

AN INDUSTRY SUPPLEMENT
TO A BDO BLUEPRINT

Lease Accounting for the Retail and Restaurant Industries

March 2025



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Lease Accounting for the Retail and Restaurant Industries

1. INTRODUCTION

Leasing has historically been a significant activity for most retail and restaurant companies. Retailers and restaurants often lease their store locations and various equipment, including smart safes, security cameras, and other operating equipment. Retailers and restauranters can obtain the right to use those assets under lease contracts or in service arrangements that contain embedded leases. With ASC 842, *Leases*, now effective for all companies, retailers and restauranters must determine whether those contracts are or contain leases and, if so, record leases on their balance sheets.

Further, in recent years, companies in the retail and restaurant sectors have strategically closed some locations or reduced their office space footprints. These activities can result in lease terminations, modifications, impairments, or abandonments, any of which can affect companies' income statements and balance sheets. In other words, the recognition of a lease in the financial statements is not a "set it and forget it" exercise after the commencement date of the lease.

Lastly, credit conditions have tightened in recent years because of rising prices and interest rates. In search of alternative financing options, retailers and restauranters that own real estate have entered sale-leaseback agreements. Sale-leaseback transactions can have significant accounting implications.

About This Publication

This publication discusses ASC 842 provisions most applicable to companies in the retail and restaurant sectors, primarily from a lessee's perspective. This industry supplement reflects key aspects of Accounting Standards Updates (ASUs) through ASU 2023-01, *Leases (Topic 842): Common Control Arrangements*.

Illustrations provided throughout this publication were developed primarily from the perspective of a sample retailer company. However, the examples are equally relevant for any retailer or restaurant company. The tables and calculations in the examples are consistent with how they would be displayed in a spreadsheet, with amounts shown with no decimals, and no rounding function used. Lease accounting varies based on the specific facts and circumstances of each contract and therefore may differ from the examples and insights in this publication or in our Blueprint, [Accounting for Leases Under ASC 842](#).

We encourage you to read the interpretations and examples in this publication with our Blueprint on lease accounting, which includes a detailed discussion of the accounting for leases and other key concepts in ASC 842. Additional information on the accounting for leases under International Financial Reporting Standards (IFRS) is available [here](#).

2. SCOPE AND SCOPE EXCEPTIONS

ASC 842 applies to leases of property, plant, and equipment. For retailers and restauranters, the analysis of the scope and related exceptions is generally straightforward. For example, many retailers and restaurants choose to lease, rather than buy, their store locations. Leasing is also not limited to real estate, with many companies choosing to rent various equipment, including soda dispensers, smart safes, security cameras, and other operating equipment. All these assets are property, plant, and equipment (PP&E) subject to evaluation under ASC 842.

ASC 842 does not apply to assets other than PP&E. For example, it does not apply to leases of intangible assets or inventory. However, these scope exceptions do not preclude a retailer or restauranter from reviewing its population of contracts to ascertain if some of these arrangements that relate to scope exceptions, such as inventory, contain a lease of PP&E. Examples of contracts to evaluate include warehouse, manufacturing, and distribution arrangements for finished goods and raw materials.

See Chapter 1 of our Blueprint, [Accounting for Leases Under ASC 842](#), for further discussion.

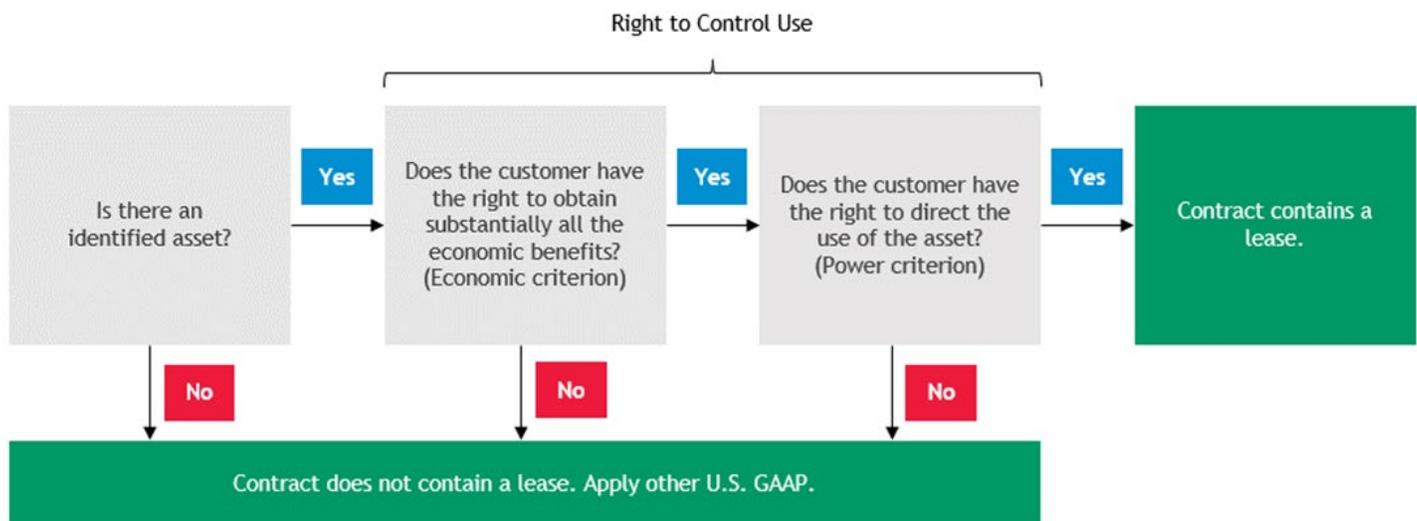
3. IDENTIFYING A LEASE

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

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

- ▶ Obtain substantially all the economic benefits from the asset's use (the economic criterion)
- ▶ Direct the use of the identified asset (the power criterion)

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



Also, for a retail or restaurant company to appropriately evaluate the three criteria in the flowchart above, it is important to understand the following:

- ▶ The contract must be for a period of time (for example, a perpetual land easement would not contain a lease, while a land easement for 99 years is for a period of time).
- ▶ The evaluation of whether a contract is or contains a lease is performed based on the **period of use**, which is the total period of time an asset is used to fulfill the contract with the customer, including the sum of any nonconsecutive periods. The period of use is not always the contract term. Once determined, the period of use is applied to evaluate whether supplier substitution rights are substantive and whether the economic and power criteria are met. Accordingly, it is a key concept of the evaluation. Example 3-1 illustrates the period of use concept.

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

The evaluation of whether a contract is or contains a lease is performed at contract inception, and it is not subsequently reassessed unless the contract's terms and conditions are modified.



EVALUATE CONTRACTS FOR EMBEDDED LEASES

Arrangements with suppliers for goods and services may include the use of specified assets. For example, manufacturing and distribution arrangements for finished goods and raw materials or IT service arrangements may include a lease (an embedded lease) of the facility, warehouse, IT equipment, or other PP&E. Such embedded leases are subject to ASC 842, and a retail or restaurant company must therefore review and assess those legal contracts. Retail and restaurant companies also should discuss with business partners the types of equipment that suppliers or service providers may keep onsite to ascertain the completeness of their lease population. Examples may include smart safes and security equipment.

EXAMPLE 3-1: CUSTOMER USES ASSET DURING NONCONSECUTIVE PERIODS

FACTS

- ▶ Retailer sells calendars and holiday merchandise. To sell its products, it enters a contract for the right to use a storefront in a mall for November and December each year for five years.

CONCLUSION AND ANALYSIS

- ▶ The period of use for the storefront in the mall is 10 months.
- ▶ Retailer considers the period of use as defined in ASC 842-10-20, which is “*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).*” Because the periods are not consecutive, Retailer must consider the aggregate term for which it has the right to use the storefront. Here, the period of use is 10 months (two months per year for five years), not the five-year contract term. Accordingly, the evaluation of whether the contract is or contains a lease considers the 10-month period that the storefront is used to fulfill the contract.

3.1 Identified Asset

An asset is typically identified when it is either explicitly specified in the contract or implicitly specified when it is made available for use by the customer. Even if an asset is specified, there is no identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. In other words, when a supplier substitution right is considered substantive, the supplier (rather than the customer) controls the use of the asset. Supplier substitution rights are substantive if, throughout the period of use, the supplier **both**:

- ▶ Has the practical ability to substitute alternative assets (for example, the customer cannot prevent the supplier from exercising its right of substitution and the supplier has alternative assets readily available or could source alternative assets within a reasonable period)
- ▶ Would benefit economically from substituting the asset (that is, the economic benefits of substituting the asset exceed the related substitution costs, such as transportation and installation costs)

The supplier’s ability to substitute the asset only on or after a particular date or event (for example for repairs and maintenance or based on the availability of a technical upgrade) is not considered substantive.

The evaluation of supplier substitution rights is key because if the right is substantive, there is no identified asset, so the contract does not contain a lease. See Example 3-2 in Section 3.4 for an illustration.

BDO INSIGHTS – SUBSTITUTION RIGHT REQUIREMENTS SET A HIGH HURDLE

The Financial Accounting Standards Board (FASB) has provided guidance to determine when a supplier substitution right is substantive, in which case there is no identified asset and therefore no lease. Based on the first sentence in ASC 842-10-15-10, to conclude that a supplier substitution right is substantive, the supplier must have the practical ability plus an economic opportunity to substitute the asset **throughout the period of use** rather than during only parts of the period of use. For example, the supplier would not have a substantive substitution right if it could benefit economically from substitution only during some portions of the period of use (such as in the last nine months of or starting in Year 3 of a 10-year period of use). The supplier also would not have a substantive substitution right if it has the practical ability to substitute the asset but has the right to do so only during some portions of that period of use (such as if the supplier can substitute the specified asset only when it is in the shop for scheduled maintenance and inspection). The requirements on substitution rights therefore set a high hurdle for a customer to conclude that there is no identified asset when an asset is explicitly or implicitly specified.

See Section 2.2 of our Blueprint, [Accounting for Leases Under ASC 842](#), for further discussion.

3.2 Right to Control Use of Identified Asset

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

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

Restrictions on use of the asset and supplier protective rights do not necessarily prevent the customer from meeting the economic and power criteria. Rather, they define the scope of the customer's use.

3.2.1 Restrictions and Supplier Protective Rights

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

Instead, the analysis focuses on what the customer can do **within that scope** of use of the asset. Consider the following example:

RETAIL UNIT SPACE	
Example contract	Contract for the use of a retail unit within a larger mall for a 10-year period.
 Defines the scope of use	The contract limits the hours of operations of the retail store from 10am to 10pm.
 But within that scope of use	Customer has exclusive use of the retail unit and decides when to open (subject to the limit), the mix of goods to sell, and at what price to sell the goods.

In the above example, even though the contract includes restrictions or limitations on the use of the asset, it would include a lease, as further explained in the next two sections.

3.2.2 Economic Criterion

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

ASC 842 clarifies that only the economic benefits arising from use of an asset are considered when assessing whether a customer has the right to obtain substantially all economic benefits. Economic benefits arising from owning an asset (such as tax benefits) are excluded in the evaluation. In many cases, the evaluation will be straightforward. For example, when the customer has exclusive use of an identified asset, it typically obtains 100% of the economic benefits from that use. This is true for the retail unit example in Section 3.2.1. In other situations, this evaluation requires the use of professional judgment.

If a contract requires a customer to pay the supplier or another party a portion of the cash flows derived from using the asset, those cash flows paid as consideration are considered economic benefits the customer obtains from using the asset. For example, if a retailer is required to pay a mall operator a percentage of sales as consideration for use of retail space, that requirement does not prevent the customer from having the right to obtain substantially all the economic benefits from using the space. The cash flows arising from those sales are considered economic benefits the customer obtains from use of the retail space, a portion of which it then pays to the mall operator as consideration for the right to use the space (see Example 3-4 in Section 3.4).

BDO INSIGHTS – MEANING OF SUBSTANTIALLY ALL

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

See Section 2.3.2 of our Blueprint, [Accounting for Leases Under ASC 842](#), for further discussion.

3.2.3 Power Criterion

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

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

Determining which guidance above applies (that is, the first or second bullet point) is key. So long as there is at least one relevant decision to be made throughout the period of use, the guidance in the first bullet point applies. In other words, the guidance in the second bullet point applies only in situations in which all relevant decisions are predetermined in the contract. In practice, retailers and restauranters will typically assess the first condition.

Examples of relevant decision-making rights to consider in the power criterion analysis include the following:

RELEVANT DECISIONS	RETAIL UNIT
Right to change the type of output produced by the asset	Deciding on the mix of products sold in the retail store
Right to change when the output is produced	Deciding when the retail store is open to customers
Right to change where the output is produced	Typically not applicable for a retail space but could be relevant in other situations (for example, where to deploy a delivery truck)
Right to change whether the output is produced and how much is produced	Deciding whether to open the retail store, how long it is open, and the volume of goods to sell to customers during that period

These rights are examples only and are neither determinative nor prescriptive. For example, a requirement to use an asset in a specified location does not necessarily imply that the customer does not direct the use of the asset. It also is common for retail and restaurant leases to preclude the lessee from changing concepts or from operating a concept that is similar to that of another tenant in the area. For example, a restaurant lease may preclude the lessee from operating a pizza-based restaurant if a preexisting tenant is operating a pizza restaurant. These types of restrictions are protective in nature and do not preclude the lessee from directing the use of the asset. Further, in some instances, the design of the asset may limit the relevant decisions available. For example, a retailer may lease a propane tank. The fact that the tank is designed to store and dispense propane does not preclude the retailer from making the relevant decisions that are available, such as determining how much propane to store in the tank and when to dispense propane for internal use or sale to customers, thus controlling the use of the tank.

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

BDO INSIGHTS – CAPITALIZATION THRESHOLDS

ASC 842 does not provide a scope exception for small value leases similar to the exception in IFRS 16, the leasing standard issued by the International Accounting Standards Board. Even so, retailer and restaurant companies may adopt reasonable capitalization thresholds below which lease assets and liabilities are not recognized, consistent with other applications of accounting policies, such as capitalization of PP&E. However, we believe any application of a lease capitalization threshold should result in materially the same result when considering all leases (not solely the impact from applying the policy to a single lease) and must consider the impact of not recognizing both the right-of-use (ROU) asset and the lease liability. Companies should therefore consider the resulting nonrecognition of lease liabilities, which may result in the use of lower capitalization thresholds for leases as compared to PP&E.

See Section 2.3.3 of our Blueprint, [Accounting for Leases Under ASC 842](#), for further discussion.

3.3 Common Control Arrangements

Retailers and restaurants may enter arrangements with parties under common control. Assessing those arrangements under ASC 842, including determining whether the arrangement is a lease, can be challenging. Common control arrangements may be unwritten and, even when written, may be amended or unenforced by the common owner. ASU 2023-01 provides nonpublic entities¹ a practical expedient to use the written terms and conditions of a common control arrangement to determine whether a lease exists and, if so, to classify and account for that lease. Under the practical expedient, a company assesses whether the written terms and conditions convey the practical right (rather than an enforceable right) to control the use of an identified asset for a period of time in exchange for consideration. If a lease exists, the company classifies and accounts for it based on those written terms and conditions. The practical expedient may be applied arrangement by arrangement.

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

See Section 2.5 of our Blueprint, [Accounting for Leases Under ASC 842](#), for further discussion.

3.4 Definition of a Lease – Application Examples

Examples 3-2 to 3-4 illustrate various concepts discussed in Section 3.

EXAMPLE 3-2 (ADAPTED FROM ASC 842-10-55-52 THROUGH 55-54): CONCESSION SPACE

FACTS

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

CONCLUSION AND ANALYSIS

The contract does not contain a lease because there is no identified asset.

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

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

Accordingly, Airport Operator's substitution right is substantive.

¹ Includes entities that are not public business entities (as defined in U.S. GAAP); not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, listed, or quoted on an exchange; and over-the-counter market or employee benefit plans that file or furnish financial statements with or to the SEC.

EXAMPLE 3-3 (ADAPTED FROM ASC 842-10-55-100 THROUGH 55-107): CONTRACT FOR SHIRTS**FACTS**

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

CONCLUSION AND ANALYSIS

While there is an identified asset, the agreement does not contain a lease because neither the economic nor power criterion is met.

- ▶ The agreement contains an implicitly specified asset because CMC can fulfill the contract only through the use of this factory.
- ▶ The economic criterion is not met because Retailer does not have the right to obtain substantially all the economic benefits from using the factory. CMC could decide to use the factory to fulfill orders from other customers during the three-year term of the agreement, and the factory's capacity significantly exceeds the output for which Retailer has contracted.
- ▶ The power criterion is also not met. Retailer's rights are limited to specifying output from the factory in its contract, and it has only the same rights regarding use of the factory as any other customers purchasing shirts or other products from the factory. CMC, not Retailer, has the right to direct the use of the factory because it can decide how and for what purpose the factory is used.

EXAMPLE 3-4: RETAIL STORE**FACTS**

- ▶ Retailer enters a 10-year contract for retail space (Unit A), which is part of a large mall with many retail units.
- ▶ Retailer is required to use Unit A to operate its well-known store brand to sell its goods when the mall is open.
- ▶ Retailer makes all decisions about the use of Unit A when the mall is open (for example, deciding on the mix of goods to sell and at what price to sell those goods).
- ▶ Mall Operator can require Retailer to relocate to another retail unit in the mall. In that case, Mall Operator must provide Retailer with a retail unit of similar quality and specifications as Unit A and to pay for Retailer's relocation costs, including reimbursement for any leasehold improvements that cannot be relocated.
- ▶ Mall Operator would benefit economically from relocating Retailer only if a major new tenant were to decide to occupy a large amount of retail space at a rate sufficiently favorable to cover the costs of relocating Retailer and other tenants for the space the new tenant would occupy. Although it is possible that those circumstances will arise, at contract inception it is not likely to. Whether such circumstances occur is also highly susceptible to factors outside Mall Operator's control.
- ▶ Payments for Unit A are \$100,000, paid in arrears, and increase 5% each year. Retailer also must pay 6% of monthly net sales.

CONCLUSION AND ANALYSIS

The contract contains a lease of retail space because there is an identified asset and both the economic and power criteria are met.

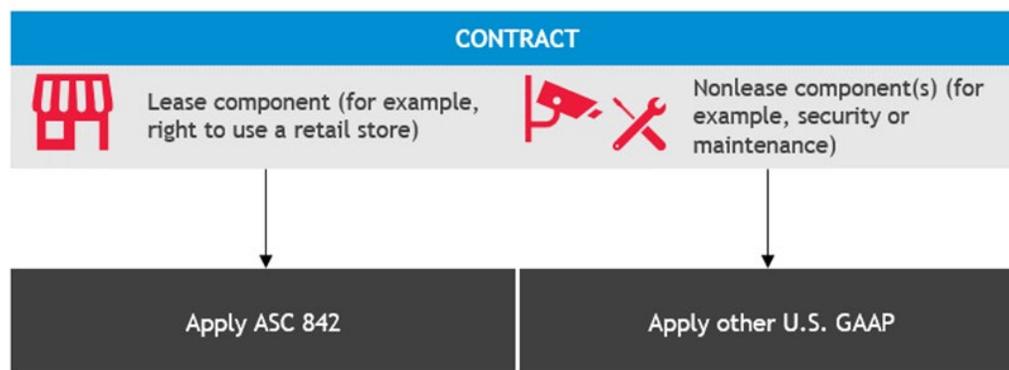
- ▶ Unit A is explicitly specified in the contract, and Mall Operator’s substitution right is not substantive because Mall Operator would benefit economically from substitution only in specific circumstances that at inception of the contract are not likely to occur. Therefore, the contract contains an identified asset.
- ▶ The economic criterion is met. Retailer has exclusive use of Unit A and therefore obtains substantially all the economic benefits from using it throughout the period of use. Although Retailer will pay Mall Operator a portion of the cash flows derived from sales in Unit A (6% of monthly net sales), this represents consideration that Retailer pays to Mall Operator for the use of Unit A and does not affect the evaluation of the economic criterion (see Section 3.2.2).
- ▶ The power criterion is also met. The contractual restrictions on the types of goods that can be sold and when the store must be open define the scope of Retailer’s use of Unit A. Within that scope, Retailer makes the relevant decisions about how and for what purpose the space is used (for example, how much inventory to hold at the store, the mix of its goods to sell, and the price of goods sold).

The accounting for Example 3-4 is discussed throughout this publication. See Chapter 2 of our Blueprint, [Accounting for Leases Under ASC 842](#), for additional examples.

4. IDENTIFYING AND SEPARATING COMPONENTS

4.1 Identifying Lease and Nonlease Components

Once a retailer or restaurant has determined that a contract is or includes a lease, the next step is to identify the components of the contract, which are the units of account that determine which U.S. GAAP applies. The definition of a lease is based on the right to use an identified asset, so the lease component typically represents the right to use that identified asset (such as the right to use a retail store). A contract may also include one or more nonlease components (such as maintenance or security services for that retail store). In that scenario, the lease component is accounted for under ASC 842, while the nonlease component(s) are generally accounted for under other U.S. GAAP as shown in the graphic below, unless the company elects the practical expedient not to separate (see Section 4.4).



A contract sometimes includes the lease of more than one asset. In those situations, the company evaluates whether the contract contains multiple lease components. Generally, the right to use each individual asset represents a separate lease component. For example, in a contract for the right to use two delivery trucks, each truck represents a separate lease component, so the contract therefore includes two lease components. If multiple assets are interdependent or interrelated, they may be accounted for as one lease component. However, ASC 842 includes specific considerations for leases of land, as discussed below.

Items or activities that do not transfer a good or service to the lessee are not components of the contract and include, for example:

- ▶ Administrative tasks to set up the lease contract
- ▶ Costs that the lessor would incur in its role as lessor or owner of the underlying asset (for example, property taxes for which the lessor is the primary obligor and insurance that protects the lessor’s asset)

The following table provides examples of lease and nonlease components and noncomponents.

LEASE COMPONENT EXAMPLES	NONLEASE COMPONENT EXAMPLES	NONCOMPONENT EXAMPLES
 Right to use real estate, such as a retail store or restaurant space	 Repairs and maintenance, such as common area maintenance	 Administrative tasks to initiate the contract, such as set-up activities
 Right to use computer equipment	 Other goods or services provided by the lessor to the lessee, such as security services or consumables	 Reimbursement of lessor costs related to ownership of the leased asset, such as property taxes and
 Right to use a vehicle, such as a delivery truck		 insurance that protects the lessor's asset

BDO INSIGHTS – IDENTIFYING LEASES OF LAND

ASC 842 requires a lease of land to be accounted for as a separate lease component unless the accounting effects of that separation would be insignificant, such as when:

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

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

If it is determined that the contract includes a lease of land, the retail or restaurant lessee must account for the lease of land separately from the lease of the other assets unless doing so would be insignificant as discussed above.



