BLUEPRINT: A BDO SERIES

# Accounting for Leases Under ASC 842

Updated January 2025

BDO

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# INTRODUCTION

In February 2016, the Financial Accounting Standards Board (FASB) issued new lease accounting guidance in Accounting Standards Update (ASU) 2016-02, *Leases (Topic 842)* (Accounting Standards Codification (ASC) 842). Under its core principle, a lessee recognizes a right-of-use (ROU) asset and a related lease liability on the balance sheet for most leases, which is the most significant change ASC 842 introduced for lessees. ASC 842 reflects that at the commencement date of a lease, a lessee has a financial obligation to make lease payments to the lessor in exchange for its right to use the underlying asset, and accordingly it must recognize an ROU asset and a lease liability for these rights and obligations. For the income statement, a lessee's pattern of expense recognition depends on a lease's classification and is generally consistent with legacy U.S. generally accepted accounting principles (GAAP) (that is, ASC 840, *Leases*). The recognition of a lease in the financial statements is also not a "set it and forget it" exercise. A lessee must comply with certain remeasurement requirements, modification requirements and it must assess its ROU assets for impairment.

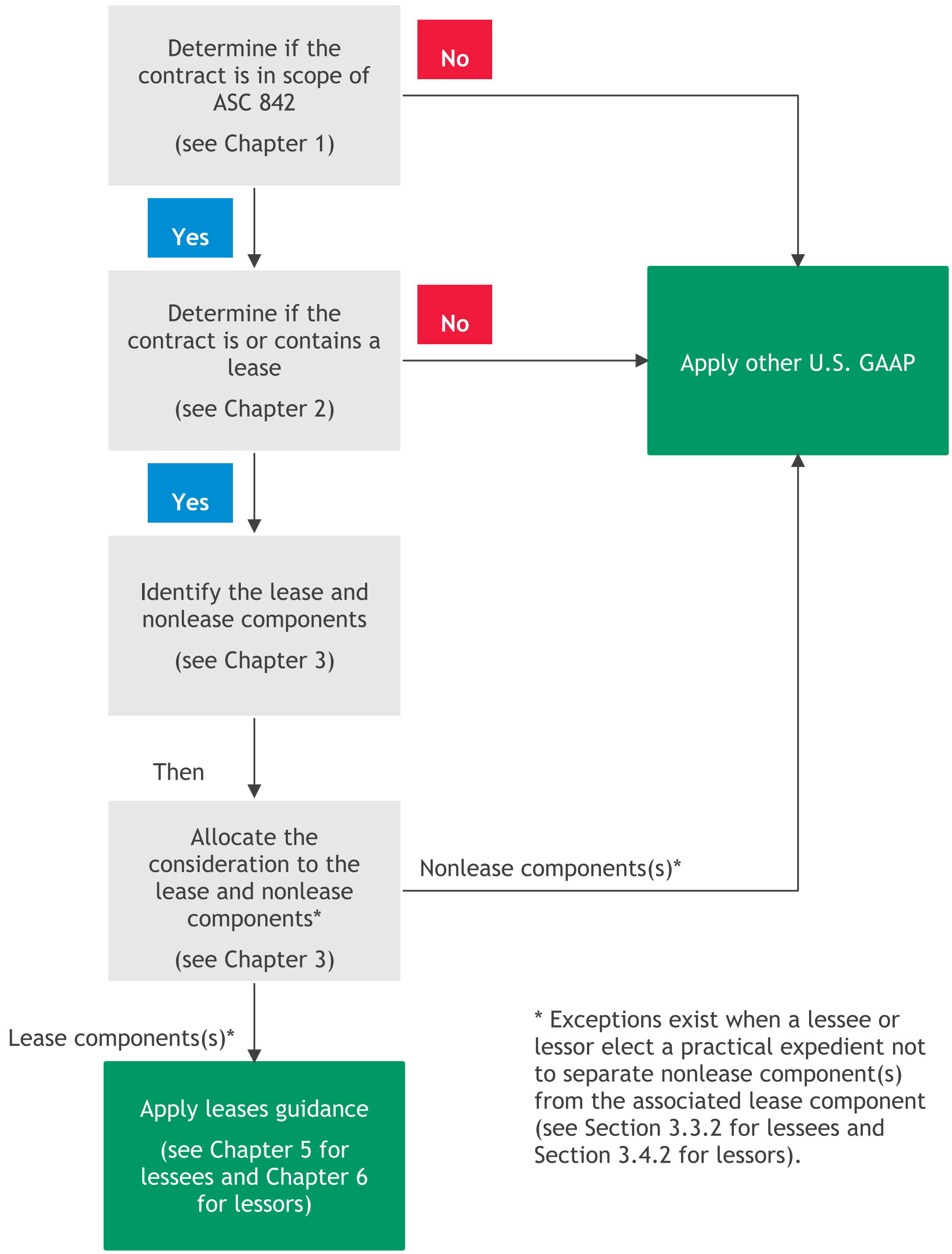
Lessor accounting varies depending on classification which can be either a sales-type, direct financing, or operating lease. Since leasing is fundamentally a revenue-generating activity for lessors, key aspects of lessor accounting are aligned with ASC 606, *Revenue from Contracts with Customers*. For example, under ASC 842 a lessor recognizes selling profit (or sales revenue) at lease commencement only if the lease transfers control of the underlying asset to the lessee, consistent with a sale of an asset under ASC 606. Under ASC 842, this occurs when the lease is a sales-type lease and, because control of the underlying asset has transferred to the lessee, a lessor derecognizes the underlying asset at the commencement date and recognizes a net investment in the lease. If the lease is not sales-type the lessor must determine whether to classify the lease as a direct financing or operating lease. A lease classified as direct financing effectively converts the lessor's risk arising from ownership of the asset (asset risk) into credit risk.

Lessees and lessors must also disclose key information about their leasing arrangements.

The leases project began as one of several joint projects between the FASB and the International Accounting Standards Board (IASB) to converge U.S. GAAP and international financial reporting standards (IFRS). However, after several years of deliberations and two exposure drafts, the FASB and IASB reached different conclusions on various aspects of lease accounting (such as classification of leases by lessees) and in early 2016 issued separate guidance. Additional information on the accounting for leases under IFRS is available **here**.

## ASC 842 IN A NUTSHELL

The flowchart below provides a high-level summary of what an entity considers when applying ASC 842. The entity applies the steps in the gray boxes at the inception of the contract, although an entity may need to reassess those subsequently (for example, for some modifications). We explore the steps in further detail throughout this Blueprint.




* Exceptions exist when a lessee or lessor elect a practical expedient not to separate nonlease component(s) from the associated lease component (see Section 3.3.2 for lessees and Section 3.4.2 for lessors).

An entity applies ASC 842 consistently to leases with similar characteristics and in similar circumstances.

## SCOPE AND SCOPE EXCEPTIONS

An entity must first determine if a contract is in scope of ASC 842, which applies to leases of property, plant, and equipment (PP&E). Accordingly, it does not apply to contracts related to any of the following:

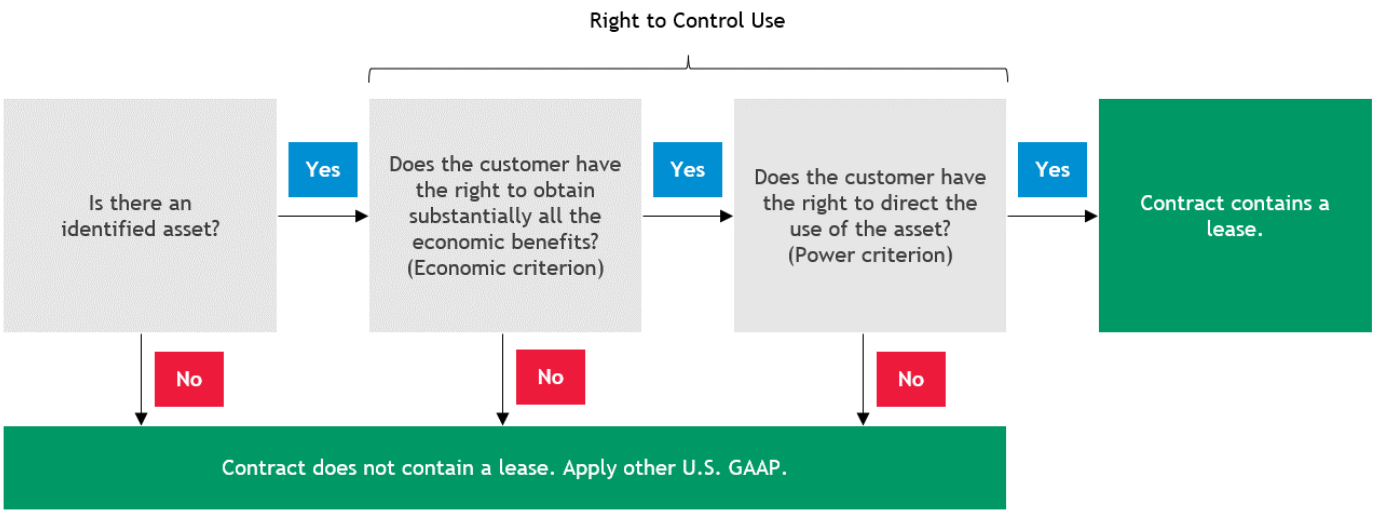
| | RELEVANT GUIDANCE AND OBSERVATIONS |
|---|---|
| **Leases of intangible assets, such as licenses of intellectual property** | Apply ASC 350, *Intangibles — Goodwill and Other* |
| **Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources** | Apply ASC 930, *Extractive Activities — Mining*, and ASC 932, *Extractive Activities — Oil and Gas*<br>(See Section 1.1.2) |
| **Leases of biological assets, such as plants and animals** | Apply ASC 905, *Agriculture*<br>(This scope exception includes timber.) |
| **Leases of inventory** | Apply ASC 330, Inventory |
| **Leases of assets under construction** | Apply ASC 360, *Property, Plant, and Equipment*<br>(Transactions in which the underlying asset must be constructed or redesigned for use by the lessee may be in scope of the sale-leaseback guidance if the lessee controls the asset under construction before the lease commencement date (see Section 7.2.2.2.)) |

See Chapter 1 for further guidance.

## IDENTIFYING A LEASE

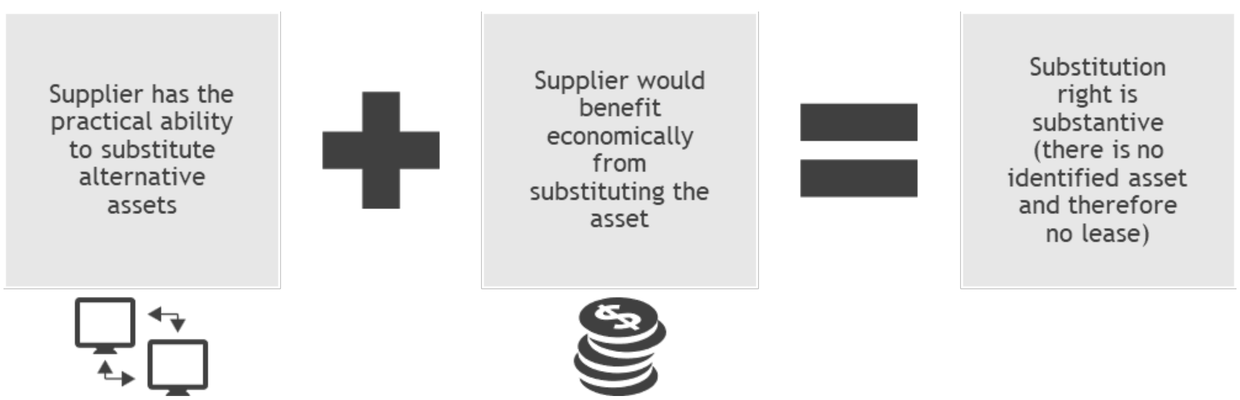
If the contract is in the scope of ASC 842, the entity determines whether the contract is or contains a lease. A lease is a contract or part of a contract that conveys the right to control the use of identified PP&E (an identified asset) for a period of time in exchange for consideration. A period of time may be described in terms of the amount of an identified asset's use (for example, the number of units a piece of equipment will be used to produce).

The definition of a lease focuses on three criteria, as described in the flowchart.




An asset is typically identified when it is either explicitly specified in the contract or implicitly specified when it is made available for customer use. However, 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 substantive, the supplier (rather than the customer) controls the use of the asset.

Supplier substitution rights are substantive when **both** the conditions below are met throughout the period of use.




An entity evaluates whether a contract is or contains a lease at contract inception and does not subsequently reassess it unless the contract's terms and conditions are modified.

See Chapter 2 for further guidance.

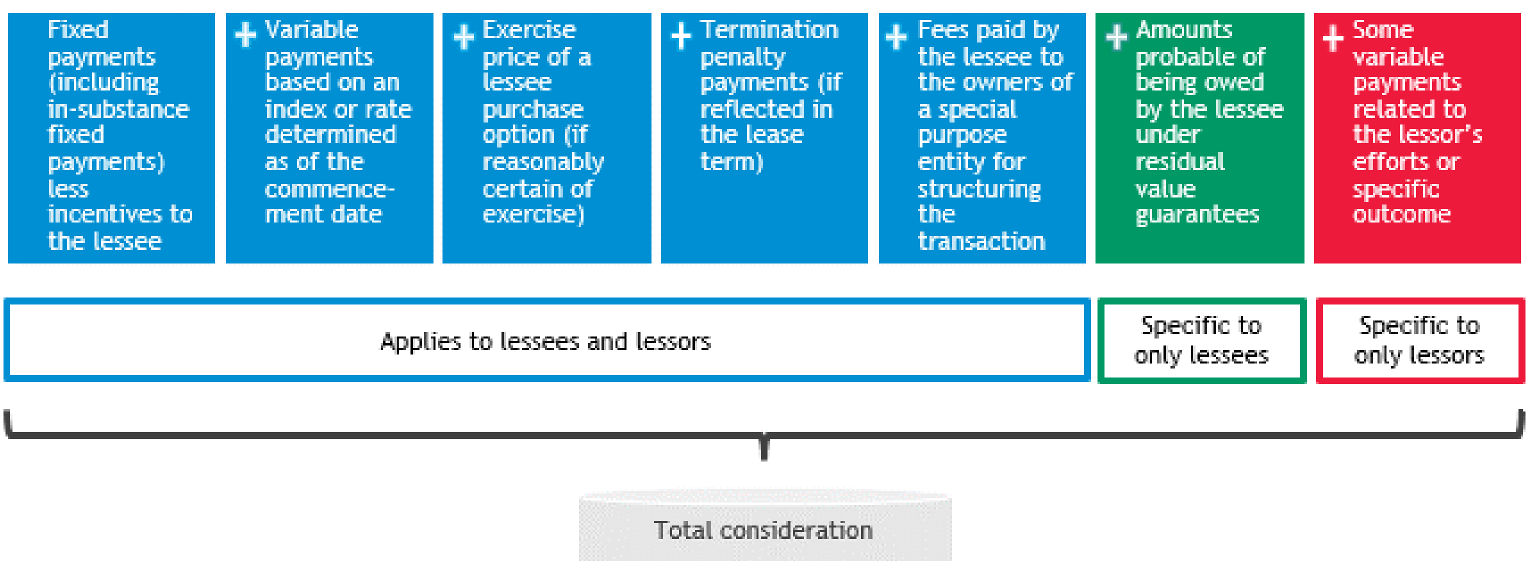
## IDENTIFYING AND SEPARATING COMPONENTS

Once an entity concludes that a contract is or includes a lease, it identifies the components of the contract, which are the units of account that determine which U.S. GAAP applies. Components of a contract include only those items or activities that transfer a good or service to the lessee. Other items or activities are not components.

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

A lessee or lessor must identify the individual lease and nonlease components of the contract but do not have to separate the nonlease components from the associated lease component if a practical expedient not to separate is elected (see Section 3.3.2 for lessees and Section 3.4.2 for lessors).

The entity also must determine at contract inception the consideration in the contract as summarized in the graphic.

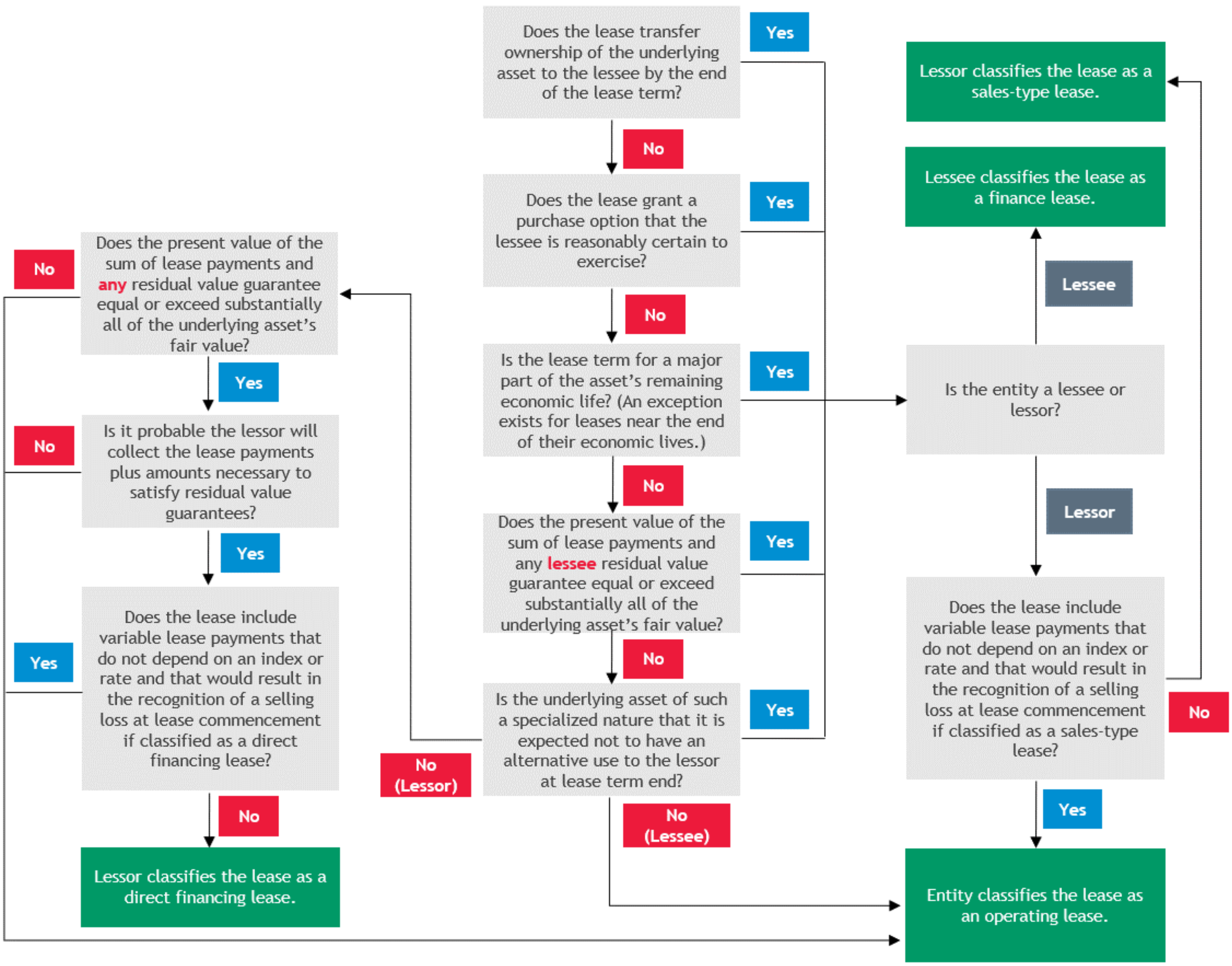



Once the entity determines the consideration, it allocates that consideration to the contract components. If a contract includes more than one lease component, or includes a lease component and at least one nonlease component, the entity must separate and allocate the consideration in the contract to those components unless it elected the practical expedient not to separate the nonlease components (and, for a lessor, if specific conditions are met). The allocation of the consideration is generally made on a relative standalone (selling) price basis (that is, not necessarily based on any stated prices in the contract). Lessors also must apply the allocation guidance in ASC 606. If the components are separated, an entity accounts for the nonlease components under other U.S. GAAP and the lease components under ASC 842.

See Chapter 3 for further guidance.

## LEASE CLASSIFICATION

Once the components are separated, an entity (lessee or lessor) classifies each lease component at the commencement date of the lease using the steps in the flowchart below. An entity may be required to reassess classification subsequently (for example, for some modifications).




See Chapter 4 for further discussion.

## LESSEE ACCOUNTING

Once a lessee determines lease classification, it recognizes the lease on the balance sheet at the commencement date unless it elected the short-term lease accounting policy for the asset class (discussed below). The table summarizes a lessee's accounting for leases if the lease is recognized on the balance sheet.

| | FINANCE LEASES | | OPERATING LEASES | |
|---|---|---|---|---|
| | ROU ASSET | LEASE LIABILITY | ROU ASSET | LEASE LIABILITY |
| Balance Sheet | Initially measure the ROU asset at the amount of the lease liability plus initial direct costs and prepaid lease payments less lease incentives received. | Initially measure the lease liability at the present value of the unpaid lease payments using the discount rate for the lease. | Initial measurement is the same as for finance leases. | |
| | Subsequently, amortize the ROU asset (typically on a straight-line basis) to the earlier of the end of its useful life or lease term.* | Subsequently, increase the lease liability to reflect interest using the effective interest method and decrease it for lease payments made. | Amortize the ROU asset for the difference between the periodic straight-line lease cost (which includes amortization of initial direct costs) and the periodic interest accretion. | Subsequent measurement is the same as for finance leases. |
| Income Statement | Recognize amortization on the ROU asset, interest on the lease liability, and variable lease payments not included in the lease liability when incurred.** | | Recognize single lease cost (lease payments plus initial direct costs) generally on a straight-line basis and variable lease payments not included in the lease liability when incurred.** | |
| Cash Flow Statement | Classify the repayments of the principal portion of the lease liability in financing activities and payments of interest on the lease liability and variable lease payments generally in operating activities. | | Classify all cash payments for leases in operating activities. | |

* 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.

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

ASC 842 requires lessees to update the measurement of leases for some lease modifications and other reassessment events, and lessees need robust processes and controls to timely and completely identify and account for such events. When remeasuring the lease liability and adjusting the ROU asset, the ROU asset's amortization is adjusted prospectively from the remeasurement date. The FASB has also provided lessees with an accounting policy not to recognize short-term leases on balance sheet. A short-term lease is a lease with a lease term of no more than 12 months and that does not include a lessee purchase option that is reasonably certain of exercise. That election is by asset class and under it, a lessee recognizes lease payments on a straight-line basis over the lease term along with variable lease payments when incurred.

See Chapter 5 for further discussion.

## LESSOR ACCOUNTING

A lessor classifies each separate lease component at the commencement date as either a sales-type, direct financing, or operating lease using the lease classification flowchart provided above. Once a lessor determines lease classification, it accounts for the lease as shown in the table below.

<table>
<tr><th></th><th>SALES-TYPE LEASES</th><th>DIRECT FINANCING LEASES</th><th>OPERATING LEASES</th></tr>
<tr><td>Balance Sheet</td><td>Derecognize the underlying asset and recognize a net investment in the lease at the commencement date if collectability of the lease payments and any lessee residual value guarantee is probable.*</td><td>Derecognize the underlying asset and recognize a net investment in the lease (which includes selling profit and initial direct costs) at the commencement date.</td><td>Continue to recognize the underlying asset.<br>Defer initial direct costs.</td></tr>
<tr><td rowspan="2">Income Statement</td><td>Recognize selling profit or loss.<br>Expense initial direct costs (unless the fair value of the underlying asset equals its carrying amount, in which case initial direct costs are included in the net investment in the lease).</td><td>Recognize any selling loss.</td><td rowspan="2">Recognize lease payments generally on a straight-line basis over the lease term if collectability is probable. Otherwise, lease income is limited generally to lease payments collected.<br>Recognize variable lease payments in the period when changes in the facts and circumstances on which the payments are based occur (or when collected—see above).<br>Expense initial direct costs on the same basis as lease income over the lease term.<br>Recognize depreciation expense (and any impairment of the underlying asset) under ASC 360.</td></tr>
<tr><td colspan="2">Recognize interest income on the net investment in the lease.<br>Recognize variable lease payments not included in the net investment in the lease in the period when changes in the facts and circumstances on which the payments are based occur.<br>Recognize credit losses on the net investment in the lease under ASC 326, Financial Instruments — Credit Losses.</td></tr>
<tr><td>Cash Flow Statement</td><td colspan="2">Classify all payments received as operating cash flows except that entities within the scope of ASC 942, Financial Services — Depository and Lending, present principal payments within investing activities.</td><td>Classify all payments received as operating cash flows.</td></tr>
</table>

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

Also, leveraged lease accounting no longer exists for leases that are entered into or modified after the effective date of ASC 842. As a result, new or modified leases that met the ASC 840 definition of a leveraged lease are now accounted for as one of the three types of leases described above. Leveraged leases that existed when an entity adopted ASC 842 are grandfathered and continue to be accounted for as such until they expire or are modified.

See Chapter 6 for further discussion.

## ADOPTION DATES

Except for ASU 2023-01, *Leases (Topic 842): Common Control Arrangements*, ASC 842 is now effective for all companies. ASU 2023-01 simplifies the lease identification assessment of and accounting for common control arrangements for nonpublic entities and changes how to amortize and account for the transfer of leasehold improvements for all lessees in common control leases. ASU 2023-01 is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years; early adoption is permitted.

## ABOUT THE BLUEPRINT

This Blueprint reflects key aspects of the relevant ASUs affecting lease accounting, including ASU 2023-01 (all of which it refers to as ASC 842).

The Blueprint includes detailed guidance and flowcharts on analyzing and accounting for contracts under ASC 842. The graphics and illustrations are provided to assist readers in understanding various aspects of the lease accounting guidance. Accounting for contracts may vary based on the specific facts and circumstances of each contract and therefore may differ from the illustrations provided herein.

While this Blueprint does not include all requirements of ASC 842, it summarizes key aspects that commonly arise in applying ASC 842. It also includes practical examples and interpretive guidance to assist entities and practitioners in applying ASC 842.

The chapters in this Blueprint address key aspects of lease accounting. They are organized in the order in which an entity generally applies ASC 842 and include questions an entity needs to answer as it proceeds with its evaluation. Other aspects of ASC 842 related to specific transactions and interactions with other areas of U.S. GAAP have been grouped into the chapter "Other Topics," which includes accounting for sale and leaseback transactions, subleases, business combinations, and income taxes.

## ACKNOWLEDGMENTS

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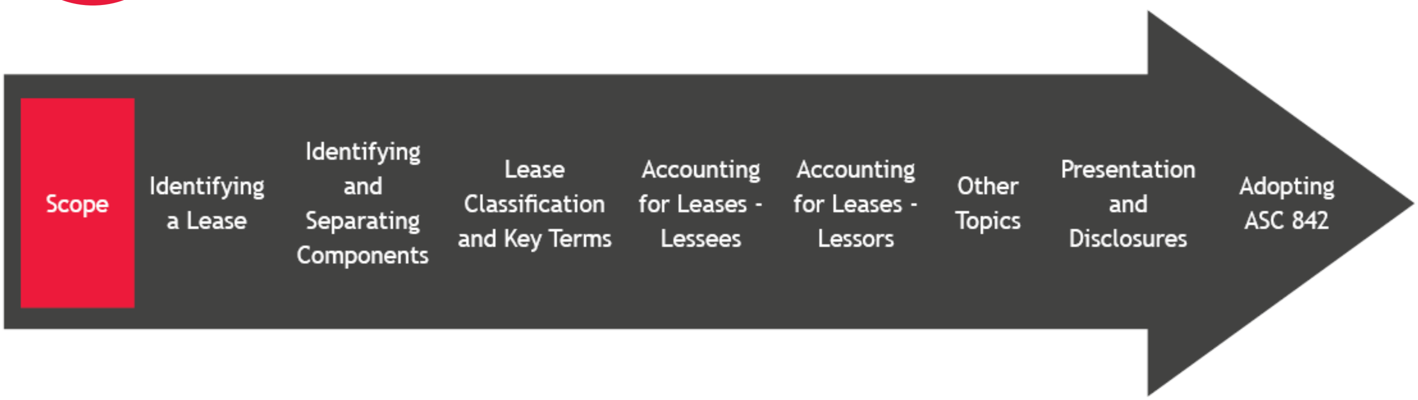
# CHAPTER 1 — SCOPE




## 1.1 SCOPE AND SCOPE EXCEPTIONS

**FASB REFERENCES**

ASC 842-10-15-1

ASC 842 applies to leases of PP&E. Accordingly, it does not apply to any of the below.

| | RELEVANT GUIDANCE AND OBSERVATIONS |
|---|---|
| **Leases of intangible assets, such as licenses of intellectual property** | Apply ASC 350 |
| **Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources** | Apply ASC 930 and ASC 932<br>(See Section 1.1.2) |
| **Leases of biological assets, such as plants and animals** | Apply ASC 905<br>(This scope exception includes timber.) |
| **Leases of inventory** | Apply ASC 330 |
| **Leases of assets under construction** | Apply ASC 360<br>(Transactions in which the underlying asset must be constructed or redesigned for use by the lessee may be in scope of the sale-leaseback guidance if the lessee controls the asset under construction before the lease commencement date (see Section 7.2.2.2.)) |

**BDO INSIGHTS — SCOPE IS LIMITED TO PROPERTY, PLANT, AND EQUIPMENT**

ASC 842 applies only to leases of PP&E (that is, land and depreciable assets). The FASB acknowledged in paragraph BC110 of ASU 2016-02 that the conceptual basis for excluding assets such as intangible assets, inventory, and assets under construction from the scope of ASC 842 was unclear. Even so, it decided to continue to limit the scope to only PP&E for pragmatic reasons, including cost-benefit considerations.

### 1.1.1 Long-Term Leases of Land

ASC 842 covers long-term leases of land, such as those for 99 years. While some stakeholders view long-term leases economically as purchases of land, the FASB noted that there is no conceptual basis for differentiating long-term leases of land from other leases and that any definition of long-term would be arbitrary. Accordingly, long-term leases of land are in the scope of ASC 842. See Section 1.2 for a discussion of land easements.

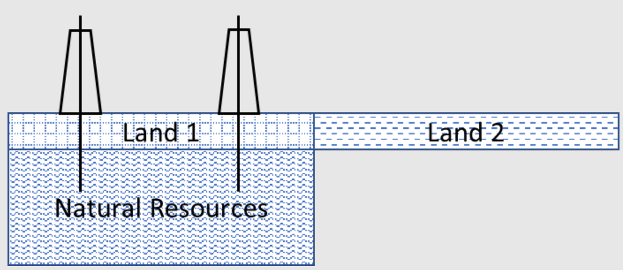
### 1.1.2 Leases to Explore for or Use Minerals, Oil, Natural Gas, and Similar Nonregenerative Resources

The scope exception discussed in Section 1.1 applies to the intangible right to explore for natural resources and rights to use the land where those resources are unless those ROUs include more than the right to explore for natural resources. The exception does not apply to equipment used to explore for the natural resources.

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

**FACTS**

- An entity obtains the intangible right to explore for or use natural resources along with rights to use the land that contains those resources (Land 1). To access Land 1 and explore for natural resources, the entity also obtains access rights to an adjacent parcel (Land 2) and contracts with other parties for the use of drilling rigs, as shown in the picture.




**CONCLUSION AND ANALYSIS**

- The scope exception includes “the intangible right to explore for those natural resources and rights to use the land in which those natural resources are contained”. Accordingly, the intangible right to explore for or use natural resources along with rights to use Land 1 are outside the scope of ASC 842. That is so even if the entity entered separate contracts with different parties for the rights to Land 1 and for the rights to explore for the underlying natural resources (for example, if the surface rights are legally separated from the mineral rights and owned by different parties).
- The exception does not apply to the access rights for Land 2 because the exception is limited to the rights to use the land where the natural resources are and for which the entity has exploration rights (which is only Land 1). Accordingly, the entity must determine whether its right to access Land 2 meets the definition of a lease. See Section 1.2 for considerations on land easements.
- The scope exception does not apply to equipment used to explore for the natural resources. Accordingly, the contracts for the use of drilling rigs are in the scope of ASC 842, and the entity must determine whether a lease exists.

## 1.2 SPECIFIC CONSIDERATIONS FOR LAND EASEMENTS

**FASB REFERENCES**

ASC 350-30-55-29 through 55-32

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

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

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

Before ASC 842, there was diversity in the accounting for land easements. For example:

- Some entities accounted for their easements as intangible assets based on the guidance in Example 10 of ASC 350-30, *Intangibles — Goodwill and Other — General Intangibles Other Than Goodwill*.
- Some entities applied ASC 360 and considered prepaid land easements as a cost to bring PP&E (such as a pipeline) to the condition and location necessary for its intended use.
- Some entities applied ASC 840 (such as a cell tower company entering a land easement for the right to erect a communications tower).

Because of that diversity, the FASB clarified that land easements are in the scope of ASC 842. However, to reduce the cost and complexity associated with assessing whether all existing and expired land easements met the definition of a lease, in adopting ASC 842, the FASB allowed entities that previously did not account for land easements as leases under ASC 840 to elect a transition practical expedient not to assess those land easements under ASC 842 when adopting it. Instead, entities continue to account for those grandfathered land easements under other U.S. GAAP unless the land easement is modified on or after the ASC 842 adoption date. Accordingly, an entity must apply ASC 842 to all new or modified land easements to determine whether those arrangements meet the definition of a lease under ASC 842.

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

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

**EXAMPLE 1-2: GRANDFATHERED LAND EASEMENTS**

**FACTS**

- Before it adopted ASC 842, an entity obtained a series of easements to install poles to which its power lines would be attached. The entity also has the right to access the poles via a corridor leading from the nearest road. It makes payments over time under the easement agreement in return for long-term access rights.
- The entity historically accounted for those land easements and its poles as PP&E under ASC 360. When adopting ASC 842, the entity elected the transition practical expedient not to assess existing land easements under ASC 842.

**CONCLUSION AND ANALYSIS**

- Because the entity did not account for those land easements as leases under ASC 840 and elected the transition practical expedient, it continues to account for those easements under ASC 360. However, if the agreement is modified on or after the entity adopted ASC 842, the entity must assess whether those easements meet the definition of a lease under ASC 842.

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

As part of its project on land easements, the FASB became aware of several unit of account questions commonly arising with land easements that affected the lease evaluation under ASC 842. For example, a midstream energy company may acquire a land easement for the right to pass a pipeline under an area in which the landowner retains rights associated with the use of the land's surface. It is unclear whether the subsurface area represents its own unit of evaluation or should be considered together with the surface. That question is important because the arrangement is more likely to contain a lease if the subsurface is considered its own unit of evaluation. The FASB chose not to provide additional clarity because it did not view those kinds of questions as being limited to land easements. If an entity determines that an arrangement does not contain a lease, it applies other U.S. GAAP, such as ASC 350 or ASC 360, to account for the arrangement.

For arrangements similar to the example above, we believe an entity can either apply ASC 842 and evaluate whether the arrangement contains a lease or analogize the subsurface rights to air rights (that is, an intangible asset outside the scope of ASC 842) if the rights conveyed relate to subsurface (underground) space that cannot be inhabited or otherwise accessed (characteristics shared with air rights). If treated like air rights, the entity would not apply the ASC 842 definition of a lease in but would apply other U.S. GAAP, such as ASC 350, to its arrangement. However, we believe an analogy to air rights is not acceptable in all cases. For example, an entity cannot analogize to the guidance on air rights for leases of underground retail space in a subway station, a basement of a commercial office building, or an underground parking garage. Because arrangements terms and conditions vary greatly, determining the accounting for land easements requires the use of professional judgment based on the facts and circumstances.

**BDO INSIGHTS — DIVERSITY IN ACCOUNTING CONTINUES WHEN A LAND EASEMENT IS NOT A LEASE**

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

## 1.3 INTERACTION WITH OTHER STANDARDS

### 1.3.1 Derivatives and Hedging

**FASB REFERENCES**

ASC 815-10-15-59(b), ASC 815-10-15-59(d), ASC 815-10-15-79 through 15-80, ASC 815-15-25-21 through 25-22, and ASC 842-10-15-43

Leases that are within the scope of ASC 842 are not derivative instruments subject to the guidance on derivatives and hedging, meaning they are not accounted for as derivative instruments in their entirety. However, a derivative instrument embedded in a lease may be subject to the ASC 815-15-25 requirements on recognition of embedded derivatives. In considering whether the derivative guidance applies to features embedded in a lease contract, an entity may consider the following:

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

### 1.3.2 Service Concession Arrangements

**FASB REFERENCES**

ASC 853-10-05-1 through 05-2, ASC 853-10-15-2 through 15-3, and ASC 853-10-25-2

A service concession arrangement allows an operating entity to operate and sometimes maintain the infrastructure (for example, airports, roads, bridges, prisons, and hospitals) of a public-sector grantor for a specified period. The infrastructure may be constructed during the arrangement's term, or the operating entity may be required to make significant renovations to existing infrastructure. During the arrangement, the operating entity manages the infrastructure to provide a public service and may receive payments from the public-entity grantor for performing those services. The operating entity may also charge third parties to use the infrastructure, such as a toll road.

ASC 853, *Service Concession Arrangements*, provides guidance on how operating entities should account for arrangements with **both** of the following conditions:

- The public sector grantor controls or can modify or approve the services the operating entity must provide with the infrastructure, to whom the entity must provide them, and at what price
- The public sector grantor controls, through ownership, beneficial entitlement, or otherwise any residual interest in the infrastructure at the end of the arrangement.

When a transaction is within the scope of ASC 853, the service concession arrangement is not under ASC 842 and:

- The operating entity cannot recognize the underlying infrastructure as PP&E
- The operating entity considers the grantor the customer of its operation services in all cases when applying ASC 606.

### 1.3.3 Revenue From Contracts With Customers

**FASB REFERENCES**

ASC 606-10-55-68

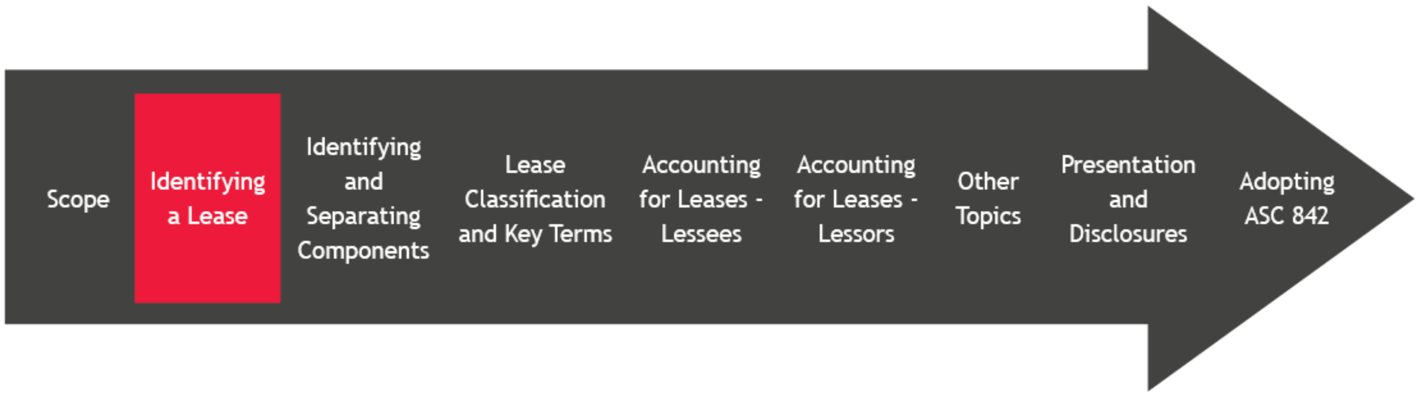
If an entity (supplier) has an obligation or right to repurchase an asset (a forward or a call option) in a revenue transaction under ASC 606, the customer does not obtain control of the asset. That is because the customer is limited in its ability to direct the use of, and obtain substantially all the remaining benefits from, the asset even though it may physically possess the asset. If the entity can or must repurchase the asset for an amount that is less than its original selling price, it accounts for the contract as a lease. However, if the contract is part of a sale and leaseback transaction, the entity accounts for it as a financing arrangement rather than a sale and leaseback transaction under ASC 842-40. See our Blueprint, Revenue Recognition Under ASC 606, for further discussion of ASC 606.

### 1.3.4 Research and Development

A lessee may enter a lease for research and development (R&D) activities for which the ROU asset has no alternative future uses in other R&D projects or otherwise.[1] In those scenarios, the accounting for the lease liability is unchanged (that is, it continues to represent an obligation the lessee reports on its balance sheet). However, we believe the accounting for the ROU asset depends on its lease classification (see Section 5.5.2.2).

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

# CHAPTER 2 — IDENTIFYING A LEASE




## 2.1 OVERVIEW

**FASB REFERENCES**

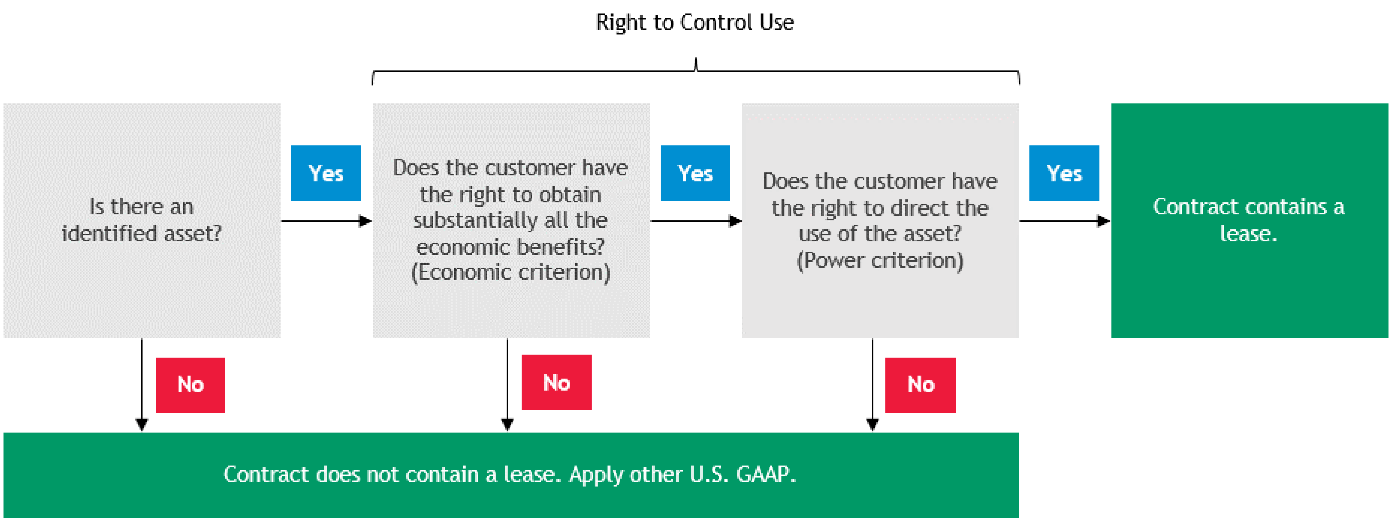
ASC 842-10-15-2 through 15-7; ASC 842-10-20: Lease, Underlying Asset; ASC 842-10-55-1; and ASC 350-30-55-30

A lease is a contract, or part thereof, that conveys the right to control the use of identified PP&E (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 units a piece 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, the contract 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 on the next page.




All relevant facts and circumstances must be considered when assessing whether a contract is or contains a lease. An entity does not need to perform the analysis in the same order as illustrated above if it is clear one criterion is not met. However, all three criteria must be assessed before concluding that a contract is or contains a lease.

If the customer in the contract is a joint operation or joint arrangement, the entity considers whether the joint operation or arrangement has the right to control the use of an identified asset throughout the period of use (see Section 2.4). For an entity 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 (see Example 2-1).
- The evaluation of whether a contract is or contains a lease is performed based on the **period of use**, which is the total period of time an asset is used to fulfill the contract with the customer, including the sum of any nonconsecutive periods of time. Thus, 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 (see Section 2.2.2) and whether the economic and power criteria are met (see Sections 2.3.2 and 2.3.3, respectively). Accordingly, it is a key concept of the evaluation, as illustrated in Example 2-2.

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.

## CONTRACTS WITH NO STATED CONSIDERATION

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

**CONTRACTS WITH EMBEDDED LEASES**

Arrangements with suppliers for goods or services may include the use of specified assets. For example, manufacturing and distribution arrangements for finished goods and raw materials, telecommunication and network service arrangements, or other IT service arrangements, may include an embedded lease of the facility, warehouse, forklift, IT equipment (such as servers, routers, and modems), or other PP&E. Such embedded leases are subject to ASC 842, so an entity should review and assess those legal contracts and discuss with business partners within the entity to ascertain the completeness of their lease population.

**EXAMPLE 2-1: CONTRACT MUST BE FOR A PERIOD OF TIME — PERPETUAL LAND EASEMENT**

**FACTS**

- An entity obtains a series of easements to install poles and attach its power lines. In addition to installing its poles, the entity has the right to access the poles via a corridor leading from the nearest road.
- The entity pays the consideration upfront in return for perpetual access rights.

**CONCLUSION**

- The agreement does not contain a lease.

**ANALYSIS**

- A contract is or contains a lease if it conveys the right to control the use of identified PP&E **for a period of time** in exchange for consideration. The contract is perpetual, which means it is not for a period of time; therefore, there is no lease. That view is consistent with Example 10 of ASC 350-30, which concluded that the perpetual easements the entity owned did not meet the definition of a lease under ASC 842 because they were perpetual and therefore did not convey the right to use the underlying land for a period of time.

**EXAMPLE 2-2: PERIOD OF USE — CUSTOMER USES ASSET DURING NONCONSECUTIVE PERIODS**

**FACTS**

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

**CONCLUSION**

- The period of use for the storefront is 10 months.

**ANALYSIS**

- The entity 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, the entity 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 the storefront is used to fulfill the contract.

## 2.2 IDENTIFIED ASSET

### 2.2.1 General Considerations

**FASB REFERENCES**

ASC 842-10-15-9, ASC 842-10-15-16, ASC 842-10-55-55 through 55-62

An asset is typically identified when it is explicitly specified in the contract or is implicitly specified when made available for customer use. Importantly, paragraph BC128 of ASU 2016-02 states:

> *When assessing whether there is an identified asset, an entity does not need to be able to identify the particular asset that will be used to fulfill the contract to conclude that there is an identified asset. Instead, the entity simply needs to know whether an asset is needed to fulfill the contract from commencement. If that is the case, an asset is implicitly specified.*

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

The following examples illustrate that requirement (assuming there are no supplier substitution rights).

| | PHYSICALLY DISTINCT ASSET | CAPACITY PORTION OF ASSET | |
|---|---|---|---|
| **FACTS** | A customer enters a 15-year contract with a supplier for the right to use three of 10 specific strands of a fiber optic cable connecting Paris and London. | A customer enters a 15-year contract with a supplier for the right to use a specified amount (95%) of the capacity of a cable connecting Paris and London. The specified amount is equivalent to the customer having the full capacity of 14 fiber strands in a 15-strand cable. | A customer enters a 15-year contract with a supplier for the right to use a specified amount (20%) of the capacity of a cable connecting Paris and London. The specified amount is equivalent to the customer having the full capacity of three fiber strands in a 15-strand cable. |
| **CONCLUSION AND ANALYSIS** | The strands of fiber optic cable are distinct from one another.<br>Each strand is an identified asset. | The capacity specified is not physically distinct but it represents substantially all the capacity of the cable.<br>The cable is an identified asset. | The capacity specified is not physically distinct and does not represent substantially all the capacity of the cable.<br>There is no identified asset. |

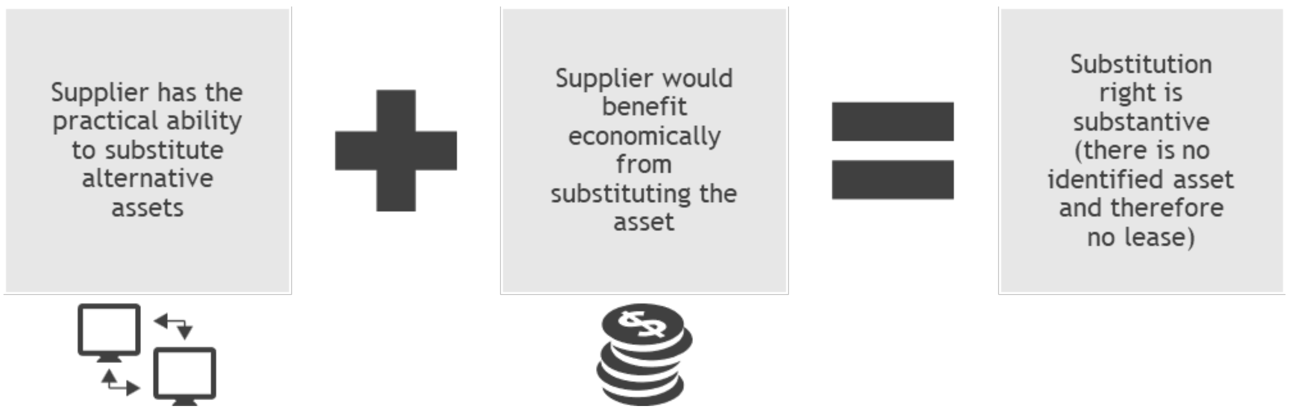
### 2.2.2 Supplier Substitution Rights

**FASB REFERENCES**

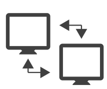
ASC 842-10-15-10 through 15-15

Even if an asset is specified as discussed in Section 2.2.1, 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 substantive, the supplier (rather than the customer) controls the use of the asset.

Supplier substitution rights are substantive when **both** the conditions below are met **throughout the period of use.**




In assessing the two conditions above, an entity considers:



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

A supplier would benefit economically from substituting the asset if the economic benefits of doing so exceed the related costs of substitution (for example, transportation or installation costs).

ASC 842 states that if the asset is located at the customer's premises, the costs of substituting the asset are generally higher than when the asset is located at the supplier's premises and therefore are more likely to exceed the related benefits. If the supplier's costs to substitute exceed the related benefits, the substitution right is not substantive, so there is an identified asset.

An entity evaluates a supplier's substitution rights at contract inception based on the facts and circumstances and excludes future events that it determines are not likely to occur. If the entity determines that the supplier right is substantive, there is no identified asset and the contract does not contain a lease.

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

| FACT PATTERN | GUIDANCE |
|---|---|
| The supplier can substitute the asset only in circumstances that are not likely to occur at contract inception (for example, an agreement with a future customer to pay an above-market price for use of the asset or the introduction of new technology not substantially developed at contract inception). | The substitution right is not substantive because the future events upon which the supplier may substitute the asset are excluded from the analysis. |
| The supplier can substitute the asset only on or after a specified future date or event. | The substitution right is not substantive because the supplier does not have the right to substitute the asset **throughout the period of use**. |
| The supplier can substitute the asset for repairs and maintenance or based on the availability of a technical upgrade. | The substitution right is not substantive as those circumstances are disregarded. |
| The customer cannot readily determine whether a substitution right is substantive (for example, the customer might not have information about the supplier's costs of substitution). | The guidance requires the customer to presume that the substitution right is not substantive. |

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

The FASB has provided guidance to determine when a supplier substitution right is substantive, which means 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** (as explained in Section 2.1), 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 during only 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 during only some portions of that period of use (such as if the supplier can substitute the specified asset only when it is in a shop for scheduled maintenance and inspection).

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

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

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

**FACTS**

- Retailer enters a five-year contract with Airport Operator for the use of a space in an airport terminal.
- Retailer owns and uses a booth that is easily transferrable to different boarding areas.
- Airport Operator has many available areas in the terminal that 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 in changing the space Retailer uses.

**CONCLUSION**

- There is no identified asset. Therefore, the contract does not contain a lease.

**ANALYSIS**

- Although the contract specifies that Retailer will use a specific space in the airport to operate its booth, Airport Operator has a substantive substitution right because:
  - There are several similar areas that Retailer may be assigned to that Airport Operator has the right to change without Retailer's approval throughout the period of use. In other words, Airport Operator has the practical ability to substitute Retailer's space.
  - The costs to move Retailer's booth are minimal, and substitution allows Airport Operator to use its airport space in the most effective way; for example, by relocating Retailer to other boarding areas to meet changing circumstances. Those conditions are likely to occur at contract inception, given Airport Operator's historical experience, business, and operations. in other words, Airport Operator would benefit economically from substituting Retailer's space.
- Because Airport Operator's substitution right is substantive, there is no identified asset.

**EXAMPLE 2-4: (ADAPTED FROM ASC 842-10-55-63 THROUGH 55-71) — RETAIL SPACE**

**FACTS**

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

**CONCLUSION**

- There is an identified asset. Therefore, the analysis continues to determine whether Retailer has the right to control the use of retail unit A (see Section 2.3).

**ANALYSIS**

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

**EXAMPLE 2-5: (ADAPTED FROM ASC 842-10-55-48 THROUGH 55-51) — RAIL CARS**

**FACTS**

- Smith & Co. enters a five-year agreement with Freight Systems Ltd. to transport a specified quantity of products via a specified type of rail car in accordance with a stated timetable. The timetable and quantity of products are economically equivalent to Smith & Co. having the use of 10 rail cars for five years.
- Freight has a large pool of similar rail cars that can be used to fulfill the contract requirements. The rail cars are stored at Freight's location when not in use.

**CONCLUSION**

- There is no identified asset. Therefore, the agreement does not contain a lease.

**ANALYSIS**

- Although Freight needs rail cars to transport Smith & Co.'s products, it has a substantive substitution right because:
  - Freight has the practical ability to substitute each rail car throughout the period of use without Smith & Co.'s approval, given the large pool of similar rail cars at Freight's location.
  - Freight would benefit economically from substituting each car because any costs to substitute would be minimal. Also, substitution allows Freight to use the cars in the most efficient way for the task; for example, because there are cars at a rail yard close to the point of origin. Those conditions are likely to occur at contract inception, given Freight's historical experience, business, and operations.
- Because Freight's substitution right is substantive, there is no identified asset. Although Smith & Co. has the right to use the equivalent of 10 rail cars for five years, Freight directs the use of those rail cars by determining which cars will be used for each delivery.

**EXAMPLE 2-6: (ADAPTED FROM ASC 842-10-55-42 THROUGH 55-47) — RAIL CARS**

**FACTS**

- Smith & Co. enters an agreement with Freight Systems Ltd. under which Freight provides Smith & Co. with the use of 10 rail cars of a particular type for five years. The contract specifies the rail cars, which Freight owns.
- The agreement limits what types of goods Smith & Co. can transport, but otherwise, Smith & Co. has the right to determine whether the rail cars are used and where, when, and which products are transported using the rail cars. When the rail cars are not in use, Smith & Co. stores them at its property.
- If a particular car needs servicing or repair, Freight is required to substitute a rail car of the same type. Otherwise, Freight cannot retrieve the rail cars during the five-year contract period other than on default by Smith & Co.

**CONCLUSION**

- There is an identified asset. Therefore, the analysis continues to determine whether Smith & Co. has the right to control the use of the rail cars (see Section 2.3).

**ANALYSIS**

- There are 10 identified rail cars because once the cars are delivered to Smith & Co., they can be substituted only when they need servicing or repair, which is not considered substantive under ASC 842-10-15-14.

**EXAMPLE 2-7: CONTRACT FOR HOSTING ARRANGEMENT**

**FACTS**

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

**CONCLUSION**

- Regional determines there is no identified asset. Therefore, the contract does not contain a lease.
- Because Bank cannot readily determine whether Regional has a substantive substitution right, it presumes such rights are not substantive and that there is an identified asset (the servers). Bank continues its evaluation to determine whether it has the right to control the use of each identified asset (see Section 2.3).

**ANALYSIS**

- In considering whether its arrangement with Bank contains identified assets for each server, Regional concludes that the contract does not include identified assets and there is thus no lease because:
  - Regional has numerous servers that meet Bank's security requirements and from which it can host Bank's software. Bank cannot prevent Regional from switching servers so long as access to Bank's software is uninterrupted. Accordingly, Regional concludes it has the practical ability to substitute Bank's servers throughout the period of use.
  - There are minimal costs to substitute servers, and Regional would benefit economically from substitution. Specifically, it is common for new hosting customers to be obtained, at which time Regional often reconfigures its server space. Also, to maximize the servers' performance, Regional regularly adds or deletes servers and moves customers as needed.
- Bank, however, does not have visibility into Regional's operations and business (including how many servers Regional has with similar security requirements and how many customers it serves). Therefore, Bank concludes based on ASC 842-10-15-15 that Regional's right of substitution is not substantive, which means the agreement includes identified assets.

**EXAMPLE 2-8: (ADAPTED FROM ASC 842-10-55-100 THROUGH 55-107) — CONTRACT FOR SHIRTS**

**FACTS**

- Brand X enters an agreement with Contract Manufacturing Co. (CMC) to purchase a particular type, quality, and quantity of shirts for three years.
- CMC has only one factory that can meet the needs of Brand X and is unable to supply the shirts from another factory or source the shirts from a third-party supplier. The capacity of the factory significantly exceeds the output for which Brand X has contracted.

**CONCLUSION**

- There is an identified asset. Therefore, the analysis continues to determine whether Brand X has the right to control the use of the factory (see Section 2.3).

**ANALYSIS**

- The agreement contains an implicitly specified asset because CMC can fulfill the contract using only this factory. It cannot supply the shirts from another factory or source them from a third-party supplier.

**EXAMPLE 2-9: CONTRACT FOR GAS GATHERING**

**FACTS**

- Midstream Co. owns and operates an oil and gas gathering system in a specific area of the Permian Basin. Midstream enters a gas gathering agreement with Oil & Gas Co. (O&G) to provide gathering services for O&G in the area covered by Midstream's system for 10 years. The pipeline lateral used to fulfill the contract connects to Midstream's integrated pipeline system.
- The contract provides Midstream with the exclusive right to receive, gather, and transmit all gas O&G produces in the area, and the system must always be available to transmit the gas produced. However, Midstream retains some rights associated with the pipeline lateral. It also has the right to connect other pipelines to the pipeline lateral without O&G's consent as long as it continues to service the volumes produced by O&G.

**CONCLUSION**

- There is an identified asset. Therefore, the analysis continues to determine whether O&G has the right to control the use of the pipeline lateral (see Section 2.3).

**ANALYSIS**

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

## 2.3 RIGHT TO CONTROL USE OF IDENTIFIED ASSET

**FASB REFERENCES**

ASC 842-10-15-4

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 that asset, which is met when, throughout the period of use, the customer has **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).

**BDO INSIGHTS — RIGHT TO CONTROL USE UNDER ASC 842 SIMILAR TO ASC 606 AND ASC 810**

ASC 842 requires a customer to have, throughout the period of use, not only the right to obtain substantially all the economic benefits from the use of an asset (the economic criterion) but also the ability to direct the use of that asset (the power criterion). In other words, a customer must have decision-making rights over the use of the asset that give it the ability to influence the economic benefits derived from the asset's use. Without such decision-making rights, the customer has no more control over the use of an asset than any customer purchasing supplies or services. That concept of control is similar to those in ASC 606 and ASC 810, *Consolidation*, which define control based on a benefits element and a power element.

**BDO INSIGHTS — IDENTIFYING A LEASE IN A MULTIPARTY ARRANGEMENT (DETERMINING WHETHER AN INTERMEDIARY ENTITY HAS OBTAINED A LEASE)**

In some multiparty arrangements involving the use of an asset, it may be challenging to determine whether an intermediary entity (for example, an operator or service provider) is leasing an asset from the asset owner and then subleasing that asset to another entity (for example, an end customer) or whether the intermediary entity is merely acting as an agent between the two entities that may have a lease between them. To determine whether a lease exists and, if so, between which parties, we believe the guidance in ASC 842 usually will be sufficient. The analysis will focus on which party — the intermediary entity or another entity — has the right to control the use of the underlying asset as discussed in this section. However, we believe it may be useful in some cases to look to the principal-agent guidance in ASC 606. That may be the case, for example, if the intermediary entity (operator or service provider) must pay substantially all the fees it receives from another entity back to the asset owner. An intermediary entity cannot sublease an asset to another entity unless it has first obtained a lease from the asset owner. See Section 7.4 of this Blueprint for accounting if there is a sublease and Section 7.2 of our Blueprint, Revenue Recognition Under ASC 606, for further discussion on the principal-agent guidance in ASC 606. The analysis of multiparty arrangements requires the use of professional judgment based on facts and circumstances.

## 2.3.1 Restrictions and Supplier Protective Rights

**FASB REFERENCES**

ASC 842-10-15-18 and ASC 842-10-15-23

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) or protect the supplier's interest in the asset (such as by requiring the customer to follow industry standard operating procedures) do not in isolation prevent the customer from having the right to control the use of the identified asset. Instead, the analysis must focus on what the customer can do **within that scope** of asset use.

Consider the examples below.

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

In all the above examples, even though the contract includes restrictions or limitations on the use of the asset, they would include a lease, as further explained in Sections 2.3.2 and 2.3.3, assuming there is an identified asset (see Section 2.2).

### 2.3.2 Economic Criterion

**FASB REFERENCES**

ASC 842-10-15-17 and ASC 842-10-15-19

A customer can directly or indirectly obtain economic benefits from the use of 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 those 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 the **use** of an asset are considered when assessing whether a customer has the right to obtain substantially all economic benefits. In many cases, the evaluation will be straightforward. For example, when the customer has exclusive use of an identified asset, it typically obtains 100% of the economic benefits from that use. That is true for the corporate jet, commercial truck, and retail unit examples in Section 2.3.1. In other situations, the evaluation may require the use of professional judgment based on the facts and circumstances.

Economic benefits (such as tax benefits) arising from the ownership of an asset are excluded in the evaluation because a lease conveys the right to use an asset, not ownership of the asset. Consider a utility company (customer) that enters a contract with a power company (supplier) to purchase all electricity produced by a specific solar farm. The supplier owns the solar farm and will receive tax credits related to its ownership thereof. Customer will receive renewable energy credits related to the use of the farm. The table summarizes the relevant outputs to consider in determining whether the customer obtains substantially all the economic benefits from the use of the asset.

| INCLUDE | EXCLUDE |
|---|---|
| ▶ Electricity produced by the solar farm (customer)<br>▶ Renewable energy credits because they relate to the **use** of the solar farm (customer) | ▶ Tax credits because they relate to the ownership, not the use, of the asset (supplier) |

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

Also, if a contract requires a customer to pay the supplier or another party a portion of the cash flows derived from using the asset, those cash flows are considered economic benefits the customer obtains from using the asset. For example, if a retailer must pay a mall operator a percentage of sales as consideration for use of the retail space, that 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 the 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 2-4).

**BDO INSIGHTS — MEANING OF “SUBSTANTIALLY ALL”**

In practice, the term “substantially all” is generally interpreted as around 90% or more. That term is used in the lease classification test (see Section 4.9), 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 is also mentioned in many other areas of U.S. GAAP and generally has been applied in a similar manner.

**EXAMPLE 2-4: RETAIL SPACE (CONTINUED)**

**FACTS**

- Retailer enters a five-year contract with Airport Operator for the use of retail unit A. Retail unit A is part of an airport terminal with many retail units.
- Retailer is required to use retail unit A to operate its well-known store brand to sell its goods while the terminal is open.
- Example 2-4 in Section 2.2.2 concluded that retail unit A is an identified asset.
- Retailer pays Airport Operator $50,000 per month plus 6% of monthly net sales.

**CONCLUSION**

- The economic criterion is met. The analysis continues to determine whether Retailer has the right to direct the use of retail unit A (see Section 2.3.3).

**ANALYSIS**

- Retailer has exclusive use of retail unit A and therefore obtains substantially all the economic benefits from its use throughout the period of use. Although Retailer will pay Airport Operator a portion of the cash flows derived from sales in retail unit A (6% of monthly net sales), those are considered economic benefits Retailer obtains from using the asset.

**EXAMPLE 2-6: RAIL CARS (CONTINUED)**

**FACTS**

- Smith & Co. enters a five-year agreement with Freight Systems Ltd. under which Freight provides Smith & Co. with the use of 10 rail cars of a particular type.
- The contract specifies the rail cars, which Freight owns. When the rail cars are not in use, Smith & Co. stores them at its property.
- Example 2-6 in Section 2.2.2 concluded that each rail car is an identified asset.

**CONCLUSION**

- The economic criterion is met. The analysis continues to determine whether Smith & Co. has the right to direct the use of each rail car (see Section 2.3.3).

**ANALYSIS**

- Smith & Co. has the right to obtain substantially all the economic benefits from use of the rail cars over the five-year period of use because it has exclusive use of the cars during that period.

**EXAMPLE 2-7: CONTRACT FOR HOSTING ARRANGEMENT (CONTINUED)**

**FACTS**

- Bank enters a hosting arrangement with Regional Hosting Co. under which Regional will provide a specific number of servers on which it will host software licenses owned by Bank. Regional also will provide connectivity to allow Bank to access the software it hosts.
- Because of the number of users in, as well as the complexity of, Bank's software environment, Regional must host Bank's software on dedicated servers with specific security requirements, and no other customer can be hosted on the same servers.
- Example 2-7 in Section 2.2.2 concluded that each server is an identified asset.

**CONCLUSION**

- The economic criterion is met. The analysis continues to determine whether Bank has the right to direct the use of each server (see Section 2.3.3).

**ANALYSIS**

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

**EXAMPLE 2-8: CONTRACT FOR SHIRTS (CONTINUED)**

**FACTS**

- Brand X enters a three-year agreement with Contract Manufacturing Co. (CMC) to purchase a particular type, quality, and quantity of shirts.
- CMC has only one factory that can meet the needs of Brand X and is unable to supply the shirts from another factory or source the shirts from a third-party supplier. The capacity of the factory significantly exceeds the output for which Brand X has contracted.
- CMC makes all decisions about the operations of the factory, including the production level at which to run the factory and which customer contracts to fulfill with the output of the factory not used to fulfill Brand X's contract.
- Example 2-8 in Section 2.2.2 concluded that the factory is an identified asset.

**CONCLUSION**

- The economic criterion is not met. Therefore, the contract does not contain a lease.

**ANALYSIS**

- Brand X does not have the right to obtain substantially all the economic benefits from use of the factory. CMC could decide to use the factory to fulfill orders from other customers during the three-year term of the agreement, and the factory's capacity significantly exceeds the output for which Brand X has contracted.
- (The contract also limits Brand X's rights to specified output from the factory and gives Brand X only the same rights regarding use of the factory as any other customers purchasing shirts or other products from the factory do. CMC has the right to direct the use of the factory because it can decide how and for what purpose the factory is used. Accordingly, the power criterion is also not met (see Section 2.3.3.))

