of a construction project under legacy GAAP but the construction project is still in progress as of the effective date of ASC 842, the lessee should review the guidance in ASC 842-40-55-4 to determine whether it should be considered the owner under ASC 842.

For lessees using the modified retrospective transition method, if construction is in progress as of the effective date and the lessee is deemed to control the asset based on ASC 842-40, the asset should be recognized at the later of the beginning of the earliest period presented or the date when control was established.

11.7 Lessor transition

Transition accounting for lessors is based on the classification of each lease under legacy GAAP and, if the lessor does not elect the package of transition practical expedients, under ASC 842. For leases that are reclassified upon transition to ASC 842, the objective is for the lessor to account for the lease as if it had always been accounted for under ASC 842. Figure 11.2 below summarizes the transition accounting for lessors. See Section 4 for a discussion of lease classification under ASC 842.

Figure 11.2: Summary of lessor transition accounting

Classification	ASC 842 operating lease	ASC 842 sales-type or direct financing lease
Legacy operating lease	<p>Bring forward carrying amounts of the underlying asset and any assets or liabilities related to the lease</p> <p>Account for securitized receivables as secured borrowings</p> <p>Write off unamortized initial direct costs that do not meet the definition in ASC 842</p>	<p>Derecognize the underlying asset recorded under legacy GAAP</p> <p>Recognize the net investment in lease as if the lease had always been classified as sales-type or direct financing</p> <p>Record any difference as an adjustment to equity</p>
Legacy sales-type or direct financing lease	<p>Recognize the underlying asset as if the lease was always classified as operating</p> <p>Derecognize the net investment in the lease recorded under legacy GAAP</p> <p>Record any difference as an adjustment to equity</p>	<p>Bring forward the net investment in the lease</p> <p>Before effective date, continue to apply legacy GAAP</p> <p>Beginning at effective date, apply ASC 842 guidance for lessors on recognition, subsequent measurement, presentation, and disclosure</p>



Grant Thornton insights: Application date of ASC 606 when a contract no longer qualifies as a lease

Some contracts that qualified as a lease under legacy GAAP will no longer qualify as a lease under ASC 842 and will be accounted for instead under other applicable guidance, such as ASC 606. For contracts previously accounted for under legacy leasing GAAP that will prospectively be accounted for under ASC 606, a question arises: As of which date should ASC 606 be applied, assuming an entity adopts ASC 606 using the modified retrospective transition approach?

For example, assume that Lessor, a PBE, adopts ASC 842 on January 1, 2019 using the modified retrospective transition method. Therefore, the application date is the beginning of the earliest period presented, or January 1, 2017. Since Lessor is a PBE, its adoption date of ASC 606 is January 1, 2018. Assume Lessor adopted ASC 606 using the modified retrospective transition method. Lessor has one contract accounted for as a lease under legacy GAAP that no longer meets the definition of a lease under ASC 842.

Because the contract no longer qualifies as a lease under ASC 842, we believe it must be accounted for under the revenue guidance that was effective during the transition period when Lessor recasts its comparative periods upon adopting ASC 842. As the entity adopted ASC 606 on January 1, 2018 under the modified retrospective transition method, Lessor should apply ASC 605 to this contract for the recasted year ended December 31, 2017 and should thereafter apply ASC 606. Also, Lessor should recognize the cumulative effect of applying the guidance in ASC 606 to the contract as part of its cumulative-effect adjustment to retained earnings on January 1, 2018.

Since ASC 606 was not effective until January 1, 2018, we believe it would be inappropriate for Lessor to apply ASC 606 during the ASC 842 transition period prior to the effective date of ASC 606 in this circumstance.

11.7.1 Leases classified as operating leases under legacy GAAP

How a lessor accounts for an operating lease under ASC 842 has not substantially changed from legacy GAAP. If a lease continues to be classified as an operating lease under ASC 842, the lessor should carry forward the amount of the underlying asset, treat any securitized receivables as secured borrowings, and assess initial direct costs under the ASC 842 definition of initial indirect costs (unless the package of transition practical expedients is elected). If the lease is classified as a sales-type lease or direct financing lease under ASC 842, the underlying asset is derecognized and a net investment in the lease is recognized, with any difference recorded as an adjustment to equity.

Leases classified as operating leases under ASC 842

A lessor with a lease classified as an operating lease under legacy GAAP that continues to be classified as operating under ASC 842 carries forward the previously recognized carrying amount of the underlying asset, as well as any associated lease assets and liabilities. Any securitized receivables recorded under legacy GAAP are accounted for as secured borrowings in accordance with other applicable GAAP, such as the guidance in ASC 860.

If a lessor elects the package of practical expedients, or if it does not elect the package of practical expedients but determines that its deferred costs continue to meet the definition of initial direct costs under ASC 842, those costs remain capitalized and should continue to be amortized in line with the requirements in ASC 842. If the lessor does not elect the package of practical expedients and determines

that some of its deferred costs do not meet the definition of initial direct costs under ASC 842, those costs must be written off. If the lease commenced before the beginning of the earliest period presented, the costs are written off as an adjustment to equity. If the lessor is using the modified retrospective transition method and the lease commenced during the transition period, the lessor writes off the costs to earnings in the period in which they were incurred.