MASTER LEASE ARRANGEMENTS

Often, one legal document may involve leases of multiple assets that are determined to be separate lease components. These documents are typically called “master lease arrangements.” The lease and nonlease component analysis applies to these arrangements. Further, when assessing each lease component, the lease’s commencement date for each lease component may differ, thus affecting the timing of recognition and classification of the lease component (see Section 5.1 for guidance on commencement date).

For master leases, a best practice is to determine the ROU asset and lease liability for each underlying asset and record each lease component separately in the system of record. This approach will make subsequent measurement events (see Section 7) such as modifications easier to account for, as well as ease any subsequent impairment analysis required under ASC 360, *Property, Plant and Equipment*, for the ROU asset (see Section 8).

EXAMPLE 4-1: RETAIL STORE – COMPONENTS IN THE CONTRACT**FACTS**

- ▶ In Example 3-4, Retailer enters a 10-year contract for retail space (Unit A), which is part of a large mall with many retail units. We concluded the contract contains a lease.
- ▶ Unit A represents a significant portion of the west aisle of the mall and comprises two floors that can be accessed from multiple points, including external entrances to the first floor, escalators within Unit A, and internal mall entrances on the first and second floors.
- ▶ Mall Operator must provide maintenance and security services.

CONCLUSION AND ANALYSIS

- ▶ The contract contains a lease component and two nonlease components. The contract does not contain an explicit or implicit lease of land.
- ▶ Retailer determines that Unit A represents one lease component. While Retailer has the right to use two floors in the mall, it notes that there is ample access to and from each floor within the retail unit. Therefore, the individual floors cannot be used on their own without significant modifications to remove the escalators and separate the floors.
- ▶ Retailer assesses whether the lease for Unit A includes an explicit or implicit lease of land. In doing so, it notes that it does not lease the entire retail space in the mall. While Retailer leases a significant portion of mall space, there are many other tenants, and the space Retailer occupies does not represent substantially all the shopping mall space.
- ▶ Retailer also concludes that the maintenance and security services each represent a nonlease component.

See Section 3.2 of our Blueprint, [Accounting for Leases Under ASC 842](#), for further discussion.

4.2 Determining the Consideration in the Contract

In addition to identifying the components of the contract, retailers and restaurant companies must determine the consideration in the contract, which typically includes fixed payments (including in-substance fixed payments) and variable payments based on an index or rate, measured using the index or rate at the commencement date. The consideration may also include other payments depending on the contract's terms and facts and circumstances, such as the exercise price of a lessee purchase option if reasonably certain of exercise or termination penalties if the lease term reflects exercise of a lessee termination option. Any incentives paid or payable by the lessor to the lessee are included as a reduction in the consideration.

Variable payments that do not depend on an index or rate are not included. For example, variable payments based on the performance of the asset, such as payments based on a percentage of sales of the lessee's retail store or restaurant space, are excluded.

Example 4-2 illustrates determining the consideration in the contract.

EXAMPLE 4-2: RETAIL STORE— CONSIDERATION IN THE CONTRACT**FACTS**

- ▶ In Example 4-1, Retailer enters a 10-year contract for retail space (Unit A). We concluded the contract contains a lease and includes one lease component and two nonlease components.
- ▶ Annual lease payments are \$100,000, paid in arrears, and increase 5% each year during the lease. Retailer also must pay 6% of monthly net sales.
- ▶ Mall Operator must provide maintenance and security services. In exchange for providing these services, Retailer reimburses its proportionate share of Mall Operator's costs monthly.
- ▶ At the commencement date, Mall Operator paid Retailer \$30,000 as an incentive to enter the lease.

CONCLUSION AND ANALYSIS

- ▶ The consideration in the contract is \$1,227,789.
- ▶ The annual payments of \$100,000 that increase by 5% meet the definition of lease payments (see Section 5.3) and therefore are included in the consideration in the contract. The sum of those payments is \$1,257,789.
- ▶ The lease incentive of \$30,000 received from Mall Operator also meets the definition of a lease payment and reduces the total consideration in the contract.
- ▶ The payments based on percentage of sales are excluded because they are based on the performance of the asset and not on an index or rate.
- ▶ Retailer's reimbursements to Mall Operator for maintenance and security are variable payments that are not based on an index or rate, so they are not included in the consideration in the contract.

See Section 3.3.1 of our Blueprint, [Accounting for Leases Under ASC 842](#), for further discussion.

4.2.1 Property Taxes and Insurance

A lessee's requirement to pay costs that the lessor may incur in its role as lessor or owner of the underlying asset do not transfer a good or service to the lessee separate from the lease. For example, the lessor owes property taxes on its building regardless of whether it leases it. Further, when the lessor is the named insured on the building insurance policy, the insurance protects its investment in the building. Accordingly, a requirement for the lessee to pay those costs is solely a reimbursement of the lessor's costs. That the lessee pays a third party, including the taxing authority, rather than reimbursing the lessor does not change this conclusion. Also, the classification of a lease (as operating versus finance) does not affect the analysis of whether costs are considered lessor or lessee costs.

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

FIXED PAYMENTS

Payments are included in the consideration in the contract, which consideration is allocated to the lease and nonlease components in the contract on a relative standalone price basis unless the lessee elects the practical expedient not to separate for the asset class (see Section 4.4). Those payment amounts (or a portion thereof if there are nonlease components or more than one lease component) will affect the lease's measurement on the balance sheet.

Example: Lessee must pay lessor a fixed amount per year for insurance coverage on the leased asset.

VARIABLE PAYMENTS

Payments do not represent variable payments based on an index or rate and therefore are not included in the consideration in the contract. Once the variable payments are incurred, they are allocated between the lease and nonlease components using the same allocation as at the contract's inception or most recent reallocation, unless the lessee elects the practical expedient not to separate for the asset class (see Section 4.4).

Example: Lessee must reimburse lessor for actual property taxes due on the asset under lease. Property taxes do not represent an index or rate and therefore are not included in the consideration in the contract.

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

4.2.2 Common Area Maintenance Payments

A contract that contains a property lease often will require the lessee to pay for common area maintenance (CAM) services the lessor provides. As discussed in Section 4.1, such services are a nonlease component (and may represent more than one nonlease component). Lessee accounting for CAM services depends on whether the CAM payments are fixed or variable and whether the lessee has elected the practical expedient not to separate lease and nonlease components (see Section 4.4). See Section 3.3.1.3 in our Blueprint, [Accounting for Leases Under ASC 842](#), for CAM

payment arrangements frequently encountered and their accounting treatment based on whether the lessee has elected the practical expedient not to separate.



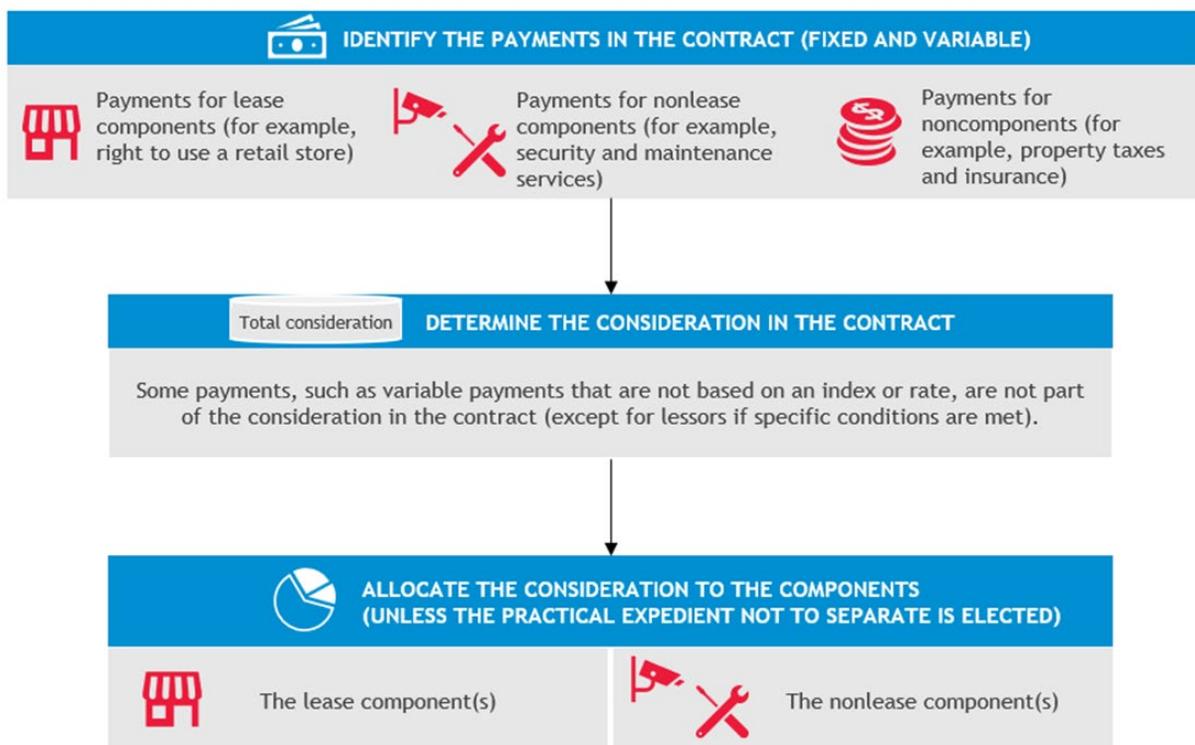
ESTIMATED CAM PAYMENTS WITH ANNUAL TRUE-UPS

A lessor may require a lessee to pay **estimated** CAM costs each year of the lease with a subsequent additional payment or refund to adjust the estimated payments to the actual CAM costs the lessor incurred (a true-up). When a lease contract does not specify fixed CAM amounts to be paid by the lessee (that is, the payments are not subject to a floor, but instead could result in a refund to the lessee), such estimated amounts are neither fixed nor variable payments that depend on an index or rate. Therefore, when determining the consideration in the contract, a lessee does not include those estimated CAM payments in the consideration (even though making a set level of CAM payments is virtually certain or highly probable). Rather, such estimated payments are treated as variable payments (that is, they are allocated to the lease and nonlease components based on the allocation at contract’s inception or most recent allocation unless the lessee elected the practical expedient not to separate).

4.3 Allocating the Consideration to Lease and Nonlease Components

If a retailer or restaurant lessee does not elect the practical expedient not to separate for an asset class (see Section 4.4), once the consideration in the contract is determined and the components are identified, the lessee allocates the consideration to the lease and nonlease components on a relative standalone price basis based on the observable standalone price of each component. A price is observable if it is the price at which either the lessor or similar suppliers sell similar lease or nonlease components on a standalone basis. If observable standalone prices are not readily available, a lessee must estimate those prices, maximizing the use of observable information. A residual approach may be acceptable if the standalone price for a component is highly variable or uncertain, which is rare for retailers and restauranters.

Also, as discussed in Section 4.1, items or activities that do not transfer a good or service to the lessee do not receive an allocation of the consideration in the contract because they are not considered components of the contract. This means that any payments in the contract for these items or activities, whether fixed or variable, are generally allocated to the components of the contract as illustrated below.



See Section 3.3.3 of our Blueprint, [Accounting for Leases Under ASC 842](#), for further discussion.

4.4 Practical Expedient Not to Separate

A retailer or restaurant lessee may elect as an accounting policy by asset class to not separate nonlease components from lease components and instead to account for each lease component and any nonlease components associated with that lease component as a single lease component. The FASB provided this practical expedient to reduce cost and complexity in applying ASC 842. While the election of the practical expedient results in a larger ROU asset and lease liability on the balance sheet and may change classification from an operating to a finance lease (see Section 6.1), our experience is that many retailer and restaurant lessees elect it for cost-benefit reasons.

If the practical expedient is not elected, the payments in the contract must be allocated between the lease and nonlease components, including variable payments even if, for example, the lease clearly provides for specific charges related to the nonlease services, such as common area maintenance. This is because lessees are not allowed to allocate variable consideration solely to the nonlease component, as lessors are.

BDO INSIGHTS – NONLEASE COMPONENTS ASSOCIATED WITH THE LEASE COMPONENT

ASC 842 does not define or provide guidance for determining whether a nonlease component is associated with the lease component. A literal read of the requirements for the practical expedient may suggest that all nonlease components, whether provided at a point in time or over time, associated with the lease component should be combined with that lease component when the lessee elects the practical expedient. However, Example 11 of ASC 842 illustrates the application of the practical expedient to a contract in which the nonlease component is **maintenance services** on construction vehicles. Also, BC149 of ASU 2016-02, *Leases*, notes that the FASB “*decided that lessees should account for lease and non-lease (typically, service) components separately (unless they elect the practical expedient).*” [Added emphasis.] Accordingly, we believe the practical expedient not to separate was primarily intended for services and other nonlease components transferred over time and that relate to the lease component such as maintenance of leased equipment or common area maintenance for leased office space, and a lessee may develop a reasonable policy on the meaning of the phrase “associated with.” For example, for nonlease components provided at a point in time, such as inventory purchases, we believe a lessee will frequently conclude that the component is not associated with the lease component because the lessee usually will be able to redirect the inventory and use it with a different asset or resell it in the market.

Example 4-3 illustrates application of the practical expedient not to separate.

EXAMPLE 4-3: RETAIL STORE – PRACTICAL EXPEDIENT NOT TO SEPARATE

FACTS

- ▶ In Example 4-2, Retailer enters a 10-year contract for retail space (Unit A). We concluded the contract contains a lease and includes one lease component and two nonlease components and that the consideration in the contract is \$1,227,789.
- ▶ Retailer elected the practical expedient not to separate for this asset class.

CONCLUSION AND ANALYSIS

- ▶ Retailer accounts for the contract as a single lease component.
- ▶ Because Retailer elected the practical expedient not to separate for this asset class, the two nonlease components (maintenance and security), which are associated with the lease component, are combined with the lease component. In effect, the contract includes a single lease component.
- ▶ Because there is a single lease component, the lease payments are the same as the consideration in the contract (\$1,227,789).
- ▶ Variable payments Retailer will incur based on store sales and to reimburse Mall Operator for maintenance and security are variable **lease** payments.

- ▶ If Retailer instead did not elect the practical expedient not to separate for this asset class, it would allocate the consideration in the contract to the lease and nonlease components (security and maintenance) on a relative standalone price basis. In that case, the amount allocated to the lease component would be used to assess lease classification and recognize the lease on the balance sheet. The amounts allocated to the security and maintenance nonlease components would be accounted for under other U.S. GAAP. All variable payments would be allocated when incurred using the same allocation basis as for the consideration in the contract.

See Section 3.3.2 of our Blueprint, [Accounting for Leases Under ASC 842](#), for further discussion.

4.5 Remeasuring and Reallocating the Consideration

Inevitably, modifications to contracts and changes in facts and circumstances may occur during the lease. A lessee must remeasure the consideration in the contract and reallocate it to the components in the contract when specific events occur. Those are:

- ▶ The effective date of a contract modification that is not accounted for as a separate contract (see Section 7.2)
- ▶ Remeasurements of the lease payments, such as a remeasurement resulting from a change in the lease term or a change in the assessment of a lessee purchase option (see Section 7.1)

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

4.6 Portfolio Approach

A retailer or restaurant lessee can apply the leases guidance at a portfolio level for leases with similar characteristics as long as the use of the portfolio approach would not differ materially from the application of ASC 842 to the individual leases in the portfolio. ASC 842-20-55-18 through 55-20 provide an example in which the portfolio approach is used in determining the discount rate for the lease.

The portfolio approach may also be used to account for multiple lease components that have the same characteristics, including commencement date; lease term; and lease classification, such as a lease of three delivery trucks or a lease of multiple floors in a multi-floor building. However, the application of the portfolio approach could result in additional complexity when the company must apply the subsequent measurement guidance of ASC 842 (for example, for a lessee, on impairment and abandonment considerations (see Section 8) or contract modification considerations (see Section 7)).

4.7 Contract Combination

When two or more contracts, at least one of which is or contains a lease, are entered at or near the same time with the same counterparty (or related parties), they must be combined and considered as a single transaction if **any** of the following criteria are met:

- ▶ They were negotiated as a package with the same commercial objective.
- ▶ The amount of consideration to be paid in one contract depends on the price or performance of another one.
- ▶ The rights to use the underlying assets conveyed in the contracts are a single lease component based on the separation guidance (see Section 4.1).

BDO INSIGHTS — COMBINATION GUIDANCE ALIGNED WITH REVENUE GUIDANCE

The guidance on contract combination above is consistent with the guidance on combining revenue contracts under ASC 606, *Revenue From Contracts With Customers*. This linkage was intentional because ASC 842 incorporates concepts from the revenue recognition guidance. See Section 2.6 of our Blueprint, [Revenue Recognition Under ASC 606](#), for more guidance on combining contracts.

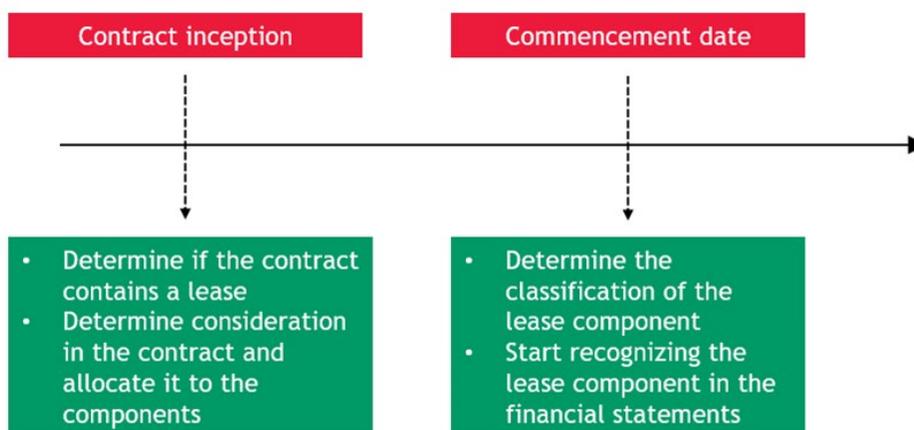
5. KEY TERMS

Once a retail or restaurant company identifies and separates components in a lease contract, it then generally accounts for the lease component(s) under ASC 842 and the nonlease component(s) under other U.S. GAAP (unless it elects the practical expedient not to separate in Section 4.4). The company applies the guidance in ASC 842 at the lease component level, and the accounting for that lease component is governed by how that lease component is classified. Key terms in ASC 842 are important to understand because they affect when a lease is recognized and how that lease is classified and measured.

5.1 Commencement Date

A lease commences when the lessee takes possession of or is given control over the use of the underlying asset. The contract does not always specify the commencement date. Often, a lessee and lessor negotiate an expected commencement date based on the asset's availability. Other times, there will be a contractual commencement date in the contract, but that date may not coincide with the commencement date for accounting purposes. Documents to consider in determining the commencement date may include letters acknowledging the transfer of possession, certificates of occupancy, and construction start dates. Importantly, the date on which payments under the lease begin is not relevant in determining the commencement date.

The lease commencement date also may be different from the contract inception date, which is usually the date the contract was executed. ASC 842 distinguishes between those dates and provides for different accounting requirements on those dates, as illustrated below.



Sometimes an agreement may involve leases of multiple assets that are determined to be separate lease components (such as “master lease arrangements,” as discussed in Section 4.1). In those cases, there may be multiple commencement dates, which affects the timing of lease classification and recognition for each lease component in the financial statements. Although a master lease agreement may specify that the lessee must take a minimum number of units or dollar value of equipment, there will be multiple commencement dates unless all the underlying assets subject to that minimum are made available for use by the lessee on the same date.

A lessor makes the underlying asset available for the lessee’s use when it gives the lessee control over the use of the asset. Accordingly, in evaluating a lease’s commencement date, it is useful to look to the definition of a lease, and more specifically, at what comprises the right to control the use of the asset, which is discussed in Section 3.2. The lessee has the right to control the use of the asset when it has both the right to obtain substantially all the economic benefits from using the identified asset and the right to direct the use of the asset. In many cases, the lessee has both of these rights when it has exclusive use of the asset – even if it is using the period to construct **lessee assets** (for example, leasehold improvements) and has not yet commenced operations – so the lease typically has commenced at that date.

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

In some lease arrangements, the lessor may make the underlying asset available for the lessee's use before the lessee begins operations or makes lease payments so that the lessee can construct a **lessee asset** (for example, leasehold improvements) during that period. Contract terms may vary and may (or may not) require the lessee to make lease payments during construction or before it begins operations, but such timing of payments is irrelevant to the assessment. ASC 842 does not explicitly discuss how to determine whether improvements are a lessee or lessor asset. However, it is important to determine if the improvements relate to a lessee asset or a lessor asset (for example, lessor's own improvements or lessee performing services on lessor's behalf) because that may affect the commencement date and consideration in the contract (and therefore the lease payments). Determining the accounting owner of the improvements requires the use of professional judgment based on the terms of the lease contract and the nature of improvements made. Factors to consider include:

FACTOR	LESSEE ASSET INDICATOR	LESSOR ASSET INDICATOR
Rights to construct improvements	Lessee decides whether to construct the improvements and how to design them.	Lease or other contract requires the lessee to construct specific improvements as designed by the lessor.
Removal or alteration of improvements	Lessee can remove or alter improvements without the lessor's approval.	Lessor does not permit or must approve removing or altering improvements.
Legal ownership of improvements	Lessee legally owns the improvements.	Lessor legally owns the improvements.
Specificity of improvements	Improvements are specific to the lessee and therefore do not have an economic value to the lessor at the end of the lease term (for example, the lessor cannot use the improvements in arrangements with other lessees).	Improvements are not specific to the lessee and therefore have an economic value to the lessor at the end of the lease term (for example, the lessor can use the improvements in arrangements with other lessees).
Economic life of improvements and lease term	The lease term is for substantially all the leasehold improvements' economic life.	The lease term is significantly less than the leasehold improvements' economic life.

Which party is deemed the accounting owner of the improvements affects lease accounting as follows:

LESSEE IS THE ACCOUNTING OWNER

- ▶ The lease commences when the lessee takes possession of the underlying asset and starts constructing its improvements. There is no distinction between the right to use the underlying asset during and after the construction period.
- ▶ Lease costs associated with building and ground leases incurred during and after construction are both for the right to use the underlying asset and

LESSOR IS THE ACCOUNTING OWNER

- ▶ The lease does not commence until construction of the lessor improvements is substantially complete, and the lessee obtains control over the use of the underlying asset, including the improvements.
- ▶ Lessee payments for the right to use the underlying asset are lease payments, regardless of the timing or form of those payments.

therefore are recognized by the lessee in accordance with ASC 842-20 (see Section 6.3). The timing of when lease payments begin does not affect the commencement date.

- ▶ Any payments from the lessor, including those made directly to a third party providing the construction services, are considered incentives to the lessee that reduce the consideration in the contract (see Section 4.2) and lease payments (see Section 5.3).
- ▶ Payments made by the lessor generally do not affect the consideration in the contract (for example, payments from the lessor to the lessee to reimburse the lessee for costs incurred on the lessor's behalf to construct the lessor asset).