**EXAMPLE 2-9: CONTRACT FOR GAS GATHERING (CONTINUED)**

**FACTS**

- Midstream Co. owns and operates an oil and gas gathering system in a specific area within the Permian Basin. Midstream enters a gas gathering agreement with Oil & Gas Co. (O&G) to provide gathering services for O&G in the area covered by Midstream's gathering system for 10 years. The pipeline lateral used to fulfill the contract connects to Midstream's integrated pipeline system.
- The contract provides Midstream with the exclusive right to receive, gather, and transmit all gas produced by O&G in the area, and the system must always be available to transmit the gas produced. However, Midstream retains some rights associated with the pipeline lateral. For example, Midstream can use the pipeline lateral to store other customers products or for system balancing purposes, or to take advantage of market price fluctuations through park and loan services. Midstream also has the right to connect other pipelines to the pipeline lateral without O&G's consent as long as Midstream continues to service the volumes produced by O&G.
- Example 2-9 in Section 2.2.2 concluded that the pipeline lateral is an identified asset.

**CONCLUSION**

- The economic criterion is not met. Therefore, the contract does not contain a lease.

**ANALYSIS**

- Although Midstream's system must always be available to transmit the gas produced by O&G, O&G does not have exclusive use of the pipeline lateral because Midstream has the right to use the pipeline for other purposes. The pipeline lateral can handle more capacity than that requested by O&G, and Midstream can increase the capacity of the pipeline lateral through various mechanisms. Throughout the 10-year contract term and period of use, Midstream has the right to use that excess capacity for its own economic benefits (for example, to store other customers' products, for system balancing purposes, and to take advantage of market price fluctuations through park and loan services), which are considered significant.
- (O&G can also request only that Midstream transport the quantity of gas it produces and does not have the right to direct how and for what purpose the pipeline is used. Midstream retains the relevant decisions about the use of the pipeline lateral throughout the 10 years. Those decisions include whether to store other customers' products or use excess capacity for other purposes and whether to connect additional pipelines. Midstream makes those decisions throughout the contract term and period of use. Accordingly, the power criterion also is not met (see Section 2.3.3.))

### 2.3.3 Power Criterion

**FASB REFERENCES**

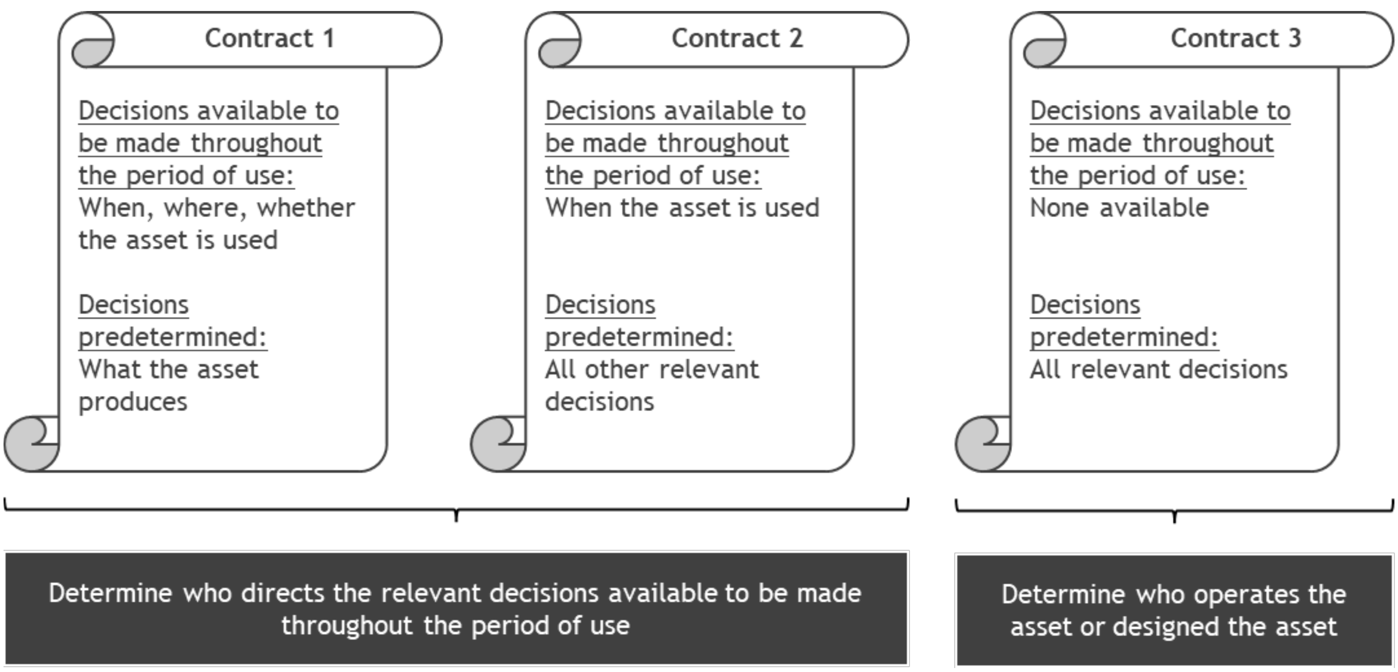
ASC 842-10-15-20 through 15-22, and ASC 842-10-15-24 through 15-26

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.

  The relevant decisions could be predetermined, for example, by contractual restrictions on use of the asset or by the design of the asset.

Determining which power condition criterion applies is key. So long as there is at least one relevant decision to be made throughout the period of use, the first bullet point applies. In other words, the guidance in the second bullet point applies only if all relevant decisions are predetermined. In practice, entities will typically assess the first condition. The scenarios below illustrate those considerations.



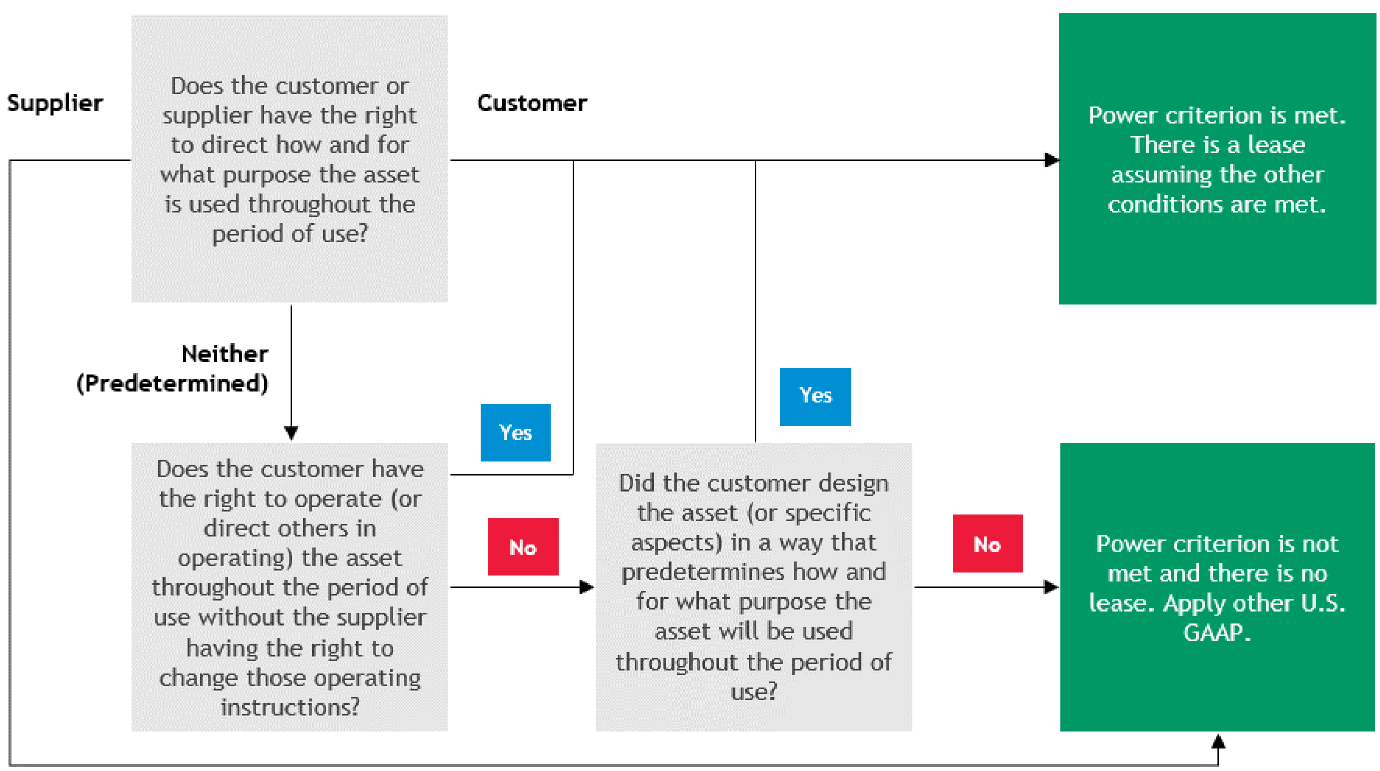

Accordingly, in assessing the power criterion, an entity considers only decision-making rights about use of the asset during the period of use unless the customer designed the asset (or specific aspects of it), as discussed above. Said differently, unless the customer designed the asset, an entity does not consider decisions predetermined before the period of use. Consequently, appropriately identifying the relevant decisions and determining whether those are predetermined is important.

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

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

Those rights are examples only and are neither determinative nor prescriptive. For example, a requirement to use an asset in a specified location does not necessarily imply that the customer does not direct the use of the asset. Example of decision-making rights that are not relevant include maintaining 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 supplier but typically will not affect the analysis. However, a right to operate the asset is relevant when all relevant decision-making rights are predetermined.

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



**EXAMPLE 2-4: RETAIL SPACE (CONTINUED)**

**FACTS**

- Retailer enters a five-year contract with Airport Operator for the use of retail unit A. Retail unit A is part of an airport terminal with many retail units.
- Retailer must use retail unit A to operate its well-known store brand to sell its goods when the terminal is open.
- Retailer makes all decisions about the use of retail unit A when the airport terminal is open (for example, deciding on the mix of goods to sell and at what price to sell the goods).
- Retailer pays Airport Operator $50,000 per month plus 6% of monthly net sales.
- Example 2-4 in Section 2.2.2 concluded that retail unit A is an identified asset and Example 2-4 in Section 2.3.2 concluded the economic criterion is met.

**CONCLUSION**

- The power criterion is met. Therefore, the contract contains a lease.

**ANALYSIS**

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

**EXAMPLE 2-6: RAIL CARS (CONTINUED)**

**FACTS**

- Smith & Co. enters a five-year agreement with Freight Systems Ltd. under which Freight provides Smith & Co. with the use of 10 rail cars of a particular type. The contract specifies the rail cars, which Freight owns.
- The agreement limits what types of goods Smith & Co. can transport, but otherwise, Smith & Co. has the right to determine whether the rail cars are used and, if so, where, when, and which products are transported. When not in use, Smith & Co. stores them at its property.
- If a car needs servicing or repairs, Freight must substitute a rail car of the same type. Otherwise, Freight cannot retrieve the rail cars during the five-year contract and period of use other than on default by Smith & Co.
- Example 2-6 in Section 2.2.2 concluded that each rail car is an identified asset and Example 2-6 in Section 2.3.2 concluded the economic criterion is met.

**CONCLUSION**

- The power criterion is met. Therefore, the contract contains a lease of ten rail cars.

ANALYSIS

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

**EXAMPLE 2-7: CONTRACT FOR HOSTING ARRANGEMENT (CONTINUED)**

**FACTS**

- Bank enters a hosting arrangement with Regional Hosting Co. under which Regional will provide a specific number of servers on which it will host software licenses owned by Bank. Regional also will provide connectivity to allow Bank to access the software it hosts.
- Because of the number of users in, as well as the complexity of, Bank's software environment, Regional must host Bank's software on dedicated servers with specific security requirements, and no other customer can be hosted on the same servers. However, Regional has the right to rehome Bank's software onto different servers with similar security requirements without Bank's approval so long as access to its software licenses is uninterrupted.
- Although Regional will provide monitoring services, Bank makes all decisions about which software to load onto the servers and what types and how much data to transmit using the servers.
- Example 2-7 in Section 2.2.2 concluded each server is an identified asset and Example 2-7 in Section 2.3.2 concluded the economic criterion is met.

**CONCLUSION**

- The power criterion is met. Therefore, the contract contains a lease of the servers.

**ANALYSIS**

- Bank makes all decisions about which software to load onto the servers and what types and how much data to transmit using the servers. Those are the relevant decisions regarding how and for what purpose the servers are used throughout the period of use.

**EXAMPLE 2-10: (ADAPTED FROM ASC 842-10-55-108 THROUGH 55-111) — SOLAR FARM**

**FACTS**

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

**CONCLUSION**

- The contract contains a lease.

**ANALYSIS**

- The solar farm is explicitly specified in the contract, and SPC does not have the right to substitute the specified solar farm. Therefore, there is an identified asset.
- CEC takes all the electricity produced by the farm and receives the renewable energy credits that are a by-product of the use of the farm. Although SPC receives economic benefits from the solar farm in the form of tax credits, those credits relate to the ownership of the farm rather than from its use, and thus are not considered in the evaluation of the economic criterion. Accordingly, CEC receives 100% of the economic benefits from use of the solar farm throughout the period of use and the economic criterion is met.

- There are no decisions to be made during the period of use about whether, when, or how much electricity will be produced because the design of the asset predetermined those decisions. Although CEC does not operate the solar farm, its design of the farm has given it the right to direct the use of the farm. Because the design of the solar farm has predetermined how and for what purpose the asset will be used throughout the period of use, CEC's control over that design is substantially no different from CEC controlling those decisions. Therefore, the power criterion is met.

**EXAMPLE 2-11: (ADAPTED FROM ASC 842-10-55-112 THROUGH 55-116) — SOLAR FARM**

**FACTS**

- Assume the same facts as in Example 2-10, except that SPC, not CEC, designed and constructed the solar farm before entering the contract with CEC. CEC was not involved in that design.

**CONCLUSION**

- The contract does not contain a lease.

**ANALYSIS**

- Like Example 2-10, there is an identified asset. The economic criterion is met for the same reasons as in that example.
- Unlike Example 2-10, while the relevant decisions about how and for what purpose the solar farm is used are predetermined, SPC, not CEC, designed and operates the solar farm. Therefore, SPC has the right to direct the use of the farm.

## 2.4 JOINT OPERATIONS OR ARRANGEMENTS

**FASB REFERENCES**

ASC 842-10-15-4, ASC 910-810-45-1, ASC 930-810-45-1, and ASC 932-810-45-1

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

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

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

| OPERATOR IS THE CUSTOMER | JOINT OPERATION IS THE CUSTOMER |
|---|---|
| ▶ The supplier applies lessor accounting to its lease contract with the operator (see Chapter 6)<br>▶ The operator as lessee recognizes 100% of the ROU asset and lease liability on its balance sheet (see Chapter 5)<br>▶ The operator assesses whether a sublease of the asset to the joint operation exists (such as if the joint operating agreement conveys the right to control the use of the joint operation's underlying asset for a period of time through a governing body represented by each party to the joint operation), in which case the operator accounts for the sublease to each of the other parties in the joint operation as a sublessor (see Section 7.4). | ▶ The supplier applies lessor accounting to its lease contract with the joint operation (see Chapter 6)<br>▶ ASC 842 does not provide specific recognition and measurement guidance for leases when the joint operation is the lessee (that is, when multiple unrelated parties are the customer or lessee)<br>▶ If the parties are in the construction or extractive industry, each may recognize an ROU asset and lease liability for its proportionate share or interest in the joint operation (assuming proportionate consolidation is appropriate)<br>▶ If specialized industry guidance does not apply, the entity's accounting will depend on the facts and circumstances. In some cases, it may be appropriate to look to the guidance in ASC 405-40 on obligations resulting from joint and several liability arrangements. |

## 2.5 COMMON CONTROL ARRANGEMENTS

**FASB REFERENCES**

ASC 842-10-15-3A through 15-3C

Private company stakeholders raised concerns about applying ASC 842 to common control arrangements (such as arrangements between sister entities controlled by a common owner), including how to determine whether a common control arrangement is or contains a lease based on the legally enforceable terms and conditions. For example, the assessment might be challenging because the common control arrangement might be unwritten or, even when written, might be amended or not enforced by the common owner. Accordingly, ASU 2023-01 provides nonpublic entities [2] a practical expedient to use the written terms and conditions of a common control arrangement to determine whether a lease exists and, if so, to classify and account for that lease. Under the practical expedient, an entity assesses whether the written terms and conditions convey the **practical** right (rather than an enforceable right) to control the use of an identified asset for a period of time in exchange for consideration to determine whether a lease exists. If a lease exists, the entity classifies and accounts for 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 entity cannot apply the practical expedient and must use the enforceable rights and obligations to apply ASC 842 to the common control arrangement (as it must for any arrangement between unrelated parties or related parties not under common control).

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

The following concepts are also important:

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

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

| | |
|---|---|
| Arrangement previously was and continues to be a lease | Classify and account for the lease based on enforceable terms and conditions.<br>If the enforceable terms and conditions differ from the written terms and conditions previously applied under the practical expedient, apply modification accounting. |
| Arrangement previously was not a lease and is determined to be a lease | Account for the arrangement as a new lease at the date of the change in the common control relationship. |
| Arrangement previously was a lease and is no longer a lease | Apply lease termination accounting, which depends on whether the entity is the lessee or lessor, and, for a lessor, on the classification of the lease. |

**BDO INSIGHTS — PRACTICAL EXPEDIENT CONSIDERATIONS**

Similar to its decisions in previous projects, the FASB decided not to define the term "common control," noting that the term is used in other areas of U.S. GAAP. It observed that an entity may refer to the SEC staff's observations in Emerging Issues Task Force (EITF) Issue 02-5, "*Definition of 'Common Control' in Relation to FASB Statement No. 141*," acknowledging that private companies and most not-for-profit entities may apply a broader definition of common control. [4] We believe an entity should apply the term consistently as an accounting policy. Also, at a minimum, we believe common control arrangements include arrangements in which a controlling financial interest exists, as defined in ASC 810. See our Blueprint, Control and Consolidation Under ASC 810, for further discussion.

Nonpublic entities that elect to apply the practical expedient must have processes to periodically update the common control arrangement to ensure they can continue to use the expedient. For example, if the written terms and conditions are for a short lease term (for example, a one-month or one-year lease) and expire without a replacement written agreement, the entity will be unable to use the practical expedient. Instead, it will need to evaluate the legally enforceable terms and conditions (as it would with any other lease between unrelated parties or related parties not under common control).

Also, if the written terms and conditions allow the lessee to extend the one-month or one-year lease at its option, or if the lease continues unless terminated by either party and the lessee would incur a significant penalty to terminate the lease, the guidance in ASC 842 on determining the lease term applies. That could result in a lease term for accounting that is longer than the stated term.

[3] Paras. BC16 and BC24 of ASU 2023-01.
[4] *Id.* at paras BC10 and BC11 of ASU 2023-01.

Lastly, the FASB decided not to prescribe the documentation requirements necessary to use the practical expedient.[5] Rather, entities can use reasonable judgment to determine how an arrangement's terms and conditions are conveyed in writing. Therefore, we believe a written document does not need to meet the legal definition of a contract to qualify for the practical expedient. For example, an email documenting the arrangement's written terms and conditions may suffice, even if it does not include other clauses that generally appear in a legal contract.

For transition to ASC 842 related to existing common control arrangements, see Section 9.1.1.

## 2.6 OTHER ILLUSTRATIONS

The three criteria required for a contract to include a lease — identified asset (see Section 2.2), economic criterion (see Section 2.3.2), and power criterion (see Section 2.3.3) — are explored further through various examples below, some of which include nonlease components (see Chapter 3). The examples and their conclusions focus solely on whether the contract is or contains a lease.

**EXAMPLE 2-12: CONTRACT FOR PRINTER**

**FACTS**

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

**CONCLUSION**

- The contract contains a lease.

**ANALYSIS**

- There is an identified asset. Although Printers R Us has the right to replace the copy machine at any time and without Paper Co.'s approval, such substitution would likely not generate an economic benefit for Printers R Us. As noted in ASC 842-10-15-12, if the asset is located at the customer's premises, the costs associated with substitution are likely to exceed the benefits associated with substituting the asset. Printers R Us would incur costs to substitute the copy machine, such as employee time and costs of transporting and installing another copy machine and removing and transporting back the original copy machine. It is not likely that events or circumstances would arise at contract inception from which Printers R Us would generate more cash flows by substituting the copy machine than the costs it would incur. Also, as noted in ASC 842-10-15-14, rights to substitute identified equipment solely for repairs and maintenance are not substantive. Accordingly, Printers R Us's substitution right is not substantive.
- The economic criterion is met. Paper Co. has the right to obtain substantially all the economic benefits from use of the copier throughout the period of use because it has exclusive use of the copier.
- The power criterion is met. While Printers R Us has the right to approve before Paper Co. can move the printer to another location, that right is protective in nature. The monthly copy limit also protects Printers R Us's copier and in effect defines the scope of the contract. Within that scope, Paper Co. has the right to direct the use of the copier, including when to use it and for how long, how many copies to make (subject to the limit), and where to use it throughout the three-year period, which is also the period of use. Those decisions are the relevant ones affecting the economic benefits from use of the copier.

[5] *Id*. at para. BC22 of ASU 2023-01.

**EXAMPLE 2-13: CONTRACT FOR SYRUP DISPENSERS AND SUPPLIES**

**FACTS**

- Pizzeria Co. enters a syrup supply agreement with Beverage Co. under which Beverage Co. agrees to supply soft drink syrup to Pizzeria Co. for three years. Beverage Co. also will provide dispensers that combine the syrup with $CO_2$ to deliver soft drinks to Pizzeria Co.'s customers.
- Pizzeria Co. is responsible for purchasing the $CO_2$ and maintaining the dispensers, and the agreement prohibits Pizzeria Co. from using the dispensers with another supplier's syrup.
- Beverage Co. will provide two maintenance services per year per store to repair the dispensers at no charge, but additional maintenance visits will be charged on a time and materials basis.
- The contract stipulates a fixed monthly payment and a variable payment based on the volume of syrup purchased by Pizzeria Co. [6]

**CONCLUSION**

- The contract contains a lease.

**ANALYSIS**

- There is an identified asset. While the agreement does not explicitly specify the individual beverage dispensers, the units are implicitly specified because the dispensers are required for Beverage Co. to fulfill its promise under the arrangement. Once the equipment is installed, Beverage Co. has no right to substitute it.
- The economic criterion is met. Pizzeria Co. has exclusive use of the dispensers throughout the period of use.
- The power criterion is met. Pizzeria Co. has the right to direct the use of the dispensers, including determining when and how often to use them, throughout the period of use. The fact that the agreement prohibits Pizzeria Co. from using the dispensers with another supplier's products is a protective right that defines the scope of the contract but does not prevent Pizzeria Co. from controlling the use of the dispensers.

**EXAMPLE 2-14: CONTRACT FOR CO-LOCATION SPACE**

**FACTS**

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

**CONCLUSION**

- The contract contains a lease.

**ANALYSIS**

- There is an identified asset. Although the space is not initially a physically distinct portion of the larger warehouse and the space occupied does not represent substantially all the capacity of the warehouse, the caging

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

and other barriers required to be installed by Software Co. render the space physically distinct and allow Software Co. to control access to that specific space. In addition, Co-Lo has no ability to substitute comparable space throughout the term of the contract, which is also the period of use. Therefore, there is an identified asset.

- The economic criterion is met. Because Software Co. has the right to control access to the specified space, it has the right to obtain substantially all the economic benefits from use of the space throughout the period of use (it has exclusive use of it).
- The power criterion is met. Software has the ability to make decisions about whether to use the space and, if so, when, how, and how much to use the space throughout the period of use.

**EXAMPLE 2-15: CONTRACT FOR SMART SAFES**

**FACTS**

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

**CONCLUSION**

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

**ANALYSIS**

- There is an identified asset. Each smart safe is implicitly specified once it is installed at the convenience store location, and State Bank does not have any substitution rights.
- The economic criterion is met. EZ Co. obtains substantially all the economic benefits from use of the safes throughout the three-year period of use because it has exclusive use of those safes. No other customer of State Bank can use the safes.
- The power criterion is met. Although State Bank has the right to access the safes to collect the funds deposited in them, that access is predetermined in the contract (the dates and times are predetermined and cannot be changed absent emergency situations). The ability to access the safes also would not grant State Bank the right to determine how and for what purpose the safe is used, given that State Bank gives EZ Co. access to funds deposited in the safe before collecting the funds. On the other hand, EZ Co. determines whether and when to use the safe and how much cash and checks to deposit into the safe throughout the period of use. Those are the most relevant decision-making rights that affect the economic benefits from use of the safes, and EZ Co. controls them.

**EXAMPLE 2-16: CONTRACT FOR OFFSHORE DRILLING RIG**

**FACTS**

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

**CONCLUSION**

- The contract contains a lease.

**ANALYSIS**

- There is an identified asset. The agreement specifies the drilling rig and DrillCo has no other rig it could use in the area to fulfill the contract or that it could source within a reasonable period. In other words, DrillCo does not have the practical ability to substitute the drilling rig throughout the period of use and therefore does not have a substantive substitution right.
- The economic criterion is met. BOI receives substantially all the output from use of the drilling rig throughout the period of use because it has exclusive use of the rig. DrillCo cannot use the rig to provide services to any other customer during the term of the agreement, either contractually or practically, because BOI has exclusive exploration rights in that geographical area.
- The power criterion is met. Although DrillCo operates the drilling rig, and operating it is essential to the efficient use of the rig, the right to operate the rig depends on the relevant decisions regarding how and for what purpose to use the rig (which are where and how long to drill, at what depth, and where to drill next). BOI is the party that controls those relevant decisions throughout the period of use.

**EXAMPLE 2-17: CONTRACT FOR PROCESSING RETURN OF HANDSETS**

**FACTS**

- Telco and Logistics Co. enter a five-year agreement that requires Logistics Co. to build a warehouse in a specified geographic area to process returned handsets from Telco. Logistics Co. is the legal owner of the warehouse and continues to be throughout the term of the contract.
- The agreement does not result in Telco controlling the warehouse under construction (see Section 7.2.2.2).
- While Logistics Co. has some latitude in selecting the warehouse location, it must be in the specified area. Once constructed, the warehouse cannot be relocated or substituted, even within the specified area, absent extraordinary circumstances (for example, destruction by fire).
- For the term of the agreement, Logistics Co. will process all returned handsets directed by Telco to this warehouse pursuant to repair instructions Telco provides. If Telco does not direct handsets to the warehouse, the warehouse does not operate. Under the contract, Logistics Co. cannot service any customers other than Telco in the warehouse.
- Logistics Co.is required to operate and maintain the warehouse daily in accordance with industry-approved operating procedures.

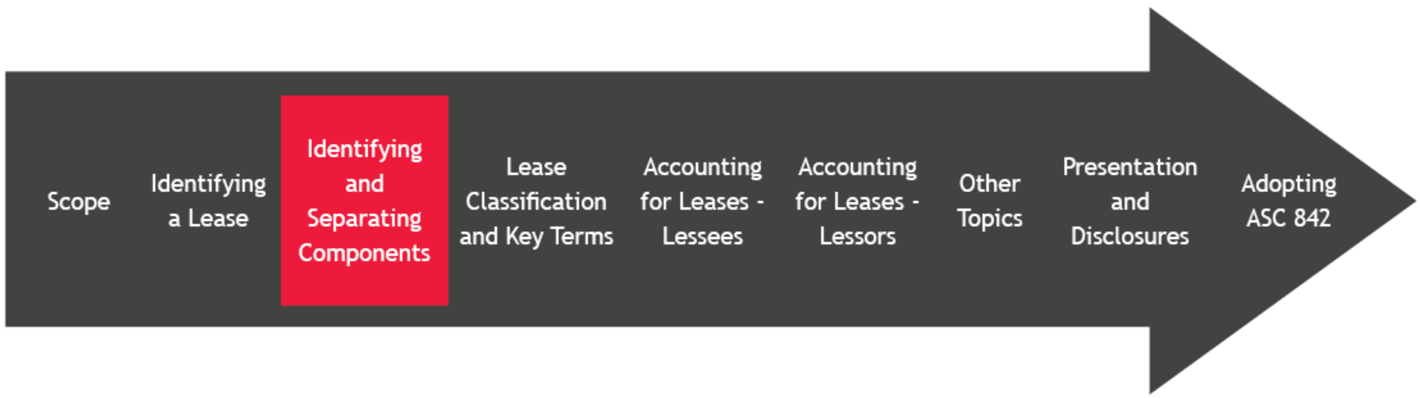
**CONCLUSION**

- The contract contains a lease.

**ANALYSIS**

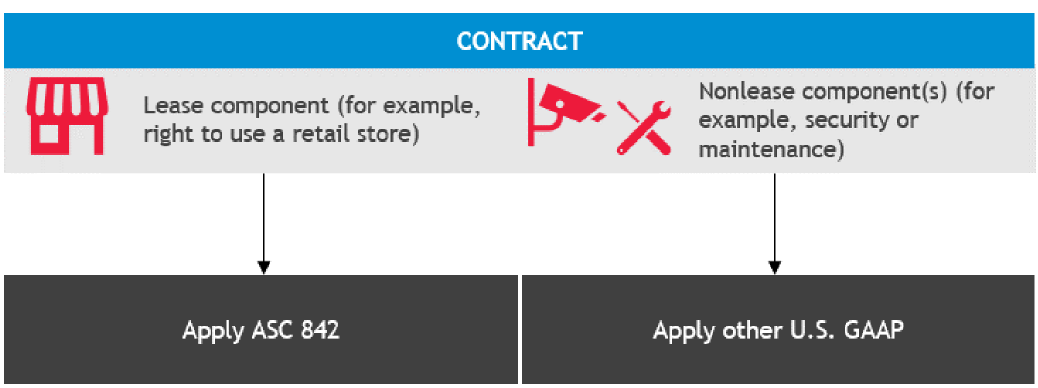
- There is an identified asset. Once the location is selected and the warehouse constructed, the warehouse is specified, and Logistics Co. does not have the right to substitute the specified warehouse location.
- The economic criterion is met. If Telco does not direct handsets to the warehouse, the warehouse does not operate because Logistics Co. cannot service other customers. In other words, Telco has exclusive use of the warehouse throughout the period of use.
- The power criterion is met. Telco makes the relevant decisions about how and for what purpose the warehouse is used because it has the right to determine whether, when, and how many handsets are processed in the warehouse throughout the period of use. Because Logistics Co. cannot use the warehouse for any other customer or purpose, Telco’s decision-making about the timing and quantity of handsets processed in effect determines whether and when the warehouse will be used.

# CHAPTER 3 — IDENTIFYING AND SEPARATING COMPONENTS




## 3.1 OVERVIEW

In Chapter 2, we discussed how to identify a lease. Once an entity concludes that a contract is or 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 components are accounted for under other U.S. GAAP unless the entity elects a practical expedient not to separate the nonlease components from the associated lease component for the asset class.



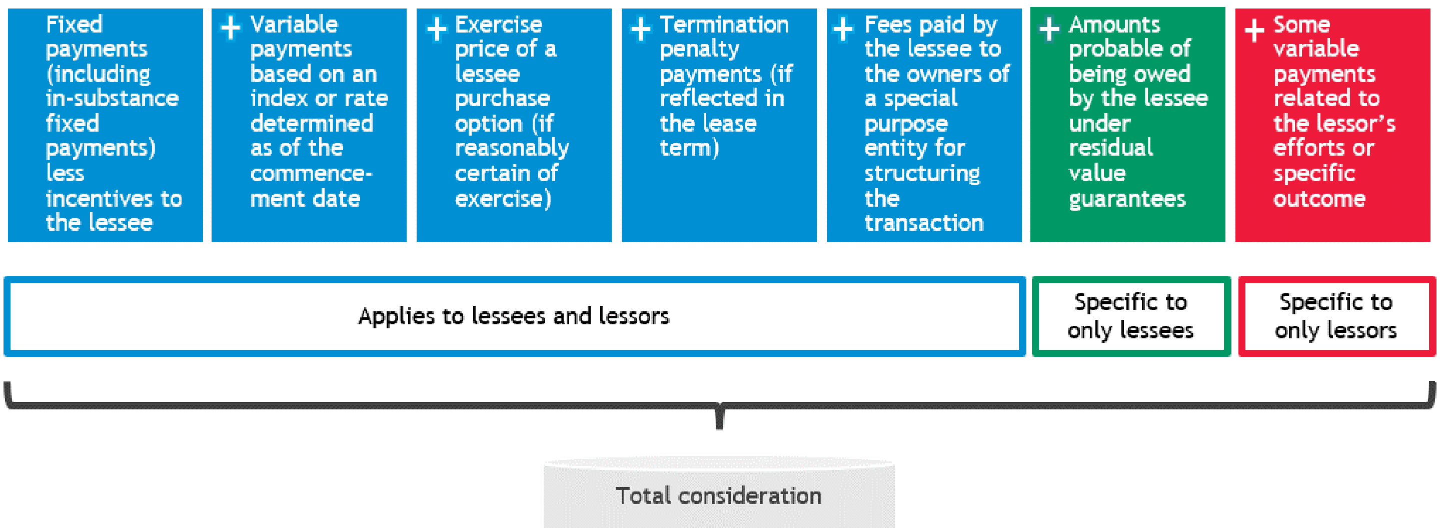

A contract sometimes includes the lease of more than one asset. In those situations, the entity evaluates whether the contract contains multiple lease components. Generally, the right to use each individual asset represents a separate lease component. For example, in a contract for the right to use two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

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 contract
- Costs a 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)

In addition to identifying the components of the contract, the entity must determine the consideration in the contract. Broadly speaking, consideration 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. Also, a lessee does not include variable payments other than those based on an index or rate, while lessors sometimes must include some variable payments that relate specifically to nonlease components.

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




Once the entity determines the consideration, it allocates it to the components in the contract. If a contract includes more than one lease component or a lease component and at least one nonlease component, the entity must separate and allocate the consideration in the contract to those components unless it elected the practical expedient not to separate the nonlease components (discussed below). The allocation of the consideration is generally made on a relative standalone (selling) price basis (that is, not necessarily based on any stated prices in the contract). Lessors also must apply the allocation guidance in ASC 606.

Items or activities that do not transfer a good or service to the lessee do not receive an allocation of the consideration because they are not components of the contract. That means that any payments in the contract for these items or activities, whether fixed or variable, will be allocated to the components of the contract.

**IDENTIFY THE PAYMENTS IN THE CONTRACT (FIXED AND VARIABLE)**

| | | |
|---|---|---|
| Payments for lease components (for example, right to use a retail store) | Payments for nonlease components (for example, security and maintenance services) | Payments for noncomponents (for example, property taxes and insurance) |

↓

Total consideration — **DETERMINE THE CONSIDERATION IN THE CONTRACT**

Some payments, such as variable payments that are not based on an index or rate, are not part of the consideration in the contract (except for lessors if specific conditions are met).

↓

**ALLOCATE THE CONSIDERATION TO THE COMPONENTS (UNLESS THE PRACTICAL EXPEDIENT NOT TO SEPARATE IS ELECTED)**

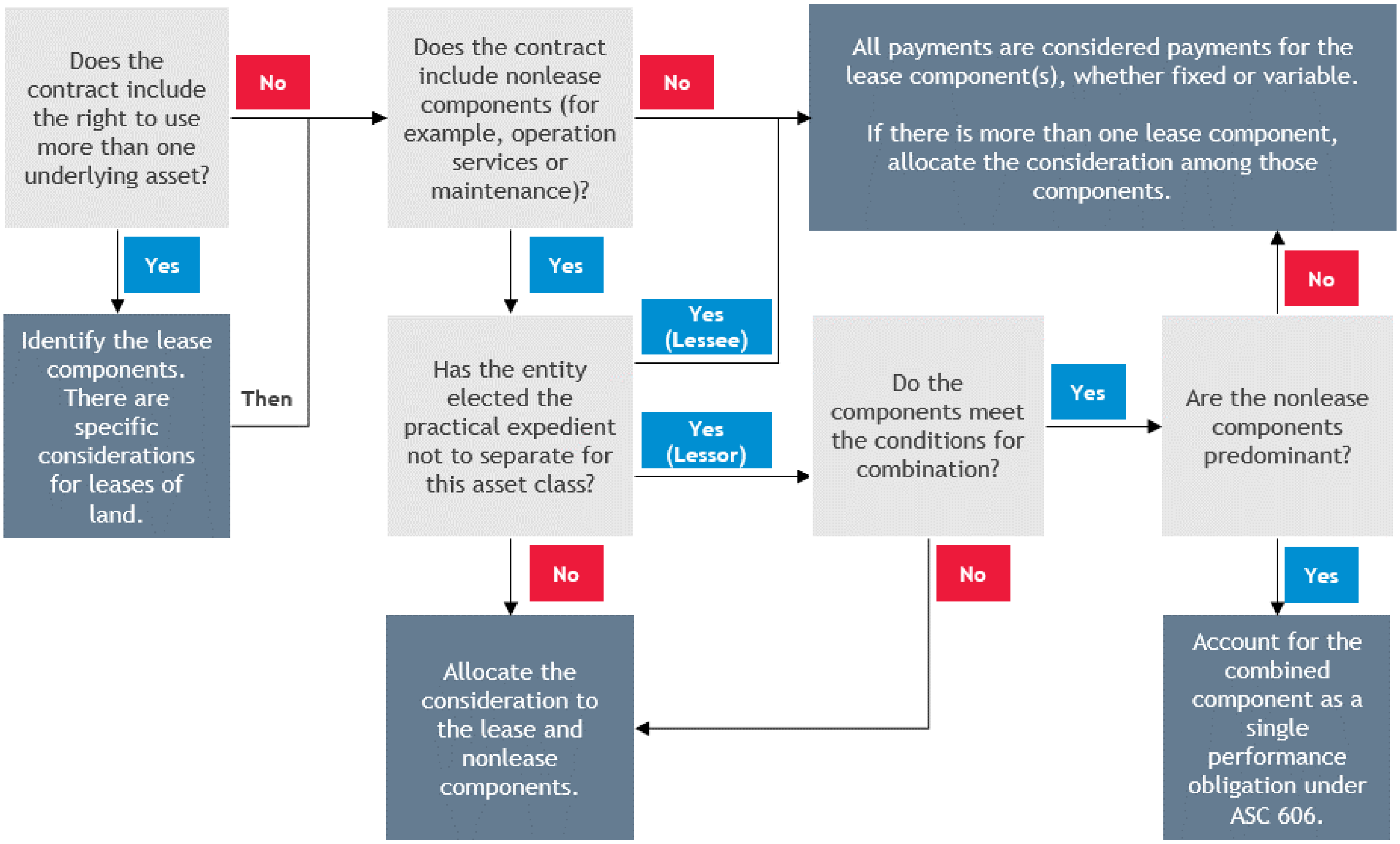
| | |
|---|---|
| The lease component(s) | The nonlease component(s) |

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

- Lessees can generally apply the practical expedient without regard to conditions, and the combined component is accounted for under ASC 842.
- Lessors may account for each separate lease component and the nonlease components associated with that lease component as a single lease component if **all** three conditions are met:
  - The nonlease component(s) otherwise would be accounted for under ASC 606
  - The timing and pattern of transfer of the lease component and nonlease component(s) associated with that lease component are the same
  - The lease component, if accounted for separately, would be classified as an operating lease.

  If all conditions are met, the accounting for the combined component depends on which component of the contract is predominant, which dictates whether the lessor applies ASC 842 or ASC 606.

The flowchart summarizes the key steps an entity must perform, which we discuss in further detail in this chapter.




However, note the following on the practical expedient not to separate:

- For a lessee, not all nonlease components in the contract will be combined with the lease component. For example, in some cases, such as when the lessor maintains the leased asset but also performs maintenance services on an asset the lessee owns, that nonlease component may not be associated with the lease component, so the lessee may still be required to allocate the consideration among some of the components.
- For a lessor, not all nonlease components in the contract will meet the conditions to be combined with the lease component. For example, a contract may include a lease of equipment, maintenance services related to that equipment, and a sale of consumables. In that situation, the lease component and maintenance services may meet the criteria to be combined if they are provided over time, but the consumables may not if they are a component that transfers at a point in time under ASC 606. In those cases, if the lessor elected the practical expedient for the asset class, it must allocate the consideration in the contract between the combined component (the lease component and related maintenance) and the other nonlease component (the consumables).

# 3.2 IDENTIFYING LEASE AND NONLEASE COMPONENTS

## 3.2.1 Identifying Components of the Contract

**FASB REFERENCES**

ASC 842-10-15-28 and ASC 842-10-15-30 through 15-31

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

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

Lessees and lessors must identify the individual lease and nonlease components of the contract but do not have to separate the nonlease components from the associated lease component if a practical expedient not to separate is elected (see Section 3.3.2 for lessees and Section 3.4.2 for lessors).

## 3.2.2 Lease Component Separation Guidance

### 3.2.2.1 General Considerations

**FASB REFERENCES**

ASC 842-10-15-28, ASC 842-10-55-132 through 55-140, ASC 842-10-55-146 through 149

ASC 842 provides the following guidance on identifying separate lease components:

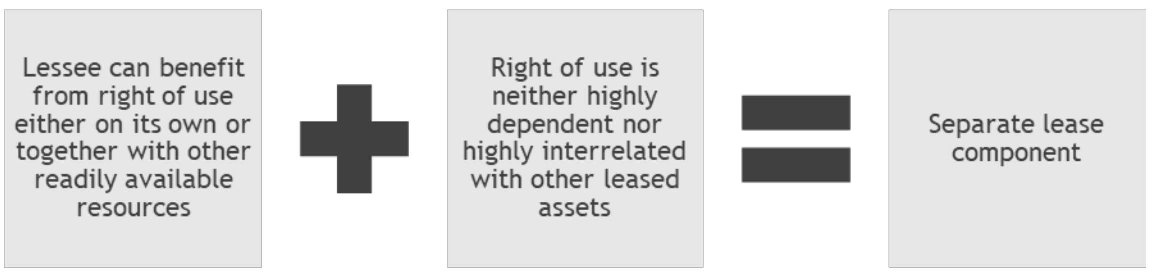
**FASB REFERENCES**

ASC 842-10-15-28

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

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

Accordingly, a right to use an underlying asset is a separate lease component if both conditions below are met.




In assessing the first condition, readily available resources are goods or services that are sold or leased separately (by the lessor or other suppliers) or resources the lessee already has obtained (from the lessor or from other transactions or events). An entity might consider the following questions in determining whether this condition is met:

- Is the asset readily sold or leased separately by the lessor or other suppliers?
- Could the lessee readily lease or purchase an alternative asset to use with the other leased asset?

In evaluating the second condition, a lessee's right to use an underlying asset is highly dependent on or highly interrelated with the right to use another underlying asset if **each** right of use significantly affects **the other**. An entity might consider the following questions in determining whether this condition is met:

- Can the lessor fulfill its obligations to lease one of the underlying assets independently of its fulfilment of the other lease obligations?
- Would there be significant costs and time for the lessor to be able to fulfill its obligation on each leased asset?
- Is the lessee's ability to derive benefits from the lease of each asset significantly affected by its decision to lease or not lease the other asset(s) from the lessor?

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

The guidance in ASC 842-10-15-28 on identifying lease components is similar to the guidance in ASC 606-10-25-19 through 25-21 (see Section 3.3 of our Blueprint, Revenue Recognition Under ASC 606) on determining whether a good or service promised in a revenue contract is distinct and therefore represents a separate performance obligation. That linkage was intentional because ASC 842 incorporates concepts from ASC 606, so ASC 842-10-15-28 should be applied similarly to ASC 606.

Generally, the right to use an underlying 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 includes two lease components. However, while there are several potential underlying components that make up each truck, such as the engine and seats, the integral parts of the truck do not meet the criteria for treatment as separate lease components. In other words, each truck is the lease component.

In some cases, the right to use multiple underlying assets will represent a single lease component. Example 13 in ASC 842-10-55 involves a contract for the lease of a gas-fired turbine plant that consists of the turbine housed in a building together with the land on which the building sits. The rights to use the turbine, the building, and the land are highly interrelated because each is an input to the customized combined item for which the lessee contracted (which is the right to use a gas-fired turbine plant that can produce electricity for distribution to the lessee’s customers). However, the fact that a lessee will use multiple underlying assets for one purpose is not sufficient to conclude that the rights of use are highly interrelated or interdependent. The FASB illustrated that in Example 11 of ASC 842-10-55. We also illustrate it in Examples 3-1 through 3-3.

### EXAMPLE 3-1: LEASE OF HELICOPTER AND JET

#### FACTS

- Lessee and Lessor enter a two-year lease of a helicopter and a private jet to transport Lessee’s key executives for a specific project requiring significant travel.
- Lessor agrees to maintain the helicopter and jet throughout the contract term.

#### CONCLUSION

- There are two separate lease components and two separate nonlease components unless the entity elects the practical expedient not to separate for this asset class, in which case:
  - For Lessee, the contract has two separate lease components under ASC 842 (see Section 3.3).
  - For Lessor, depending on predominance, the contract has either two separate lease components under ASC 842 or two separate performance obligations under ASC 606 (see Section 3.4).

#### ANALYSIS

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

**EXAMPLE 3-2: LEASE OF AIR PURIFICATION SYSTEM**

**FACTS**

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

**CONCLUSION**

- The contract contains one lease component (the right to use the air purification system) and one nonlease component (maintenance of the system) unless the entity elects the practical expedient not to separate for this asset class, in which case:
  - For Lessee, the contract has one lease component under ASC 842 (see Section 3.3).
  - For Lessor, depending on predominance, the contract has either one lease component under ASC 842 or one performance obligation under ASC 606 (see Section 3.4).

**ANALYSIS**

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

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

**FACTS**

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

**CONCLUSION**

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

**ANALYSIS**

- Lessee can benefit from each of the light fixtures on its own or together with other readily available resources. For example, Lessee could readily lease or purchase alternative light fixtures.
- The purpose of the light fixtures is to provide a lower cost alternative to traditional lighting solutions. However, each light fixture provides a similar estimated cost savings and would provide the same level of cost savings regardless of whether each light fixture was installed on its own or as part of a larger installation. Therefore, the

right to use each light fixture is neither highly dependent on nor highly interrelated with the use of the other light fixtures.

### 3.2.2.2 Specific Considerations for Land

**FASB REFERENCES**

ASC 842-10-15-29

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

Irrespective of the guidance in Section 3.2.2.1 on separating lease components, ASC 842 requires a lease of land to be accounted for as a separate lease component unless the accounting effects of such separation would be insignificant, such as when:

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

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

**BDO INSIGHTS — IDENTIFYING LEASES OF LAND**

Determining whether a contract includes a lease of land 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 office building includes 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 and directs its use. In other cases, further analysis may be required. For example, in a contract for a lessee to lease retail space in a shopping mall, the analysis may depend on whether the lessee is the anchor tenant and whether, as anchor tenant, it 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 entity must account for the lease of land separately from the lease of the other assets unless doing so would be insignificant (for example, lease classification would not change for either component or the amounts for the lease of land are insignificant).

**EXAMPLE 3-4: LEASE OF LAND AND BUILDING**

**FACTS**

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

**CONCLUSION**

- The contract includes two components: a single lease component (comprising the right to use the land and building) and a nonlease component (landscaping services) unless the entity elects the practical expedient not to separate for this asset class.
  - For Lessee, see Section 3.3 for guidance on accounting for the components and Example 3-7 for a continuation of this example.
  - For Lessor, see Section 3.4 for guidance on accounting for the components and Example 3-9 for a continuation of this example.

**ANALYSIS**

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

**EXAMPLE 3-5: LEASE OF OFFICE SPACE**

**FACTS**

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

**CONCLUSION**

- The contract includes two components: one lease component (the floor) and one nonlease component (common area maintenance services) unless the entity elects the practical expedient not to separate.
  - For Lessee, see Section 3.3 for guidance on accounting for the components and Example 3-8 for a continuation of this example.
  - For Lessor, see Section 3.4 for guidance on accounting for the components and Examples 3-10 and 3-11 for a continuation of this example.

**ANALYSIS**

- The contract does not include a lease of land because Lessee does not occupy substantially all the building. In other words, all the tenants share the land on which the building sits. Accordingly, the only lease component in the contract is the lease of the floor.

- The real estate taxes and insurance Lessee will pay to Lessor are not considered components of the contract because they are considered reimbursements of Lessor's costs for the building (see Sections 3.3 and 3.4 for lessees and lessors, respectively, for additional considerations on taxes and insurance).
- The CAM is a nonlease component because it transfers a good or service to Lessee that is separate from the lease of the floor. Lessor also determines under ASC 606 that the common area maintenance represents a single performance obligation.

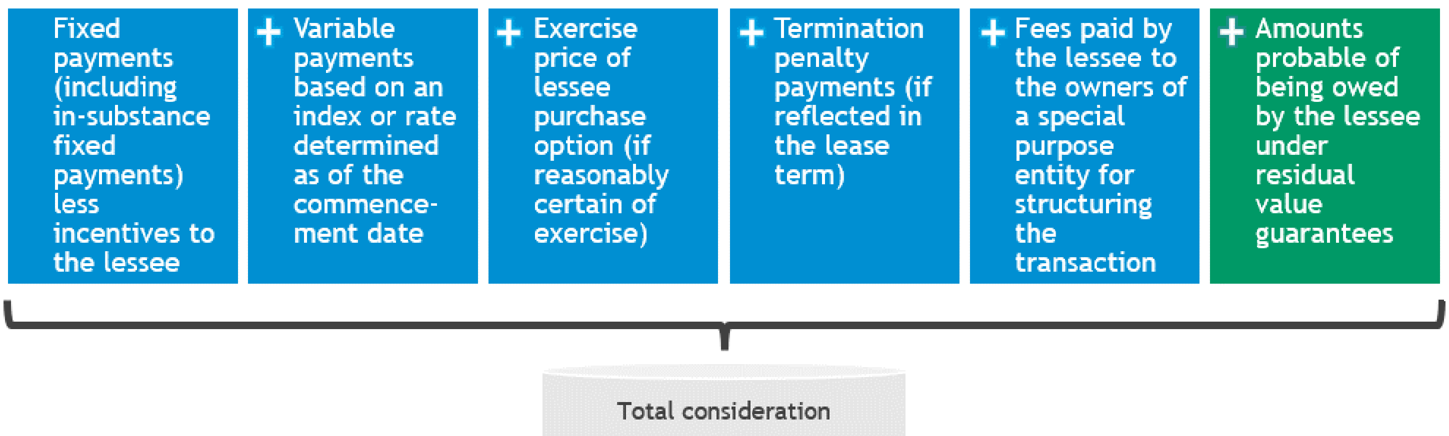
## 3.3 SEPARATING COMPONENTS — LESSEES

### 3.3.1 Determining the Consideration in the Contract

**FASB REFERENCES**

ASC 842-10-15-35 and ASC 842-10-30-5

A lessee determines the consideration in the contract at contract inception and includes the payments shown in the graphic to the lessor (or by the lessor, for incentives) during the lease term.




A lessee then allocates the consideration to the lease and nonlease components of the contract (see Section 3.3.3) unless the lessee elects the practical expedient not to separate for this asset class (see Section 3.3.2).

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

Variable payments that do not depend on an index or rate are not included in the consideration in the contract. For example, variable payments based on the performance of the asset, such as payments based on a percentage of the lessee's sales, or on energy the leased asset produces, or reimbursement of actual lessor costs (such as property taxes and some insurance costs) are not included in the consideration.

See Section 4.4 for further discussion of in-substance fixed payments, lease incentives, purchase options, and termination options.

### 3.3.1.1 Property Taxes and Insurance

| FASB REFERENCES |
|---|
| ASC 842-10-15-30 and ASC 842-10-55-141 through 145 |

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

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

Accordingly, the lessee's paying those costs represents solely a reimbursement of the lessor's costs. The fact that the lessee may pay a third party, including a taxing authority, rather than reimbursing the lessor does not change that conclusion. Classification of a lease (as operating versus finance for the lessee) also does not affect whether costs are considered lessor or lessee costs.

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

| PAYMENTS ARE FIXED | PAYMENTS ARE VARIABLE |
|---|---|
| The lessee includes the payments in the consideration in the contract, which it allocates to the lease and nonlease components in the contract based on relative standalone price unless the lessee elects the practical expedient not to separate for the asset class. Those payment amounts (or a portion thereof if there are nonlease components or more than one lease component) will affect the lease's classification and measurement on balance sheet. | The lessee excludes the payments from the consideration because they do not represent variable payments based on an index or rate. Once the variable payments are incurred, the lessee allocates them between the lease and nonlease components using the same allocation as at contract's inception or most recent reallocation (see Section 3.3.4) unless the lessee elected the practical expedient not to separate for the asset class. |
| **Example**: The lessee must pay the lessor a fixed amount per year for insurance coverage on the leased asset. | **Example:** The lessee must reimburse the lessor for actual property taxes due on the leased asset. Property taxes do not represent an index or rate and therefore are not part of the consideration in the contract. |

In some cases, additional complexity may arise in differentiating between lessee and lessor costs, particularly for insurance contracts for which there may be elements benefiting the lessor (for example, coverage protecting the leased asset) and others benefiting the lessee (for example, coverage protecting the lessee's owned assets or other contingencies). In those situations, further analysis may be required to determine the portion of 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.

#### 3.3.1.2 Sales Taxes and Similar Taxes

**FASB REFERENCES**

ASC 842-10-15-30

When an entity enters a lease, a governmental authority may assess taxes on the contract. Those taxes may be both imposed on and concurrent with a specific lease revenue-producing transaction and collected by the lessor from a lessee. That includes, for example, sales, use, value-added, and some excise taxes. Unlike lessors (see Section 3.4.1.3), lessees do not have a practical expedient not to assess such taxes. Accordingly, a lessee must analyze sales taxes and similar taxes jurisdiction by jurisdiction to determine whether those taxes are the lessor's primary obligation as owner of the leased asset (in which case the tax is a lessor cost) or whether the lessor collects them on behalf of third parties (in which case the tax is a lessee cost).

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

Like property taxes and insurance discussed in Section 3.3.1.1, the fact that the lessee pays a third party directly rather than reimbursing the lessor for the tax does not affect that conclusion.

#### 3.3.1.3 Common Area Maintenance Payments

A contract that contains a property lease often includes provisions requiring the lessee to pay for CAM services the lessor provides. As discussed in Section 3.2.1, 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 3.3.2).

The table below summarizes CAM payment arrangements frequently encountered and their accounting treatment based on whether the lessee has elected the practical expedient not to separate. The table assumes that if the lessee elects the practical expedient, the nonlease components are considered associated with the lease component to which they relate and therefore are not accounted for separately. It also assumes that the lease costs are not capitalized under other U.S. GAAP (for example, as inventory costs under ASC 330).

For CAM arrangements not listed in the table, a lessee determines the appropriate accounting based on facts and circumstances, including whether the CAM payments are fixed (including in-substance fixed) or variable and whether the lessee elected the practical expedient not to separate.

| CAM ARRANGEMENT | FIXED OR VARIABLE PAYMENT? | PRACTICAL EXPEDIENT ELECTED? | ACCOUNTING TREATMENT |
|---|---|---|---|
| **Scenario 1:** Lessee pays a fixed amount for CAM services throughout the lease. | Fixed | Yes | The lessee includes the fixed payments in the consideration in the contract, which it then allocates to each lease component in the contract based on relative standalone price (see Section 3.3.3). The payment amounts allocated to each lease component affect their classification and measurement on the balance sheet and are recognized over the lease term based on lease classification (see Chapter 5). |

| CAM ARRANGEMENT | FIXED OR VARIABLE PAYMENT? | PRACTICAL EXPEDIENT ELECTED? | ACCOUNTING TREATMENT |
|---|---|---|---|
| | | No | The lessee includes the fixed payments in the consideration in the contract, which it then allocates to each lease and nonlease component in the contract based on relative standalone price (see Section 3.3.3). The payment amounts allocated to each lease component affect their classification and measurement on the balance sheet and are recognized over the lease term based on lease classification (see Chapter 5). Amounts allocated to the nonlease components are accounted for under other U.S. GAAP. |
| **Scenario 2:** Lessee reimburses lessor for actual CAM costs. | Variable | Yes | Variable CAM payments are not based on an index or rate and therefore are not included in the consideration in the contract. Once the variable payments are incurred, the lessee allocates them to each lease component using the same allocation as at contract inception or most recent reallocation (see Section 3.3.4) and recognizes the allocated amounts as variable lease expense (see Example 3-8). |
| | | No | Variable CAM payments are not based on an index or rate and therefore are not included in the consideration in the contract. Once the variable payments are incurred, the lessee allocates them to each lease and nonlease component using the same allocation as at contract inception or most recent reallocation (see Section 3.3.4). The amounts allocated to each lease component are considered variable lease expense. Amounts allocated to the nonlease components are accounted for under other U.S. GAAP (see Example 3-8 ). |
| **Scenario 3:** Lessee pays a fixed amount for CAM services during only the first year of the lease. Lessee reimburses lessor for actual CAM costs in subsequent years. | Fixed (first year only)<br>Variable (subsequent years) | Yes | The lessee includes the first-year fixed CAM payment in the consideration in the contract, which it then allocates to each lease component in the contract on a relative standalone price basis (see Section 3.3.3). The payment amounts allocated to each lease component affect their classification and measurement on the balance sheet and are recognized over the lease term based on lease classification (see Chapter 5).<br>The variable CAM payments in subsequent years are not based on an index or rate and therefore are not included in the consideration in the contract. Once the variable payments are incurred, the lessee allocates them to each lease component using the same allocation as at contract inception or most recent reallocation (see Section 3.3.4) and recognizes the allocated amounts as variable lease expense. |

| CAM ARRANGEMENT | FIXED OR VARIABLE PAYMENT? | PRACTICAL EXPEDIENT ELECTED? | ACCOUNTING TREATMENT |
|---|---|---|---|
| | | No | The lessee includes the first-year fixed CAM payment in the consideration in the contract, which it then allocates to each lease and nonlease component in the contract based on relative standalone price (see Section 3.3.3). The payment amounts allocated to each lease component affect their classification and measurement on the balance sheet and are recognized over the lease term based on lease classification (see Chapter 5). Amounts allocated to the nonlease components are accounted for under other U.S. GAAP.<br><br>Variable CAM payments in subsequent years are not based on an index or rate and therefore are not included in the consideration in the contract. Once the variable payments are incurred, the lessee allocates them to each lease and nonlease component using the same allocation as at contract inception or most recent reallocation (see Section 3.3.4). Amounts allocated to each lease component are considered variable lease expense. Amounts allocated to the nonlease components are accounted for under other U.S. GAAP. |
| **Scenario 4:** Lessee pays a fixed amount for CAM services throughout the lease term. Lessee reimburses lessor for any overages (CAM costs in excess of the fixed amount). There is no requirement for lessor to reimburse lessee if actual CAM costs | Fixed (annual payment)<br><br>Variable (overages) | Yes | The lessee includes the fixed annual CAM payments in the consideration in the contract, which it then allocates to each lease component in the contract based on relative standalone price (see Section 3.3.3). The payment amounts allocated to each lease component affect their classification and measurement on the balance sheet and are recognized over the lease term based on lease classification (see Chapter 5).<br><br>The variable payments for CAM overages are not based on an index or rate and therefore are not included in the consideration in the contract. Once the variable payments are incurred, the lessee allocates them to each lease component using the same allocation as at contract inception or most recent reallocation (see Section 3.3.4) and recognizes the allocated amounts as variable lease expense. |

| CAM ARRANGEMENT | FIXED OR VARIABLE PAYMENT? | PRACTICAL EXPEDIENT ELECTED? | ACCOUNTING TREATMENT |
|---|---|---|---|
| are less than the lessee paid amounts. | | No | The lessee includes the fixed annual CAM payments in the consideration in the contract, which it then allocates to each lease and nonlease component in the contract based on relative standalone price (see Section 3.3.3). The payment amounts allocated to each lease component affect their classification and measurement on the balance sheet and are recognized over the lease term based on lease classification (see Chapter 5). Amounts allocated to the nonlease components are accounted for under other U.S. GAAP.<br><br>The variable CAM payments for overages are not based on an index or rate and therefore are not included in the consideration in the contract. Once the variable payments are incurred, the lessee allocates them to each lease and nonlease component using the same allocation as at contract inception or most recent reallocation (see Section 3.3.4). The amounts allocated to the lease components are considered variable lease expense. Amounts allocated to the nonlease components are accounted for under other U.S. GAAP. |

### 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, as in Scenario 4 in the table above, 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).

### 3.3.2 Practical Expedient Not to Separate

**FASB REFERENCES**

ASC 842-10-15-37 and ASC 842-10-55-131 through 140

A lessee may elect as an accounting policy by asset class not to separate nonlease components from lease components and to account for each lease component and its associated nonlease components as a single lease component. The FASB provided that practical expedient to reduce cost and complexity in applying ASC 842. While electing the practical expedient results in a larger ROU asset and lease liability on balance sheet and may change classification from an operating lease to a finance lease (see Section 4.9), our experience is that many lessees elect it for cost-benefit reasons. Entities need to consider the pros (for example, simplicity) and cons (for example, impact on accounting for the lease, including on balance sheet) of electing the practical expedient for their asset classes.

If a lessee does not elect the practical expedient for an asset class, it must allocate the payments in the contract between the lease and nonlease components. That includes variable payments even if, for example, the contract clearly provides for specific charges related to the nonlease services, such as common area maintenance. That 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, paragraph BC149 of ASU 2016-02 notes that the FASB "*decided that lessees should account for lease and nonlease (**typically, service**) components separately (unless they elect the practical expedient)*." [Added emphasis.] Accordingly, we believe the practical expedient not to separate was primarily intended to apply to services and other nonlease components transferred over time and that relate to the lease component, such as maintenance of leased equipment or CAM 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, a lessee may conclude that the component is not associated with the lease component because it usually will be able to redirect the inventory and use it with a different asset or resell it in the market.

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

#### 3.3.3.1 General Considerations

**FASB REFERENCES**

ASC 842-10-15-33 through 15-34, ASC 842-20-55-1

If a lessee does not elect the practical expedient not to separate for an asset class (see Section 3.3.2) or if there is more than one lease component, once it identifies the components in the contract and determines the total consideration, the lessee allocates the consideration to the lease and nonlease components on a relative standalone price basis using the observable standalone price of each component.

**FASB REFERENCES**

ASC 842-10-15-33

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

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

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

A price is observable if it is the price at which either the lessor or similar suppliers sell similar lease or nonlease components on a standalone basis. If observable standalone prices are not readily available, a lessee must estimate standalone prices maximizing the use of observable information. A residual approach may be acceptable if the standalone price for a component is highly variable or uncertain. Paragraph BC156 in ASU 2016-02 states in part that "*the allocation guidance for lessees is similar to that for lessors and also is broadly consistent with that in previous GAAP*."

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

**EXAMPLE 3-6: LEASE OF A CAR**

**FACTS**

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

**WHAT ARE THE COMPONENTS?**

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

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

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

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

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

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

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

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

| COMPONENTS | STANDALONE PRICE | RELATIVE STANDALONE PRICE |
|---|---|---|
| Car lease | $ 14,400 | $ 13,898 (93.02%) |
| Maintenance | 1,080 | 1,042 (6.98%) |
| | $ 15,480 | $ 14,940 |

- The amount of consideration allocated to the lease component ($13,898) is used to account for the lease component (for example, to assess lease classification and recognize the lease on balance sheet).
- The amount of consideration for the maintenance component ($1,042) is accounted for under other U.S. GAAP.
- Lessee will allocate and recognize all variable payments for insurance and any extra mileage and maintenance when incurred using the same allocation basis as for the consideration in the contract (on a 93.02%/6.98% basis).

**EXAMPLE 3-7: LEASE OF LAND AND BUILDING — LESSEE ACCOUNTING**

**FACTS**

- In Example 3-4, Lessor and Lessee entered a five-year lease of a single-story commercial office building.
- Lessee has exclusive use of the single-tenant building.
- The lease requires Lessor to perform landscaping services for Lessee.
- Lessee pays a fixed monthly payment of $12,000 in arrears, which includes rent, landscaping services, and reimbursement of Lessor's costs.
- There are no lease incentives or initial direct costs.

**WHAT ARE THE COMPONENTS?**

- As evaluated in Example 3-4, the contract includes two components: a single lease component (comprising the right to use the land and building) and a nonlease component (landscaping services).
- However, Lessee may elect to apply the practical expedient not to separate for this asset class, in which case the contract would contain a single lease component.

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

- The consideration in the contract is $720,000 ($12,000 * 12 months * 5 years).

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

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

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

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

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

| COMPONENTS | STANDALONE PRICE | RELATIVE STANDALONE PRICE |
|---|---|---|
| Lease component | $ 680,000 | $ 670,685 (93.15%) |
| Maintenance component | 50,000 | 49,315 (6.85%) |
| | $ 730,000 | $ 720,000 |

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

**EXAMPLE 3-8: LEASE OF OFFICE SPACE — LESSEE ACCOUNTING**

**FACTS**

- In Example 3-5, Lessor and Lessee entered a five-year lease for one floor in a 30-story office building.
- The lease requires Lessor to perform CAM services.
- The contract requires Lessee to pay rent of $50,000 per month in arrears and to reimburse Lessor for Lessee's pro-rata share of real estate taxes and insurance Lessor incurs on the building. Lessee must also pay CAM charges.
- Lessee initially estimates the pro-rata share of those reimbursements at $9,000 per month ($5,000 for taxes and insurance and $4,000 for CAM). The CAM charges can be adjusted upward and downward based on actual work Lessor performs.
- There are no lease incentives or initial direct costs.

**WHAT ARE THE COMPONENTS?**

- As evaluated in Example 3-5, the contract includes two components: one lease component (lease of the floor) and one nonlease component (CAM services).
- However, Lessee may elect to apply the practical expedient not to separate for this asset class, in which case the contract would contain a single lease component.

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

- The consideration in the contract is $3 million ($50,000 * 12 months * 5 years).
- The other payments for Lessee's pro-rata share of real estate taxes, insurance, and CAM are variable payments that do not depend on an index or rate. Therefore, they are not included in the consideration in the contract.

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

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

- In that situation, the contract includes only one component (the lease component).
- The consideration in the contract of $3 million is allocated entirely to the lease component and used to account for the lease (for example, to assess lease classification and recognize the lease on balance sheet).
- Lessee's payments for its pro-rata share of property taxes, insurance, and CAM are variable lease payments that do not depend on an index or rate and are excluded from the measurement of the lease liability. Lessee recognizes those variable lease payments in the income statement when incurred.

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

- In that case, Lessee allocates the consideration in the contract to the lease and CAM components based on relative standalone price. Lessee determines the standalone prices for the lease component and CAM component are $3.27 million and $270,000, respectively. Therefore, the consideration in the contract is allocated to the lease and nonlease components as follows:

| COMPONENTS | STANDALONE PRICE | RELATIVE STANDALONE PRICE |
|---|---|---|
| Lease component | $ 3,270,000 | $ 2,771,186 (92.37%) |
| CAM component[1] | 270,000 | 228,814 (7.63%) |
| | $ 3,540,000 | $ 3,000,000 |

(1) Includes an appropriate profit margin

- The amount of the consideration allocated to the lease component ($2,771,186) is used to account for the lease component (for example, to assess lease classification and recognize the lease on balance sheet).
- The amount of consideration allocated to CAM services ($228,814) is accounted for under other U.S. GAAP.
- Lessee will allocate and recognize all variable payments for its pro-rata share of real estate taxes, insurance, and CAM using the same allocation basis as for the consideration in the contract (on a 92.37%/7.63% basis).