ASC 842-10-65-1 (excerpt)

- v. For each lease classified as an operating lease in accordance with this Topic, a lessor shall do all of the following:
1. Continue to recognize the carrying amount of the underlying asset and any lease assets or liabilities at the application date as determined in (c) as the same amounts recognized by the lessor immediately before that date in accordance with Topic 840.
 2. Account for previously recognized securitized receivables as secured borrowings in accordance with other Topics.
 3. If a lessor does not elect the practical expedients described in (f), write off any unamortized initial direct costs that do not meet the definition of initial direct costs in this Topic as an adjustment to equity unless the entity elects the transition method in (c)(1) and the costs were incurred after the beginning of the earliest period presented, in which case those costs shall be written off as an adjustment to earnings in the period the costs were incurred.

Leases classified as sales-type or direct financing leases under ASC 842

A lessor with a lease classified as an operating lease under legacy GAAP that is classified as a sales-type lease or direct financing lease under ASC 842 should account for the lease as if it had always been a sales-type or direct financing lease accounted for under ASC 842, as follows:

- Derecognize the carrying amount of the underlying asset at the application date.
- Recognize a net investment in the lease at the application date as if the lease had been accounted for as a sales-type or a direct financing lease under ASC 842 since lease commencement.
- If the lessor is using the modified retrospective transition method and the lease commenced after the application date, recognize the difference between the amounts recognized and derecognized as an adjustment to earnings in the period the lease commenced. Otherwise, recognize the difference as an adjustment to equity.
- Subsequently account for the lease in accordance with ASC 842.



ASC 842-10-65-1 (excerpt)

- w. For each lease classified as a direct financing or a sales-type lease in accordance with this Topic, the objective is to account for the lease, beginning on the application date as determined in (c) as if it had always been accounted for as a direct financing lease or a sales-type lease in accordance with this Topic. Consequently, a lessor shall do all of the following:

1. Derecognize the carrying amount of the underlying asset at the application date as determined in (c).
2. Recognize a net investment in the lease at the application date as determined in (c) as if the lease had been accounted for as a direct financing lease or a sales-type lease in accordance with Subtopic 842-30 since lease commencement.
3. Record any difference between the amounts in (w)(1) and (w)(2) as follows:
 - i. If an entity elects the transition method in (c)(1), as an adjustment to equity (if the commencement date of the lease was before the beginning of the earliest period presented or if the lease was acquired as part of a business combination; see also (h)(3)) or earnings (if the commencement date of the lease was on or after the beginning of the earliest period presented).
 - ii. If an entity elects the transition method in (c)(2), as an adjustment to equity.
4. Account for the lease in accordance with this Topic after the application date as determined in (c).

11.7.2 Leases classified as sales-type or direct financing leases under legacy GAAP

If a lease continues to be classified as a sales-type lease or a direct financing lease under ASC 842, the net investment in the lease is brought forward by the lessor. The lease is accounted for under legacy GAAP before the effective date, and under ASC 842 after the effective date. If a lease is classified as an operating lease under ASC 842, the underlying asset is recognized as though it had always been recognized on the lessor's statement of financial position, and the net investment in the lease is derecognized, with any difference recorded as an adjustment in equity.

Leases classified as sales-type or direct financing leases under ASC 842

A lessor with a lease classified as a sales-type lease or a direct financing lease under legacy GAAP that is still classified as a sales-type or direct financing lease under ASC 842 should continue to recognize a net investment in the lease at the application date of ASC 842, including any unamortized initial direct costs capitalized as part of the lessor's net investment in the lease under legacy GAAP, as follows:

- Before the effective date, a lessor that elects the modified retrospective transition method accounts for the lease in accordance with legacy GAAP.
- Beginning on the effective date, the lessor accounts for the lease in accordance with the recognition, subsequent measurement, presentation, and disclosure guidance for operating leases in ASC 842-30.
- Beginning on the effective date, the lessor accounts for a modification that does not require accounting for a separate contract in accordance with the appropriate modification guidance in ASC 842-10-25, depending on whether the lease is a sales-type or direct financing lease before and after the modification.

**ASC 842-10-65-1 (excerpt)**

- x. For each lease classified as a direct financing lease or a sales-type lease in accordance with this Topic, do all of the following:
1. Continue to recognize a net investment in the lease at the application date as determined in (c) at the carrying amount of the net investment at that date. This would include any unamortized initial direct costs capitalized as part of the lessor's net investment in the lease in accordance with Topic 840.
 2. If an entity elects the transition method in (c)(1), before the effective date, a lessor shall account for the lease in accordance with Topic 840.
 3. Regardless of the transition method selected in (c), beginning on the effective date, a lessor shall account for the lease in accordance with the recognition, subsequent measurement, presentation, and disclosure guidance in Subtopic 842-30.
 4. Beginning on the effective date, if a lessor modifies the lease (and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8), it shall account for the modified lease in accordance with paragraph 842-10-25-16 if the lease is classified as a direct financing lease before the modification or paragraph 842-10-25-17 if the lease is classified as a sales-type lease before the modification. A lessor shall not remeasure the net investment in the lease on or after the effective date unless the lease is modified (and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8).