Example 5-1 illustrates the concept.

EXAMPLE 5-1: RETAIL STORE – ACCOUNTING OWNERSHIP OF IMPROVEMENTS AND COMMENCEMENT DATE

FACTS

- ▶ In Example 3-4, Retailer enters a 10-year contract for retail space (Unit A).
- ▶ Retailer entered the lease with Mall Operator on November 15, 2019 (the inception date).
- ▶ Mall Operator agreed to pay Retailer \$30,000 as reimbursement for a portion of Retailer's costs for improvements to the retail space, which are specific to Retailer. Retailer has the right to remove or alter the improvements made throughout the lease term without Mall Operator's permission, as long as the resulting improvements conform with general requirements associated with the shopping mall.
- ▶ The economic life of the improvements is estimated at approximately 10 years, after which Retailer's policy is to refresh its stores.
- ▶ Mall Operator obtains the permits required to begin the improvements and grants Retailer access to the site on January 1, 2020, at which point Retailer can start constructing the improvements.
- ▶ Retailer completes the construction of the improvements and opens its retail store on March 1, 2020.

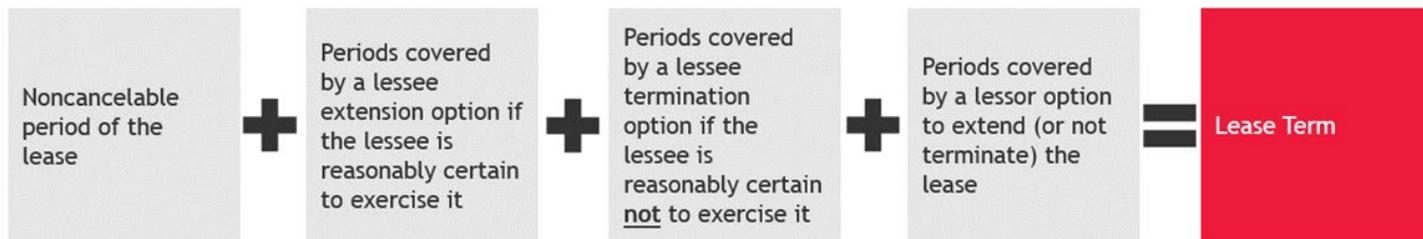
CONCLUSION AND ANALYSIS

- ▶ Retailer is the accounting owner of the improvements, and the commencement date for the lease is January 1, 2020.
- ▶ Retailer is the accounting owner of the improvements because (a) the improvements are specific to Retailer's brand and could not be used by Mall Operator in arrangements with other lessees, (b) Retailer has the right to remove or alter the improvements at any time during the lease term without Mall Owner's permission (the restrictions imposed by the shopping mall policy are protective in nature), and (c) the economic life of the improvements approximates the 10-year lease term.
- ▶ Because Retailer is the accounting owner of the improvements, the \$30,000 payment from Mall operator to Retailer is a lease incentive that reduces both the consideration in the contract and the lease payments (as discussed in Section 4.2 and Section 5.3).
- ▶ Retailer separately accounts for the leasehold improvements as an asset in accordance with ASC 360.
- ▶ Because Retailer is the accounting owner of the improvements, the commencement date of the lease is January 1, 2020. That is the date on which Mall Operator makes the space available for use by Retailer, who can then start constructing its improvements. Starting on that date, including during the construction of its leasehold improvements, Retailer has exclusive use of the retail store (it obtains substantially all economic benefits from the space) and directs its use.
- ▶ Lease classification and recognition of the lease liability, ROU asset, and lease expense begins January 1, 2020.

See Section 4.2 of our Blueprint, [Accounting for Leases Under ASC 842](#), for further discussion.

5.2 Lease Term

The lease term begins at the commencement date and includes any rent-free periods the lessor provides to the lessee. A retailer or restaurant company determines the lease term as follows:



In determining whether it is reasonably certain to exercise an option, a retailer or restauranter must consider all relevant economic factors (contract based, asset based, entity based, and market based) consistent with ASC 842-10-55-26, which include:

- ▶ Contractual terms and conditions, such as amount of lease payments or variable lease payments in optional periods compared with current market rates
- ▶ Significant leasehold improvements expected to have significant economic value for the lessee when the lessee option becomes exercisable (judgment must be consistently applied to determine what constitutes significant leasehold improvements that would require a lessee to include one or more renewal options in the initial lease term)
- ▶ Costs related to exiting the lease and signing a new one, including negotiating costs, relocation costs, costs of returning the underlying asset in a contractually specified condition and/or location, and installation costs for the new leased asset
- ▶ The importance of the underlying asset to the lessee's operations, including whether the asset is specialized or in a remote location, as well as lost revenue or other economic losses that might occur absent exercise of the option (for example, when the lessee does not have an equivalent asset and must identify and locate a replacement asset)



JUDGMENT REQUIRED IN ASSESSING REASONABLY CERTAIN THRESHOLD

Reasonably certain is a high threshold that is generally understood to encompass economic compulsion. The assessment requires the use of professional judgment and will often consider a combination of the above factors, along with how far in the future the option is exercisable (for example, an option exercisable in one year versus in five or 10 years). The further away the option is exercisable, the more evidence will be needed to conclude that a lessee is reasonably certain to exercise (or not exercise) the option. Also, an expectation of exercise alone (and without a significant economic incentive to do so) is not sufficient. A company's history of exercising renewal options may not indicate the existence of significant economic factors and therefore is not determinative. See Example 26 in ASC 842-10-55 for an illustration of the assessment of a lessee termination option.

Example 5-2 illustrates the concept.

EXAMPLE 5-2: RETAIL STORE – LEASE TERM

FACTS

- ▶ In Example 5-1, Retailer enters a 10-year contract for retail space (Unit A) in a shopping mall.
- ▶ The initial term of 10 years cannot be terminated by either party.
- ▶ The contract includes a one-time 10-year extension option. If Retailer elects to extend the term, rent during the extension period is \$150,000 annually, which is expected to approximate market rent.

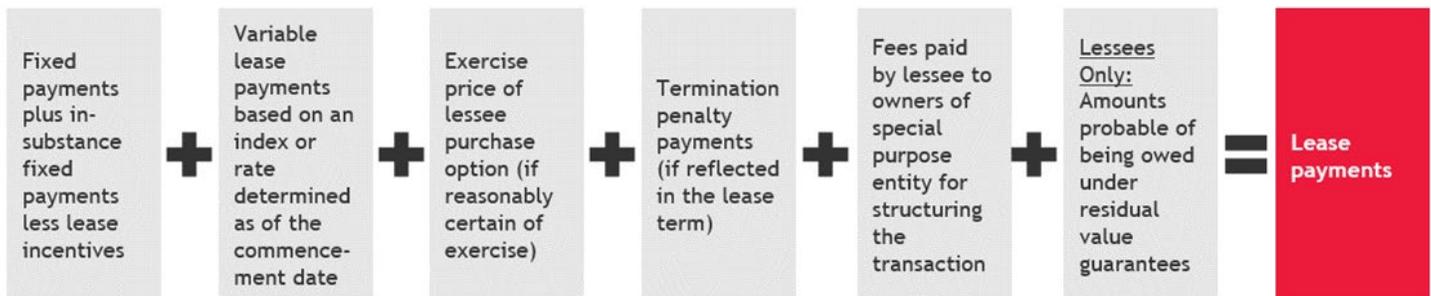
CONCLUSION AND ANALYSIS

- ▶ The lease term is 10 years.
- ▶ The starting point is to determine the noncancelable period of the lease. Here, it is 10 years.
- ▶ Retailer then evaluates the extension option. Here, there are no economic factors that would indicate Retailer is reasonably certain to exercise its extension option. While Unit A is important for Retailer’s presence in this geographical area, 10 years is a long time, and there are no economic factors that would suggest Retailer is reasonably certain to exercise the extension option. For example, payments in the renewal period are substantially the same as the amount otherwise due in the final year of the initial period and are intended to approximate market rent. Further, Retailer’s leasehold improvements are not expected to have a significant economic value at the end of the 10-year noncancelable term.
- ▶ Accordingly, the lease term is 10 years.

See Section 4.3 of our Blueprint, [Accounting for Leases Under ASC 842](#), for more guidance.

5.3 Lease Payments

Once the lease term is identified, a retailer or restaurant company can determine the lease payments, which are the following payments related to the use of the underlying asset during the lease term:



In contrast, the following are **not** lease payments:

- ▶ Variable lease payments other than those based on an index or rate – for example, payments based on either a percentage of the lessee’s sales, energy produced by a solar farm, units produced by machinery – even if there is a high likelihood based on historical and other data that a specific level of sales, energy, or units will be produced. However, if lease payments are a fixed percentage of the lessee’s sales, subject to a floor of, say, \$1,000, the \$1,000 floor represents an unavoidable payment that must be included as lease payments.
- ▶ Lessee guarantees of the lessor’s debt, which a lessee generally accounts for under ASC 460, *Guarantees*. However, if the guarantee is in substance a residual value guarantee, a lessee must apply the guidance on estimating amounts probable of being owed under residual value guarantees (shown in the graphic above). This could occur, for example, if the lender has recourse only to the leased asset (the debt is nonrecourse to the lessor) or if the lessor does not have significant assets other than the underlying asset subject to the lease.

While fixed payments, purchase options, and termination penalties are typically specified in the lease agreement, it may require judgment to determine whether variable payments are in fact unavoidable, and at what amount. Likewise, estimating the amount expected to be owed under a residual value guarantee requires judgment.

BDO INSIGHTS – IN-SUBSTANCE FIXED PAYMENTS

Leases may include in-substance fixed payments and other unavoidable payments that must be included in the lease payments. Examples of in-substance fixed payments include (1) payments that require the lower of two payments be made when a lessee has a choice about a set of payments it makes and (2) payments that do not create genuine variability (such as those that result from clauses that do not have economic substance). Reviewing the terms of the lease is important, and a retail or restaurant company must focus on identifying payments that are unavoidable. For example, if a lease contract includes payments based on the lower of X times a change in the consumer price index (CPI) or Y% (a fixed percentage), there might not be any economic substance if, based on historical changes in the CPI, the application of the leverage (X) results in Y% always being reached. In those situations, the increase based on Y% should be included in the lease payments. As another example, in a lease in which lease payments increase by the greater of the change in CPI or a fixed percentage, they will always increase by at least that percentage, making an increase of that amount an unavoidable payment that should be included as lease payments.

When assessing whether payments are unavoidable and thus represent in-substance fixed payments, a retail or restaurant lessee must determine whether there is a minimum or floor amount it must pay or whether contract terms that purport variability in payments lack economic substance. Common phrases to look for that may signal those payments or require further analysis include: “the greater of,” “not to be less than,” “minimum amount of,” and “the lesser of.”



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

As discussed in Section 4.3, the amount of lease payments results from an allocation of the consideration in the contract to the lease and nonlease components. Amounts allocated to the nonlease components are therefore not considered lease payments unless the lessee elected the practical expedient not to separate for the asset class (see Section 4.4).



FAIR MARKET RENT AS VARIABLE PAYMENTS BASED ON AN INDEX OR RATE

Variable payments based on an index or rate are included in the lease payments using the index or rate at the commencement date. Examples of variable payments based on an index or rate include payments based on CPI, the secured overnight financing rate (SOFR), and market rental rates. Accordingly, if a lease contract includes payments based on fair market rents, the calculation of lease payments includes payments based on fair market rent at the commencement date. For example, if a lease has a term of 10 years with an initial five-year noncancelable term and a reasonably certain renewal option for five years, and if rent during the renewal period is determined based on fair market rent at that time, the lessee uses the fair market rent at the commencement date of the lease to calculate lease payments during the renewal period for assessing lease classification and measuring the lease on the balance sheet. Differences in fair market rent during the renewal period versus that at lease commencement would be considered variable lease payments absent a modification or remeasurement of the lease (see Section 7).

See Section 4.4 of our Blueprint, [Accounting for Leases Under ASC 842](#), for more guidance, including for contingent lease incentives.

5.3.1 Contingent Lease Incentives Neither Received nor Receivable at Commencement Date

Lessors frequently provide lessees with tenant improvement allowances to reimburse the lessee for costs related to leasehold improvements (a lessee asset (see Section 5.1)). Reimbursements typically are contingent on the lessee incurring qualifying costs and submitting evidence to the lessor and often are subject to a maximum amount or cap. Accordingly, the lease incentive is neither received nor contractually receivable at the commencement date.

BDO INSIGHTS – ACCOUNTING FOR CONTINGENT LEASE INCENTIVES NEITHER RECEIVED NOR RECEIVABLE

As discussed above, a lease incentive might not be received or contractually receivable at the commencement date. In those cases, we believe a lessee may account for those contingent lease incentives, based on the facts and circumstances, as follows:

- ▶ **Receivable approach:** The lessee considers the lease incentive amount as a reduction of the lease payments (see Section 5.3) at the commencement date (that is, as if it were receivable for accounting purposes), which reduces the initial measurement of the lease on balance sheet (see Section 6.3). We believe this approach is acceptable if, at the commencement date, the contingent event (construction of the improvements) is probable and within the lessee's control and it is reasonably certain the lessee will incur qualifying costs subject to reimbursement that will equal or exceed the maximum incentive amount specified in the contract. If those conditions are not met, the lessee applies the resolution of contingency approach discussed below. See Example 4-9 in our Blueprint, [Accounting for Leases Under ASC 842](#), for an illustration of this approach.
- ▶ **Resolution of contingency approach:** The contingent lease incentive is not included in the lease payments at the commencement date and therefore does not affect the initial measurement of the lease. When the contingency on which the variable lease incentive is based is resolved (that is, when the incentive is received or becomes receivable), the lessee remeasures the lease payments consistent with ASC 842-10-35-4(b). However, lease classification and the discount rate for the lease are not reassessed or updated (see Section 7.1). See Example 4-10 in our Blueprint, [Accounting for Leases Under ASC 842](#), for an illustration of this approach.

We believe the lessee should apply the approaches above consistently in similar facts and circumstances.

BDO INSIGHTS – ACCOUNTING FOR CONTINGENT LEASE INCENTIVES NEITHER RECEIVED NOR RECEIVABLE WHEN LEASE PAYMENTS ARE ENTIRELY VARIABLE

In some cases, a lease contract might have no lease payments (as defined in ASC 842 (see Section 5.3)). For example, a lease of retail space might require only rent based on a fixed percentage of the lessee's gross sales each month. If there are no fixed or other payments that meet the definition of lease payments at the commencement date, there is no lease recognized on balance sheet (assuming there are no prepaid lease payments or initial direct costs). Accordingly, if the lease contract provides for contingent lease incentives related to tenant improvement allowances, the analysis differs from the BDO Insights above because there are no lease payments (and therefore, no lease liability or ROU asset) against which to offset the lease incentive amounts.

In those cases, we believe the following approaches may be acceptable based on the facts and circumstances:

- ▶ **Receivable approach:** The lessee may apply the receivable approach discussed in the BDO Insights above if the conditions to apply that approach are met at the commencement date. In that case, the lessee recognizes a lease receivable and a lease incentive liability. We believe it would be inappropriate for a lessee to measure a ROU asset at less than zero or to recognize the amount immediately through income. When or as the lessor reimburses the lessee, the lessee reduces the lease receivable balance. The liability is reduced on a straight-line basis over the lease term as an offset to lease cost (for example, rent as a percentage of gross sales) not to exceed lease cost recognized in the period. Time value of money (and therefore the discount rate for the lease) might need to be considered if there is a significant lapse of time between the commencement date of the lease and when the lease incentive is expected to be received (or becomes receivable). If so, the reduction in liability and interest on the lease receivable are recorded as an offset to lease cost over the lease term. If the conditions

to apply the receivable approach are not met, the lessee applies the resolution of contingency approach discussed below.

- ▶ **Resolution of contingency approach:** The lessee does not recognize any lease incentive at the commencement date (consistent with the BDO Insights above), so no amounts are initially recognized for the lease. When the contingency on which the lease incentive is based is resolved (that is, when the incentive is received or becomes receivable), the lessee remeasures the lease payments consistent with ASC 842-10-35-4(b). Because there continue to be no lease payments other than the lease incentive (which reduces lease payments and therefore results in negative lease payments), we believe the lessee should recognize a lease incentive receivable (or cash, if received) and a corresponding liability. In other words, we believe it would be inappropriate for a lessee to measure an ROU asset at less than zero or to recognize the amount immediately through income. The liability is then reduced on a straight-line basis over the remaining lease term (that is, prospectively) as an offset to lease cost (for example, rent as a percentage of gross sales) not to exceed lease cost recognized in the period.

We believe the lessee should apply the approaches above consistently in similar facts and circumstances.

5.4 Initial Direct Costs

Initial direct costs are defined as incremental lease costs that would not have been incurred if the lease had not been obtained. Initial direct costs include, for example, commissions and payments made to encourage an existing tenant to terminate its lease.

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

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

The initial direct costs guidance in ASC 842 is aligned with the definition of costs to acquire a contract under ASC 606.

A lessee allocates initial direct costs to the separate lease components on the same basis as the lease payments and includes them in the measurement of the ROU asset (see Section 6.3).

Example 5-3 illustrates the concept.

EXAMPLE 5-3: RETAIL STORE – INITIAL DIRECT COSTS

FACTS

- ▶ In Example 3-4, Retailer enters a 10-year lease for retail space (Unit A).
- ▶ Retailer incurred the following costs related to the lease:
 - \$10,000 for employee wages for negotiating lease terms and conditions
 - \$20,000 for commissions paid to a broker
 - \$15,000 for external legal fees

CONCLUSION AND ANALYSIS

- ▶ Lessee capitalizes broker fees as initial direct costs and expenses the other costs as incurred.
- ▶ Retailer recognizes as initial direct costs only the fees paid to the broker (\$20,000) because the external legal fees and employee wages would have been incurred even if Retailer had not obtained the lease.

5.5 Discount Rate

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 must use its incremental borrowing rate.

The rate implicit in the lease is the interest rate that at a given date causes the aggregate present value of the lease payments and the amount 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.

The incremental borrowing rate is the interest rate a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment.

A lessee that is not a public business entity can use a risk-free discount rate determined using a period comparable with that of the lease term as an accounting policy election by asset class. Risk-free rates are typically lower than collateralized rates and as such will result in higher ROU assets and lease liabilities and may change lease classification. Also, if a non-public business retailer or restaurant elects this option and later engages in an initial public offering, it would have to recast the financial statements in its filing by remeasuring its ROU assets and liabilities using a discount rate based on a collateralized basis.

BDO INSIGHTS – DISCOUNT RATE FOR THE LEASE

With rare exception (such as a common control related party lease), a lessee typically cannot readily determine the rate implicit in the lease because it does not have all required lessor inputs. Accordingly, a lessee typically uses its incremental borrowing rate, which is a secured (recourse) rate that is fully collateralized (that is, it cannot be undercollateralized). The lessee is not limited to the underlying asset and may use other collateral if accepted by a lender, although the lessee should consider that collateral's nature and quality (liquidity).

ASC 842 does not explicitly refer to "lease term" in the definition of incremental borrowing rate. Depending on the lease contract, we believe a lessee may use as an accounting policy either the lease term (as determined under ASC 842 (see Section 5.2)) or the lease term plus options not reasonably certain of exercise. However, if the lessee elected the risk-free rate practical expedient for the asset class, it must use the lease term because that is specifically required.

Payments are determined based on the ASC 842 definition of lease payments (see Section 5.3). Accordingly, variable payments other than those based on an index or rate are not considered. We also believe that the determination of the incremental borrowing rate should be consistent with the pattern of lease payments and how such payments are reflected in the measurement of the lease liability, which generally should result in the use of a rate that reflects an amortizing loan.

The rate should reflect a rate that would be paid by the retail or restaurant lessee on borrowings that are entered into at or near the same time, in the same or similar jurisdiction, and in the same currency.

Using a weighted average cost of capital, property yield, cost of money, or blended rate (mix of secured and unsecured rates) is not appropriate under ASC 842.



RISK-FREE RATE ELECTION DOES NOT APPLY TO ALL LEASES

A lessee must use the rate implicit in the lease when it is readily determinable, even if it elected the risk-free discount rate accounting policy for the asset class to which the lease contract relates. While the rate implicit in the lease is typically not readily determinable, it may be in some leases (for example, common control leases).

See Section 4.6 of our Blueprint, [Accounting for Leases Under ASC 842](#), for more guidance.

5.6 Economic Life

ASC 842 defines economic life as “*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.*” Consequently, we believe the definition of economic life contemplates the period over which the asset is economically usable (provides benefits) for both the current lessee and future lessees or owners with normal repairs and maintenance.

5.7 Fair Value

ASC 842 defines fair value as “*the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date,*” which is the same definition of fair value used in ASC 820, *Fair Value Measurement*. As a result, a retailer or restaurant lessee applies the guidance in ASC 820 when determining the fair value of an underlying asset.

BDO INSIGHTS – DETERMINING FAIR VALUE WITHOUT UNDUE COSTS AND EFFORTS

ASC 842-10-55-3 notes that it may not always be practicable for a company to determine the fair value of an underlying asset, meaning that a reasonable estimate cannot be made without undue cost or effort. If not practicable, the entity assesses lease classification without considering the present value classification criterion (see Section 6.1).