In Example 3-8, if the lessee does not elect the practical expedient not to separate, it must allocate the variable payments between the lease and nonlease components even though the contract clearly provides for specific charges related to the nonlease services (that is, CAM). That is because a lessee cannot allocate variable consideration solely to the nonlease component, as lessors can.

### 3.3.3.2 Applying the Residual Approach

**FASB REFERENCES**

ASC 842-10-15-33, ASC 606-10-32-34

If a lessee has elected to separate lease and nonlease components, it must allocate the consideration in the contract between the lease and nonlease components based on relative standalone price. Should observable standalone prices not be readily available, the lessee must estimate the standalone prices maximizing the use of observable information. A lessee may use a residual estimation approach if the standalone price for a component is highly variable or uncertain.

Paragraph BC156 of ASU 2016-02 states in part that "*the allocation guidance for lessees is similar to that for lessors and also is broadly consistent with that in previous GAAP.*" Lessors apply the allocation requirements in ASC 606, which provides guidance on the suitable methods for estimating the standalone selling prices (including a residual approach).

**FASB REFERENCES**

ASC 606-10-32-34

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

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

As suggested by the FASB guidance above, to apply the residual approach, an entity must have **observable** standalone prices for at least some of the components in the contract. If the lessee does not have observable standalone prices for any of the components, it must estimate the standalone price for all components, and it cannot use the residual approach. Further, to meet the additional criteria and thus use the residual approach in a lease, the entity either:

- Leases similar assets (for example, similar asset types in a similar location) for a broad range of amounts, which indicates a representative standalone price is not discernible from past transactions
- Has not previously leased the applicable type of assets and is unable to determine a standalone price because there are no similar transactions the entity can use as a benchmark.

The criteria are deliberately restrictive. Consequently, although a lessee could use the residual method if it meets the criteria, it is very unlikely that will occur frequently (see section 5.3.2 of our Blueprint, Revenue Recognition Under ASC 606).

### 3.3.4 Remeasuring and Reallocating the Consideration

**FASB REFERENCES**

ASC 842-10-15-36

Inevitably, modifications to contracts and changes in facts and circumstances may occur during the contract term. A lessee must remeasure the consideration in the contract and reallocate it to the components in the contract upon:

- The effective date of a contract modification that is not accounted for as a separate contract (see Section 5.8)
- Remeasurements of the lease payments, such as a remeasurement resulting from a change in the lease term or in the assessment of a lessee purchase option (see Section 5.7).

However, a lessee's requirement to reallocate the consideration in the contract depends on whether it elected the practical expedient not to separate for the relevant asset class (see Section 3.3.2).

## 3.4 SEPARATING COMPONENTS — LESSORS

### 3.4.1 Determining the Consideration in the Contract

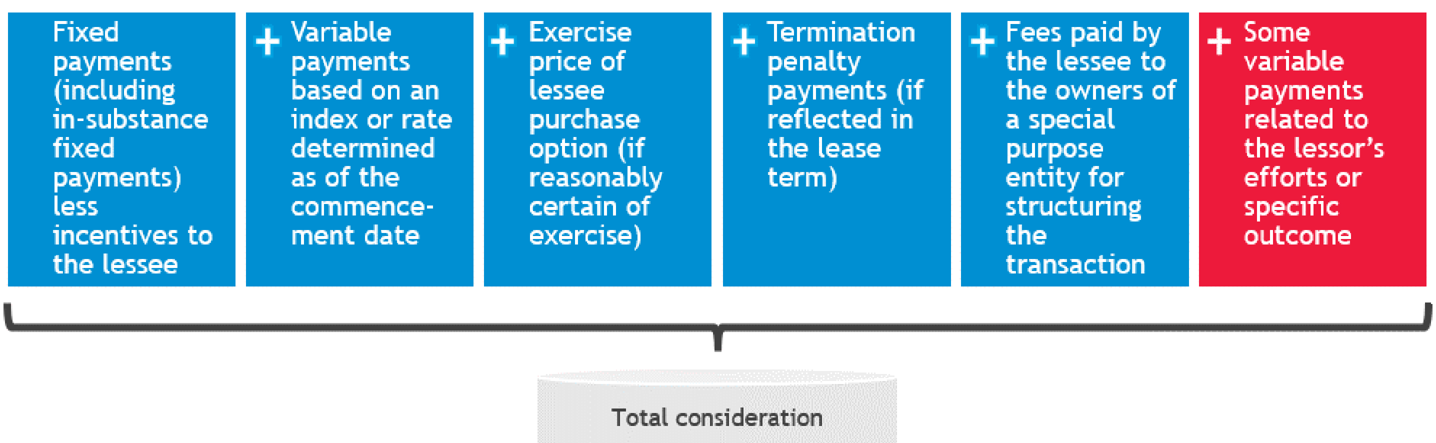
**FASB REFERENCES**

ASC 842-10-15-35, ASC 842-10-15-39, ASC 842-10-30-5

A lessor determines the consideration in the contract at contract inception. For a lessor, the consideration in the contract includes **as a starting point** the same payment amounts as those determined by the lessee (see Section 3.3.1) except that a lessor does not include amounts probable of being owed under a lessee residual value guarantee (see Section 4.4).

The consideration also includes some variable payments related to the lessor's efforts in transferring (or an outcome from transferring) one or more goods or services that are not leases and that would be included under ASC 606 (see Section 3.4.1.1). There is also additional guidance for reimbursements of lessor costs (see Section 3.4.1.2) and sales taxes and similar taxes (see Section 3.4.1.3).

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




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

**FASB REFERENCES**

ASC 842-10-15-39, ASC 842-10-15-40, ASC 842-10-55-150 through 55-158 and ASC 606-10-32-11

Unlike lessees, lessors must include some variable payments in the consideration in the contract. The consideration for a lessor includes variable payment amounts that would be included in the transaction price under ASC 606 when they relate specifically to either:

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

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

However, if the terms of a variable payment amount (other than those that depend on an index or rate) relate to a lease component **even partially**, the lessor does not include those payments in the consideration in the contract. Example 14 in ASC 842-10-55 involves a contract for the lease of equipment that includes maintenance for which consideration is a fixed amount plus a variable payment amount based on a minimum number of hours the asset operates at a specified productivity level. In Cases B and C of that example, the variable payment amounts for maintenance are included in the consideration in the contract because the maintenance services on the equipment are highly specialized and no entity would expect the equipment to meet the performance metrics without the specialized services. In other words, the variable payments relate specifically to the lessor's efforts in transferring (or an outcome from transferring) one or more goods or services that are not leases (the maintenance services).

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

However, even if variable payments relate specifically to the nonlease components, when a lessor elects the practical expedient not to separate for the asset class (assuming the nonlease component qualifies for combination with the lease component, which is the predominant component (see Section 3.4.2)), the variable payments are not included in the consideration in the contract. That is because the lessor elected the practical expedient and, in effect, the variable payments now relate to the lease component.

**BDO INSIGHTS — ASSESSMENT ON VARIABLE PAYMENTS BY LESSOR IN ACCORDANCE WITH ASC 606**

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

### 3.4.1.2 Reimbursement of Lessor Costs

**FASB REFERENCES**

ASC 842-10-15-30, ASC 842-10-15-40A, and ASC 842-10-55-141 through 55-142

As explained in Section 3.1, lessor costs for items or activities such as property taxes on the underlying asset and insurance that protects the lessor's asset are not components of the contract. Absent guidance to the contrary, a lessor would be required to report such lessor costs on a gross basis (as revenue and expenses) whether the lessee reimburses the lessor or pays such costs to a third party on the lessor's behalf. However, when the lessee pays a third party directly, lessors noted that reporting those costs in profit or loss would be costly and complex because the lessor may not have visibility into the actual amounts paid by the lessee and therefore may need to estimate those amounts. Lessors also questioned the usefulness of amounts that would be reported because those often would be based on estimates affected by lessee-specific factors (for example, insurance premiums paid by the lessee for a policy that protects both the lessor's asset and other assets the lessee owns and the amount of deductible selected by the lessee).

Accordingly, notwithstanding the guidance on variable payments previously discussed, a lessor's accounting for its costs is:

| LESSEE PAYS LESSOR COSTS DIRECTLY TO A THIRD PARTY | LESSOR PAYS COSTS AND IS REIMBURSED BY LESSEE |
|---|---|
| ▸ Exclude from variable payments.<br>▸ In other words, treat like a lessee cost, which does not affect the accounting for the lease. | ▸ Account for costs excluded from the consideration in the contract as lessor costs (that is, as variable payments). In other words, recognize on a gross basis.<br>▸ This requirement does not preclude a lessor from electing the accounting policy discussed in Section 3.4.1.3. |

#### 3.4.1.3 Sales Taxes and Similar Taxes

**FASB REFERENCES**

ASC 842-10-15-39A

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

That practical expedient is consistent with that in ASC 606 and reduces costs and complexity in assessing sales taxes and similar taxes. When the lessor makes the election, it must comply with some disclosure requirements (see Section 8.3). However, taxes assessed on a lessor's total gross receipts or on the lessor as owner of the underlying asset (for example, property taxes (see Section 3.4.1.2)) are excluded from the scope of the election.

### 3.4.2 Practical Expedient Not to Separate

**FASB REFERENCES**

ASC 842-10-15-42A through 15-42C

As it does for lessees, ASC 842 provides lessors with a practical expedient not to separate lease and nonlease components by asset class. Unlike lessees, lessors must meet specific criteria.

**FASB REFERENCES**

ASC 842-10-15-42A

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

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

For arrangements that meet the criteria above, a lessor's accounting for the combined component depends on a predominance assessment.

| NONLEASE COMPONENTS ARE PREDOMINANT | LEASE COMPONENT IS PREDOMINANT |
|---|---|
| ▶ Account for the combined component as a single performance obligation under ASC 606. | ▶ Account for the combined component as a single lease component under ASC 842. |
| ▶ Use the measure of progress used in determining whether the arrangement qualified for the expedient (that is, the lessor uses a straight-line measure of progress). | ▶ Account for the lease as an operating lease. |
| ▶ Account for all variable payments related to any good or service, **including the lease**, that is part of the combined component under the variable consideration guidance in ASC 606. | ▶ Account for all variable payments related to any good or service that is part of the combined component as variable **lease** payments. |

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

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

### BDO INSIGHTS — APPLICATION CONSIDERATIONS FOR LESSOR PRACTICAL EXPEDIENT NOT TO SEPARATE

In our experience, many lessors (such as real estate entities and cable providers) take advantage of the lessor practical expedient because it generally lets them account for their transactions under either ASC 842 or ASC 606 and in a manner similar to how they have historically accounted for them and how users of their financial statements have used the information. However, a lessor should consider the following when evaluating whether a contract qualifies for the practical expedient:

- The practical expedient applies only to nonlease components that otherwise would be accounted for under ASC 606. It does not apply, for example, to a contract that includes a lease component and a loan component accounted for under ASC 310, *Receivables*.

- Determining whether the lease component would be classified as an operating lease if accounted for separately generally should not require a detailed quantitative analysis. That may often be determined using either a reasonable qualitative assessment or simplified quantitative approach in which all payments in the contract are used to perform the present value classification test (to test if the lease would be classified as an operating lease even with all payments) in addition to assessing the other lease classification tests (see Section 4.9). However, in some situations, the lessor may need to perform additional analysis.
- Because the timing and pattern of transfer of the nonlease components must be the same as the timing and pattern of transfer of the lease, the nonlease components generally need to be recognized on a straight-line basis (that is, using an over time, time-based measure of progress) to qualify for the practical expedient. Performance obligations satisfied over time but using a measure of progress different from a time-elapsed measure of progress or performance obligations satisfied at a point in time (even if satisfied ratably throughout the lease term) do not qualify for the practical expedient.
  - A lessor recognizes operating lease payments on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which the lessee benefits from use of the underlying asset (see Section 6.6). It generally is uncommon for anything other than straight-line recognition to apply.
  - The revenue recognition for the lease and nonlease components does not have to be the same. For example, if the contract includes variable consideration, the revenue recognition pattern under ASC 606 for the nonlease component may be different from the pattern of lease income recognition under ASC 842. That the two topics provide for differences in the recognition of variable consideration does not preclude a lessor from electing the practical expedient as long as the timing and pattern of **transfer** of the lease and nonlease components are the same.
- A lessor should be able to reasonably determine which component is predominant (a lessor does not have to perform a detailed quantitative analysis or theoretical allocation). We also believe entities may use a greater than 50% threshold in determining which component is predominant, as the FASB discussed in a public meeting.

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

A consequence of the lessor practical expedient not to separate is that it may change the consideration in the contract when the contract includes variable payments. For example, a real estate contract may provide for the right to use an office building along with CAM services. The contract may stipulate that the lessee will pay a fixed payment amount per month and will reimburse the lessor for CAM costs the lessor incurred. Absent the lessor applying the practical expedient for this asset class, the lessee's reimbursements for CAM services would meet the conditions in ASC 842-10-15-39 and the lessor would include those payment amounts in the consideration in the contract because the payments relate specifically to the lessor's efforts in transferring a good or service to the lessee that is not the lease. However, when the lessor has elected and applies the practical expedient for this asset class, the contract includes only one lease component (assuming there are no other nonlease components in the contract that do not qualify for the practical expedient). Accordingly, variable payments the lessee will make to the lessor under the contract are all related to the lease component (even the payments for CAM services), and therefore no variable payment amounts will be included in the consideration in the contract. Examples 3-10 and 3-11 illustrate the concept.

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

**FASB REFERENCES**

ASC 842-10-15-38 through 15-39, ASC 842-10-15-40, and ASC 606-10-32-28 through 32-41

If a lessor does not elect the practical expedient not to separate, or elects it but the criteria for combination are not met for one or more nonlease components (see Section 3.4.2), the lessor allocates the consideration in the contract using the revenue guidance in ASC 606-10-32-28 through 32-41. A lessor also allocates any capitalized costs (for example, initial direct costs or contract costs capitalized under ASC 340-40 on other assets and deferred costs) to the separate lease or nonlease components to which those costs relate.

Also, as discussed in Section 3.4.1.1, lessors must include in the consideration (subject to the constraint) variable payments that relate specifically to either:

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

If included in the consideration, those variable payment amounts are allocated entirely to the nonlease components to which the variable payment specifically relate if doing so would be consistent with the transaction price allocation objective in ASC 606.

However, if the terms of the variable payment amount (other than those that depend on an index or rate) relate to a lease component **even partially**, the lessor cannot recognize those payments before the changes in facts and circumstances on which the variable payment is based occur.

**FASB REFERENCES**

ASC 842-10-15-40

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

When the changes in facts and circumstances on which the variable payment is based occur, the lessor allocates those payments to the lease and nonlease components of the contract. In doing so, the allocation must be on the same basis as the initial allocation of the consideration in the contract or the most recent modification not accounted for as a separate contract (see Section 3.4.4) unless the variable payment meets the criteria in ASC 606-10-32-40 to be allocated only to a lease component. After allocation, the lessor then recognizes:

- Variable payment amounts allocated to the lease components as income in profit or loss in accordance with ASC 842
- Variable payment amounts allocated to nonlease components in accordance with other topics such as ASC 606.

**EXAMPLE 3-9: LEASE OF LAND AND BUILDING — LESSOR ACCOUNTING**

**FACTS**

- In Example 3-4, Lessor and Lessee entered a five-year lease of a single-story commercial office building.
- Lessee has exclusive use of the single-tenant office building.
- The lease requires Lessor to perform landscaping services for Lessee.
- Lessee pays a fixed monthly payment of $12,000 per months in arrears, which includes rent, landscaping services, and reimbursement of Lessor's costs.
- There are no lease incentives or initial direct costs.

**WHAT ARE THE COMPONENTS?**

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

- Lessor determines that the contract meets the scope conditions under ASC 842-10-15-42A because:
  - The landscaping services would otherwise be accounted for under ASC 606.
  - The lease component would be accounted for as an operating lease. Lessor performed that assessment qualitatively considering the terms of the lease (see Section 4.9).
  - The lease and nonlease components have the same timing and pattern of transfer (which is over time and time-based). Lessor determined the pattern of transfer of the landscaping services would be time-based and over time under ASC 606 based on the nature of the performance obligation.
- Lessor also determines that the nonlease component is not the predominant component because Lessee would be reasonably expected to ascribe more value to the lease component than the nonlease component.
- Lessor notes that ASC 842-10-15-42C does not apply because there is only one nonlease component, and it qualifies for the practical expedient not to separate.
- Accordingly, the contract includes one lease component (the combined components), which Lessor accounts for as an operating lease under ASC 842 consistent with ASC 842-10-15-42B.

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

- As evaluated in Example 3-4, the contract includes two components: a single lease component (comprising the right to use the land and building) and a nonlease component (landscaping services).
- Lessor determines under ASC 606 that its landscaping services represent a single performance obligation.

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

- There are no variable payments in the contract. Therefore, the guidance in ASC 842-10-15-39 does not apply.
- The consideration in the contract for Lessor is $720,000 ($12,000 * 12 months * 5 years).

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

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

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

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

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

| COMPONENTS | STANDALONE SELLING PRICE | RELATIVE STANDALONE SELLING PRICE |
|---|---|---|
| Lease component | $ 680,000 | $ 670,685 (93.15%) |
| Maintenance component | 50,000 | 49,315 (6.85%) |
| | $ 730,000 | $ 720,000 |

- Lessor uses the amount of the consideration allocated to the lease component ($670,685) to account for the lease component (for example, to assess lease classification and recognize lease revenue).
- Lessor accounts for the amount of consideration for the landscaping component ($49,315) under ASC 606.

**EXAMPLE 3-10: LEASE OF OFFICE SPACE — LESSOR ELECTS PRACTICAL EXPEDIENT NOT TO SEPARATE**

**FACTS**

- In Example 3-5, Lessor and Lessee entered a five-year lease for one floor in a 30-story office building.
- The lease requires Lessor to perform CAM services.
- The contract requires Lessee to pay rent of $50,000 per month in arrears and to reimburse Lessor for Lessee's pro-rata share of real estate taxes and insurance Lessor incurs on the building. Lessee also reimburses Lessor for CAM charges.
- Lessor initially estimates the pro-rata share of those reimbursements at $9,000 per month ($5,000 for taxes and insurance and $4,000 for CAM). The CAM charges can be adjusted upward and downward based on the actual work Lessor performs.
- There are no lease incentives or initial direct costs.
- Lessor elected the practical expedient not to separate for this asset class.

**WHAT ARE THE COMPONENTS?**

- Lessor determines that the contract meets the scope conditions in ASC 842-10-42A because:
  - The CAM services would otherwise be accounted for under ASC 606.
  - The lease component would be accounted for as an operating lease. Lessor performed that assessment qualitatively considering the terms of the contract (see Section 4.9).
  - The lease and nonlease components have the same timing and pattern of transfer (which is over time and time-based). Lessor determined that the pattern of transfer of CAM would be time-based and over time under ASC 606 based on the nature of the performance obligation.
- Lessor also determines that the nonlease component is not the predominant component because Lessee would be reasonably expected to ascribe more value to the lease component than the nonlease component.
- Lessor notes that ASC 842-10-15-42C does not apply because there is only one nonlease component, and it qualifies for the practical expedient not to separate.
- Accordingly, the contract includes one lease component (the combined components).

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

- The consideration in the contract starts with the same amount as determined by Lessee (see Example 3-8), which is $3 million ($50,000 * 12 months * 5 years).
- There are variable payments in the contract. Therefore, Lessor applies the guidance in ASC 842-10-15-39. However, Lessor determines that the payments Lessee will make for its pro-rata share of real estate taxes and insurance are variable payments that are not based on an index or rate and relate to the lease component. Also, although the CAM payments relate specifically to the CAM services, Lessor elected the practical expedient, so those payments relate entirely to the lease component.
- Accordingly, the expected amounts for property taxes, insurance, and CAM are excluded from the consideration in the contract in accordance with ASC 842-10-15-40. The consideration in the contract for Lessor is $3 million.

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

- The lease is accounted for as an operating lease consistent with ASC 842-10-15-42B.
- The consideration in the contract of $3 million is allocated entirely to the lease component and used to recognize lease revenue on a straight-line basis over the lease term.
- Because Lessee reimburses Lessor for property taxes and insurance (as opposed to directly paying a third party), Lessee's payments for its pro-rata share of those activities are considered lessor costs in accordance with ASC 842-10-15-40A and are recognized on a gross basis in profit or loss.

- Also, because Lessor elected the practical expedient not to separate, variable payments for property taxes, insurance, and CAM are considered variable lease payments and recognized in accordance with ASC 842-30-25-11(b), which is when the changes in facts and circumstances on which the variable payments are based occur.

**EXAMPLE 3-11: LEASE OF OFFICE SPACE — LESSOR DOES NOT ELECT PRACTICAL EXPEDIENT NOT TO SEPARATE**

**FACTS**

- Assume the same facts as in Example 3-10, except that Lessor does not elect the practical expedient not to separate for this asset class.

**WHAT ARE THE COMPONENTS?**

- As evaluated in Example 3-5, the contract includes two components: one lease component (lease of the floor) and one nonlease component (CAM services).
- Also, Lessor determines under ASC 606 that its CAM services represent a single performance obligation.

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

- The consideration in the contract starts with the same amount as determined by Lessee (see Example 3-8), which is $3 million ($50,000 * 12 months * 5 years).
- There are also variable payments in the contract, so Lessor applies the guidance in ASC 842-10-15-39. Lessor determines that Lessee's payments for CAM services relate specifically to Lessor's efforts to transfer the CAM services. Consequently, Lessor evaluates the variable payments in accordance with the variable consideration guidance in ASC 606-10-32-5 through 32-13.
  - Lessor estimates that it will be entitled to receive $240,000 in variable payments for the CAM services ($4,000 * 12 * 5 years).
  - Lessor also determines that it is probable that including that amount in the consideration will not result in a significant reversal in cumulative revenue when the uncertainty of the payments is resolved.
  - Accordingly, Lessor includes the $240,000 in the consideration in the contract.
- The other payments Lessee will make to Lessor for its pro-rata share of real estate taxes and insurance are not based on an index or rate. They also relate at least partially to the lease component. Accordingly, the consideration in the contract excludes the expected reimbursement amounts for property taxes and insurance in accordance with ASC 842-10-15-40.
- The consideration in the contract for Lessor is $3.24 million ($3 million + $240,000).

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

- Lessor allocates the consideration in the contract to the lease and nonlease components using an appropriate allocation method consistent with ASC 606. For example, if the CAM charges are not at their standalone selling price (for example, CAM services are charged at cost without a profit margin), one acceptable allocation approach may be for Lessor to allocate the entire amount of expected CAM reimbursements to the CAM component plus a portion of the fixed consideration to reflect an appropriate profit margin on the CAM services if that reasonably depicts the consideration Lessor expects to be entitled for the lease and CAM components.
- Lessor then uses the amount of the consideration allocated to the lease component to account for the lease component under ASC 842 (for example, to assess lease classification and recognize lease revenue on a straight-line basis over the lease term if an operating lease).
- Lessor accounts for the consideration allocated to CAM services in accordance with the guidance on satisfaction of performance obligations in ASC 606-10-25-23 through 25-37. In this case, Lessor determines that CAM services are provided over time, using a time-based measure of progress (a straight-line basis).
- Lessor will consider the guidance on variable consideration in ASC 606 and update the expected amounts for CAM services each reporting period. Lessor will allocate those changes consistently with its initial allocation. For example, if Lessor initially allocated the estimated CAM payments entirely to the CAM component, subsequent changes to that estimate may be allocated entirely to the CAM component.

- Because Lessee reimburses Lessor for property taxes and insurance (as opposed to paying directly a third party), Lessee's payments for its pro-rata share of those activities are considered lessor costs in accordance with ASC 842-10-15-40A and Lessor recognizes them on a gross basis in profit or loss.
- Also, Lessor will allocate the variable payments for property taxes and insurance to the lease and nonlease components in accordance with ASC 842-10-15-40 (that is, on the same basis as the initial allocation of the consideration in the contract (or most recent modification not accounted for as a separate contract, if any)) unless the variable payments meet the criteria in ASC 606-10-32-40 to be allocated only to the lease component. For example, Lessor may allocate the entire payments for property taxes and insurance to the lease component if that is consistent with the initial allocation performed and the allocation objective under ASC 606. Once allocated, Lessor will then recognize:
  - Variable payment amounts allocated to the lease component as income in profit or loss in accordance with ASC 842-30-25-11(b), which is when the changes in facts and circumstances on which the variable payments are based occur.
  - Variable payment amounts allocated to the nonlease component in accordance with ASC 606.

### 3.4.4 Remeasuring and Reallocating the Consideration

**FASB REFERENCES**

ASC 842-10-15-41 through 15-42, ASC 842-10-35-3, and ASC 606-10-32-42 through 32-45

A lessor remeasures and reallocates the remaining consideration in the contract when there is a contract modification that is not accounted for as a separate contract (see Section 6.7) or when additional events described in ASC 842-10-35-3 occur (for example, when the lessee exercises a renewal or purchase option that the lessor previously determined was not reasonably certain of exercise).

Also, a lessor allocates subsequent changes in variable consideration in accordance with ASC 606-10-32-42 through 32-45. For example, in Example 3-11, the lessor included estimated CAM payments in the consideration in the contract. If the estimate subsequently changes, the additional consideration must be allocated to the lease and nonlease components on the same basis as the initial consideration.

## 3.5 PORTFOLIO APPROACH

**FASB REFERENCES**

ASC 842-20-55-18 through 55-20

Paragraph BC120 of ASU 2016-02 indicates that ASC 842 permits an entity (lessee or lessor) to apply the leases guidance at a portfolio level for leases with similar characteristics as long as the use of the portfolio approach would not differ materially from the application of ASC 842 to the individual leases in the portfolio. Example 2 in ASC 842-20-55 also illustrates application of the portfolio approach in determining the discount rate for the lease.

The portfolio approach may be used to account for multiple lease components with the same characteristics, including commencement date; lease term; and lease classification, such as a lease of three delivery trucks or of multiple floors in a building. However, applying the portfolio approach could result in additional complexity when the entity must apply the subsequent measurement guidance of ASC 842 (for example, for a lessee, contract modification considerations (see Section 5.8) or impairment and abandonment considerations (see Section 5.9)).

## 3.6 CONTRACT COMBINATIONS

**FASB REFERENCES**

ASC 842-10-25-19

When two or more contracts, at least one of which is or contains a lease, are entered into 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 discussed in Section 3.2.2.

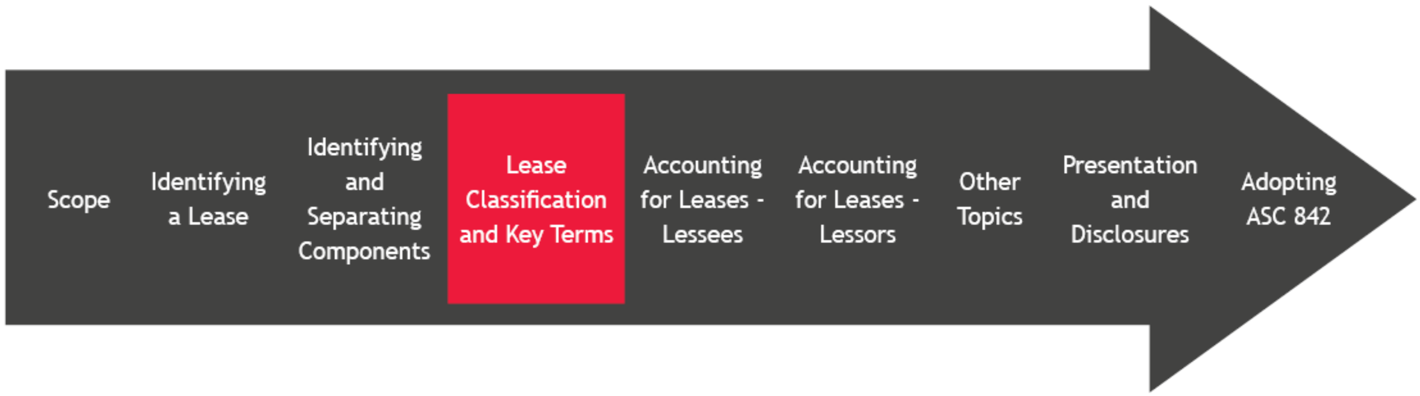
**BDO INSIGHTS — COMBINATION GUIDANCE ALIGNED WITH REVENUE GUIDANCE**

The guidance on contract combination above is consistent with the guidance on combining revenue contracts under ASC 606. That 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.

**BDO INSIGHTS — INTERACTION WITH CONTRACT MODIFICATION GUIDANCE**

The contract combination guidance may be relevant in accounting for a new lease if the parties modify an existing lease at or near the same time. For example, a lessee and lessor may add a lease for a smaller office space in another building the lessor owns, while reducing the lease term for a larger office space, or the lessee may relocate from one retail location to another one owned by the same lessor. In those scenarios, the two parts of the transaction (that is, creation of a new lease and modification of an existing lease) are typically combined under the contract combination guidance. If so, as discussed in Section 5.8 for lessees and Section 6.7 for lessors, the new lease is not viewed as a separate contract under the lease modification guidance. That conclusion applies regardless of whether the transaction is legally executed as two separate transactions or as a single amendment to the existing contract. See Section 5.8 for lessees and Section 6.7 for lessors for additional considerations on lease modifications.

# CHAPTER 4 — LEASE CLASSIFICATION AND KEY TERMS




## 4.1 OVERVIEW

In Chapter 3, we discussed how an entity identifies and separates components in a lease contract. An entity then generally accounts for lease components under ASC 842 and nonlease components under other U.S. GAAP (for example, ASC 606 for a lessor). An entity also applies the guidance in ASC 842 at the lease component level, and the accounting for the component depends on how it is classified.

In some cases, however, an entity may elect a practical expedient by asset class not to separate the nonlease components from the associated lease component. In those situations:

- A lessee generally applies the practical expedient without regard to conditions and accounts for the combined component as a single lease component (see Section 3.3.2). The lessee then applies the guidance in ASC 842, including on lease classification, to that single (combined) lease component. Accordingly, a lessee applies the lease classification guidance after it combines the lease and related nonlease components.
- A lessor must meet specific conditions to apply the practical expedient not to separate (see Section 3.4.2). One condition is that if accounted for separately, the lease component would be classified as an operating lease. Accordingly, a lessor applies the lease classification guidance at the individual lease component before it combines the lease and related nonlease components. That lease classification assessment determines whether the lessor meets the scope conditions to apply the practical expedient not to separate. If the lessor meets all the scope conditions, the accounting for the combined component then depends on which component of the contract is predominant. If the nonlease components are predominant, the lessor accounts for the combined component under ASC 606; otherwise, it accounts for the combined component as an operating lease. In other words, a lessor does not reassess lease classification once the components are combined.

The following table summarizes that accounting treatment:

| LESSEE | LESSOR |
|---|---|
| ▶ Assess lease classification at the **combined** lease component level if the lessee elected the practical expedient not to separate for the asset class. | ▶ Assess lease classification at the **individual** lease component level, irrespective of whether the lessor elected the practical expedient not to separate for the asset class. |

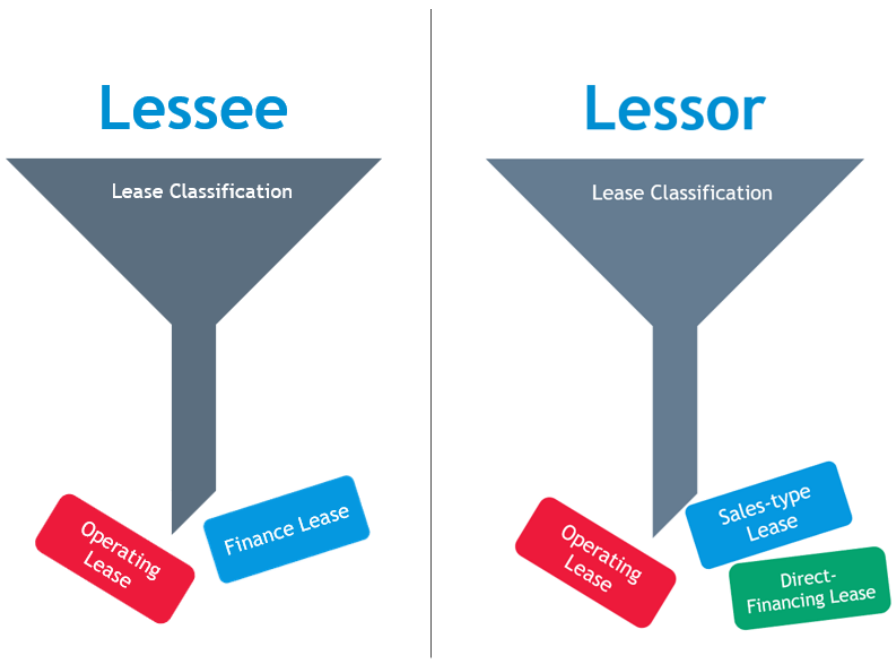
A lease component is initially classified and recognized in the financial statements at the commencement date. For example, a lessee assesses lease classification and recognizes the lease on balance sheet at the commencement date. It is therefore important for an entity to appropriately identify that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

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

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

This chapter discusses those questions in further detail, along with how to determine lease classification once those questions have been answered.

Lessees classify leases as either an operating or finance lease. Lessors classify leases as either a sales-type, direct financing, or operating lease. ASC 842 no longer includes leveraged lease classification for lessors for leases that are entered into or modified after its effective date. However, existing leveraged leases are grandfathered into ASC 842 and continue to be accounted by the lessor as such until they expire or are modified.




This chapter discusses only the initial assessment (at the commencement date). Subsequent changes to the lease term, lease payments, discount rate, and so forth are discussed in Chapter 5 for lessees and Chapter 6 for lessors.

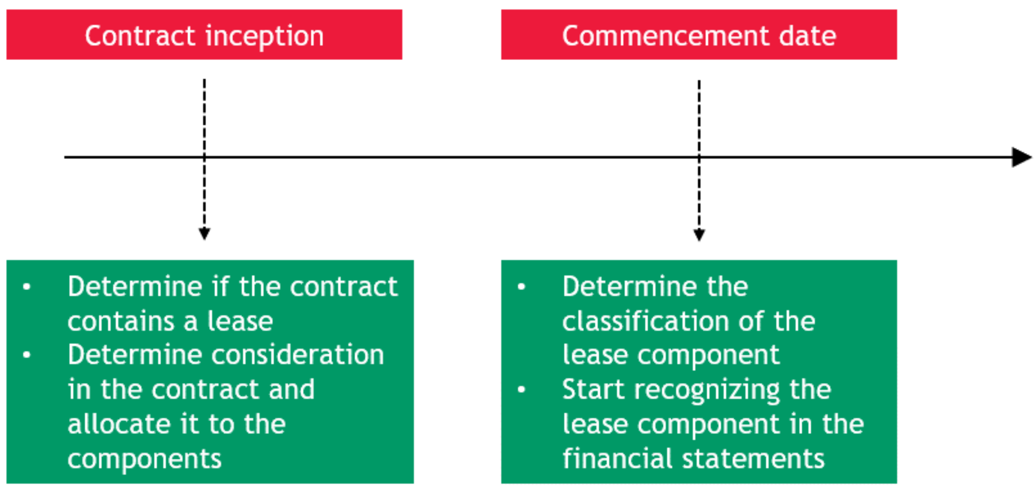
## 4.2 COMMENCEMENT DATE

**FASB REFERENCES**

ASC 842-10-20: Commencement Date of the Lease and ASC 842-10-55-19 through 55-22

A lease commences when the lessor makes the underlying asset available for use by the lessee, such as when the lessee takes possession of or is given control over the use of the asset. The lease contract might not specify a commencement date and, even if it does, that date might not represent the commencement date for accounting purposes. For example, there might be a contractual commencement date in the contract that represents the date when the lessee must start making payments, which is not relevant to the assessment. Or a lessee and lessor might negotiate an expected commencement date based on the asset's availability or expected improvements required. Accordingly, an entity determines the commencement date based on the facts and circumstances. Documents to consider in that assessment could include letters acknowledging the transfer of possession, certificates of occupancy, and construction start dates.

The lease commencement date may differ from the contract inception date, which is usually the date both parties executed the contract. ASC 842 distinguishes between those dates and provides for different accounting requirements at those dates, as illustrated below.




In some cases, one legal document may involve leases of multiple assets that are determined to be separate lease components, sometimes called "master lease arrangements." If so, there may be multiple commencement dates, which affects the timing of lease classification and recognition of each lease component in the financial statements. Although a master lease agreement may specify that the lessee must take a minimum number of units or dollar value of equipment, there will be multiple commencement dates unless all 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 sometimes may be useful to look to the definition of a lease and more specifically, the right to control the use of the asset (see Section 2.3). A 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 its use. In many cases, the lessee has both those 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. Thus, 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 the 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 the 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 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 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 considered 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 therefore are recognized by the lessee in accordance with ASC 842-20 (see Chapter 5).
- 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 Chapter 2) and lease payments (see Section 4.4).

**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.
- Payments made by the lessor generally do not affect the consideration in the contract (for example, payments from the lessor to reimburse the lessee for costs incurred on the lessor's behalf to construct the lessor asset).

**EXAMPLE 4-1: RETAIL STORE**

**FACTS**

- Lessee and Lessor on December 1, 20X8, enter a five-year lease for the use of a retail store.
- As part of the contract, Lessor pays Lessee $50,000 as reimbursement for improvements to the retail space, which are specific to Lessee. Lessee has the right to remove or alter the improvements made throughout the lease term without Lessor's permission.
- Lessor gives Lessee the keys to the store on January 1, 20X9, at which point Lessee can start constructing the improvements.
- On March 1, 20X9, Lessee completes the construction of the improvements, and opens its retail store.
- The contract requires Lessee to make monthly payments in arrears of $10,000 starting March 31, 20X9.

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

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

**WHAT IS THE COMMENCEMENT DATE?**

- Because Lessee is the accounting owner of the improvements, the commencement date of the lease is January 1, 20X9, which is the date Lessor makes the space available for use by Lessee and at which point Lessee can start its improvements. Starting on that date, including during construction of its leasehold improvements, Lessee has exclusive use of the retail store and directs its use.
- In accordance with ASC 842-10-55-20, the timing of when Lessee must make lease payments is not relevant to the analysis. Recognition of the lease liability, ROU asset, and lease expense, begins January 1, 20X9.

**EXAMPLE 4-2: MEDICAL OFFICE BUILDING**

**FACTS**

- On December 1, 20X7, Lessee and Lessor enter a 10-year lease for the use of a medical office building.
- At contract inception, the building was in poor condition and required significant improvements. As part of the negotiations with Lessee, Lessor agrees to spend up to $6 million on renovations, including mechanical upgrades, roof replacement, replacing and reconfiguring some interior walls, and other improvements. The renovations are expected to take 12 to 15 months.
- The lease indicates that all improvements are the legal property of Lessor. Lessee cannot remove or alter the improvements during the lease term without Lessor's approval, which Lessor may reject at its sole discretion.
- The improvements have an average expected economic life of 20 years and are not specific to Lessee. In other words, Lessor can use the improvements in arrangements with other lessees operating in the medical and healthcare industry.
- Lessor provides Lessee with limited access to the building on October 31, 20X8, so that Lessee can inspect the renovations and plan for construction of its own leasehold improvements. However, Lessee does not yet have the right to construct its leasehold improvements.
- Lessor substantially completes the renovations on January 1, 20X9, at which point Lessee is given full access to the building to install its own leasehold improvements.
- Lessee starts operations in the building on March 1, 20X9.
- The contract requires Lessee to make monthly payments in arrears of $150,000 once construction is substantially complete, with fixed annual increases of 5%.

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

- Lessor is the accounting owner of the improvements because the renovations are not specific to Lessee. Lessor can use the improvements at the end of the lease term for other lessees in the medical and healthcare field. Lessor also is the legal owner of the improvements and controls whether they are altered.
- Lessor's payments for the improvements do not affect accounting for the lease.
- We believe the above conclusions would be true even if Lessee made the improvements on behalf of Lessor, which then reimbursed Lessee for costs incurred on its behalf. That is because, in substance, Lessee acted as an agent for Lessor.
- If Lessee made payments to Lessor to fund some or all of the construction costs related to the improvements Lessor owns, those payments would be considered lease payments (assuming there are no nonlease components). That is because payments by a lessee for the right to use the underlying asset are lease payments, regardless of the timing or form of those payments. Alternatively, if Lessor also constructed Lessee's improvements on its behalf, Lessee would account for any related payments under ASC 360. Determining which payments relate to the lease and which relate to assets owned by the lessee in similar situations may require judgment.

**WHAT IS THE COMMENCEMENT DATE?**

- Because Lessor is the accounting owner of the improvements, the commencement date of the lease is January 1, 20X9, which is when Lessor substantially completes the improvements and makes the space available for use by Lessee.
- The lease does not commence on October 31, 20X8, because Lessor provides only limited access to Lessee (for it to plan for its own leasehold improvements). From October 31, 20X8, to January 1, 20X9, Lessee neither obtains substantially all the economic benefits from use of the building nor does it direct its use.
- Consistent with ASC 842-10-55-19, the date when Lessee starts operations is not relevant in determining the commencement date because Lessee has exclusive use of the building and directs its use even during the construction of its own leasehold improvements.

**EXAMPLE 4-3: RESTAURANT SPACE**

**FACTS**

- Lessee and Lessor enter a lease for a new restaurant on May 1, 20X9. At that time, both Lessee and Lessor begin work to obtain the relevant permits required to operate a restaurant in that location.
- The lease provides for payments of $16,000 per month if Lessee begins operations in the location on or before November 1, 20X9; the monthly lease payments increase by $500 for every month the grand opening is delayed beyond that date.
- The lease term ends 10 years after the first payment, which is due when the restaurant opens for business.
- Lessee obtains the relevant permits and Lessor grants Lessee access to the site on August 1, 20X9. On that date, Lessee begins constructing leasehold improvements to conform the building to its brand requirements. The improvements are a lessee asset.
- The restaurant opens for business December 1, 20X9, at which time, payments under the lease begin.

**WHAT IS THE COMMENCEMENT DATE?**

- The commencement date of the lease is August 1, 20X9, because that is when Lessee has the right to control access to and use the building, as evidenced by it starting construction of leasehold improvements.
- In accordance with ASC 842-10-55-20, the timing of when Lessee must make lease payments is not relevant to the analysis. However, because Lessee does not know at lease commencement when lease payments will begin and therefore what the payment amounts will be and what the end of the lease term is, it must estimate the total payments and term. Further, Lessee must update its estimates and remeasure the payments when the contingency on which the payments are based is resolved (when Lessee begins operations) to reflect any difference between the estimates at lease commencement and the final determinations.

## 4.3 LEASE TERM

**FASB REFERENCES**

ASC 842-10-20: Lease Term, Penalty; ASC 842-10-30-1 through 30-4; ASC 842-10-55-23 through 55-26; and ASC 842-10-55-235 through 55-238

The lease term begins at the commencement date (see Section 4.2) and includes any rent-free periods the lessor provides to the lessee. An entity determines the lease term as shown below.

Noncancelable period of the lease + Periods covered by a lessee extension option if the lessee is reasonably certain to exercise it + Periods covered by a lessee termination option if the lessee is reasonably certain <u>not</u> to exercise it + Periods covered by a lessor option to extend (or not terminate) the lease = Lease Term

The following table provides additional guidance on how an entity determines the lease term:

<table>
<tr><th>STEP</th><th>ADDITIONAL GUIDANCE</th></tr>
<tr><td>Determine the noncancelable period of the lease.</td><td>When an entity assesses the length of the noncancelable period of a lease, it should apply the definition of a contract and determine the period for which the contract is enforceable (see BDO Insights below).</td></tr>
<tr><td>If there is a lessee extension option, determine if the lessee is reasonably certain to exercise it. (If so, the extension period is included in the lease term.)</td><td rowspan="2">In determining whether a lessee is reasonably certain to exercise (or not exercise) an option, an entity considers all relevant economic factors (contract-, asset-, entity-, and market-based) including:<ul><li>Contractual terms and conditions, such as amount of lease payments or variable lease payments in optional periods compared with current market rates</li><li>Significant leasehold improvements expected to have significant economic value to the lessee when the lessee option becomes exercisable (judgment should 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)</li><li>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 or location, and installation costs for the new leased asset</li><li>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)</li></ul>JUDGMENT REQUIRED IN ASSESSING REASONABLY CERTAIN THRESHOLD<br><br>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 include 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 might not indicate the existence of significant economic factors and therefore is not determinative.<br><br>See Example 26 in ASC 842-10-55 for an illustration of the assessment of a lessee termination option.</td></tr>
<tr><td>If there is a lessee termination option, determine if the lessee is reasonably certain not to exercise it. (If so, the period covered by the termination option is included in the lease term.)</td></tr>
<tr><td>If there are periods covered by a lessor option to extend (or not to terminate), include those periods in the lease term.</td><td>Periods controlled by a lessor are included in the lease term, irrespective of likelihood of exercise.</td></tr>
</table>

**BDO INSIGHTS — NONCANCELABLE PERIOD AND ENFORCEABILITY OF THE CONTRACT**

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

The enforceability of a contract depends in part on whether both parties can cancel the contract with no more than an insignificant penalty. ASC 842 does not limit the term "penalty" to cash payments or contractual penalties, instead defining it more broadly as:

> *Any requirement that is imposed or can be imposed on the lessee by the lease agreement or by factors outside the lease agreement to do any of the following:*
>
> *a. Disburse cash*
>
> *b. Incur or assume a liability*
>
> *c. Perform services*
>
> *d. Surrender or transfer an asset or rights to an asset or otherwise forego an economic benefit or suffer an economic detriment. Factors to consider in determining whether an economic detriment may be incurred include, but are not limited to, all of the following:*
>
> 1. *The uniqueness of purpose or location of the underlying asset*
> 2. *The availability of a comparable replacement asset*
> 3. *The relative importance or significance of the underlying asset to the continuation of the lessee's line of business or service to its customers*
> 4. *The existence of leasehold improvements or other assets whose value would be impaired by the lessee vacating or discontinuing use of the underlying asset*
> 5. *Adverse tax consequences*
> 6. *The ability or willingness of the lessee to bear the cost associated with relocation or replacement of the underlying asset at market rental rates or to tolerate other parties using the leased property.*

If only the lessee has the right to terminate a lease, the entity evaluates the option like a lessee option to terminate consistent with the previous table. If only the lessor has the right to terminate the lease, the lease term includes the period covered by the option to terminate the lease.

**BDO INSIGHTS — LEASE TERM CANNOT EXCEED THE ECONOMIC LIFE OF THE LEASED ASSET**

While not specifically addressed in ASC 842, the economic life of the underlying asset in a lease is relevant to determine the lease term. Specifically, we believe the lease term cannot exceed the underlying asset's economic life (or useful life to the lessor). For example, a lessee and lessor may enter a seven-year service arrangement whereby the lessor agrees to provide to the lessee services that require the use of a piece of hardware throughout the contract term. If the contract includes an embedded lease for the piece of hardware that has an economic life (or useful life to the lessor) of five years, it is implied that the lessor will have to replace the original hardware during the term of the arrangement to continue providing services to the lessee because the specified term of seven years exceeds the five-year life of the hardware. In this case, the agreement may include two lease components: the right to use the original hardware and the right to use the replacement hardware, assuming there is a lease for each asset.

The lease term of each lease component may also depend on the facts and circumstances of the arrangement. For example, if the arrangement requires the lessor to replace the leased asset at a specific date, such as at the end of four years, the original hardware lease component and replacement hardware lease component would have a lease term of four years and three years, respectively. In contrast, if the arrangement does not specifically require the lessor to replace the original hardware lease component at a specific date, the original and replacement hardware lease components might have a lease term of five years (the life of the original hardware) and two years (the remaining term of the arrangement), respectively. In either case, at lease inception, the entity would allocate the consideration between any nonlease components and the two lease components, classify and account for the original hardware lease component at its commencement date, and disclose a forward-starting lease for the replacement hardware. If there is a difference with the lease term initially used when the lessor replaces the hardware, the entity would apply the lease modification guidance (see related discussion in Section 5.8 for lessees and Section 6.7 for lessors). Contract terms may also vary and require the lessor to provide specific performance levels throughout the contract term. An entity should determine the lease term under such arrangements based on the facts and circumstances.

**EXAMPLE 4-4: RETAIL STORE — LESSEE NOT REASONABLY CERTAIN TO EXERCISE EXTENSION OPTION**

**FACTS**

- Lessee and Lessor enter a five-year lease for the use of a retail store for which Lessee must pay $10,000 monthly in arrears.
- Neither party can terminate the initial term of five years.
- The contract includes two one-year extension options. If Lessee elects to extend the term, it must pay $11,000 monthly in arrears in the first extension period and $12,000 in the second.
- No economic factors (such as significant leasehold improvements) exist to indicate that Lessee would extend.

**WHAT IS THE LEASE TERM?**

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

**EXAMPLE 4-5: RETAIL STORE — LESSEE TERMINATION OPTION**

**FACTS**

- Assume the same as in Example 4-4, except that:
  - The lease has a fixed term of five years with no extension options. Instead, Lessee can terminate the lease with six months' notice.
  - There is no stated termination penalty if Lessee vacates the space early.
  - Lessee did not construct significant leasehold improvements because the store is in a new geographical area and market that Lessee is testing.

**WHAT IS THE LEASE TERM?**

- Lessee has no significant economic penalty that would require it to stay in the lease for longer than the notice (noncancelable) period. As such, the lease term is initially six months.

**EXAMPLE 4-6: RETAIL STORE — LESSEE REASONABLY CERTAIN TO EXERCISE EXTENSION OPTION**

**FACTS**

- Assume the same as in Example 4-4, except that:
  - The lease has a fixed term of five years, but after the fifth year, the lease converts to a month-to-month arrangement with rent at $11,000 per month in arrears.
  - Either party can cancel the lease after the initial term without permission from the other party. There is no stated penalty in the contract for canceling.
  - The retail location is important to Lessee, and it constructed and paid for significant leasehold improvements such as retail shelving, reception counters, and other layout and design specific to Lessee that Lessor did not reimburse.
  - If Lessee were to terminate the lease before the end of the eighth year, the shelving and other leasehold improvements would be dismantled and abandoned before the end of their useful lives, and Lessee would incur a more than insignificant economic penalty.

**WHAT IS THE LEASE TERM?**

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

**EXAMPLE 4-7: RETAIL SPACE — LEASE WITH NONCONSECUTIVE PERIODS**

**FACTS**

- Assume the same as in Example 4-4, except that:
  - Lessee specializes in selling Thanksgiving accessories (such as tablecloths and décor).
  - The contract with Lessor is for a space, rather than a specific retail store, in a shopping mall and the contract meets the definition of a lease.
  - The contract has a fixed term of five years, but Lessee controls the use of the space in the mall only during October and November of each year.
  - There are no extension or termination options.

**WHAT IS THE LEASE TERM?**

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

**EXAMPLE 4-8: RETAIL STORE — LESSEE AND LESSOR MUST NEGOTIATE RENEWAL TERMS**

**FACTS**

- Assume the same as in Example 4-4, except that:
  - The lease is initially for five years, and neither party can cancel the lease without significant cancellation fees.
  - After the initial term, there are two additional extension periods. However, Lessee and Lessor must both agree on the renewal terms, including rental payments.
- There is no penalty to either party for not agreeing to one or both extension options.
- There are ample other retail stores or spaces that are available in the marketplace to consider after the fifth year.

**WHAT IS THE LEASE TERM?**

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

## 4.4 LEASE PAYMENTS

**FASB REFERENCES**

ASC 842-10-20: Lease Payments, ASC 842-10-30-5 through 30-6, ASC 842-10-55-26, ASC 842-10-55-30 through 55-31, and ASC 842-10-55-211 through 55-234

An entity determines the lease payments at the commencement date (see Section 4.2). Those payments consist of the following payments related to the use of the underlying asset during the lease term (see Section 4.3):

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Fixed payments plus in-substance fixed payments less lease incentives | + | Variable lease payments based on an index or rate determined as of the commence-ment date | + | Exercise price of lessee purchase option (if reasonably certain of exercise) | + | Termination penalty payments (if reflected in the lease term) | + | Fees paid by lessee to owners of special purpose entity for structuring the transaction | + | Lessees Only: Amounts probable of being owed under residual value guarantees | = | **Lease payments** |

The following table provides additional guidance on how an entity determines the lease payments.

| STEP | ADDITIONAL GUIDANCE |
|---|---|
| Determine the fixed payments, including in-substance fixed payments, less lease incentives paid or payable to the lessee. | ▶ In-substance fixed payments are payments that may appear to contain variability but are **unavoidable**. Examples include:<br>• Payments with no genuine variability (such as clauses with no economic substance)<br>• Lower of the set of payments for which the lessee has a choice, but the lessee must make at least one set of payments<br>▶ In some leases, the lessee may provide noncash consideration (for example, equity shares of the lessee). Noncash lease payments are treated the same as cash in determining whether the payments are fixed or variable.<br>▶ Lease incentives paid or payable to the lessee include:<br>• Payments made to (or on behalf of) the lessee.<br>• Losses the lessor incurs for assuming a lessee's preexisting lease with a third party. The lessor and lessee independently estimate such losses.<br>– The lessee may estimate the lease incentive by comparing the new lease with market rental rates for similar underlying assets or lessor rates without the lease assumption.<br>– The lessor must estimate any loss based on the total remaining costs less the sublease's expected benefits for use of the assumed underlying asset.<br>See BDO Insights below for further discussion on in-substance fixed payments and noncash consideration.<br>See also Section 4.2 for a discussion on determining the accounting owner of improvements, which affects whether payments by the lessor are considered lease incentives.<br>See Section 4.4.4 for a discussion on whether some lease incentives are considered received or receivable at the commencement date. |

| STEP | ADDITIONAL GUIDANCE |
|---|---|
| **Add** variable lease payments based on an index or rate. | ▶ Variable payments based on an index or rate are included using the index or rate at the commencement date. Examples of variable payments based on an index or rate include payments based on the consumer price index (CPI) or secured overnight financing rate, and payments based on changes in fair market rental rates.<br>▶ Subsequent changes in the index or rate are generally recognized as variable lease payments (see Section 5.7.3 for lessees and Chapter 6 for lessors; see also Example 25, Case A, in ASC 842-10-55). |
| **Add** the exercise price of a lessee purchase option (if reasonably certain of exercise). | ▶ An entity assesses a lessee purchase option the same as a lessee extension or termination option (see Section 4.3). In doing so, an entity also considers the significance of any discount between the purchase option price and the expected fair value of the underlying asset when the option is exercisable, as well as how consistent expected values have historically been for the underlying asset. As discussed in Section 4.3, reasonably certain is a high threshold that is generally understood to encompass economic compulsion.<br>▶ See Examples 23 and 24 in ASC 842-10-55 for illustrations of the assessment of lessee purchase options. |
| **Add** termination penalty payments (if reflected in the lease term). | ▶ If the lease term reflects the lessee exercising a termination option, the entity includes the penalty payments for terminating the lease as lease payments (see Section 4.3). |
| **Add** fees paid by lessee to owners of special purpose entity for structuring the transaction. | ▶ If the lessee paid fees to the owners of a special purpose entity to structure the transaction, those fees are included as lease payments. However, such fees are excluded from the fair value of the underlying asset when performing the present value lease classification test (see Section 4.9). |
| **For lessees only**, determine and **add** the amount probable of being owed under residual value guarantees. | ▶ This requirement applies to lessees only.<br>▶ "Probable" means that the future event or events are likely to occur.<br>See below for discussions on in-substance residual value guarantees and other guarantees provided by a lessee. |

While fixed payments, purchase option payments, and termination penalty payments are typically specified in the lease agreement, determining the amount of lease payments may require judgment, such as determining whether option payments should be included, whether variable payments are in fact unavoidable and, if so, at what amount. Likewise, estimating the amount probable of being owed under a residual value guarantee requires judgment.

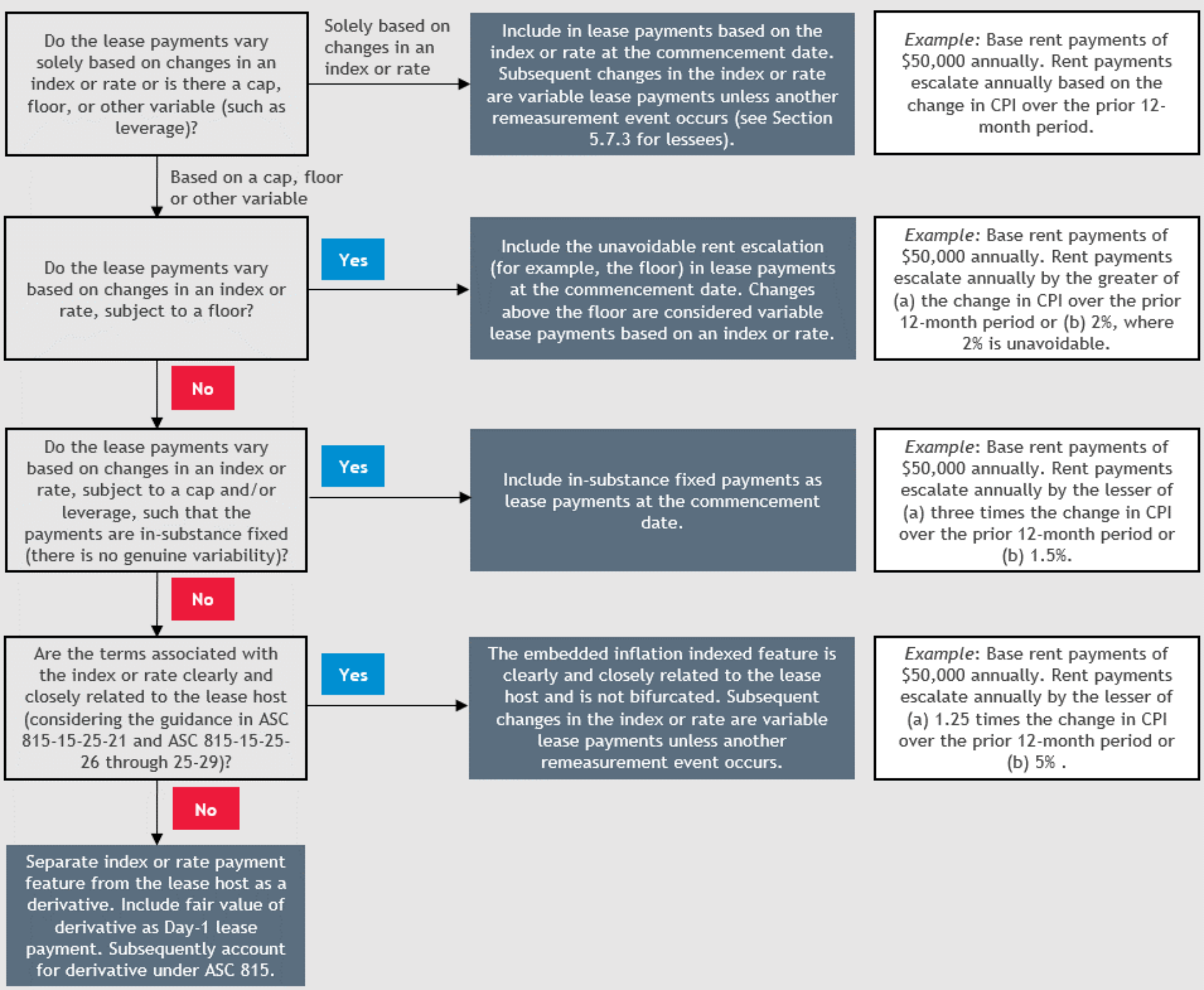
### FAIR MARKET RENT AS VARIABLE PAYMENTS BASED ON AN INDEX OR RATE

As discussed above, variable payments based on an index or rate (including fair market rent) are included in the lease payments using the index or rate at the commencement date. 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 based on fair market rent at that time, the lessee should use the fair market rent at the commencement date 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 lease modification or remeasurement (see Section 5.7.3).

## BDO INSIGHTS — IDENTIFYING UNAVOIDABLE FIXED PAYMENTS

Leases may include in-substance fixed payments or other unavoidable payments that must be included in the lease payments. Examples of in-substance fixed payments include payments that (1) require the lower of two payments to be made when a lessee has a choice about a set of payments it makes and (2) 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 an entity 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 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, if 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 or represent in-substance fixed payments, an entity 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.” The flowchart illustrates steps an entity might find helpful when determining the accounting treatment of some payment provisions based on an index or rate.



**BDO INSIGHTS — NONCASH LEASE PAYMENTS**

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

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

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

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

- Consideration allocated to nonlease components (see Chapter 3).
- Variable lease payments other than those based on an index or rate — for example, payments based on 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. That is because those payments relate directly and proportionately to the use or performance of the underlying asset. In other words, those variable payments have economic substance. However, if payments are a fixed percentage of the lessee’s sales, subject to a floor of, say, $1,000, that 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. However, if the guarantee is in substance a residual value guarantee, a lessee must apply the guidance in the table above on estimating amounts probable of being owed under residual value guarantees. That 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.
- Leasehold improvements a lessee recognizes in common control arrangements (see Section 5.6.3.2).

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

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:

- A lessee elects the practical expedient not to separate for the asset class (see Section 3.3.2).
- A lessor elects the practical expedient not to separate for the asset class and meets the scope conditions and the nonlease components are not the predominant components (see Section 3.4.2).

See Chapter 3 for further discussion on separating components and allocating the consideration in the contract to the components.

### 4.4.1 Residual Value Guarantees

**FASB REFERENCES**

ASC 842-10-20: Residual Value Guarantee and ASC 842-10-55-34 through 55-36

As discussed in Section 4.4, a lessee includes in the lease payments the amounts probable of being owed under residual value guarantees. ASC 842 defines a residual value guarantee as "*a guarantee made to a lessor that the value of an underlying asset returned to the lessor at the end of a lease will be at least a specified amount*."

Depending on the lease contract's terms, there may be additional factors for a lessee to consider, including:

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

### 4.4.2 Obligations Imposed at End of Lease Term

**FASB REFERENCES**

ASC 410-20-15-3(e), ASC 842-10-30-7, and ASC 842-10-55-37

Some lease contracts impose obligations on the lessee to return the underlying asset to specific conditions at the end of the lease term. The accounting for such obligations depends on which asset (lessor or lessee's) the obligation relates to (see Section 4.2 for a discussion on determining the accounting owner of improvements):

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

### 4.4.3 Tax Benefit Indemnifications

**FASB REFERENCES**

ASC 842-10-55-38 through 55-40

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

### 4.4.4 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 4.2)). 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 4.4) 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 5.5.2). 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 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 5.7.2). See Example 4-10 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 4.4)). 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.

**EXAMPLE 4-9: ACCOUNTING FOR CONTINGENT LEASE INCENTIVES (RECEIVABLE APPROACH)**

**FACTS**

- Lessee and Lessor enter a five-year lease for a retail store.
- The lease is an operating lease, and there are no nonlease components.
- Lease payments are $150,000 annually, paid in arrears, with no escalation.
- Lessee has the right to construct leasehold improvements (a lessee asset (see Section 4.2)) and be reimbursed by Lessor up to $50,000. If Lessee incurs qualifying costs, Lessor will deduct the reimbursable amount from rent otherwise due at the end of the year in which the qualifying costs are incurred. Lessee is responsible for the construction.
- At the commencement date, Lessee determines the contingent event (construction of the improvements) is probable and within its control, and it is reasonably certain Lessee will incur qualifying costs in excess of $50,000. Lessee also expects to complete the improvements during the first year of the lease. Accordingly, Lessee expects to receive the $50,000 credit as a reduction of rent due at the end of Year 1.
- Lessee’s incremental borrowing rate is 6%.
- There are no initial direct costs.
- The receivable approach applies.

**CONCLUSION AND ANALYSIS**

- Because the receivable approach applies, Lessee includes the $50,000 contingent lease incentive as a reduction of the Year 1 payment of $150,000, resulting in a net expected payment of $100,000 at the end of Year 1.
- The present value of the lease payments ($100,000 at the end of Year 1 and $150,000 thereafter), discounted at 6%, results in an initial measurement of the lease liability and ROU asset of $584,685.
- The periodic lease cost for the lease is $140,000 ([$100,000+$150,000+$150,000+$150,000+$150,000]/5).
- On the commencement date, Lessee records the following entry:

| | | | |
|---|---|---|---|
| Debit | ROU Asset | $ 584,685 | |
| Credit | Lease Liability | | $ 584,685 |

- Lessee completes the improvements within six months of the lease and incurs qualifying construction costs in excess of $50,000. In accordance with the lease, the payment due at the end of Year 1 is reduced to $100,000. Therefore, Lessee does not adjust its initial accounting for the lease.
- Lessee records the following journal entry for Year 1:

| | | | |
|---|---|---|---|
| Debit | Lease expense | $ 140,000 | |
| Debit | Lease Liability[1] | 64,919 | |
| Credit | Cash | | $ 100,000 |
| Credit | ROU Asset[2] | | 104,919 |

[1] Payment of $100,000 less interest accretion of $35,081.

[2] Periodic lease cost of $140,000 less interest accretion of $35,081.

- Throughout the remainder of the lease term, Lessee recognizes periodic lease expense of $140,000.
- The following table summarizes the accounting for the lease throughout the lease term, assuming no remeasurements, modifications, or impairment:

| | LEASE LIABILITY | | | | ROU ASSET | | |
|---|---|---|---|---|---|---|---|
| | BEGINNING BALANCE | INTEREST (6%) | PAYMENT | ENDING BALANCE | BEGINNING BALANCE | AMORTIZATION | ENDING BALANCE |
| Year 1 | 584,685 | 35,081 | (100,000) | 519,766 | 584,685 | (104,919) | 479,766 |
| Year 2 | 519,766 | 31,186 | (150,000) | 400,952 | 479,766 | (108,814) | 370,952 |
| Year 3 | 400,952 | 24,057 | (150,000) | 275,009 | 370,952 | (115,943) | 255,009 |
| Year 4 | 275,009 | 16,501 | (150,000) | 141,509 | 255,009 | (123,499) | 131,509 |
| Year 5 | 141,509 | 8,491 | (150,000) | — | 131,509 | (131,509) | — |

**EXAMPLE 4-10: ACCOUNTING FOR CONTINGENT LEASE INCENTIVES (RESOLUTION OF CONTINGENCY APPROACH)**

**FACTS**

- Assume the same facts as in Example 4-9, except that the resolution of contingency approach applies.
- Lessee completes the related improvements incurring qualifying costs above $50,000, and the lease incentive becomes receivable on June 30 of Year 1.