Leases classified as operating leases under ASC 842

A lessor with a lease classified as a sales-type lease or a direct financing lease under legacy GAAP that is classified as an operating lease under ASC 842 should record transition adjustments to reflect the lease as if it had always been accounted for as an operating lease under ASC 842, as follows:

- Recognize the underlying asset at an amount equal to what the carrying amount would have been if the lease had always been classified as an operating lease under legacy GAAP.
- Derecognize the carrying amount of the net investment in the lease.
- If the lessor is using the modified retrospective transition method and the lease commenced after the application date, recognize the difference between the amounts recognized and derecognized as an adjustment to earnings in the period the lease commenced. Otherwise, recognize the difference as an adjustment to equity.
- Subsequently, account for the lease in accordance with ASC 842.



ASC 842-10-65-1 (excerpt)

- y. For each lease classified as an operating lease in accordance with this Topic, the objective is to account for the lease, beginning on the application date as determined in (c), as if it had always been accounted for as an operating lease in accordance with this Topic. Consequently, a lessor shall do all of the following:
1. Recognize the underlying asset at what the carrying amount would have been had the lease been classified as an operating lease under Topic 840.
 2. Derecognize the carrying amount of the net investment in the lease.
 3. Record any difference between the amounts in (y)(1) and (y)(2) as follows:
 - i. If an entity elects the transition method in (c)(1), as an adjustment to equity (if the commencement date of the lease was before the beginning of the earliest period presented or if the lease was acquired as part of a business combination) or earnings (if the commencement date of the lease was on or after the beginning of the earliest period presented).
 - ii. If an entity elects the transition method in (c)(2), as an adjustment to equity.
 4. Subsequently account for the operating lease in accordance with this Topic and the underlying asset in accordance with other Topics.

11.7.3 Leases classified as leveraged leases under legacy GAAP

The Board did not retain the legacy leveraged leasing model in ASC 842. Therefore, no leases that commence or are modified after the effective date of ASC 842 will be accounted for under the leveraged leasing guidance. However, a lease that was classified as a leveraged lease in accordance with legacy GAAP with a commencement date before the effective date of ASC 842 will be accounted for under the guidance in ASC 842-50, which carries forward the leveraged lease guidance from legacy GAAP solely for legacy leveraged leases that have not been modified. Under that guidance, a leveraged lease that is modified on or after the effective date is accounted for as a new lease as of the modification date in accordance with the general lessor leasing guidance in ASC 842, which does not include a leveraged lease accounting model. See Section 8 for a discussion of leveraged leases under ASC 842.



ASC 842-10-65-1 (excerpt)

- z. For leases that were classified as leveraged leases in accordance with Topic 840, and for which the commencement date is before the effective date, a lessor shall apply the requirements in Subtopic 842-50. If a leveraged lease is modified on or after the effective date, it shall be accounted for as a new lease as of the effective date of the modification in accordance with the guidance in Subtopics 842-10 and 842-30.
1. A lessor shall apply the pending content that links to this paragraph to a leveraged lease that meets the criteria in (z) that is acquired in a business combination or an acquisition by a not-for-profit entity on or after the effective date.

11.8 Transition for sale-leaseback transactions

An entity does not reassess a transaction that was a successful sale-leaseback transaction under legacy GAAP to determine if it meets the new sale-leaseback criteria under ASC 842. Only a transaction accounted for as a failed sale-leaseback under legacy GAAP that remains a failed sale at the effective date of ASC 842 is reassessed to determine if a sale would have occurred under the sale-leaseback criteria in ASC 842. The Board explained in paragraph BC396 of ASU 2016-02 that this treatment of a failed sale-leaseback was intended to align with the modified retrospective transition method in ASC 606, whereby an uncompleted contract is reassessed, while a completed contract is not.

An entity using the modified retrospective transition method must reassess a failed sale-leaseback to determine if a sale would have occurred under the guidance in ASC 842 at any point on or after the beginning of the earliest period presented. If the entity determines that a sale has occurred, it accounts for the sale-leaseback on a modified retrospective basis from the sale date. An entity using the current-period adjustment transition method should reassess a failed sale-leaseback at the effective date of ASC 842, and a transaction meeting the sale criteria in ASC 842 should be recorded as an adjustment to equity at the effective date. The leaseback is then accounted for under the lessee guidance in ASC 842-20 after the effective date.

An entity that has an existing leaseback for which the sale is not reassessed accounts for that leaseback using the general lessee and lessor transition guidance. See Section 7 for a discussion of the accounting for sale-leaseback transactions under ASC 842.