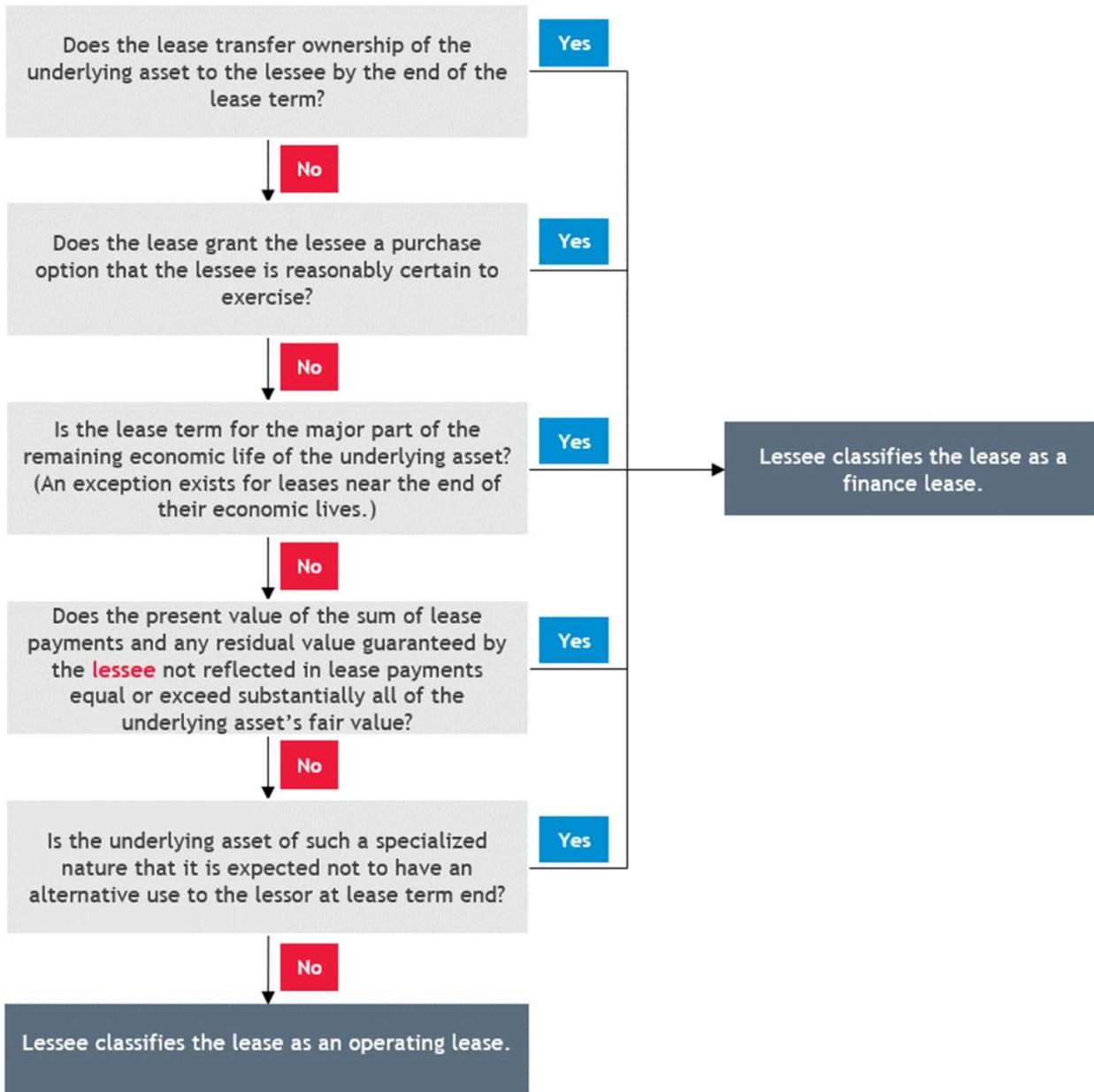
However, we believe fair value can be determined without undue cost or effort in most cases. A retail or restaurant company is not always required to obtain an appraisal or similar valuation and may be able to make a reasonable estimate of fair value. For example, for the lease of one floor of a building,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

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

6. RECOGNITION AND MEASUREMENT

6.1 Lease Classification

A retailer or restaurant lessee determines lease classification at the commencement date by analyzing the facts in the steps shown below:



BDO INSIGHTS – CLASSIFICATION WHEN NOT USING THE ALLOWED BRIGHT LINES

ASC 842 uses terms such as “major part” when discussing the lease term criterion and “substantially all” when discussing the present value criterion but also allows lessees to use 75% as a threshold for assessing major part and at least 90% as a threshold for assessing substantially all. The FASB provided those thresholds to assist companies in establishing internal accounting policies and controls and in applying the requirements in an operational and scalable manner. While retail and restaurant companies do not have to apply those bright lines, if they deviate from those lines, they must consider how best to articulate accounting policies to achieve consistent classification for similar leases, while adhering to the economic structure of the arrangement and the lease classification principles in ASC 842. While companies could adopt a policy that establishes ranges (like the approach taken when determining whether a contingent liability is probable under ASC 450-20, *Contingencies – Loss Contingencies*) they should also consider whether those terms are consistently applied, considering other areas of U.S. GAAP. For example, the phrase “substantially all” is used in many other areas of U.S. GAAP and is understood to generally be at or around 90%. A company should document its definition of the terms “substantially all” and “major part” for lease classification. Deviating from the bright lines will require companies to document their considerations in arriving at the thresholds used and demonstrate that the use of such thresholds is appropriate.

See Section 4.9 of our Blueprint, [Accounting for Leases Under ASC 842](#), for more guidance.

6.2 Short-Term Leases

A short-term lease is a lease that at the commencement date has a lease term of 12 months or less and does not include a lessee purchase option that is reasonably certain of exercise. ASC 842 provides lessees with a practical expedient under which the balance sheet recognition provisions are not applied to short-term leases. This election is made by class of underlying asset to which the right of use relates (for example, office equipment, real estate, or vehicles). If elected, leases that qualify for the exemption are not recognized on the balance sheet, and lease payments are recognized on a straight-line basis over the lease term. Variable lease payments are also recognized in the period in which the obligation for those payments is incurred.

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

BDO INSIGHTS – SHORT-TERM LEASES NOT SCOPED OUT OF ASC 842

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

See Section 5.4 of our Blueprint, [Accounting for Leases Under ASC 842](#), for further discussion.

6.3 Recognition and Initial Measurement

A lessee recognizes an ROU asset and lease liability at the lease commencement date and initial measurement is the same for operating and financing leases. The following table summarizes the accounting treatment by the lessee:

	FINANCE LEASES		OPERATING LEASES	
	ROU ASSET	LEASE LIABILITY	ROU ASSET	LEASE LIABILITY
Balance Sheet	ROU asset is initially measured at the amount of the lease liability plus initial direct costs and prepaid lease payments less lease incentives received.	Lease liability is initially measured at the present value of the unpaid lease payments, discounted using the discount rate for the lease.	Initial measurement is the same as for finance leases.	
	Subsequently, ROU asset is typically amortized on a straight-line basis to the earlier of the end of its useful life or lease term. ²	Subsequently, lease liability is increased to reflect interest using the interest method and decreased for lease payments made.	Amortize based on difference between periodic straight-line lease cost (including amortization of initial direct costs) and periodic interest accretion.	Subsequent measurement is the same as for finance leases.
Income Statement	<ul style="list-style-type: none"> ▶ Recognize amortization of ROU asset. ▶ Recognize interest on lease liability. ▶ Recognize variable lease payments not included in the lease liability when incurred. ▶ Recognize an impairment loss if the ROU asset is impaired under ASC 360 (see Section 8). 		<ul style="list-style-type: none"> ▶ Recognize a single lease cost generally on a straight-line basis. ▶ Recognize variable lease payments not included in the lease liability when incurred. ▶ Recognize an impairment loss if the ROU asset is impaired under ASC 360 (see Section 8). After an impairment, recognition of lease cost is no longer on a straight-line basis (but still recognized as a single lease cost). 	

Also, note the following:

- ▶ ASC 842 considers the right to control the use of the underlying asset the equivalent of physical use. Therefore, recognition of lease cost under the operating lease model or amortization of the ROU asset for finance leases is not affected by how much the lessee uses the underlying asset and therefore is typically on a straight-line basis.
- ▶ The ROU asset is a nonmonetary asset, while the lease liability is a monetary liability. Therefore, when accounting for a lease denominated in a foreign currency, if remeasurement into the lessee’s functional currency is required, the lease liability is remeasured using the current exchange rate, while the ROU asset is remeasured using the exchange rate as of the commencement date.
- ▶ Once recognized on the balance sheet, ASC 842 includes requirements for lessees to update the measurement of leases for specific lease modifications and other reassessment events. Lessees will need robust processes and controls to timely and completely identify and account for such events (see Section 7).

² However, if the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee amortizes the ROU asset to the end of the useful life of the underlying asset.

BDO INSIGHTS – VARIABLE PAYMENTS BASED ON AN INDEX OR RATE

As discussed in Section 5.3, variable lease payments that depend on an index or rate are included in the lease payments and are initially measured using the index or rate at the commencement date. Other variable payments (for example, those based on the lessee's sales) typically are not included in the lease payments.

Subsequent changes in the index or rate do not represent the resolution of a contingency, so absent another event requiring remeasurement of the lease payments (see Section 7), the amounts resulting from the difference between the index or rate at commencement and upon subsequent changes are recognized as variable lease payments. When lease payments are remeasured for another reason (for example, when there is a change in the lease term), a lessee remeasures variable lease payments that depend on an index or rate using the index or rate at the remeasurement date.

BDO INSIGHTS – LESSEE COSTS TO READY THE LEASED ASSET FOR ITS INTENDED USE

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

The SEC staff addressed this question in a [speech](#), saying that costs paid to third parties (other than the lessor) to place a leased asset into its intended use may be in the scope of other U.S. GAAP (such as ASC 340-40, *Other Assets and Deferred Costs – Contracts With Customers*) or may be expensed if not under other U.S. GAAP. Alternatively, the lessee may analogize to the ASC 360 guidance and therefore capitalize the costs incurred to place the leased asset into its intended use.

Accordingly, we believe that to the extent the costs are not in the scope of other U.S. GAAP, either approach (expensing or capitalizing under ASC 360) is acceptable as an accounting policy election applied at the entity level and disclosed if material. If the lessee elects to capitalize the costs to ready the leased asset for its intended use, we believe the lessee can recognize the costs as part of the ROU asset or as a separate asset. Regardless of the lessee's choice, the amortization pattern of those costs should be the same, and the lessee should include the assets in the same asset group for impairment testing purposes.

**ROU ASSET INITIAL MEASUREMENT MAY EXCEED THE UNDERLYING ASSET'S VALUE**

ASC 842 does not include any cap on the initial measurement of an ROU asset, so the initial measurement of an ROU asset may exceed the underlying asset's fair value at the commencement date. In those situations, a lessee must first verify the inputs and assumptions used in measuring the lease (for example, the incremental borrowing rate). If the inputs and assumptions are appropriate and the initial measurement of the ROU asset exceeds the underlying asset's fair value, the lessee must consider whether the ROU asset (or asset group to which the leased asset relates) is not recoverable and thus may be impaired (see Section 8).

Example 6-1 illustrates application of the initial measurement guidance.

EXAMPLE 6-1: RETAIL STORE – INITIAL MEASUREMENT OF LEASE LIABILITY AND ROU ASSET**FACTS**

- ▶ In Example 4-3, Retailer enters a 10-year lease for retail space (Unit A), which is part of a large mall.
- ▶ Retailer elected the practical expedient not to separate, and the contract therefore includes one single lease component.
- ▶ The lease payments (and consideration in the contract) are \$1,227,789. Those include (a) the sum of the annual lease payments of initially \$100,000, paid in arrears, increasing 5 percent each year during the lease term less (b) \$30,000 of lease incentives.
- ▶ Payments Retailer makes based on percentage of sales and to reimburse Mall Operator's costs for maintenance and security are variable lease payments, which are excluded from the measurement of the lease.
- ▶ Retailer incurred various lease-related costs of which only \$20,000 (broker commissions) met the definition of initial direct costs (see Example 5-3).
- ▶ The rate implicit in the lease is not readily determinable. Retailer's incremental borrowing rate (IBR) at lease commencement is 6%. Retailer did not elect the risk-free rate practical expedient for this asset class.
- ▶ Initial measurement of the lease on the balance sheet is the same regardless of lease classification.

CONCLUSION AND ANALYSIS

- ▶ The unpaid lease payments are discounted using a 6% discount rate (Retailer's IBR) because the rate implicit in the lease is not readily determinable and Retailer did not elect the risk-free discount rate practical expedient.
- ▶ The lease incentives of \$30,000 are reflected in the initial measurement of the ROU asset but do not affect the initial measurement of the lease liability because they were received at the commencement date.
- ▶ The lease liability at the commencement date is \$904,337, calculated as follows:

	PAYMENT
Year 1	\$ 100,000
Year 2	105,000
Year 3	110,250
Year 4	115,763
Year 5	121,551
Year 6	127,628
Year 7	134,010
Year 8	140,710
Year 9	147,746
Year 10	155,133
Undiscounted Payments	\$ 1,257,789
Present Value (PV) (6%) =	\$ 904,337

- ▶ Retailer initially measures the ROU asset at \$894,337, calculated as follows:

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

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

Debit	ROU asset	\$ 894,337
Debit	Operating expenses*	25,000
Credit	Lease liability	\$ 904,337
Credit	Cash**	15,000

* Legal fees and employee wages (see Example 5-3). For simplification, this example assumes that those expenses are incurred at the commencement date.

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

BDO INSIGHTS – LEASE INCENTIVES AND LEASEHOLD IMPROVEMENTS

As illustrated in Example 6-1, lease incentives paid by the lessor at or before the commencement date reduce the initial measurement of the ROU asset (if the lease incentive were payable, rather than paid, by the lessor at the commencement date, it would reduce the initial measurement of the lease liability and, in turn, of the ROU asset). This is because lease incentives paid or payable to the lessee reduce the total consideration in the contract (see Section 4.2) and therefore also reduce the lease payments (see Section 5.3).

In Example 6-1, Mall Operator paid Retailer \$30,000 as an incentive to enter the lease. If the lease incentives reimburse the lessee for the cost of improving the leased asset and the lessee is the accounting owner of the improvements (see Section 5.1 and Example 5-1), the lessee capitalizes the full cost of the leasehold improvements (rather than only the cost of improvements it paid for). For example, if costs to construct the leasehold improvements are \$40,000 and the lessor reimburses the lessee \$30,000, the lessee recognizes leasehold improvements of \$40,000. The \$30,000 in lease incentives paid by the lessor affects the measurement of the lease for the retail space, not the accounting for the leasehold improvements.

See Section 5.5 of our Blueprint, [Accounting for Leases Under ASC 842](#), for further discussion.

6.4 Subsequent Measurement

The FASB concluded that operating leases are different from finance leases and purchases of nonfinancial assets; thus, ASC 842 provides for different financial statement reporting for the ROU asset between operating leases and finance leases. However, the lessee's subsequent accounting for lease liabilities is the same, based on the view that the lessee should measure lease liabilities in a manner as it would other similar financial liabilities (that is, on an amortized cost basis), regardless of lease classification. Lease classification is discussed in Section 6.1.

6.4.1 Finance Leases

After the commencement date, a lessee accounts for its finance leases in its financial statements (absent impairments, modifications, and reassessments, which are discussed in Sections 7 and 8) as follows:

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

*Unless the costs are included in the carrying amount of another asset in accordance with other U.S. GAAP.

Example 6-2 illustrates application of the subsequent measurement guidance to a finance lease.

EXAMPLE 6-2: RETAIL STORE – SUBSEQUENT MEASUREMENT (FINANCE LEASE)

FACTS

- ▶ Assume the same facts as in Example 6-1, in which the ROU asset and lease liability were initially measured at \$894,337 and \$904,337, respectively, except that:
 - The lease is for equipment rather than retail space.
 - At lease commencement, the remaining economic life of the equipment is 12 years.
- ▶ There is no transfer of ownership or purchase option.

CONCLUSION AND ANALYSIS

- ▶ Retailer classifies the lease as a finance lease because the lease term (10 years) is for a major part of the remaining economic life of the underlying asset (see Section 6.1).
- ▶ Because there is no transfer of ownership or purchase option, the ROU asset is amortized from the commencement date to the earlier of the end of its useful life or the lease term, which is 10 years.
- ▶ Lease liability accounting throughout the lease term (assuming no modifications and remeasurements) is:

	BEGINNING BALANCE	INTEREST (6%)	PAYMENT	CLOSING BALANCE
Year 1	\$ 904,337	\$ 54,260	\$ (100,000)	\$ 858,598
Year 2	858,598	51,516	(105,000)	805,114
Year 3	805,114	48,307	(110,250)	743,170
Year 4	743,170	44,590	(115,763)	671,998
Year 5	671,998	40,320	(121,551)	590,767
Year 6	590,767	35,446	(127,628)	498,585
Year 7	498,585	29,915	(134,010)	394,491
Year 8	394,491	23,669	(140,710)	277,450
Year 9	277,450	16,647	(147,746)	146,352
Year 10	146,352	8,781	(155,133)	—

► ROU asset annual amortization is 89,434 (894,337/10).

See Section 5.6.1 of our Blueprint, [Accounting for Leases Under ASC 842](#), for further discussion.

6.4.2 Operating Leases

After the commencement date, a retailer or restaurant lessee accounts for its operating leases in its financial statements (absent impairments, modifications, and reassessments, which are discussed in Sections 7 and 8) as follows:

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

*Unless the costs are included in the carrying amount of another asset in accordance with other U.S. GAAP.

Example 6-3 illustrates the subsequent measurement of an operating lease.

EXAMPLE 6-3: RETAIL STORE – SUBSEQUENT MEASUREMENT (OPERATING LEASE)**FACTS**

- ▶ Assume the same facts as in Example 6-1, in which:
 - The ROU asset and lease liability were initially measured at \$894,337 and \$904,337, respectively.
 - The unpaid lease payments were \$1,257,789 on an undiscounted basis.
 - Initial direct costs were \$20,000 and lease incentives received were \$30,000.
- ▶ The lease is an operating lease.
- ▶ Variable lease payments (payments based on Retailer's percentage of sales and to reimburse Mall Operator's costs for maintenance and security) are not illustrated herein and would be recognized as incurred.

CONCLUSION AND ANALYSIS

- ▶ The accounting for the lease liability is the same as in Example 6-2 on finance leases, assuming no modifications and remeasurements, because accounting for operating lease liabilities and finance lease liabilities is the same.
- ▶ For the ROU asset, Retailer first calculates the total lease cost to be recognized over the lease term:

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

*This amount reflects the total lease payments and comprises (a) \$1,257,789 of fixed payments for the 10-year lease term less (b) the lease incentives of \$30,000.

- ▶ Accounting for the ROU asset, assuming no impairment, modifications, or reassessments, is as follows:

	OPENING BALANCE	PERIODIC LEASE COST	INTEREST (6%)	ROU AMORTIZATION	CLOSING BALANCE
	[A]	[B]	[C]	[D] = [B] + [C]	[A] + [D]
Year 1	\$ 894,337	\$ (124,779)	\$ 54,260	\$ (70,519)	\$ 823,819
Year 2	823,819	(124,779)	51,516	(73,263)	750,556
Year 3	750,556	(124,779)	48,307	(76,472)	674,084
Year 4	674,084	(124,779)	44,590	(80,189)	593,895
Year 5	593,895	(124,779)	40,320	(84,459)	509,436
Year 6	509,436	(124,779)	35,446	(89,333)	420,103
Year 7	420,103	(124,779)	29,915	(94,864)	325,239
Year 8	325,239	(124,779)	23,669	(101,109)	224,130
Year 9	224,130	(124,779)	16,647	(108,132)	115,998
Year 10	115,998	(124,779)	8,781	(115,998)	—

See Section 5.6.2 of our Blueprint, [Accounting for Leases Under ASC 842](#), for further discussion.

6.5 Leasehold Improvements

6.5.1 Leasehold Improvements – Leases Other Than Common Control

Leasehold improvements are amortized over the shorter of the useful life of those improvements or the remaining lease term. That is so unless the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, in which case the lessee amortizes the leasehold improvements to the end of their useful life.

6.5.2 Leasehold Improvements – Common Control Leases

ASU 2023-01 addresses the accounting for leasehold improvements in common control leases. Common control leases often have a short lease term (for example, one year), even if the lessee makes significant leasehold improvements with an estimated useful life significantly longer than the lease term (for example, 10 years). A lessee amortizes leasehold improvements associated with a lease between entities under common control over the useful life of those improvements to the common control group, regardless of the lease term, if it controls the use of the underlying asset through a lease. If the lessor obtained the right to control the underlying asset's use through a lease with another entity outside the common control group, the amortization period cannot exceed that of the common control group determined in accordance with ASC 842-20-35-12.

If the lessee loses control of the use of the leased asset to another entity in the common control group, the remaining balance of leasehold improvements is accounted for as a transfer between entities under common control through an adjustment to equity (or net assets for an NFP entity).

Those requirements apply to all entities, including public business entities. The FASB has also clarified that leasehold improvements associated with common control leases are assessed for impairment by applying the guidance in ASC 360 for long-lived assets to be exchanged or distributed to owners in a spinoff, considering the improvements' useful life to the common control group.³

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

See Section 5.6.3.2 of our Blueprint, [Accounting for Leases Under ASC 842](#), for further discussion.

7. REMEASUREMENTS AND MODIFICATIONS

The discussion in prior sections illustrates the initial and subsequent accounting for leases, assuming no changes occur. However, ASC 842 requires lessees to remeasure leases to provide more up-to-date and useful information to financial statement users. Those remeasurements include remeasurement events (other than modifications) and modifications.

7.1 Remeasurements (Other Than Modifications)

A key input and assumption used in the initial accounting for a lease is the assessment of options (extensions, terminations, and purchase options), which affects the determination of the lease term and lease payments. The FASB decided that lessees would be required to update their assessments about those options and therefore remeasure leases on the balance sheet to provide users with more relevant information. However, to reduce the burden on preparers, the FASB decided to limit such remeasurements to significant events or changes in circumstances that are within the lessee's control. Lessees must remeasure the lease payments when a contingency on which some or all of the variable lease payments are based is resolved such that the payments become fixed (that is, the payments now meet the definition of lease payments). They also must reassess amounts probable of being owed under residual value guarantees, which are part of the lease payments, to reflect current economic conditions.

³ ASC 360-10-40-4.

Accordingly, ASC 842 requires lessees to remeasure the lease payments upon the occurrence of the following events:

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

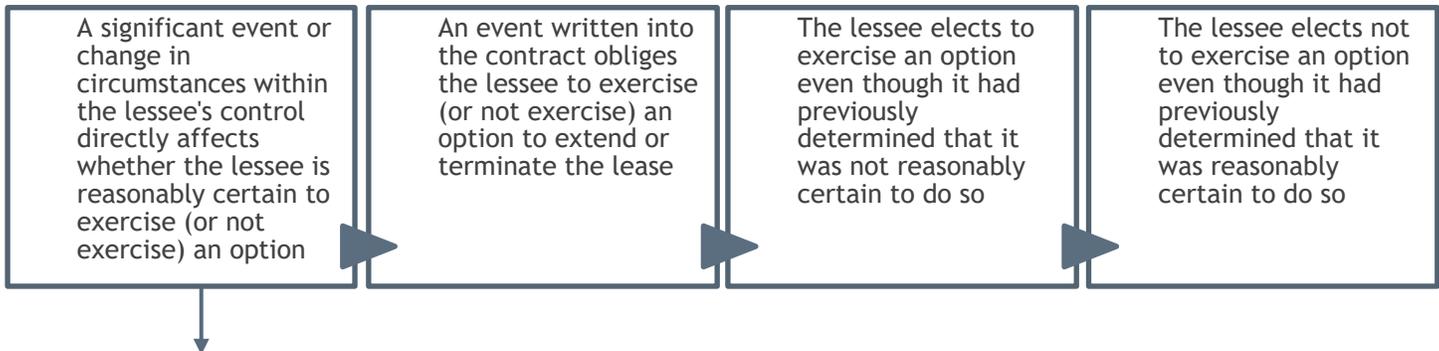
* When the lessee updates the discount rate, it determines the new rate at the remeasurement date based on the remaining lease term and the remaining lease payments.