**CONCLUSION AND ANALYSIS**

- Because the resolution of contingency approach applies, Lessee does not initially consider any lease incentive when measuring the lease at the commencement date.
- The present value of the lease payments ($750,000 ($150,000 * 5 years)), discounted at 6%, results in an initial measurement of the lease liability and ROU asset of $631,855.
- The periodic lease cost for the lease is initially $150,000 ([$150,000 * 5 years]/5).
- On the commencement date, Lessee records the following entry:

| | | | |
|---|---|---|---|
| Debit | ROU Asset | $ 631,855 | |
| Credit | Lease Liability | | $ 631,855 |

- When the lease incentive becomes receivable on June 30 of Year 1, it represents the resolution of a contingency, and Lessee remeasures the lease payments. However, Lessee does not reassess lease classification and does not update the discount rate for the lease (see Section 5.7 on remeasurements).
- On June 30 of Year 1, the carrying values of the lease liability and ROU asset are:
  - Lease liability: $650,810, which is the initial balance of $631,855 plus interest accretion for six months of $18,955 ($631,855 * 6% / 2)
  - ROU asset: $575,810, which is the initial balance of $631,855 less amortization of $56,045 (periodic lease cost of $75,000 for six months less interest accretion of $18,955).
- The present value of the remaining lease payments ($100,000 at the end of Year 1 and $150,000 thereafter), discounted at 6%, results in a revised measurement of $601,714 for the lease liability on June 30 of Year 1, or a decrease of $49,096 ($650,810 – $601,714).
- Lessee records the following journal entry on June 30 of Year 1.

| | | | |
|---|---|---|---|
| Debit | Lease liability | $ 49,096 | |
| Credit | ROU asset | | $ 49,096 |

- After remeasurement, the carrying values of the lease liability and ROU asset are $601,714 and $526,714 ($575,810 - $49,096), respectively.
- Because the lease is classified as operating, Lessee updates the periodic lease cost for the remainder of the lease (4.5 years) as follows (see Section 5.6.2):

| | AMOUNT |
|---|---|
| Total lease payments (paid and not yet paid)* | $ 700,000 |
| Plus initial direct costs | — |
| Less periodic lease cost recognized in prior periods** | (75,000) |
| Total remaining lease cost [A] | $ 625,000 |
| **Periodic lease cost** [B] ([A] / 4.5 years) | **$ 138,889** |

* Reflects the total revised lease payments ($100,000 in Year 1 and $150,000 thereafter).

** Prior periodic lease cost of $150,000 / 2 for the period January 1 to June 30 of Year 1.

- Post remeasurement, Lessee recognizes a single lease expense of $138,889 each year (or $69,444 for the period July 1 to December 31 Year 1) for the remainder of the lease term, assuming no impairment, modifications, or other reassessments.
- The following table summarizes the accounting for the lease throughout the remaining lease term post remeasurement (assuming no other remeasurements, modifications, or impairment):

| | LEASE LIABILITY | | | | ROU ASSET | | |
|---|---|---|---|---|---|---|---|
| | BEGINNING BALANCE | INTEREST (6%) | PAYMENT | ENDING BALANCE | BEGINNING BALANCE | AMORTIZATION | ENDING BALANCE |
| Year 1[1] | 601,714 | 18,051 | (100,000) | 519,766 | 526,714 | (51,393) | 475,321 |
| Year 2 | 519,766 | 31,186 | (150,000) | 400,952 | 475,321 | (107,703) | 367,618 |
| Year 3 | 400,952 | 24,057 | (150,000) | 275,009 | 367,618 | (114,832) | 252,787 |
| Year 4 | 275,009 | 16,501 | (150,000) | 141,509 | 252,787 | (122,388) | 130,398 |
| Year 5 | 141,509 | 8,491 | (150,000) | — | 130,398 | (130,398) | — |

[1] Beginning balance at the remeasurement date (June 30 of Year 1). Interest and amortization computed for six months only.

- The following table summarizes lease expense Lessee recognizes throughout the lease term (both before and after remeasurement):

| PERIOD | LEASE COST | |
|---|---|---|
| Year 1 | 144,444 | $75,000 (first six months) plus $69,444 (last six months) |
| Year 2 | 138,889 | |
| Year 3 | 138,889 | |
| Year 4 | 138,889 | |
| Year 5 | 138,889 | |
| Total | 700,000 | |

## 4.5 INITIAL DIRECT COSTS

**FASB REFERENCES**

ASC 842-10-20: Initial Direct Costs, ASC 842-10-30-9 through 30-10, and ASC 842-10-55-240 through 55-242

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

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

- Fixed employee salaries (for example, allocation of employee costs for time negotiating lease terms and conditions)
- General overhead, 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. See Example 27 in ASC 842-10-55 for an illustration of the determination of initial direct costs for a lessee and lessor.

A lessee allocates initial direct costs to the separate lease components on the same basis as the lease payments (see Section 3.3.3) and includes them in the measurement of the ROU asset (see Section 5.5). A lessor allocates any capitalized costs (for example, initial direct costs or contract costs capitalized under ASC 340-40 on other assets and deferred costs) to the separate lease components or nonlease components to which those costs relate (see Section 3.4.3) and accounts for initial direct costs under ASC 842 based on lease classification (see Section 6.3).

# 4.6 DISCOUNT RATE

## 4.6.1 Definitions

**FASB REFERENCES**

ASC 842-10-20: Discount Rate for the Lease, Incremental Borrowing Rate, Rate Implicit in the Lease; and ASC 842-20-30-2 through 30-3

The discount rate for the lease is initially calculated using information available at the commencement date (see Section 4.2). The three definitions below, along with additional guidance, are important in applying ASC 842.

| | DISCOUNT RATE FOR THE LEASE | RATE IMPLICIT IN THE LEASE | INCREMENTAL BORROWING RATE |
|---|---|---|---|
| ASC 842 | *For a lessee, the discount rate for the lease is the rate implicit in the lease unless that rate cannot be readily determined. In that case, the lessee is required to use its incremental borrowing rate.*<br>*For a lessor, the discount rate for the lease is the rate implicit in the lease.* | *The rate of interest that, at a given date, causes the aggregate present value of (a) the lease payments and (b) the amount that a lessor expects to derive from the underlying asset following the end of the lease term to equal the sum of (1) the fair value of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor and (2) any deferred initial direct costs of the lessor. However, if the rate determined in accordance with the preceding sentence is less than zero, a rate implicit in the lease of zero shall be used.* | *The rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment.* |
| | ▶ With rare exception (such as some common control leases), a lessee typically cannot readily determine the rate implicit in the lease because it does not have all required lessor inputs (see BDO Insights below). Accordingly, a lessee typically uses its incremental borrowing rate.<br>▶ A lessor must always use the rate implicit in the lease. | ▶ How the rate is calculated as it relates to initial direct costs depends on the lease classification test the entity performs (see Section 4.9; see also Chapter 6 for example calculations).<br>▶ If the entity expects the residual value of the underlying asset to increase over the lease term (for example, if the underlying asset is land), we believe the entity must use the asset's fair value at the commencement date in determining the rate implicit in the lease. | ▶ 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 by asset class (see Section 4.6.3).<br>▶ Risk-free rates are typically lower than a collateralized rate and as such will result in higher ROU assets and lease liabilities for lessees and possibly in a change of lease classification. |

**BDO INSIGHTS — USE OF RATE IMPLICIT IN THE LEASE BY LESSEES IS RARE**

As discussed in the table above, the calculation of the rate implicit in the lease considers inputs and assumptions specific to the lessor. Those assumptions include the residual value that the **lessor** expects to derive from the underlying asset at the end of the lease term and any deferred initial direct costs the lessor incurred. Because such internal information is usually considered sensitive, lessees will rarely have access to it. Further, a lessee should estimate neither the rate implicit in the lease nor any of the inputs to the calculation of that rate, even if it has a reasonable basis for making the estimate. Consequently, a lessee typically uses its incremental borrowing rate as the discount rate for the lease.

### 4.6.2 Incremental Borrowing Rate

**FASB REFERENCES**

ASC 842-10-20: Incremental Borrowing Rate, ASC 842-20-35-5(a), and ASC 842-20-55-17 through 55-20

The table provides additional information for a lessee to determine the incremental borrowing rate when the rate implicit in the lease is not readily determinable:

| WHAT THE STANDARD SAYS | WHAT IT MEANS |
|---|---|
| It is the rate of interest a lessee would have to pay | The rate must be based on the credit standing of the lessee (or, in some cases, the credit standing of the parent entity (see BDO Insights below)). |
| to borrow on a collateralized basis | The rate must be a secured (recourse) rate that is fully collateralized (that is, it cannot be under-collateralized). The lessee is not limited to the underlying asset and may use other collateral if accepted by a lender, but it must consider that collateral's nature and quality (liquidity). |
| over a similar term | ASC 842 does not explicitly refer to "lease term" in the definition of incremental borrowing rate. We believe a lessee may use as an accounting policy either the lease term as determined under ASC 842 (see Section 4.3) or the lease term plus options not reasonably certain of exercise (see BDO Insights below). |
| an amount equal to the lease payments | Payments are determined based on ASC 842's definition of lease payments (see Section 4.4). Accordingly, variable payments other than those based on an index or rate are not considered. |
| in a similar economic environment. | It must reflect a rate that would be paid by the entity on borrowings that are entered into at or near the same time, in the same or similar jurisdiction, and in the same currency. |

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

- A lessee may consider its existing debt arrangements and whether those can be used to derive the incremental borrowing rate, with appropriate adjustments to materially comply with the definition of the incremental borrowing rate described above (for example, by adjusting the rate to reflect a similar term as the lease). If a lessee borrows on only an unsecured basis, the entity may still use that rate as a starting point, with further adjustments as appropriate.

- A lessee with little or no debt may use published reference rates such as government rates as a starting point and adjust them for the lessee's credit risk, financing term, quality of collateral, and so forth.
- A lessee with a high volume of leases might want to consider constructing a synthetic corporate yield curve in which it considers an appropriate risk-free rate and a credit spread (whether based on its public credit rating or implied credit rating). Further adjustments would be made, for example, for the collateral, for which the lessee may use a notching or recovery rate approach to reflect a secured rate. A lessee using yield curves to determine its incremental borrowing rate should develop processes and controls to periodically review and update the assumptions used in developing the yield curve. For example, a lessee could develop a process to periodically pull market data and compare it to the inputs used in the yield curve to monitor any changes and establish appropriate thresholds for determining whether and when to update the inputs of the yield curve. A lessee would also need to periodically monitor any changes in its credit profile.
- A lessee may use a portfolio approach when determining the incremental borrowing rate of multiple leases when the leases have similar characteristics, such as lease term, lease payment, and economic environment, as illustrated in Example 2 of ASC 842-20-55. A single discount rate applied to all leases in a portfolio must not result in a materially different answer than using a discount rate determined for each lease.

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

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

- Commercial mortgage rates, although they could be used as an input
- Weighted-average cost of capital
- Property yields
- Cost of money
- Blended rate (mix of secured and unsecured rate).

#### BDO INSIGHTS — USE OF PARENT VS. SUBSIDIARY RATE

A lessee subsidiary should consider its specific facts and circumstances in determining whether it can use its parent rate or must use its own. The FASB noted in paragraph BC 201 of ASU 2016-02 that depending on the lease's terms and conditions and negotiations with the lessor, it may be reasonable for a subsidiary to use a parent's incremental borrowing rate. Further, that rate may be the most appropriate to use as a practical means of reflecting the interest rate in the contract (for example, when the subsidiary does not have its own treasury function and the parent provided a guarantee of the lease payments as part of the negotiations with the lessor). The FASB noted that in the BC 201 fact pattern, pricing of the lease was more heavily influenced by the parent's credit standing rather than the subsidiary's. Example 2 in ASC 842-20-55 also illustrates the use of a parent's incremental borrowing rate. There, pricing of the lease was influenced by the parent's credit standing even though the parent did not provide a guarantee.

Accordingly, we believe a lessee subsidiary may use its parent's rate when pricing of the lease was more heavily influenced by the parent's credit standing rather than its own (for example, when the subsidiary does not have its own treasury function and the parent was involved in negotiations for the lease).

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

ASC 842 defines the incremental borrowing rate as "*the rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment*." That definition does not refer to "lease term" as defined in ASC 842 (see Section 4.3), but rather to "a similar term."

When the lease includes options (such as lessee extension options) that are not reasonably certain of exercise at the commencement date, we believe a lessee may determine its incremental borrowing rate using either the lease term as defined in ASC 842 (see Section 4.3) or a rate that reflects the existence of any options. That is consistent with the guidance in ASC 842-20-35-5(a) on subsequent remeasurement of the lease liability which indicates that when there is a change in the lease term or assessment of a purchase option, the discount rate does not have to be updated if the rate already reflects that the lessee had such option. We believe lessees should elect that accounting policy and apply it consistently to all leases.

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

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

**FASB REFERENCES**

ASC 842-20-30-3

The discount rate for the lease is an important input in a lessee's accounting for a lease because it could affect lease classification and directly affects the balance sheet amounts for the lease, and for finance leases, the amounts of interest and amortization expense in the income statement. Determining the discount rate can require time and effort.

Accordingly, ASC 842 allows lessees that are not public business entities to use a risk-free discount rate as an accounting policy by asset class. For example, a lessee may elect to use the risk-free discount rate for asset classes that have lower values and/or greater volumes of leases (for example, some office equipment leases), while using its incremental borrowing rate for more material asset classes (such as real estate). A lessee is not precluded from electing the risk-free discount rate for all asset classes. Some FASB members and staff observed at a public meeting in September 2021 that there are no prescribed requirements for determining asset classes and that a lessee therefore has flexibility in identifying its asset classes for purposes of applying ASC 842.

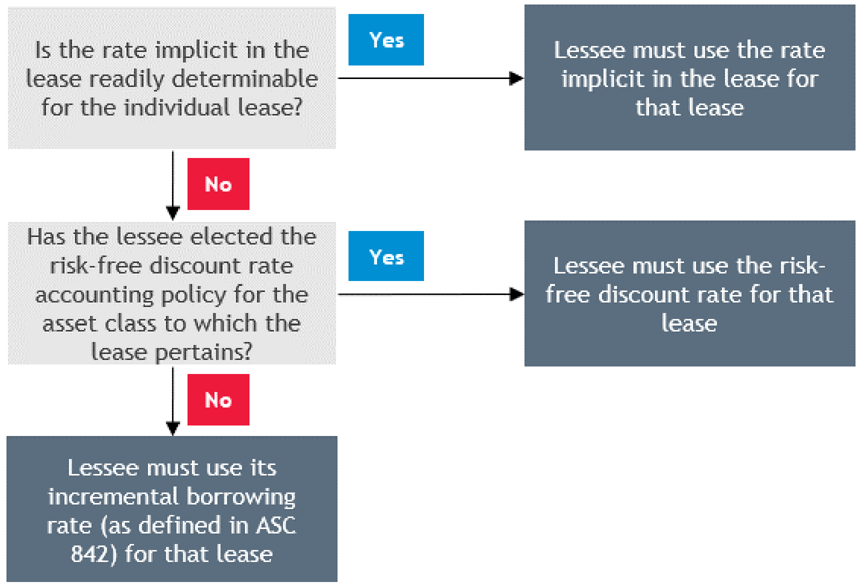
The accounting policy is limited to entities that are not public business entities. Because not-for-profit entities (including conduit bond obligors) and employee benefit plans are not public business entities (according to the Master Glossary), they may make the risk-free discount rate election.

A lessee that elects this accounting policy must disclose that fact, as well as the asset classes it elected it for.

**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 (see Section 4.6).

The flowchart summarizes a lessee's decision steps in determining the discount rate for the lease when it is not a public business entity.




## 4.7 ECONOMIC LIFE

**FASB REFERENCES**

ASC 842-10-20: 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 and future lessees or owners with normal repairs and maintenance.

## 4.8 FAIR VALUE

**FASB REFERENCES**

ASC 820-10-20 and ASC 842-10-20: Fair Value, ASC 842-10-55-3, ASC 842-10-55-13, and ASC 842-30-55-17A

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 in ASC 820, *Fair Value Measurement*. As a result, an entity must apply the guidance in ASC 820 when determining an underlying asset's fair value.

However, for lessors that are not manufacturers or dealers (that is, generally financial institutions and captive finance companies), the underlying asset's fair value at lease commencement is defined as its cost, reflecting any volume or trade discounts that apply. That exception applies only if there has not been a significant lapse of time between the acquisition of the underlying asset and lease commencement. Otherwise, the lessor must apply the ASC 820 definition of fair value.

**BDO INSIGHTS — DETERMINING FAIR VALUE WITHOUT UNDUE COSTS AND EFFORTS**

ASC 842-10-55-3 notes that it might not be practicable for an entity to determine the fair value of an underlying asset, meaning that a reasonable estimate cannot be made without undue cost or effort. If not practicable, the entity assesses lease classification without considering the present value classification criteria (see Section 4.9).

However, we believe fair value can be determined without undue cost or effort in most cases. An entity 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 might 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.

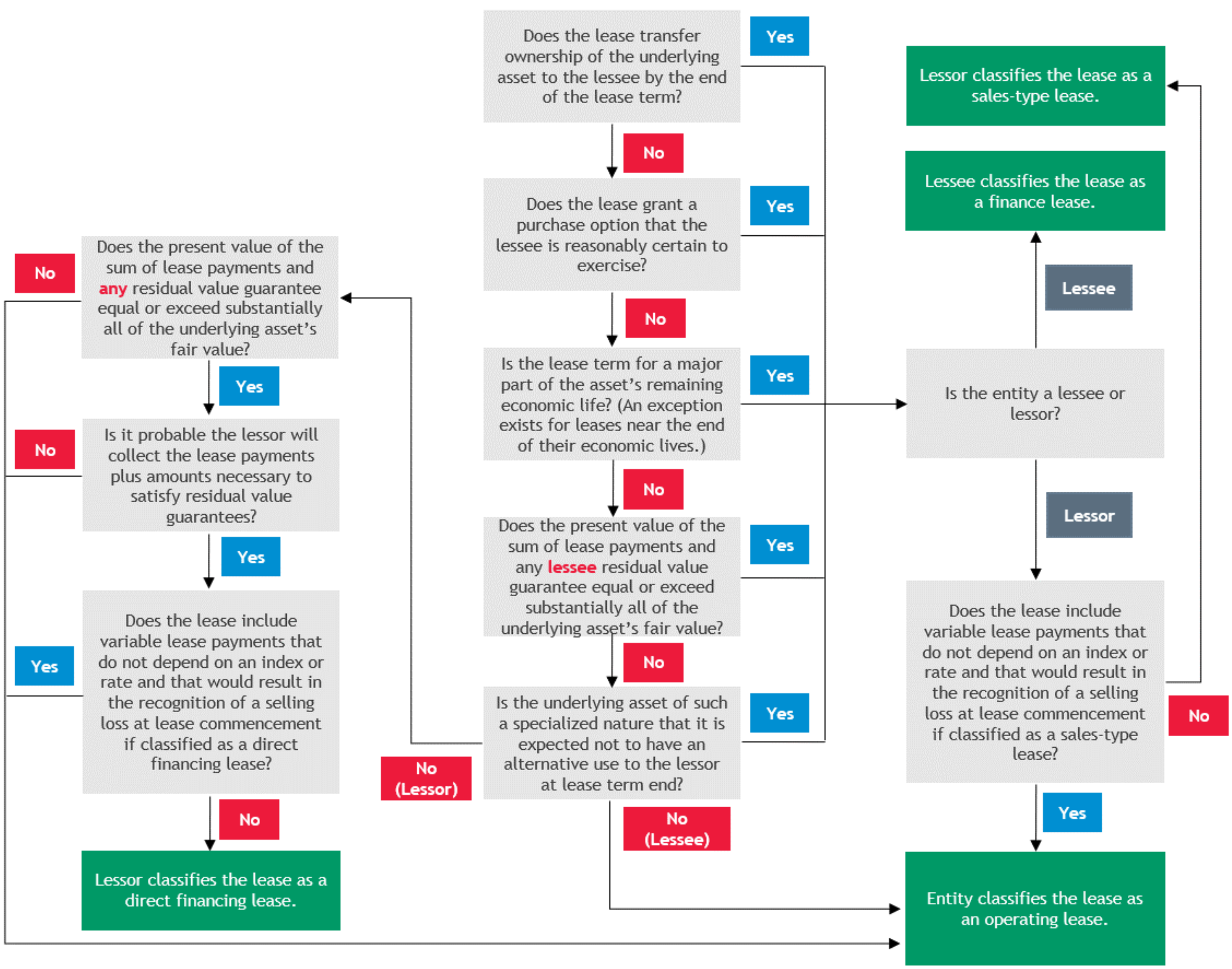
One exception to the above requirement is for leases involving terminal space and other airport facilities, ports, and bus terminals, as well as similar spaces owned by a governmental unit or authority. For those leases, it might not be practicable to determine the underlying asset's fair value. If so, such leases are classified as operating leases if they do not provide 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.

## 4.9 LEASE CLASSIFICATION

**FASB REFERENCES**

ASC 842-10-15-3A, ASC 842-10-25-1 through 25-5, ASC 842-10-55-2, ASC 842-10-55-4 through 55-12, and ASC 842-10-55-15

An entity initially determines lease classification at the commencement date (see Section 4.2) by analyzing the facts in the steps shown in the flowchart.



The table provides additional guidance on the lease classification analysis described in the above flowchart.

| STEP | ADDITIONAL GUIDANCE |
|---|---|
| **Transfer of Ownership Criterion** | ▶ This criterion requires the lessor to execute and deliver to the lessee such documents (including, if applicable, a bill of sale) as may be required to release the underlying asset from the lease and transfer ownership to the lessee upon the lessee's performance in accordance with the terms of the lease.<br>▶ This criterion is also met when the lease **requires** the lessee to pay a nominal amount (for example, minimum fee required by statutory regulation to transfer ownership) in connection with the transfer of ownership. If instead the lease transfers ownership of the asset if the lessee **elects** to pay a specified fee (whether nominal or otherwise) to complete the transfer, an entity assesses it as a purchase option. |
| **Purchase Option Criterion** | ▶ If a lessee is reasonably certain to exercise a purchase option (see Section 4.4), the lease payments include the purchase option exercise price and the lease is classified as:<br>• A finance lease by the lessee<br>• A sales-type lease by the lessor (unless there are variable lease payments not based on an index or rate and the lessor would recognize a selling loss at the commencement date, in which case it classifies the lease as operating). |
| **Lease Term Criterion** | ▶ One reasonable approach to assessing this lease classification criterion is that:<br>• At least 75% represents a major part of the asset's remaining economic life<br>• A commencement date that falls within the last 25% of the total economic life of the underlying asset is a commencement date that falls at or near the end of the asset's economic life.<br>▶ If the lease contract includes the right to use multiple underlying assets that represent a single lease component (see Section 3.3), the entity uses the remaining economic life of the predominant asset in assessing this criterion. |
| **Present Value Criteria** | ▶ One reasonable approach to assess the two present value criteria is that at least 90% of the asset's fair value amounts to substantially all.<br>▶ The underlying asset's fair value is reduced by any related investment tax credit retained and expected to be realized by the lessor.<br>▶ While included in lease payments, fees paid by a lessee to owners of a special purpose entity for structuring the transaction are not included in the underlying asset's fair value when assessing the sales-type lease present value criterion.<br>▶ For lessees only, because lease payments already include amounts probable of being owed under residual value guarantees (see Section 4.4), the finance lease present value criterion is based on the sum of lease payments and any lessee residual value guarantee not already reflected in lease payments. Thus, the full amount of the residual value guarantee is considered.<br>▶ For lessors only, in applying the sales-type lease present value criterion, the rate implicit in the lease excludes any initial direct costs if the underlying asset's fair value differs from its carrying amount. For assessing the direct financing lease present value criterion, initial direct costs are included in all cases (see Chapter 6).<br>▶ Also, lessors only are precluded by the residual value guarantees of a portfolio of underlying assets from determining the amount of the guaranteed residual value of any individual underlying asset within the portfolio. That is because settlement is not solely based on the residual value of individual underlying assets and excesses in residual value on some assets offset shortfalls that exist in other assets in the portfolio. Consequently, a lessor must not consider such amounts when evaluating the two present value criteria. |

| STEP | ADDITIONAL GUIDANCE *(CONTINUED)* |
|---|---|
| **Alternative Use Criterion** | ▶ In assessing this criterion, an entity considers the effects of contractual restrictions and practical limitations on the lessor's ability to readily direct the underlying asset for another use (for example, by selling it or leasing it to an entity other than the lessee).<br>• A contractual restriction must be substantive (that is, enforceable) for the asset not to have an alternative use to the lessor.<br>• A practical limitation exists if the lessor would incur significant economic losses to direct the underlying asset for another use, such as if the lessor either would incur significant costs to rework the asset or would be able to sell or re-lease the asset only at a significant loss. Examples include when the underlying asset has design specifications unique to the lessee or is in a remote area.<br>• The possibility of the contract with the customer being terminated does not affect the assessment of this criterion. |
| **Probability of Collection Criterion (Lessors Only)** | ▶ The question of collectability is not relevant for determining whether a lease is a sales-type lease, but it does affect whether a lease is a direct financing lease. If collection is not probable and the lease does not meet other criteria for sales-type lease classification, a lessor classifies the lease as operating. See Chapter 6 for further discussion of collectability and how it affects a lessor's accounting based on lease classification. |

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

| TRANSACTION | ADDITIONAL GUIDANCE |
|---|---|
| **Business Combinations or Acquisition by Not-for-profit Entity or Joint Venture Formation** | ▶ The acquiring entity (or joint venture in the scope of ASC 805-60) must retain the previous lease classification unless there is a lease modification that is not accounted for as a separate contract (see Chapter 7). |
| **Related Party Leases** | ▶ Except for common control leases accounted for under the practical expedient discussed below:<br>• An entity classifies a related-party lease based on the classification criteria applicable to all other leases using the legally enforceable terms and conditions of the lease<br>• The classification and accounting for the lease are the same as for leases between unrelated parties in the separate financial statements of the related parties.<br>▶ For common control leases, see Section 2.5 for discussion of a practical expedient to use the written terms. If the entity elects the practical expedient and the common control arrangement includes a lease, the entity uses the written terms to classify the lease.<br>▶ An entity typically must use the legally enforceable terms and conditions of a related-party lease (or the written terms and conditions, if the practical expedient in Section 2.5 for common control arrangements is elected) even if they are not consistent with rates or terms that would be required in a transaction between unrelated market participants. |
| **Lessee Indemnification for Environmental Contamination** | ▶ A provision that requires lessee indemnification for environmental contamination, whether caused during the lessee's use of the underlying asset over the lease term or preexisting, does not affect lease classification. Those indemnifications are accounted for under other U.S. GAAP (ASC 410-20 or ASC 460-10, depending on the indemnification). |

### 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 criteria but also allows entities to use at least 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 assists entities in establishing internal accounting policies and controls and in applying the requirements in an operational and scalable manner. While an entity does not have to apply those bright lines, if it deviates from them it 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 an entity could adopt a policy that establishes ranges, such as the approach for determining whether a contingent liability is probable under ASC 450-20, it should also consider how those terms are applied in other areas of U.S. GAAP and ensure their consistent application. 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%. An entity should document its definition of the terms “substantially all” and “major part” for lease classification. Deviating from the bright lines will require the entity to document its considerations in arriving at the thresholds used and demonstrate that their use is appropriate.

### BDO INSIGHTS — ALTERNATIVE USE CRITERION

One criterion to classify a lease as a finance lease (for a lessee) or sales-type lease (for a lessor) is that the underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term. However, when this criterion is met, we expect that at least another finance or sales-type lease classification criterion would also generally be met. For example, most lessors would structure such contracts to ensure that they recover their investment in the underlying asset through the required lease payments and that therefore the present value of the lease payments would represent substantially all the fair value of the underlying asset. However, that might not always be the case, such as when a significant portion of the payments are variable. Even so, the lessor’s inability to readily direct that asset for another use at the end of the lease term will result in:

- For a lessee, a finance lease
- For a lessor, a sales-type lease unless (1) there are variable lease payments not based on an index or rate, and (2) classifying the lease as sales type would result in a selling loss, in which case the lessor would classify the lease as operating.

### EXAMPLE 4-11: ALTERNATIVE USE CRITERION MET

**FACTS**

- Widget Co. enters a lease agreement with Bob’s Custom Manufacturing.
- Under the agreement, Bob’s will construct a piece of equipment to be used in Widget’s production process.
- Widget provides the requirements for the asset, which are subject to a U.S. patented design.
- It would be cost prohibitive for Bob’s to modify the equipment in such a way that it no longer complies with the patented design requirements.
- Widget is not the accounting owner during construction or design of the asset (see Section 7.2.2.2).

**CONCLUSION AND ANALYSIS**

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

# CHAPTER 5 — ACCOUNTING FOR LEASES — LESSEES


## 5.1 OVERVIEW

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

Under ASC 842, a lessee recognizes most leases (whether operating or finance) on balance sheet at the commencement date unless it elected the short-term lease accounting policy for the asset class to which the lease contract relates. ASC 842 reflects that at the lease commencement date, a lessee has a financial obligation to make lease payments to the lessor in exchange for its right to use the underlying asset and accordingly must recognize an ROU asset and lease liability for those rights and obligations.

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

The FASB provided lessees with an accounting policy not to recognize short-term leases on balance sheet. A short-term lease is a lease that at the commencement date both:

- Has a lease term of 12 months or less
- Does not include a lessee purchase option that is reasonably certain of exercise.

That election is by asset class and, if a lessee so elects, it recognizes lease payments on a straight-line basis over the lease term along with variable lease payments when incurred.

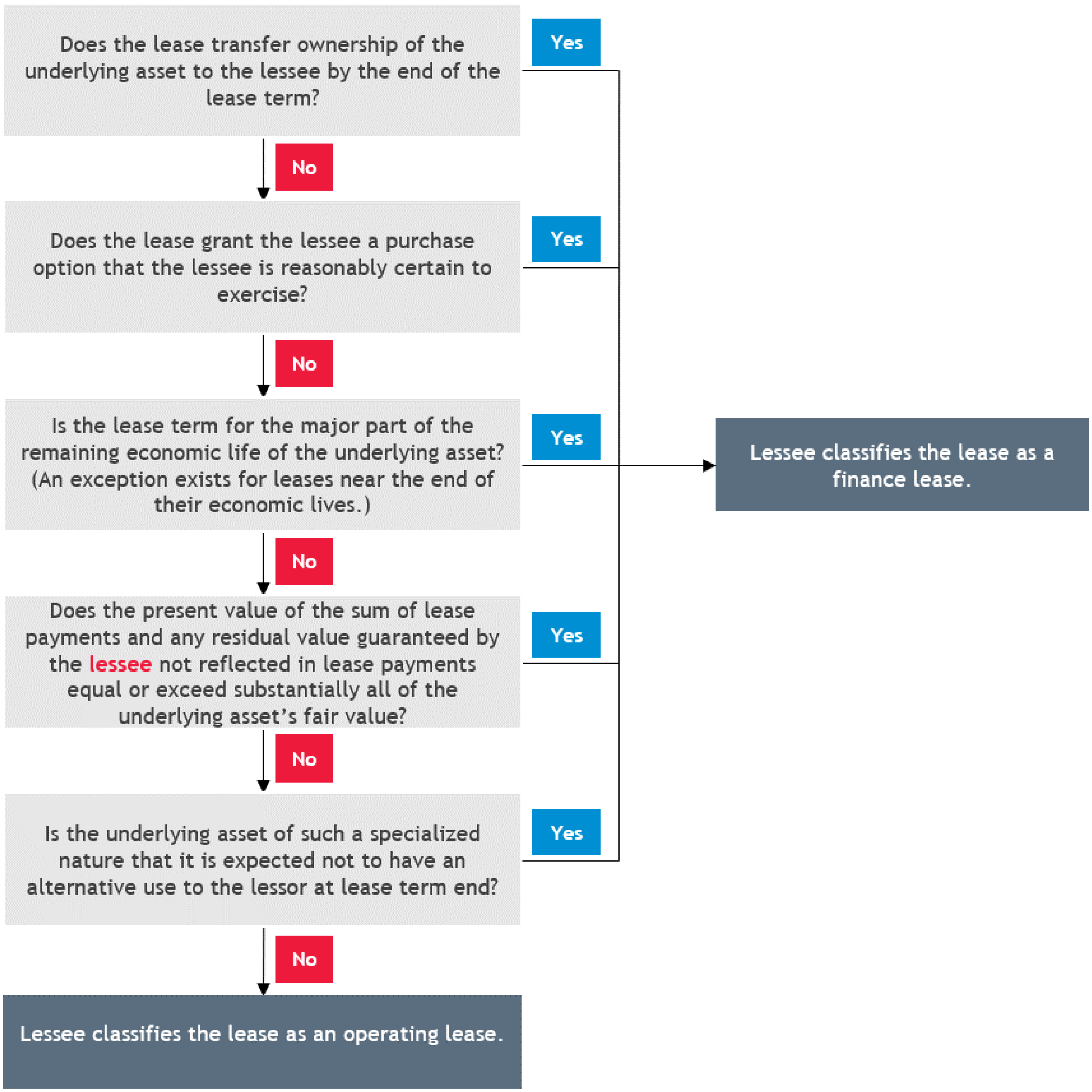
The recognition of a lease in the financial statements is also not a "set it and forget it" exercise after the commencement date of the lease. A lessee must comply with some remeasurement and modification requirements (see Sections 5.7 and 5.8, respectively) and must assess its ROU assets for impairment under ASC 360 (see Section 5.9).

## 5.2 LEASE CLASSIFICATION BY LESSEES

**FASB REFERENCES**

ASC 842-10-25-2 through 25-3

A lessee initially determines lease classification at the commencement date by analyzing the facts in the steps in the flowchart (see Section 4.9).



## 5.3 SUMMARY ACCOUNTING REQUIREMENTS BASED ON LEASE CLASSIFICATION

The table summarizes a lessee's accounting for leases assuming the lease is recognized on the balance sheet.

| | FINANCE LEASES | | OPERATING LEASES | |
|---|---|---|---|---|
| | **ROU ASSET** | **LEASE LIABILITY** | **ROU ASSET** | **LEASE LIABILITY** |
| **Balance Sheet** | Initially measure the ROU asset at the amount of the lease liability plus initial direct costs and prepaid lease payments less lease incentives received. | Initially measure the lease liability at the present value of the unpaid lease payments using the discount rate for the lease. | Initial measurement is the same as for finance leases. | |
| | Subsequently, amortize the ROU asset typically on a straight-line basis to the earlier of the end of its useful life or lease term.* | Subsequently, increase the lease liability to reflect interest using the interest method and decrease it for lease payments made. | Amortize the ROU asset based on the difference between the periodic straight-line lease cost (which includes amortization of initial direct costs) and the periodic interest accretion. | Subsequent measurement is the same as for finance leases. |
| **Income Statement** | ▶ Recognize:<br>• Amortization of the ROU asset<br>• Interest on the lease liability<br>• Variable lease payments not included in the lease liability when incurred<br>• Impairment loss if the ROU asset is impaired under ASC 360 (see Section 5.9). | | ▶ Recognize:<br>• A single lease cost, generally on a straight-line basis<br>• Variable lease payments not included in the lease liability when incurred<br>• Impairment loss if the ROU asset is impaired under ASC 360 (see Section 5.9); after impairment, recognition of lease cost is no longer on a straight-line basis (but still as a single lease cost). | |

* 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.

Also:

- ASC 842 considers the right to control the use of the underlying asset the equivalent of physical use. In other words, recognition of lease cost for operating leases or amortization of the ROU asset for finance leases is not affected by the extent to which the lessee uses the underlying asset, so it 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 lessee remeasures the lease liability using the current exchange rate and the ROU asset using the exchange rate as of the commencement date.
- Once recognized on balance sheet, ASC 842 also includes requirements for lessees to update the measurement of leases for some lease modifications and other reassessment events (see Sections 5.7 and 5.8).
- The accounting in the table might not apply to some leases for R&D activities (see Section 5.5.2.2).

# 5.4 SHORT-TERM LEASES

## 5.4.1. General

**FASB REFERENCES**

ASC 805-20-25-28B, ASC 842-10-20: Short-Term Lease, and ASC 842-20-25-2 through 25-4

ASC 842 defines a short-term lease as "*a lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise*."

A lessee may elect an accounting policy under which it does not apply the balance sheet recognition provisions to short-term leases. The election is by asset class to which the ROU relates (for example, office equipment, real estate, vehicles). If a lessee so elects, it does not recognize the relevant leases on balance sheet. It recognizes the lease payments on a straight-line basis over the lease term and variable lease payments in the period in which the obligation for those payments is incurred.

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 is a short-term lease. In that case, the lessee must apply the general guidance, including balance sheet recognition, as if the date of the change in circumstances is the lease commencement date.

The FASB provided that practical expedient 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 (see Sections 4.3 and 4.4, respectively). Short-term leases are also subject to the lease term and purchase option reassessment requirements (see Section 5.7), as well as to specific disclosure requirements (see Section 8.3.2). Accordingly, even with that accounting policy, short-term leases are not entirely scoped out of ASC 842.

In deliberating whether to include the short-term lease exception, the FASB considered the risk that entities might want to structure a lease to obtain short-term lease accounting; for example, by setting a noncancelable lease period shorter than 12 months while incorporating a series of one-year renewal option, or entering a longer-term lease that includes a series of termination options. However, in paragraph BC381 of ASU 2016-02, the FASB noted:

> *There are significant economic disincentives to both parties to entering into a series of short-term leases in place of longer-term leases such that there is not a significant structuring risk throughout the system. For example, lessees may have to pay a premium rental price to compensate the lessor for its increased residual asset risk, and some lessors will be unable to enter into short-term leases depending on the terms of the financing they obtained to acquire the underlying asset.*

**BDO INSIGHTS — DAY 2 CONSIDERATIONS FOR SHORT-TERM LEASE EXEMPTION**

As noted above, an entity that elects the short-term lease accounting policy for an asset class assesses at the commencement date whether its leases in that asset class are short-term leases. If at the commencement date, a lease has a lease term greater than 12 months or includes a purchase option the lessee is reasonably certain to exercise, it is not a short-term lease. Consequently, the lessee must recognize that lease on the balance sheet.

A lease that is not initially a short-term lease cannot become a short-term lease, even if its term changes to be 12 months or less or the assessment of a purchase option changes such that the lessee is no longer reasonably certain to exercise the purchase option. That is because the assessment of whether a lease is short term occurs at the commencement date. The only exception is for leases acquired in a business combination for which the acquirer may elect as an accounting policy by asset class and for all of an entity's acquisitions not to recognize assets or liabilities for acquired lessee leases that at the acquisition date, have a remaining lease term of 12 months or less. See our Blueprint, Business Combinations Under ASC 805, for further discussion.

In contrast, a lease that initially is short term might no longer qualify for the exemption if the lease term or the assessment of a purchase option changes such that after the change, either:

- The remaining lease term extends more than 12 months from the end of the previously determined lease term
- The lessee is reasonably certain to exercise a purchase option.

See Section 5.7 for lease term and purchase option reassessment requirements and Section 5.8 for modification requirements.

**EXAMPLE 5-1: LEASE IS A SHORT-TERM LEASE — EXTENSION OPTION NOT REASONABLY CERTAIN OF EXERCISE**

**FACTS**

- Lessee enters a lease with an auto leasing company for the use of 20 cars by its sales force.
- The stated term of the lease is 12 months, with Lessee having the right to extend the lease for an additional 12 months. Monthly lease payments during the renewal period are the same as during the initial period.
- There are no purchase options.
- The cars are not specialized, and alternative cars are available in the market at similar lease rates.
- Lessee elected an accounting policy not to recognize short-term leases for all asset classes.

**CONCLUSION**

- The lease meets the definition of a short-term lease because the lease term is 12 months or less and there are no purchase options. Consequently, Lessee does not recognize the lease on balance sheet. Rather, Lessee recognizes the lease payments on a straight-line basis over one year.

**ANALYSIS**

- Lessee considered all relevant factors at the commencement date, including lease rates in the renewal period and availability of similar leases in the market, and determined that it is not reasonably certain to exercise the extension option. Accordingly, the lease term is 12 months.
- Because there are no purchase options in the lease, no further analysis is required.

**EXAMPLE 5-2: LEASE IS NOT A SHORT-TERM LEASE — TERMINATION OPTIONS**

**FACTS**

- Lessee enters a lease with a lessor for the use of two cranes.
- The stated term of the lease is three years, with Lessee having the right to terminate it at any time after one year.
- The contract specifies an early termination penalty equal to 15% of the total lease payments.
- Lessee elected an accounting policy not to recognize short-term leases for all asset classes.

**CONCLUSION**

- Lessee concludes that the lease is not a short-term lease. Accordingly, it applies the general requirements in ASC 842 to the lease, including recognizing an ROU asset and lease liability at the commencement date.

**ANALYSIS**

- Lessee determines that because of the significant termination penalty and other factors, it is reasonably certain not to exercise the termination option. Accordingly, the lease term is three years.

**EXAMPLE 5-3: LEASE IS A SHORT-TERM LEASE — EVERGREEN LEASE**

**FACTS**

- Assume the same facts as in Example 5-2, except that the contract does not specify a stated term. Instead, the cranes are subject to a fixed daily rental rate and the lease can be renewed indefinitely.

**CONCLUSION**

- The lease is a short-term lease because the lease term is 12 months or less and there are no purchase options. Consequently, Lessee does not recognize the lease on balance sheet. Rather, Lessee recognizes the lease payments on a straight-line basis over the lease term.

**ANALYSIS**

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

**EXAMPLE 5-4: LEASE IS NOT A SHORT-TERM LEASE — PURCHASE OPTION REASONABLY CERTAIN OF EXERCISE**

**FACTS**

- Lessee is a music band (and legal entity) that enters a lease for the use of three guitars, four amplifiers, two loopers, and a drum set for the band's three-month summer tour.
- The stated term of the lease is three months, with Lessee having the right to purchase the equipment at a 15% discount at the end of the summer tour.
- Lessee elected an accounting policy not to recognize short-term leases for all asset classes.

**CONCLUSION**

- Lessee concludes that the leases are not short-term leases because it is reasonably certain to exercise the purchase option. Consequently, Lessee applies the general requirements in ASC 842 to the leases, including recognizing an ROU asset and lease liability at the commencement date.

**ANALYSIS**

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

### 5.4.2. Application at Lease Component Level

As discussed in Chapter 3, the components of a contract are items or activities that transfer a good or service to the lessee. Those components are the units of account that determine which U.S. GAAP applies. Lease components are accounted for under ASC 842, while nonlease components are accounted for under other U.S. GAAP (unless the entity has elected not to separate the nonlease components from the associated lease components (see Section 3.3.2)).

The guidance in ASC 842 applies at the lease component level. Specifically, lease classification is determined for each lease component based on its lease term, lease payments, discount rate, and other relevant terms (for example, ownership transfer at the end of the lease or existence of purchase options), and each lease component is recognized on balance sheet at its respective lease commencement date. The short-term lease exemption also applies at the lease component level. If a contract includes multiple lease components, the short-term lease exemption might apply to only some lease components in the contract (see Example 5-5). Even so, a lessee must allocate the consideration in the contract to each component, including short-term leases (see Section 3.3.3).

**EXAMPLE 5-5: MULTIPLE LEASE COMPONENTS — ONLY ONE COMPONENT IS A SHORT-TERM LEASE**

**FACTS**

- On January 1, 20X4, Lessee enters an arrangement with Lessor to lease the 20$^{th}$ floor in an office building for 10 years, with lease payments initially starting at $100,000 per month.
- The 20$^{th}$ floor will not be available for Lessee's use for several months because Lessor is renovating the space (for which Lessor is determined the accounting owner of the improvements (see Section 4.2)).
- The lease arrangement provides Lessee with the right to use the 30$^{th}$ floor of the same building while Lessor is renovating the 20$^{th}$ floor. Lessee begins using the 30$^{th}$ floor on January 1, 20X4, and payments are $120,000 per month.
- Lessee can use the 30$^{th}$ floor while Lessor is preparing the 20$^{th}$ floor for lease. However, the term of the 30$^{th}$ floor cannot exceed 12 months, at which point Lessee and Lessor must renegotiate the lease.
- The contract does not contain a lease of land because Lessee is one of multiple tenants in the office building (see Section 3.2.2.2) and there are no nonlease components.
- Lessee has made an accounting policy election not to recognize ROU assets and lease liabilities arising from short-term leases for this asset class.

CONCLUSION

- Lessee determines the arrangement contains two lease components: One for the 20$^{th}$ floor and another for the 30$^{th}$ floor.
- Lessee also determines the 30$^{th}$ floor lease component qualifies for the short-term lease exemption, while the 20$^{th}$ floor lease component does not.

**CONCLUSION AND ANALYSIS**

- Lessee evaluates the guidance in ASC 842-10-25-28 and determines that the rights to use the 20$^{th}$ and 30$^{th}$ floors are separate lease components because:
  - Lessee can benefit from using each floor on its own
  - The two office spaces are neither highly dependent on nor highly interrelated with each other — the office spaces are multiple floors apart and thus are not connected to each other. Lessor also was able to give Lessee possession of the 30$^{th}$ floor space without having to also give possession of the 20$^{th}$ floor space.
- Because Lessor expects to make the 20$^{th}$ floor available within several months and the lease term for the 30$^{th}$ floor cannot exceed 12 months, Lessee determines that the lease for the 30$^{th}$ floor is a short-term lease and thus qualifies for the short-term lease exemption.
- Lessee determines that the lease term for the 20$^{th}$ floor is 10 years and therefore the 20$^{th}$ floor lease does not qualify for the short-term lease exemption.
- Lessee allocates the consideration in the contract to each of the lease components (see Section 3.3.3).
  - Lessee recognizes the lease payments allocated to the 30$^{th}$ floor lease in the income statement on a straight-line basis over the lease term, starting January 1, 20X4 (the commencement date).
  - Lessee will classify and account for the 20$^{th}$ floor lease component at its commencement date based on its allocated lease payments.

### 5.4.3. Leases With Nonconsecutive Period of Use

In some arrangements, the lease will include not a continuous and uninterrupted period of use but rather nonconsecutive periods of use. That can be because of the availability of the ROU asset to the lessee or the lessee's specific needs. With regards to the definition of a lease, ASC 842 defines the period of use as "*the total period of time that an asset is used to fulfill a contract with a customer (including the sum of any nonconsecutive periods of time).*"

That definition, and specifically the parenthesis, confirms that if a lease's period of use includes nonconsecutive periods, the lease term will also include those nonconsecutive periods. Conversely, the lease term cannot include periods for which a lessee does not have the right to use the underlying asset. Similarly, a lessee assesses whether a lease is short term based on the sum of the nonconsecutive periods for which it has the right to use the underlying asset.

**EXAMPLE 5-6: LEASE IS NOT A SHORT-TERM LEASE — NONCONSECUTIVE PERIODS**

**FACTS**

- Lessee is a basketball association that wants to host its playoffs in a large venue each season.
- Lessee enters a lease with a lessor for the use of two basketball arenas.
- Lessee has the right to use the arenas every May and June during a 10-year period.
- The lease contract does not include any options.
- Lessee elected an accounting policy not to recognize short-term leases for all asset classes.

**CONCLUSION**

- Lessee concludes that the lease is not a short-term lease because the lease term is for more than 12 months. Consequently, Lessee applies the general requirements in ASC 842 to the lease, including recognizing an ROU asset and lease liability at the commencement date. Example 5-10 continues this example and illustrates subsequent accounting for this lease.

**ANALYSIS**

- While each time increment (each playoff season) is shorter than 12 months (that is, two months), Lessee determines that the lease term is 20 months (two months a year times 10 years).

## 5.5 RECOGNITION AND INITIAL MEASUREMENT

### 5.5.1 Recognition

**FASB REFERENCES**

ASC 842-20-25-1

A lessee recognizes an ROU asset and a lease liability at the commencement date of the lease, which is the date on which the lessor makes the underlying asset available for use by the lessee. Section 4.2 explains that the lessor may make the underlying asset available for use by the lessee (that is, a lease has commenced) before the lessee begins operations or makes lease payments.

**BDO INSIGHTS — CAPITALIZATION THRESHOLDS**

ASC 842 does not provide a scope exception for small value leases like the exception in IFRS 16, the leasing standard issued by the IASB. Even so, entities 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 ROU asset and the lease liability. Entities should therefore carefully consider the resulting nonrecognition of lease liabilities, which may result in the use of lower capitalization thresholds for leases as compared to PP&E. Entities should also consider the effects of not recognizing leases on other ASC 842 requirements, such as disclosures.

**BDO INSIGHTS — ONEROUS LEASES BEFORE COMMENCEMENT DATE**

As discussed above, a lessee recognizes an ROU asset when the lease commences. Also, as discussed in Section 5.9.1, once recognized on the balance sheet, an ROU asset is a long-lived nonfinancial asset subject to the impairment guidance in ASC 360. Accordingly, when the carrying amount of the ROU asset exceeds its expected future economic benefits, an impairment loss may be recognized under ASC 360.

In some cases, a lessee may incur a loss before the lease commences and thus before it recognizes the ROU asset on the balance sheet. For example, the lessee (as sublessor) may enter a sublease before the head lease commences, with the head lease cost exceeding sublease income. ASC 842 does not address that scenario, so it is unclear whether the lessee should accrue a loss at sublease inception under other U.S. GAAP, such as ASC 450. We believe a loss should not be accrued on executory contracts (for example, contracts under which both parties must perform) unless specifically required under other U.S. GAAP. Accordingly, in the situation described herein, we believe the lessee (sublessor) should not recognize a loss at sublease inception. Rather, the lessee (sublessor) considers whether the ROU asset is impaired when the head lease commences. The lessee should provide appropriate disclosures in the period in which the sublease is entered regarding expected effects upon lease commencement.

## 5.5.2 Initial Measurement

**FASB REFERENCES**

ASC 842-20-30-1 through 30-3, and ASC 842-20-30-5

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

A lessee initially measures the lease liability at the present value of the unpaid lease payments, discounted using the discount rate for the lease. That discount rate is calculated based on information available at the commencement date. A lessee uses the rate implicit in the lease whenever that rate is readily determinable; otherwise it uses its incremental borrowing rate. A lessee that is not a public business entity is permitted to use a risk-free discount rate for the lease, determined using a period comparable with that of the lease term, as an accounting policy by asset class (see Section 4.6).

The ROU asset is initially measured at cost (see Section 4.4 for a discussion on lease payments and Section 4.5 for initial direct costs) as shown below.

Initial measurement of lease liability + Lease payments made on or before the commencement date + Initial direct costs incurred − Lease incentives received = ROU asset

**BDO INSIGHTS — ACCOUNTING WHEN INITIAL MEASUREMENT OF ROU ASSET IS LESS THAN ZERO**

In some cases, a lease contract may have little or no lease payments (as defined in ASC 842 (see Section 4.4)). For example, a lease of retail space may require the retailer lessee to pay rent based on a fixed percentage of its gross sales each month. If there are no fixed or other payments to the lessor 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).

If the lessor paid the lessee a fixed lease incentive on or before the commencement date, the initial measurement guidance discussed above may result in an initial measurement for the ROU asset of less than zero. In those cases, we believe the lessee should recognize the excess as a liability, which the lessee reduces on a straight-line basis over the lease term as an offset to lease cost. We believe it would be inappropriate for a lessee to initially measure an ROU asset at less than zero or to recognize the excess amount through income.

See also Section 4.4.4 for additional guidance and examples related to contingent lease incentives neither received nor receivable at the commencement date.

**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 its initial measurement 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 5.9).

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

**FASB REFERENCES**

ASC 340-40-25-1 through 25-3, ASC 360-10-30-1, ASC 842-10-20: Initial Direct Costs, and ASC 842-20-30-5

A lessee may incur costs such as 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 (see Section 3.3.1). However, the guidance is not clear when the lessee pays those costs to a party other than the lessor or when the lessee incurs the costs itself. Costs for such activities are not initial direct costs because they are not costs to obtain a lease contract, so a lessee cannot capitalize them as initial direct costs.

The SEC staff has addressed that situation, as excerpted below.

### SEC STAFF GUIDANCE

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

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

December 10, 2018

**Certain lessee and lessor costs**

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

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

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

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

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

Accordingly, we believe that to the extent the costs to ready the leased asset for its intended use are not in the scope of other U.S. GAAP, either approach below is acceptable as an accounting policy applied at the entity level and disclosed if material:

- Expense the costs as incurred.
- Capitalize, by analogy to ASC 360 on PP&E, the costs incurred to bring the asset to the condition and location necessary for its intended use. If the lessee elects to capitalize the costs, it 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.

#### 5.5.2.2 Leases Entered for R&D Activities

**FASB REFERENCES**

ASC 730-10-15-4 through 15-5 and ASC 730-10-25-1 through 25-2

A lessee may enter a lease for R&D activities when the ROU asset has no alternative future uses in other R&D projects or otherwise.[7]

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

| FINANCE LEASES | OPERATING LEASES |
|---|---|
| Consistent with legacy guidance and as discussed in paragraph BC56 of ASU 2016-02, a finance lease under ASC 842 is economically like the acquisition of the underlying asset.<br><br>Therefore, a lessee must account for a finance lease ROU asset entered for R&D activities by applying the recognition guidance in ASC 730, *Research and Development*, applicable to items of PP&E purchased or constructed solely for a particular R&D project unless a scope exception applies (see ASC 730-10-15-4 and 15-5). Accordingly, if the ROU asset has no alternative future uses (in other R&D projects or otherwise), the finance lease ROU asset is expensed as R&D costs at lease commencement. | ASC 842 continues to differentiate the financial statement reporting between operating and finance leases (see paragraph BC57 of ASU 2016-02). Also, as discussed in paragraph BC388 of ASU 2016-02, other than recognizing operating leases on balance sheet, the accounting for operating leases in a lessee's income statement or statement of cash flows is substantially the same as that in previous U.S. GAAP.<br><br>Therefore, and because U.S. GAAP is not clear on this topic, we believe an entity may apply either of the following approaches consistently for operating lease ROU assets that have no future alternative uses:<br><br>▶ Expense the ROU asset at the commencement date under ASC 730 (like finance leases).<br>▶ Continue to recognize the ROU asset and apply the general subsequent measurement guidance in ASC 842-20, including impairment considerations under ASC 360. |

[7] See discussion on evaluation of alternative future uses in Chapter 3 of the AICPA's Accounting and Valuation Guide: *Assets Acquired to Be Used in Research and Development Activities*.

### 5.5.2.3 Application Example — Initial Measurement

Example 5-7 illustrates the initial recognition and measurement of a lease on balance sheet.

**For the illustrations throughout this Chapter:**

- The fact pattern in Example 5-7 serves as the basis for most of the subsequent examples in this Chapter.
- The tables in each example are consistent with how they would be displayed in a spreadsheet, with amounts shown with no decimals and no rounding function used.

**EXAMPLE 5-7: INITIAL MEASUREMENT OF LEASE LIABILITY AND ROU ASSET**

**FACTS**

- Retailer enters a 10-year lease for 10,000 square feet of retail space.
- Annual lease payments are $100,000, paid in arrears, and increase 5% each year during the lease term.
- The rate implicit in the lease is not readily determinable. Retailer's incremental borrowing rate at lease commencement is 6%. Retailer did not elect the risk-free rate accounting policy for this asset class.
- Retailer does not provide a residual value guarantee and there is no transfer of ownership or purchase option.
- At the commencement date, the lessor paid Retailer $30,000 as an incentive to enter the lease.
- Retailer incurred the following lease-related costs :
  - $10,000 for employee wages for negotiating lease terms and conditions
  - $20,000 for commissions paid to a broker
  - $15,000 for external legal fees.
- There are no nonlease components.
- 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 incremental borrowing rate) because the rate implicit in the lease is not readily determinable and Retailer did not elect the risk-free discount rate accounting policy.
- The lease liability at the commencement date is $904,337, calculated as:

| | 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 recognizes as initial direct costs only the fees paid to the broker because the external legal fees and employee wages would have been incurred even if Retailer had not obtained the lease.
- The lease incentive of $30,000 is reflected in the initial measurement of the ROU asset but does not affect the initial measurement of the lease liability because it was received at the commencement date.
- Retailer initially measures the ROU asset at $894,337, calculated as:

| | 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 | $ 894,337 |

- 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. For simplification, this example assumes that those expenses are incurred at the commencement date.

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

### BDO INSIGHTS — LEASE INCENTIVES AND LEASEHOLD IMPROVEMENTS

As illustrated in Example 5-7, lease incentives paid by the lessor at or before the commencement date reduce the ROU asset's initial measurement (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). That is because lease incentives paid or payable to the lessee reduce the consideration in the contract (see Section 3.3.1) and therefore also reduce the lease payments (see Section 4.4).

In Example 5-7, the lessor 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 4.2), 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.

# 5.6 SUBSEQUENT MEASUREMENT

## 5.6.1 Finance Leases

**FASB REFERENCES**

ASC 842-20-25-5, ASC 842-20-35-1 through 35-2, ASC 842-20-35-7 through 35-8, and ASC 842-20-55-3

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

<table>
<tr><th rowspan="2"></th><th colspan="2">FINANCE LEASES</th></tr>
<tr><th>ROU ASSET</th><th>LEASE LIABILITY</th></tr>
<tr><td>Balance Sheet</td><td>▶ Amortize the ROU asset on a straight-line basis (unless another systematic basis is more representative of the pattern in which the lessee expects to consume the economic benefits of the ROU asset) from the commencement date to the earlier of the end of its useful life or lease term.<br>▶ 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 asset’s useful life.</td><td>▶ Increase the lease liability to reflect interest using the interest method and decrease it for lease payments made during the period.</td></tr>
<tr><td rowspan="2">Income Statement*</td><td>▶ Recognize amortization of the ROU asset.</td><td>▶ Recognize interest on the lease liability.</td></tr>
<tr><td colspan="2">▶ Recognize variable lease payments not included in the lease liability when incurred.<br>▶ If variable lease payments are triggered based on a specified target, recognize costs from those payments before the achievement of such target if achievement is probable. Such variable lease costs must be reversed when it is probable the specified target will not be met (see Section 5.6.1.2).</td></tr>
</table>

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

As noted, the accounting for a finance lease is consistent with the accounting for a financed purchase of PP&E because the FASB generally views finance leases economically as the purchase of a nonfinancial asset.

The lease liability is measured on an amortized cost basis. It essentially reflects at each reporting period the present value of the remaining lease payments discounted using the discount rate established at lease commencement (or at the most recent lease modification not accounted for as a separate contract (see Section 5.8) or the most recent remeasurement resulting from a reassessment of the lease term or purchase option (see Section 5.7)).

The ROU asset is measured at cost, net of accumulated amortization, and is amortized typically on a straight-line basis like PP&E is under ASC 360. ASC 842 considers the right to control the use of the underlying asset the equivalent of physical use. In other words, amortization of the ROU asset for finance leases is not affected by the extent to which the lessee uses the underlying asset, so it is typically on a straight-line basis.

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

**FASB REFERENCES**

ASC 842-20-35-8

A lessee may classify a lease of land as a finance lease if any of the criteria in Section 4.9 are met. Because land is considered to have an indefinite useful life, a question may arise regarding the amortization of the ROU asset related to a finance lease of land. We believe it is appropriate for a lessee not to amortize the ROU asset associated with a finance lease of land if the lease is classified as a finance lease because either:

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

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

#### 5.6.1.2 Variable Lease Payments Based on Achieving a Target

**FASB REFERENCES**

ASC 842-20-55-1 through 55-2

Lessees recognize variable lease payments in the period in which they are incurred, as discussed in Section 5.6.1. Further, if variable lease payments are triggered based on a specified target, the costs are recognized before achievement of that target if achievement is probable. The FASB included that provision to ensure that a lessee recognizes lease payments in the periods in which it benefits from use of the leased asset.

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

In contrast, if the lease required the lessee to pay $7,000 per year plus $1 for every mile driven, the lessee would not assess probability and instead would recognize the $1 every time it drives one mile, as discussed in Section 5.6.1.

Variable lease costs recognized because achievement of a target was probable are reversed only when it is probable that the specified target will not be met.

#### 5.6.1.3 Application Example — Subsequent Measurement of a Finance Lease

Example 5-8 illustrates the subsequent measurement and recognition of a finance lease.

**EXAMPLE 5-8: SUBSEQUENT MEASUREMENT OF LEASE LIABILITY AND ROU ASSET — FINANCE LEASE**

**FACTS**

- Assume the same facts as in Example 5-7, except that:
  - The lease is for a manufacturing equipment rather than retail space.
  - The remaining economic life of the equipment at lease commencement is 12 years (that is, the equipment is not near the end of its economic life).

**CONCLUSION AND ANALYSIS**

- Retailer classifies the lease as a finance lease because the lease term (10 years) is for the major part of the remaining economic life of the underlying asset (see Section 5.2).
- Because there is no transfer of ownership or purchase option, Retailer amortizes the ROU asset from the commencement date to the earlier of the useful life of the ROU asset and the lease term, which in this example is 10 years.
- Lease liability accounting throughout the lease term (assuming no modifications and remeasurements) is:

| | BEGINNING BALANCE | INTEREST (6%) | PAYMENT | ENDING 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).
- Journal entries (only Year 1 shown):

| | | | |
|---|---|---|---|
| Debit | Interest expense | $ 54,260 | |
| Credit | Lease liability | | $ 54,260 |
| Debit | Lease liability | 100,000 | |
| Credit | Cash | | 100,000 |
| Debit | Amortization expense | 89,434 | |
| Credit | ROU asset | | 89,434 |

### 5.6.2 Operating Leases

**FASB REFERENCES**

ASC 842-20-25-6, ASC 842-20-25-8, ASC 842-20-35-3, and ASC 842-20-55-3

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

<table>
<tr><th rowspan="2"></th><th colspan="2">OPERATING LEASES</th></tr>
<tr><th>ROU ASSET</th><th>LEASE LIABILITY</th></tr>
<tr><td>Balance Sheet</td><td>▶ ROU asset equals the amount of the lease liability adjusted for prepaid or accrued lease payments, unamortized lease incentives, and unamortized initial direct costs.<br>(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 (see discussion below)).</td><td>▶ Increase the lease liability to reflect interest using the interest method and decrease it for lease payments made during the period.</td></tr>
<tr><td rowspan="2">Income Statement*</td><td colspan="2">▶ 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.</td></tr>
<tr><td colspan="2">▶ Recognize variable lease payments not included in the lease liability when incurred.<br>▶ 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 must be reversed when it is probable the specified target will not be met (see Section 5.6.1.2).</td></tr>
</table>

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

The FASB concluded that operating leases are different from finance leases and purchases of nonfinancial assets, so ASC 842 provides for different financial statement reporting for operating and finance leases. For operating leases, a lessee recognizes a single lease cost based on the pattern in which the benefits conveyed by the lease are consumed. ASC 842 considers the right to control the use of the underlying asset the equivalent of physical use. In other words, recognition of lease cost for operating leases is not affected by the extent to which the lessee uses the underlying asset, so it is typically on a straight-line basis.

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

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

#### 5.6.2.1 Total Lease Cost and ROU Asset Amortization

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

- The total lease payments, including those paid and not yet paid (see Section 4.4)
- The initial direct costs attributable to the lease (see Section 4.5).

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

Opening balance of ROU asset − Periodic lease cost + Periodic interest expense = Closing balance of ROU asset

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

#### 5.6.2.2 Application Example — Subsequent Measurement of an Operating Lease

Example 5-9 illustrates the subsequent measurement and recognition of an operating lease.

**EXAMPLE 5-9: SUBSEQUENT MEASUREMENT OF LEASE LIABILITY AND ROU ASSET — OPERATING LEASE**

**FACTS**

- Assume the same facts as in Example 5-7, 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.

**CONCLUSION AND ANALYSIS**

- The accounting for the lease liability is the same as in Example 5-8 (assuming no modifications and remeasurements) because there are no differences in accounting between operating lease liabilities and finance lease liabilities.
- 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] | $ 1,247,789 |
| Periodic lease cost [B] = [A] / 10 | $ 124,779 |

*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.

- Having determined the periodic lease cost, Retailer can calculate the amortization of the ROU asset, which is the difference between the periodic lease cost and the periodic interest accretion on the lease liability.
- Therefore, the accounting for the ROU asset, assuming no impairment, modifications, or reassessments, can be determined as:

| | BEGINNING BALANCE | PERIODIC LEASE COST | INTEREST (6%) | ROU AMORTIZATION | ENDING 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) | — |

- Journal entries (Year 1 only):

| | | | |
|---|---|---|---|
| Debit | Lease liability | $ 100,000 | |
| Credit | Cash | | $ 100,000 |
| Debit | Lease expense | 124,779 | |
| Credit | ROU asset | | 70,519 |
| Credit | Lease liability (interest) | | 54,260 |

**OPERATING LEASE ROU ASSETS' SUBSEQUENT MEASUREMENT DIFFERS FROM FINANCE LEASES**

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

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

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

#### 5.6.2.3 Remaining Cost of an Operating Lease

**FASB REFERENCES**

ASC 842-20-25-8

ASC 842 notes that throughout the lease term, the remaining cost of an operating lease for which the ROU asset has not been impaired consists of:

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

However, if there are no modifications or reassessments and the operating lease ROU asset is not impaired, the periodic lease cost remains the same throughout the lease term as illustrated in Example 5-9 and does not need to be recomputed each reporting period.

For example, the remaining lease cost of the lease in Example 5-9 at the end of Year 2 would be calculated as shown below and would result in the same periodic lease cost as in Year 1:

| | AMOUNT | |
|---|---|---|
| Total lease payments (paid and not yet paid) | $ 1,227,789 | (see table in Example 5-9) |
| Plus initial direct costs | 20,000 | (same as in Example 5-9) |
| Less periodic lease cost recognized in Years 1 and 2 | (249,558) | ($124,779 * 2 years) |
| Total remaining lease cost [A] | $ 998,231 | |
| Periodic lease cost [B] = [A] / 8 years left | $ 124,779 | |

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

| | AMOUNT | |
|---|---|---|
| Carrying value of ROU asset at end of Year 2 | $ 750,556 | (same as in Example 5-9) |
| Plus sum of interest accretion Years 3 through 10 | 247,675 | |
| Total remaining lease cost [A] | $ 998,231 | |
| Periodic lease cost [B] = [A] / 8 years left | $ 124,779 | |

That alternative method also could be used as an independent recalculation of the remaining lease cost or for remeasurement of the lease in more complicated fact patterns, such as when lease classification changes from finance to operating (see Example 5-17) or there is a partial termination (see Example 5-19).

### 5.6.2.4 Operating Leases With Nonconsecutive Period of Use

In some arrangements, the lease will not include a continuous and uninterrupted period of use but rather will consist of nonconsecutive periods of use. ASC 842 defines the period of use as "*the total period of time that an asset is used to fulfill a contract with a customer (including the sum of any nonconsecutive periods of time)*." Accordingly, the lease term for a lease with nonconsecutive periods of use is the sum of the nonconsecutive periods for which the lessee has the right to use the underlying asset.

Example 5-10 illustrates the subsequent measurement and recognition of an operating lease with a nonconsecutive period of use. It is a continuation of Example 5-6.