ASC 842-10-65-1 (excerpt)

- aa. If a previous sale and leaseback transaction was accounted for as a sale and a leaseback in accordance with Topic 840, an entity shall not reassess the transaction to determine whether the transfer of the asset would have been a sale in accordance with paragraphs 842-40-25-1 through 25-3.
- bb. If a previous sale and leaseback transaction was accounted for as a failed sale and leaseback transaction in accordance with Topic 840 and remains a failed sale at the effective date:
 - 1. If an entity elects the transition method in (c)(1), the entity shall reassess whether a sale would have occurred at any point on or after the beginning of the earliest period presented in the financial statements in accordance with paragraphs 842-40-25-1 through 25-3. The sale and leaseback transaction shall be accounted for on a modified retrospective basis from the date a sale is determined to have occurred.
 - 2. If an entity elects the transition method in (c)(2), the entity shall reassess whether a sale would have occurred at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph in accordance with paragraphs 842-40-25-1 through 25-3 and recognize the sale as an adjustment to equity. The entity shall then account for the leaseback in accordance with the guidance in Subtopic 842-20 after the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph.
- cc. An entity shall account for the leaseback in accordance with the lessee and lessor transition requirements in (k) through (y).

Sale and capital leaseback under legacy GAAP

For a transaction accounted for as a sale and capital leaseback under legacy GAAP, the seller-lessee should recognize any deferred gain or loss that exists at the application date of ASC 842 as follows:

- If the underlying asset is land only, the deferred gain or loss should be recognized on a straight-line basis over the remaining lease term.
- If the underlying asset is not land only and the leaseback is a finance lease, the gain or loss should be recognized in a proportionate manner to the amortization of the right-of-use asset.
- If the underlying asset is not land only and the leaseback is an operating lease, the gain or loss should be recognized in a proportionate manner to the total lease cost.



ASC 842-10-65-1 (excerpt)

- dd. If a previous sale and leaseback transaction was accounted for as a sale and capital leaseback in accordance with Topic 840, the transferor shall continue to recognize any deferred gain or loss that exists at the later of the beginning of the earliest comparative period presented in the financial statements and the date of the sale of the underlying asset (if an entity elects the transition method in (c)(1)) or that exists at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph (if an entity elects the transition method in (c)(2)), as follows:
1. If the underlying asset is land only, straight line over the remaining lease term.
 2. If the underlying asset is not land only and the leaseback is a finance lease, in proportion to the amortization of the right-of-use asset.
 3. If the underlying asset is not land only and the leaseback is an operating lease, in proportion to the recognition in profit or loss of the total lease cost.



At the crossroads: Sale and capital leaseback in transition

Under legacy GAAP, a sale and capital leaseback is accounted for by the seller-lessee by (1) recognizing a capital lease asset and capital lease liability, and (2) deferring any gain over the lease term. Under ASC 842, a finance leaseback precludes a seller from accounting for a transaction as a sale-leaseback. In paragraph BC396(c) of ASU 2016-02, the Board clarified its decision to allow entities to continue to account for sale-capital leasebacks in transition, noting that the cost of reevaluating and unwinding these transactions would not be worth the benefit.

Sale and operating leaseback under legacy GAAP

If a transaction was accounted for as a sale and an operating leaseback under legacy GAAP, the seller-lessee's treatment of deferred gain or loss on the transaction under ASC 842 depends on whether the gain or loss arose from off-market terms. "Off-market terms" exist when the consideration paid is not equal to the asset's fair value or when the lease payments are not at the market rate.

If the terms are not off-market, the seller-lessee recognizes any deferred gain or loss as an adjustment to equity or prior-period earnings, depending on the transition method selected and when the sale occurred. An entity using the current-period adjustment method, or using the modified retrospective method when the sale date precedes the beginning of the earliest period presented, recognizes the deferred gain or loss as an adjustment to equity. An entity using the modified retrospective transition method when the sale occurs after the beginning of the earliest period presented recognizes the deferred gain or loss in earnings in the period the sale occurred.

When terms are off-market, any gain represents additional financing related to the sale and should not be written off to equity. A deferred gain resulting from off-market terms is recognized as a financial liability at the application date or, if the sale occurs after the beginning of the earliest period presented but before the effective date and the entity elects the modified retrospective transition method, at the date of the sale.

Any deferred loss associated with an off-market transaction is recognized as an adjustment to the leaseback right-of-use asset at the later of the application date or the date of the sale of the underlying asset.