** When the lessee reassesses lease classification, it does so based on the facts and circumstances at the reassessment date (for example, based on the fair value and remaining economic life of the underlying asset at that date).

Also note:

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

Remeasurement events driven by reassessment of the lease term and purchase options are one of the most common types experienced by retail or restaurant lessees. A retailer or restauranter must reassess the lease term or its option to purchase the underlying asset only if and at the point in time that any of the following occur:



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

- ▶ Constructing leasehold improvements that are expected to have significant value when the option becomes exercisable (common repair and maintenance activities would typically not be considered significant)
- ▶ Making significant modifications or customizations to the underlying asset
- ▶ Making a business decision that is directly relevant to the ability to exercise an option, such as extending the lease of a complementary asset
- ▶ Subleasing the underlying asset for a period beyond the option's exercise date

However, changes in market factors alone, such as market rates to lease comparable assets, do not trigger a reassessment and a requirement to test an asset group that includes the ROU asset for impairment does not necessarily require reassessment of the lease term or purchase options. Rather, the lessee must determine whether the impairment trigger represents a requirement to reassess the lease term or purchase option. For example, an asset group that is tested for impairment because of a history of cash flow losses or a significant decrease in the market price of a long-lived asset may not alone require reassessing the lease term or purchase options.

BDO INSIGHTS – BUSINESS DECISIONS AND RENEWAL OPTIONS

Business decisions may affect key assumptions such as the lease term or exercise of lessee purchase options and trigger reassessments. A lessee should work with business partners in the organization to develop processes to identify and track which type of decisions are relevant to the assessment and when these decisions are made so that decisions that trigger reassessment are timely identified and documented. It is also critical to understand the process for making those decisions and when they become binding on the organization. For example, a decision to update all locations with a new brand image over two years could result in a reassessment at that time for all affected leases or only as each location is updated depending on corporate policies and processes.

It is also common for companies in the retail and restaurant industries to exercise renewal options that were not previously considered reasonably certain of exercise. Companies must determine when those renewal periods are effective, thus triggering a reassessment, paying attention to notice periods that could result in reassessment before the start of the renewal period. Conversely, the issuance of a letter of intent might not be legally binding and thus may not trigger the reassessment requirement.

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



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

The accounting for a lease that is remeasured because of a change in the assessment of the lease term or a purchase option is essentially like the accounting for a new lease because the lessee re-performs all steps required for a new lease (for example, measure and allocate the consideration in the contract, determine the discount rate, assess lease classification). Example 7-1 illustrates this concept.

EXAMPLE 7-1: RETAIL STORE – REASSESSMENT OF THE LEASE TERM (OPERATING LEASE)

FACTS

- ▶ Assume the same facts as in Example 6-3, in which the lease of the retail store is an operating lease.
- ▶ The contract includes one 10-year extension option, with annual lease payments of \$150,000 during the optional period.
- ▶ At the commencement date, Retailer concluded it was not reasonably certain to exercise the extension option (see Section 5.2).
- ▶ During the first five years of the lease, the retail store's financial performance was higher than initially expected, and Retailer installs significant additional leasehold improvements at the beginning of Year 6. Those improvements are expected to have significant economic value for Retailer at the end of Year 10. Consequently, construction of the leasehold improvements is considered a significant event or change in circumstances that directly affects whether Retailer is reasonably certain to exercise the extension option.
- ▶ Example 6-2 (for the lease liability) and Example 6-3 (for the ROU asset) discussed the initial accounting for the lease throughout the lease term, absent a remeasurement or modification. At the reassessment date, the lease liability and ROU asset have carrying amounts of \$590,767 and \$509,436, respectively.

CONCLUSION AND ANALYSIS

- ▶ At the beginning of Year 6, Retailer must reassess the lease term and remeasure the lease payments.
- ▶ Upon reassessing the lease term at the beginning of Year 6, Retailer concludes it is reasonably certain to exercise the option to extend the lease for an additional 10 years.
- ▶ Retailer remeasures the lease payments (the consideration in the contract) to reflect the revised lease term. Because it elected not to separate nonlease components from the associated lease component, there is no reallocation of the consideration necessary. In other words, there continues to be a single lease component.
- ▶ Considering the extended remaining lease term (15 years in total at the reassessment date) and remaining lease payments, as well as its current borrowing costs, Retailer determines that its incremental borrowing rate at the beginning of Year 6 is 8%.
- ▶ Retailer reassesses lease classification based on the fair value and remaining economic life of the underlying asset at the beginning of Year 6 and determines the lease continues to be an operating lease.
- ▶ Retailer remeasures the lease liability using the revised lease payments and updated discount rate, resulting in an updated lease liability of \$1,243,959, or an increase of \$653,192 (1,243,959 - 590,767).
- ▶ The remeasurement of the lease liability is recognized as an adjustment to the ROU asset. Accordingly, the carrying value of the ROU asset immediately after the remeasurement is \$1,162,628 (509,436 + 653,192).
- ▶ Because the lease is classified as an operating lease, Retailer updates the periodic lease cost for the remainder of the lease (15 years):

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

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

**Prior periodic lease cost of \$124,779 x 5 years (see Example 6-3).

- ▶ Following the remeasurement, and assuming no impairment, modifications, or other reassessments, Retailer recognizes a single lease expense of \$141,593 each year for the remainder of the lease term (including the renewal period).
- ▶ The amortization of the ROU asset is determined as the difference between the single lease cost of \$141,593 and the periodic interest accretion on the lease liability. For example, for Year 6, amortization of the ROU asset is \$42,076 (\$141,593 - \$99,517).
- ▶ The table summarizes the accounting for the lease after the remeasurement and throughout the remaining lease term (assuming no impairment, modifications, or other reassessments):

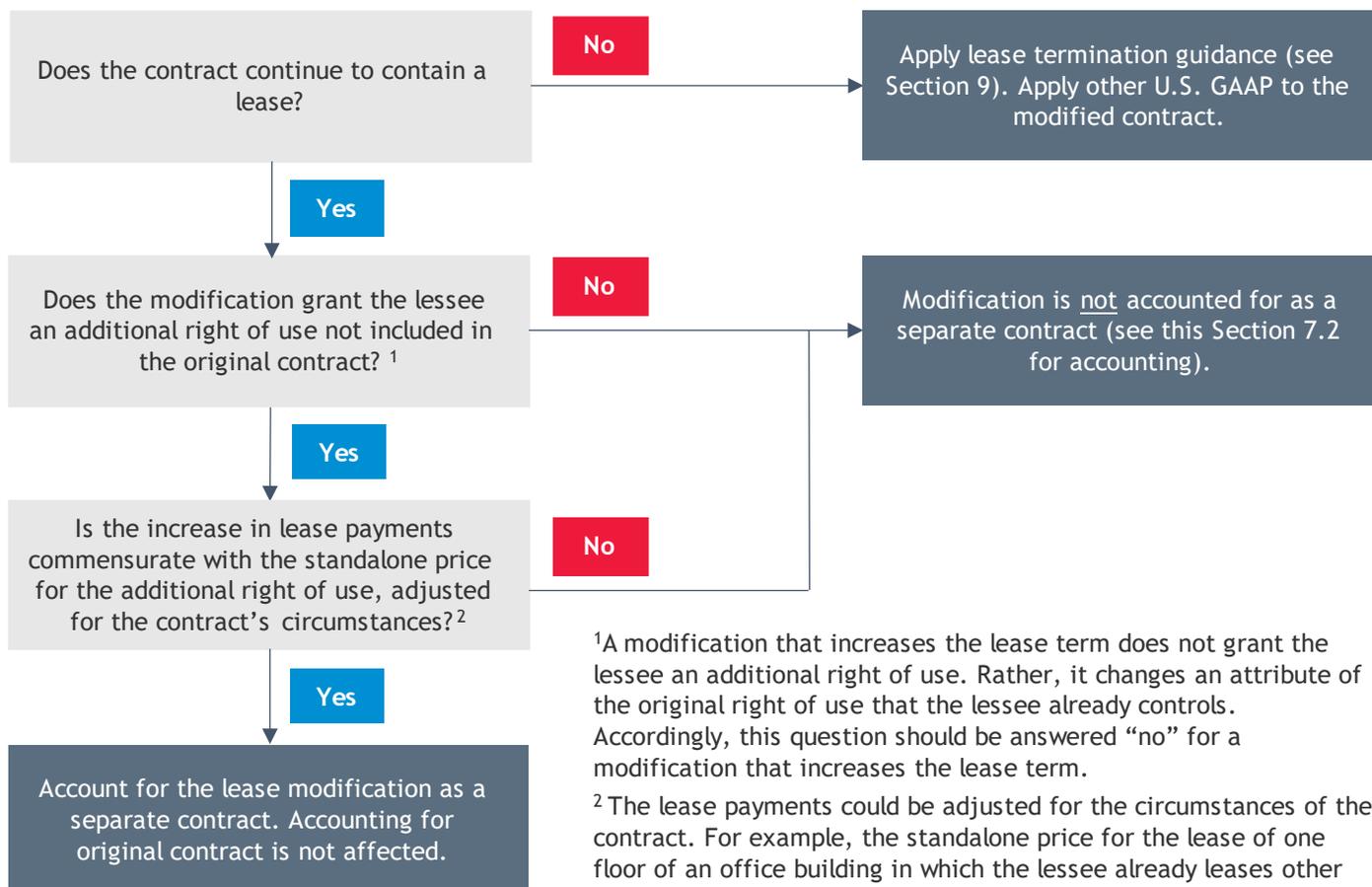
	LEASE LIABILITY				ROU ASSET		
	BEGINNING BALANCE	INTEREST (8%)	PAYMENT	CLOSING BALANCE	OPENING BALANCE	AMORTI-ZATION	CLOSING BALANCE
Year 6	\$1,243,959	\$99,517	\$(127,628)	\$1,215,848	\$1,162,628	\$(42,076)	\$1,120,552
Year 7	1,215,848	97,268	(134,010)	1,179,106	1,120,552	(44,325)	1,076,227
Year 8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

See Section 5.7 of our Blueprint, [Accounting for Leases Under ASC 842](#), for further discussion.

7.2 Modifications

A lease modification is a change to a contract’s terms and conditions that results in a change in the scope of or consideration for a lease (for example, an amendment that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term). Modifications include only changes to the terms and conditions that did not exist in the original contract. For example, the exercise of an option that was included in the original lease does not constitute a modification. Lessees must account for modifications on the date the lease modification is approved by the lessee and lessor, which is the effective date of the modification under ASC 842.

ASC 842 differentiates between modifications that result in a separate contract and therefore do not affect the accounting for the original contract and modifications that are accounted for as part of the original contract. That determination can be made using the following steps:



¹A modification that increases the lease term does not grant the lessee an additional right of use. Rather, it changes an attribute of the original right of use that the lessee already controls. Accordingly, this question should be answered “no” for a modification that increases the lease term.

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

BDO INSIGHTS – REASSESSING WHETHER A MODIFIED CONTRACT IS OR CONTAINS A LEASE

The changes to the terms and conditions from a lease modification generally will not affect the assessment of whether the arrangement includes a lease. In some cases, however, they might. Therefore, a retailer or restaurant lessee must reassess that the modified contract continues to contain a lease and document that assessment.

The accounting for the modified contract depends on whether it continues to be or contain a lease.

- ▶ If there is still a lease, the entity applies the lease modification guidance in this section.
- ▶ If there is no longer a lease, the lease termination guidance discussed in Section 9 applies. However, the entity also should account for the modification based on the facts and circumstances and consider other U.S GAAP that applies to the modified contract.
- ▶ If the contract previously was not or did not contain a lease, but the modified contract is or contains a lease, the contract is a new lease accounted under ASC 842.

BDO INSIGHTS – MODIFICATION CONSIDERATIONS ASSOCIATED WITH ADDITIONAL RIGHT OF USE

As discussed above, a lessee accounts for a lease modification as a separate contract if the modification grants the lessee an additional right of use and the increase in lease payments is commensurate with the additional right of use's standalone price adjusted for the contract's circumstances.

In some cases, a lease modification between a lessor and lessee may include both:

- ▶ An additional right of use not included in the original contract
- ▶ Changes related to the scope of, or consideration for, the original lease (for example, a change to the term or a change in payments for the original lease).

For example, a lessor and lessee may enter a new lease for office space in another building the lessor owns while also reducing the term or changing the payments for an existing office space lease. In those cases, we believe the modification cannot be accounted for as a separate contract because other changes are made to the existing lease. That conclusion applies regardless of whether the transaction is legally executed as a single amendment to the existing contract or as two transactions that must be combined under the contract combination guidance (see Section 4.7).

In other cases, a lessor and lessee may agree to modify an existing lease to add distinct services (nonlease components) rather than an additional right of use. For example, a lessor and lessee may agree to modify a lease to add maintenance services the lessor will perform on the lessee's owned assets. While the lease modification guidance does not contemplate such increases in scope (it refers to only "additional right of use" (that is, additional leases)), we believe a lessee may account for the modification as a separate contract if the increase in payments is commensurate with the standalone price for the nonlease component. However, given that ASC 842 refers to only "additional right of use," it may be acceptable to conclude that the modification is not a separate contract and to apply the modification guidance. Entities are encouraged to discuss such transactions with their accounting advisor or auditor.

The accounting for modification transactions requires the application of professional judgment based on the facts and circumstances.

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

MODIFICATION	GENERAL ACCOUNTING	ADDITIONAL GUIDANCE
Grants the lessee an additional ROU not included in the original contract, and the lease payments are not commensurate with standalone price	<ul style="list-style-type: none"> ▶ Remeasure the lease payments and the consideration in the contract. ▶ Reallocate the remaining consideration to the lease and nonlease components (unless the practical expedient not to separate is elected). 	<ul style="list-style-type: none"> ▶ Recognize the remeasurement amount of the lease liability as an adjustment to the ROU asset. However, if the carrying amount of the ROU asset is reduced to zero, the remaining amount is generally recognized in profit or loss.
Extends or reduces the term of an existing lease other than through exercise of an option in the original contract	<ul style="list-style-type: none"> ▶ Update the discount rate for the lease. 	<ul style="list-style-type: none"> ▶ If a finance lease is modified and the modified lease is classified as an operating lease, recognize as a rent prepayment or lease incentive any difference between the adjusted carrying amount of the ROU asset and the carrying amount of the ROU asset that would result from applying the initial operating ROU asset measurement guidance to the modified lease (see Example 5-18 in our Blueprint, Accounting for Leases Under ASC 842).
Changes only the consideration in the contract	<ul style="list-style-type: none"> ▶ Remeasure the lease liability. ▶ Reassess lease classification and update the subsequent accounting for the lease accordingly. 	
Fully or partially terminates an existing lease (for example, reduces the assets subject to the lease)		<ul style="list-style-type: none"> ▶ Decrease the carrying amount of the ROU asset on a basis proportionate to the full or partial termination. Any difference between the reduction in lease liability and proportionate reduction in ROU asset is recognized as a gain or loss at the modification’s effective date. ▶ ASC 842 provides two acceptable methods for determining the proportional reduction in the ROU asset (see Example 5-19 in our Blueprint, Accounting for Leases Under ASC 842).



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

When a modification is not accounted for as a separate contract, the lessee remeasures the lease liability for the modified existing lease as of the modification’s effective date as if the modified lease were a new lease that commenced on that date. Therefore, the lessee reassesses lease classification and remeasures the ROU asset and lease liability based on the changed terms and conditions of the modified contract. Initial direct costs, lease incentives, and any other payments made to or by the retail or restaurant lessee in connection with a lease modification must be accounted for in the same manner as they would be in connection with a new lease.

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

The guidance related to full or partial terminations in the table above applies only if the right of use or a portion thereof **immediately** ceases at the modification's effective date (for example, the lessee immediately returns the leased asset or immediately vacates leased office space). If a lessee and lessor execute an amendment to fully or partially terminate the lease, but the change is effective only after a period of time or upon the occurrence of a specified event, the lessee applies the guidance on lease term reductions rather than the guidance on terminations. See BDO Insights below for additional considerations when the termination is executed concurrently with a new lease with the same lessor.

BDO INSIGHTS – MODIFICATION CONSIDERATIONS FOR LEASE TERMINATIONS AND NEW LEASE WITH SAME LESSOR

In some cases, a lessor and lessee may agree to terminate a lease and enter a new lease for another asset the lessor owns. For example, a lessor and lessee may execute a new lease for a smaller office space in another building the lessor owns while also reducing or terminating the term of an existing larger office space lease. In those cases, as discussed in this Section 7.2, we believe the new lease typically cannot be accounted for as a separate contract under the lease modification guidance because other changes are made to the existing lease. That conclusion applies regardless of whether the transaction is legally executed as a single amendment to the existing contract or as two transactions that must be combined under the contract combination guidance (see Section 4.7).

Additional care should be given if, in the example above, the lease of the larger office space terminates **immediately**. The accounting for a standalone lease termination typically results in the lessee recognizing in the income statement the difference between the carrying amounts of the ROU asset and lease liability along with any termination payments. However, in the above fact pattern, the lease termination is accompanied by a new lease with the same lessor, raising questions about whether any amounts that otherwise would be recognized in the income statement for the termination should instead be considered in the accounting for the new lease (for example, as lease incentives or prepayments). Because ASC 842 is not clear, we believe multiple approaches may be acceptable based on facts and circumstances. For example, if the new lease is not off-market, it may be acceptable to account for the difference between the carrying amounts of the ROU asset and lease liability of the existing lease as either a gain or loss on termination recognized in the income statement or a lease incentive or prepayment accounted for as part of the initial measurement of the new lease.

In contrast, if the termination is not immediate, the lessee applies the lease term reduction guidance discussed earlier in this section (rather than the full or partial termination guidance) for the lease component for which the term is shortened. In the above example, that approach would require the lessee to remeasure and reallocate the remaining consideration in the contract to the remaining components on a relative standalone price basis. For the lease components, it would require accounting for the effect of the amendments typically on a prospective basis over the remaining lease term. The remaining components in this case include the lease components for the larger and smaller office spaces, along with any nonlease components.

The accounting for modification transactions requires the application of professional judgment based on the facts and circumstances.

BDO INSIGHTS – MODIFICATION CONSIDERATIONS FOR MASTER LEASES

Master lease agreements typically provide a lessee with the right to use multiple underlying assets. If a master lease agreement allows, but does not require, the lessee to gain control over the use of additional underlying assets during the contract's term, the lessee should account for those additional assets as a lease modification when it takes control over the use of the assets, as described above.

In contrast, a master lease agreement that specifies a minimum number of units or dollar value of equipment does not result in a lease modification when the lessee obtains control over the use of those additional assets. Rather, the contract may include separate lease components and potentially multiple commencement dates (see Section 5.1). In those situations, the lessee should allocate the consideration in the contract to the various lease components and any applicable nonlease components, recognize the related lease components on the balance sheet at their respective commencement dates, and disclose the forward starting leases for the lease components that have not yet commenced.

A lessee and lessor may also modify a master lease agreement to early terminate the right to use some of the assets (lease components) in the agreement. Even if the modification does not change the economics of the remaining lease components, the lessee should apply modification accounting, including reassessing classification and adjusting the accounting for the remaining lease components. This requires the lessee to reconsider inputs, such as the economic life and fair value of the underlying assets and the discount rate for the lease, for classification and measurement purposes.

In 2020, the FASB proposed changes to the modification guidance in response to stakeholder feedback questioning the usefulness and costs of applying modification accounting to modifications reducing the scope of arrangements such as master lease agreements. However, the FASB abandoned the project, so the guidance remains unchanged.

BDO INSIGHTS – MODIFICATIONS RELATED TO VARIABLE LEASE PAYMENTS NOT BASED ON AN INDEX OR RATE

Variable lease payments that are not based on an index or rate, such as payments based on a percentage of the lessee's sales, are excluded from the definition of lease payments and thus from the consideration in the contract under ASC 842. Therefore, those payments are not included in the measurement of the lease on the balance sheet. However, if the lessee and lessor modify the agreement to change those payments, such as by lowering the percentage applied to the lessee's sales or to add variable lease payments not based on an index or rate, we believe the lessee should apply the modification framework described above. The lease modification guidance under ASC 842 is not limited to changes in the consideration in the contract (as defined in ASC 842); rather, it applies more broadly to **any** changes in the consideration for a lease. In other words, any modification that results in changes in the payments required by the lease, whether those payments meet the definition of lease payments or not, should be evaluated under the modification guidance discussed above.

See Section 5.8 of our Blueprint, [Accounting for Leases Under ASC 842](#), for further discussion.

8. IMPAIRMENT

8.1 General Considerations

An ROU asset is a long-lived nonfinancial asset and therefore within the scope of the ASC 360 subsection on impairment or disposal of long-lived assets. As a result, ROU assets must be monitored for impairment like other long-lived nonfinancial assets, regardless of whether the lease is an operating lease or finance lease.

The impairment assessment is performed at the asset group level, which is the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. For those in the retail and restaurant sector, the asset group will typically be at the individual store or restaurant level.

An asset group is tested for impairment when events or changes in circumstances indicate that the asset group may not be recoverable, as discussed in ASC 360. When impairment indicators exist, an asset (or asset group) must be tested to determine whether there is an impairment. The impairment test is a two-step process:

Step 1: Determine if the asset group is recoverable. To do so, a retailer or restaurateur compares (a) the carrying value of the asset group with (b) the undiscounted cash flows expected from the asset group’s direct use and eventual disposal. If (a) exceeds (b), the asset group is not recoverable, and the company moves to Step 2.

If applying ASC 360-10-35 at the individual store or restaurant level, the retailer or restaurant lessee must consider all relevant store-level assets and liabilities, such as leasehold improvements, inventory, and operating payables, as part of the carrying value of the asset group in the Step 1 recoverability assessment.

Step 2: Determine the impairment loss. To do so, a retailer or restauranter determines the asset group’s fair value and recognizes any impairment loss for the excess of the asset group’s carrying amount over its fair value.

- ▶ The impairment loss reduces only the carrying amounts of a long-lived asset or assets of the group.
- ▶ The impairment loss is allocated pro rata to the long-lived assets in the asset group (including ROU assets) using the relative carrying amounts of those assets, except that individual long-lived assets cannot be written down below their individual fair values whenever that fair value is determinable without undue cost and effort.

For finance leases, lease liabilities are excluded when testing an asset group for impairment because debt related to financing of long-lived assets generally is excluded. Because the finance lease liability is excluded from the asset group, the finance lease payments also are excluded when determining the undiscounted cash flows of the asset group.