**EXAMPLE 5-10: OPERATING LEASE WITH NONCONSECUTIVE PERIODS — SUBSEQUENT MEASUREMENT**

**FACTS**

- Lessee is a basketball association that wants to host its playoff games in a large venue each season.
- In July 2021, Lessee entered a lease with Lessor for the use of two basketball arenas during the months of May and June each year for a 10-year period, starting in May 2022.
- At lease inception, Lessee paid Lessor $150,000. Additional payments of $150,000 are due in arrears each month Lessee has the right to use the arenas (for example, $150,000 is due May 31, 2022; $150,000 June 30, 2022; and no payments are due from July 2022 to April 2023).
- The lease contract does not include any options (extension, termination, or purchase) and Lessee did not provide a residual value guarantee.
- There are no nonlease components.
- Lessee did not incur any initial direct costs or receive any lease incentives.
- As in Example 5-6, the lease term is 20 months and therefore is not a short-term lease.
- The rate implicit in the lease is not readily determinable. Lessee's incremental borrowing rate at lease commencement is 6%.
- The lease is an operating lease.
- Lessee's fiscal year ends June 30.

**CONCLUSION AND ANALYSIS**

- As discussed in Section 5.5.1, a lessee recognizes a lease on balance sheet at the lease's commencement date, which here is May 1, 2022.
- From lease inception (July 2021) through April 2022, Lessee's balance sheet reflects only a prepaid lease payment of $150,000. Lessee also discloses information about its lease that has not yet commenced (see Section 8.3.2).
- On May 1, 2022 (commencement date of the lease), Lessee recognizes the lease on balance sheet. Lessee reclassifies the prepaid lease payment of $150,000 and includes it in the initial measurement of the ROU asset.
- Lessee calculates the total lease cost to be recognized over the lease term:

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

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

**The number of months is calculated as two months per year times 10 years.

- Lessee recognizes a periodic lease expense of $157,500 each month it uses the arenas (May and June of each year during the lease term).
- From July to April of every year, Lessee recognizes no lease expense.
- The table summarizes Lessee's accounting for the lease during the lease term assuming no impairment, reassessments, or modifications.

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

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

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

| | LEASE LIABILITY | | | | ROU ASSET | | |
|---|---|---|---|---|---|---|---|
| | Beginning Balance | Interest | Payment | Ending Balance | Beginning Balance | Amortization | Ending Balance |
| **Q1** | 2,030,754 | 30,614 | — | 2,061,368 | 2,165,754 | 30,614**** | 2,196,368 |
| **Q2** | 2,061,368 | 31,075 | — | 2,092,444 | 2,196,368 | 31,075 | 2,227,444 |
| **Q3** | 2,092,444 | 31,544 | — | 2,123,987 | 2,227,444 | 31,544 | 2,258,987 |
| **Q4** | 2,123,987 | 31,269 | (300,000) | 1,855,257 | 2,258,987 | (283,731) | 1,975,257 |

**** As discussed in Section 5.6.2.1, the periodic amortization of the ROU asset can be calculated as the difference between the periodic lease cost and periodic interest on the lease liability. Because Lessee recognizes periodic lease cost only during the periods of use (that is, May and June), for the other periods, the balance of the ROU asset increases by the amount of the periodic interest on the lease liability.

## 5.6.3 Leasehold Improvements

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

**FASB REFERENCES**

ASC 842-20-35-12

A lessee amortizes leasehold improvements over the shorter of the useful life of those improvements and 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. Also, as discussed in Section 4.3, the existence of significant leasehold improvements with a useful life longer than the noncancelable term of the lease may indicate that it is reasonably certain the lessee will exercise a renewal option. Therefore, a lessee must consider the useful life of the improvements when determining the remaining lease term.

### 5.6.3.2 Leasehold Improvements — Common Control Leases

**FASB REFERENCES**

ASC 360-10-40-4, and ASC 842-20-35-12A through 35-12C

ASU 2023-01 addresses the accounting for leasehold improvements in common control leases and applies to all entities, including public business entities.

Common control leases often have a short lease terms (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). Amortizing the significant leasehold improvements over the lease term as discussed in Section 5.6.3.1 may not result in economically faithful information when the lessee and lessor are under common control. That is because the common control group benefits from the improvements either by extending the lease with the lessee after the expiration of the initial lease or by transferring the assets to the lessor or another entity in the group.

Consequently, 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 (see Section 2.5). 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 Section 5.6.3.1.

Further, if the lessee loses control of the use of the leased asset to another entity in the common control group, the lessee accounts for the remaining balance of leasehold improvements as a transfer between entities under common control through an adjustment to equity (or net assets for a not-for-profit entity).

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.

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

**BDO INSIGHT — PROCESSES AND CONTROLS CONSIDERATIONS**

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

The FASB did not address how to determine which party to the common control lease is the accounting owner of improvements made to a leased asset. The FASB acknowledged in paragraph BC40 of ASU 2023-01 that various reasonable approaches exist and therefore decided not to provide guidance. See Section 4.2 for guidance on determining the accounting owner of improvements.

For disclosure requirements, see Section 8.3.2. For transition to ASC 842 related to existing common control leases, see Section 9.1.2.

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

**FASB REFERENCES**

ASC 842-20-35-13

A lessee amortizes over the shorter of the useful life of the assets and the remaining lease term at the date of acquisition leasehold improvements that are acquired in a business combination or in an acquisition by a not-for-profit entity or that are recognized by a joint venture upon formation in ASC 805-60.

## 5.7 REMEASUREMENTS

**FASB REFERENCES**

ASC 842-10-15-36 through 15-37, ASC 842-10-25-1, ASC 842-10-35-1, ASC 842-10-35-4, and ASC 842-20-35-4 through 35-5

The discussion in prior sections illustrates the initial and subsequent accounting for leases if no changes occur. 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 (see Section 4.3) and lease payments (see Section 4.4). Consequently, the FASB decided that lessees should update their assessments about those options — and therefore remeasure leases on 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 (see Section 5.7.1).

Also, to avoid lessees circumventing the balance sheet recognition of leases (such as by initially including only a nominal lease payment or variable payments that become fixed at a later date), 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).

Lastly, lessees must reassess amounts probable of being owed under residual value guarantees, which are part of the lease payments (see Section 4.4), to reflect current economic conditions.

Accordingly, ASC 842 requires lessees to remeasure the lease payments upon the occurrence of the events in the table and requires the accounting as shown (see Section 5.8 for lease modifications).

<table>
<tr><th>REMEASUREMENT EVENT</th><th>ACCOUNTING APPLICABLE TO ALL REMEASUREMENT EVENTS</th><th>UPDATE THE DISCOUNT RATE?</th><th>REASSESS LEASE CLASSIFICATION?</th></tr>
<tr><td>A change in the lease term or the assessment of whether the lessee is reasonably certain to exercise a purchase option (see Section 5.7.1)</td><td rowspan="3">▶ Remeasure the lease payments and consideration in the contract (see Sections 3.3.1 and 4.4)<br>▶ Reallocate the consideration to the lease and nonlease components (unless the practical expedient not to separate is elected) (see Sections 3.3.2 and 3.3.3)<br>▶ 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, recognize the remaining amount in profit or loss</td><td>Yes, unless the discount rate already reflects the lessee's option (see Section 4.6)*</td><td>Yes (see Section 4.9)**</td></tr>
<tr><td>A contingency upon which some or all of the variable lease payments are based is resolved such that those payments become fixed (see Section 5.7.2)</td><td>No</td><td>No</td></tr>
<tr><td>A change in the amount probable of being owed to the lessor under a residual value guarantee</td><td>No</td><td>No</td></tr>
</table>

* 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).

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 is met) (see Section 5.7.3).

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

**FASB REFERENCES**

ASC 842-10-35-1, ASC 842-10-55-28 through 55-29, and ASC 842-20-55-31 through 55-36

A lessee 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:

- A significant event or change in circumstances within the lessee's control directly affects whether the lessee is reasonably certain to exercise (or not exercise) an option
- An event written into the contract obliges the lessee to exercise (or not exercise) an option to extend or terminate the lease
- The lessee elects to exercise an option even though it had previously determined it was not reasonably certain to do so
- The lessee elects not to exercise an option even though it had previously determined it was reasonably certain to do so

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 for comparable assets, do not trigger a reassessment, and a requirement to test for impairment an asset group that includes the ROU asset does not necessarily result in a requirement to reassess the lease term or purchase options. Rather, the lessee should determine whether the impairment trigger represents a requirement to reassess the lease term or purchase option. For example, an asset group 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 a reassessment of the lease term or purchase options.

**BDO INSIGHT — BUSINESS DECISIONS AND RENEWAL OPTIONS**

Business decisions may affect key assumptions such as the lease term and the assessment 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 those 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 retailer's 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 entities to exercise renewal options that were not previously considered reasonably certain of exercise. Entities 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 might not trigger the reassessment requirements. The requirements for a lessee to remeasure the lease therefore requires an entity to implement robust processes and controls to completely and timely identify events requiring such remeasurements.

Example 5-11 illustrates the remeasurement requirements for a change in lease term.

**EXAMPLE 5-11: REASSESSMENT OF THE LEASE TERM — OPERATING LEASE**

**FACTS**

- Assume the same facts as in Examples 5-7 and 5-9, in which the lease of the retail space is an operating lease.
- Also:
  - 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 4.3) because payments in the renewal period are substantially the same as the amount otherwise due in the final year of the initial period, there is significant uncertainty as to whether Retailer will need the underlying asset after 10 years, and Retailer did not construct improvements with an economic life longer than the initial term. Therefore, at the commencement date, Retailer determined that the lease term was 10 years.
  - The discount rate for the lease of 6% at the commencement date does not reflect that Retailer has an option to extend the lease.
  - At the beginning of Year 6 of the lease, the financial performance of the retail space is higher than initially expected, and Retailer installs significant leasehold improvements. Retailer expects those improvements to have significant economic value for Retailer at the end of Year 10. Consequently, Retailer considers the construction of the leasehold improvements a significant event or change in circumstances that directly affects whether it is reasonably certain to exercise the extension option.
  - The carrying values of the ROU asset and lease liability immediately before the reassessment are $509,436 and $590,767, respectively.

**CONCLUSION AND ANALYSIS**

- 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 there are no nonlease components and there is only one lease component, there is no reallocation of the consideration necessary.
- Because the discount rate at commencement did not reflect Retailer having the extension option, Retailer updates the discount rate at the reassessment date. Based on the extended remaining lease term (15 years in total) and remaining lease payments, Retailer determines its incremental borrowing rate at the beginning of Year 6 is 8%.
- Retailer reassesses lease classification based on the fair value of the underlying asset and remaining economic life at the beginning of Year 6 and determines that the lease continues to be an operating lease.
- Retailer remeasures the lease liability using the revised lease payments and updated discount rate. That results in an updated lease liability of $1,243,959, or an increase of $653,192 ($1,243,959 - $590,767).
- Retailer recognizes the remeasurement of the lease liability as an adjustment to the ROU asset. Accordingly, the carrying value of the ROU asset immediately after the remeasurement is $1,162,628 ($509,436 + $653,192).
- Retailer updates the periodic lease cost for the remainder of the lease (15 years) as follows:

| | AMOUNTS |
|---|---|
| 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] | $ 2,123,894 |

| | | |
|---|---|---|
| Periodic lease cost [B] = [A] / 15 years | $ | 141,593 |

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

** Prior periodic lease cost of $124,779 times five years (see Example 5-9).

- Following remeasurement, Retailer recognizes a single lease expense of $141,593 each year for the remainder of the lease term (including the renewal period), assuming no impairment, modifications, or other reassessments.
- Lessee determines the ROU asset amortization based on 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 | Payments | Ending Balance | Beginning Balance | Amortization | Ending 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) | — |

**EXAMPLE 5-12: REASSESSMENT OF THE LEASE TERM — OPERATING LEASE**

**FACTS**

- Assume the same as in Example 5-11, except that at the beginning of Year 6, Retailer only refreshes the store. It spends $40,000 to repaint the interior of the store and reconfigure the floor space, including relocating the registers and some fixed display racks.

**CONCLUSION AND ANALYSIS**

- The above expenditures are not typically considered leasehold improvements but rather typical maintenance activities that must be expected in the life cycle of an asset. As such, in these specific facts and circumstances, the expenditures would not trigger a reassessment event and Retailer would expense the costs as incurred.

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

The accounting for a lease that is remeasured because of a change in the assessment of the lease term or a purchase option is essentially like the accounting for a new lease because the lessee reperforms all steps required for a new lease (for example, measure and allocate the consideration in the contract, determine the discount rate, and assess lease classification) (see Example 5-11).

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

**FASB REFERENCES**

ASC 842-10-35-4 and ASC 842-20-35-4

As discussed in section 5.7, the FASB decided that after the commencement date, a lessee should remeasure the lease payments only upon specific events, including the resolution of a contingency. Under that guidance, a lessee must remeasure the lease payments when a contingency on which some or all of the variable lease payments that will be paid over the remainder of the lease term are based is resolved such that the payments become fixed (and meet the definition of lease payments). For example, a lessee would remeasure the lease payments when an event occurs that results in variable lease payments that were linked to the performance or use of the underlying asset (such as payments based on sales of a retail store) becoming fixed payments for the remainder of the lease term. However, for variable lease payments that depend on an index or a rate (for example, variable lease payments based on CPI), subsequent changes in the index or rate do not represent the resolution of a contingency (see Section 5.7.3).

While a lessee remeasures the lease payments when a contingency on which some or all the variable lease payments are based is resolved, it does not reassess lease classification or update the discount rate for the lease.

See Section 4.4.4 for guidance and examples related to contingent lease incentives neither received nor receivable at the commencement date.

Example 5-13 illustrates the resolution of contingencies requirement.

**EXAMPLE 5-13: RESOLUTION OF A CONTINGENCY — OPERATING LEASE**

**FACTS**

- Assume the same facts as in Examples 5-7 and 5-9, in which the lease of the retail space is an operating lease.
- Also:
  - At lease inception, Retailer was selling only Product A and was in the process of developing Product B, a product that would complement the use of, and increase customer experience with, Product A.
  - In addition to the fixed annual payments described in Example 5-7, the contract requires Retailer to pay annually as additional rent an amount equal to 2% of its sales. However, upon its launch of Product B, Retailer will pay an additional annual payment of $20,000 for the remainder of the lease term instead of the 2% payment on sales.

- Retailer's sales in Years 1 and 2 are $350,000 and $500,000, respectively.
- At the beginning of Year 3, Retailer launches Product B in the market and starts selling it in the retail store.

**CONCLUSION AND ANALYSIS**

- The payment as a percentage of sales initially is a variable lease payment that does not depend on an index or rate. Therefore, Retailer recognizes it as a periodic variable lease expense, so it does not affect the measurement of the lease liability at the commencement date.
- Retailer recognizes variable lease expense of $7,000 (350,000 * 2%) and $10,000 (500,000 * 2%) in Years 1 and 2, respectively.
- At the beginning of Year 3 (when Retailer launches Product B and the contingency is resolved), Retailer remeasures the lease payments and discounts the revised lease payments using the original discount rate (see Section 5.7). Retailer recognizes the remeasurement amount as an adjustment to the ROU asset.
- At the beginning of Year 3, the carrying value of the lease liability and ROU asset are $805,114 and $750,556, respectively.
- Retailer remeasures the lease liability to $929,309 as shown in the table.

| | PAYMENTS | INTEREST (6%) | PRINCIPAL AMORTIZATION | ENDING BALANCE |
|---|---|---|---|---|
| **Year 3** | 130,250 | 55,759 | (74,491) | 854,818 |
| **Year 4** | 135,763 | 51,289 | (84,473) | 770,345 |
| **Year 5** | 141,551 | 46,221 | (95,330) | 675,015 |
| **Year 6** | 147,628 | 40,501 | (107,127) | 567,887 |
| **Year 7** | 154,010 | 34,073 | (119,936) | 447,951 |
| **Year 8** | 160,710 | 26,877 | (133,833) | 314,118 |
| **Year 9** | 167,746 | 18,847 | (148,898) | 165,220 |
| **Year 10** | 175,133 | 9,913 | (165,220) | — |
| **Undiscounted payments** | 1,212,789 | | | |
| **Present Value (6%)** | 929,309 | | | |

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

| | | | |
|---|---|---|---|
| Debit | ROU asset | $ 124,195 | |
| Credit | Lease liability | | $ 124,195 |

- The updated balance of the ROU asset is therefore $874,751 ($750,556 + $124,195).
- Because the lease liability was remeasured, Retailer updates the periodic lease cost for the remainder of the lease term (8 years) as shown in the table.

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

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

** Represents prior periodic lease cost of $124,779 times two years (see Example 5-9).

- Following remeasurement, Retailer recognizes a single lease expense of $144,779 each year for the remainder of the lease term assuming no impairment, modifications, or other reassessments.
- The accounting for the ROU asset after the remeasurement and throughout the remaining lease term (assuming no impairment, modifications, or other reassessments) can be determined as shown in the table.

| | BEGINNING BALANCE [A] | PERIODIC LEASE COST [B] | INTEREST (6%) [C] | ROU AMORTIZATION [D] = [B] + [C] | ENDING BALANCE [A] + [D] |
|---|---|---|---|---|---|
| Year 3 | 874,751 | (144,779) | 55,759 | (89,020) | 785,730 |
| Year 4 | 785,730 | (144,779) | 51,289 | (93,490) | 692,240 |
| Year 5 | 692,240 | (144,779) | 46,221 | (98,558) | 593,682 |
| Year 6 | 593,682 | (144,779) | 40,501 | (104,278) | 489,404 |
| Year 7 | 489,404 | (144,779) | 34,073 | (110,706) | 378,698 |
| Year 8 | 378,698 | (144,779) | 26,877 | (117,902) | 260,797 |
| Year 9 | 260,797 | (144,779) | 18,847 | (125,932) | 134,865 |
| Year 10 | 134,865 | (144,779) | 9,913 | (134,865) | — |

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

**FASB REFERENCES**

ASC 842-10-35-5 and ASC 842-10-55-226 through 55-231

As discussed in Section 4.4, 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, the amounts resulting from the difference between the index or rate at commencement and upon subsequent changes are recognized as variable lease payments. When the 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 at the remeasurement date. The FASB considered, but rejected, an approach in IFRS 16, *Leases*, in which the lessee remeasures the lease payments when there is a change in the cash flows (when the adjustment to the lease payments takes effect). The table summarizes the accounting for variable lease payments based on an index or rate under ASC 842.

| ACCOUNTING UNDER ASC 842 |
|---|
| ▶ Variable lease payments based on an index or rate are initially measured using the index or rate at the commencement date (see Section 4.4).<br>▶ Variable lease payments based on an index or rate are not subsequently remeasured. In other words, subsequent changes in the index or rate are recognized as variable lease payments, unless the lessee remeasures the lease payments for another reason (see Section 5.7).<br>▶ When lease payments are remeasured for another reason (for example, 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.<br>▶ A lessee updates the discount rate for the lease if the lease payments are remeasured because of:<br>• A modification not accounted for as a separate contract (see Section 5.8)<br>• A change in the lease term or the assessment of a purchase option (see Section 5.7.1). |

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

**EXAMPLE 5-14: CHANGES IN VARIABLE LEASE PAYMENTS THAT DEPEND ON AN INDEX OR RATE**

**FACTS**

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

**CONCLUSION AND ANALYSIS**

- The initial measurement of the lease liability after the first payment is $338,721 (present value of four payments of $100,000 due at the beginning of Years 2 to 5 discounted at $7%).
- The initial measurement of the ROU asset is $428,721 (amount of the lease liability of $338,721 plus the lease prepayment of $100,000 plus initial direct costs of $20,000 less lease incentives of $30,000).
- In Year 1, Retailer recognizes a single lease cost of $98,000. That is calculated as the total lease payments of $470,000 [$500,000 – $30,000 of lease incentives] plus initial direct costs of $20,000 for a total lease cost of $490,000 divided by the lease term of five years.
- If Retailer is not required to remeasure the lease liability for another reason, it does not make an adjustment to the lease liability for the increase in payments stemming from the increase in CPI at the end of each reporting period. That is because subsequent changes in CPI do not constitute the resolution of a contingency and are

accounted for as variable lease payments in the period incurred. In other words, the measurement of the lease liability continues to reflect annual lease payments of $100,000.

- For example, the Year 2 payment amount is $102,000. Even so, Retailer continues to recognize the $100,000 annual fixed payment as a reduction in the lease liability and a single lease cost of $98,000. Retailer recognizes the $2,000 incremental payment as a variable lease payment in profit or loss in Year 2. The lease liability is not remeasured.
- In its quantitative disclosures for Year 2, Retailer will disclose operating lease cost of $100,000 and variable lease cost of $2,000.

## 5.8 MODIFICATIONS

### 5.8.1 Determining Whether a Modification Is a Separate Contract

**FASB REFERENCES**

ASC 842-10-15-6, ASC 842-10-20: Lease Modification, ASC 842-10-25-8, ASC 842-10-55-17 through 55-18, ASC 842-10-55-160 through 161, and ASC 848

A lease modification is a change to a contract's terms and conditions that alters the scope of or consideration for a lease (for example, an amendment that adds or terminates the right to use an underlying asset 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 lessee and lessor approve the modification, which is the effective date of the modification under ASC 842.

**CAREFULLY EVALUATE EFFECTIVE DATE OF A LEASE MODIFICATION**

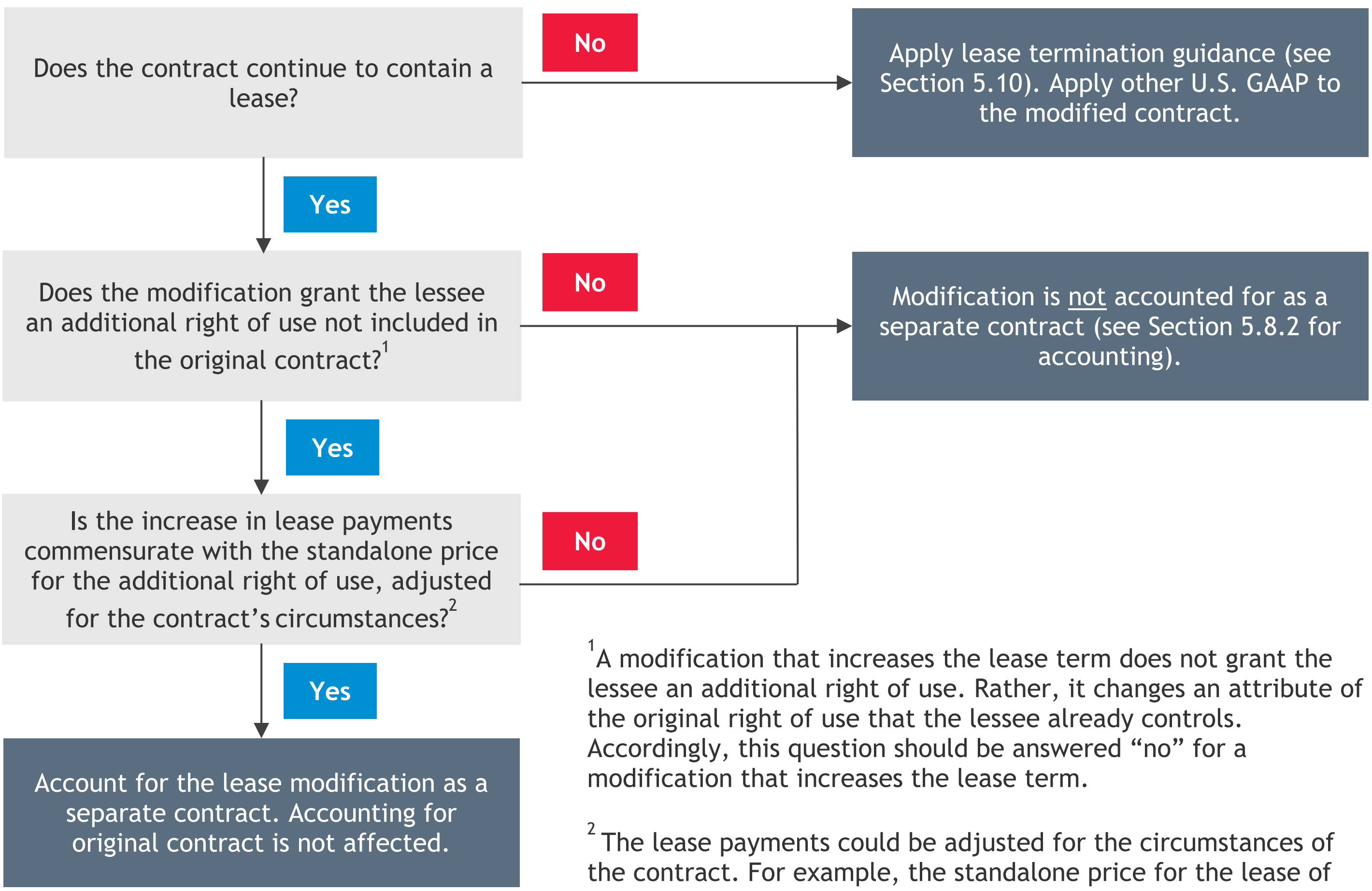
The date on which a lease modification is approved by both a lessee and lessor may not be the date on which the lease modification is executed by both parties. If there are legally enforceable rights and obligations before the parties sign the lease modification, the accounting date for the modification is the date on which such rights and obligations became **legally enforceable**. In other words, the modification need not be in writing. Oral and implied lease modifications may trigger lease modification accounting. For example, a lessee and lessor might orally agree to modify lease terms in December and formally execute the modification in January. If the oral agreement creates legally enforceable rights and obligations in December, the lessee must account for the lease modification in December. Similarly, if a lessor signs a lease amendment in December but for administrative or other reasons, the lessee signs the amendment in January, the effective date of the modification may still be December (if the lessor signing the amendment creates enforceable rights and obligations, such as when the changes benefit the lessee). Determining when rights and obligations become legally enforceable is based on the facts and circumstances and may require consultation with legal counsel.

## BDO INSIGHTS — WHETHER A CONTRACT MODIFICATION IS SUBSTANTIVE

An entity reassesses whether a contract is or contains a lease only if the contract's terms and conditions change. We believe changes to terms and conditions are generally presumed to be substantive, so the flowchart below applies. However, some changes to the terms of a lease may not be accounted as a modification under ASC 842. For example, a lease may be amended in a business combination to change only the name of the parties to the lease contract.

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 should be accounted for as part of the original contract.

That determination can be made by using the steps in the flowchart.




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

[2] The lease payments could be adjusted for the circumstances of the contract. For example, the standalone price for the lease of one floor of an office building in which the lessee already leases other floors 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.

### RELIEF IS PROVIDED FOR REFERENCE RATE REFORM

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

### 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. For example, an original lease agreement might give the customer (lessee) the right to purchase all power produced by a power plant, as well as decision-making rights related to the timing and amount of power produced by the plant. If the contract is modified to prospectively reduce the quantity of power the customer will purchase while allowing the lessor to determine the amount of power to generate, the parties must reassess whether the modified agreement continues to be a lease. That includes whether the customer continues to have the right to direct the use of the plant and obtain substantially all the economic benefits from use of the plant throughout the period of use.

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 5.10 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 3.6).

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.

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

Master lease agreements typically provide a lessee with the right to use multiple underlying assets. If a master lease agreement 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 could include separate lease components and multiple commencement dates (see Section 4.2). 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 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. That 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 following stakeholder feedback questioning the usefulness and costs of applying modification accounting to modifications reducing the scope of arrangements such as master lease agreements. However, it abandoned the project, so the guidance remains unchanged.

### BDO INSIGHTS — MODIFICATIONS RELATED TO VARIABLE LEASE PAYMENTS THAT ARE NOT BASED ON AN INDEX OR RATE

Variable lease payments, such as payments based on a percentage of the lessee's sales, that are not based on an index or rate 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 balance sheet. Even so, if the lessee and lessor modify the agreement to change such payments, such as by lowering the percentage applied to 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.

### 5.8.2 Accounting for Modifications That Are Not Separate Contracts

**FASB REFERENCES**

ASC 842-10-15-36 through 15-37, ASC 842-10-25-1, ASC 842-10-25-9 through 25-14, ASC 842-10-55-162 through 189, and ASC 842-20-35-4 through 35-5

If a modification is **not** accounted for as a separate contract (see Section 5.8.1), the lessee accounts for the modification at the modification's effective date as shown in the table.

<table>
<tr><th>MODIFICATION</th><th>GENERAL ACCOUNTING</th><th>ADDITIONAL GUIDANCE</th></tr>
<tr><td>Grants the lessee an additional ROU not included in the original contract and the lease payments are not commensurate with standalone price.</td><td rowspan="4">▶ Remeasure the lease payments and the consideration in the contract (see Sections 3.3.1 and 4.4).<br>▶ Reallocate the remaining consideration to the lease and nonlease components (unless the practical expedient not to separate is elected) (see Sections 3.3.2 and 3.3.3).<br>▶ Update the discount rate for the lease (see Section 4.6).<br>▶ Remeasure the lease liability.<br>▶ Reassess lease classification (see Section 4.9) and update the subsequent accounting for the lease accordingly.</td><td rowspan="3">▶ 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.<br>▶ 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).</td></tr>
<tr><td>Extends or reduces the term of an existing lease other than through exercise of an option in the original contract.</td></tr>
<tr><td>Changes only the consideration in the contract.</td></tr>
<tr><td>Fully or partially terminates an existing lease (for example, reduces the assets subject to the lease).</td><td>▶ 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.<br>▶ ASC 842 provides two acceptable methods for determining the proportional reduction in the ROU asset (see Example 5-19).</td></tr>
</table>

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

When a modification is not accounted for as a separate contract, the lessee remeasures the lease liability for the modified 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 entity in connection with a lease modification should be accounted for 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 above table 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 should apply 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 Section 5.8.1, 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 3.6).

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.

### 5.8.3 Application Examples — Modifications

Examples 5-15 through 5-20 illustrate examples on the accounting treatment for lease modifications. Examples 15 through 19 in ASC 842-10-55 provide additional scenarios.

**EXAMPLE 5-15: MODIFICATION IS ACCOUNTED FOR AS A SEPARATE LEASE**

**FACTS**

- Assume the same facts as in Examples 5-7 and 5-9, in which the lease of the retail space is an operating lease.
- Also:
  - At the end of Year 5 of the lease, Retailer and Lessor agree to modify the contract to include an additional 9,000 square feet of retail space in an adjacent building for the remaining five years of the original 10-year lease term. No costs are incurred with the modification.
  - Lessor makes the additional space available for use by Retailer at the beginning of Year 6.
  - The annual lease payments in Years 6-10 increase by $140,000, payable in arrears.
  - Retailer's incremental borrowing rate at the effective date of the modification is 7%.

**CONCLUSION AND ANALYSIS**

- Retailer notes that the modification grants it an additional right-of-use not included in the original contract. It also assesses the corresponding increase in lease payments and determines that the increase is commensurate with the market lease rate for similar space at the modification date. Retailer therefore accounts for the modification as a separate contract.
- Thus, the accounting for the original 10-year lease of 10,000 square feet is not affected by the modification (see Example 5-9 for the accounting).
- Retailer determines that the separate lease is an operating lease.
- The accounting for the lease liability for the new 9,000 square feet of retail space lease is:

| | PAYMENT | INTEREST (7%) | PRINCIPAL AMORTIZATION | ENDING BALANCE |
|---|---|---|---|---|
| **Year 1** | 140,000 | 40,182 | (99,818) | 474,210 |
| **Year 2** | 140,000 | 33,195 | (106,805) | 367,404 |
| **Year 3** | 140,000 | 25,718 | (114,282) | 253,123 |
| **Year 4** | 140,000 | 17,719 | (122,281) | 130,841 |
| **Year 5** | 140,000 | 9,159 | (130,841) | — |
| **Present Value (7%)** | **574,028** | | | |

- Retailer initially measures the ROU asset at the same amount as the lease liability of $574,028 (because there are no initial direct costs or lease incentives received for the additional ROU).
- Retailer accounts for the ROU asset, assuming no impairment and remeasurements, as:

| | BEGINNING BALANCE [A] | PERIODIC LEASE COST [B] | INTEREST (7%) [C] | AMORTIZATION [D] = [B] + [C] | ENDING BALANCE [A] + [D] |
|---|---|---|---|---|---|
| Year 1 | 574,028 | (140,000) | 40,182 | (99,818) | 474,210 |
| Year 2 | 474,210 | (140,000) | 33,195 | (106,805) | 367,404 |
| Year 3 | 367,404 | (140,000) | 25,718 | (114,282) | 253,123 |
| Year 4 | 253,123 | (140,000) | 17,719 | (122,281) | 130,841 |
| Year 5 | 130,841 | (140,000) | 9,159 | (130,841) | — |

**EXAMPLE 5-16: MODIFICATION IS NOT ACCOUNTED FOR AS A SEPARATE LEASE — LEASE CLASSIFICATION UNCHANGED**

**FACTS**

- Assume the same facts as in Examples 5-7 and 5-9, in which Retailer's lease of retail space is an operating lease.
- Also:
  - At the beginning of Year 6, Retailer and Lessor agree to extend the term of the lease by five years for fixed annual lease payments of $140,000.
  - At the beginning of Year 6, the carrying amount of the lease liability and ROU assets are $590,767 and $509,436, respectively.
  - Retailer's incremental borrowing rate at the effective date of the modification is 7%.

**CONCLUSION AND ANALYSIS**

- The modification does not grant Retailer an additional right of use. It merely changes an attribute of the original lease by extending the period of use for the original ROU asset. In other words, Retailer still controls only a single ROU it received at lease commencement.
- Therefore, Retailer cannot account for the modification as a separate contract.
- At the effective date of the modification, Retailer reassesses lease classification using the revised lease term and lease payments, remaining economic life, current fair value, and updated discount rate, and concludes that it continues to be an operating lease.
- Retailer remeasures the lease liability based on the remaining 10-year lease term and 10 remaining payments using its incremental borrowing rate at the modification date of 7%.

| | PAYMENT | INTEREST (7%) | PRINCIPAL AMORTIZATION | ENDING BALANCE |
|---|---|---|---|---|
| Year 6 | 127,628 | 68,865 | (58,763) | 925,022 |
| Year 7 | 134,010 | 64,752 | (69,258) | 855,764 |
| Year 8 | 140,710 | 59,903 | (80,807) | 774,957 |
| Year 9 | 147,746 | 54,247 | (93,499) | 681,458 |
| Year 10 | 155,133 | 47,702 | (107,431) | 574,028 |
| Year 11 | 140,000 | 40,182 | (99,818) | 474,210 |
| Year 12 | 140,000 | 33,195 | (106,805) | 367,404 |
| Year 13 | 140,000 | 25,718 | (114,282) | 253,123 |
| Year 14 | 140,000 | 17,719 | (122,281) | 130,841 |
| Year 15 | 140,000 | 9,159 | (130,841) | — |
| **Present Value (7%)** | **983,785** | | | |

- Consequently, the modified lease liability is $983,785 (or an increase of $393,017).
- Retailer recognizes the increase to the lease liability as an adjustment to the ROU asset (that is, there is no income or loss recognized at the modification date). The updated balance of the ROU asset is $902,453 ($509,436 + $393,017).
- Retailer updates the periodic lease cost for the remainder of the lease (10 years):

| | AMOUNTS |
|---|---|
| Total lease payments (paid and not yet paid)* | $ 1,927,789 |
| Plus initial direct costs | 20,000 |
| Less periodic lease cost recognized in prior periods** | (623,895) |
| Total remaining lease cost [A] | $ 1,323,894 |
| Periodic lease cost [B] = [A] / 10 years | $ 132,389 |

* This amount reflects the total revised lease payments. It includes those paid in Years 1 – 5 and the revised lease payments for the remaining lease term less the lease incentive received at commencement date of $30,000.

** Represents period lease cost of $124,779 for five years.

- Retailer recognizes annual straight-line lease expense of $132,389 for the remainder of the lease term.
- The table summarizes the accounting for the ROU asset after the remeasurement, assuming no impairment and remeasurements.

| | BEGINNING BALANCE [A] | PERIODIC LEASE COST [B] | INTEREST ON LEASE LIABILITY [C] | AMORTIZATION [D] = [B] + [C] | ENDING BALANCE [A] + [D] |
|---|---|---|---|---|---|
| **Year 6** | 902,453 | (132,389) | 68,865 | (63,525) | 838,929 |
| **Year 7** | 838,929 | (132,389) | 64,752 | (67,638) | 771,291 |
| **Year 8** | 771,291 | (132,389) | 59,903 | (72,486) | 698,805 |
| **Year 9** | 698,805 | (132,389) | 54,247 | (78,142) | 620,662 |
| **Year 10** | 620,662 | (132,389) | 47,702 | (84,687) | 535,975 |
| **Year 11** | 535,975 | (132,389) | 40,182 | (92,208) | 443,767 |
| **Year 12** | 443,767 | (132,389) | 33,195 | (99,195) | 344,573 |
| **Year 13** | 344,573 | (132,389) | 25,718 | (106,671) | 237,901 |
| **Year 14** | 237,901 | (132,389) | 17,719 | (114,671) | 123,231 |
| **Year 15** | 123,231 | (132,389) | 9,159 | (123,231) | — |

### EXAMPLE 5-17: MODIFICATION NOT ACCOUNTED FOR AS A SEPARATE LEASE — LEASE CLASSIFICATION CHANGES FROM OPERATING TO FINANCE

#### FACTS

- Assume the same facts as in Example 5-16, except that at the modification's effective date, Retailer concludes the lease classification changes from operating to finance.

#### CONCLUSION AND ANALYSIS

- The assessment of the modification is the same as in Example 5-16, so Retailer cannot account for the modification as a separate contract.
- The remeasurement of the lease liability and adjustment to the ROU asset is the same as in Example 5-16. In other words, after the remeasurement, the carrying value of the lease liability and ROU asset are $983,785 and $902,453, respectively.
- Unlike Example 5-16, Retailer does not calculate the updated straight-line lease cost. Instead, as of the effective date of the lease modification, the ROU asset is amortized on a straight-line basis to the earlier of the end of its useful life or lease term. 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.

### EXAMPLE 5-18: MODIFICATION IS NOT ACCOUNTED FOR AS A SEPARATE LEASE — LEASE CLASSIFICATION CHANGES FROM FINANCE TO OPERATING

#### FACTS

- Assume the same facts as in Examples 5-7 and 5-8, in which Retailer's lease of manufacturing equipment was a finance lease.
- Also:
  - At the beginning of Year 6, Retailer and Lessor agree to modify the lease to reduce the remaining lease term by two years and revise the annual lease payments to $130,000 for the remaining three years of the lease.
  - At the beginning of Year 6, the carrying amount of the lease liability and ROU assets are $590,767 and $447,169 (894,337 * [5/10]), respectively.
  - Retailer's incremental borrowing rate at the effective date of the modification is 7%.

#### CONCLUSION AND ANALYSIS

- The modification reduces the lease term, which is an attribute of the lease. Therefore, Retailer cannot account for the modification as a separate contract.
- Retailer remeasures the lease liability using the remaining three-year lease term, three remaining payments and its incremental borrowing rate at the modification date of 7%.

| | PAYMENT | INTEREST (7%) | PRINCIPAL AMORTIZATION | ENDING BALANCE |
|---|---|---|---|---|
| **Year 6** | 130,000 | 23,881 | (106,119) | 235,042 |
| **Year 7** | 130,000 | 16,453 | (113,547) | 121,495 |
| **Year 8** | 130,000 | 8,505 | (121,495) | — |
| **Present Value (7%)** | **341,161** | | | |

- Consequently, the remeasured lease liability is $341,161 (or a decrease of $249,606).
- Retailer recognizes the decrease in lease liability as an adjustment to the ROU asset (that is, there is no income or loss recognized at the modification date). The ROU asset's updated balance is $197,562.
- Retailer accounts for the lease at the modification date as an operating lease because, for example, the revised lease term is not for the major part of the remaining economic life of the underlying asset (3/7= 42.86%). Accordingly, Retailer will recognize a single lease cost over the remaining lease term (three years).
- Further, in accordance with ASC 842-10-25-14, Retailer accounts for the difference between the ROU asset's updated carrying amount and the carrying amount that would result from applying the initial measurement guidance for operating ROU assets as either a rent prepayment or lease incentive. Retailer calculates that amount as:

| | AMOUNTS |
|---|---|
| Updated ROU asset carrying amount | $ 197,562 |
| ROU operating lease carrying amount* | 341,161 |
| Rent prepayment (lease incentive) | $ (143,599) |

* This amount represents the amount of the lease liability after remeasurement. There are no initial direct costs or lease incentives for the modification, so there are no further adjustments under ASC 842-20-30-5.

- Next, Retailer calculates the remaining cost for the lease as:

| | AMOUNTS* |
|---|---|
| Sum of remaining lease payments** | $ 390,000 |
| Less lease incentive adjustment from above | (143,599) |
| Total remaining lease cost [A] | $ 246,401 |
| Periodic lease cost [B] = [A] / 3 years | $ 82,134 |

* Based on application of ASC 842-10-25-14. Alternatively, Retailer could determine the remaining lease cost by applying ASC 842-20-25-8. In doing so, the lease incentive of $143,599 calculated above would not be included under ASC 842-20-25-8(a) (it relates only to the application of the method described in ASC 842-10-25-14), and the periodic lease cost previously recognized under ASC 842-20-25-8(c) would be determined as the sum of periodic interest and amortization of the ROU asset. See Section 5.6.2.3 for another method to determine the remaining lease cost based on the ROU asset carrying amount and remaining interest accretion. Regardless of the approach selected, the total remaining lease cost should be the same.

** This amount reflects the remaining (modified) lease payments ($130,000 * 3 years).

- Retailer recognizes annual straight-line lease expense of $82,134 for the remainder of the lease term.
- The table summarizes the accounting for the ROU asset after remeasurement.

| | BEGINNING BALANCE [A] | PERIODIC LEASE COST [B] | INTEREST ON LEASE LIABILITY [C] | AMORTIZATION [D] = [B] + [C] | ENDING BALANCE [A] + [D] |
|---|---|---|---|---|---|
| **Year 6** | 197,562 | (82,134) | 23,881 | (58,253) | 139,310 |
| **Year 7** | 139,310 | (82,134) | 16,453 | (65,681) | 73,629 |
| **Year 8** | 73,629 | (82,134) | 8,505 | (73,629) | — |

**EXAMPLE 5-19: MODIFICATION NOT ACCOUNTED AS A SEPARATE LEASE — PARTIAL TERMINATION**

**FACTS**

- Assume the same facts as in Examples 5-7 and 5-9, in which the lease is an operating lease.
- Also:
  - At the beginning of Year 6 of the lease, Retailer and Lessor agree to modify the original lease for the remaining five years to immediately reduce the leased retail space to only 5,000 square feet. Also, the annual lease payments in Years 6-10 decrease to $65,000.
  - At the beginning of Year 6, the carrying amount of the lease liability and ROU assets are $590,767 and $509,436, respectively.
  - Retailer's incremental borrowing rate at the effective date of the modification is 7%.

**CONCLUSION AND ANALYSIS**

- Retailer concludes that it cannot account for the modification as a separate contract because the modification does not grant it an additional right of use. Rather, the modification decreases the original scope of the lease (from 10,000 square feet to 5,000 square feet).
- At the effective date of the modification, Retailer reassesses lease classification and concludes that the lease continues to be an operating lease.
- Retailer remeasures the lease liability based on the remaining five-year lease term and discounts the remaining payments using its incremental borrowing rate at that date.

| | PAYMENT | INTEREST (7%) | PRINCIPAL AMORTIZATION | ENDING BALANCE |
|---|---|---|---|---|
| **Year 6** | 65,000 | 18,656 | (46,344) | 220,169 |
| **Year 7** | 65,000 | 15,412 | (49,588) | 170,581 |
| **Year 8** | 65,000 | 11,941 | (53,059) | 117,521 |
| **Year 9** | 65,000 | 8,226 | (56,774) | 60,748 |
| **Year 10** | 65,000 | 4,252 | (60,748) | — |
| **Present Value (7%)** | **266,513** | | | |

- The carrying amount of the ROU asset is determined using either of the approaches below.

| METHOD A— REMEASURING THE ROU ASSET BASED ON THE CHANGE IN LEASE LIABILITY | | | METHOD B — REMEASURING THE ROU ASSET BASED ON THE REMAINING ROU | | |
|---|---|---|---|---|---|
| Lease liability after modification | | 266,513 | Reduction in ROU (5,000)/10,000 | | (50)% |
| Lease liability before modification | | (590,767) | Premodification ROU asset | | 509,436 |
| Remeasurement adjustment | | (324,254) | Percentage of change in ROU | | (50)% |
| Percentage change in liability | | (54.89)% | Reduction to ROU asset | | (254,718) |
| Premodification ROU asset | | 509,436 | Pre-modification lease liability | | 590,767 |
| Percentage of change in liability | | (54.89)% | Percentage of change in ROU | | (50)% |
| Reduction ROU asset | | (279,614) | Reduction to lease liability | | (295,384) |
| | $ | $ | | $ | $ |
| Lease liability | 324,254 | | Lease liability | 295,384 | |
| Other income/gain | | 44,640 | Other income/gain | | 40,666 |
| ROU asset | | 279,614 | ROU asset | | 254,718 |
| | | | The difference between the remeasurement of the lease liability of $266,513 (reflecting the revised lease payments and updated discount rate) and the remaining lease liability of $295,383 ($590,767 – $295,384) after the above journal entry is recognized as an adjustment to the ROU asset: | | |
| | | | | $ | $ |
| | | | Lease liability | 28,870 | |
| | | | ROU asset | | 28,870 |
| The updated balance of the lease liability and ROU asset after the above journal entry are $266,513 and $229,822, respectively. | | | The updated balance of the lease liability and ROU asset after the above journal entries are $266,513 and $225,848, respectively. | | |

- Retailer then updates the periodic lease cost for the remainder of the lease (10 years):

If Method A (change in lease liability) is used:

| | AMOUNTS |
|---|---|
| Total lease payments (paid and not yet paid)* | $ 560,744 |
| Plus initial direct costs** | 9,023 |
| Less periodic lease cost recognized in prior periods*** | (281,458) |
| Total remaining lease cost [A] | $ 288,309 |
| Periodic lease cost [B] = [A] / 5 years | $ 57,662 |

* This amount reflects the total revised lease payments. It includes the relative portion (45.11% reduction in ROU (100% - 54.89%)) after remeasurement of the payments paid in Years 1-5 ($249,278 ($552,563 * 45.11%)) plus the revised lease payments for the remaining lease term ($325,000) less the relative balance of the lease incentive received at commencement date ($13,534 ($30,000 * 45.11%)).

** Represents the relative portion of the initial direct costs after remeasurement ($20,000 * 45.11%)

*** Represents the relative portion of the periodic lease cost recognized in Years 1-5 ($124,779 * 45.11% * 5).

| | BEGINNING BALANCE [A] | PERIODIC LEASE COST [B] | INTEREST ON LEASE LIABILITY [C] | ROU AMORTIZATION [D] = [B] + [C] | ENDING BALANCE [A] + [D] |
|---|---|---|---|---|---|
| Year 6 | 229,822 | (57,662) | 18,656 | (39,006) | 190,816 |
| Year 7 | 190,816 | (57,662) | 15,412 | (42,250) | 148,566 |
| Year 8 | 148,566 | (57,662) | 11,941 | (45,721) | 102,845 |
| Year 9 | 102,845 | (57,662) | 8,226 | (49,435) | 53,410 |
| Year 10 | 53,410 | (57,662) | 4,252 | (53,410) | — |
| | | | 58,487 | | |

**Note:** As discussed in Section 5.6.2.3, Retailer could also have determined the remaining lease cost based on the updated ROU asset of $229,822 plus the sum of periodic interest accretion in Years 6-10 of $58,487 (per above table), which equals $288,309, or an annual lease cost of $57,662. That could be used as an independent recalculation of the remaining lease cost for accuracy purposes.

If Method B (Percentage of the remaining ROU) is used:

| | AMOUNTS |
|---|---|
| Total lease payments (paid and not yet paid)* | $ 586,282 |
| Plus initial direct costs** | 10,000 |
| Less periodic lease cost recognized in prior periods*** | (311,947) |
| Total remaining lease cost [A] | $ 284,335 |
| Periodic lease cost [B] = [A] / 5 years | $ 56,867 |

* This amount reflects the total revised lease payments. It includes the relative portion (50% reduction in ROU (100% - 50%)) after remeasurement of the payments paid in Years 1-5 ($276,282 ($552,563 * 50%)) plus the revised lease payments for the remaining lease term ($325,000) less the relative balance of the lease incentive received at commencement date ($15,000 (($30,000 * 50%)).

** Represents the relative portion of the initial direct costs after remeasurement ($20,000 * 50%).

*** Represents the relative portion of the periodic lease cost recognized in Years 1-5 ($124,779 * 50% * 5).

| | BEGINNING BALANCE [A] | PERIODIC LEASE COST [B] | INTEREST ON LEASE LIABILITY [C] | ROU AMORTIZATION [D] = [B] + [C] | ENDING BALANCE [A] + [D] |
|---|---|---|---|---|---|
| Year 6 | 225,848 | (56,867) | 18,656 | (38,211) | 187,637 |
| Year 7 | 187,637 | (56,867) | 15,412 | (41,455) | 146,182 |
| Year 8 | 146,182 | (56,867) | 11,941 | (44,926) | 101,255 |
| Year 9 | 101,255 | (56,867) | 8,226 | (48,640) | 52,615 |
| Year 10 | 52,615 | (56,867) | 4,252 | (52,615) | — |
| | | | 58,487 | | |

**Note:** Retailer could also have determined the remaining lease cost based on the updated ROU asset of $225,848 plus the sum of periodic interest accretion in Years 6-10 of $58,487 (per above table), which equals $284,335, or an annual lease cost of $56,867. That could be used as an independent recalculation of the remaining lease cost for accuracy purposes.

**PROPORTIONATE REDUCTION IN ROU ASSET MAY BE CALCULATED USING TWO APPROACHES**

Example 18 in ASC 842-10-55-177 through 55-185 provides two different methodologies for determining the proportionate reduction in the ROU asset in a partial termination and for calculating the gain or loss on partial termination. Example 5-19 in this Blueprint illustrates that accounting. The FASB noted in paragraph BC177 of ASU 2016-02 that both approaches are acceptable. We believe an entity must consistently apply an approach to lease modifications with similar characteristics and in similar circumstances.

**EXAMPLE 5-20: MODIFICATION NOT ACCOUNTED AS A SEPARATE LEASE — PARTIAL TERMINATION AND EXTENSION OF THE LEASE TERM**

**FACTS**

- Assume the same facts as in Examples 5-7 and 5-9, in which the lease of the retail space is an operating lease.
- Also:
  - At the beginning of Year 6 of the lease, Retailer and Lessor agree to modify the original lease such that the space Retailer uses is reduced from 10,000 square feet to 5,000 square feet effective at the modification date, the term is extended by three years, and lease payments are reset to $68,000 annually with a 5% annual increase for the remainder of the revised term.
  - At the beginning of Year 6, the carrying amount of the lease liability and ROU asset are $590,767 and $509,436, respectively.
  - Retailer's incremental borrowing rate at the effective date of the modification is 7%.

**CONCLUSION AND ANALYSIS**

- Retailer concludes that the modification cannot be accounted for as a separate contract because it does not grant Retailer an additional right of use but rather decreases the original scope of the lease (from 10,000 square feet to 5,000 square feet) and extends the lease term for the remaining ROU (an attribute of the original lease).
- Retailer must account for the partial termination and extension of the term considering the change in lease payments. To do so, Retailer can first account for the partial termination (in the same manner as in Example 5-19) and then account for the term extension.
- Retailer applies Method B described in Example 5-19 (remeasuring the ROU asset based on the remaining right of use).
- Regardless of the method used to account for the reduction in the ROU asset, the remeasured lease liability after accounting for the partial termination and term extension is the same. It is based on the remaining lease term and payments discounted using Retailer's incremental borrowing rate at the modification date.

| | PAYMENTS | INTEREST (7%) | PRINCIPAL AMORTIZATION | ENDING BALANCE |
|---|---|---|---|---|
| Year 6 | 68,000 | 33,346 | (34,654) | 441,711 |
| Year 7 | 71,400 | 30,920 | (40,480) | 401,231 |
| Year 8 | 74,970 | 28,086 | (46,884) | 354,347 |
| Year 9 | 78,719 | 24,804 | (53,914) | 300,433 |
| Year 10 | 82,654 | 21,030 | (61,624) | 238,809 |
| Year 11 | 86,787 | 16,717 | (70,071) | 168,738 |
| Year 12 | 91,127 | 11,812 | (79,315) | 89,423 |
| Year 13 | 95,683 | 6,260 | (89,423) | — |
| **Present Value (7%)** | **476,365** | | | |

- Retailer applies the following steps to account for the partial termination and term extension:

**Worksheet for partial termination accounting:**

| | AMOUNTS |
|---|---|
| Reduction in ROU (5,000)/10,000= | (50)% |
| Premodification ROU asset | 509,436 |
| Percentage change in ROU | (50)% |
| Reduction to ROU asset | (254,718) |

| | AMOUNTS |
|---|---|
| Premodification lease liability | 590,767 |
| Percentage change in ROU | (50)% |
| Reduction to lease liability | (295,384) |

Journal entry for the partial termination:

| | | | | | |
|---|---|---|---|---|---|
| Debit | Lease liability | $ | 295,384 | | |
| Credit | Other income/gain | | | $ | 40,666 |
| Credit | ROU Asset | | | | 254,718 |

**Worksheet for term extension accounting:**

| | AMOUNTS | |
|---|---|---|
| Lease liability before modification | $ 590,767 | |
| Partial termination adjustment (journal entry above) | (295,384) | |
| Lease liability balance after partial termination | 295,383 | [A] |
| Remeasured lease liability amount (see table above) | 476,365 | [B] |
| Remaining adjustment [B] - [A] | $ 180,982 | |

- The difference between the remeasured lease liability of $476,365 and the lease liability balance after the partial termination entry of $295,383 is recognized as an adjustment to the ROU asset:

| | | | | | |
|---|---|---|---|---|---|
| Debit | ROU asset | $ | 180,982 | | |
| Credit | Lease liability | | | $ | 180,982 |

- Following the above entries, the carrying amounts of the lease liability and ROU asset are $476,365 and $435,700, respectively. Retailer will then update the periodic lease cost using a method consistent with those discussed in Example 5-19 and update the accounting for the ROU asset prospectively.

# 5.9 IMPAIRMENT

## 5.9.1 General Considerations — Interaction With ASC 360

**FASB REFERENCES**

ASC 360-10-15-4, ASC 360-10-35, ASC 842-20-35-9

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, a lessee must monitor ROU assets for impairment like other long-lived nonfinancial assets, regardless of whether the lease is an operating or finance lease.

An entity performs the impairment assessment at the asset group level, which is the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities.

An asset group is tested for impairment when events or changes in circumstances indicate that the asset group may not be recoverable and include the factors in the table.

| | | |
|---|---|---|
| A significant decrease in the market price of a long-lived asset (asset group) | A significant adverse change in the physical condition of a long-lived asset (asset group) or the extent or manner in which the asset is being used | A significant adverse change in legal factors or the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator |
| An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group) | A current period operating or cashflow loss combined with a history of operating or cashflow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group) | A current expectation that a long-lived asset (asset group) will more likely than not be sold or otherwise disposed of significantly before the end of its previously estimated useful life (the term “more likely than not" refers to a level of likelihood that is more than 50%) |

When impairment indicators exist, an asset (asset group) should be tested to determine whether there is an impairment. The impairment test is a two-step process:

**Step 1: Determine if the asset group is recoverable**. An entity 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 entity moves to Step 2.

**Step 2: Determine the impairment loss**. An entity 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. However, individual long-lived assets cannot be written down below their individual fair values whenever that fair value is determinable without undue cost and effort.

The impairment model is not new, but the recognition of ROU assets associated with operating leases has resulted in questions about the application of ASC 360.

For finance leases, consistent with legacy U.S. GAAP, 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. However, for operating leases, the guidance is less clear and there are other practice issues (see Section 5.9.2).

Further, a lessee may decide to stop using the leased asset in its operations before the end of the lease term or plan to sublease it for some or all the remaining lease term. These may be necessary business decisions, but they will result in additional accounting questions to address, as discussed in Section 5.9.3.

Lastly, ASC 360 provides guidance on accounting for long-lived assets that are considered held for sale, which applies to ROU assets (see Section 5.9.4).

## 5.9.2 Impairment Considerations for Operating Leases

As discussed above, practice issues associated with operating lease ROU assets arise when applying the guidance in ASC 360.

### 5.9.2.1 Testing Operating Lease ROU Assets for Impairment

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 approaches shown in the table are acceptable.

| | 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 above | 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.

We believe the above approaches are acceptable because:

- For Approach A, the operating lease liability is akin to a financial liability and is measured the same way as finance lease liabilities. Therefore, the approach under ASC 360 must be the same whether the lease is an operating lease or a finance lease.
- For Approach B, as an operating lease, the related liability may be viewed as an operating liability rather than debt (see paragraph BC14 of ASU 2016-02). Therefore, like other operating liabilities, the operating lease liability is included in determining the carrying amount of the asset group. However, the lease payments must exclude the portion related to interest accretion on the lease liability because it relates to capitalization or financing of the entity, not its operations.
- Approach C is consistent with Approach B, except that the lease payments included in the undiscounted cash flows are the total operating lease payments, which is appropriate because the operating lease cost is recognized as a single lease cost.

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

#### 5.9.2.2 Accounting for Operating Leases Once Impaired

**FASB REFERENCES**

ASC 842-20-25-7, ASC 842-20-35-10, and ASC 842-20-55-47 through 55-51

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, that means the updated single lease cost following an impairment is calculated as the sum of:

- Amortization of the remaining balance of the ROU asset after impairment, generally on a straight-line basis (unless another systematic basis is more representative of the pattern in which the lessee expects to consume the remaining economic benefits)
- 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, paragraph 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 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 Sections 5.7 and 5.8, 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, the lessee still 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.

#### 5.9.2.3 Operating Lease ROU Assets That Are Not Impaired (Estimated Useful Life Considerations)

**FASB REFERENCES**

ASC 360-10-35-22

Even if an ROU asset is not impaired, a lessee should consider whether to revise (shorten) the asset's estimated useful life. That applies to finance lease and operating lease ROU assets. However, additional practice issues arise for operating leases, including the pattern of single lease cost to recognize in the income statement after an ROU asset's useful life has been shortened. As excerpted below, the SEC 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 5.9.3).

**SEC STAFF GUIDANCES**

Remarks before the 2020 AICPA Conference on Current SEC and PCAOB Developments

Geoff Griffin, Professional Accounting Fellow, Office of the Chief Accountant

December 7, 2020

**Right-of-use asset guidance**

The second topic I would like to discuss today relates to the accounting for abandonment of right-of-use assets under the leases standard.

Consider a fact pattern where the registrant identified leases for abandonment, but expected there to be an extended period of time between the identification of abandonment and the actual abandonment date. The registrant noted that the leases standard requires a lessee to recognize any impairment loss for a right-of-use asset in accordance with existing guidance on impairment or disposal of long-lived assets;[9] however, upon performing an impairment assessment of the asset group, the registrant concluded there was no impairment. In this fact pattern, the registrant's identification of specific leases for abandonment did not result in a change to the asset group (i.e., the lowest level of identifiable cash flows) for which it assessed impairment.

The registrant noted that the leases standard did not provide explicit guidance to address its unique circumstances. The registrant identified a number of alternatives that it believed could be acceptable but ultimately concluded that it would be appropriate to adjust the amortization period of the right of use assets associated with the leases identified for abandonment. Given its plans to abandon these leases, and in the absence of any impairment, the registrant re-evaluated the economic life of the associated right-of-use assets and determined that the remaining right-of-use assets should be amortized ratably over the period between identification of abandonment and the actual abandonment date.

The staff did not object to the registrant's conclusion.

[9] See ASC 842-20-35-9.

**BDO INSIGHTS — OPERATING LEASE ROU ASSET NOT IMPAIRED BUT ESTIMATED USEFUL LIFE 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 that occurs, the link for an operating lease 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 5.9.2.2).

### 5.9.2.4 Application Example — Impairment of Operating Lease ROU Asset

Example 5-21 illustrates application of the impairment guidance in ASC 360 to an operating lease.

**EXAMPLE 5-21: IMPAIRMENT OF ROU ASSET — OPERATING LEASE**

**FACTS**

- Assume the same facts as in Examples 5-7 and 5-9 apply, in which the lease of retail space is an operating lease.
- Also:
  - 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 5.9.2.1). 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.

**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<br>The asset group is considered not recoverable because the carrying value of the asset group 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 here are the operating lease ROU asset and 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:

| | | | | |
|---|---|---|---|---|
| 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
  - 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 ENDING 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) |

### 5.9.3 Abandonments and Subleases

**FASB REFERENCES**

ASC 360-10-35, ASC 420-10, and ASC 842-10-15-28

As described in the sections above, ASC 842 requires an entity 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, an entity may consider subleasing or abandoning either the entire 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, as discussed below.

| CONSIDERATIONS | GUIDANCE |
|---|---|
| **Did the entity appropriately identify its lease components (the unit of account under ASC 842)?** | A lessee may have initially assumed at commencement that the rights to use multiple underlying assets represented a single lease component under ASC 842 (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. |
| **Does it affect asset groupings for impairment testing purposes?** | ASC 360 requires an entity to group assets at the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. Judgment is generally required in determining asset groupings, although entering 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. Professional judgment may be required based on facts and circumstances. |
| Is the entity required to test the asset group for impairment? | Subleasing an 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.<br><br>Also, deciding to abandon an ROU asset may 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 depends on how significant the asset to be abandoned is to the asset group and requires the use of professional judgment. |

| | |
|---|---|
| **Should the entity revise the useful life of some of the long-lived assets, including the leased asset?** | When a long-lived asset is tested for recoverability, it also might be necessary to review depreciation estimates and methods as required by ASC 250. 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.<br><br>Further, if an entity 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.<br><br>See also ASC 360-10-S99-2 (SAB Topic 5.CC, *Impairments*) for an example related to a mainframe computer to be abandoned for additional considerations, including timing of revision of estimated useful lives, and Section 5.9.2.3 for an SEC staff speech on this topic. |
| **Should the entity record additional liabilities, such as exit or disposal cost obligations, under ASC 420, *Exit or Disposal Cost Obligations*?** | While charges that are considered lease payments (whether fixed or variable) are excluded from the guidance in ASC 420 on exit or disposal cost obligations, if the lease contract includes nonlease components and the lessee separately accounts for the lease and nonlease components, the lessee should, on the cease-use date of an underlying asset subject to a lease, accrue the portion of fixed payments and estimated variable payments allocated to the nonlease components. Accordingly, a lessee's accounting for a cease-use depends on whether it elected the practical expedient not to separate (see Section 3.3.2):<br>▶ **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.<br>▶ **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, CAM) at the cease-use date. |

### 5.9.4 ROU Asset Included in a Disposal Group That Is Held for Sale

**FASB REFERENCES**

ASC 360-10-15-4, ASC 360-10-35-43 through 35-45, ASC 360-10-45-5 through 45-12, and ASC 360-10-55-43

The guidance in ASC 360 on determining whether a long-lived asset (disposal group) is held for sale and consequent accounting applies to an ROU asset. ASC 360 requires a long-lived asset (disposal group) to be classified as held for sale when specific criteria are met. If a disposal group includes any ROU assets and meets the criteria to be classified as held for sale, the ROU assets will similarly be classified as held for sale. However, the following situations do not result in held for sale classification:

- A commercial leasing and finance entity is holding for sale or lease equipment that has recently come off-lease and the entity has not yet determined the ultimate form of a future transaction (that is, a sale or lease).
- An entity commits to a plan to sell and lease back an asset that is in use, and the transfer of the asset will not be accounted for as a sale and leaseback transaction because the buyer-lessor does not obtain control of the asset (see Section 7.2).

When (and as long as) the criteria for held for sale classification are met, an entity should not depreciate (or amortize) a long-lived asset but should continue to accrue interest and other expenses on the liabilities of the disposal group.

**BDO INSIGHTS — ACCOUNTING FOR LEASES WHILE CLASSIFIED AS HELD FOR SALE**

We believe it is acceptable for a lessee to stop amortizing an ROU asset while classified as held for sale, regardless of lease classification (as operating or finance), and to continue to recognize interest expense (for a finance lease) and lease cost accretion associated with the lease liability (for an operating lease). For an operating lease, this approach means that recognition of lease cost will no longer be on a straight-line basis. However, because a lessee recognizes a single lease cost for operating leases rather than depreciation or amortization and interest expense, other approaches may be acceptable for operating leases when applying ASC 360-10-35-43.

If circumstances change and a disposal group is reclassified as held and used, an ROU asset is reclassified and measured at the lower of:

- Its carrying amount before it was classified as held for sale adjusted for any amortization that would have been recognized had the ROU asset been continuously classified as held and used
- Its fair value at the date of the subsequent decision not to sell.

Such adjustment is reported in income from continuing operations in the same income statement caption as losses on sales of long-lived assets (disposal groups).

## 5.10 DERECOGNITION

**FASB REFERENCES**

ASC 405-20-40-2, ASC 805-20-30-1, and ASC 842-20-40-1 through 40-3

ASC 842 provides specific derecognition requirements for the events in the table.

| EVENTS | ACCOUNTING |
|---|---|
| Lease termination before expiration of lease term | ▶ Derecognize ROU asset and lease liability.<br>▶ Recognize any difference in profit or loss. |
| Purchase of the underlying asset | ▶ 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.<br>• 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).<br>▶ This accounting does not apply for underlying assets acquired in a business combination, which are initially measured at fair value under ASC 805. |

| EVENTS | ACCOUNTING |
|---|---|
| Sublease in which the original lessee is relieved of primary obligation under the original lease | ▶ Derecognize ROU asset and lease liability.<br>▶ Recognize any difference in profit or loss.<br>▶ 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.<br>▶ If the original lessee is secondarily liable, it recognizes a guarantee obligation in accordance with ASC 405-20. |

# CHAPTER 6 — ACCOUNTING FOR LEASES — LESSORS

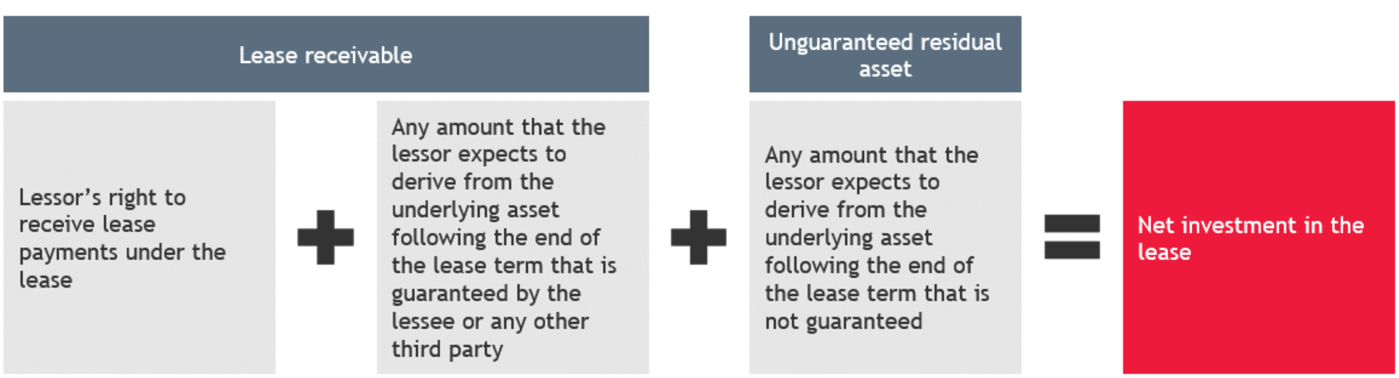

## 6.1 OVERVIEW

The accounting for leases by lessors varies depending on lease classification. As discussed in Section 4.9, a lessor may classify a lease as either a sales-type, direct financing, or operating lease.