ASC 842-10-65-1 (excerpt)

- ee. If a previous sale and leaseback transaction was accounted for as a sale and operating leaseback in accordance with Topic 840, the transferor shall do the following:
1. Recognize any deferred gain or loss not resulting from off-market terms (that is, where the consideration for the sale of the asset is not at fair value or the lease payments are not at market rates) as a cumulative-effect adjustment to equity unless the entity elects the transition method in (c)(1) and the date of sale is after the beginning of the earliest period presented, in which case any deferred gain or loss not resulting from off-market terms shall be recognized in earnings in the period the sale occurred.
 2. Recognize any deferred loss resulting from the consideration for the sale of the asset not being at fair value or the lease payments not being at market rates as an adjustment to the leaseback right-of-use asset at the later of the beginning of the earliest comparative period presented in the financial statements and the date of the sale of the underlying asset (if an entity elects the transition method in (c)(1)) or at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph (if an entity elects the transition method in (c)(2)).
 3. Recognize any deferred gain resulting from the consideration for the sale of the asset not being at fair value or the lease payments not being at market rates as a financial liability at the later of the beginning of the earliest comparative period presented in the financial statements and the date of the sale of the underlying asset (if an entity elects the transition method in (c)(1)) or at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph (if an entity elects the transition method in (c)(2)).

Appendix A: Determining the incremental borrowing rate

One of the most significant challenges for lessees applying the guidance in ASC 842 is determining the incremental borrowing rate (IBR) used to calculate the lease liability. While the IBR is defined in ASC 842, there is little authoritative guidance regarding how a lessee should go about estimating this rate.

When accounting for a lease under ASC 842, a lessee must recognize a lease liability at an amount equal to the present value of the remaining lease payments. To calculate present value, a lessee typically uses a discount rate equal to its IBR. The IBR is the rate of interest a lessee would have to pay to borrow, on a collateralized basis, an amount equal to the lease payments for a term similar to the lease term in a similar economic environment as the lease.

The discount rate is a critical component in accounting for a lease, because it directly affects how the lessee determines the carrying amount of the lease liability and the right-of-use asset for both operating and finance leases. For finance leases, the discount rate also affects the lessee's statement of comprehensive income, since the rate determines the amount of interest expense recognized each reporting period.

The following questions and answers are designed to help clarify how a lessee should estimate the IBR.

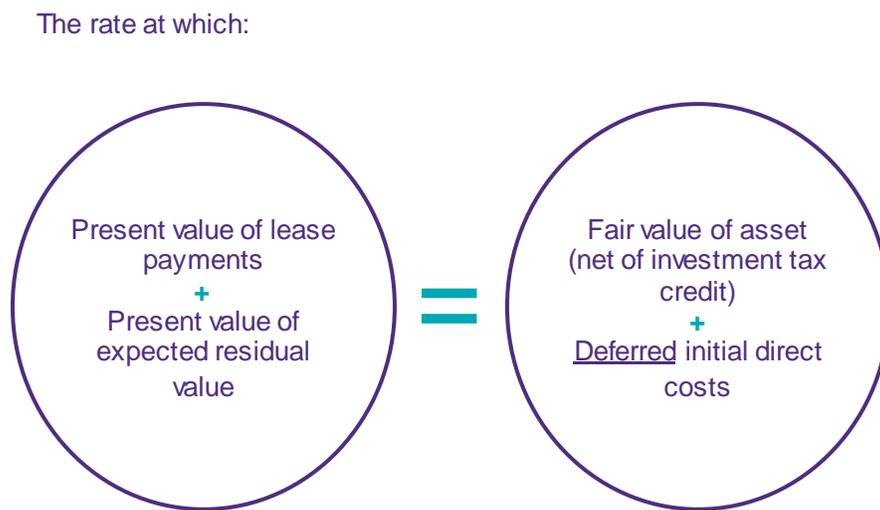
1. Are there circumstances in which a lessee should not use its IBR as its discount rate?

We believe that in most cases, lessees will use the IBR as the discount rate for lease accounting purposes.

ASC 842 stipulates that a lessee must use the rate implicit in the lease to discount the lease payments if this rate is readily determinable. If the rate implicit in the lease is not readily determinable, then a lessee must use its IBR to discount the lease payments. Under ASC 842, lessees that are not public business entities are also permitted to make an accounting policy election to use a risk-free discount rate instead of the rate implicit in the lease or the IBR.

Although ASC 842 requires a lessee to use the rate implicit in the lease, if readily determinable, as the discount rate, in practice a lessee typically is unable to readily determine the rate implicit in the lease, because calculating the rate requires input from the lessor. The rate implicit in the lease is the discount rate that satisfies the following equation, as discussed in Section 1.8.

Figure A.1: Rate implicit in the lease



Because the lessee is typically unable to readily determine both the lessor's expected residual value and the amount of any deferred initial direct costs incurred by the lessor, most lessees will use the IBR to calculate present values when applying ASC 842. In our view, it would not be appropriate for a lessee to use its own estimates of these amounts to compute the rate implicit in the lease.

In addition, lessees should be aware that a rate specified in the contract does not necessarily represent the rate implicit in the lease. If a contractual rate is specified, a lessee should determine that the rate was calculated consistent with the definition of the rate implicit in the lease in ASC 842.

2. How does the amount of the lease payments affect a lessee's IBR?

The IBR is the rate the lessee would pay to borrow an amount equal to the lease payments, as defined in ASC 842 (see Section 1.4 for more information about lease payments).