BDO INSIGHTS – IMPAIRMENT ASSESSMENT FOR OPERATING LEASES

Because ASC 842 and ASC 360 do not specify whether the related lease liability for operating leases should be included in an asset group for impairment testing purposes, we believe the following are acceptable approaches:

	APPROACH A	APPROACH B	APPROACH C
Step 1 - In determining the carrying amount of the asset group:	Exclude operating lease liability	Include operating lease liability	Include operating lease liability
Step 1 - In determining the undiscounted cash flows. ^{a,b}	Exclude lease payments	Include lease payments but exclude the portion related to interest accretion	Include lease payments, with inclusion of the portion related to interest accretion
Step 2 - In determining the fair value of the asset group under a discounted cash flow approach. ^{a,b,c}	Same approach as Step 1	Same approach as Step 1, but include the total lease payments (because the cash flows will be discounted)	Same approach as Step 1

Note a: Use entity-specific assumptions in Step 1, and market-participant assumptions (highest and best use) in Step 2.

Note b: Cash flows include variable lease payments not included in the measurement of the lease liability.

Note c: In allocating the impairment loss to the long-lived assets in the asset group (that is, the pro rata allocation subject to the individual fair value limitation), consider the ROU asset without the lease liability.

Because the different approaches are consistent in how they treat the liability and related cash flows (both are either included or excluded), the approach selected generally should not significantly change whether an asset group is impaired.

BDO INSIGHTS – OPERATING LEASE ROU ASSET NOT IMPAIRED BUT ESTIMATED USEFUL LIFE IS SHORTENED

If an ROU asset is determined not to be impaired under ASC 360, there is no basis to write down its carrying amount. However, a lessee may have to revise (shorten) the asset’s previously estimated useful life if it anticipates abandoning the asset before the end of the lease term. When this occurs, the link between the economic benefits to be derived from the lease and the lease payments is broken. While ASC 842 is not explicit on how to handle those situations, we believe it may be appropriate for the lessee to account for the operating lease as if the ROU asset has been impaired (see Section 8.2).

BDO INSIGHTS – ADDITIONAL COMPLEXITIES RELATED TO APPLICATION OF ASC 360 TO ROU ASSETS – ABANDONMENTS AND SUBLEASES

As described above, ASC 842 requires a retailer or restauranter to apply the ASC 360 guidance on impairment of long-lived assets to ROU assets. However, additional complexities may arise if a lessee decides to stop using the leased asset in its operations before the end of the lease term. For example, after a lease has begun, a retailer or restaurant lessee may consider subleasing or abandoning either the leased asset or a portion of it. These may be necessary business decisions, but they will result in additional accounting questions that need to be addressed, including:

CONSIDERATIONS	GUIDANCE
<p>Did the company appropriately identify its lease components (the unit of account under ASC 842)?</p>	<p>A lessee may have initially assumed that the unit of account under ASC 842 was a single lease component (for example, one lease component for a lease of multiple floors in an office building). The accounting outcome under ASC 842 may have been the same whether the contract included a single lease component or a lease component for each floor leased. However, entering a sublease or deciding to abandon a portion of an ROU asset raises a unit of account question. Because of the sublease or abandonment, the lessee should confirm whether its initial identification of lease components continues to be appropriate because that may, for example, affect asset groupings (and whether impairment triggers exist) or revisions to the ROU asset’s useful life under ASC 360.</p>
<p>Does it affect asset groupings for impairment testing purposes?</p>	<p>ASC 360 requires a company to group assets at the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. There generally is judgment in determining asset groupings, although entering into a sublease will usually result in that asset being deemed its own asset group because it will generate standalone cash flows from the sublease. A lessee should have processes to evaluate whether and when asset groupings would change as a result of sublease and abandonment decisions.</p>

CONSIDERATIONS	GUIDANCE
Is the company required to test the asset group for impairment?	<p>Subleasing the underlying asset for the remainder of the lease term is not considered abandoning the asset because the lessee continues to derive economic benefits from using the asset (through the cash flows on the sublease). However, if a lessee enters a sublease and the lease cost for its original lease term exceeds the anticipated sublease income for that same period, the original lessee should treat that circumstance as an indicator that the carrying amount of the ROU asset associated with the original lease may not be recoverable.</p> <p>The decision to abandon an ROU asset may also indicate that an impairment test is required for the asset group because it represents a significant adverse change in the extent or manner in which the asset is being used. Whether an impairment test is performed will depend on how significant the asset to be abandoned is to the asset group, which will require the use of professional judgment.</p>
Should the company revise the useful life of some of the long-lived assets, including the leased asset?	<p>When a long-lived asset is tested for recoverability, it also may be necessary to review depreciation estimates and methods as required by ASC 250, <i>Accounting Changes and Error Corrections</i>. Any revision to the remaining useful life of a long-lived asset resulting from that review should be considered in developing future cash flow estimates when testing the asset (asset group) for recoverability.</p> <p>Further, if a company commits to a plan to abandon a long-lived asset before the end of its previously estimated useful life, depreciation estimates should be revised to reflect the asset's use over its shortened useful life.</p> <p>See also ASC 360-10-S99-2 (SAB Topic 5.CC, <i>Impairments</i>) for an example related to a mainframe computer to be abandoned for additional considerations, including timing of revision of estimated useful lives, as well as an SEC staff speech on this topic.</p>
Should the company record additional liabilities, such as exit or disposal cost obligations?	<p>While charges that are considered lease payments (whether fixed or variable) are excluded from the guidance in ASC 420, <i>Exit or Disposal Cost Obligations</i>, if the lease contract includes nonlease components and the lessee elected to separate the lease and nonlease components, the lessee should accrue the portion of fixed payments and estimated variable payments allocated to the nonlease components on the cease-use date of an underlying asset subject to a lease. This is summarized as follows:</p> <ul style="list-style-type: none"> ▶ Lessee elected nonseparation practical expedient. Payments for nonlease components or noncomponents (such as taxes and insurance) are all lease payments (whether fixed or variable) and therefore outside the scope of ASC 420. ▶ Lessee did not elect nonseparation practical expedient. The lessee should accrue the portion of the fixed payments and estimated variable payments allocable to the nonlease component (for example, common area maintenance).

The SEC staff [discussed](#) the accounting for abandonment of ROU assets at the 2020 AICPA Conference on Current SEC and PCAOB Developments, saying it did not object to a fact pattern in which some leases were identified for abandonment and were not impaired, and the ROU assets were amortized ratably over the period between abandonment identification and actual abandonment date.

See Section 5.9 of our Blueprint, [Accounting for Leases Under ASC 842](#), for further discussion.

8.2 Accounting for Operating Leases Once Impaired

After an ROU asset has been impaired, it is measured at its carrying amount immediately after the impairment less any accumulated amortization and amortized from the impairment date to the earlier of the end of its useful life or lease term. A previously recognized impairment loss cannot be reversed. For an operating lease, this means that the updated single lease cost following an impairment is calculated as the sum of:

- ▶ Amortization of the remaining balance of the ROU asset after the impairment, generally on a straight-line basis (unless another systematic basis is more representative of the pattern in which the lessee expects to consume the ROU asset's remaining economic benefits); and
- ▶ Accretion of the lease liability using the interest method, as before the impairment.



PATTERN OF LEASE COST IS NO LONGER STRAIGHT-LINE ONCE OPERATING LEASE ROU ASSET IS IMPAIRED

When an operating lease ROU asset is impaired, BC259 of ASU 2016-02 states:

The link that many perceive between the economic benefits to be derived from the lease and the lease payments, and reference in support of a single, generally straight-line lease cost for operating leases, is effectively “broken” after the right-of-use asset is impaired because the lessee will no longer obtain future economic benefits from the lease equal to (or greater than) the payments it is required to make to the lessor. In other words, the lease payments no longer have any direct correlation to the economic benefits the lessee can derive from the lease but, instead, represent a liability reflective of a past expectation of economic benefits that could be derived from the lease.

Therefore, while a lessee will continue to recognize a single lease cost for an operating lease following an impairment, it will no longer be recognized on a straight-line basis.

BDO INSIGHTS — OPERATING LEASE ROU ASSET IMPAIRED AND SUBSEQUENTLY MODIFIED OR REMEASURED

After an ROU asset is impaired, the lease may be modified (and not accounted for as a separate contract) or remeasured (for example, because of a reassessment of the lease term or purchase option). As discussed in Section 7, some reassessment events and modifications not accounted for as separate contracts result in accounting for the lease essentially in the same way as a new lease. Even so, we believe the lessee should continue to apply the guidance on operating leases that have been impaired because the link between the economic benefits to be derived from the lease and the lease payments continues to be broken even after a modification or reassessment. In other words, it remains that the lessee does not obtain future economic benefits from the lease equal to (or greater than) the revised lease payments, so it continues to amortize the remeasured ROU asset on a straight-line basis.

Example 8-1 illustrates application of the impairment guidance to an operating lease.

EXAMPLE 8-1: RETAIL STORE — IMPAIRMENT OF ROU ASSET (OPERATING LEASE)

FACTS

- ▶ Assume the same facts as in Example 6-3, in which the lease of retail space is an operating lease. Also assume:
 - For impairment testing purposes, the leased retail space is part of Asset Group A, which includes the operating lease ROU asset, leasehold improvements, inventory, and operating payables.
 - At the end of Year 2 of the lease, Retailer experiences a significant adverse change in the business climate and lower financial performance than initially anticipated. It tests Asset Group A for recoverability.

- The asset group comprises the ROU asset with an ending balance of \$750,556 and unamortized leasehold improvements of \$100,000. The carrying value of inventory and operating payables offset each other. The ending balance of the lease liability is \$805,114.
- ▶ Retailer elected to assess impairment by applying Approach C (see Section 8.1). Based on that approach, the undiscounted expected cash flows associated with Asset Group A are determined to be \$40,000 over the retail space’s remaining lease term, and the fair value of Asset Group A is \$35,000.

CONCLUSION AND ANALYSIS

- ▶ Retailer applies Approach C as follows:

APPROACH C	
Step 1: Determine the carrying amount of the asset group by including the operating lease liability.	\$45,442 (ROU asset of \$750,556 less lease liability of \$805,114 plus unamortized leasehold improvements of \$100,000).
Step 1: Determine the undiscounted expected cash flows, which include the entire amount of the lease payments.	\$40,000. The asset group is considered not recoverable because its carrying value of \$45,442 is higher than the undiscounted cash flows of \$40,000. Retailer proceeds to Step 2.
Step 2: Determine the impairment loss using a fair value approach, such as the discounted cash flow analysis.	\$10,442 (carrying value of \$45,442 less fair value of \$35,000).

- ▶ Retailer records an impairment charge of \$10,442. The impairment loss is applied pro rata only to the long-lived assets in the asset group, which in this example are the operating lease ROU asset and the leasehold improvements. The impairment loss does not reduce each long-lived asset’s carrying value below their respective fair value; Retailer records a journal entry as follows:

Debit	Impairment Loss	\$	10,442	
Credit	ROU Asset	\$	9,215	= 10,442 * (750,556/850,556)
Credit	Leasehold Improvements	\$	1,227	= 10,442 * (100,000/850,556)

- ▶ The carrying amount of the ROU asset after impairment is \$741,341 (750,556 - 9,215).
- ▶ Retailer determines that amortizing the ROU asset over the remaining lease term remains appropriate (that is, the useful life is not shortened).
- ▶ Retailer recognizes a single lease cost in each period following the impairment calculated as the sum of:
 - The straight-line amortization of the remaining carrying amount of the ROU asset over the remaining lease term of 8 years; and
 - The interest accretion of the lease liability in each of the remaining years (which is unchanged).
- ▶ That results in the single lease cost no longer being fixed at each of the remaining periods, as illustrated in the table.

	ROU OPENING BALANCE	AMORTIZATION	ROU ASSET CLOSING BALANCE	INTEREST ON LEASE LIABILITY	PERIODIC LEASE COST
	[A]	[B]	[A] + [B]	[C]	[B] + [C]
Year 3	\$ 741,341	\$ (92,668)	\$ 648,673	\$ (48,307)	\$ (140,974)
Year 4	648,673	(92,668)	556,006	(44,590)	(137,258)
Year 5	556,006	(92,668)	463,338	(40,320)	(132,988)
Year 6	463,338	(92,668)	370,671	(35,446)	(128,114)
Year 7	370,671	(92,668)	278,003	(29,915)	(122,583)
Year 8	278,003	(92,668)	185,335	(23,669)	(116,337)
Year 9	185,335	(92,668)	92,668	(16,647)	(109,315)
Year 10	92,668	(92,668)	—	(8,781)	(101,449)

9. DERECOGNITION

ASC 842 provides specific derecognition requirements for the following events:

EVENTS	ACCOUNTING
Lease termination before expiration of lease term	<ul style="list-style-type: none"> ▶ Derecognize ROU asset and lease liability. ▶ Recognize any difference in profit or loss.
Purchase of the underlying asset	<ul style="list-style-type: none"> ▶ Adjust the carrying amount of the asset for any difference between the purchase price and the carrying amount of the lease liability immediately before the purchase. ▶ For example, a lessee and lessor enter a five-year lease of equipment. If at the end of year four of the lease, when the carrying amounts of the ROU asset and lease liability are \$50,000 and \$53,000, respectively, the lessee purchases the equipment for \$55,000 the lessee would derecognize the lease liability and account for the \$2,000 difference (between the purchase price of \$55,000 and \$53,000 carrying value of the lease liability) as an adjustment to the carrying amount of the asset. The lessee would recognize PP&E for \$52,000 (\$50,000 plus \$2,000). ▶ This accounting does not apply for underlying assets acquired in a business combination, which are initially measured at fair value in accordance with ASC 805-20-30-1. See our Blueprint, Business Combinations Under ASC 805, for more guidance.
Sublease in which the original lessee is relieved of primary obligation under the original lease	<ul style="list-style-type: none"> ▶ Derecognize ROU asset and lease liability. ▶ Recognize any difference in profit or loss. ▶ Any consideration paid or received upon termination that was not included in the lease payments (for example, a termination payment) is included in the determination of profit or loss. ▶ If original lessee is secondarily liable, it also recognizes a guarantee in accordance with ASC 405-20-40-2.

10. ADDITIONAL TRANSACTIONS

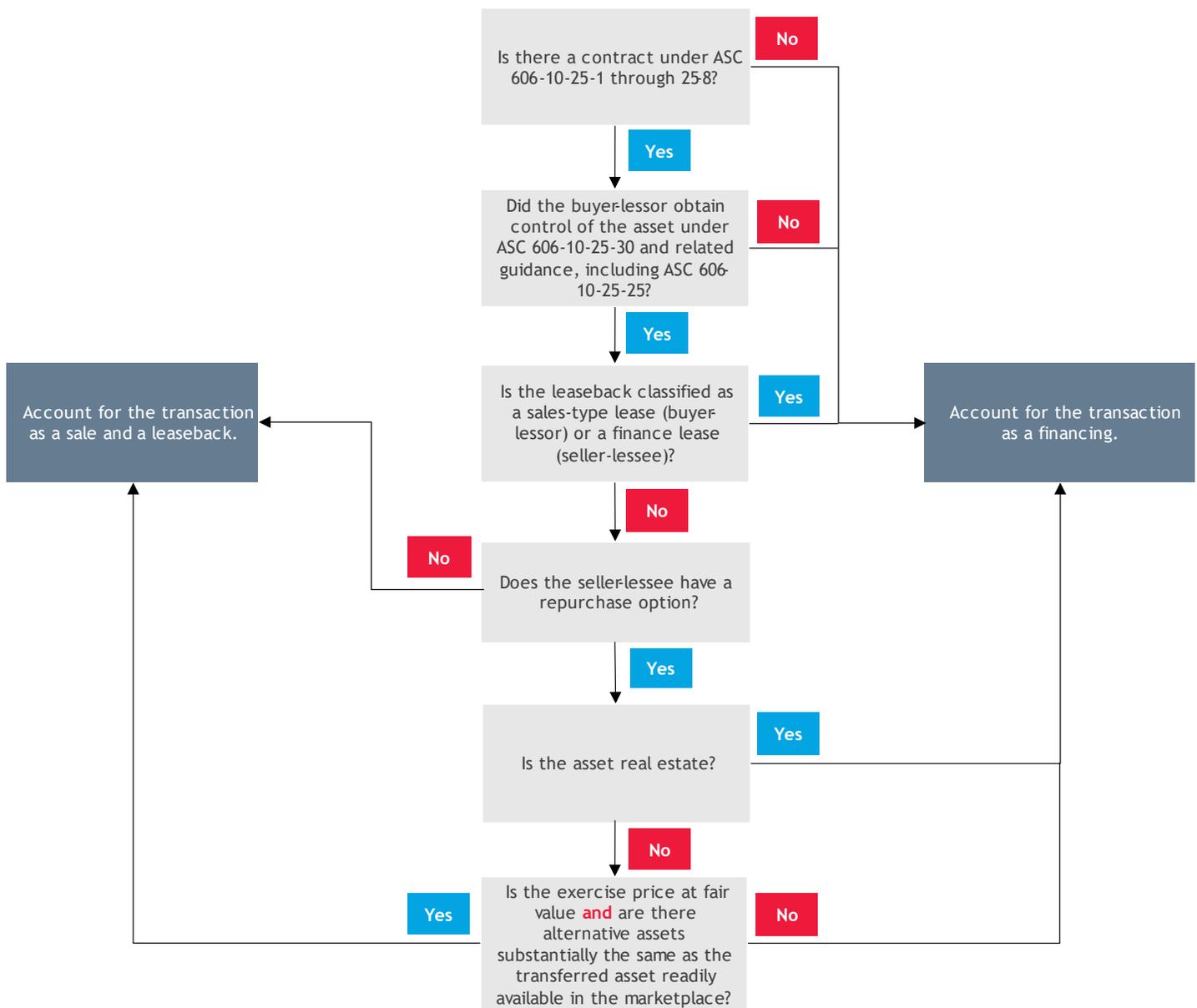
10.1 Sale and Leaseback Transactions

10.1.1 Overview of Sale and Leaseback Transactions

For transactions within the scope of the sale and leaseback guidance (see Section 10.1.2), the seller-lessee **and** the buyer-lessor apply the following requirements to determine whether to account for the transaction as a sale and a leaseback or as a financing arrangement:

<p>Evaluate under ASC 606 whether a contract exists and whether the buyer-lessor obtains control of the asset.</p>	<p>ASC 842-40 relies on the guidance in ASC 606 in substantially the same way as does the guidance in ASC 610-20, <i>Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets</i>, which applies to sales of nonfinancial assets to parties other than customers. If under ASC 606 a contract does not exist or the buyer-lessor does not obtain control of the asset, no sale has occurred, and the transaction is accounted for as a financing. If a contract exists and the buyer-lessor obtains control of the asset, the retail or restaurant company applies the other requirements below.</p>
<p>Determine whether the leaseback is classified as a sales-type lease (buyer-lessor) or finance lease (seller-lessee).</p>	<p>The existence of a leaseback does not itself prevent the buyer-lessor from obtaining control of the asset. However, if the leaseback is classified as a finance lease by the seller-lessee or as a sales-type lease by the buyer-lessor, the buyer-lessor does not obtain control of the asset. The transaction is a financing because the seller-lessee directs the use of, and obtains substantially all the remaining benefits from, the underlying asset before and after the transaction.</p>
<p>Identify whether the seller-lessee has a repurchase option and, if so, evaluate whether that option precludes sale accounting.</p>	<p>ASC 606 notes that a customer does not obtain control of an asset if the seller has the obligation or the right to repurchase the asset. However, for sale and leaseback transactions, a seller-lessee repurchase option does not preclude sale accounting if both of the following are met:</p> <ul style="list-style-type: none"> ▶ The exercise price is the asset's fair value at the time of exercise. ▶ There are alternative assets that are substantially the same as the transferred asset readily available in the marketplace (that is, the buyer-lessor could use the proceeds from the repurchase to acquire an asset that is substantially the same in the marketplace). <p>If either of those conditions is not met or the transferred asset is real estate (which is considered unique), the transaction is accounted for as a financing.</p>

The flowchart summarizes the decision steps to evaluate the accounting for sale and leaseback transactions:



ACCOUNTING WHEN LEASEBACK HAS NOT YET COMMENCED

In some sale and leaseback transactions, the leaseback does not commence until a future period (for example, until a building or warehouse is constructed or renovated). In those situations, the retail or restaurant company cannot recognize a sale (or purchase) until the leaseback commences because ASC 842-40-25-2 requires an assessment of the classification of the leaseback, which is done at lease commencement. Therefore, even if there is a high likelihood that the lease will be classified as an operating lease by the seller-lessee or a direct financing or operating lease by the buyer-lessor, a company cannot determine that a sale exists until the leaseback commences (see Example 10-1).

Transactions involving the sale and leaseback of real estate often include various forms of repurchase rights. Those rights may include conditional (or contingent) repurchase rights, rights of first refusal, and rights of first offer. We discuss those below, along with considerations as to whether such clauses preclude sale accounting.

BDO INSIGHTS – REPURCHASE OPTIONS

The FASB noted in BC352(c) of ASU 2016-02 that its Board members generally observed that real estate assets would not meet the alternative assets criterion because “*real estate is, by nature, ‘unique’ (that is, no two pieces of land occupy the same space on this planet) such that no other similar real estate asset is ‘substantially the same.’*” Therefore, a repurchase option in a sale-leaseback transaction involving real estate (including integral equipment as defined in ASC 978, *Real Estate – Time-Sharing Activities*) **always** precludes sale accounting, even if the repurchase option is at fair value.

See Section 7.2.3.4 of our Blueprint, [Accounting for Leases Under ASC 842](#), for discussion of contingent repurchase options on real estate, whose analysis depends on facts and circumstances and requires professional judgment.

BDO INSIGHTS – RENEWAL CLAUSES

Some lease arrangements provide for fixed price or fair value renewal options for all or substantially all the remaining economic life of the underlying asset. In BC218 of ASU 2016-02, the FASB said:

A purchase option is the ultimate option to extend the lease term. A lessee that has an option to extend a lease for all of the remaining economic life of the underlying asset is, economically, in a similar position to a lessee that has an option to purchase the underlying asset. Accordingly, the Board decided that those two options should be accounted for in the same way.

Accordingly, we believe that care should be used in determining whether renewal options are economically the same as repurchase rights and, if so, whether such renewals preclude sale accounting. We believe one reasonable approach may be to view a renewal option for all or substantially all the remaining economic life of the underlying asset as a repurchase option. However, other approaches may be acceptable based on facts and circumstances.

BDO INSIGHTS – RIGHT OF FIRST REFUSAL

A right of first refusal is most commonly structured as an option that grants the seller-lessee the right to repurchase the property subject to the sale-leaseback transaction if the buyer-lessor obtains a bona fide offer from a third party to purchase the property. A right of first refusal will generally grant the seller-lessee only the right to match that third-party offer. If the seller-lessee elects to exercise that right, the buyer-lessor must sell the property to the seller-lessee rather than to the third party. A provision that allows the seller-lessee the option to repurchase the property only if the buyer-lessor has decided to sell the property and has obtained an offer from a third party ordinarily will not result in a failed sale or purchase (if the other conditions in ASC 842-40-25-1 and 25-2 are also met). In that scenario, the buyer-lessor controls the property through retaining the right to decide whether and when to sell it.