Because leasing is fundamentally a revenue-generating activity for lessors, key aspects of lessor accounting are aligned with ASC 606. For example, under ASC 842, a lessor recognizes selling profit (or sales revenue) at lease commencement **only** if the lease transfers control of the underlying asset to the lessee, such as with a sale of an asset under ASC 606. That is consistent with the principle of transfer of control in ASC 606 in which a customer (in this case, the lessee) has the ability to direct the use of and obtain substantially all the remaining benefits from the underlying asset. Under ASC 842, that occurs when the lease is a sales-type lease, and because control of the underlying asset has transferred to the lessee, a lessor derecognizes the underlying asset at the commencement date and recognizes a net investment in the lease that comprises:

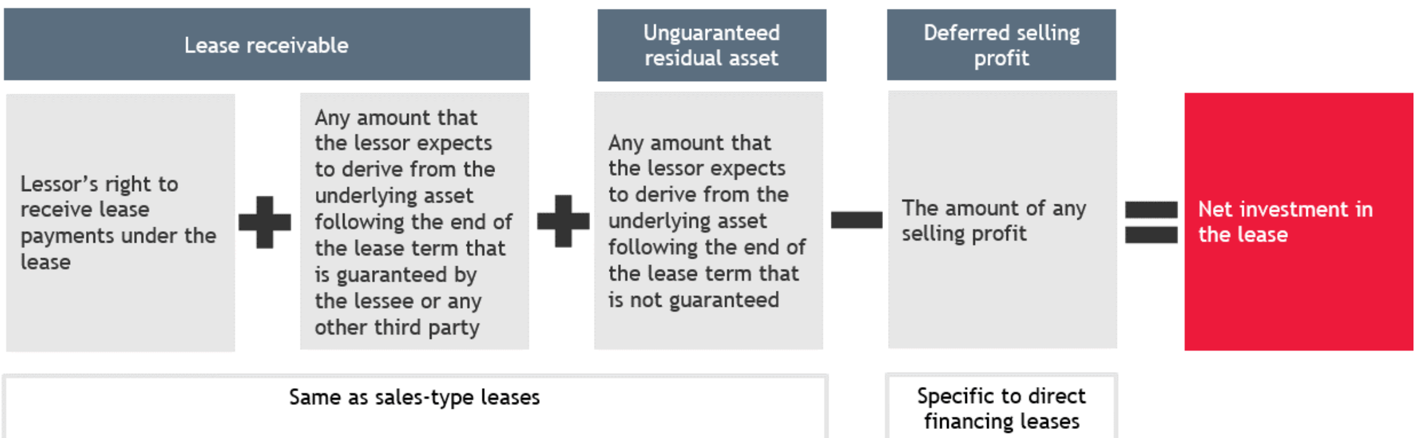
- A lease receivable, which represents the lessor's rights to receive lease payments and payment amounts under residual value guarantees that either the lessee or a third party provided
- The unguaranteed residual asset, which is the estimated residual value the lessor expects for the asset at lease term end that neither the lessee nor a third party guaranteed.

Accordingly, the net investment in a sales-type lease is the sum of the items shown below, discounted using the rate implicit in the lease (see Section 4.6).



If the lease is not sales-type, the lessor must determine whether to classify it as a direct financing or operating lease. A lessor classifies a lease as a direct financing lease when it obtains a third-party residual value guarantee that along with the lease payments, results in the present value classification test being met if some additional conditions are also met (see Sections 4.9 and 6.2). A lease classified as direct financing effectively converts the lessor's risk arising from ownership of the asset (asset risk) into credit risk. For that reason, the lessor derecognizes the underlying asset and recognizes a net investment in the lease (like a sales-type lease). However, unlike a sales-type lease, the lessor cannot recognize selling profit (or sales revenue) because control of the asset did not transfer to the lessee. Any selling profit reduces the net investment in the lease and is recognized over the lease term.

Accordingly, a net investment in a direct financing lease can be depicted as shown below.




Accordingly, for sales-type and direct financing leases, a lessor recognizes the economic benefits associated with the underlying asset and the lease in a single unit of account; namely, a net investment in the lease. As discussed in Chapter 8, lessors must disclose the components and carrying amounts of their net investments in leases.

If the lease is an operating lease, the lessor continues to recognize the underlying asset and recognizes lease income generally on a straight-line basis. Unlike lessees (which recognize a lease liability), lessors do not recognize a lease receivable for operating leases.

A few additional points to remember are:

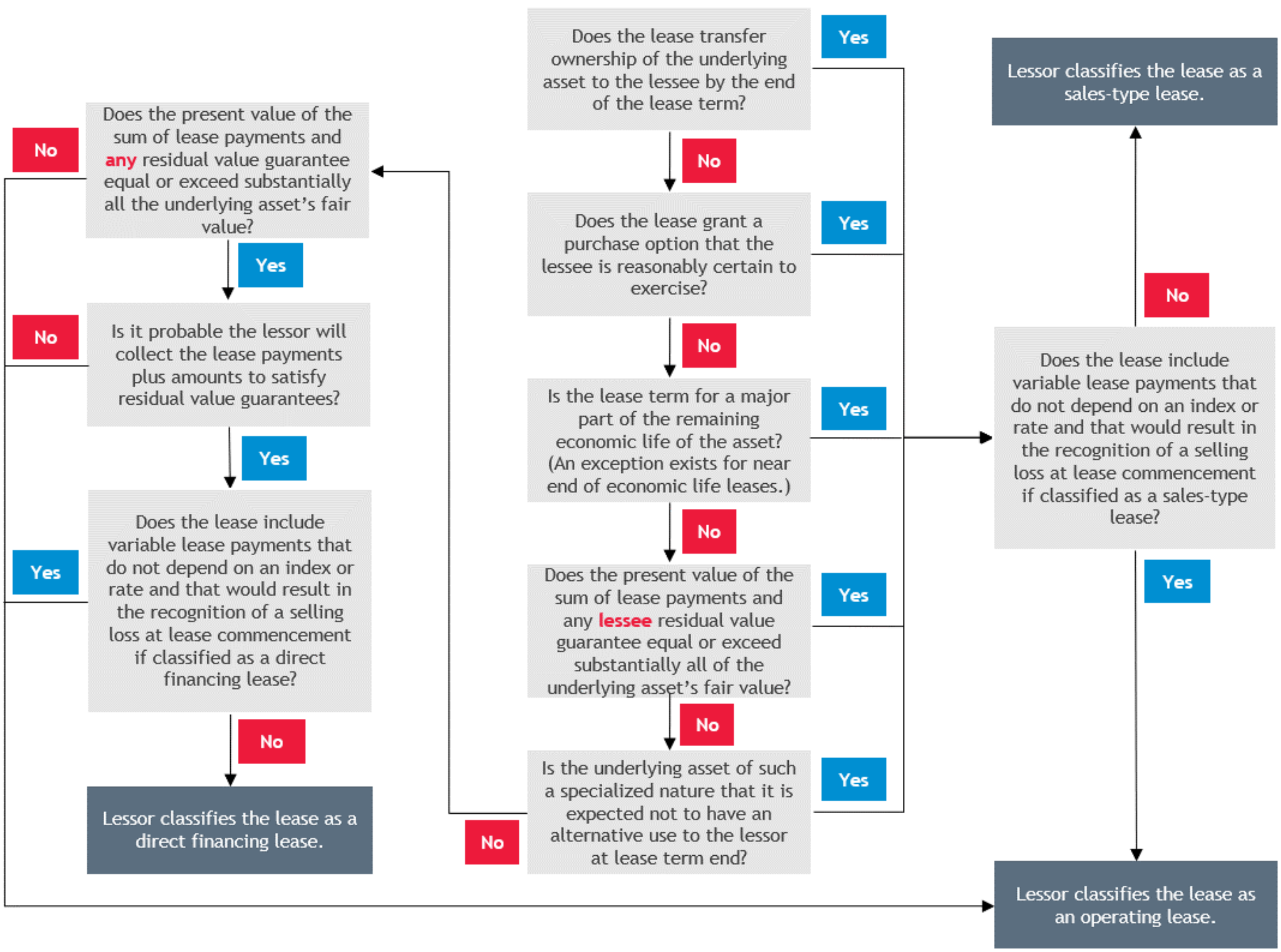
- Like ASC 606, ASC 842 does not differentiate between leases of real estate and leases of other assets.
- Additional guidance on collectability of lease payments and whether the lease includes variable lease payments not based on an index or rate may affect classification and accounting for the lease.
- While lessors are not subject to the reassessment requirements that lessees must apply (see Section 5.7), they are subject to modification requirements (see Section 6.7).
- Lessors must apply the guidance in ASC 326, *Credit Losses*, related to their net investments in sales-type and direct financing leases (see Section 6.8.1), while ASC 842 includes specific guidance for operating leases (see Section 6.8.2).

## 6.2 LEASE CLASSIFICATION BY LESSORS

**FASB REFERENCES**

ASC 842-10-25-2 through 25-3A

As discussed in Section 6.1, the lessor accounting model distinguishes between sales-type, direct financing, and operating leases (see Section 4.9).



## 6.3 SUMMARY ACCOUNTING REQUIREMENTS BASED ON LEASE CLASSIFICATION

The table summarizes a lessor's accounting for leases by classification.

<table>
<tr><th></th><th>SALES-TYPE LEASE</th><th>DIRECT FINANCING LEASE</th><th>OPERATING LEASE</th></tr>
<tr><td rowspan="2">Balance Sheet</td><td><ul><li>If collectability is probable, derecognize the underlying asset and recognize a net investment in the lease at the commencement date.</li><li>Otherwise, continue to recognize the underlying asset and recognize any payments received as a deposit liability.</li></ul></td><td><ul><li>Derecognize the underlying asset and recognize a net investment in the lease at the commencement date.</li><li>Defer any selling profit and include it in the net investment in the lease.</li></ul></td><td><ul><li>Continue to recognize the underlying asset.</li><li>Defer initial direct costs.</li></ul></td></tr>
<tr><td><ul><li>If collectability was probable initially, increase the net investment in the lease for interest income and reduce it for lease payments received. Also assess the net investment in the lease for credit losses under ASC 326.</li><li>If collectability was not probable initially, monitor collectability and specific other events (termination of contract or repossession of the underlying asset).</li></ul></td><td><ul><li>Subsequently, increase the net investment in the lease for interest income and reduce it for lease payments received.</li><li>Assess the net investment in the lease for credit losses under ASC 326.</li></ul></td><td><ul><li>The underlying asset is subject to other U.S. GAAP (for example, ASC 360 on PP&E, including for impairment)</li><li>Amortize initial direct costs over the lease term.</li></ul></td></tr>
<tr><td rowspan="2">Income Statement</td><td><ul><li>Recognize selling profit or loss at the commencement date of the lease.</li><li>Initial direct costs: If the fair value of the underlying asset differs from its carrying amount, expense them. Otherwise, defer and include them in the net investment in the lease.</li></ul></td><td><ul><li>Recognize selling profit over the lease term through interest income. If there is a selling loss, recognize at the commencement date.</li><li>Defer initial direct costs and include them in the net investment in the lease.</li></ul></td><td rowspan="2"><ul><li>If collectability is probable, recognize lease payments in income over the lease term, usually on a straight-line basis. Otherwise, lease income is limited generally to lease payments collected.</li><li>Expense initial direct costs on same basis as lease income over the lease term.</li><li>Recognize variable lease payments in the period when the changes in facts and circumstances on which they are based occur (or when collected (see above)).</li><li>Recognize any impairment charges of the underlying asset under ASC 360.</li></ul></td></tr>
<tr><td colspan="2"><ul><li>Recognize interest income using the rate implicit in the lease.</li><li>Recognize variable lease payments not included in the net investment in the lease in the period when changes in facts and circumstances on which the payments are based occur.</li><li>Recognize any credit losses.</li></ul></td></tr>
</table>

### 6.3.1 Fair Value Exception for Lessors That Are Not Manufacturers or Dealers

**FASB REFERENCES**

ASC 842-30-55-17A

A lessor applies the guidance in ASC 820 on fair value measurement when determining the fair value of an underlying asset. However, for lessors that are not manufacturers or dealers (generally financial institutions and captive finance companies), the fair value of the underlying asset at lease commencement is defined as its cost, reflecting any volume or trade discounts that apply. That exception applies only if there has not been a significant lapse of time between the acquisition of the underlying asset and lease commencement. If there has been a significant lapse of time, the lessor must apply the ASC 820 definition of fair value.

### 6.3.2 Lessor Costs to Ready the Leased Asset for Its Intended Use

**FASB REFERENCES**

ASC 340-40-25-5 through 25-8 and ASC 842-10-30-9 through 30-10

A lessor may incur costs, such as shipping and mobilization costs, to ready the leased asset for its intended use. Costs for such activities are not initial direct costs because they are not costs to **obtain** a lease contract. Therefore, a lessor cannot capitalize them by applying the guidance on initial direct costs. However, questions arose as to whether such costs must be expensed in all cases or could be capitalized by analogy to other U.S. GAAP. The SEC staff addressed the topic in the speech excerpted below.

**SEC STAFF GUIDANCE**

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

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

December 10, 2018

**Certain lessee and lessor costs**

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

…The second lease cost consultation related to lessor accounting for costs incurred to fulfill its obligations under a lease. For example, a lessor may incur costs to transport a leased asset to the lessee. If the specific lessor costs are not within the scope of other GAAP, and to the extent the costs would qualify for deferral if the lease was within the scope of Topic 606,[11] in lieu of recognizing those costs in current period earnings, the staff did not object to a lessor's analogy to Subtopic 340-40 as an accounting policy election.

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

[11] FASB ASC Topic No. 606, *Revenue from Contracts with Customers* ("Topic 606").

Accordingly, unless other U.S. GAAP apply, we believe either of the approaches below is acceptable as an accounting policy election applied to all leases and disclosed if material:

- Expense the costs as incurred
- Capitalize the costs by analogy to the guidance on contract fulfillment costs under ASC 340-40, *Other Assets and Deferred Costs — Contracts With Customers*, assuming the costs meet the criteria for capitalization. If capitalized, the costs are subsequently measured in accordance with ASC 340-40-35. See section 7.7.3 in our Blueprint, **Revenue Recognition Under ASC 606**.

See also Section 6.3.1 for lessors that are not manufacturers or dealers. For example, assuming there has been no significant lapse of time between acquisition and lease commencement, a lessor that classifies a lease as sales-type or direct financing would capitalize the fulfillment costs in the initial measurement of the net investment in the lease.

## 6.4 SALES-TYPE LEASES

Under ASC 842, lessors do not consider the collectability of the lease payments and amounts to satisfy a lessee residual value guarantee when assessing classification of a lease as sales type. However, it does affect the accounting for the sales-type lease, as discussed in Sections 6.4.1 and 6.4.2. For example, if collectability is not probable at the commencement date, the lessor cannot derecognize the underlying asset and must recognize lease payments received as a deposit liability.

### 6.4.1 Collectability Is Probable at Commencement Date

**FASB REFERENCES**

ASC 842-30-20: Selling Profit or Selling Loss, ASC 842-30-25-1 through 25-2, ASC 842-30-25-6, ASC 842-30-30-1, ASC 842-30-35-1 through 35-2, and ASC 842-30-40-1

In a sales-type lease, the lessor is considered to transfer control of the underlying asset to the lessee at the commencement date (see Section 4.2). Therefore, assuming collectability of the lease payments, including any amount necessary to satisfy a lessee residual value guarantee is probable, a lessor recognizes a net investment in the lease and derecognizes the underlying asset at lease commencement with any selling profit or loss arising from the lease recognized immediately.

The net investment in a sales-type lease is calculated as shown below, discounted using the rate implicit in the lease (see Section 4.6).

| Lease receivable | | | | Unguaranteed residual asset | | |
|---|---|---|---|---|---|---|
| Lessor's right to receive lease payments under the lease | + | Any amount that the lessor expects to derive from the underlying asset following the end of the lease term that is guaranteed by the lessee or any other third party | + | Any amount that the lessor expects to derive from the underlying asset following the end of the lease term that is not guaranteed | = | Net investment in the lease |

Because of the way the rate implicit in the lease is defined, the net investment in the lease recognized typically will equal the fair value of the underlying asset plus any deferred initial direct costs (less any prepaid lease payments).

At the commencement date, the selling profit or selling loss equals:

| | | | | | | |
|---|---|---|---|---|---|---|
| The lower of:<br>A. Fair value of the underlying asset<br>B. Sum of the lease receivable and any prepaid lease payments | − | Carrying amount of the underlying asset net of any unguaranteed residual asset | − | Any deferred initial direct costs | = | **Selling profit or selling loss** |

A lessor expenses initial direct costs if the fair value of the underlying asset at the commencement date differs from its carrying amount. Otherwise, the lessor defers the initial direct costs and includes them in the measurement of the net investment in the lease. Those costs are reflected in the calculation of the rate implicit in the lease.

If a lessor concludes that collectability is probable at commencement, it does not reassess that conclusion for classification purposes. A lessor assesses subsequent changes in the credit risk of the lessee for credit losses under ASC 326 (see Section 6.8.1).

After the commencement date, a lessor measures the net investment in the lease by:

- Increasing the carrying amount to reflect interest income on the net investment in the lease using the rate implicit in the lease
- Reducing the carrying amount to reflect the lease payments collected during the period.

Also, the net investment in the lease is not remeasured after the commencement date except in a lease modification that is not accounted for as a separate contract (see Section 6.7).

A lessor recognizes in the income statement:

- Interest income on the net investment in the lease using the rate implicit in the lease
- Variable lease payments not included in the net investment in the lease as income in the period when the changes in facts and circumstances on which the variable lease payments are based occur
- Any credit losses on the net investment in the lease.

### 6.4.2 Collectability Is Not Probable at Commencement Date

**FASB REFERENCES**

ASC 842-30-25-3 through ASC 842-30-25-5

If collectability of the lease payments plus any amount necessary to satisfy a lessee residual value guarantee is not probable at lease commencement, a lessor does not derecognize the underlying asset. Instead, it recognizes any lease payments received, including variable lease payments, as a deposit liability. The lessor then continues to monitor collectability for any changes in assessment.

The deposit liability recognized for payments received is derecognized at the earlier of:

<table>
<tr><th>EVENT</th><th>ACCOUNTING</th></tr>
<tr><td>Collectability of the lease payments and any amounts required to satisfy a lessee residual value guarantee becomes probable.</td><td>The lessor:<ul><li>Derecognizes the carrying amount of the underlying asset</li><li>Derecognizes the carrying amount of any deposit liability</li><li>Recognizes a net investment in the lease based on the remaining lease payments and remaining lease term, using the rate implicit in the lease determined at the commencement date</li><li>Recognizes selling profit or selling loss calculated as:<ul><li>The lease receivable</li><li>Plus the carrying amount of the deposit liability</li><li>Less the carrying amount of the underlying asset net of the unguaranteed residual asset.</li></ul></li></ul></td></tr>
<tr><td>The contract has been terminated and the lease payments received from the lessee are nonrefundable.</td><td rowspan="2">The lessor derecognizes the carrying amount of any deposit liability with the corresponding amount recognized as lease income.</td></tr>
<tr><td>The lessor has repossessed the underlying asset and has no further obligation under the contract to the lessee, and the lease payments received from the lessee are nonrefundable.</td></tr>
</table>

The above treatment for sales-type leases when collectability is not probable is consistent with the guidance in ASC 606 related to contracts with customers for which collectability of the consideration is not probable.

### 6.4.2.1 Assessing Collectability

In assessing collectability, a lessor must consider all facts and circumstances regarding the lessee's ability and intent to pay, including:

- The lessee's credit quality
- Other income or assets with which the lessee could make the lease payments if the business in which the asset is used is not successful
- The economic climate of the business in which the asset will be used (level of competition and risk, lessee experience in the industry, and so forth)
- The lessor's history of collections and repossessions with similar lessees
- The lessor's past practice of providing any concessions or waivers to its lessees.

The SEC staff has discussed the topic of collectability assessment by a lessor for sales-type leases, as excerpted below.

**SEC STAFF GUIDANCE**

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

Erin Bennet, Professional Accounting Fellow, Office of the Chief Accountant

December 9, 2019

**ASC 842 and Collectibility**

We continue to be engaged in monitoring implementation of the new lease accounting standard. I would like to share observations from a recent consultation about assessing collectibility for lessors. Under ASC 842, lessors are required to evaluate whether collectibility of the lease payments, including any amount necessary to satisfy a residual value guarantee, is probable at lease commencement date. In a sales-type lease, if collectibility is not probable, the lessor should not derecognize the asset and should defer recognition of any income or loss. The lessor would instead recognize lease payments received as a deposit liability until either: (a) collectibility becomes probable or (b) the contract has been terminated or the lessor has taken back the asset, and the lease payments are nonrefundable. *[Footnote omitted]*

OCA staff recently considered a fact pattern where the registrant enters into sales-type leases of equipment. The lessee is required to make a down payment and also make periodic lease payments, generally over a four-year contractual period. The registrant has historically experienced a high rate of payment delinquencies, leading to defaults that result in termination of the contract and, in most cases, repossession of the equipment. Based on historical experience, the registrant collects an average of 60% of the contractual lease payments. The registrant continues to expect a high rate of defaults and structures its leases to compensate for the high credit risk of its customers through a high rate implicit in the lease, a residual value guarantee, and the intent and ability to repossess the equipment if the customer defaults.

The registrant concluded collectibility of the lease payments was probable at lease inception. The registrant asserted that at the lease commencement date, the customer had the intent and ability to pay as evidenced by a credit evaluation and a substantive down payment, among other factors. *[Footnote omitted]* Further, the registrant asserted that the historical lessee defaults were generally due to a change in the lessee’s circumstances subsequent to the lease inception.

The staff objected to the registrant’s view and concluded that there was not a sufficient basis to assert that collectibility of the lease payments was probable at the lease commencement date. In reaching this conclusion, the staff considered all factors including the registrant’s assessment of the lessee’s credit quality and the registrant’s history of collections with similar lessees.

### 6.4.3 Accounting at the End of Lease Term

**FASB REFERENCES**

ASC 842-30-35-5

At the end of the lease term, a lessor reclassifies the net investment in the lease to the appropriate category of asset (for example, PP&E) in accordance with other U.S. GAAP, measured at the carrying amount of the net investment in the lease. The lessor then accounts for the underlying asset in accordance with other U.S. GAAP, such as ASC 360.

### 6.4.4 Accounting for Lease Termination

**FASB REFERENCES**

ASC 842-30-35-7 and ASC 842-30-40-2 through 40-3

If a sales-type lease is terminated before the end of the lease term, a lessor:

- Tests the net investment in the lease for credit losses under ASC 326 (see Section 6.8.1)
- Reclassifies the net investment in the lease to the appropriate category of asset in accordance with other U.S. GAAP, measured as the sum of the carrying amounts of the lease receivable (less any amounts the lessor still expects to receive) and the residual asset
- Accounts for the underlying asset that was the subject of the lease in accordance with other U.S. GAAP, such as ASC 360.

If the lessor replaces the original lease with a new agreement with a new lessee, it accounts for the termination of the original lease as discussed above and accounts for the new lease as a separate transaction. In contrast, if the original lessee enters a sublease or transfers (sells) the original lease to a third party, the original lessor's accounting does not change.

### 6.4.5 Application Examples — Sales-Type Leases

Examples 6-1 through 6-3 illustrate the initial and subsequent measurement of a sales-type lease under different scenarios.

**For the illustrations in this Chapter, the tables 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.**

**EXAMPLE 6-1: SALES-TYPE LEASE WITH LESSEE RESIDUAL VALUE GUARANTEE — COLLECTABILITY IS PROBABLE**

**FACTS**

- Lessor enters a six-year lease of nonspecialized equipment with Lessee.
- Lease payments are $25,000 per year, due at the end of each year.
- Lessee provides a residual value guarantee of $35,000.
- At lease commencement, the equipment has a fair value of $170,000 and a carrying value of $150,000.
- The equipment has a remaining economic life of 10 years, and Lessor expects its residual value at the end of the lease to be $55,000.
- The lease does not transfer ownership of the equipment to Lessee nor grant Lessee a purchase option.
- Lessor incurs $2,000 of initial direct costs.
- There are no nonlease components in the agreement.
- Lessor retained no investment tax credits.
- Lessor concludes at the commencement date that it is probable it will collect the lease payments and the amount necessary to satisfy the residual value guarantee provided by Lessee.

## CONCLUSION AND ANALYSIS

Accounting at the commencement date

- To determine whether the lease is a sales-type lease, Lessor calculates the rate implicit in the lease as shown in the table. Because the fair value of the underlying asset differs from its carrying value at lease commencement, no initial direct costs are deferred, and they are not reflected in the calculation.
- Because initial direct costs are expensed and there are no investment tax credits, the rate implicit in the lease is the rate that causes the aggregate present value of the lease payments and of Lessor's expected residual value of the equipment at the end of the lease to equal the fair value of the underlying asset at commencement.

| | PAYMENTS | |
|---|---|---|
| Year 1 | (170,000) | Beginning of year (commencement date) fair value |
| Year 1 | 25,000 | End of year payment |
| Year 2 | 25,000 | |
| Year 3 | 25,000 | |
| Year 4 | 25,000 | |
| Year 5 | 25,000 | |
| Year 6 | 80,000 | (25,000 lease payment + 55,000 estimated residual value) |
| **Undiscounted payments** | **205,000** | |
| **Rate implicit in the lease** | **4.68%** | |

- At the commencement date, Lessor calculates the present value of the lease payments and of Lessee's residual value guarantee as shown in the table, using the rate implicit in the lease determined above.

| | PAYMENTS | |
|---|---|---|
| Year 1 | 25,000 | |
| Year 2 | 25,000 | |
| Year 3 | 25,000 | |
| Year 4 | 25,000 | |
| Year 5 | 25,000 | |
| Year 6 | 60,000 | (25,000 lease payment + 35,000 lessee guarantee ) |
| **Undiscounted payments** | **185,000** | |
| **Present value (4.68%)** | **154,800** | |

- Lessor classifies the lease as a sales-type lease because (1) the present value of the lease payments and of Lessee's residual value guarantee amounts to substantially all the fair value of the equipment at the commencement date (91% (154,800/170,000)) and (2) there are no variable lease payments not based on an index or rate (ASC 842-10-25-3A).
- The net investment in the lease is initially measured at $170,000 and represents the sum of:
  - Lease receivable of $154,800 (see calculation above)
  - Unguaranteed residual asset of $15,200 (present value of the $20,000 expected unguaranteed residual value discounted at 4.68%).

The net investment in the lease equals the fair value of the underlying asset because there are no deferred initial direct costs or prepaid lease payments.

- At the commencement date, Lessor calculates the selling profit/loss as:

| | AMOUNT |
|---|---|
| Lease receivable* | $ 154,800 |
| Less carrying value of the equipment net of unguaranteed residual value** | 134,800 |
| Less deferred initial direct costs*** | — |
| Selling profit | $ 20,000 |

* Lessor uses the lease receivable because it is lower than the fair value of the underlying asset of $170,000.

** The unguaranteed residual value used for this calculation equals the present value of the difference between the amount the lessor expects to receive at lease term end ($55,000) and the lessee residual value guarantee ($35,000), or $15,200.

*** The initial direct costs are not eligible for deferral because the fair value of the underlying asset differs from its carrying amount at the commencement date. Accordingly, Lessor expenses these costs at the commencement date.

- At the commencement date, Lessor records the journal entry below to derecognize the underlying asset, recognize a net investment in the lease, and recognize selling profit.

| | | | |
|---|---|---|---|
| Debit | Net investment in the lease | $ 170,000 | |
| Debit | Operating expenses | 2,000 | |
| Credit | Cash (or prepaid asset) | | $ 2,000 |
| Credit | Equipment (carrying value) | | 150,000 |
| Credit | Selling profit | | 20,000 |

<u>Subsequent measurement (assuming no modifications)</u>

- Lessor increases the carrying amount of the net investment in the lease for interest income using the rate implicit in the lease of 4.68% and reduces it to reflect the lease payments collected. For example, Lessor recognizes the following journal entry at the end of Year 1:

| | | | |
|---|---|---|---|
| Debit | Cash | $ 25,000 | |
| Credit | Net investment in the lease | | $ 17,044 |
| Credit | Interest income* | | 7,956 |

* Net investment in the lease of $170,000 at 4.68%.

- In accordance with ASC 842-30-30-1, and for disclosure purposes, Lessor calculates the components of the net investment in the lease, which include the lease receivable and the unguaranteed residual asset.

- The table summarizes the accounting for the lease receivable throughout the lease term.

| | BEGINNING BALANCE [A] | INTEREST [B] = [A] X 4.68% | PAYMENT [C] | ENDING BALANCE [D] = [A] + [B] + [C] |
|---|---|---|---|---|
| Year 1 | 154,800 | 7,245 | (25,000) | 137,045 |
| Year 2 | 137,045 | 6,414 | (25,000) | 118,459 |
| Year 3 | 118,459 | 5,544 | (25,000) | 99,003 |
| Year 4 | 99,003 | 4,634 | (25,000) | 78,637 |
| Year 5 | 78,637 | 3,680 | (25,000) | 57,317 |
| Year 6 | 57,317 | 2,683 | (25,000) | 35,000 |

- The table summarizes the accounting for the unguaranteed residual asset throughout the lease term, along with the ending balance of each component and of the net investment in the lease.

| | UNGUARANTEED RESIDUAL ASSET BEGINNING BALANCE [A] | INTEREST [B] = [A] * 4.68% | UNGUARANTEED RESIDUAL ASSET ENDING BALANCE [C] = [A] +[B] | LEASE RECEIVABLE ENDING BALANCE [D] - SEE ABOVE | NET INVESTMENT IN THE LEASE ENDING BALANCE [E]= [C]+[D] |
|---|---|---|---|---|---|
| Year 1 | 15,200 | 711 | 15,911 | 137,045 | 152,956 |
| Year 2 | 15,911 | 745 | 16,656 | 118,459 | 135,115 |
| Year 3 | 16,656 | 780 | 17,436 | 99,003 | 116,439 |
| Year 4 | 17,436 | 816 | 18,252 | 78,637 | 96,889 |
| Year 5 | 18,252 | 854 | 19,106 | 57,317 | 76,423 |
| Year 6 | 19,106 | 894 | 20,000 | 35,000 | 55,000 |

At the end of the lease term, the net investment in the lease equals the estimated residual value of the asset of $55,000, the lease receivable equals Lessee's residual value guarantee of $35,000, and the unguaranteed residual asset is the difference between $55,000 and $35,000.

- The table summarizes interest income recognized in profit or loss throughout the lease term.

| | AMOUNT |
|---|---|
| Year 1 | 7,956 |
| Year 2 | 7,159 |
| Year 3 | 6,324 |
| Year 4 | 5,450 |
| Year 5 | 4,535 |
| Year 6 | 3,577 |
| Total | 35,000 |

Total interest income of $35,000 represents the difference between the undiscounted lease payments plus the expected residual value of the asset at lease term end of $205,000 and the fair value of the underlying asset at the commencement date of $170,000.

- At the end of Year 6, Lessor reclassifies the net investment in the lease of $55,000 to PP&E and then accounts for it under ASC 360.

**EXAMPLE 6-2: SALES-TYPE LEASE WITH NO RESIDUAL VALUE GUARANTEE — COLLECTABILITY IS PROBABLE**

**FACTS**

- Lessor enters a 10-year lease with Lessee for a piece of nonspecialized equipment.
- Lease payments are $50,000 per year and due at the beginning of each year.
- The lease neither transfers ownership of the equipment to Lessee nor grants Lessee a purchase option.
- At lease commencement, the equipment has a fair value of $425,000 and a carrying value of $395,400.
- The equipment has a remaining economic life of 12 years, and Lessor expects its residual value at the end of the lease term to be $20,000.
- Lessor incurs $5,000 of initial direct costs.
- Neither Lessee nor a third party unrelated to Lessor provides any residual value guarantees.
- There are no nonlease components in the agreement.
- Lessor retained no investment tax credits.
- Lessor concludes at the commencement date that it is probable it will collect the lease payments.
- Lessor uses the lease of the equipment as an alternative means of realizing value from goods it otherwise sells in the ordinary course of business (see Section 8.2.3).

**CONCLUSION AND ANALYSIS**

Accounting at the commencement date

- Because (a) the lease term is for a major part (in this case 83%) of the remaining economic life of the equipment and (b) there are no variable lease payments not based on an index or rate (ASC 842-10-25-3A), Lessor classifies the lease as a sales-type lease. Here, the lease payments also represent substantially all of the equipment's fair value.
- Because the fair value of the underlying asset differs from its carrying amount, no initial direct costs are deferred, and they are not reflected in the calculation. Because initial direct costs are expensed and there are no investment tax credits, Lessor calculates the rate implicit in the lease as shown below.

| | PAYMENT | |
|---|---|---|
| Year 1 | (375,000) | (425,000 fair value – 50,000 first lease payment) |
| Year 2 | 50,000 | |
| Year 3 | 50,000 | |
| Year 4 | 50,000 | |
| Year 5 | 50,000 | |
| Year 6 | 50,000 | |
| Year 7 | 50,000 | |
| Year 8 | 50,000 | |
| Year 9 | 50,000 | |
| Year 10 | 50,000 | Beginning of year — lease payment |
| Year 10 | 20,000 | End of year — estimated residual value |
| **Rate implicit in the lease** | **4.58%** | |

- Lessor calculates the present value of lease payments during Years 2–10 at the commencement date discounted at 4.58% plus the lease payment received at lease commencement, which amounts to $412,214 (or 97% of the equipment's fair value).

- Lessor recognizes a net investment in the lease of $375,000, initially measured as the sum of:
  - Lease receivable of $362,214, which is the present value of the remaining unpaid lease payments (or $412,214 discussed above less the first payment of $50,000 received). There are no residual value guarantees provided by either Lessee or a third party.
  - Unguaranteed residual asset of $12,786 (present value of $20,000 expected unguaranteed residual value, discounted at 4.58%).

The net investment in the lease equals the fair value of the underlying asset of $425,000 less $50,000 prepaid lease payment. There are no deferred initial direct costs.

- At the commencement date, Lessor records the entries below to derecognize the underlying asset, recognize a net investment in the lease, and recognize selling profit.

| | | | |
|---|---|---|---|
| Debit | Net investment in the lease | $ 375,000 | |
| Debit | Cost of goods sold | 382,614* | |
| Debit | Cash (lease payment for Year 1) | 50,000 | |
| Credit | Equipment (carrying value) | | $ 395,400 |
| Credit | Sales-type lease — revenue | | 412,214** |

* In accordance with ASC 842-30-45-4a, cost of goods sold is the carrying amount of the equipment ($395,400) less the unguaranteed residual asset ($12,786).

**In accordance with ASC 842-30-45-4a, revenue is recognized at the lesser of the fair value of the underlying asset ($425,000) and the sum of the lease receivable and any lease payments prepaid by the lessee ($412,214).

- Lessor also expenses the initial direct costs at the commencement date.

| | | | |
|---|---|---|---|
| Debit | Operating expenses | $ 5,000 | |
| Credit | Cash (or prepaid asset) | | $ 5,000 |

<u>Subsequent measurement (assuming no modifications)</u>

- Lessor increases the carrying amount of the net investment in the lease for interest income using the rate implicit in the lease of 4.58% and reduces it to reflect the lease payments collected. For example:
  - Lessor records the journal entry below at the end of Year 1 to recognize interest accrued.

| | | | |
|---|---|---|---|
| Debit | Net investment in the lease | $ 17,157 | |
| Credit | Interest income* | | $ 17,157 |

* Net investment in the lease of $375,000 multiplied by the rate implicit in the lease of 4.58%

  - Lessor records the journal entry below at the beginning of Year 2 to reflect the second lease payment.

| | | | |
|---|---|---|---|
| Debit | Cash | $ 50,000 | |
| Credit | Net investment in the lease | | $ 50,000 |

- In accordance with ASC 842-30-30-1, and for disclosure purposes, Lessor calculates the components of the net investment in the lease, which include the lease receivable and the unguaranteed residual asset.
- The table summarizes the accounting for the lease receivable throughout the lease term.

| | BEGINNING BALANCE [A] | PAYMENT [B] | INTEREST [C] = [A + B] * 4.58% | ENDING BALANCE [D] = [A] + [B] + [C] |
|---|---|---|---|---|
| Year 1 | 362,214 | — | 16,572 | 378,785 |
| Year 2 | 378,785 | (50,000) | 15,042 | 343,827 |
| Year 3 | 343,827 | (50,000) | 13,443 | 307,270 |
| Year 4 | 307,270 | (50,000) | 11,770 | 269,040 |
| Year 5 | 269,040 | (50,000) | 10,021 | 229,062 |
| Year 6 | 229,062 | (50,000) | 8,192 | 187,254 |
| Year 7 | 187,254 | (50,000) | 6,279 | 143,533 |
| Year 8 | 143,533 | (50,000) | 4,279 | 97,813 |
| Year 9 | 97,813 | (50,000) | 2,187 | 50,000 |
| Year 10 | 50,000 | (50,000) | — | — |

- The table summarizes the accounting for the unguaranteed residual asset throughout the lease term, along with the ending balance of each component and of the net investment in the lease.

| | UNGUARANTEED RESIDUAL ASSET BEGINNING BALANCE [A] | INTEREST ACCRETION [B] = [A] * 4.58% | UNGUARANTEED RESIDUAL ASSET ENDING BALANCE [C] = [A] +[B] | LEASE RECEIVABLE ENDING BALANCE [D] SEE ABOVE | NET INVESTMENT IN THE LEASE ENDING BALANCE [E]= [C]+[D] |
|---|---|---|---|---|---|
| Year 1 | 12,786 | 585 | 13,371 | 378,785 | 392,157 |
| Year 2 | 13,371 | 612 | 13,983 | 343,827 | 357,810 |
| Year 3 | 13,983 | 640 | 14,623 | 307,270 | 321,893 |
| Year 4 | 14,623 | 669 | 15,292 | 269,040 | 284,332 |
| Year 5 | 15,292 | 700 | 15,991 | 229,062 | 245,053 |
| Year 6 | 15,991 | 732 | 16,723 | 187,254 | 203,977 |
| Year 7 | 16,723 | 765 | 17,488 | 143,533 | 161,022 |
| Year 8 | 17,488 | 800 | 18,288 | 97,813 | 116,101 |
| Year 9 | 18,288 | 837 | 19,125 | 50,000 | 69,125 |
| Year 10 | 19,125 | 875 | 20,000 | — | 20,000 |

At the end of the lease term, the net investment in the lease equals the estimated residual value of the asset of $20,000.

- The table summarizes interest income recognized in profit or loss throughout the lease term.

| | AMOUNT |
|---|---|
| Year 1 | 17,157 |
| Year 2 | 15,654 |
| Year 3 | 14,083 |

| | |
|---|---|
| **Year 4** | 12,439 |
| **Year 5** | 10,721 |
| **Year 6** | 8,924 |
| **Year 7** | 7,045 |
| **Year 8** | 5,079 |
| **Year 9** | 3,024 |
| **Year 10** | 875 |
| **Total** | 95,000 |

Total interest of $95,000 represents the difference between the undiscounted lease payments plus the expected residual value of the asset at the end of the lease term of $520,000 and the fair value of the underlying asset at the commencement date of $425,000.

- At the end of Year 10, Lessor reclassifies the net investment in the lease of $20,000 to the appropriate asset category in accordance with other U.S. GAAP.

**EXAMPLE 6-3: SALES-TYPE LEASE WITH LESSEE RESIDUAL VALUE GUARANTEE — COLLECTABILITY NOT PROBABLE**

**FACTS**

- Assume the same facts as in Example 6-1, except that at the commencement date, Lessor concludes that collectability of the lease payments plus the amount necessary to satisfy Lessee's residual value guarantee is not probable. In reaching that conclusion, Lessor considers both Lessee's ability and intent to pay the required payments. Specifically, Lessee has limited credit history and no significant other income or assets with which to make the payments if its operations were unsuccessful.
- At the end of Year 3, collectability of the lease payments and the amount necessary to satisfy Lessee's residual value guarantee becomes probable, the contract has not been terminated, and the underlying asset has not been repossessed.

**CONCLUSION AND ANALYSIS**

<u>Accounting while collectability is not probable</u>

- At the commencement date, because collectability is not probable, Lessor continues to recognize the equipment. In other words, it does not recognize a net investment in the lease or any selling profit or selling loss.
- Consistent with Example 6-1, Lessor expenses the initial direct costs at the commencement date.
- Lessor continues to reassess collectability to determine whether the lease payments and the amount necessary to satisfy Lessee's residual value guarantee are probable of collection. For Years 1 and 2, collectability is still not probable. Therefore, Lessor accounts for the $25,000 Year 1 and Year 2 lease payments received as a deposit liability.
- Also, because the underlying asset is not derecognized, Lessor recognizes depreciation expense on the equipment. Here, annual depreciation is $15,800.
- Lessor therefore records the below journal entries each year:
  - For the lease payments collected

| | | | | | |
|---|---|---|---|---|---|
| Debit | Cash | $ | 25,000 | | |
| Credit | Deposit liability | | | $ | 25,000 |

- For depreciation expense

| | | | |
|---|---|---|---|
| Debit | Depreciation expense | $ 15,800 | |
| Credit | Equipment | | $ 15,800 |

<u>Accounting once collectability becomes probable</u>

- At the end of Year 3:
  - Lessee makes the $25,000 payment due under the lease, which Lessor records as a deposit liability. The updated balance of the deposit liability is therefore $75,000.
  - Lessor also recognizes depreciation expense of $15,800 on the equipment. Therefore, the updated carrying amount of the equipment is $102,600 [$150,000 carrying value at the commencement date – ($15,800 * 3)].
- At the end of Year 3, Lessor concludes that collectability of the lease payments plus the amount necessary to satisfy Lessee's residual value guarantee is now probable based on Lessee's payment history under the lease (three lease payments made on time) and the fact that the business in which the leased asset is used has proven to be successful and has significantly improved since the commencement date.
- Lessor does not reassess the classification, so the lease remains a sales-type lease.
- Once collectability is probable at the end of Year 3, Lessor:
  - Derecognizes the carrying amount of the equipment ($102,600)
  - Derecognizes the carrying amount of the deposit liability ($75,000)
  - Recognizes a net investment in the lease based on the remaining lease payments and remaining lease term using the rate implicit in the lease determined at the commencement date (4.68%)
  - Recognizes a selling profit or loss (see below for calculation).
- The net investment in the lease is calculated as:

| | PAYMENT | |
|---|---|---|
| Year 4 | 25,000 | |
| Year 5 | 25,000 | |
| Year 6 | 80,000 | (25,000 lease payment + 55,000 estimated residual value) |
| **Undiscounted payments** | **130,000** | |
| **Present value (4.68%)** | **116,439** | (rate implicit in the lease determined at commencement date) |

- The net investment in the lease of $116,439 consists of:
  - Lease receivable of $99,003 (present value of three lease payments of $25,000 and the amount of Lessee's residual value guarantee of $35,000 at the end of the lease term)
  - Unguaranteed residual asset of $17,436 [($55,000 estimated residual value - $35,000 Lessee guaranteed amount) * (1.0468) ^-3]

  The above balances are the same as the ending balances in Example 6-1 at the end of Year 3 because none of the accounting assumptions (for example, estimated residual value) have been updated.

- Lessor calculates the selling profit/loss as follows:

| | AMOUNT |
|---|---|
| Lease receivable ($99,003) plus deposit liability balance ($75,000) | $ 174,003 |
| Less carrying value of equipment ($102,600) net of unguaranteed residual asset ($17,436) | 85,164 |

| | |
|---|---|
| Selling profit | $ 88,839 |

- Lessor records the following journal entry:

| | | | |
|---|---|---|---|
| Debit | Net investment in the lease | $ 116,439 | |
| Debit | Deposit liability | 75,000 | |
| Credit | Equipment (carrying value) | | $ 102,600 |
| Credit | Sales-type lease — selling profit | | 88,839 |

- Lessor then accounts for the remaining three years of the lease as any other sales-type lease. The table summarizes the accounting for the net investment in the lease for the remaining three years.

| | BEGINNING BALANCE | INTEREST | PAYMENT | ENDING BALANCE |
|---|---|---|---|---|
| | [A] | [B] = [A] * 4.68% | [C] | [D] = [A] + [B] + [C] |
| **Year 4** | 116,439 | 5,450 | (25,000) | 96,889 |
| **Year 5** | 96,889 | 4,535 | (25,000) | 76,423 |
| **Year 6** | 76,423 | 3,577 | (25,000) | 55,000 |

- At the end of the lease (Year 6), Lessor reclassifies the net investment in the lease, which then equals the estimated residual value of the asset of $55,000, to PP&E and accounts for it under ASC 360.

# 6.5 DIRECT FINANCING LEASES

## 6.5.1 Recognition and Initial Measurement

**FASB REFERENCES**

ASC 842-30-25-7 through 25-8 and ASC 842-30-30-1 through 30-2

As discussed in Sections 4.9 and 6.2, a lessor classifies a lease as a direct financing lease if none of the classification criteria for a sales-type lease are met and **both** of the following apply:

- The present value of the sum of lease payments and residual value guaranteed by the lessee or any third party unrelated to the lessor equals or exceeds substantially all the fair value of the underlying asset
- It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.

However, a lessor classifies the lease as operating if the lease includes variable lease payments that do not depend on an index or rate and classifying the lease as a direct financing lease would result in the recognition of a selling loss at lease commencement.

Also, if a lessor classifies a lease as an operating lease because collectability is not probable at the commencement date, subsequent changes in collectability do not change lease classification (the lease continues to be classified as operating). However, collectability will affect the amount of lease income recognized in profit or loss over the lease term (see Section 6.6)

When a lease is a direct financing lease, the lessor has converted its risk in the underlying asset (asset risk) into credit risk. Therefore, at the commencement date, a lessor recognizes a net investment in the lease and derecognizes the underlying asset. The net investment in a direct financing lease is calculated the same way as for a sales-type lease, except that:

- Any selling profit arising from the lease (see Section 6.4.1) is deferred and included in the measurement of the net investment in the lease.
- Initial direct costs incurred are deferred and included in the measurement of the net investment in the lease, regardless of whether the fair value of the underlying asset at the commencement date equals its carrying amount. The rate implicit in the lease is defined in such a way that initial direct costs deferred are included automatically in the net investment in the lease.

A lessor expenses any selling loss arising from a direct financing lease at the commencement date.

The graphic summarizes the initial measurement of the net investment in a direct financing lease.

| Lease receivable | | | | Unguaranteed residual asset | | Deferred selling profit | | |
|---|---|---|---|---|---|---|---|---|
| Lessor's right to receive lease payments under the lease | + | Any amount that the lessor expects to derive from the underlying asset following the end of the lease term that is guaranteed by the lessee or any other third party | + | Any amount that the lessor expects to derive from the underlying asset following the end of the lease term that is not guaranteed | − | The amount of any selling profit | = | Net investment in the lease |

Because of the way the rate implicit in the lease is defined and because selling profit is deferred in a direct financing lease, the initial net investment in a direct financing lease typically equals the carrying value of the underlying asset plus any initial direct costs (less any prepaid lease payments).

Like sales-type leases for which collectability is probable at the commencement date (see Section 6.4.1), after the commencement date for leases that are classified as direct financing, changes in the credit risk of the lessee are accounted for in accordance with ASC 326 (see Section 6.8.1).

### 6.5.2 Subsequent Measurement

**FASB REFERENCES**

ASC 842-30-25-9 and ASC 842-30-35-1 through 35-2

After the commencement date, a lessor measures the net investment in the lease by both:

- Increasing the carrying amount to reflect interest income using the rate implicit in the lease (but unlike a sales-type lease, the rate implicit in the lease is determined using the carrying amount of the underlying asset rather than its fair value because selling profit is deferred and recognized over the lease term)
- Reducing the carrying amount to reflect the lease payments collected during the period.

The net investment in the lease is not remeasured after the commencement date except in a lease modification that is not accounted for as a separate contract (see Section 6.7)

**INTEREST INCOME ACCRETION FOR A DIRECT FINANCING LEASE REQUIRES DIFFERENT RATES**

As discussed above, a lessor determines total periodic interest income on a direct financing lease based on the carrying amount of the net investment in the lease multiplied by the rate implicit in the lease (which is determined using the carrying amount of the underlying asset). However, a lessor uses the rate implicit in the lease (using the fair value of the underlying asset at the commencement date) to accrete interest income on the lease receivable and unguaranteed residual asset. Therefore, the portion of the deferred selling profit a lessor amortizes each period equals the difference between total periodic interest income recognized on the net investment in the lease less the periodic interest income earned on the lease receivable and unguaranteed residual asset (see Example 6-4).

After the commencement date, a lessor recognizes in the income statement:

- Interest income on the net investment in the lease using the rate implicit in the lease (as discussed above)
- Variable lease payments that are not included in the net investment in the lease as income in the period when the changes in facts and circumstances on which the variable lease payments are based occur
- Any credit losses on the net investment in the lease.

### 6.5.3 Accounting at the End of Lease Term

**FASB REFERENCES**

ASC 842-30-35-5

At the end of the lease term, a lessor reclassifies the net investment in the lease to the appropriate category of asset (for example, PP&E) in accordance with other U.S. GAAP, measured at the carrying amount of the net investment in the lease. The lessor then accounts for the underlying asset that was the subject of a lease in accordance with other topics, such ASC 360.

### 6.5.4 Accounting for Lease Termination

**FASB REFERENCES**

ASC 842-30-35-7 and ASC 842-30-40-2 through 40-3

If a direct financing lease is terminated before the end of the lease term, a lessor:

- Tests the net investment in the lease for credit losses under ASC 326 (see Section 6.8.1)
- Reclassifies the net investment in the lease to the appropriate category of asset in accordance with other U.S. GAAP, measured at the sum of the carrying amounts of the lease receivable (less any amounts the lessor still expects to receive) and the residual asset
- Accounts for the underlying asset that was the subject of the lease in accordance with other U.S. GAAP, such as ASC 360.

If the lessor replaces the original lease with a new agreement with a new lessee, it accounts for the termination of the original lease as discussed above and accounts for the new lease as a separate transaction. In contrast, if the original lessee enters a sublease or transfers (sells) the original lease to a third party, the original lessor's accounting does not change.

### 6.5.5 Application Example — Direct Financing Leases

Example 6-4 illustrates the initial and subsequent measurement of a direct financing lease with additional details on determining the rate implicit in the lease for classification and accounting.

### EXAMPLE 6-4: DIRECT FINANCING LEASE

#### FACTS

- Assume the same facts as in Example 6-1, except that the $35,000 residual value guarantee is provided by a third party, not by Lessee.
- Collectability of the lease payments and any amount necessary to satisfy the third-party residual value guarantee are probable.

#### CONCLUSION AND ANALYSIS

Accounting at the commencement date

- The interest rate information below is necessary (1) to assess classification of the lease as a sales-type lease; (2) if not a sales-type lease, to assess classification as a direct financing lease; and (3) if classified as a direct financing lease, to account for the net investment in the direct financing lease.

| | Step 1: Calculate rate implicit in the lease as defined | Step 2: Add initial direct costs to the fair value of the underlying asset | Step 3: Replace fair value of the underlying asset by its carrying amount |
|---|---|---|---|
| | **PAYMENTS** | **PAYMENTS** | **PAYMENTS** |
| **Year 0** | (170,000) | (172,000) | (152,000) |
| **Year 1** | 25,000 | 25,000 | 25,000 |
| **Year 2** | 25,000 | 25,000 | 25,000 |
| **Year 3** | 25,000 | 25,000 | 25,000 |
| **Year 4** | 25,000 | 25,000 | 25,000 |
| **Year 5** | 25,000 | 25,000 | 25,000 |
| **Year 6** | 80,000 | 80,000 | 80,000 |
| **Undiscounted payments** | **205,000** | **205,000** | **205,000** |
| **Rate implicit in the lease** | **4.68% (Sales-type lease classification rate)** | **4.38% (Direct financing lease classification rate)** | **7.68% (Direct financing rate)** |

- The sales-type lease classification rate is used to assess whether the lease qualifies as a sales-type lease under ASC 842-10-25-2(d). It is the same rate as calculated in Example 6-1 based on the fair value of the underlying asset at the commencement date, the lease payments to be received over the lease term, and the expected amount of the residual asset at the end of the lease term. Initial direct costs are excluded because the fair value of the underlying asset differs from its carrying value.
- The direct financing lease classification rate is used to assess whether the lease qualifies as a direct financing lease under ASC 842-10-25-3(b)(1). It is calculated like the sales-type lease classification rate, except that initial direct costs are deferred (added to the fair value of the underlying asset). This rate will also be used to initially and subsequently measure the lease receivable and the unguaranteed residual asset if the lease is a direct financing lease.
- The direct financing rate is used for initial and subsequent measurement of the net investment in the lease. It is calculated like the direct financing lease classification rate, except that the carrying amount of the asset, rather than fair value, is used because the selling profit is deferred and recognized in the measurement of the net investment in the lease.

- To determine if the lease qualifies as a sales-type lease, Lessor calculates the present value of the lease payments at the commencement date using the sales-type lease classification rate. The lease payments include only the annual payments of $25,000 made by Lessee. Because a third party, not Lessee, provided the residual value guarantee, it is not considered in the sales-type lease classification test.

| | PAYMENT |
|---|---|
| Year 1 | 25,000 |
| Year 2 | 25,000 |
| Year 3 | 25,000 |
| Year 4 | 25,000 |
| Year 5 | 25,000 |
| Year 6 | 25,000 |
| **Undiscounted payments** | **150,000** |
| **Present value (4.68%)** | **128,200** |

- Lessor concludes that none of the criteria for classifying the lease as a sales-type lease are met because:
  - The lease does not transfer ownership of the equipment to Lessee or grant it a purchase option.
  - The lease term is not for the major part of the remaining economic life of the underlying asset (6/10 = 60%) because "major part" requires at least 75%.
  - The present value of the lease payments does not amount to substantially all the fair value of the equipment (128,200/170,000 = 75%) because "substantially all" requires at least 90%. This calculation does not consider the residual value guarantee provided by the third party.
  - The underlying asset is not of a specialized nature, and it will have alternative uses to the lessor at the end of the lease term.
- Lessor then assesses classification of the lease as a direct financing lease, using the direct financing lease classification rate and including the third-party residual value guarantee, as shown in the table.

| | PAYMENT | |
|---|---|---|
| Year 1 | 25,000 | |
| Year 2 | 25,000 | |
| Year 3 | 25,000 | |
| Year 4 | 25,000 | |
| Year 5 | 25,000 | |
| Year 6 | 60,000 | (25,000 lease payment + 35,000 third-party guarantee) |
| **Undiscounted payments** | **185,000** | |
| **Present value (4.38%)** | **156,532** | |

- Lessor classifies the lease as a direct financing lease because:
  - The sum of the present value of the lease payments and of the third-party residual value guarantee amounts to substantially all the fair value of the equipment (156,532/170,000 = 92%)
  - It is probable Lessor will collect the lease payments and any amount necessary to satisfy the third-party residual value guarantee
  - ASC 842-10-25-3A on variable lease payments not based on an index or rate does not apply.

- Therefore, at the commencement date, Lessor derecognizes the equipment for $150,000 and recognizes a net investment in the lease of $152,000 measured using the direct financing rate as shown in the table.

| | PAYMENT | |
|---|---|---|
| Year 1 | 25,000 | |
| Year 2 | 25,000 | |
| Year 3 | 25,000 | |
| Year 4 | 25,000 | |
| Year 5 | 25,000 | |
| Year 6 | 80,000 | (25,000 lease payment + 55,000 estimated residual value) |
| **Undiscounted payments** | **205,000** | |
| **Present value (7.68%)** | **152,000** | |

The net investment in the lease equals the carrying value of the underlying asset of $150,000 plus the initial direct costs of $2,000. There are no prepaid lease payments.

- The net investment in the lease includes:
  - Lease receivable of $156,532 (which is the present value of the lease payments and of the third-party residual value guarantee, discounted using the direct financing lease classification rate of 4.38%)
  - Unguaranteed residual asset of $15,468 (which is the difference between the estimated residual value of $55,000 and the third-party residual value guarantee of $35,000, also discounted at 4.38%)
  - Deferred selling profit of $20,000, which is calculated as follows:

| | AMOUNT |
|---|---|
| Lease receivable | $ 156,532 |
| Less carrying value of the equipment net of unguaranteed residual value | (134,532) |
| Less deferred initial direct costs | (2,000) |
| Deferred selling profit | $ 20,000 |

The sum of the lease receivable, unguaranteed residual asset, and deferred selling profit equals the carrying amount of the net investment in the lease of $152,000.

- Lessor records the following journal entry at the commencement date to derecognize the underlying asset and recognize a net investment in the direct financing lease:

| | | | |
|---|---|---|---|
| Debit | Net investment in the lease | $152,000 | |
| Credit | Equipment (carrying value) | | $150,000 |
| Credit | Cash (or prepaid asset) | | 2,000 |

Subsequent measurement (assuming no modification)

- Lessor increases the carrying amount of the net investment in the lease for interest income using the direct financing rate of 7.68% and reduces it to reflect the lease payments collected. For example, Lessor records the following journal entry at the end of Year 1:

| | | | |
|---|---|---|---|
| Debit | Cash | $25,000 | |
| Credit | Net investment in the lease | | $13,331 |
| Credit | Interest income* | | 11,669 |

* Net investment in the lease of $152,000 multiplied by the direct financing rate of 7.68%

- Lessor subsequently measures the net investment in the lease using the direct financing rate of 7.68%, assuming no modifications throughout the lease term, as shown in the table.

| | BEGINNING BALANCE | INTEREST (7.68%) | PAYMENT | ENDING BALANCE |
|---|---|---|---|---|
| Year 1 | 152,000 | 11,669 | (25,000) | 138,669 |
| Year 2 | 138,669 | 10,646 | (25,000) | 124,315 |
| Year 3 | 124,315 | 9,544 | (25,000) | 108,859 |
| Year 4 | 108,859 | 8,357 | (25,000) | 92,217 |
| Year 5 | 92,217 | 7,080 | (25,000) | 74,296 |
| Year 6 | 74,296 | 5,704 | (25,000) | 55,000 |

- In accordance with ASC 842-30-30-1, and for disclosure purposes, Lessor calculates the separate components of the net investment in the lease as shown below.
  - Lease receivable (using the direct financing lease classification rate):

| | BEGINNING BALANCE | INTEREST (4.38%) | PAYMENT | ENDING BALANCE |
|---|---|---|---|---|
| Year 1 | 156,532 | 6,850 | (25,000) | 138,382 |
| Year 2 | 138,382 | 6,056 | (25,000) | 119,438 |
| Year 3 | 119,438 | 5,227 | (25,000) | 99,665 |
| Year 4 | 99,665 | 4,361 | (25,000) | 79,026 |
| Year 5 | 79,026 | 3,458 | (25,000) | 57,484 |
| Year 6 | 57,484 | 2,516 | (25,000) | 35,000 |

  - Unguaranteed residual value (using the direct financing lease classification rate):

| | BEGINNING BALANCE | INTEREST (4.38%) | ENDING BALANCE |
|---|---|---|---|
| Year 1 | 15,468 | 677 | 16,145 |
| Year 2 | 16,145 | 706 | 16,851 |
| Year 3 | 16,851 | 737 | 17,588 |
| Year 4 | 17,588 | 770 | 18,358 |
| Year 5 | 18,358 | 803 | 19,161 |
| Year 6 | 19,161 | 839 | 20,000 |

- Deferred selling profit:

| | BEGINNING BALANCE | PROFIT EARNED* | ENDING BALANCE |
|---|---|---|---|
| **Year 1** | (20,000) | 4,142 | (15,858) |
| **Year 2** | (15,858) | 3,884 | (11,974) |
| **Year 3** | (11,974) | 3,580 | (8,394) |
| **Year 4** | (8,394) | 3,226 | (5,168) |
| **Year 5** | (5,168) | 2,818 | (2,350) |
| **Year 6** | (2,350) | 2,350 | — |

* The portion of the deferred selling profit recognized in the income statement each period equals the difference between the interest income recognized on the net investment in the lease during the period and the sum of the interest income earned on the lease receivable and the unguaranteed residual asset during that same period.

For example, in Year 1:

- Interest income on the net investment in the lease is $11,669 (initial net investment in the lease of $152,000 * direct financing rate of 7.68%)
- Amortization of deferred selling profit is $4,142 and is equal to interest income of $11,669 less interest recognized on the lease receivable of $6,850 less interest recognized on the unguaranteed residual asset of $677.

At the end of the lease term, the net investment in the lease equals the estimated residual value of the asset of $55,000, the lease receivable equals the third-party residual value guarantee of $35,000, the unguaranteed residual asset is the difference between $55,000 and $35,000, and the deferred selling profit balance is zero (all selling profit has been recognized over the lease term).

- The table summarizes interest income recognized in profit or loss throughout the lease term.

| | AMOUNT |
|---|---|
| **Year 1** | 11,669 |
| **Year 2** | 10,646 |
| **Year 3** | 9,544 |
| **Year 4** | 8,357 |
| **Year 5** | 7,080 |
| **Year 6** | 5,704 |
| **Total** | 53,000 |

Total interest income recognized is $53,000 and represents the difference between the undiscounted lease payments plus the expected residual value of the asset at the end of the lease term of $205,000 and the carrying value of the underlying asset at the commencement date of $150,000 plus initial direct costs of $2,000.

- At the end of the lease term, Lessor reclassifies the net investment in the lease of $55,000 to PP&E and then accounts for it under ASC 360.

## 6.6 OPERATING LEASES

### 6.6.1 Recognition and Initial Measurement

**FASB REFERENCES**

ASC 842-30-25-10 and ASC 842-30-30-4

In an operating lease, a lessor does not derecognize the underlying asset at the commencement date, and it defers any initial direct costs as a separate asset.

### 6.6.2 Subsequent Measurement

**FASB REFERENCES**

ASC 842-30-25-11 through 25-13, ASC 842-30-35-6, ASC 842-30-55-17, and ASC 842-30-55-40 through 55-43

After the commencement date, a lessor continues to measure the underlying asset subject to an operating lease, including testing it for impairment, in accordance with other topics, such as ASC 360 on PP&E.

A lessor recognizes lease income in profit or loss, which depends on whether collectability of the lease payments plus any amount necessary to satisfy a residual value guarantee provided by either the lessee or a third party is probable.

| COLLECTABILITY IS PROBABLE | COLLECTABILITY IS NOT PROBABLE |
|---|---|
| Recognize:<br>▶ The lease payments as income over the lease term typically on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the use of the underlying asset (see below).<br>▶ Variable lease payments in the period when the changes in facts and circumstances on which the payments are based occur. | Lease income is limited to the lesser of:<br>▶ The amounts described in the left column<br>▶ The lease payments, including variable lease payments, that have been collected from the lessee (that is, a cash basis). |

Initial direct costs are recognized as an expense over the lease term on the same basis as lease income.

**PATTERN OF BENEFITS EXPECTED FROM USE OF UNDERLYING ASSET**

ASC 842 considers the right to control the use of the underlying asset as the equivalent of physical use. In other words, if the lessee controls the use of the underlying asset, recognition of lease income is not affected by the extent of the lessee's use of the underlying asset.

The lessor must also reassess changes in collectability after the commencement date. If collectability of the remaining lease payments plus amounts necessary to satisfy a residual value guarantee becomes probable, any difference between the cumulative lease income that would have been recognized on an accrual basis and cumulative lease income that has been recognized on a cash basis is recognized as a current-period adjustment to lease income. Example 1, Case D, in ASC 842-30-55-40 through 55-43 illustrates a lease classified as an operating lease because collectability of the lease payments and amounts necessary to satisfy a residual value guarantee is not probable at the commencement date. See Section 6.8.2 for additional discussion on collectability and impairment considerations for operating leases.

### 6.6.3 Application Example — Operating Leases

Example 6-5 illustrates the initial and subsequent measurement of an operating lease.

**EXAMPLE 6-5: OPERATING LEASE**

**FACTS**

- Assume the same facts as in Example 6-1 except that neither Lessee nor an unrelated third party provides a residual value guarantee.
- Collectability of the lease payments is probable at the commencement date and throughout the lease term.

**CONCLUSION AND ANALYSIS**

- To determine whether to classify the lease as a sales-type lease, Lessor calculates the present value of the lease payments at the commencement date using the rate implicit in the lease of 4.68% (see Example 6-1):

| | PAYMENT |
|---|---|
| Year 1 | 25,000 |
| Year 2 | 25,000 |
| Year 3 | 25,000 |
| Year 4 | 25,000 |
| Year 5 | 25,000 |
| Year 6 | 25,000 |
| **Undiscounted payments** | **150,000** |
| **Present value (4.68%)** | **128,200** |

- Lessor concludes that none of the criteria for classifying the lease as a sales-type lease are met because:
  - The lease does not transfer ownership of the equipment to Lessee or grant it a purchase option.
  - The lease term is not for a major part of the remaining economic life of the underlying asset (6/10 = 60%).
  - The present value of the lease payments does not amount to substantially all the fair value of the equipment (128,200/170,000 = 75%).
  - The underlying asset is not of a specialized nature and will have alternative uses to the lessor at the end of the lease term.
- Also, the lease cannot be a direct financing lease because there is no third-party residual value guarantee. Accordingly, Lessor classifies the lease as an operating lease.
- Lessor initially recognizes the amount of initial direct costs ($2,000) as a separate asset.
- Lessor continues to measure the equipment in accordance with ASC 360.
- In Years 1 through 6, assuming the lease is not modified or terminated and the assessment of collectability as probable does not change, Lessor recognizes periodic lease income of $25,000 and amortization of the deferred initial direct costs of $333.

# 6.7 MODIFICATIONS

## 6.7.1 Determining if a Modification is a Separate Contract

**FASB REFERENCES**

ASC 842-10-15-6, ASC 842-10-20: Lease Modification, ASC 842-10-25-8, ASC 842-10-35-3, ASC 842-10-55-18, and ASC 848

ASC 842-10-20 defines a lease modification as "*a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for the lease (for example, a change to the terms and conditions of the contract that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term).*"

A lessor must account for the modification at the date that the lease modification is approved by both the lessee and the lessor (the effective date of the modification under ASC 842).

**CAREFULLY EVALUATE EFFECTIVE DATE OF A LEASE MODIFICATION**

The date on which a lease modification is approved by both a lessee and lessor may not be the date on which the lease modification is executed by both parties. If there are legally enforceable rights and obligations before the parties sign the lease modification, the accounting date for the modification is the date on which such rights and obligations became **legally enforceable**. In other words, the modification need not be in writing. Oral and implied lease modifications may trigger lease modification accounting. For example, a lessee and lessor may orally agree to modify lease terms in December and formally execute the modification in January. If the oral agreement creates legally enforceable rights and obligations in December, the lessor must account for the lease modification in December. Similarly, if a lessor signs a lease amendment in December but for administrative or other reasons the lessee signs the amendment in January, the effective date of the modification may still be December (if the lessor signing the amendment creates enforceable rights and obligations; for example, when the changes benefit the lessee). Determining when rights and obligations become legally enforceable is based on facts and circumstances and may require consultation with legal counsel.