For example, the IBR for a ten-year lease with fixed \$10,000 annual payments would be based on a borrowing with a principal amount of \$100,000. Although in practice the principal amount of a hypothetical borrowing generally has little impact on the IBR, a lessee should consider whether the magnitude of the lease payments affects the IBR in light of its particular circumstances.

3. Is a lessee required to estimate the IBR based on borrowing with a repayment pattern that matches the payment pattern in the lease?

Based on discussions with the FASB staff, we believe that the phrase "over a similar term" in the definition of IBR refers to the timing of each lease payment as well as the "lease term" as defined in ASC 842. Therefore, we believe that a lessee must estimate the IBR based on a loan that amortizes in a similar pattern to the lease payments over the lease term.

4. How does the lease term affect a lessee's IBR?

A lessee's IBR reflects a borrowing with a term that is similar to the lease term, as defined in ASC 842 (see Section 1.5 for more information about the lease term). In general, the interest rate increases as the borrowing term increases.

5. How should a lessee consider renewal and termination options when estimating the IBR?

For leases with renewal and termination options, we believe a lessee should make an accounting policy election to estimate either (1) the borrowing rate on debt with a fixed term that matches the “lease term,” as defined in ASC 842, or (2) the borrowing rate on debt with extension and prepayment options that mirror the renewal and termination options, respectively, in the lease. We believe the latter approach is consistent with the guidance in ASC 842-20-35-5(a), which precludes a lessee from remeasuring the discount rate when there is a change in the lease term or in the lessee’s assessment of whether it will exercise an option to purchase the underlying asset if the discount rate “already reflects that the lessee has an option to extend or terminate the lease or to purchase the underlying asset.”

6. How does collateral affect a lessee’s IBR?

A lessee’s IBR reflects a borrowing that is fully collateralized. For a lease with lease payments that total \$100,000, the IBR should reflect the rate on a borrowing with a principal amount of \$100,000, collateralized by an asset (or assets) with a fair value of \$100,000. In general, the addition of collateral to a borrowing arrangement reduces the interest rate. In addition, as the “quality” of the collateral increases, the interest rate declines, because higher quality collateral better protects the lender’s investment in the debt. For example, U.S. government bonds would generally be viewed as higher quality collateral than sovereign debt issued by a government whose economy is highly inflationary.

7. If a lessee only borrows on an unsecured basis, can it use its unsecured borrowing rate as its IBR?

No. Full collateralization must be presumed for purposes of estimating the IBR, regardless of whether a lessee typically borrows on an unsecured basis.

It is important to distinguish between recourse and collateral when determining the IBR, especially if a lessee is referencing the rate on an existing borrowing arrangement and must determine whether it needs to adjust the rate to reflect collateralization.

Recourse debt provides the lender with the legal right to pursue the borrower’s assets if the debt is not repaid, whereas collateral refers to specific assets in which the borrower has granted a security interest to the lender. The IBR reflects the existence of both recourse and collateral. In other words, when estimating the IBR, a lessee starts with a rate based on a full recourse debt obligation, and then adjusts that rate to reflect full collateralization.

8. Should the lessee presume that the collateral is the asset underlying the lease for purposes of estimating the IBR?

ASC 842 does not specify the type of asset that should be presumed as collateralizing the borrowing. In our view, a lessee can presume the collateral to be any asset that the lessee could pledge, and the lender would accept, as collateral. Since the lessee does not own the asset underlying the lease, it would generally be unable to pledge that asset as collateral. However, a lessee might be able to pledge its leasehold interest as collateral.

9. How does the economic environment affect a lessee’s IBR?

A lessee’s IBR is based on a borrowing arrangement executed in an economic environment similar to the lease’s economic environment. Two key aspects of the economic environment that could affect the IBR are jurisdiction and currency.

A lessee should consider the jurisdiction where the lease is executed when estimating its IBR. For example, a lessee that executes U.S. dollar-denominated leases in the United States, United Kingdom, and France must consider the rate it would incur to borrow funds in each of those countries when estimating its IBR for leases executed in each of those countries. If the cost of borrowing U.S. dollars in each of those countries differs based on the jurisdiction where the loan is executed, the lessee should reflect these differences in the IBR applied to leases executed in those countries.

In addition, a lessee should consider the currency in which the lease is denominated when estimating its IBR. For example, a lessee might execute two leases in Japan, one denominated in Japanese yen and the other in U.S. dollars. The IBR for these leases would differ since the lessee incurs different rates to borrow Japanese yen and U.S. dollars within a single jurisdiction.

10. What are some methods for estimating the IBR?

ASC 842 does not prescribe a method for estimating the IBR, and there are a variety of methodologies in practice that a lessee could use. We believe that a lessee should consider what information is readily available in deciding how to estimate the IBR. Therefore, we've summarized some potential methods based on a starting point that will vary, depending on what information is readily available to a particular reporting entity.