BDO INSIGHTS – RIGHT OF FIRST OFFER

A right of first offer is most commonly structured as an option that grants the seller-lessee the right to offer to repurchase the property from the buyer-lessor. Rights of first offers may have varying terms and be exercisable only after a period of time or at a specified time, and only for a fixed or determinable amount, based on a formula or at market rates. Whether a right of first offer in a sale-leaseback transaction results in a failed sale or purchase depends on the specific terms and conditions. Generally, if the buyer-lessor can reject the seller-lessee's offer with no significant adverse economic consequences, the existence of the right of first offer will not preclude sale accounting (if the other conditions in ASC 842-40-25-1 and 25-2 are also met). However, if the buyer-lessor would be compelled economically or contractually to accept the offer, the right of first offer is equivalent to a repurchase option and would thus result in a failed sale or purchase for real estate transactions. Further, if the seller-lessee is economically or contractually compelled to make an offer, a right of first offer may be the equivalent of an obligation to repurchase the property (a forward) if the buyer-lessor is compelled to accept the offer, which also will result in a failed sale or purchase. The buyer-lessor and seller-lessee should consider all relevant factors when determining whether the buyer-lessor or the seller-lessee would be compelled to accept the offer, or make an offer, respectively. The factors in ASC 842-10-55-26 typically will be useful in evaluating the existence of economic compulsion.

See Section 7.2 of our Blueprint, [Accounting for Leases Under ASC 842](#), for further discussion.

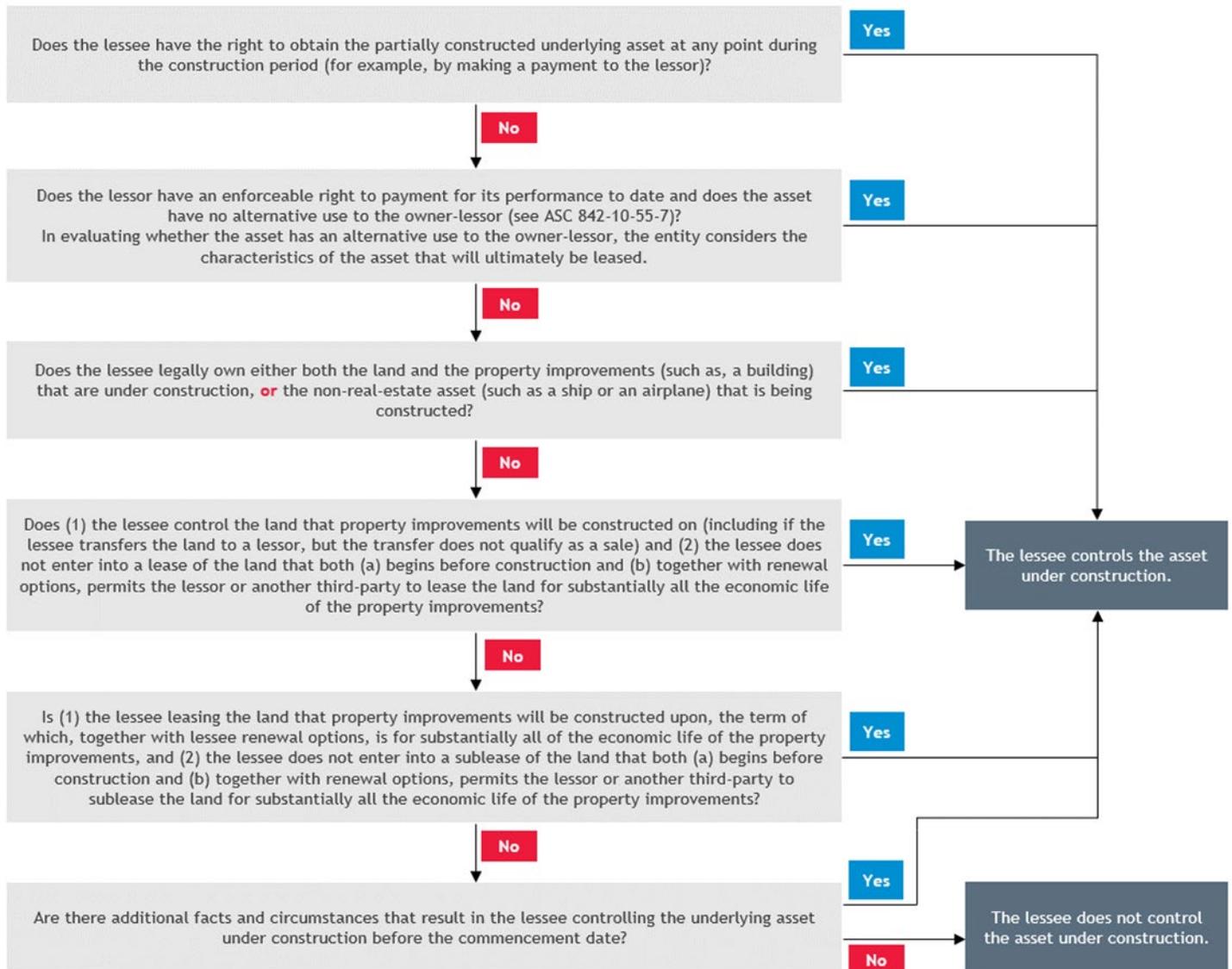
10.1.2 Scope Considerations

Properly identifying transactions that must be evaluated under the sale and leaseback guidance is critical because it may result in accounting for the transaction very differently (for example, the seller accounting for the transaction as a financing rather than a sale of the asset). The guidance in ASC 842-40 applies to both the seller-lessee **and** the buyer-lessor (that is, it is intended to be symmetrical), which is different from ASC 606, which applies only to the seller, not the customer. This symmetrical treatment also applies in situations in which the lessee is considered the accounting owner of an asset before lease commencement, as discussed below.

The sale and leaseback guidance applies when the lessee controls the underlying asset before lease commencement. The most common form of sale and leaseback transactions is when a retailer or restaurant lessee sells an asset that it owns to a lessor and at the same time enters a leaseback of the same asset. However, other transactions may be in the scope of the sale and leaseback guidance. For example, depending on facts and circumstances, the following transactions may be in scope of the sale and leaseback guidance:

- ▶ The lessee obtains legal title to the underlying asset before title is transferred to the lessor and the asset is leased to the lessee.
- ▶ The retail or restaurant company negotiates a lease before the underlying asset is available for use by the lessee, which is referred to as a “build-to-suit” transaction (the underlying asset must be constructed or redesigned).

The flowchart summarizes the decision steps to determine if the lessee controls an underlying asset under construction:



Because the list of circumstances in ASC 842-40-55-5 is not exhaustive, other circumstances could result in the lessee controlling the underlying asset under construction before the commencement date. Therefore, in answering the last question in the flowchart, professional judgment will be required to identify such circumstances. The FASB has said the evaluation in the flowchart is like the evaluation under ASC 606-10-25-27 for determining if a performance obligation is satisfied over time (see Section 6.3 of our Blueprint, [Revenue Recognition Under ASC 606](#)).

BDO INSIGHTS – ASSESSING REPURCHASE OPTIONS

In answering the first question in the flowchart, we believe a purchase option on the partially constructed asset exercisable solely with the passage of time during the construction period results in the lessee controlling the asset under construction from the arrangement's inception. However, if a purchase option becomes exercisable only after a contingent event, we believe the analysis will require professional judgment based on the transaction's facts and circumstances, including whether the lessee or lessor controls the occurrence of the contingent event. Also, if the lessor has a put option, we believe the analysis should be consistent with the guidance under ASC 606 (that is, whether the lessor has a significant economic incentive to put the asset back to the lessee).

See ASC 842-40-55, Example 3, for an illustration of the application of the guidance in the above flowchart.

If the lessee controls the asset under construction, it recognizes that asset just as it would any other asset it controls, along with a liability for any amounts funded by the lessor. The lessor recognizes a receivable rather than construction in progress. Also, both entities must apply the sale and leaseback guidance to determine if and when to recognize a sale. As discussed in Section 10.1.1, an entity typically cannot conclude that there is a sale until the commencement date of the leaseback.

Finally, a seller-lessee may need to determine whether it has a variable interest in the buyer-lessor legal entity regardless of the transaction's legal form or accounting classification. This could be the case when the lease absorbs the leased asset's variability, such as if the leaseback is a finance lease or includes a fixed-price repurchase option, residual value guarantee, or another similar feature. If the seller-lessee has a variable interest in the buyer-lessor legal entity as a whole, it must apply the guidance in ASC 810, *Consolidation*. See our Blueprint, [Control and Consolidation Under ASC 810](#) for discussion on the application of ASC 810.

BDO INSIGHTS – SALE OR TRANSFER OF PURCHASE OPTIONS TO THIRD PARTIES WITH CONCURRENT LEASEBACK

A retail or restaurant company may sell or transfer a purchase option on an asset to a third party with a commitment from the third party to exercise the option and lease the asset back to the company. For example, a retail or restaurant lessee may have a purchase option under an existing lease of a building (or equipment) that it assigns to a third party. In turn, the third party commits to exercise the option to purchase the building (or equipment) and to lease the asset back to the lessee once the asset is purchased. The terms and conditions of those transactions, such as the price at which the purchase option is exercisable (fair value or fixed price) and whether the purchase option is currently exercisable, may vary.

Professional judgment is required based on the facts and circumstances of the transaction to determine whether the sale and leaseback guidance applies. However, consistent with the concepts underlying the guidance in ASC 842-40-25-3 on repurchase options, we believe that if there are alternative assets that are substantially the same as the asset subject to the transaction and the strike price is fair value, the transaction may not be within the scope of the sale and leaseback guidance. In this situation, the lessee could have negotiated with a third party (such as a bank) for the direct purchase and lease of a different (but substantially similar) asset, which would not be subject to the sale and leaseback guidance. However, for assets like real estate, we believe such transactions will be in the scope of the sale and leaseback guidance because no two real estate assets are the same.

Examples 10-1 through 10-3 illustrate various aspects of the scope guidance.

EXAMPLE 10-1: SALE OF LAND WITH LEASEBACK FOLLOWING CONSTRUCTION OF A BUILDING**FACTS**

- ▶ Retailer owns vacant land in a large metropolitan area and plans to build a new store on the land.
- ▶ Retailer sells the land to Developer Inc., who will construct the new building.
- ▶ Once construction is complete, Retailer will lease the building for a noncancellable 20-year term with two five-year extension options.

CONCLUSION AND ANALYSIS

- ▶ The leaseback of the building once construction is complete includes a lease of land (whether explicit or implicit (see Section 4.1)). Therefore, the sale of the land is in the scope of the sale and leaseback guidance.
- ▶ Retailer (and Developer) cannot conclude that a sale of the land has occurred until leaseback classification is assessed, which is at the lease commencement date. Therefore, Retailer, not Developer, recognizes the land during the construction period.
- ▶ Both entities must also determine whether Retailer is the accounting owner of the building under construction.

EXAMPLE 10-2: LEASE OF LAND WITH LEASEBACK FOLLOWING CONSTRUCTION OF A BUILDING**FACTS**

- ▶ Assume the same facts as in Example 10-1, except:
 - Before construction begins, Retailer leases, rather than sells, the vacant land to Developer Inc. for a 40-year term with two five-year extension options. The completed building is expected to have an economic life of 40 years.
 - Retailer will lease the completed building for an initial 20-year term with two five-year extension options.
 - Retailer has a purchase option on the asset under construction exercisable at any time throughout the construction period.

CONCLUSION AND ANALYSIS

- ▶ Retailer entered a lease of the land before construction begins for a term, including renewals, that allows Developer to lease the land for substantially all the property improvements' economic life. However, because Retailer has a purchase option exercisable at any time during construction, it is the accounting owner during construction, and the transaction is in the scope of the sale and leaseback guidance.
- ▶ Retailer recognizes the construction in progress in accordance with ASC 360. Any amounts funded by Developer are recognized as a financial liability.
- ▶ Because Retailer is the accounting owner of the construction project, Developer does not obtain the economic benefits from use of the land. Therefore, a lease of the land does not exist during the construction period.
- ▶ At the end of the construction period (commencement date of the lease), Retailer (and Developer) will assess whether the transaction qualifies as a sale and leaseback of the building, and a lease of the land.

EXAMPLE 10-3: LEASE OF LAND WITH LEASEBACK FOLLOWING CONSTRUCTION OF A BUILDING**FACTS**

- ▶ Assume the same facts as Example 10-2, except Retailer does not have a purchase option during construction. Also, there are no other circumstances resulting in Retailer being the accounting owner of the asset being constructed.
- ▶ Retailer provides various materials during construction of the building.

CONCLUSION AND ANALYSIS

- ▶ The transaction is not in the scope of the sale and leaseback guidance because Retailer is not the accounting owner of the asset being constructed.
- ▶ Retailer accounts for the various materials provided during construction based on their nature. If the costs relate to leasehold improvements, Retailer accounts for those under ASC 360. If the costs do not relate to leasehold improvements or other goods or services (other than the lease) Developer provides to Retailer, they are considered payments for the right to use the building once constructed. If so, Retailer accounts for the provision of those materials as prepaid lease payments.
- ▶ Retailer accounts for the lease of land to Developer during construction under ASC 842.

See Section 7.2.2 of our Blueprint, [Accounting for Leases Under ASC 842](#), for further discussion on scope considerations.

10.1.3 Accounting When Transfer of the Asset Is a Sale

If after analyzing the terms as discussed in the previous sections the transfer of the asset is determined to be a sale, the sale of the asset and subsequent leaseback are accounted for independently, with the leaseback accounted for by both party as any other lease under ASC 842.

When the transaction is at market terms, the following occurs at the date the buyer-lessor obtains control of the asset:

THE SELLER-LESSEE

- ▶ Derecognizes the carrying amount of the underlying asset.
- ▶ Recognizes the transaction price in accordance with ASC 606-10-32-2 through 32-27.
- ▶ Recognizes a gain or loss for the difference between the transaction price and carrying amount of the asset.
- ▶ Accounts for the leaseback in accordance with ASC 842-20 on lessee accounting (see Section 6).

THE BUYER-LESSOR

- ▶ Accounts for the purchase of the asset in accordance with other U.S. GAAP (typically ASC 360).
- ▶ Accounts for the leaseback in accordance with ASC 842-30 on lessor accounting (see Chapter 6 of our Blueprint, [Accounting for Leases Under ASC 842](#)).

The sale price and lease payments in a sale and leaseback transaction are interdependent because they are negotiated as a package. For example, the sale price might be more than the fair value of the asset because the leaseback payments are above market, or vice versa. Because both the day-1 accounting (the sale) and day-2 accounting (the leaseback) could be misstated in this situation, the FASB decided that an entity must adjust the sale (purchase) price of the asset if the sale and leaseback occurs at other than a market rate. See Section 7.2.4.2 of our Blueprint, [Accounting for Leases Under ASC 842](#), for further guidance.

Example 10-4 illustrates the accounting when the transfer of the asset is a sale.

EXAMPLE 10-4: SALE-LEASEBACK TRANSACTION WHEN TRANSFER OF ASSET IS A SALE**FACTS**

- ▶ For strategic and liquidity reasons, Retailer sells one of its warehouses to an unrelated Buyer-Lessor for \$3.0 million, which is the warehouse's fair value.
- ▶ The carrying amount of the warehouse is \$2.7 million, and it has a remaining useful life of 15 years.
- ▶ At the same time, Retailer enters a contract with Buyer-Lessor for the right to use the warehouse for five years with annual payments of \$300,000 payable in arrears and escalating 2% annually.
- ▶ The leaseback does not transfer ownership to Retailer at the end of the lease term and does not include a purchase option. There are no initial direct costs.
- ▶ Assume that the requirements in ASC 606 on contract existence and transfer of control are met and that the leaseback is classified as an operating lease by Retailer.
- ▶ Retailer's incremental borrowing rate is 4%. The rate implicit in the lease is not readily determinable.

CONCLUSION AND ANALYSIS

- ▶ Retailer determines that the transfer of the asset is a sale because:
 - The requirements in ASC 606 on contract existence and transfer of control are met.
 - The leaseback is classified as an operating lease.
 - There is no repurchase option.
- ▶ At the commencement date, Retailer records the following journal entry for the sale of the warehouse:

Debit	Cash	\$ 3,000,000
Credit	PP&E	\$ 2,700,000
Credit	Gain on sale	\$ 300,000

- ▶ Retailer also recognizes a lease liability for the leaseback at the present value of the lease payments, discounted using its incremental borrowing rate of 4%, which results in an initial lease liability of \$1,387,891, calculated as follows:

	PAYMENT
Year 1	\$ 300,000
Year 2	306,000
Year 3	312,120
Year 4	318,362
Year 5	324,730
Undiscounted Payments	<u>\$ 1,561,212</u>
PV (4%) =	<u>\$ 1,387,891</u>

- ▶ The initial measurement of the ROU asset is the same as the lease liability because there are no prepayments, lease incentives, or initial direct costs.

- ▶ Retailer calculates the total lease cost to be recognized over the lease term:

	AMOUNT
Total lease payments (paid or not yet paid)	\$ 1,561,212
Plus initial direct costs	—
Total Lease Cost [A]	<u>\$ 1,561,212</u>
Periodic Lease Cost [B] = [A] / 5	<u>\$ 312,242</u>

- ▶ The table summarizes the accounting for the lease liability, assuming no modifications or remeasurements (see Section 7).

	BEGINNING BALANCE	INTEREST (4%)	PAYMENT	CLOSING BALANCE
Year 1	\$ 1,387,891	\$ 55,516	\$ (300,000)	\$ 1,143,407
Year 2	1,143,407	45,736	(306,000)	883,143
Year 3	883,143	35,326	(312,120)	606,349
Year 4	606,349	24,254	(318,362)	312,240
Year 5	312,240	12,490	(324,730)	—

- ▶ The table summarizes the accounting for the ROU asset, assuming no modifications or remeasurements (see Section 7) and impairments (see Section 8).

	BEGINNING BALANCE	PERIODIC LEASE COST	INTEREST (4%)	AMORTIZATION	CLOSING BALANCE
	[A]	[B]	[C] (see above)	[D] = [B] + [C]	[A] + [D]
Year 1	\$ 1,387,891	\$ (312,242)	\$ 55,516	\$ (256,727)	\$ 1,131,164
Year 2	1,131,164	(312,242)	45,736	(266,506)	864,658
Year 3	864,658	(312,242)	35,326	(276,917)	587,741
Year 4	587,741	(312,242)	24,254	(287,988)	299,753
Year 5	299,753	(312,242)	12,490	(299,753)	—

- ▶ Retailer recognizes straight-line lease expense of \$312,242 annually throughout the lease term.

10.1.4 Accounting When Transfer of the Asset Is Not a Sale

If the transfer is not a sale, the transaction is accounted for as a financing by **both** the seller-lessee and buyer-lessor.

THE SELLER-LESSEE	THE BUYER-LESSOR
<ul style="list-style-type: none"> ▶ Continues to recognize the transferred asset and apply ASC 360 (depreciation, impairment, etc.). ▶ Accounts for amounts received as a financial liability in accordance with other U.S. GAAP. ▶ Allocates rent payments made between interest expense and principal amortization. 	<ul style="list-style-type: none"> ▶ Does not recognize the transferred asset under ASC 360. ▶ Accounts for amounts paid as a receivable in accordance with other U.S. GAAP. ▶ Allocates rent payments received between interest income and principal amortization.

A seller-lessee – but not a buyer-lessor – also adjusts the interest rate on the financial liability as necessary to avoid negative amortization of the financial liability and a built-in-loss when the asset is derecognized. This is achieved by determining that **both**:

- ▶ Interest on the financial liability is not greater than the payments over the shorter of the lease term or the term of the financing. The term of the financing could be shorter, for example, when a repurchase option that precluded sale accounting expires before the end of the lease term. We believe the requirement to avoid negative amortization of the financial liability applies over the **entire** lease term or term of financing (for example, five years) rather than to individual periods (each year of the five-year term). Said differently, no adjustment to the interest rate would be made if, for example, there is negative amortization of the financial liability in the first year but there is no negative amortization in the aggregate over the five-year term.
- ▶ The carrying amount of the asset does not exceed the carrying amount of the financial liability at the earlier of the end of the lease term and the date at which control of the asset transfers to the buyer-lessor. That is, there is no built-in loss at the earlier of the end of the lease term or the term of the financing.



EXCEPTION FOR SOME SALE AND LEASEBACKS

We believe the above requirements on adjusting the interest rate apply only to situations in which control of the asset is expected to transfer to the buyer-lessor at some point. If, for example, the leaseback includes a lessee option to repurchase the asset at the end of the lease term that is reasonably certain of exercise, we believe the seller-lessee should impute interest at a rate that amortizes the financial liability at the end of the lease term to the price of the repurchase option. In other words, there should be no gain or loss recognized at the end of the leaseback term because control of the asset is not expected to transfer to the buyer-lessor at any point (see Example 7-14 in our Blueprint, [Accounting for Leases Under ASC 842](#)).

At the end of the leaseback period (or at the date the buyer-lessor obtains control of the underlying asset), the seller-lessee recognizes any remaining balance of the financial liability as proceeds from the sale of the asset. Any gain recognized reflects any difference between those proceeds and the carrying amount of the asset at that date. The buyer-lessor derecognizes the carrying amount of its financial asset and recognizes the transferred asset at that same amount. This accounting is consistent with Example 2 in ASC 842-40-55.

As discussed above, in a failed sale and leaseback transaction the buyer-lessor may obtain control of the underlying asset before the end of the leaseback (for example, when a repurchase option that precluded sale accounting expires before the end of the leaseback term). Example 2 in ASC 842-40-55 illustrates the accounting both initially and once the purchase option expires. However, that example has led to numerous questions, including whether lease classification must be reassessed once the repurchase option expires. Accordingly, those situations require the application of professional judgment based on facts and circumstances.

Example 10-5 illustrates the concept.

EXAMPLE 10-5: ACCOUNTING FOR FAILED SALE-LEASEBACK

FACTS

- ▶ Assume the same facts as in Example 10-4, except Retailer has a fixed price repurchase option at the end of year five for \$1.8 million that it is not reasonably certain to exercise.
- ▶ Absent the repurchase option, there are no other terms or conditions that would preclude sale accounting.
- ▶ Retailer's incremental borrowing rate is 4%.