**BDO INSIGHTS — WHETHER A CONTRACT MODIFICATION IS SUBSTANTIVE**

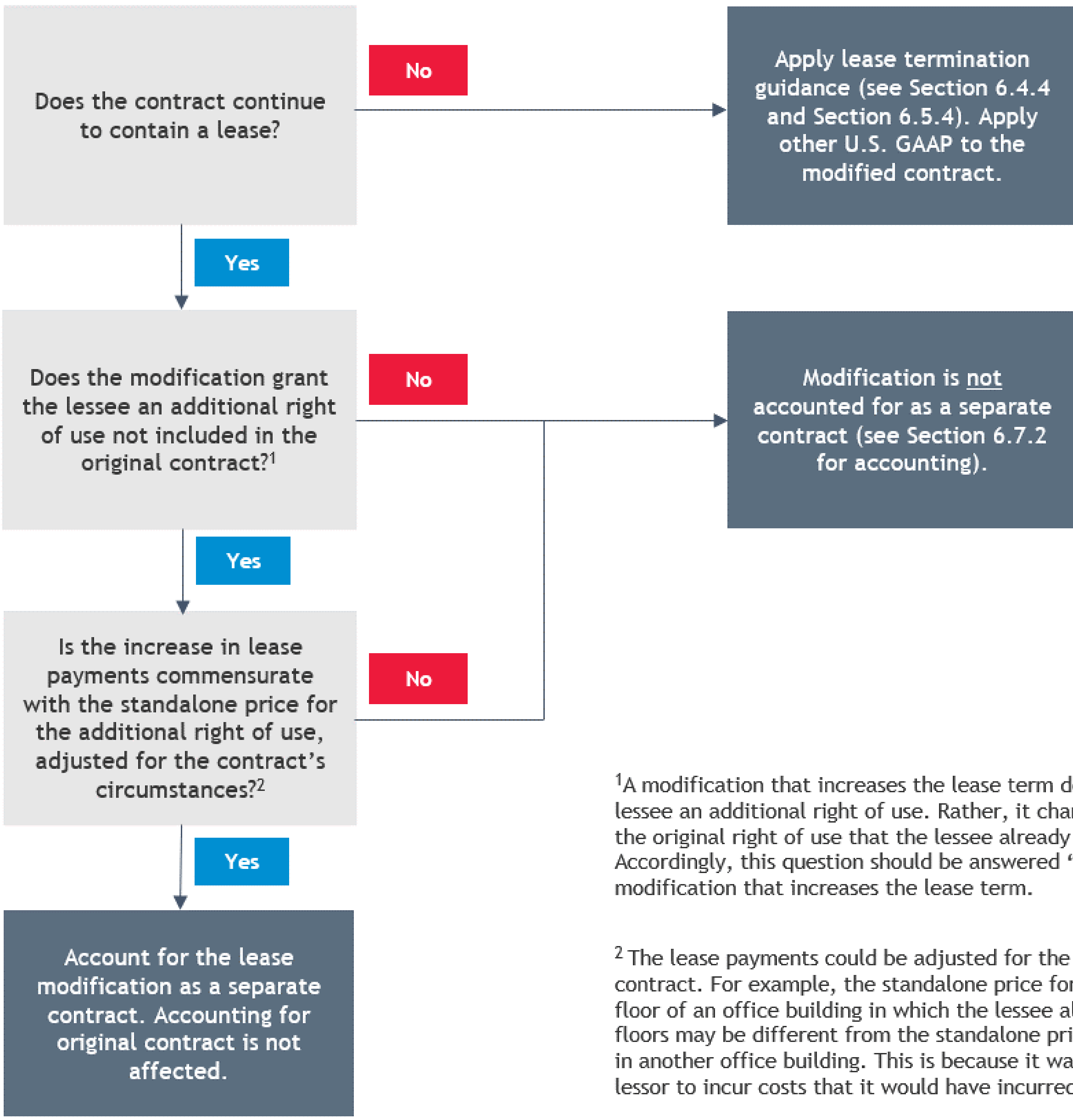
An entity reassesses whether a contract is or contains a lease only if the contract's terms and conditions are changed. We believe changes to the terms and conditions of a contract are generally presumed to be substantive, so the flowchart below typically applies. However, some changes to the terms of a lease may not be accounted as a modification under ASC 842. For example, a lease may be amended in a business combination to change only the name of the parties specified in the lease contract.

A lessor also accounts for the following events as modifications:

- When the lessee exercises a renewal or purchase option included in the original contract that the lessor previously determined was not reasonably certain of exercise
- When the lessee exercises a termination option included in the original contract that the lessor had determined the lessee was reasonably certain not to exercise

- When the lessee takes control over the use of an additional underlying asset under a master lease agreement that allows (but does not require) the lessee to gain control over the use of additional underlying assets during the term of the agreement.

In accounting for lease modifications, ASC 842 differentiates between modifications that result in a separate contract and that therefore do not affect the accounting for the original contract and modifications that must be accounted for as part of the original contract. That determination can be made by following the steps below.




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

[2] The lease payments could be adjusted for the circumstances of the contract. For example, the standalone price for the lease of one floor of an office building in which the lessee already leases other floors 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.

**RELIEF IS PROVIDED FOR REFERENCE RATE REFORM**

ASU 2020-04 provides entities with optional expedients and exceptions for applying U.S. GAAP to contracts and transactions affected by the reference rate reform (discontinuation of LIBOR or other reference rate expected to be discontinued). Accordingly, lessors may account for modifications to contracts within the scope of ASC 842 as a continuation of the existing contract. In other words, the change in reference rate is treated as variable lease payments that were based on the reference rate in the original lease. However, qualifying for the optional expedient requires analysis on any other terms concurrently modified. Any additional modifications must relate solely to the replacement of a reference rate because of reference rate reform. For example, changes to the contractual term of the lease; additions or terminations of right-to-use underlying assets; changes to renewal, termination, or purchase options, are deemed unrelated to the replacement of a reference rate and therefore are not eligible for the expedient. See ASC 848-20-15-2 through 15-6 for additional information about scope of the expedient and ASC 848-20-35-11 and 35-12 for application of the expedient to leases by lessors.

**BDO INSIGHTS — REASSESSING WHETHER A MODIFIED CONTRACT IS OR CONTAINS A LEASE**

Changes to the terms and conditions resulting from a lease modification generally will not affect the assessment of whether the arrangement includes a lease. In some cases, however, they might. For example, an original lease agreement may provide the customer (lessee) with the right to purchase all power a power plant produces, as well as decision-making rights related to the timing and amount of power produced by the plant. If the contract is modified to prospectively reduce the quantity of power the customer will purchase while allowing the lessor to determine the amount of power to generate, the parties must reassess whether the modified agreement continues to be a lease, including whether the customer continues to have the right to direct the use of the plant and obtain substantially all the economic benefits from use of the plant throughout the period of use.

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 6.4.4 on sales-type leases or Section 6.5.4 on direct financing leases may apply. ASC 842 does not address lease termination accounting for operating leases. However, we believe the lessor generally should write off any remaining lease-related accounts (for example, accrued or prepaid lease payments) at the effective date of the modification. 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 a lease or did not contain one but the modified contract is or contains a lease, the contract is a new lease accounted for under ASC 842.

**BDO INSIGHTS — MODIFICATION CONSIDERATIONS ASSOCIATED WITH ADDITIONAL RIGHT OF USE**

As discussed above, a lessor 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 execute a new lease for an office space in another building the lessor owns while 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 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 3.6).

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 only to "additional right of use" (that is, additional leases) — we believe a lessor may account for the modification as a separate contract if the increase in payments is commensurate with the standalone selling price for the nonlease component. That approach is consistent with the FASB's intent to align the lease modification guidance for lessors with the revenue modification guidance in ASC 606. However, given that ASC 842 refers to only "additional right of use," it may also be acceptable to conclude that the modification is not a separate contract and to apply the modification guidance.

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

**BDO INSIGHTS — MODIFICATION CONSIDERATIONS RELATED TO MASTER LEASE AGREEMENTS**

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

In contrast, a master lease agreement that specifies a minimum number of units or dollar value of equipment does not result in a lease modification when the lessee obtains control over the use of those additional assets. Rather, there could be separate lease components in the contract (see Section 3.2.2) and multiple commencement dates (see Section 4.2).

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 lessor must apply modification accounting, including reassessing classification and adjusting the accounting for the remaining lease components. That requires the lessor to reconsider inputs for classification and measurement purposes, such as the economic life and fair value of the underlying assets and the discount rate for the lease. In 2020, the FASB proposed changes to the modification guidance following stakeholder feedback questioning the usefulness and costs of applying modification accounting to modifications reducing the scope of some arrangements, such as master lease agreements. However, the FASB later 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, such as payments as a percentage of lessee's sales, that are not based on an index or rate are excluded from the definition of lease payments and are thus excluded from the consideration in the contract under ASC 842. However, if the lessee and lessor modify the agreement to change such payments, such as by lowering the percentage applied to the lessee's sales or to add variable lease payments not based on an index or rate, we believe the lessor should apply the modification framework discussed in this section. The lease modification guidance under ASC 842 is not limited to changes in the **consideration in the contract** (as defined in ASC 842) but rather applies more broadly to **any** changes in the consideration for a lease. In other words, any modification that results in changes in the payments required by the lease, whether those meet the definition of lease payments or not, should be evaluated under the modification guidance.

### 6.7.2 Accounting for Modifications That Are Not Separate Contracts

**FASB REFERENCES**

ASC 842-10-15-41 through 42, ASC 842-10-25-9 through 25-10, ASC 842-10-25-15 through 25-17, ASC 842-10-35-3, and ASC 842-10-55-190 through 55-209

If a modification is **not** accounted for as a separate contract (see Section 6.7.1), a lessor:

- Reassesses the lease term and any purchase option. See Sections 4.3 and 4.4 for additional details on assessing whether renewal options, purchase options, and termination options are reasonably certain to be exercised.
- Remeasures and reallocates the remaining consideration in the contract. See Section 4.4 for additional details on measuring the lease payments and Section 3.4 for additional details on measuring and allocating the consideration.
- Reassesses lease classification based on the facts and circumstances (and the modified terms and conditions) as of the effective date of the modification (for example, using the fair value and remaining economic life of the underlying asset at that date). See Section 4.9 for additional details on determining lease classification.

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

**SALES-TYPE LEASES WITH SELLING LOSS MODIFIED AFTER ADOPTION OF ASU 2021-05**

Before adopting ASU 2021-05, a lessor may have recognized a selling loss (or day-one loss") for a sales-type lease because of variable lease payments not based on an index or rate, such as payments based on energy produced by a solar farm. ASU 2021-05 changed the classification requirements for those leases and now requires a lessor to classify a lease as operating if:

- The lease includes variable lease payments not based on an index or rate
- Classifying the lease as sales-type would result in a selling loss.

We believe a lessor that has adopted ASU 2021-05 must apply those updated lease classification requirements to all leases that are modified on or after adoption of ASU 2021-05, including leases previously classified as sales-type, even if the lessor previously recognized a selling loss at the commencement date. In determining whether the modified lease would result in a selling loss (as defined in the Master Glossary) if classified as a sales-type lease, the lessor must use the carrying amount of the net investment in the lease immediately before the effective date of the modification as the carrying amount of the underlying asset. That is consistent with the guidance in ASC 842-10-25-16(b) on modifications to direct financing leases.

The table summarizes the accounting for modifications that are not considered separate contracts, depending on how classification changes (and assuming there continues to be a lease after the modification).

| MODIFICATION TYPE | ACCOUNTING CONSIDERATIONS |
|---|---|
| Operating lease to operating lease | ▶ Account for the modification as a termination of the existing lease and creation of a new lease that commences on the effective date of the modification.<br>▶ Consider any prepaid or accrued lease rentals related to the original lease as part of the lease payments for the modified lease.<br>▶ See Example 20 at ASC 842-10-55-190 through 55-193 for illustration. |
| Operating lease to sales-type or direct financing lease | ▶ Account for the modification as a termination of the existing lease and creation of a new lease that commences on the effective date of the modification.<br>▶ Recognize a net investment in the modified lease and derecognize both the underlying asset and any deferred rent liability or accrued rent asset (which adjusts the selling profit or loss).<br>• If the modified lease is classified as a sales-type lease, the selling profit or loss is recognized in profit or loss at the effective date of the modification. See Example 21, Case A, at ASC 842-10-55-194 through 55-197 for an illustration.<br>• If the modified lease is classified as a direct financing lease, any selling loss is recognized in profit or loss at the effective date of the modification. However, any selling profit is deferred and included in the measurement of the net investment in the lease. See Example 21, Case B, at ASC 842-10-55-198 through 55-200 for an illustration.<br>▶ After the effective date of the modification, a lessor accounts for the modified lease in the same manner as any other sales-type or direct financing lease. |
| Direct financing lease to direct financing lease or sales-type lease to sales-type or direct financing lease | ▶ Adjust the discount rate for the modified lease so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease immediately before the effective date of the modification.<br>▶ See Example 22, Case A, at ASC 842-10-55-201 through 55-205 for an illustration. |
| Direct financing lease to sales-type lease | ▶ Account for the modified lease under the guidance for sales-type leases. The effective date of the modification is the commencement date of the modified lease.<br>▶ Calculate the selling profit or selling loss on the lease as the difference between the fair value of the underlying asset at the effective date of the modification and the carrying amount of the net investment in the original lease immediately before that date.<br>▶ See Example 22, Case B, at ASC 842-10-55-206 and 55-207, and Example 6-6 of this Blueprint for illustrations. |
| Direct financing or sales-type lease to operating lease | ▶ The carrying amount of the underlying asset equals the net investment in the original lease immediately before the effective date of the modification.<br>▶ See Example 22, Case C, at ASC 842-10-55-208 and 55-209 and Example 6-7 of this Blueprint for illustrations. |

### 6.7.3 Application Examples — Modifications

Examples 6-6 and 6-7 illustrate the accounting for modifications that are not considered separate contracts.

**EXAMPLE 6-6: MODIFICATION OF A DIRECT FINANCING LEASE TO A SALES-TYPE LEASE**

**FACTS**

- Assume the same facts as in Example 6-4, in which Lessor and Lessee entered a six-year lease of nonspecialized equipment, with annual lease payments of $25,000 payable at the end of each year and a third-party residual value guarantee of $35,000. The lease was classified as a direct financing lease at the commencement date.
- Also:
  - At the end of Year 1 of the lease, Lessor and Lessee agree to extend the lease term by two years.
  - The annual lease payments in Years 7 and 8 are $30,000.
  - The fair value of the equipment at the effective date of the modification is $162,000.
  - The carrying amount of the net investment in the lease immediately before the modification is $138,669.
  - The estimated residual value of the equipment at the end of the modified lease is $20,000, of which $8,000 is guaranteed by a third party unrelated to Lessee or Lessor.
  - At the effective date of the modification, the remaining economic life of the equipment is nine years.
  - There are no initial direct costs related to the modification.

**CONCLUSION AND ANALYSIS**

- The modification does not grant Lessee an additional right of use but rather alters Lessee's already obtained right to use the equipment. The modification is not accounted for as a separate contract.
- Because the lease term is for a major part (in this case 78%) of the remaining economic life of the equipment at the effective date of the modification, Lessor classifies the lease as a sales-type lease (the lease payments are also substantially all of the equipment's fair value). ASC 842-10-25-3A on variable lease payments not based on an index or rate does not apply.
- The rate implicit in the modified lease is calculated as:

| END OF | PAYMENT | |
|---|---|---|
| Year 1 | (162,000) | |
| Year 2 | 25,000 | |
| Year 3 | 25,000 | |
| Year 4 | 25,000 | |
| Year 5 | 25,000 | |
| Year 6 | 25,000 | |
| Year 7 | 30,000 | |
| Year 8 | 50,000 | (30,000 lease payment + 20,000 estimated residual value) |
| **Rate implicit in the lease** | 5.64% | |

- At the modification's effective date, Lessor recognizes a net investment in the sales-type lease of $162,000 (the fair value of the underlying equipment at that date). It also derecognizes the outstanding balance of the net investment in the direct financing lease of $138,669. Lessor recognizes the difference of $23,331 as selling profit.
- The net investment in the lease consists of a lease receivable of $153,826 (present value of lease payments and third-party residual value guarantee) and unguaranteed residual asset of $8,174, all discounted at 5.64%.
- Following the modification, Lessor accounts for the sales-type lease in the same manner as any other sales-type lease (see Examples 6-1 and 6-2).

**EXAMPLE 6-7: MODIFICATION OF A SALES-TYPE LEASE TO AN OPERATING LEASE**

**FACTS**

- Assume the same facts as in Example 6-1, in which Lessor and Lessee entered a six-year lease of nonspecialized equipment, with annual lease payments of $25,000 payable at the end of each year and Lessee's residual value guarantee of $35,000. The lease was classified as a sale-type lease at the commencement date.
- Also:
  - At the end of Year 1 of the lease, Lessor and Lessee agree to shorten the lease term by two years.
  - The annual lease payments in Years 2 through 4 increase to $30,000, due at the end of each year.
  - The fair value of the equipment at the effective date of the modification is $162,000.
  - The carrying amount of the net investment in the lease immediately before the modification is $152,956.
  - Lessor expects that the equipment's residual value at the end of the remaining three-year lease term will be $90,000, of which $25,000 is guaranteed by Lessee.
  - At the effective date of the modification, the remaining economic life of the equipment is nine years.
  - There are no initial direct costs related to the modification.

**CONCLUSION AND ANALYSIS**

- Because the modification does not grant Lessee an additional right-of-use, Lessor does not account for it as a separate contract.
- The rate implicit in the modified lease is calculated as:

| END OF | PAYMENT | |
|---|---|---|
| **Year 1** | (162,000) | |
| **Year 2** | 30,000 | |
| **Year 3** | 30,000 | |
| **Year 4** | 120,000 | (30,000 lease payment + 90,000 estimated residual value) |
| **Rate implicit in the lease** | **4.33%** | |

- Lessor concludes that none of the criteria for classifying the lease as a sales-type lease are met because:
  - The lease does not transfer ownership of the equipment to Lessee nor grant it a purchase option.
  - The lease term is not for a major part of the remaining economic life of the underlying asset (3/9 = 33%).
  - The present value of the lease payments plus Lessee's residual value guarantee, discounted at 4.33%, does not amount to substantially all the fair value of the equipment at the effective date of the modification (104,756/162,000 = 65%).
  - The underlying asset is not of a specialized nature and will have alternative uses to the lessor at the end of the lease term.
- Because there is no residual value guarantee provided by a third party, Lessor classifies the modified lease as an operating lease in accordance with ASC 842-10-25-3(b).
- Lessor therefore recognizes the equipment at the carrying amount of the net investment in the lease immediately before the modification ($152,956) and derecognizes the net investment in the lease.
- If collectability of the lease payments plus Lessee's residual value guarantee is considered probable, Lessee will recognize the lease payments of $90,000 ($30,000 * 3 years) on a straight-line basis over the three-year modified lease term, as well as depreciation on the equipment over its remaining useful life.

## 6.8 IMPAIRMENT

### 6.8.1 Net Investment in Sales-Type and Direct Financing Leases

**FASB REFERENCES**

ASC 326-20-30-6A and ASC 842-30-35-3

As explained in Sections 6.4 and 6.5, the net investment in a sales-type or direct financing lease is an asset measured at amortized cost. Consequently, a lessor determines and records any loss allowance related to net investment in leases in accordance with ASC 326. In determining the loss allowance for a net investment in the lease, a lessor considers the collateral relating to the net investment in the lease, which represents the cash flows the lessor would expect to receive (or derive) from the lease receivable and the unguaranteed residual asset during and following the end of the remaining lease term.

Also, the contractual term over which expected credit losses are measured may differ from the lease term (see Section 4.3) under requirements that may shorten or extend the contractual term. For example, consideration of lease extension options under ASC 842 may not be reflected in the contractual term otherwise used for applying ASC 326 unless specific conditions are met. However, the FASB clarified that lessors must use the lease term determined under ASC 842 as the contractual term for the net investment in leases for purposes of measuring credit losses under ASC 326.

### 6.8.2 Operating Leases

**FASB REFERENCES**

ASC 450-20, ASC 842-30-25-11 through 25-13, and ASC 842-30-35-6

Because lessors do not derecognize the underlying asset associated with an operating lease, there is no net investment in the lease to assess for loss allowance. Instead, lessors must both:

- Assess the underlying asset for impairment in accordance with the guidance in ASC 360-10-35
- Consider the collectability of lease payments and any amounts due under residual value guarantees for recognition of lease income and therefore of operating lease receivables.

ASC 842-30 establishes a collectability constraint whereby a lessor recognizes lease income for operating leases on a straight-line basis (or other systematic basis) **only when** collectability of the lease payments and any amounts due under residual value guarantees is probable (see Approach 1 below for further discussion).

ASC 842-30 is silent as to whether a lessor can (or must) apply other U.S. GAAP, such as ASC 450-20, *Loss Contingencies*, for further impairment of its operating lease receivables. Operating lease receivables are outside the scope of ASC 326 on credit losses.

However, questions arose regarding whether the guidance in ASC 842-30 is the complete set of accounting guidance that a lessor considers for its operating lease receivables or whether a lessor can (or must) recognize reserves on its operating lease receivables under ASC 450-20.

The FASB clarified that two approaches are acceptable and that lessors must provide appropriate disclosures to the extent material: (1) Apply only ASC 842-30; (2) Apply ASC 842-30, then ASC 450-20.

- Approach 1: Apply only ASC 842-30.

Under this approach, a lessor applies only ASC 842-30 and consequently evaluates its operating leases for collectability on an individual lease basis at the lease commencement date and throughout the lease term.

| COLLECTABILITY OF LEASE PAYMENTS PLUS ANY AMOUNT NECESSARY TO SATISFY A RESIDUAL VALUE GUARANTEE IS: | LESSOR RECOGNIZES LEASE INCOME: |
|---|---|
| Probable | On a straight-line basis (or other systematic basis) plus variable lease payments in the period in which the changes in facts and circumstances on which those payments are based occur (an accrual basis method).<br>ASC 842 considers the right to control the use of the underlying asset as the equivalent of physical use. Accordingly, the extent to which the lessee uses the asset is not relevant when the lessee controls use of the asset and lease income is typically recognized on a straight-line basis. |
| Not probable | At the lesser of:<br>▶ Straight-line lease income (or other systematic basis) plus variable lease payments (the accrual basis method described above)<br>▶ Lease payments, including variable lease payments, collected (a cash basis method). |

When the assessment of collectability changes during the lease term, a lessor recognizes on a **cumulative basis** as a current period adjustment to lease income, the difference between (1) the accrual basis method and (2) the cash basis method, typically as either a credit to lease income (if collectability becomes probable) or as a debit to lease income (if collectability becomes not probable). The lessor then continues to assess collectability throughout the remainder of the lease term and makes further adjustments when the assessment of collectability subsequently changes (also on a cumulative basis as a current period adjustment to lease income).

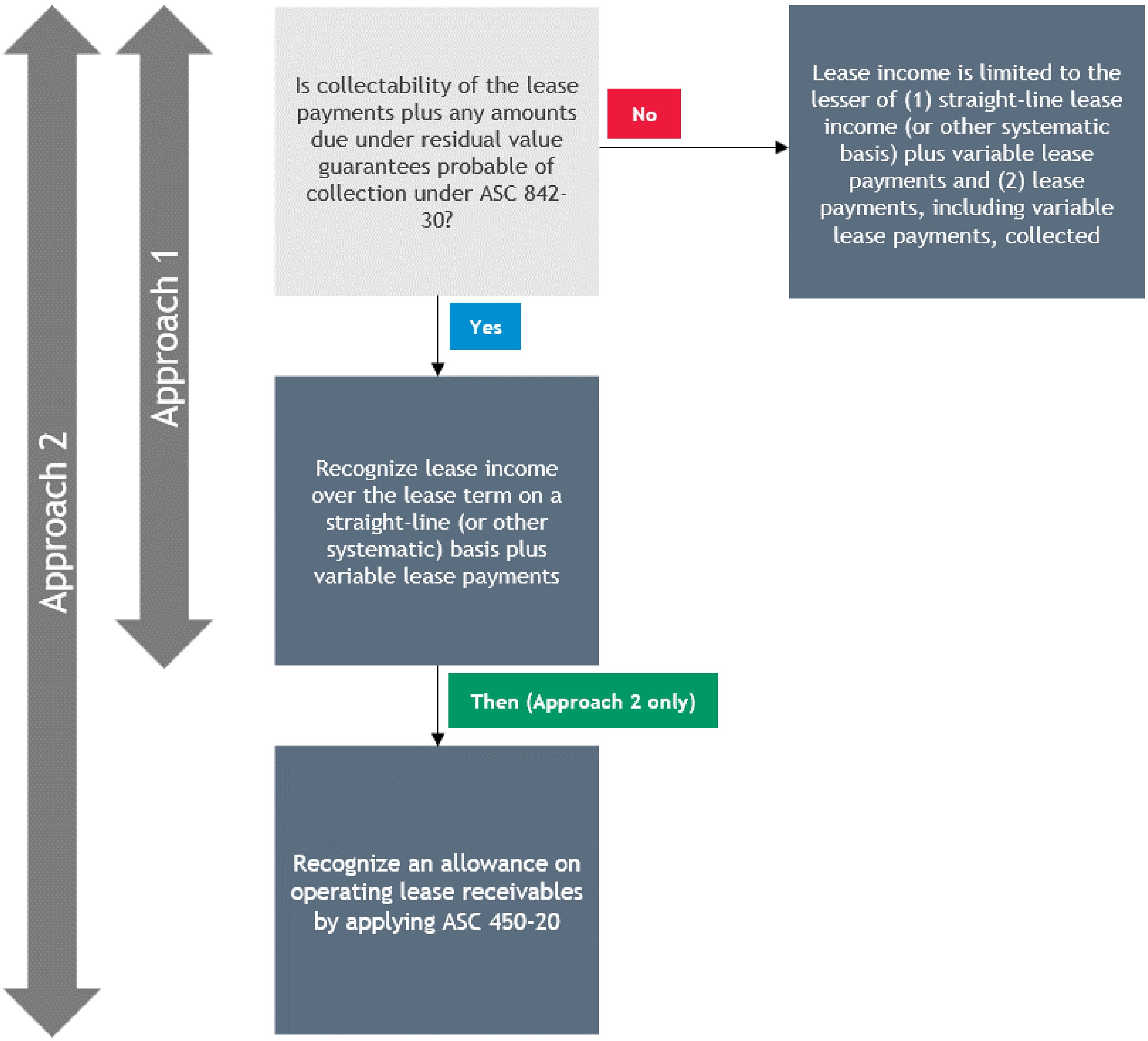
When collectability is not probable, the lessor recognizes lease income subject to the constraint described above, which means any lease receivable is fully reserved.

- Approach 2: Apply ASC 842-30, then ASC 450-20.

Under this approach (like Approach 1 above), a lessor assesses its operating lease receivables at the individual lease level under ASC 842-30 to determine whether collectability of the lease payments (plus any amount necessary to satisfy a residual value guarantee) is probable. If collectability is not probable, the lessor recognizes revenue subject to the cash basis constraint described in Approach 1, which means any lease receivable is fully reserved.

Next, a lessor applies ASC 450-20. For operating leases that were considered probable of collection under ASC 842-30 and for which receivables are recognized, the lessor establishes and maintains a general allowance (reserve) in accordance with ASC 450-20, reflecting the lessor’s expectation that a portion of the operating lease receivables will be uncollectable.

The flowchart summarizes the initial considerations when applying Approaches 1 and 2 (but does not address changes in the assessment of collectability).



The application of Approach 2 also results in additional practice issues, as summarized in the table.

| ISSUE | CONSIDERATIONS |
|---|---|
| Must reserves recognized under ASC 450-20 be established through a reduction of lease income or through bad debt expense? | Based on discussions with the FASB staff, either approach is acceptable. |
| If reserves under ASC 450-20 are established through bad debt expense, how must a lessor account for a change in assessment of collectability going from probable to not probable? | Broadly speaking, the FASB staff has said it is acceptable for the reserve accounting for operating lease receivables to be consistent with that applied for trade receivables (before ASC 326 became effective) as long as the lessor ceases recognizing lease income on a straight-line basis for an individual lease when collectability is no longer probable for that lease.<br>Specifically, we believe multiple approaches may be acceptable depending on the lessor's methodology for establishing and maintaining reserves under ASC 450-20, including:<br>▶ Writing off the gross receivable for the individual lease as an adjustment to lease income and separately adjusting the ASC 450-20 reserve as a bad debt expense adjustment (adjustments are made on a gross basis).<br>▶ Writing off the portion of the ASC 450-20 reserve attributable to the individual lease against the gross receivable for that lease and writing off the remaining balance of the lease receivable as an adjustment to lease income (adjustments are made on a net basis). This approach assumes that a lessor can identify on a systematic and rational basis the portion of the ASC 450-20 reserve attributable to individual leases.<br>Other approaches may be acceptable depending on the reserve methodology the lessor applied. In those circumstances, entities may want to discuss with their accounting advisor or auditor the appropriateness of their methodology for recapturing amounts from the general reserve. |

# 6.9 OTHER TRANSACTIONS

## 6.9.1 Sales of Lease Receivables

**FASB REFERENCES**

ASC 470-10, ASC 842-30-35-4, and ASC 860-10-55-6

Transfers of lease receivables from sales-type and direct financing leases (which, as discussed in Sections 6.4 and 6.5, include the lease payments and amounts under residual value guarantees that either the lessee or a third party provided) are subject to the requirements of ASC 860 on transfers and servicing. However, the unguaranteed residual assets do not meet the definition of financial assets. If a lessor sells substantially all the lease receivable associated with a sales-type or direct financing lease and retains an interest in the unguaranteed residual asset, it no longer accretes the unguaranteed residual asset to its estimated value over the remaining lease term. Instead, the lessor reports any remaining unguaranteed residual asset at its carrying amount at the date of sale and subsequently evaluates it for impairment using the guidance in ASC 360.

Future lease payments in an operating lease are executory in nature and do not qualify as a recognized financial asset in the balance sheet unlike lease receivables stemming from sales-type or direct financing leases discussed above. Accordingly, those lease payments are in the scope of ASC 860 **only** when they are due. A lessor accounts for the sale or assignment of future lease payments under an operating lease as a secured borrowing under ASC 470 because the lessor's economic interest in an operating lease represents the sale of future revenues in an executory contract rather than a receivable. Therefore, the lessor continues to record lease income on the operating lease in addition to recognizing interest expense on the borrowing. As the lessee makes payments under the lease, the lessor reduces the amount of borrowing based on the portion of the lease payments that represent principal reductions rather than interest expense. Lessors must not offset the lease income and the interest expense on the borrowing (that is, gross presentation in the income statement is required) because the secured borrowing transaction is separate from the operating lease.

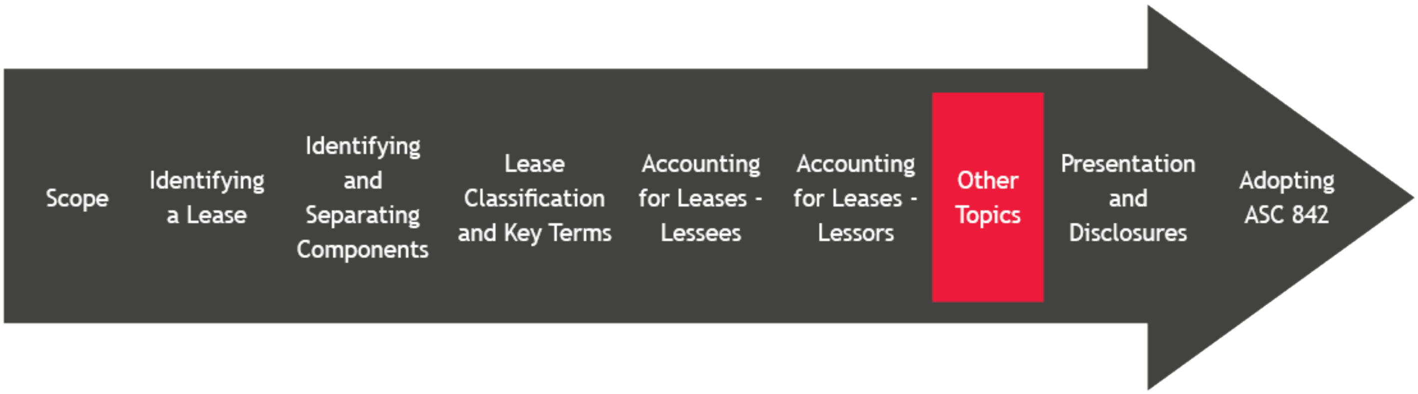
## 6.9.2 Other Transactions

This Chapter does not address other transactions, including:

- Sale and leaseback transactions (see Section 7.2)
- Sale of equipment with guaranteed minimum resale amount (see ASC 842-30-55-1 through 55-15)
- Guarantee payments received (see ASC 842-30-55-16).

# CHAPTER 7 — OTHER TOPICS

## 7.1 OVERVIEW



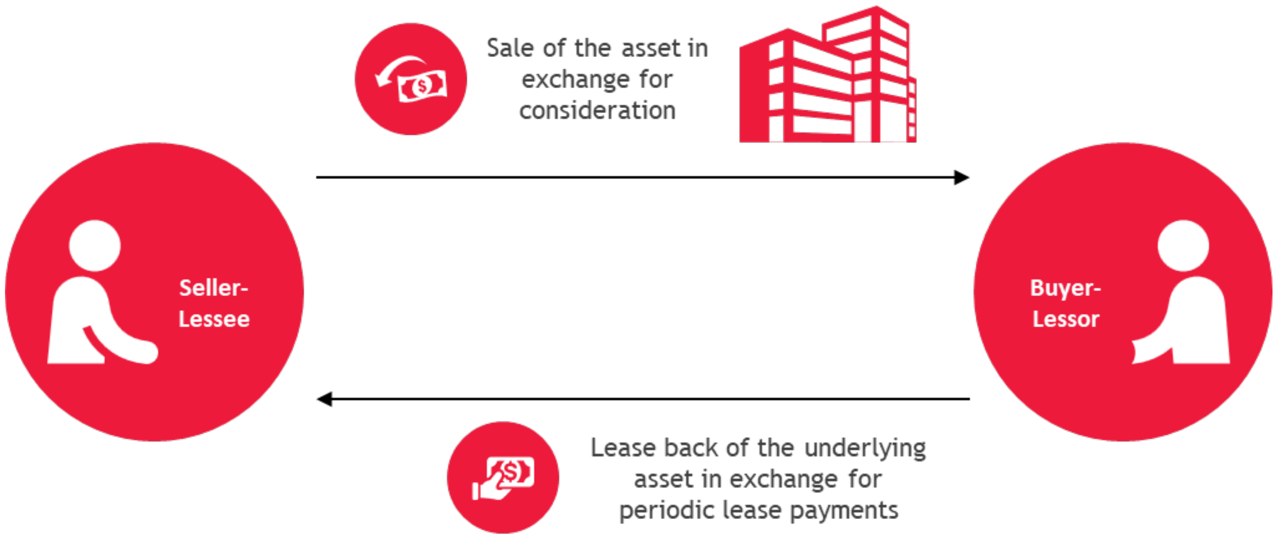

Chapters 5 and 6 discussed the accounting for leases by lessees and lessors, respectively. This chapter addresses other transactions and topics affected by the requirements under ASC 842, including:

- Sale and leaseback transactions
- Business combinations
- Subleases
- Income taxes

# 7.2 SALE AND LEASEBACK TRANSACTIONS

## 7.2.1 Overview

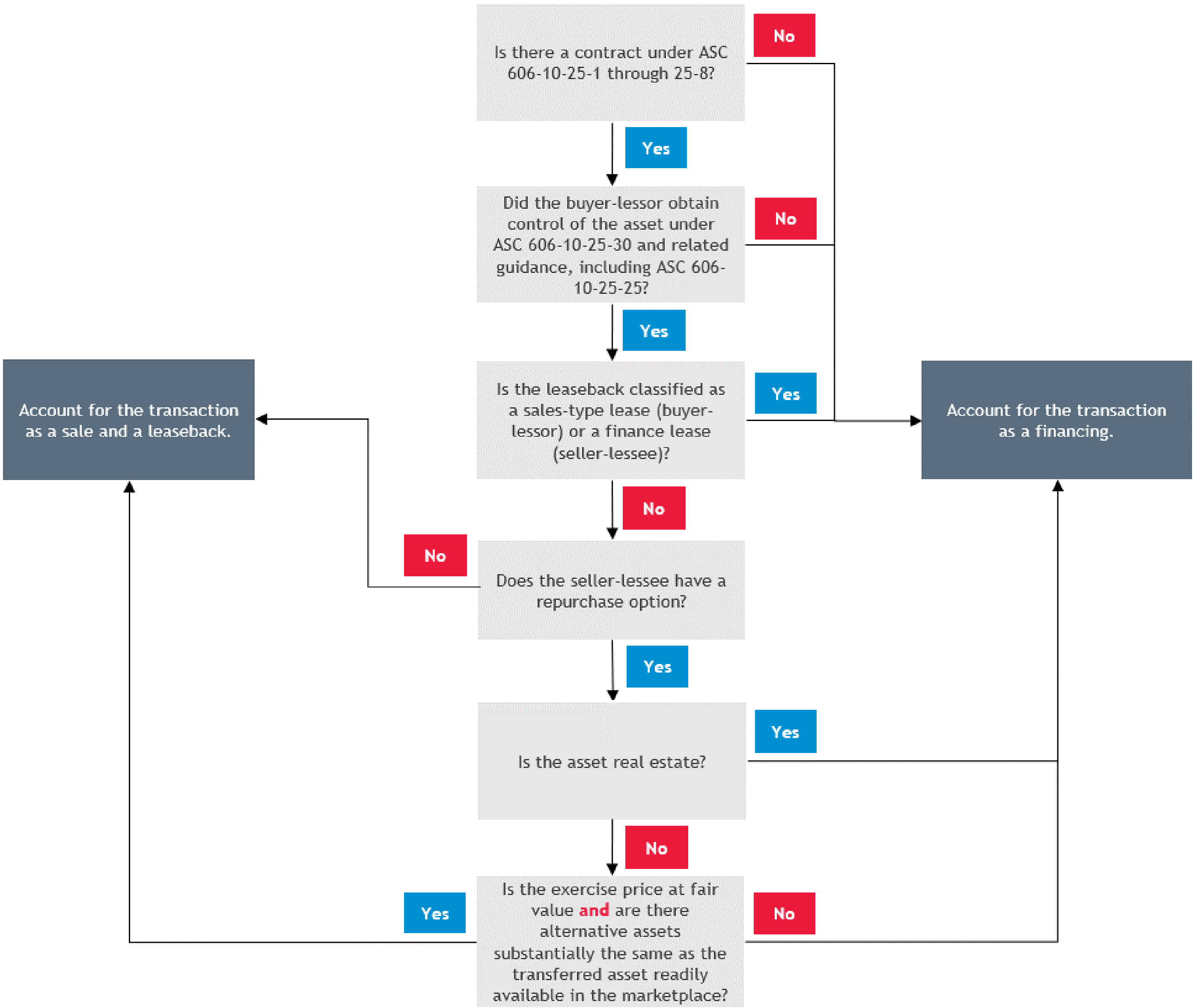
In a sale and leaseback transaction, one entity (the seller-lessee) transfers an asset it owns to another entity (the buyer-lessor) and leases that asset back from the second entity for a period of time in exchange for consideration.




For transactions within the scope of the sale and leaseback guidance, the seller-lessee **and** the buyer-lessor apply the requirements below to determine whether to account for the transaction as a sale and leaseback or as a financing arrangement.

| | |
|---|---|
| **Evaluate under ASC 606 whether a contract exists and whether the buyer-lessor obtains control of the asset** | ASC 842-40 relies on the guidance in ASC 606 in substantially the same way as does the guidance in ASC 610-20, which applies to sales of nonfinancial assets to parties other than customers. If under ASC 606 a contract does not exist or the buyer-lessor does not obtain control of the asset, no sale has occurred, and the transaction is accounted for as a financing. If a contract exists and the buyer-lessor obtains control of the asset, the entity applies the other requirements below. |
| **Determine whether the leaseback is classified as a sales-type lease (buyer-lessor) or finance lease (seller-lessee)** | The existence of a leaseback does not itself prevent the buyer-lessor from obtaining control of the asset. However, if the leaseback is classified as a finance lease by the seller-lessee or a sales-type lease by the buyer-lessor, the buyer-lessor does not obtain control of the asset. 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. |
| **Identify whether the seller-lessee has a repurchase option and, if so, evaluate whether that option precludes sale accounting** | ASC 606 notes that a customer does not obtain control of an asset if the seller has the obligation or 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:<br>▶ The exercise price is the asset's fair value at the time of exercise.<br>▶ 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).<br>If either of those two conditions is not met or the transferred asset is **real estate** (which is considered unique), the transaction is accounted for as a financing. |

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




## 7.2.2 Scope Considerations

### 7.2.2.1 Application by Seller-Lessee and Buyer-Lessor

**FASB REFERENCES**

ASC 842-40-15-2

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 to only the seller, not the customer. That symmetrical treatment also applies when the lessee is considered the accounting owner of an asset before lease commencement (see Section 7.2.2.2).

#### 7.2.2.2 Control of Underlying Asset Before Commencement Date

**FASB REFERENCES**

ASC 606-10-25-27, ASC 842-40-55-1 through 55-5, and ASC 842-40-55-39 through 55-44

The sale and leaseback guidance applies when the lessee controls the underlying asset before lease commencement. Depending on the facts and circumstances, the transactions below may be in scope of the sale and leaseback guidance.

**Lessee obtains legal title to the underlying asset before that title is transferred to the lessor and the asset is leased to the lessee.** →

The entity assesses whether the lessee **controls** the underlying asset before the asset transfers to the lessor (that is, whether the lessee directs the use of, and obtains substantially all the remaining benefits from, the asset before it transfers to the lessor). If the lessee controls the asset before the commencement date, the transaction is in the scope of the sale and leaseback guidance. Otherwise, the transaction is accounted as a purchase of the asset by the lessor and a lease between the parties.

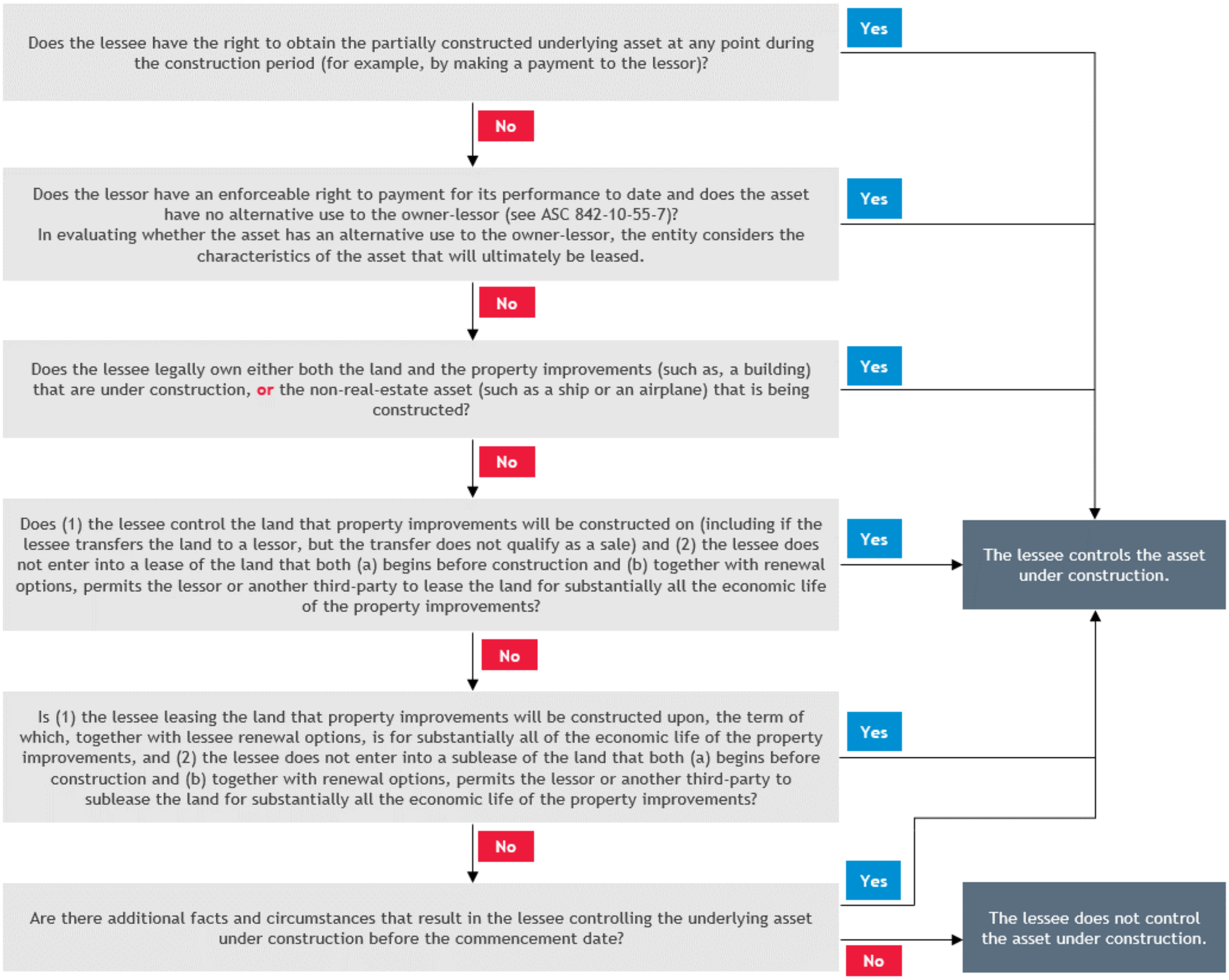
That could occur in, for example, transactions between a manufacturer, a lessor, and a lessee for the lessor's purchase of an asset from the manufacturer in which the lessee obtains legal title momentarily for tax or other reasons. If the lessee obtains legal title to the asset but does not obtain control of it before it is transferred to the lessor, the transaction is not a sale and leaseback transaction. The evaluation of control must be based on the specific facts and circumstances of the transaction, including whether the lessee obtains physical possession of the asset, has the significant risks and rewards of ownership, and accepts the asset before it is transferred to the lessor.

**Entity negotiates a lease before the underlying asset is available for use by the lessee, which is referred to as "build-to-suit transactions" (the underlying asset must be constructed or redesigned).** →

The entity assesses whether the lessee controls the underlying asset being constructed before the commencement date by applying the guidance in this section. If the lessee controls the asset being constructed before lease commencement, the transaction is in the scope of the sale and leaseback guidance. If not, the lessee may still incur costs relating to the construction or design of the underlying asset (for example, architectural services in developing the building specifications) before the commencement date. In those situations, the lessee accounts for those costs as follows:

- Under other U.S. GAAP, such as ASC 360 or ASC 330, for lessee-owned assets (for example, leasehold improvements the lessee pays for during the construction period that will benefit the lessee in future periods) and for goods or services (other than the lease) provided to the lessee.
- As lease payments (prepaid rent), regardless of the timing or form of those payments, such as contribution of construction materials, if the payments are made for the right to use the lessor-owned assets.

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




Because the list of circumstances discussed above 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 in 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 above guidance by both the seller-lessee and buyer-lessor.

If the lessee controls the asset under construction, it must recognize 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 guidance in Section 7.2.3 of this Blueprint to determine if and when to recognize a sale. As discussed in that section, an entity typically cannot conclude that there is a sale until the commencement date of the leaseback.

### EXAMPLE 7-1: LESSEE IS THE ACCOUNTING OWNER DURING ASSET CONSTRUCTION

#### FACTS

- Hospital owns vacant land adjacent to its hospital. It plans to use the land to expand its operations to include additional medical facilities that will complement current services provided to patients.
- Hospital leases the vacant land to Developer before construction begins and for a 40-year term with two five-year extension options. The completed building is expected to have an economic life of 40 years.
- Hospital will lease the completed building from Developer for an initial 20-year term with two five-year extension options.
- Hospital has a purchase option on the asset exercisable at any time throughout the construction period.

#### CONCLUSION AND ANALYSIS

- Hospital entered a lease of the land before construction begins and for a term including renewals that allow Developer to lease the land for substantially all the property improvements' economic life. However, Hospital has a purchase option on the partially constructed asset exercisable at any time during construction. It is therefore the accounting owner during construction, and the transaction is in the scope of the sale and leaseback guidance.
- Hospital recognizes the construction in progress in accordance with ASC 360 and any amounts funded by Developer as a financial liability.
- Because the accounting is symmetrical under ASC 842-40, Developer recognizes a receivable for construction costs incurred (rather than construction in progress) during the construction period.
- Because Hospital is the accounting owner of the construction project, Developer does not obtain the economic benefits from use of the land during construction. 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), Hospital and Developer will assess whether the transaction qualifies as a sale and leaseback.

**EXAMPLE 7-2: LESSEE IS NOT THE ACCOUNTING OWNER DURING ASSET CONSTRUCTION**

**FACTS**

- Assume the same facts as in Example 7-1, except that Hospital does not have a purchase option. There are no other circumstances resulting in Hospital being the accounting owner of the asset being constructed.
- Hospital provides various materials during construction of the additional building.

**CONCLUSION AND ANALYSIS**

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

**EXAMPLE 7-3: LESSOR PARTIALLY CONSTRUCTED THE ASSET BEFORE LEASE INCEPTION**

**FACTS**

- Lessee is in the luxury cruise line industry and enters a lease with Developer for a new cruise ship that Developer partially constructed at lease inception. The ship's fair value at lease inception is $25 million, and total expected costs to complete it are approximately $600 million.
- Lessee has an option to purchase the partially constructed asset at any point during construction.

**CONCLUSION AND ANALYSIS**

- Because of the purchase option, Lessee controls the luxury cruise ship under construction, and the transaction is in the scope of the sale and leaseback guidance. Lessee therefore recognizes construction in progress at its fair value and a financing obligation at lease inception.
- Because the accounting is symmetrical under ASC 842-40, Developer derecognizes the construction in progress and recognizes a receivable. The amount of the receivable recognized and any selling profit depend on the facts and circumstances. For example, if Developer has an obligation to complete the construction of the cruise ship, we believe it should recognize a receivable at cost plus an appropriate margin based on the percentage of completion method.

#### 7.2.2.3 Sale of Partially Constructed Asset With Contemporaneous Lease Upon Construction Completion

In some transactions, the owner of a partially constructed asset may sell the asset as is to a developer (lessor) who commits to complete construction of the asset and lease the completed asset back to the seller at the end of the construction period. The asset sold may be in different stages of construction (only soft costs incurred, hard costs incurred in varying degrees, and so forth). ASC 842 does not specifically address those transactions, so there may be multiple approaches for determining whether such transactions are in the scope of the sale and leaseback guidance. For example, the following approaches may be acceptable if an entity applies them consistently as an accounting policy:

- All sales of construction-in-progress assets, irrespective of the dollar amounts incurred or the stage of construction, with a commitment to lease the asset back once construction is completed are in the scope of the sale and leaseback guidance.

- Only transactions for which the construction-in-progress asset is substantially similar to the completed asset are in the scope of the sale and leaseback guidance.

However, because ASC 842 is not clear, other approaches, such as establishing a threshold at which construction-in-progress assets with a commitment to lease the asset back once construction is completed, may also be acceptable.

#### EXAMPLE 7-4: SALE OF A PARTIALLY CONSTRUCTED ASSET

**FACTS**

- Lessee is in the logistics industry and has started construction of a new plane, which it owns. So far, Lessee has incurred $75,000 in construction costs and expects total costs to be approximately $350,000.
- Lessee sells the partially constructed plane to Aircraft Builder who agrees to complete construction and lease the completed plane back to Lessee at the end of the construction period.
- Lessee is not the accounting owner of the asset during the remainder of the construction period (see Section 7.2.2.2).

**CONCLUSION AND ANALYSIS**

- Lessee has made an accounting policy to account for such transactions under the sale and leaseback guidance only if the partially constructed asset is substantially similar to the completed asset.
- Lessee considers the transaction's facts and circumstances, including costs incurred to date compared to total expected costs, and concludes that the transaction is not in the scope of the sale and leaseback guidance because the partially constructed asset is not substantially similar to the completed asset.
- Lessee applies other U.S. GAAP (for example, ASC 610-20) to determine whether and when to recognize the sale.

#### EXAMPLE 7-5: SALE OF A PARTIALLY CONSTRUCTED ASSET WITH A REPURCHASE OPTION

**FACTS**

- Assume the same facts as Example 7-4, except that the sale contract with Aircraft Builder provides Lessee with an option to purchase the partially constructed plane at any time during construction.

**CONCLUSION AND ANALYSIS**

- The purchase option results in Lessee being the accounting owner of the asset under construction (see Section 7.2.2.2). Therefore, Lessee does not derecognize the partially constructed plane, and it accounts for the proceeds from the sale as a financial liability. Lessee will recognize any additional amounts funded by Aircraft Builder for the construction of the plane as increases to value of the construction-in-progress asset and the financial liability.
- Because sale-leaseback accounting is symmetrical, Aircraft Builder accounts for the cash paid and any additional amounts funded for the construction of the plane as a receivable rather than as construction in progress.
- Lessee and Airplane Builder must wait until the commencement date of the leaseback to determine whether sale and leaseback is achieved. That is because ASC 842-40 precludes sale accounting when the leaseback is classified as a finance lease by the seller-lessee or sales-type lease by the buyer-lessor and classification of the leaseback cannot be assessed before the commencement date (see Section 7.2.3.3).

#### 7.2.2.4 Sale or Transfer of Purchase Option to Third Party With Leaseback of Asset

An entity may sell or transfer a purchase option on an asset to a third party with a commitment from the third party to exercise the option and lease the asset back to the entity. For example, a lessee may have a purchase option under an existing lease of a building (or equipment) that it assigns to a third party. In turn, the third party commits to exercise the option to purchase the building (or equipment) and 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 transaction's facts and circumstances to determine whether the sale and leaseback guidance applies.

**BDO INSIGHTS — ASSESSING TRANSFERS OF OPTIONS**

Consistent with the concepts underlying the guidance on repurchase options (see Section 7.2.3.4), 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 might not be within the scope of the sale and leaseback guidance. In that 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.

**EXAMPLE 7-6: ASSIGNMENT AND EXERCISE OF A PURCHASE OPTION IN A REAL ESTATE LEASE**

**FACTS**

- Distributor is the lessee of a warehouse that has a noncancelable term of 10 years and for which the expiration is approaching. The lease includes two fixed-price extension options for 10 years each and a fair value purchase option exercisable at the end of the initial 10-year term.
- Distributor assigns the purchase option to Real Estate Co., which commits to exercise the purchase option and purchase the warehouse subject to due diligence procedures. Upon closing, Real Estate Co. agrees to lease the warehouse to Distributor for a noncancelable period of 10 years. The lease includes two fixed-price extension options and a fair value purchase option.
- Following the due diligence procedures being satisfactory to Real Estate Co., the transaction closes and the lease commences.

**CONCLUSION AND ANALYSIS**

- Distributor and Real Estate Co. evaluate the transaction and determine based on the transaction's facts and circumstances (including that the purchase option is on a real estate asset, which is considered unique) that Distributor is considered to control the warehouse before Real Estate Co.'s purchase, even though Distributor does not legally own the warehouse. Therefore, the transaction is in the scope of the sale and leaseback guidance.
- Because the lease between Distributor and Real Estate Co. includes a purchase option, the transaction is accounted for as a financing by Distributor and Real Estate Co.

#### 7.2.2.5 Sale-Leaseback Transactions — Consolidation of Buyer-Lessors

Some sale-leaseback transactions may be structured with a legal entity the buyer-lessor specifically created for tax, legal, or other reasons to hold assets related to any sale and leaseback transactions. 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. That 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; see also this **consultation** the SEC staff discussed at the 2019 AICPA Conference on Current SEC and PCAOB Developments related to a sale-leaseback transaction involving a variable interest entity). Because transactions may be structured in many ways, reaching a conclusion requires the application of professional judgment based on facts and circumstances.

#### 7.2.2.6 Lessee Indemnity for Preexisting Environmental Contamination

**FASB REFERENCES**

ASC 842-40-55-7

A lessee may be required to indemnify the lessor for preexisting environmental contamination. However, that kind of provision alone does not mean the lessee controlled the underlying asset before the lease commencing, regardless of the likelihood of a loss resulting from the indemnity. Therefore, the presence of such a provision does not mean the transaction is in the scope of the sale and leaseback guidance.

#### 7.2.2.7 Sale-Leaseback-Sublease Transactions

**FASB REFERENCES**

ASC 842-40-55-18 through 55-19

An entity may enter a sale-leaseback transaction for which the asset is subject to an operating lease or is subleased (or intended to be subleased) by the seller-lessee to another party under an operating lease. A sale-leaseback-sublease transaction is within the scope of the sale and leaseback guidance. However, the existence of the operating lease or sublease does not itself prevent the buyer-lessor from obtaining control of the asset nor does it prevent the seller-lessee from controlling the asset before the transfer. All facts and circumstances must be considered in determining whether the buyer-lessor obtains control of the underlying asset in a sale-leaseback-sublease transaction.

#### 7.2.2.8 Sale Subject to a Preexisting Lease

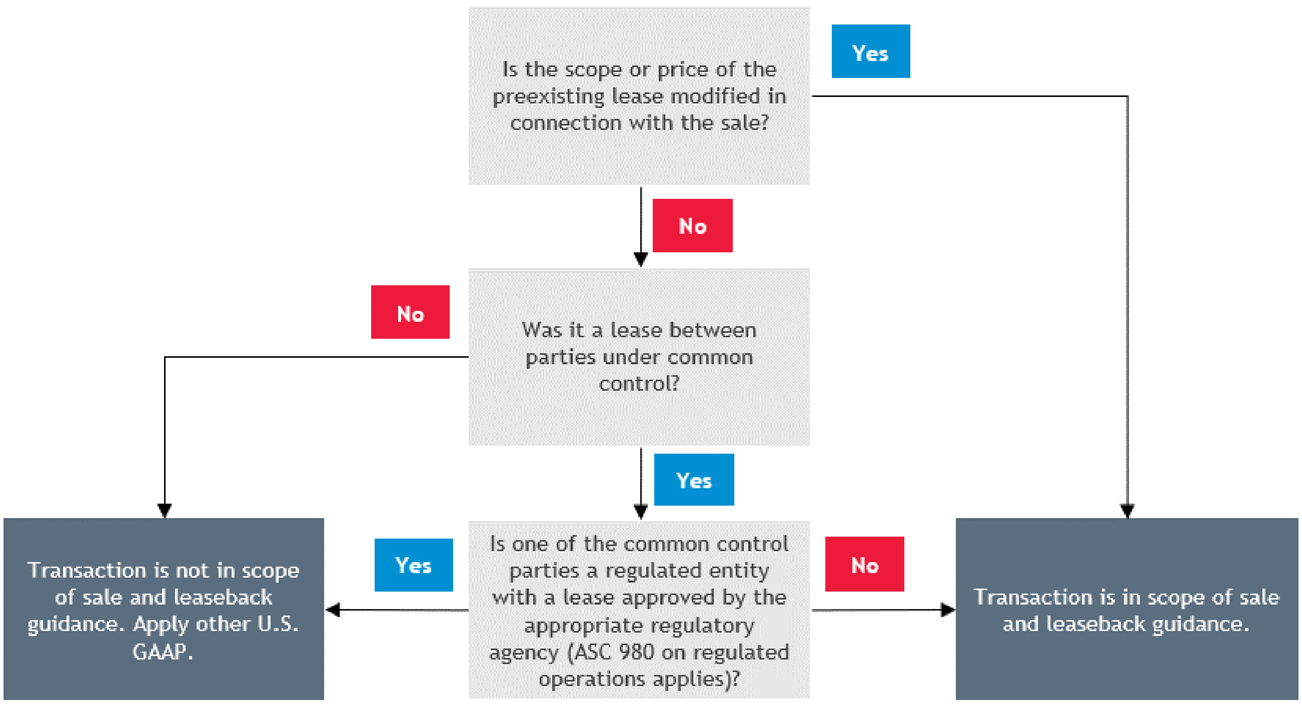
**FASB REFERENCES**

ASC 842-40-55-8 through 55-10

An entity or person may obtain an ownership interest in an underlying asset and at or near the same time enter an operating lease as a lessee for all or a portion of the underlying asset. For example, a medical practice or physician might obtain an ownership interest in a partnership or similar entity that owns a medical office building and at or near the same time enter a lease for all or a portion of the building.

If the lessee (the medical practice or physician) sells its interest in the partnership or the partnership sells the underlying asset to an unrelated third party (buyer-lessor) and the lessee continues to lease the underlying asset, the reporting entity must first determine whether the transaction is in the scope of the sale and leaseback guidance.

The flowchart provides additional details to determine whether the guidance applies.




As depicted above, when the answer to the first question in the flowchart is no because the lease scope or price is not modified as part of the transaction, whether the transaction is in scope of the sale and leaseback guidance depends on whether the in-place lease between the lessee and original owner/lessor was considered a common control lease. A lease between parties under common control is not considered a preexisting lease, so the transaction would be in the scope of the sale and leaseback guidance (except for entities in the scope of ASC 980).

**BUYER-LESSOR CONSIDERATIONS FOR SALES SUBJECT TO PREEXISTING LEASE**

As discussed in Section 7.2.2.1, the sale and leaseback guidance under ASC 842 applies to **both** seller-lessees and buyer-lessors. It may be challenging for the buyer-lessor to determine whether the original lessor and lessee were under common control if it does not have the necessary information. Therefore, it may be helpful for the buyer-lessor to request relevant information to making this determination as part of the negotiations.

**BDO INSIGHTS — DEFINING COMMON CONTROL**

Although U.S. GAAP does not define the term "common control," it generally has been interpreted to include relationships in which a controlling financial interest exists under the voting or variable interest entity model (unless a scope exception applies). It also includes fact patterns observed by the SEC staff in EITF Issue 02-5. We believe an entity must apply the term "common control" consistently in its financial statements (for example, when applying ASC 810 and evaluating sale and leaseback transactions).

Reaching a conclusion on whether an arrangement is a common control lease requires the application of professional judgment based on facts and circumstances (see our Blueprint, Control and Consolidation Under ASC 810).

#### 7.2.2.9 Modification of a Finance Lease to an Operating Lease

**FASB REFERENCES**

ASC 842-10-25-14

An entity may modify a finance lease such that the modified lease is classified as an operating lease. When that occurs, ASC 842 requires specific adjustments to account for the lease prospectively (see Section 5.8.2). Therefore, we believe the modification of a finance lease to an operating lease under ASC 842 is not within the scope of the sale and leaseback guidance.

#### 7.2.2.10 Transfer of Tax Benefits

**FASB REFERENCES**

ASC 842-40-55-11 through 55-17

ASC 842 provides guidance on determining whether the transfer of an ownership right in, but not necessarily title to, an asset by a U.S. entity to a foreign investor is a sale under the sale and leaseback guidance. If there is no sale, the entity accounts for the cash received as a financial liability. If there is a sale, the entity considers the facts and circumstances, and immediate income recognition may not be appropriate if there are indemnification or other contingencies.

### 7.2.3 Determining Whether the Transfer of the Asset Is a Sale

**FASB REFERENCES**

ASC 842-40-25-1 through 25-3

If a transaction is in the scope of the sale and leaseback guidance (see Section 7.2.2), the entity (seller-lessee or buyer-lessor) must determine whether the transfer of the asset is a sale. To do so, the entity must do all the following:

- Evaluates under ASC 606 both:
  - Whether a contract exists
  - Whether the buyer-lessor obtains control of the asset
- Assesses classification of the leaseback to determine whether the leaseback is classified as a finance lease (seller-lessee) or sales-type lease (buyer-lessor)
- Identifies repurchase options and determines if such repurchase options preclude sale accounting.

**BDO INSIGHTS — LEVEL OF ANALYSIS FOR SALE ASSESSMENT**

In some sale and leaseback transactions, a seller-lessee may sell an entire asset and enter a leaseback of only a physically distinct portion of that asset based on its business needs. For example, a seller-lessee may sell a multistory office building in which it leases back only some floors in the building. In other transactions, a seller-lessee may sell and lease back land and improvements, such as an office building or a warehouse. In those situations, a question arises as to the correct level at which to perform the sale analysis.

We believe the transfer of control (or sale) assessment under ASC 606 is typically performed at the legal title level, such as a legally titled piece of equipment or real estate property. For example, in the multistory sale and leaseback transaction described above, the analysis under ASC 606 will depend on whether the distinct portion leased back (the floor) is legally distinct (that is, whether the building is legally subdivided).

- If the portion leased back is legally distinct, the entity performs the analysis under ASC 606 to the legally distinct portion (floor) being leased back. The other legally distinct portions of the asset (the other floors not leased back by the seller-lessee) are not in scope of the sale and leaseback guidance and are analyzed under other U.S. GAAP, such as ASC 610-20 for the seller and ASC 360 for the buyer.
- If the portion leased back is not legally distinct, the entity typically should perform the analysis under ASC 606 at the level at which legal title resides, which is usually the building itself.

However, there is an alternative view for land. For transactions in which a seller-lessee sells to a buyer-lessor real estate comprising a single titled land and building and then leases the property back from the buyer-lessor (which includes the leaseback of the building and an explicit or implicit leaseback of the land (see Section 3.2.2.2)), two views are applied in practice:

- An entity performs the analysis under ASC 606 at the legal title level consistent with the guidance discussed above, which results in the single titled land and building being assessed as one unit.
- An entity treats the land and building as separate units of account under ASC 606 because land is by nature unique, is accounted for as a separate asset under ASC 360, and is typically considered a separate lease component (see Section 3.2.2.2).

For sale and leaseback transactions involving a single titled land and building, an entity must select its accounting policy and apply it consistently to similar transactions.

See Section 7.2.3.3 for further discussion on leaseback classification and its effect on sale assessment.

#### 7.2.3.1 Is There a Contract?

**FASB REFERENCES**

ASC 606-10-25-1 through 25-8 and ASC 842-40-25-1

All the conditions below must be met for a contract to exist.

- The parties have approved the contract and are committed to performing their respective obligations. The contract may be in writing, oral, or in accordance with other customary business practices.
- The entity can identify each party's rights regarding the goods or services to be transferred. In other words, the legal rights regarding the transfer of the goods or property are identifiable for the seller-lessee and buyer-lessor.
- The entity can identify the payment terms for the goods or services to be transferred.
- The contract has commercial substance. In other words, the risk, timing, or amount of the entity's future cash flows is expected to change because of the contract.
- It is probable the entity (seller-lessee) will collect substantially all the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer (buyer-lessor).