Rate on lessee's debt

A lessee might have borrowed under a debt facility that it can reference when estimating its IBR. However, it would generally not be appropriate for a lessee to simply use the contractual interest rate on an existing debt facility as its IBR, without adjusting the contractual rate so that it satisfies the definition of the IBR, including the timing of the debt facility's origination compared to the lease commencement date. In other words, if a lessee issues debt in January and intends to use the rate on that debt as an input to its IBR for measuring a lease commencing in July of the same year, the lessee should consider whether any events or changes in circumstances have occurred between January and July that warrant an adjustment to the rate on the borrowing arrangement to reflect a current borrowing rate as of July.

If the debt is unsecured, then a lessee should adjust the yield to reflect the full collateralization of the borrowing. A lessee should also consider the particular characteristics of the referenced borrowing, such as original issuance discounts and debt issuance costs, which increase the yield on the debt compared to the debt's coupon rate. A lessee should refer to the effective interest rate on the debt, which includes the effect of discounts and debt issuance costs, when estimating its IBR.

Borrowing rate of entities similar to the lessee

A lessee might look to public debt markets to determine the borrowing rates for entities with credit similar to the lessee. Under this approach, the lessee must adjust the referenced borrowing rate so that it satisfies the definition of the IBR, similar to when a lessee references the effective interest rate on its own debt. For example, if the referenced borrowing rate is associated with unsecured debt, then a lessee must adjust the yield to reflect full collateralization.

Rate quoted by a lender

A lessee might ask a lender to provide a written quoted rate at which the lessee could borrow, and then use that quoted rate as the basis for estimating the IBR. If a lessee takes this approach, we believe it should develop a process to ensure that (1) the rate is based on assumptions that align with the IBR definition in ASC 842, and (2) the quoted rate represents an actual rate at which the lessee could execute a borrowing arrangement. In our view, depending on facts and circumstances, obtaining a written quote from a single lender may not provide a sufficient basis for estimating the IBR.

11. Can a lessee use a variable-interest rate as an input for estimating its IBR?

A lessee can use a variable-interest rate to estimate its IBR, but it would need to convert the variable rate into a fixed rate for this purpose. To make this conversion, a lessee could refer to a hypothetical at-market interest-rate swap in which the borrower makes fixed-interest payments to, and receives variable-interest payments from, the swap counterparty. Since the fair value of this hypothetical swap would be zero on the date it's executed, the fixed-interest payments could be used to estimate the IBR. It is important to note that in most cases, the implied fixed-interest rate will not equal the effective variable-interest rate as of the date the IBR is estimated.

12. Can a lessee that lacks a credit rating use information from public debt markets to estimate its IBR?

Without a credit rating, a lessee would have to estimate its credit rating in order to use information from public debt markets to estimate its IBR. One method for estimating an entity's credit rating is to compare its financial ratios and other metrics to those of rated borrowers. For example, if a lessee determines that its financial ratios and metrics are similar to those of issuers of traded debt securities who are rated BBB-, then the lessee could refer to information about yields on secured bonds issued by BBB- borrowers for purposes of estimating the IBR.

13. How would a lessee estimate IBRs for varying maturities?

Once a lessee determines an IBR for a particular maturity, it can determine IBRs for other maturities by referring to an appropriate yield curve. A yield curve simply plots a debt instrument's yield as a function of time to maturity.

Assume that a lessee enters into a secured borrowing arrangement on September 1, 20X8, with a term of 15 years and a yield of 5.5 percent. The lessee determines that this yield and maturity date most closely correspond to the yield curve for a borrower rated BBB- as of September 1, 20X8. The lessee could then use that yield curve to derive its IBR for various lease terms.

14. How can a lessee adjust an unsecured rate to reflect collateral?

There is no single prescribed approach for adjusting an interest rate to reflect collateral under ASC 842. One approach we have seen in practice is to reference the interest rate or the yield curve for a borrower with a credit rating that is one notch higher than the credit rating associated with an unsecured borrowing rate. For example, a lessee determines that the yield on its unsecured debt most closely corresponds with the yield curve for a senior secured debt issuer rated BBB-. The lessee might refer to the yield curve for senior secured debt of a borrower rated BBB (one notch higher than a borrower rated BBB-) to estimate the IBR.

15. Is a lessee required to engage a valuation specialist to estimate the IBR?

A lessee is not required to engage a valuation specialist to estimate the IBR, but it might determine that assistance from an outside valuation specialist is necessary in certain situations, depending on what information is readily available and to what extent the lessee's finance personnel are familiar with valuation concepts and techniques.

In general, a lessee is more likely to require assistance from a valuation specialist in the following circumstances:

- A lessee has only a variable-rate revolving credit facility to use as a basis for estimating its IBR.

- A lessee is not rated by a major credit-rating agency and does not have any rated debt that is traded.
- A lessee has a large multicurrency lease portfolio.
- A lessee has no access to corporate debt-market yield curve data.
- A lessee has ultralong term leases (for example, 99 years) that make it difficult to obtain interest rates for debt with similar characteristics.