CONCLUSION AND ANALYSIS

- ▶ Because there is a repurchase option and the underlying asset is real estate, the transaction cannot be accounted for as a sale.
- ▶ Retailer accounts for the \$3 million of proceeds as a financial liability and uses its incremental borrowing rate of 4% to recognize interest expense.
- ▶ Retailer also continues to recognize the asset and depreciate it over the remainder of its useful life (assume depreciation expense is \$180,000 annually).
- ▶ Retailer's accounting for the financial liability and asset are determined as follows:

	BEGINNING LIABILITY BALANCE	INTEREST	PAYMENT	ENDING LIABILITY BALANCE	ENDING ASSET BALANCE
	[A]	[B] = [A] × 4%	[C]	[D] = [A]+[B]+[C]	
Year 1	\$ 3,000,000	\$ 120,000	\$ (300,000)	\$ 2,820,000	\$ 2,520,000
Year 2	2,820,000	112,800	(306,000)	2,626,800	2,340,000
Year 3	2,626,800	105,072	(312,120)	2,419,752	2,160,000
Year 4	2,419,752	96,790	(318,362)	2,198,180	1,980,000
Year 5	2,198,180	87,927	(324,730)	1,961,377	1,800,000



Retailer (as seller-lessee) determines that there is no negative amortization of the financial liability and no built-in-loss at the end of the lease term (financing term). Therefore, no further adjustments to the interest rate are required.

- ▶ If at the end of Year 5 the repurchase option is not exercised and therefore expires, Retailer recognizes the sale of the asset by derecognizing the underlying asset for \$1.8 million, derecognizing the carrying amount of the financial liability of \$1.96 million, and recognizing a gain of \$161,377.

For additional examples of failed sale-leaseback transactions, see Section 7.2.5.4 of our Blueprint, [Accounting for Leases Under ASC 842](#).

10.2 Business Combinations

There are several areas in which the accounting for leases acquired in a business combination differs from the accounting for a new lease. For some of those areas, ASC 805, *Business Combinations*, and ASC 842 provide clear accounting guidance, but in other areas, the guidance, including the interaction of ASC 805 and 842, is not clear.

ASC 842-10-55-11 notes that the acquirer of a lease in a business combination retains the acquiree's previous lease classification unless the lease is modified, and the modification is not accounted for as a separate contract. This guidance applies whether the acquired entity is a lessee or a lessor. If there is a modification and the modification is not accounted for as a separate contract, the acquirer reassesses classification.

BDO INSIGHTS – MODIFICATIONS TO LEASES THAT ARE ADMINISTRATIVE IN NATURE

In some cases, an acquired lease may be amended to change only the name of the parties specified in the lease. We believe such changes are administrative in nature and are not modifications because they do not change the scope of or the consideration for the lease.

BDO INSIGHTS – REASSESSING LEASE CLASSIFICATION IN AN ASSET ACQUISITION

ASC 805-50 and ASC 842 do not specify whether classification of an acquired lease in an asset acquisition should be retained (as in business combinations) or reassessed. An acquired lease is typically measured as if it were a new lease of the acquirer; for a new lease, one of the steps an entity performs is assessing classification. However, because U.S. GAAP is not clear, we believe that for asset acquisitions, the acquiring entity could either reassess lease classification or apply by analogy the guidance for business combinations for which lease classification is retained. Entities are encouraged to discuss classification of leases acquired in an asset acquisition with their accounting consultants and auditors.

While ASC 842 discusses lease classification in a business combination, neither ASC 805 nor ASC 842 addresses whether an acquirer must reassess an acquiree's conclusions about whether a contract is or contains a lease.

BDO INSIGHTS – REASSESSING WHETHER A CONTRACT IS OR CONTAINS A LEASE IN A BUSINESS COMBINATION

Although ASC 842 does not discuss whether an acquirer should reassess an acquiree's conclusions about whether a contract is or contains a lease, the guidance in ASC 842-10-15-6 indicates that an entity reassesses whether a contract is or contains a lease only if the contract's terms and conditions are changed. Further, reassessing lease identification could result in a conclusion that the contract does not contain a lease at the acquisition date, thereby directly conflicting with the specific requirement to retain the acquiree's lease classification in a business combination. As such, we believe that an acquirer should not reassess the acquiree's previous lease identification determined under ASC 842 unless the contract is modified in connection with the transaction and the modification is not accounted for as a separate contract.

The acquirer recognizes assets and liabilities arising from leases in which the acquiree is a lessee in accordance with ASC 842. In other words, the acquirer recognizes a lease liability and ROU asset on the balance sheet. However, ASC 805-20-25-28B provides an accounting policy election in which the acquirer may elect not to recognize assets or liabilities for leases that at the acquisition date have a remaining lease term of 12 months or less. This includes not recognizing an intangible asset or liability for favorable or unfavorable market terms. The election not to recognize leases with a remaining lease term of 12 months or less on the balance sheet at the acquisition date is made by asset class and applies to all of a retailer or restaurant company's acquisitions.

BDO INSIGHTS – ACQUIRER ELECTION NOT TO RECOGNIZE LEASES WITH REMAINING LEASE TERM OF 12 MONTHS OR LESS

BC415 of ASU 2016-02 explains that when the acquiree in a business combination is a lessee, the acquirer should measure the acquiree's lease liability at the present value of the remaining lease payments as if the acquired lease was a new lease at the acquisition date. It also notes that measuring the acquired lease as if it were a new lease includes reassessing the lease term. Accordingly, and while discussed in the context of an acquirer measuring an acquired lease at the acquisition date, we believe that in assessing whether an acquired lease qualifies for the recognition exception, the acquirer should first reassess the lease term as if it were a new lease at the acquisition date and then apply the policy election (if elected) to those acquired leases that have a remaining (reassessed) lease term of 12 months or less at the acquisition date.

The table summarizes the potential assets and liabilities that may be recognized for leases acquired in a business combination when the acquiree is the lessee (except for short-term leases, as discussed above):

OPERATING AND FINANCE LEASES

Assets	<ul style="list-style-type: none"> ▶ ROU asset (equal to lease liability adjusted for above/below market terms) ▶ In-place lease intangible (fair value) ▶ Leasehold improvements owned by the acquiree (fair value)
Liabilities	<ul style="list-style-type: none"> ▶ Lease liability (present value of the remaining lease payments, as if the lease were a new lease of the acquirer at the acquisition date). Measuring the acquired lease as if it were a new lease involves reassessing the following assumptions: the lease term, any lessee purchase options, lease payments (such as amounts probable of being owed under a residual value guarantee), and the discount rate.

Leasehold improvements acquired in a business combination are amortized over the shorter of the useful life of the assets or the remaining lease term at the date of acquisition.

See Section 4.4.1.5 of our Blueprint, [Business Combinations Under ASC 805](#), for more guidance.

10.3 Subleases

Leases of ROU assets (subleases) are accounted for in the same way as other leases and are within the scope of ASC 842. Accordingly, a retail or restaurant lessee that subleases an asset accounts for the head lease and sublease as two separate contracts (two separate units of account) unless those contracts meet the contract combination guidance in ASC 842-10-25-19 (which likely will be infrequent because the counterparty to the sublease is typically a different entity from the counterparty to the head lease). The accounting by the retail or restaurant lessee (sublessor) depends on whether it retains the primary obligation under the original lease.

ORIGINAL LESSEE IS RELIEVED OF THE PRIMARY OBLIGATION

- ▶ Derecognize the ROU asset and lease liability.
- ▶ Recognize any difference in profit or loss.
- ▶ Include any consideration paid or received upon termination that was not already included in the lease payments (for example, a termination payment) when determining profit or loss to be recognized.
- ▶ Recognize a guarantee in accordance with ASC 405-20-40-2 if the original lessee is secondarily liable. In this case, the guarantee is initially measured at fair value and that amount reduces the determination of profit or loss to be recognized.

ORIGINAL LESSEE IS NOT RELIEVED OF THE PRIMARY OBLIGATION

If the sublease is classified as operating, the retail or restaurant lessee (sublessor) accounts for the two leases as follows⁴:

- ▶ Continue to account for the original lease as before the sublease commencement.
- ▶ Recognize sublease income over the lease term (see Chapter 6 of our Blueprint, [Accounting for Leases Under ASC 842](#)).
- ▶ If the lease cost of the original lease for the term of the sublease exceeds the anticipated sublease income for the same period, that circumstance is an indicator that the carrying amount of the original lease ROU asset may not be recoverable in accordance with ASC 360-10-35-21 (see Section 8).

⁴ Accounting for the original lease depends on classification of the sublease, which is assessed by reference to the underlying asset, not the ROU asset. For example, in classifying the sublease, the sublessor evaluates whether the sublease term is for a major part of the remaining economic life of the underlying asset rather than the remaining term of the head lease. For those reasons, the sublease is typically classified as operating. See Section 7.4.4.2 of our Blueprint, [Accounting for Leases Under ASC 842](#), when the sublease is a sales-type or direct financing lease.



ENTERING INTO A SUBLEASE MAY AFFECT HEAD LEASE TERM

A sublessor must consider the reassessment requirements in ASC 842-10-35-1(a) and ASC 842-10-55-28(d) applicable to the head lease upon entering the sublease. The original lessee may enter a sublease that includes extension options that if exercised by the sublessee would force the original lessee to also exercise one or more extension options in the original lease. ASC 842-10-30-1 on lease term notes that periods covered by an option to extend (or not terminate) the lease in which the lessor controls the exercise of the option are included in the lease term. However, at a public meeting the FASB has noted that this requirement does not extend to options held by third parties (such as a sublessee). Accordingly, whether sublease options are included in the assessment of the head lease term depends on the facts and circumstances. Generally, the head lessee would be required to reassess and update the head lease term when the sublease term (determined in accordance with ASC 842-10-30-1) exceeds the remaining lease term of the head lease, as illustrated in Examples 7-15 through 7-17 in our Blueprint, [Accounting for Leases Under ASC 842](#). See Section 7.1 of this publication for reassessment requirements.

See Section 7.4 of our Blueprint, [Accounting for Leases Under ASC 842](#), for further discussion.

10.4 Accounting for Income Taxes

See Section 7.5 in our Blueprint, [Accounting for Leases Under ASC 842](#).

11. PRESENTATION AND DISCLOSURES

For lessees, the FASB viewed differences in risks between leased assets and owned assets and between lease liabilities and other financial liabilities, as well as economic differences between operating and finance leases. Those differences drive some of the presentation and disclosure requirements in ASC 842. ASC 842 also includes enhanced disclosure requirements, including an overall disclosure objective and expanded disclosure requirements for leases.

11.1 Presentation

SUMMARY OF LESSEE PRESENTATION REQUIREMENTS

Balance Sheet

- ▶ Present in the statement of financial position separately from each other and from other assets or liabilities:
 - Finance lease ROU assets.
 - Operating lease ROU assets.
 - Finance lease liabilities.
 - Operating lease liabilities.
- ▶ If not presented separately, disclose which line items in the statement of financial position include the ROU assets and lease liabilities.
- ▶ If not presented separately, a lessee is precluded from presenting:
 - Finance lease ROU assets in the same line item as operating lease ROU assets.
 - Finance lease liabilities in the same line item as operating lease liabilities.
- ▶ Classify ROU assets consistent with how other depreciating assets such as PP&E are classified (that is, as noncurrent based on ASC 210-10-45-4(f)) and classify lease liabilities as current or noncurrent the same way other financial liabilities are classified.

SUMMARY OF LESSEE PRESENTATION REQUIREMENTS

Income Statement

- ▶ For finance leases, present interest expense on the lease liability and amortization of the ROU asset in a manner consistent with how the retail or restaurant company presents other interest expense and depreciation (amortization) of similar assets, respectively.
- ▶ ASC 842 does not provide specific guidance on presentation of variable lease payments for finance leases. We believe that presentation as either lease expense or interest expense may be appropriate.
- ▶ For operating leases, lease expense is included in income from continuing operations consistently with the presentation of other operating expenses and depending on the nature of the lease, is classified within cost of sales; selling, general, and administrative expense; or another expense line item.

Cash Flow Statement

- ▶ For finance leases:
 - Classify repayments of the principal portion of the lease liability within financing activities.
 - Classify interest on the lease liability in accordance with the requirements relating to interest paid in ASC 230, *Statement of Cash Flows* (which is typically in operating activities).
- ▶ For operating leases, classify payments within operating activities unless those payments represent costs to bring another asset to the condition and location necessary for its intended use. In that case, the payments are classified within investing activities.
- ▶ For all leases, classify variable lease payments and short-term lease payments not included in the lease liability within operating activities.
- ▶ The establishment of ROU assets and lease liabilities at lease commencement (or that change as a result of lease modifications or reassessment events) are disclosed as noncash investing and financing activities in accordance with ASC 230-10-50-4.

BDO INSIGHTS – APPROACHES FOR DETERMINING CURRENT LEASE LIABILITIES

Lease liabilities are classified as current and noncurrent in the balance sheet and subject to the same considerations as other financial liabilities when determining such classification. Therefore, lessees presenting a classified balance sheet must follow the presentation requirements in ASC 210, *Balance Sheet*.

Lessees present as noncurrent lease liabilities the difference between the total lease liabilities and the current portion of those lease liabilities. We believe the following approaches are acceptable for determining current lease liabilities:

- ▶ Calculate the portion of lease payments that will reduce the lease liability balance (lease payments less interest accretion on the lease liability) within 12 months (or the operating cycle, if longer)
- ▶ Calculate the present value of lease payments due within 12 months (or the operating cycle, if longer) using the discount rate for the lease.

We also believe the approach selected for determining current lease liabilities should be consistent with the approach used to determine the current portion of other similarly calculated liabilities. For example, if a lessee uses the first approach to determine the current portion of its debt obligations and such obligations are amortized using the effective interest rate method, the lessee should also use the first approach to determine the current portion of its lease liabilities.

See Section 8.2.2 of our Blueprint, [Accounting for Leases Under ASC 842](#), for further discussion.

11.2 Disclosures

The objective of the disclosure requirements for lessees is to enable users of the financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. A retail or restaurant lessee must consider the level of detail necessary to satisfy that disclosure objective and how much emphasis to place on each of the various requirements. The company should aggregate or disaggregate disclosures so that useful information is not obscured by either including a large amount of insignificant detail or aggregating items that have different characteristics.

With that objective in mind, professional judgment is required to determine the level of disclosures necessary for a retail or restaurant company. As a guiding principle, BC276 of ASU 2016-02 states that *“if leasing is a significant part of an entity’s business activities, the disclosures would be more comprehensive than for an entity whose leasing activities are less significant.”* For example, although ASC 842 does not provide specific quantitative or qualitative disaggregation requirements such as those required under ASC 606, such disaggregation might be appropriate for companies for which leasing is a significant portion of their business.

Lessees (both public and private entities) must disclose the following:

LESSEE DISCLOSURE REQUIREMENTS

Qualitative Disclosures

- ▶ Information about the nature of its leases (and subleases, as applicable), including:
 - A general description of those leases.
 - The basis and terms and conditions on which variable lease payments are determined.
 - The existence and terms and conditions of options to extend or terminate the lease. A lessee must provide narrative disclosure about the options that are and are not recognized as part of its ROU assets and lease liabilities.
 - The existence and terms and conditions of residual value guarantees provided by the lessee.
 - The restrictions or covenants imposed by leases; for example, those relating to dividends or incurring additional financial obligations.
- ▶ 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.
- ▶ Information about significant assumptions and judgments made, including:
 - The determination of whether a contract contains a lease.
 - The allocation of consideration in a contract between lease and nonlease components.
 - The determination of the discount rate for the lease.

Quantitative Disclosures

- ▶ For each period presented, disclose amounts related to a lessee’s total lease cost (including amounts recognized in income and capitalized) and the cash flows from lease transactions:
 - Finance lease cost, segregated between amortization of ROU assets and interest on lease liabilities.
 - Operating lease cost.
 - Short-term lease cost, excluding expenses relating to leases with a lease term of one month or less.
 - Variable lease cost.
 - Sublease income disclosed on a gross basis separately from finance or operating lease expense.
 - Net gain or loss recognized from sale and leaseback transactions.
 - Amounts segregated between those for finance and operating leases for:

LESSEE DISCLOSURE REQUIREMENTS

- Cash paid for amounts included in the measurement of lease liabilities segregated between operating and financing cash flows.
- Supplemental noncash information on lease liabilities arising from obtaining ROU assets.
- Weighted-average remaining lease term based on the remaining lease term and the lease liability balance for each lease as of the reporting date.
- Weighted-average discount rate based on the discount rate for the lease used to calculate the lease liability balance for each lease and the remaining balance of lease payments for each lease as of the reporting date.
- See ASC 842-20-55-53 for an example of these disclosures.
- Disclose maturity analysis of undiscounted lease liabilities (commonly referred to as the five-year table) separately for finance and operating leases, with a reconciliation of undiscounted cash flows to the finance and operating lease liabilities recognized in the statement of financial position.
- ▶ While the FASB illustrated a lessee’s disclosure of quantitative disclosures in ASC 842-30-55-53 (Example 6) by providing the information in a tabular format, the disclosure requirements in ASC 842-20-50 do not specifically require such a format.

Policy Elections and Practical Expedients

- ▶ Disclose policy election for short-term leases, if elected.
 - Also, if the short-term lease expense does not reasonably reflect the lessee’s short-term lease commitments, disclose that fact and the amount of short-term lease commitments.
- ▶ Disclose practical expedient for not separating lease and nonlease components, if elected, and to which asset classes the election applies.
- ▶ Disclose accounting policy on using the risk-free discount rate for the lease, if elected, and to which class or classes of underlying assets the election applies.

Related Party Leases

- ▶ Disclose lease transactions between related parties in accordance with ASC 850-10-50-1 through 50-6.
- ▶ For common control leases, disclose the following when the useful life of leasehold improvements to the common control group exceeds the related lease term:
 - The unamortized balance of the leasehold improvements at the balance sheet date.
 - The remaining useful life of the leasehold improvements to the common control group.
 - The remaining lease term.

Sale and Leaseback Transactions

- ▶ If a seller-lessee enters a sale and leaseback transaction, it provides the lessee-required disclosures for the leaseback.
- ▶ A seller-lessee discloses the main terms and conditions of the sale and leaseback transaction and any gains or losses arising from the transaction separately from gains or losses on disposal of other assets.

**NONCASH INFORMATION NOT LIMITED TO LEASE LIABILITIES ARISING FROM OBTAINING ROU ASSETS**

ASC 842-20-50-4(g)(2) requires disclosure of “*supplemental noncash information on lease liabilities arising from obtaining right-of-use assets.*” Also, ASC 230-10-50-3 requires disclosure of information about a company’s investing and financing activities during a period that affect recognized assets or liabilities but that do not result in cash receipts or cash payments in the period. Therefore, we believe that all material noncash changes to ROU assets, both increases and decreases, should be disclosed either on the face of the statement of cash flows or in the related notes. The initial recognition of an ROU asset should therefore be included in this disclosure, along with:

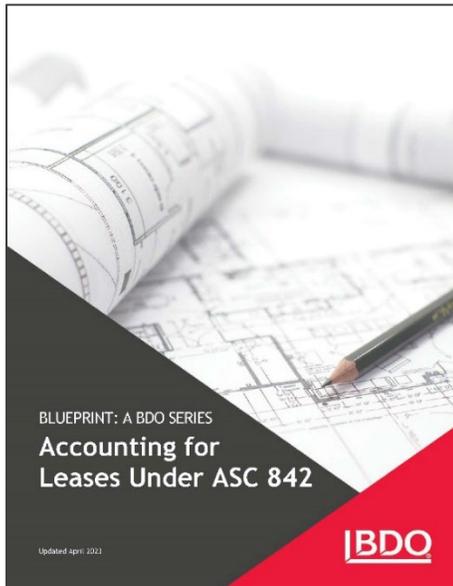
- ▶ Any lease modification that grants an additional ROU asset or removes an ROU asset.
- ▶ Any other remeasurement that results in increases or decreases (debits or credits) to the ROU asset, such as changes in the assessment of the lease term.

See Section 7 for additional information on modifications and remeasurement events.

See Example 8-2 in our Blueprint, [Accounting for Leases Under ASC 842](#), for an illustration of footnote disclosure.

Appendix A – BDO Blueprints

BDO’s Blueprint publications are available on the [BDO Center for Accounting Standards and Reporting Matters](#).



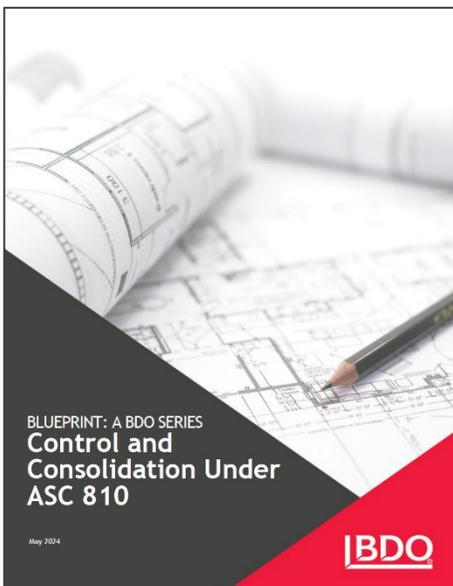
[Accounting for Leases Under ASC 842](#)



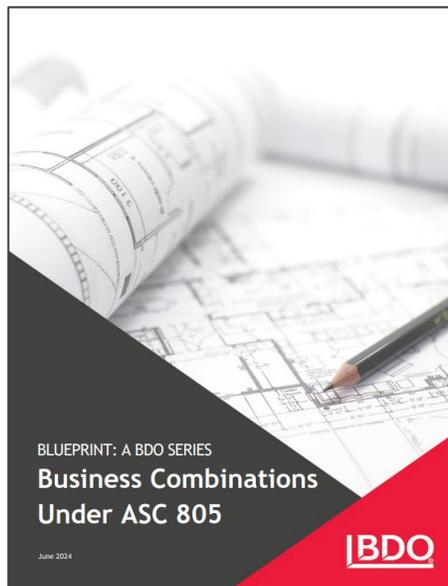
[Revenue Recognition Under ASC 606](#)



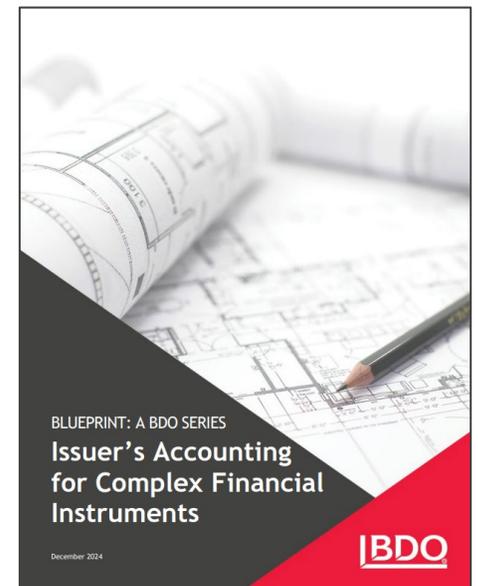
[Share-based Payments Under ASC 718](#)



[Control and Consolidation Under ASC 810](#)



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