In addition, a lessee might want to engage a valuation specialist to initially develop a methodology to estimate the IBR, and then bring that methodology “in house” for subsequent use.

16. Is it appropriate to consider materiality in establishing a method for estimating the IBR?

Yes, it is appropriate to consider materiality when estimating the IBR, provided that the methodology used results in an estimate that complies with the guidance in ASC 842.

We do not believe it is appropriate for a lessee to rely solely on a sensitivity analysis and a materiality assessment when estimating the IBR. For example, in our view, it would be inappropriate for a lessee to (1) establish a “reasonable” range for its IBR without referencing inputs, such as rates on existing borrowing arrangements, (2) assess whether using the IBR at either end of that range materially affects the financial statements and, if not, (3) arbitrarily choose a rate within the range (such as the midpoint) to account for its leases under ASC 842.

However, we believe that a sensitivity analysis and materiality assessment could be used to supplement an entity’s IBR estimation process, for example, to assess whether the estimated IBR is reasonable.

17. Can a lessee estimate the IBR for a portfolio of leases rather than separately for each lease?

A lessee is permitted to apply the guidance in ASC 842 on a portfolio basis rather than a lease-by-lease basis, provided that the lessee reasonably expects that the results of applying the guidance on a portfolio basis will not materially differ from applying this guidance on a lease-by-lease basis.

Since materiality is unique for each lessee, there is no single method that all reporting entities can use to group leases into portfolios. According to Paragraph BC201 of ASU 2016-02, a lessee can use a portfolio approach only if a reasonable portfolio can be determined. A “reasonable portfolio” consists of leases that share common key characteristics, such as lease terms and underlying assets.

18. Is a lessee required to estimate the IBR on the date when each lease commences?

We believe that lessees may apply a convention to periodically compute the IBR (for example, once a quarter) for leases entered into, or that require remeasurement of the discount rate, during the intervening period, provided that such an approach would not materially differ from a commencement-date measurement approach applied to each lease. This approach would mostly benefit lessees with a high volume of leasing activity.

Since a lessee would not necessarily know the characteristics, such as the term and currency, of leases that will commence during the intervening period, a portfolio or matrix of IBRs could be estimated each period, and the IBR that most closely matches the term of a new lease could be used to account for that lease during the intervening period.

For example, on January 1, 20X9, a lessee estimates a matrix of IBRs as shown in the following table. Note that this table is presented for illustrative purposes only. The actual terms and currencies represented in the table will vary for lessees that choose to periodically compile IBRs in this manner.

Term (years)	USD	EUR	JPY
1	3.8%	1.0%	1.1%
3	4.6%	1.8%	1.6%
5	5.1%	2.5%	2.1%
10	5.8%	3.8%	2.9%
30	6.4%	4.7%	4.1%

During the quarter ended March 31, 20X9, the lessee enters into a three-year lease denominated in U.S. dollars. Based on its current IBR matrix, the lessee uses a discount rate of 4.6 percent to account for this lease.

If a lessee adopts an approach to periodically update a matrix of IBRs, it must decide how often to update this information. How frequently a lessee should update its rates depends on its level of leasing activity and the stability of both the lessee's credit and the economic environments in which it executes leases.

A lessee that adopts this approach should also have a process in place to update its rates at an interim date relative to its established update schedule if a significant event occurs or there is a change in circumstances, which indicates the latest rates no longer reflect the lessee's IBR.

19. Can a subsidiary use its parent's IBR to account for its leases?

A subsidiary can sometimes use its parent's IBR to account for its leases. The FASB noted in Paragraph BC201 of ASU 2016-02 that there are situations where a subsidiary might use the parent's IBR, such as when the subsidiary lacks a separate treasury function, leading the parent to negotiate the lease and implicitly guarantee the lessee's payments to the lessor. In such a case, the Board noted that the pricing of the lease is more significantly influenced by the parent's credit standing than the subsidiary's credit standing and that it would therefore be appropriate for the subsidiary to refer to its parent's IBR in accounting for the lease.

Regardless of whether a subsidiary qualifies to use its parent's IBR, it must consider the economic environment in which the lease was entered into, including the currency in which the lease is denominated, when determining the IBR. In other words, the subsidiary would determine its IBR for a lease as if the parent was the lessee, and should also consider the currency in which a lease is denominated when determining an appropriate IBR to apply to that lease, similar to actions the parent would take.

20. Can a lessee use the rate on a secured revolving line of credit as its IBR?

Because secured revolving lines of credit are often over-collateralized and it is not appropriate for a lessee to use an over-collateralized rate as its IBR, a lessee could use the rate on a secured revolving

line of credit as an input to estimating its IBR, but would need to adjust the rate so that it does not reflect an over-collateralized borrowing.

21. How should a lessee that is unable to borrow estimate its IBR?

If a lessee is not creditworthy and is unable to borrow, we believe that it should estimate its IBR based on the yield for the lowest-rated traded corporate debt with characteristics that match the lease (for example, term and economic environment), adjusted for full collateralization as necessary.