Determining if a contract exists generally does not create application issues. That is because sale and leaseback transactions typically include at least a purchase and sale agreement and a lease agreement, under which each party's rights and obligations, including payment terms, are clearly identified. Also, in many sale and leaseback transactions, the transaction has economic substance because the buyer-lessor pays the consideration upfront and takes on risks associated with the asset, including credit risk and risks of changes in fair market rent and in the asset's fair value. See our Blueprint, Revenue Recognition Under ASC 606, for more discussion of those conditions.

Once the entity concludes that a contract exists, the next step is to determine whether the buyer-lessor has obtained control of the asset.

### 7.2.3.2 Does the Buyer-Lessor Obtain Control of the Asset?

**FASB REFERENCES**

ASC 606-10-25-25, ASC 606-10-25-30, ASC 842-40-25-1, and ASC 842-40-55-20 through 55-21

An entity analyzes the control indicators below to evaluate whether the buyer-lessor has obtained control of the asset.

- The seller-lessee has a present right to payment for the asset.
- The buyer-lessor has legal title to the asset.
- The seller-lessee has transferred physical possession of the asset. However, in sale and leaseback transactions, the buyer-lessor generally does not receive physical possession of the asset until the end of the lease, so this indicator is typically not present.
- The buyer-lessor has the significant risks and rewards of ownership; for example, when it can sell the asset if the property value increases and absorbs any losses if value declines.
- The buyer-lessor has accepted the asset. This indicator might not apply in sale and leaseback transactions that do not include agreed-upon asset specifications.

The assessment of most of the indicators above is objective (for example, the seller-lessee's present right to payment or the buyer-lessor's having legal title). But the analysis of the risks and rewards indicator can be subjective, and there may be limitations on the risks the buyer-lessor takes. For example, a seller-lessee may guarantee the asset's residual value at the end of the lease term. That guarantee does not itself precludes accounting for the transaction as a sale and leaseback; instead, the entity considers the guarantee in its overall consideration of the risks and rewards indicator. The analysis may therefore require the use of professional judgment. In its overall assessment, the entity should consider the principle of transfer of control in ASC 606, which is that the customer (in this case, the buyer-lessor) has the right to direct the use of, and obtain substantially all the remaining economic benefits from, the asset. See our Blueprint, Revenue Recognition Under ASC 606, for further discussion of those indicators.

Any lessee residual value guarantee is also included in the assessment of lease classification (see Section 7.2.3.3) and, if the transaction meets the conditions for sale accounting, the entity accounts for the guarantee like any other lessee residual value guarantee in lease accounting.

#### 7.2.3.3 Is the Leaseback a Finance Lease or Sales-Type Lease?

**FASB REFERENCES**

ASC 842-10-15-28 through 15-29, and ASC 842-40-25-2

The existence of the leaseback does not itself prevent the buyer-lessor from obtaining control of the asset. That is because the lease payments the buyer-lessor receives during the lease term and the benefits it can generate from the residual asset after the lease term represent substantially all the remaining benefits to be derived from the asset immediately before the asset is leased to the seller-lessee.

However, when a lease is classified as a finance lease by the seller-lessee or a sales-type lease by the buyer-lessor, the seller-lessee controls the underlying asset because it is considered to direct the use of, and obtain substantially all the remaining benefits from, the asset. Accordingly, the FASB determined that no sale should occur because a finance lease is economically like purchasing the asset and it would be inappropriate for a seller-lessee to account for a concurrent sale and, in effect, a repurchase of the same asset. In an operating lease, the seller-lessee does not obtain substantially all the remaining benefits from the underlying asset, so an operating leaseback does not preclude accounting for the transaction as a sale.

In performing this step, an entity assesses classification at the leaseback commencement date (see Section 4.2) and at the lease component level (see Section 3.2.2). Accordingly, if there are multiple assets, the lease components must be identified first.

**EXAMPLE LEASE COMPONENTS**

- Right to use real estate, such as a retail store in a mall or a floor in an office building.
- Right to use computer equipment, such as a server.
- Right to use a vehicle, such as a delivery truck.

See Section 4.9 for guidance on lease classification.

**CAREFULLY EVALUATE THE ACCOUNTING WHEN LEASEBACK HAS NOT YET COMMENCED**

In some sale and leaseback transactions, the leaseback does not commence until a future date (for example, until a building or warehouse is constructed or renovated). In those situations, the entity cannot recognize a sale (or purchase) until the leaseback commences because lease classification is assessed at the commencement date (see Section 4.9). Therefore, even if there is a high likelihood that the lease will be classified as an operating lease by the seller-lessee or as a direct financing or operating lease by the buyer-lessor, an entity cannot determine that a sale exists until the leaseback commences.

**EXAMPLE 7-7: SALE OF LAND WITH LEASEBACK FOLLOWING CONSTRUCTION OF A BUILDING**

**FACTS**

- Hospital owns vacant land adjacent to its hospital and plans to expand its operations to include additional medical facilities that complement its patient services.
- Hospital sells the vacant land to Developer, which will construct the building.
- Once Developer completes construction, Hospital agrees to lease the completed building for a noncancelable term of 20 years, with two five-year extension options.

**CONCLUSION AND ANALYSIS**

- The leaseback of the medical office building once construction is complete includes an implicit lease of land (see Section 3.2.2.2). Therefore, the sale of the land is in the scope of the sale and leaseback guidance.
- Hospital and Developer cannot conclude that a sale has occurred until leaseback commencement. Therefore, Hospital, not Developer, recognizes the land during the construction period.
- Both entities must also determine whether Hospital is the accounting owner of the building under construction (see Section 7.2.2.2 for additional discussion).

**BDO INSIGHTS — FINANCE (SALES-TYPE) LEASEBACK CLASSIFICATION FOR DISTINCT PORTION OF ASSET SOLD**

As discussed in this section, if the leaseback is classified as a finance lease by a seller-lessee or as a sales-type lease by a buyer-lessor, the transaction is accounted for as a financing (see Section 7.2.5). That aspect of the guidance is clear and generally straightforward. However, as discussed in Section 7.2.3, in some sale and leaseback transactions, a seller-lessee might not need to lease back the entire asset sold and therefore might lease back only a distinct portion of it. For example, a seller-lessee may sell a multistory office building and lease back only some floors. In those situations, the accounting for the transaction depends on the unit of evaluation — specifically, whether the portion leased back (the floor in this example) is legally distinct (that is, whether the building is legally subdivided).

- If the leased back portion is legally distinct, the entity applies the analysis under ASC 842-40 to that portion. If the leaseback of the distinct portion is a finance lease (seller-lessee) or a sales-type lease (buyer-lessor), sale accounting is precluded for that portion. The other legally distinct portions of the asset (for example, the other legally distinct floors not leased back by the seller-lessee) are not in scope of the sale and leaseback guidance and are assessed under other U.S. GAAP, such as ASC 610-20 for the seller and ASC 360 for the buyer.
- If the portion is not legally distinct (for example, legal title is for the entire building), the analysis depends on the leaseback's significance to the transaction. Consistent with the principle of transfer of control in ASC 606-10-25-25, which requires that the customer (in this case, the buyer-lessor) obtain **substantially all** the remaining economic benefits from the underlying asset, we believe sale accounting is precluded unless the leaseback is for a minor portion of the asset sold and the other requirements for sale accounting discussed in Section 7.2.3 are met. The leaseback could be minor; for example, if the leaseback is for one floor of a 20-story office building.

Also, when the portion leased back is not legally distinct and sale accounting is precluded based on the facts and circumstances, additional complexity in the accounting for the transaction as a financing may arise. Specifically, the entity should consider any accounting implications for the portions of the asset not leased back by the seller-lessee. For example, a seller-lessee may sell to a buyer-lessor a five-story office building that is not legally subdivided. If the seller-lessee leases back only the first two floors, and the leaseback of either floor is a finance (sales-type) leaseback and considered significant, sale accounting would be precluded. In that scenario, the entity should consider how to account for floors the seller-lessee does not lease back.

There is diversity in practice in those situations, with some entities:

- Concluding that the entire transaction is a financing transaction. Under this framework, the seller-lessee recognizes the full amount of consideration received as a financial liability. In subsequent accounting for the transaction, the seller-lessee allocates rents paid to the buyer-lessor for the floors being leased back between interest expense and reduction of the financial liability. The seller-lessee also imputes lease income on the floors it does not lease back (which are considered leased out because the seller-lessee remains the accounting owner of the entire building), with a portion recognized as interest expense and the remainder as a reduction of the financial liability. This accounting is consistent with guidance in legacy U.S. GAAP (ASC 840-20-35-4).

- Continuing the assessment further for the components the seller-lessee does not lease back (which are deemed leased to the buyer-lessor by the seller-lessee as accounting owner/lessor of the asset). That may result in classifying those components as sales-type leases or finance leases; for example, if title of the asset transfers by the end of the lease term or the proceeds from the purchase price allocated to those distinct portions represents substantially all the fair value of the distinct asset.

#### 7.2.3.4 Is There a Repurchase Option?

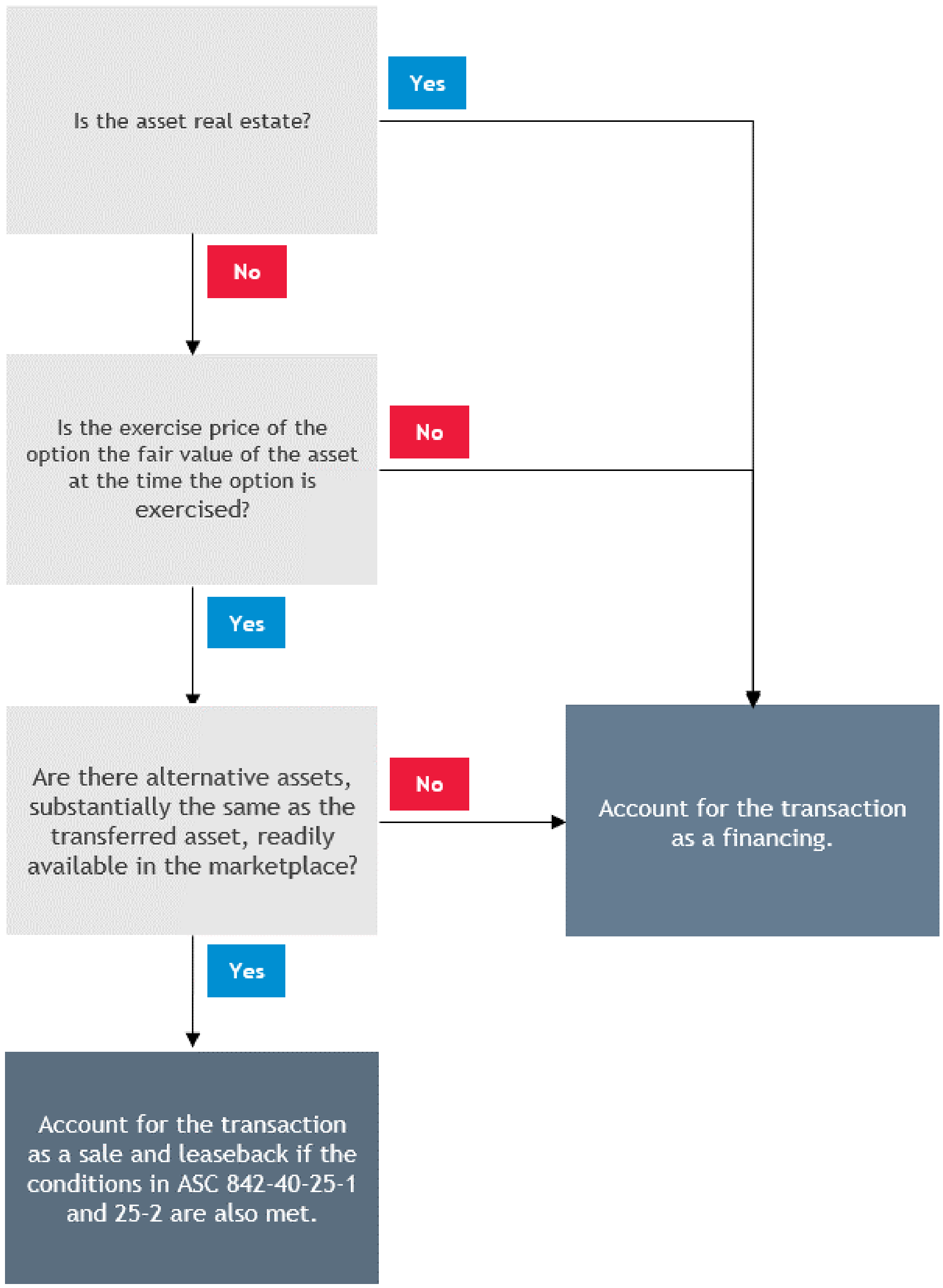
**FASB REFERENCES**

ASC 842-40-25-3

Under ASC 606, a customer does not obtain control of an asset if the seller has the obligation or right to repurchase the asset. However, for sale and leaseback transactions, the FASB decided that some repurchase options do not preclude sale accounting, stating in paragraph BC352 of ASU 2016-02 that "*a buyer-lessor is not constrained in its ability to direct the use of and obtain substantially all the remaining benefits from the asset if the seller-lessee can only repurchase the asset at its then-prevailing fair market value and the buyer-lessor could use the proceeds from the repurchase to acquire an asset that is substantially the same in the marketplace*."

The FASB noted in paragraph BC352(c) of ASU 2016-02 that its 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 and leaseback transaction involving real estate (including integral equipment as defined in ASC 978) will **always** preclude sale accounting, even if the repurchase option is at fair value.

The flowchart below summarizes the steps under ASC 842 to determine whether an unconditional repurchase option precludes sale and leaseback accounting.




Also, sale and leaseback transactions may include terms, such as extension options for substantially all the remaining economic life of the asset or residual value guarantees, that have resulted in practice issues in the application of ASC 842-40-25-3.

### BDO INSIGHTS — RENEWAL CLAUSES

Some lease arrangements may provide for fixed price or fair value renewal options for all or substantially all the remaining economic life of the underlying asset. In paragraph 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 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 — RESIDUAL VALUE GUARANTEES IN A SALE AND LEASEBACK**

In some equipment sale and leaseback transactions, a seller-lessee may guarantee the residual value of the asset and may also have a fair value repurchase option exercisable at the end of the lease term. Accordingly, the amount the buyer-lessor will receive upon exercise of the repurchase option depends on the fair value at the exercise date compared to the residual value guarantee amount. If the fair value of the asset is equal to or greater than the residual value guarantee, no payment under the residual value guarantee is triggered and the buyer-lessor receives an amount equal to fair value. If the fair value of the asset is less than the residual value guarantee and the seller-lessee exercises its repurchase right, the buyer-lessor would receive the residual value guarantee amount (that is, an amount in excess of fair value). Therefore, the repurchase option is not solely at fair value. However, if all other conditions for sale accounting (that is, the conditions in Section 7.2.3) are met, the transaction may still meet the conditions in this section on repurchase options if alternative assets substantially the same as the equipment are readily available in the marketplace. That is because the buyer-lessor will always receive an amount that is at least equal to fair value, which it could use to acquire an equivalent asset at fair value in the marketplace.

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

**BDO INSIGHTS — CONTINGENT REPURCHASE OPTIONS IN REAL ESTATE SALE AND LEASEBACK TRANSACTIONS**

Lease agreements may include repurchase rights that can be exercised only if a specified event has occurred; for example, if there is a change of control of the buyer-lessor or seller-lessee. ASC 842-40 does not specifically address contingent repurchase options. However, paragraph BC352(c) in the Basis of Conclusions of ASU 2016-02 makes clear that the guidance on repurchase options is based on the guidance on repurchase rights in ASC 606. Under ASC 606, contingent repurchase options do not automatically preclude sale accounting; rather, such options are evaluated based on the transaction's specific facts and circumstances. For example, a repurchase option that is exercisable based on a contingent event that is within the entity's (seller's) control generally implies that the customer has not obtained control of the asset and that the transaction therefore does not qualify for sale accounting. In contrast, a contingency within the customer's control may imply that the customer has the ability to determine whether the repurchase option is exercisable and therefore is not limited in its ability to direct the use of, and obtain substantially all the remaining benefits from, the asset.

Therefore, like contracts with contingent repurchase options under ASC 606, we believe that for real estate:

- A sale and leaseback transaction that includes a contingent repurchase option for which the contingency is within the seller-lessee's control would preclude sale and leaseback accounting.
- A sale and leaseback transaction that includes a contingent repurchase option for which the contingency is within the buyer-lessor's control may not preclude sale and leaseback accounting, even if the underlying asset is real estate. The evaluation would be like that of buyer put rights under ASC 606 (that is, whether the buyer-lessor has a significant economic incentive to exercise the put).
- If the contingency is outside the control of both the seller-lessee and buyer-lessor, whether sale and leaseback accounting is achieved depends on the transaction's facts and circumstances. For example, a contingent event put in place as a protective measure and the remote likelihood at the transaction date that the event will occur may imply that the buyer-lessor has obtained control of the asset, even if the underlying asset is real estate. In contrast a contingent event put in place in contemplation of a transaction or event potentially occurring in the near future and that is likely to occur at the transaction date may imply that the buyer-lessor

has not obtained control of the asset because it is limited in its ability to direct the use of, and obtain substantially all the remaining benefits from, the asset (because there is a contingency outside its control and that is likely to occur).

Determining whether a contingent repurchase option precludes sale accounting requires the application of professional judgment based on facts and circumstances.

**BDO INSIGHTS — RIGHT OF FIRST REFUSAL IN REAL ESTATE SALE AND LEASEBACK TRANSACTIONS**

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 and 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 the 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 Section 7.2.3 are met). In that scenario, the buyer-lessor controls the property by retaining the right to decide whether and when to sell it.

**BDO INSIGHTS — RIGHT OF FIRST OFFER IN REAL ESTATE SALE AND LEASEBACK TRANSACTIONS**

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. Right of first offers have varying terms and may be exercisable only after a period of time or at a specified time and only for a fixed or determinable amount based on a formula or at market rates. Whether a right of first offer in a sale and 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 Section 7.2.3 are 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.

## 7.2.4 Accounting When Transfer of the Asset Is a Sale

### 7.2.4.1 Recognition

**FASB REFERENCES**

ASC 606-10-25-30, ASC 606-10-32-2 through 32-27 and ASC 842-40-25-4

If after analyzing the terms (see Section 7.2.3), 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 both party as any other lease under ASC 842.

When the transaction is at market terms, the following occur at the date determined under ASC 606 that the buyer-lessor obtains control of the asset:

| THE SELLER-LESSEE | THE BUYER-LESSOR |
|---|---|
| ▶ Derecognizes the carrying amount of the underlying asset.<br>▶ Recognizes the transaction price in accordance with ASC 606-10-32-2 through 32-27.<br>▶ Recognizes a gain or loss for the difference between the transaction price and carrying amount of the asset.<br>▶ Accounts for the leaseback in accordance with ASC 842-20 on lessee accounting (see Chapter 5). | ▶ Accounts for the purchase of the asset in accordance with other U.S. GAAP (typically ASC 360).<br>▶ Accounts for the leaseback in accordance with ASC 842-30 on lessor accounting (see Chapter 6). |

Examples in this chapter illustrate the accounting for various sale and leaseback transactions under different scenarios. The tables 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.

**EXAMPLE 7-8: SALE-LEASEBACK TRANSACTION WHEN TRANSFER OF ASSET IS A SALE**

**FACTS**

- Seller-Lessee sells an airplane to an unrelated Buyer-Lessor for $3 million, which is its fair value.
- The airplane's carrying amount is $2.7 million, and it has a remaining useful life of 15 years.
- At the same time as the sale, Seller-Lessee enters a contract with Buyer-Lessor for the right to use the airplane for five years, with annual payments of $300,000 payable in arrears and escalating 2% annually.
- The leaseback does not transfer ownership to Seller-Lessee by lease term end and does not include a purchase option. There are no initial direct costs.
- The requirements on contract existence (see Section 7.2.3.1) and transfer of control (see Section 7.2.3.2) are met and the leaseback is classified as an operating lease by both Seller-Lessee and Buyer-Lessor (see Section 7.2.3.3).
- Seller-Lessee's incremental borrowing rate is 4%. The rate implicit in the lease is not readily determinable.

**CONCLUSION AND ANALYSIS**

<u>Assessing whether the transfer of the asset is a sale</u>

- Seller-Lessee and Buyer-Lessor determine 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.

<u>Accounting by Seller-Lessee</u>

- At the commencement date, Seller-Lessee records the following journal entry:

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

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

| | PAYMENTS |
|---|---|
| Year 1 | 300,000 |
| Year 2 | 306,000 |
| Year 3 | 312,120 |
| Year 4 | 318,362 |
| Year 5 | 324,730 |
| **Undiscounted payments** | **1,561,212** |
| **Present value (4%)** | **1,387,891** |

- 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.
- Seller-Lessee calculates the total lease cost to be recognized over the lease term:

| | AMOUNT |
|---|---|
| Total lease payments (paid and not yet paid) | $ 1,561,212 |
| Plus initial direct costs | — |
| Total lease cost [A] | $ 1,561,212 |
| Periodic lease cost [B] = [A] / 5 | $ 312,242 |

- The table summarizes the accounting for the lease liability, assuming no modifications.

| | BEGINNING BALANCE | INTEREST (4%) | PAYMENT | ENDING 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 and impairments (see Chapter 5).

| | BEGINNING BALANCE [A] | PERIODIC LEASE COST [B] | INTEREST (4%) [C] - SEE ABOVE | AMORTIZATION [D] = [B] + [C] | ENDING BALANCE [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) | — |

- Seller-Lessee recognizes straight-line lease expense of $312,242 on an annual basis throughout the lease term.

Accounting by Buyer-Lessor

- Buyer-Lessor recognizes the airplane at cost for $3 million and subsequently accounts for the asset under ASC 360.
- Because the lease is classified as an operating lease, Buyer-Lessor recognizes lease income of $312,242 annually, assuming collectability of the lease payments is probable throughout the lease term (see Section 6.8.2).

#### 7.2.4.2 Off-Market Terms

**FASB REFERENCES**

ASC 606-10-32-5 through 32-9, ASC 842-40-30-1 through 30-4, and ASC 842-40-55-23 through 55-30

In a sale and leaseback transaction, the sale price and lease payments 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 transaction occurs at other than a market rate.

**EXCEPTION EXISTS FOR RELATED-PARTY SALE AND LEASEBACK TRANSACTIONS**

The guidance on adjustments for off-market terms does not apply if the transaction is between related parties. Instead, the related-party lessee and lessor must make appropriate disclosures. That is consistent with the FASB's decision that an entity should account for a related-party lease in accordance with the enforceable terms and conditions of that lease.

The entity determines whether the transaction is at market by comparing the difference between the more readily determinable, maximizing the use of observable prices and observable information, of **either**:

- The asset's sale price and fair value
- The present value of the lease payments and market rental payments.

Accordingly, an entity does not have to determine **both** the fair value of the underlying asset and the market rental payments. The FASB decided that such a requirement would likely be unnecessary, given that any overpayment for the underlying asset by the buyer-lessor would often be accompanied by above market rental payments and vice versa.

- If the sale price is **below** fair value, the entity accounts for the difference as prepaid rent because the underpayment is in substance no different from a prepayment of rent by the seller-lessee. The buyer-lessor recognizes the prepaid rent as deferred rent (recognized over the lease term, typically on a straight-line basis) and the lessee includes the amount as part of its initial measurement of the ROU asset (recognized over the lease term as part of the subsequent measurement of the ROU asset).
- If the sale price is **above** fair value, the entity accounts for the difference as additional financing provided by the buyer-lessor to the seller-lessee in accordance with other topics because the overpayment is no different than the buyer-lessor granting the seller-lessee a loan in addition to purchasing the seller-lessee's asset. The buyer-lessor and seller-lessee recognize a financial receivable and financial liability, respectively, and allocate the payments under the contract between the lease and financing components.

See ASC 842-40-55, Example 1, for an illustration of the accounting by both the seller-lessee and buyer-lessor for off-market terms. See also Examples 7-9 and 7-10 below.

**VARIABLE PAYMENTS ARE CONSIDERED IN IDENTIFYING OFF-MARKET TERMS**

The FASB noted in paragraph BC365 of ASU 2016-02 that variable payments are part of the negotiated exchange between the parties and therefore must be considered in determining whether the transaction is at market. In doing so, the entity must consider the variable payments it reasonably expects to be entitled to (or to make) based on all reasonably available information (historical, current, and forecast). For a seller-lessee, that includes estimating any variable consideration it expects to be entitled in accordance with ASC 606-10-32-5 through 32-9. However, the FASB noted in paragraph BC365 that variable payments considered in the evaluation should not be recognized as part of the transaction price for the seller-lessee, as part of the cost of the asset to the buyer-lessor, or included in the seller-lessee's measurement of the lease liability, except in accordance with the guidance in ASC 842 or topics such as ASC 606 or ASC 360.

**EXAMPLE 7-9: SALE-LEASEBACK TRANSACTION WITH OFF MARKET TERMS — SALE PRICE EXCEEDS FAIR VALUE**

**FACTS**

- Assume the same facts as in Example 7-8, except that Seller-Lessee sells the airplane to Buyer-Lessor for $3.5 million when its observable fair value is $3 million. Because the fair value of the airplane is observable, Seller-Lessee and Buyer-Lessor use that benchmark to evaluate whether the sale is at market terms.
- The leaseback includes annual payments of $310,000, payable in arrears.

**CONCLUSION AND ANALYSIS**

Assessing whether the transfer of the asset is a sale

- Consistent with Example 7-8, Seller-Lessee and Buyer-Lessor determine that the transfer of the asset is a sale. The changes in sale price and contractual lease payments do not change the conclusion.

Accounting by Seller-Lessee

- At the commencement date, Seller-Lessee records the following journal entry:

| | | | |
|---|---|---|---|
| Debit | Cash | $ 3,500,000 | |
| Credit | PP&E | | $ 2,700,000 |
| Credit | Gain on sale | | 300,000 |
| Credit | Financial liability | | 500,000 |

- Seller-Lessee then determines the contractual payments attributable to repayment of the additional financing. In other words, the amount of each annual payment that must be attributed to repayment of the financial liability for that liability to reduce to zero at the end of the lease term.
- Seller-Lessee could calculate that amount using either of the approaches below, which should result in the same allocated amounts:
  - Use the PMT function in Excel based on the payment terms and conditions of the lease, which in this example results in $112,314 annual payments attributed to the financial obligation
  - Allocate the payments based on the relative basis of the initially recognized lease liability and financial liability. In doing so, Seller-Lessee would calculate the lease liability at the present value of five payments of $310,000 discounted at 4% (which amounts to $1,380,065) less the initial amount of the financial liability of $500,000, resulting in a lease liability of $880,065. Seller-Lessee would allocate the contractual payments as follows:

| | MEASUREMENT | PERCENTAGE | ALLOCATION |
|---|---|---|---|
| **Lease liability** | 880,065 | 63.77% | 197,686 |
| **Financial liability** | 500,000 | 36.23% | 112,314 |
| **Total** | 1,380,065 | | 310,000 |

- The table summarizes the accounting for the financial liability throughout the lease term.

| | BEGINNING BALANCE | INTEREST (4%) | PAYMENT | ENDING BALANCE |
|---|---|---|---|---|
| **Year 1** | 500,000 | 20,000 | (112,314) | 407,686 |
| **Year 2** | 407,686 | 16,307 | (112,314) | 311,680 |
| **Year 3** | 311,680 | 12,467 | (112,314) | 211,834 |
| **Year 4** | 211,834 | 8,473 | (112,314) | 107,994 |
| **Year 5** | 107,994 | 4,320 | (112,314) | — |

- Seller-Lessee also recognizes a lease liability for the leaseback at the present value of the contractual payments attributable to the lease of $197,686 ($310,000 annual payment less $112,314 attributed to the financial liability). The table summarizes the accounting for the lease liability, assuming no modifications.

| | BEGINNING BALANCE | INTEREST (4%) | PAYMENT | ENDING BALANCE |
|---|---|---|---|---|
| **Year 1** | 880,065 | 35,203 | (197,686) | 717,581 |
| **Year 2** | 717,581 | 28,703 | (197,686) | 548,598 |
| **Year 3** | 548,598 | 21,944 | (197,686) | 372,855 |
| **Year 4** | 372,855 | 14,914 | (197,686) | 190,083 |
| **Year 5** | 190,083 | 7,603 | (197,686) | — |

- The table summarizes the accounting for the ROU asset, assuming no modifications and impairments (see Chapter 5).

| | BEGINNING BALANCE [A] | PERIODIC LEASE COST [B] | INTEREST (4%) [C] - SEE ABOVE | AMORTIZATION [D] = [B] + [C] | ENDING BALANCE [A] + [D] |
|---|---|---|---|---|---|
| **Year 1** | 880,065 | (197,686) | 35,203 | (162,484) | 717,581 |
| **Year 2** | 717,581 | (197,686) | 28,703 | (168,983) | 548,598 |
| **Year 3** | 548,598 | (197,686) | 21,944 | (175,743) | 372,855 |
| **Year 4** | 372,855 | (197,686) | 14,914 | (182,772) | 190,083 |
| **Year 5** | 190,083 | (197,686) | 7,603 | (190,083) | — |

- Seller-Lessee recognizes straight-line lease expense of $197,686 along with interest expense on the financial liability (for example, $20,000 in Year 1) throughout the lease term.

<u>Accounting by Buyer-Lessor</u>

- Buyer-Lessor recognizes the airplane at a cost of $3 million, which it subsequently accounts for under ASC 360.
- Buyer-Lessor recognizes a financial asset for the additional financing provided to Seller-Lessee in the amount of $500,000.

- Buyer-Lessor determines an interest rate in accordance with ASC 835-30-25-12 through 25-13 and allocates the contractual payments between the leaseback and financial asset. The contractual payments attributable to repayment of the additional financing is the amount of each annual payment that must be attributed to the financial asset for that asset to reduce to zero at the end of the lease term (consistent with how it was calculated for Seller-Lessee above).
- Buyer-Lessor also recognizes lease income and interest income based on the amounts attributed to the leaseback and financial asset.

**EXAMPLE 7-10: SALE-LEASEBACK TRANSACTION WITH OFF-MARKET TERMS — SALE PRICE LESS THAN FAIR VALUE**

**FACTS**

- Assume the same facts as in Example 7-8, except that Seller-Lessee sells the airplane to Buyer-Lessor for $2.5 million when its observable fair value is $3 million. Because the fair value of the airplane is observable, Seller-Lessee and Buyer-Lessor use that benchmark in evaluating whether the sale is at market terms.
- The leaseback includes annual payments of $290,000 payable in arrears.

**CONCLUSION AND ANALYSIS**

<u>Assessing whether the transfer of the asset is a sale</u>

- Consistent with Example 7-8, Seller-Lessee and Buyer-Lessor determine that the transfer of the asset is a sale. The changes in sale price and contractual lease payments do not change the conclusion.

<u>Accounting by Seller-Lessee</u>

- Because the sale price is less than the fair value of the airplane, Seller-Lessee accounts for the difference of $500,000 as a prepayment of rent.
- Seller-Lessee recognizes a lease liability for the leaseback at the present value of the unpaid lease payments, discounted using its incremental borrowing rate of 4%, which results in an initial lease liability of $1,291,028, calculated as:

| | PAYMENT |
|---|---|
| **Year 1** | 290,000 |
| **Year 2** | 290,000 |
| **Year 3** | 290,000 |
| **Year 4** | 290,000 |
| **Year 5** | 290,000 |
| **Undiscounted payments** | **1,450,000** |
| **Present value (4%)** | **1,291,028** |

- The initial measurement of the ROU asset is the same as the lease liability plus the prepayment of $500,000. There are no lease incentives or initial direct costs, so the initial amount of the ROU asset is $1,791,028 (1,291,028 + 500,000).
- At the commencement date, Seller-Lessee records the following journal entry:

| | | | |
|---|---|---|---|
| Debit | Cash | $ 2,500,000 | |
| Debit | ROU asset | 1,791,028 | |
| Credit | PP&E | | $ 2,700,000 |

| | | |
|---|---|---|
| Credit | Lease liability | 1,291,028 |
| Credit | Gain on sale | 300,000 |

- Seller-Lessee calculates the total lease cost to be recognized over the lease term:

| | AMOUNT |
|---|---|
| Total lease payments (not yet paid) | $1,450,000 |
| Plus prepayment of rent (off market terms) | 500,000 |
| Plus initial direct costs | — |
| Total lease cost [A] | $1,950,000 |
| Periodic lease cost [B] = [A] / 5 | $390,000 |

- The table summarizes the accounting for the lease liability, assuming no modifications.

| | BEGINNING BALANCE | INTEREST (4%) | PAYMENT | ENDING BALANCE |
|---|---|---|---|---|
| **Year 1** | 1,291,028 | 51,641 | (290,000) | 1,052,670 |
| **Year 2** | 1,052,670 | 42,107 | (290,000) | 804,776 |
| **Year 3** | 804,776 | 32,191 | (290,000) | 546,967 |
| **Year 4** | 546,967 | 21,879 | (290,000) | 278,846 |
| **Year 5** | 278,846 | 11,154 | (290,000) | — |

- The table summarizes the accounting for the ROU asset, assuming no modifications and impairments.

| | BEGINNING BALANCE [A] | PERIODIC LEASE COST [B] | INTEREST (4%) [C] - SEE ABOVE | AMORTIZATION [D] = [B] + [C] | ENDING BALANCE [A] + [D] |
|---|---|---|---|---|---|
| **Year 1** | 1,791,028 | (390,000) | 51,641 | (338,359) | 1,452,670 |
| **Year 2** | 1,452,670 | (390,000) | 42,107 | (347,893) | 1,104,776 |
| **Year 3** | 1,104,776 | (390,000) | 32,191 | (357,809) | 746,967 |
| **Year 4** | 746,967 | (390,000) | 21,879 | (368,121) | 378,846 |
| **Year 5** | 378,846 | (390,000) | 11,154 | (378,846) | — |

- Seller-Lessee recognizes straight-line lease expense of $390,000 on an annual basis throughout the lease term.

Accounting by the Buyer-Lessor

- Buyer-Lessor recognizes the airplane at cost for $3 million and subsequently accounts for the asset under ASC 360. It also recognizes deferred rent of $500,000 at the commencement date.
- Because the lease is an operating lease, Buyer-Lessor recognizes lease income of $390,000 annually (the sum of the unpaid lease payments and the prepayment, divided by five), assuming collectability of the lease payments is probable throughout the lease term (see Section 6.8.2).

## 7.2.5 Accounting When Transfer of the Asset Is Not a Sale

### 7.2.5.1 Recognition

**FASB REFERENCES**

ASC 842-40-25-5

If the transfer is not a sale, the seller-lessee **and** buyer-lessor account for the transaction as a financing (see Example 7-11).

| THE SELLER-LESSEE | THE BUYER-LESSOR |
|---|---|
| ▶ Continues to recognize the transferred asset and apply ASC 360 (depreciation, impairment, etc.). | ▶ Does not recognize the transferred asset under ASC 360. |
| ▶ Accounts for amounts received as a financial liability in accordance with other U.S. GAAP. | ▶ Accounts for amounts paid as a receivable in accordance with other U.S. GAAP. |
| ▶ Allocates rent payments made between interest expense and principal amortization. | ▶ Allocates rent payments received between interest income and principal amortization. |

### 7.2.5.2 Seller-Lessee Adjustments to Interest Rate on Financial Liability

**FASB REFERENCES**

ASC 842-40-30-6

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

- Interest on the financial liability is not greater than the payments over the shorter of the lease term and the term of the financing. The term of the financing could be shorter when, for example, a repurchase option that precluded sale accounting expires before the end of the lease term.
  - In considering this requirement on avoiding negative amortization of the financial liability, we believe it applies over the **entire** lease term or term of the 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 asset's carrying amount does not exceed the carrying amount of the financial liability at the earlier of the end of the lease term and the date when control of the asset transfers to the buyer-lessor. In other words, there is no built-in loss at the earlier of the end of the lease term and the term of the financing (see Examples 7-12 and 7-12).

**EXCEPTION FOR SOME SALE AND LEASEBACKS**

We believe the above requirements on adjusting the interest rate apply only when 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 must impute interest at a rate that amortizes the financial liability at the end of the lease term to the repurchase option price. In other words, there must 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).

#### 7.2.5.3 Accounting at the Date Buyer-Lessor Obtains Control

**FASB REFERENCES**

ASC 842-40-55-31 through ASC 842-40-55-38

At the end of the leaseback period (or 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. That accounting is consistent with Example 2 in ASC 842-40-55.

As discussed in Section 7.2.5.2, 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, it 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 the facts and circumstances, and entities are encouraged to discuss their situations with their accounting advisors or auditors.

### 7.2.5.4 Application Examples — Failed Sale-Leaseback Transactions

Examples 7-11 through 7-14 illustrate the accounting for sale-leaseback transactions that do not qualify as a sale, including adjusting the interest rate by a Seller-Lessee.

**EXAMPLE 7-11: ACCOUNTING FOR FAILED SALE-LEASEBACK**

**FACTS**

- Seller-Lessee sells an airplane to an unrelated Buyer-Lessor for $3 million, which is the plane's fair value.
- The carrying amount of the airplane is $2.7 million, and it has a remaining useful life of 15 years.
- At the same time as the sale, Seller-Lessee enters a contract with Buyer-Lessor for the right to use the airplane for five years, with annual payments of $300,000, payable in arrears and escalating 2% annually.
- Seller-Lessee has a fixed price repurchase option at the end of Year 5 for $1.8 million, which Seller-Lessee is not reasonably certain to exercise.
- Absent the repurchase option, there are no other terms or conditions that would preclude sale accounting.
- Seller-Lessee's incremental borrowing rate is 4%.

**CONCLUSION AND ANALYSIS**

- The repurchase option exercise price is fixed and therefore precludes accounting for the transaction as a sale.
- Seller-Lessee therefore accounts for the $3 million of proceeds received as a financial liability and uses its incremental borrowing rate of 4% to recognize interest expense.
- Seller-Lessee also continues to recognize the asset and depreciate it over the remainder of its useful life (depreciation expense is $180,000 annually).
- Seller-Lessee's accounting for the financial liability and asset are determined as:

| | 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 |

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, the interest rate does not require further adjustments.

- Buyer-Lessor also accounts for the transaction as a financing and determines an appropriate interest rate in accordance with ASC 835-30-25-12 and 25-13.
- If at the end of Year 5, Seller-Lessee does not exercise the repurchase option. When it expires, Seller-Lessee recognizes the sale of the asset by derecognizing the underlying asset for $1.8 million, derecognizing the carrying amount of the financial liability of $1.96 million and recognizing a gain of $161,377. Buyer-Lessor recognizes the underlying asset at the amount of its financial receivable at that date.

**EXAMPLE 7-12: ACCOUNTING FOR FAILED SALE-LEASEBACK BY SELLER-LESSEE — NEGATIVE AMORTIZATION**

**FACTS**

- Assume the same facts as Example 7-11, except that the payments are $105,000 annually, payable in arrears.

**CONCLUSION AND ANALYSIS**

- As in Example 7-11, the transaction is considered a financing transaction.
- Seller-Lessee's accounting for the financial liability and asset are initially determined as follows:

| | BEGINNING LIABILITY BALANCE [A] | INTEREST [B] = [A] * 4.00% | PAYMENT [C] | ENDING LIABILITY BALANCE [D] = [A] + [B] + [C] | ENDING ASSET BALANCE |
|---|---|---|---|---|---|
| Year 1 | 3,000,000 | 120,000 | (105,000) | 3,015,000 | 2,520,000 |
| Year 2 | 3,015,000 | 120,600 | (105,000) | 3,030,600 | 2,340,000 |
| Year 3 | 3,030,600 | 121,224 | (105,000) | 3,046,824 | 2,160,000 |
| Year 4 | 3,046,824 | 121,873 | (105,000) | 3,063,697 | 1,980,000 |
| Year 5 | 3,063,697 | 122,548 | (105,000) | 3,081,245 | 1,800,000 |

Seller-Lessee determines there is no built-in loss at the end of the lease term (financing term). However, there is negative amortization of the financial liability (the aggregate interest expense over the five-year period exceeds the aggregate payments made), so Seller-Lessee must adjust the interest rate.

- Seller-Lessee determines an adjusted interest rate that does not result in negative amortization of the financial liability. In this case, it is 3.5% ($105,000 annual payment divided by the initial financial liability of $3 million). The updated balances are:

| | BEGINNING LIABILITY BALANCE [A] | INTEREST [B] = [A] * 3.50% | PAYMENT [C] | ENDING LIABILITY BALANCE [D] = [A] + [B] + [C] | ENDING ASSET BALANCE |
|---|---|---|---|---|---|
| Year 1 | 3,000,000 | 105,000 | (105,000) | 3,000,000 | 2,520,000 |
| Year 2 | 3,000,000 | 105,000 | (105,000) | 3,000,000 | 2,340,000 |
| Year 3 | 3,000,000 | 105,000 | (105,000) | 3,000,000 | 2,160,000 |
| Year 4 | 3,000,000 | 105,000 | (105,000) | 3,000,000 | 1,980,000 |
| Year 5 | 3,000,000 | 105,000 | (105,000) | 3,000,000 | 1,800,000 |

- If at the end of Year 5 Seller-Lessee does not exercise the repurchase option and it expires, Seller-Lessee recognizes the sale of the asset by derecognizing the underlying asset for $1.8 million, derecognizing the carrying amount of the financial liability of $3 million and recognizing a gain of $1.2 million.

**EXAMPLE 7-13: ACCOUNTING FOR FAILED SALE-LEASEBACK BY SELLER-LESSEE — BUILT-IN LOSS**

**FACTS**

- Assume the same facts as Example 7-11, except that the payments are $375,000 annually, payable in arrears.

**CONCLUSION AND ANALYSIS**

- As stated in Example 7-11, the transaction is considered a financing transaction.
- Seller-Lessee's accounting for the financial liability and asset are initially determined as follows:

| | BEGINNING LIABILITY BALANCE [A] | INTEREST [B] = [A] * 4.00% | PAYMENT [C] | ENDING LIABILITY BALANCE [D] = [A] + [B] + [C] | ENDING ASSET BALANCE |
|---|---|---|---|---|---|
| Year 1 | 3,000,000 | 120,000 | (375,000) | 2,745,000 | 2,520,000 |
| Year 2 | 2,745,000 | 109,800 | (375,000) | 2,479,800 | 2,340,000 |
| Year 3 | 2,479,800 | 99,192 | (375,000) | 2,203,992 | 2,160,000 |
| Year 4 | 2,203,992 | 88,160 | (375,000) | 1,917,152 | 1,980,000 |
| Year 5 | 1,917,152 | 76,686 | (375,000) | 1,618,838 | 1,800,000 |

Seller-Lessee determines there is no negative amortization of the financial liability, but there is a built-in loss at the end of Year 5 (the carrying amount of the asset exceeds the carrying amount of the financial liability). Therefore, Seller-Lessee must adjust the interest rate.

- Seller-Lessee determines an adjusted interest rate that does not result in a built-in loss at the end of Year 5. In this case, it is approximately 5.305% (calculated so that the financial liability equals the carrying amount of the asset at the end of the lease term).
- The updated balances are:

| | BEGINNING LIABILITY BALANCE [A] | INTEREST [B] = [A] *5.305% | PAYMENT [C] | ENDING LIABILITY BALANCE [D] = [A] + [B] + [C] | ENDING ASSET BALANCE |
|---|---|---|---|---|---|
| Year 1 | 3,000,000 | 159,149 | (375,000) | 2,784,149 | 2,520,000 |
| Year 2 | 2,784,149 | 147,698 | (375,000) | 2,556,847 | 2,340,000 |
| Year 3 | 2,556,847 | 135,640 | (375,000) | 2,317,487 | 2,160,000 |
| Year 4 | 2,317,487 | 122,942 | (375,000) | 2,065,429 | 1,980,000 |
| Year 5 | 2,065,429 | 109,570 | (375,000) | 1,800,000 | 1,800,000 |

- If at the end of Year 5 Seller-Lessee does not exercise the repurchase option and the option expires, Seller-Lessee recognizes the sale of the asset by derecognizing the underlying asset for $1.8 million, derecognizing the carrying amount of the financial liability of $1.8 million and recognizing no gain or loss.

### EXAMPLE 7-14: ACCOUNTING FOR FAILED SALE-LEASEBACK BY SELLER-LESSEE — REPURCHASE OPTION REASONABLY CERTAIN OF EXERCISE

#### FACTS

- Assume the same facts as Example 7-11, except that the repurchase option at $1.8 million is reasonably certain of exercise.

#### CONCLUSION AND ANALYSIS

- As stated in Example 7-11, the transaction is considered a financing transaction.
- Because control of the asset is not expected to transfer to Buyer-Lessor at any point, there should be no gain or loss recognized by Seller-Lessee at the end of the leaseback term. Accordingly, Seller-Lessee should adjust the interest rate so that the financial liability at the end of Year 5 equals the exercise price of the purchase option. In this case, that results in an interest rate of approximately 2.838%.
- Seller-Lessee's accounting for the financial liability and asset are determined as follows:

| | BEGINNING LIABILITY BALANCE [A] | INTEREST [B] = [A] * 2.838% | PAYMENT [C] | ENDING LIABILITY BALANCE [D] = [A] + [B] + [C] | ENDING ASSET BALANCE |
|---|---|---|---|---|---|
| **Year 1** | 3,000,000 | 85,138 | (300,000) | 2,785,138 | 2,520,000 |
| **Year 2** | 2,785,138 | 79,040 | (306,000) | 2,558,178 | 2,340,000 |
| **Year 3** | 2,558,178 | 72,599 | (312,120) | 2,318,657 | 2,160,000 |
| **Year 4** | 2,318,657 | 65,802 | (318,362) | 2,066,096 | 1,980,000 |
| **Year 5** | 2,066,096 | 58,634 | (324,730) | 1,800,000 | 1,800,000 |

- At the end of Year 5, Seller-Lessee exercises the repurchase option. It derecognizes the carrying amount of the financial liability of $1.8 million and credits cash for the payment made to Buyer-Lessor.

## 7.3 BUSINESS COMBINATIONS (OR ACQUISITIONS BY NOT-FOR-PROFIT ENTITIES)

Accounting for leases acquired in a business combination or an acquisition by a not-for-profit entity differs in several ways from the accounting for a new lease. ASC 805, *Business Combinations*, and ASC 842 provide specific accounting guidance related to leases acquired as part of a business combination. See the following sections in our Blueprint, **Business Combinations Under ASC 805**:

- Section 4.4.1.5 Accounting for Leases in a Business Combination
- Section B.7 Leases and Leasehold Improvements in Common Control Arrangements
- Section C.4.5 Lease Classification in an Asset Acquisition
- Section D.5.5 Accounting for Leases at the Formation Date in a Joint Venture

## 7.4 SUBLEASES

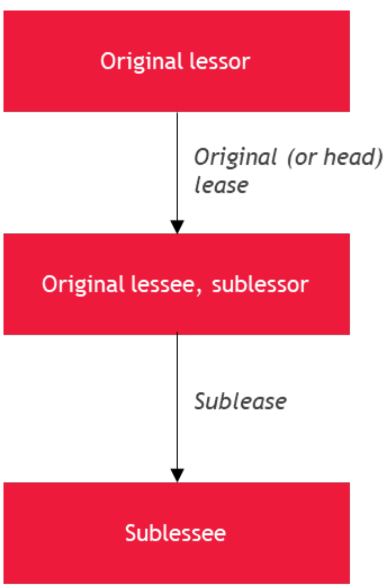
### 7.4.1 Overview

**FASB REFERENCES**

ASC 842-10-20: Sublease

ASC 842-10-20 defines a sublease as "*a transaction in which an underlying asset is re-leased by the lessee (or intermediate lessor) to a third-party (the sublessee) and the original (or head) lease between the lessor and the lessee remains in effect.*" In the FASB's view, leases of ROU assets (that is, subleases) must be accounted for the same as other leases, so subleases are within the scope of ASC 842.

The graph summarizes the accounting by each party under the original lease or sublease (discussed further in Sections 7.4.2 through 7.4.4).




The accounting by the original lessor is unchanged unless the original lease agreement is replaced by a new agreement with a new lessee (see Section 7.4.2).

The entity applies lessee accounting to the original lease (see Chapter 5) and lessor accounting to the sublease (see Chapter 6) unless the original lessee is relieved of its primary obligation under the original lease. The sublease may affect accounting for the head lease, such as the lease term or impairment of the ROU asset (see Section 7.4.4).

The sublessee accounts for the sublease like any other leases in which it is a lessee (see Chapter 5 and Section 7.4.3).

Chapter 8 discusses disclosures related to subleases.

### 7.4.2 Original Lessor Accounting

**FASB REFERENCES**

ASC 842-30-35-7, and ASC 842-30-40-3

The accounting by the original lessor depends on the nature of the transaction.

| | |
|---|---|
| **Original lessee subleases the asset or sells (transfers) the original lease agreement to a third party** | ▶ Original lessor continues to account for the lease as it did before. |
| **Original lease agreement is replaced by a new agreement with a new lessee** | ▶ Lessor accounts for the transaction as a termination of the original lease.<br>▶ Lessor classifies and accounts for the new lease as a separate transaction like any other leases (see Chapter 6). |

### 7.4.3 Sublessee Accounting

**FASB REFERENCES**

ASC 842-10-25-6

A sublessee classifies and accounts for the sublease like any other leases as a lessee (see Chapter 5). The sublessee assesses classification of the sublease by reference to the **underlying asset** rather than by reference to the ROU asset. For example, in classifying the sublease, the sublessee evaluates whether the sublease term is for a major part of the remaining economic life of the underlying asset, rather than the remaining term of the head lease (see Section 4.9).

### 7.4.4 Sublessor Accounting

A sublessor generally accounts for a head lease and sublease as two contracts (two separate units of account) unless those contracts meet the contract combination guidance in Section 3.6 (which we believe will be infrequent because the counterparty to the sublease is typically a different entity from the counterparty to the head lease).

The accounting by the original lessee (sublessor) depends on whether the original lessee retains the primary obligation under the original lease.

#### 7.4.4.1 Original Lessee is Relieved of Primary Obligation Under Original Lease

**FASB REFERENCES**

ASC 405-20-40-2 and ASC 842-20-40-3

If an original lessee is relieved of its primary obligation under the original lease because of a sublease, the original lessee:

- Derecognizes the ROU asset and lease liability
- Recognizes any difference in profit or loss
- Includes 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 recognize.

Further, if the original lessee is secondarily liable, the original lessee recognizes a guarantee obligation in accordance with ASC 405-20-40-2. That guarantee obligation is initially measured at fair value, and that amount reduces the determination of profit or loss that the original lessee recognizes.

#### 7.4.4.2 Original Lessee Retains Primary Obligation Under Original Lease

**FASB REFERENCES**

ASC 842-10-25-6 and ASC 842-20-35-14 through 35-15

If the original lessee retains the primary obligation under the original lease, the original lessee (as sublessor) accounts for the original lease in one of the two ways in the table.

| ORIGINAL LEASE CLASSIFICATION | SUBLEASE CLASSIFICATION | THE ORIGINAL LESSEE (SUBLESSOR): |
|---|---|---|
| Operating or Finance Lease | Operating Lease | ▶ Continues to account for the original lease as before the sublease commencement.<br>▶ Recognizes sublease income over the lease term (see Sections 6.6 and 6.8.2).<br>▶ Considers whether the carrying amount of the original lease ROU asset may not be recoverable if the lease cost of the original lease for the term of the sublease exceeds the anticipated sublease income for the same period (see Section 5.9).<br>▶ Evaluates the guidance in Section 5.9.3 when the lessee plans or enters a sublease. |
| Operating or Finance Lease | Sales-type or Direct Financing Lease | ▶ Derecognizes the original lease ROU asset.<br>▶ Continues to account for the original lease liability as before the sublease commencement.<br>▶ Recognizes a net investment in the sublease and any selling profit or loss, consistent with the classification of the sublease (see Sections 6.4 and 6.5).<br>▶ Evaluates the net investment in the sublease for impairment like any other lessors (see Section 6.8.1). |

In determining the accounting in the table above, a sublessor assesses classification of the sublease by reference to the **underlying asset**, rather than by reference to 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.

The original lessee as sublessor must also use the rate implicit in the lease (as defined) to determine sublease classification and measure the net investment in the sublease (if the sublease is classified as a sales-type or direct financing lease) unless that rate cannot be readily determined. If the rate implicit in the lease cannot be readily determined, the original lessee may use the discount rate for the lease established for the original (head) lease.

**ENTERING INTO A SUBLEASE MAY AFFECT HEAD LEASE TERM**

A sublessor should consider the reassessment requirements applicable to the head lease upon entering a sublease (see Section 5.7). 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 said that requirement does not extend to options held by third parties (such as sublessees). 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 (see Section 4.3) exceeds the remaining head lease term, as illustrated in Examples 7-15 through 5-17. See Section 5.7 for additional details about reassessment events and impact on accounting for lessees.

**EXAMPLE 7-15: SUBLEASE WITH A TERM THAT EXCEEDS REMAINING LEASE TERM OF ORIGINAL LEASE**

**FACTS**

- Lessee enters a retail store lease in a shopping mall for an initial period of four years with two two-year extension periods.
- At lease commencement, Lessee determined that it was not reasonably certain to exercise the extension options; therefore, the lease term was four years.
- At lease commencement, Lessee classified the original lease as an operating lease.
- One year into the lease, Lessee enters into an agreement with Sublessee to sublease the entire retail store for a noncancelable term of five years.
- Lessee is not relieved of the primary obligation under the original lease.
- Lessee determines the sublease is an operating lease.

**CONCLUSION AND ANALYSIS**

- Because Lessee is still the primary obligor under the original lease, the sublease does not represent a termination of the original lease.
- Because the sublease term of five years exceeds the original lease's remaining lease term of three years, Lessee must reassess and update the lease term of its original lease to be at least five years (three years remaining in the initial lease term plus at least one two-year extension). See Section 5.7 for additional guidance and impact on accounting for lessees.

**EXAMPLE 7-16: SUBLEASE WITH EXTENSION OPTIONS THAT ARE NOT REASONABLY CERTAIN OF EXERCISE**

**FACTS**

- Assume the same facts as in Example 7-15, except that the sublease with Sublessee has a three-year noncancelable term with two two-year extension options.
- Lessee, as sublessor, assessed the lease term of the sublease and determined that it is three years (Sublessee is not reasonably certain to exercise its extension options).

**CONCLUSION AND ANALYSIS**

- Although Lessee would be forced to exercise its extension option(s) in the original lease if Sublessee were to exercise its extension option(s) in the sublease (that is, exercise of the extension options in the original lease is outside Lessee's control), Lessee determined that Sublessee is not reasonably certain to exercise its extension options.
- Accordingly, the lease term for the sublease does not exceed the remaining lease term for the original lease (both are three years). Therefore, Lessee does not update the lease term of the original lease solely as a result of entering the sublease.

**EXAMPLE 7-17: SUBLEASE WITH EXTENSION OPTIONS THAT ARE REASONABLY CERTAIN OF EXERCISE**

**FACTS**

- Assume the same facts as in Example 7-16, except that Lessee determines Sublessee is reasonably certain to exercise its first extension option.

**CONCLUSION AND ANALYSIS**

- In this case, like in Example 7-15, the sublease term exceeds the remaining lease term of the original lease. Therefore, Lessee must reassess and update the lease term of its original lease to be at least five years (three years remaining in the initial lease term plus at least one two-year extension). See Section 5.7 for additional guidance and impact on accounting for lessees.

#### 7.4.4.3 Lessor Costs Paid by Sublessee Directly to Third Party

**FASB REFERENCES**

ASC 842-10-15-40A

In a sublease arrangement, the original lessee (sublessor) may require the sublessee to pay directly to the original lessor or a third-party either or both the rent payments and other costs such as property taxes and insurance otherwise due under the original lease.

As discussed in Section 3.4.1.2, a lessor excludes from variable payments lessor costs a lessee pays directly to a third party. In contrast, costs excluded from the consideration in the contract a lessor pays directly to a third party and is then reimbursed by a lessee are considered lessor costs that must be accounted for by the lessor as variable payments.

That requirement applies to a sublessor for lessor costs the sublessee paid directly to a third party, including the head lessor. Therefore, the accounting by the sublessor can be summarized as shown in the table.

| SUBLESSEE PAYS LESSOR COSTS DIRECTLY TO A THIRD PARTY, INCLUDING THE HEAD LESSOR | SUBLESSOR PAYS COSTS AND IS REIMBURSED BY SUBLESSEE |
|---|---|
| ▶ Exclude from variable payments.<br>▶ In other words, treat like a sublessee cost, which does not affect the accounting for the sublease. | ▶ Account for costs excluded from consideration in the contract as lessor costs (that is, as variable payments).<br>▶ In other words, recognize on a gross basis. |

**EXCEPTION FOR PAYMENTS RELATED TO RIGHT TO USE THE UNDERLYING ASSET**

The above requirements do not apply to payments (whether fixed or variable) for the right to use the underlying asset a sublessee pays directly to the original lessor. Accordingly, if the sublease requires the sublessee to make such payments directly to the original lessor, the original lessee (sublessor) must still present those amounts on a gross basis in profit or loss.

# 7.5 ACCOUNTING FOR INCOME TAXES

## 7.5.1 Overview

**FASB REFERENCES**

ASC 740-10-05-5

A leasing arrangement generally provides a financing party (the lessor) with the right to claim tax benefits from the ownership of an asset intended to be used by another party (the lessee) so that the tax benefits can be shared with the lessee through lower rent or lease payments. The basic tax benefit is tax deferral — that is, accelerated tax deductions in early years to reduce income from the leasing arrangement and from other sources in exchange for more taxable income in later years when tax depreciation deductions from the leased asset are less than in early years. Additional tax benefits might include investment tax credits.

ASC 740 provides two basic principles related to the accounting for income taxes.

| | | |
|---|---|---|
| 1 | Recognize the estimated taxes payable or refundable on tax returns for the current year as a tax liability or asset. | For example, in a true lease for federal income tax purposes, a lessor would determine taxable income based on, among other things, rental income (as earned), depreciation on the asset under the modified accelerated cost recovery system, and deductible interest expense using the interest method. |
| 2 | Recognize deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns (timing differences and carryforwards). | See Section 7.5.2. |

**BDO INSIGHTS — TAX CLASSIFICATION OF LEASES**

The U.S. federal income treatment or classification of leases range from a true lease (the lessor is considered the tax owner of the leased property — that is, the lessee does not own an asset for tax purposes); a conditional sale (the lessor is a conditional seller and the lessee is a conditional buyer); a lending transaction (the lessor is a creditor and the lessee is a debtor and the owner of a mortgaged asset); or other type of participation. Therefore, depending on the arrangement's terms, the classification of a lease arrangement for federal income tax purposes could differ from the classification for financial reporting purposes (see Section 4.9).

For a true tax lease, the lessor is considered the tax owner of the leased property. As such, the lessor is entitled to tax deductions related to the ownership of the property, including depreciation and interest expense, as noted above, while recognizing rental income. The primary focus of the U.S. federal tax classification analysis is whether the lessor retains sufficient risks and rewards from ownership, including considering whether the lessor has made a substantial equity investment and retains a meaningful interest in the residual value of the asset (that is, whether the lessor has upside and downside residual risk in the leased property).

While U.S. federal tax law does not contain a comprehensive articulation of true leases, some principles have come about through IRS administrative guidance and case law defining a true lease, including:

- Minimum unconditional at-risk investment (equity investment and remaining useful life beyond lease terms)
- No bargain purchase options (that is, less than fair market value when the option is exercised) or put options to the lessee
- No economic compulsion for the lessee to purchase the asset at the end of the term or at a fixed purchase option

- No investment by the lessee beyond some improvements or additions
- No lessee loans or guarantees
- Profit (beyond tax benefits) and positive cash flow requirements
- No limited use property
- Commercially feasible that another party can use the asset after lease expiration, considering remaining useful life and residual value
- Other considerations and facts and circumstances.

### 7.5.2 Deferred Income Taxes

**FASB REFERENCES**

ASC 740-10-05-7 and ASC 740-10-20: Deferred Tax Asset, Deferred Tax Liability, and Temporary Difference

The following concepts are important for the understanding and accounting for deferred taxes.

| TEMPORARY DIFFERENCES | DEFERRED TAX ASSETS | DEFERRED TAX LIABILITIES |
|---|---|---|
| Relate to the difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount is recovered or settled. | Result from deductible temporary differences that exist at the end of a period and are measured using enacted tax rates and provisions of the enacted tax law. | Result from taxable temporary differences that exist at the end of a period and are measured using enacted tax rates and provisions of enacted tax laws. |

ASC 842 did not change lease classification for federal income tax purposes, and deferred taxes must be recognized for book and tax basis differences in lease assets and liabilities.

**BDO INSIGHTS — DEFERRED TAXES FOR LESSEE OPERATING LEASES UNDER ASC 842**

For book purposes, under ASC 842, a lessee in an operating lease recognizes a lease liability and an ROU asset at the commencement date (see Section 4.2), except for short-term leases (see Section 5.4). However, for tax purposes, if the lease is considered a true lease, there is zero tax basis for the lease liability and ROU asset. That creates two temporary differences for which deferred taxes must be recognized. Specifically, a lessee in an operating lease recognizes:

- A deferred tax liability (measured at the applicable tax rate) for the ROU asset because future recovery of the book basis (generating cash inflows from the use of the leased asset) will not have a corresponding depreciable tax basis, thereby resulting in more taxable income to the lessee.
- A deferred tax asset (measured at the applicable tax rate) for the lease liability because the future settlement of the lease liability (paying down the carrying value or principal) will result in a tax deduction through deductible rents.

Also, the subsequent measurement of the lease liability and ROU asset will often diverge, so the respective deferred taxes will not entirely offset.

Those temporary differences must be tracked separately for disclosure purposes (because gross deferred tax assets and liabilities must be separately disclosed). Because the reversal pattern for the deferred tax liabilities may differ from the reversal pattern for the deferred tax assets, the measurement of valuation allowances could be affected.

A deferred tax asset is assessed for realizability together with all other deferred tax assets within a jurisdiction or a taxpaying entity. However, the deferred tax liability for the ROU asset would generally be considered a source of income to support realization of the deferred tax asset.

The magnitude of the deferred taxes recognized initially will depend on several factors, including the length of the lease term, significance of lease payments, and the lessee's accounting policy election related to not separating nonlease components (such as maintenance services) from the associated lease component (see Section 3.3.2). For example, a lessee that elected for its equipment asset class not to separate the nonlease components (such as maintenance) from the associated equipment lease component will include fixed payments for maintenance in the measurement of the lease liability and ROU asset that would otherwise be allocated to the maintenance component. For tax purposes, the standalone value of the nonlease component (the maintenance service) would not be capitalized as part of the cost basis of leased property. Instead, any prepayment of nonlease components could be capitalized as a separate asset and amortized over time. However, in some cases, the taxpayer may deduct costs for nonlease components as incurred, depending on the terms of the agreement and the taxpayer's method of accounting for such items. As such, the measurement of deferred taxes must consider all those factors.

### 7.5.3 Initial Direct Costs

For book purposes, lease origination costs that qualify as initial direct costs under ASC 842 (see Section 4.5) are generally capitalized and recognized as an expense over the lease term. For lessees, initial direct costs are included in the initial measurement of the ROU asset (see Section 5.5), irrespective of lease classification, and thus affect the measurement of deferred taxes associated with the ROU asset.

For operating leases, lessors capitalize initial direct costs as a separate asset and amortize them over the lease term. For tax purposes, lessors will also generally capitalize those costs but may amortize them over a different term than for book purposes. As such, initial direct costs may give rise to a separate temporary difference for operating leases. For sales-type or direct financing leases, lessors generally defer initial direct costs by automatically including them in the net investment in the lease based on how the rate implicit in the lease is calculated (see Section 4.6). As such, they will not give rise to a separate temporary difference; rather, they affect any deferred taxes associated with the net investment in the lease.

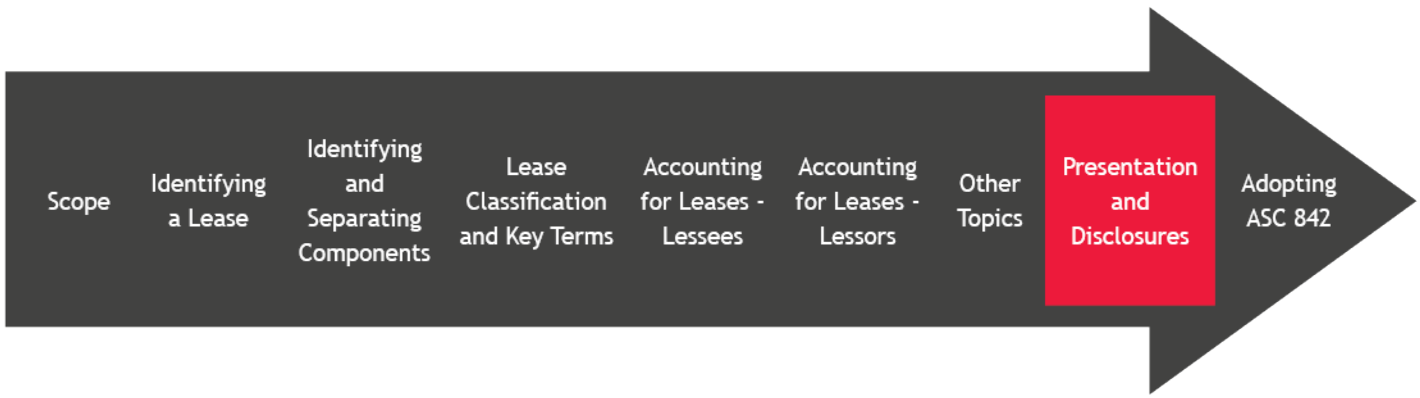
Under ASC 842, initial direct costs include incremental lease costs that would not have been incurred if the lease had not been obtained. Consequently, lessors must expense for book purposes some origination costs, such as fixed employee salaries; general overhead and other costs (for advertising, legal fees, and so forth (see Section 4.5)). Also, for sales-type leases, lessors must expense initial direct costs for leases in which the underlying asset's fair value differs from its carrying amount at lease commencement (see Section 6.4). For income tax purposes, depending on the nature of the costs, lessors must or may capitalize (and amortize) some lease origination costs (that do not meet the definition of initial direct costs under ASC 842) for sales-type and direct financing leases. That creates additional temporary differences and associated deferred income taxes, although federal tax law allows for an immediate deduction of de minimis costs incurred to acquire an asset (up to $5,000 of the entire cost). That tax deduction allowance might be suitable for small value leases (for example, some office equipment and computers).

### 7.5.4 Sale and Leaseback Transactions

As discussed in Section 7.2, ASC 842 requires an entity to apply the guidance in ASC 606 on existence of a contract and transfer of control, the lease classification guidance under ASC 842, and specific repurchase option guidance to determine whether a transaction in scope of the sale and leaseback guidance qualifies for sale accounting. If the transaction fails sale accounting, the consideration paid by the buyer-lessor for the asset represents a financing for both the seller-lessee and the buyer-lessor, and the seller-lessee continues to recognize the underlying asset and apply other U.S. GAAP (for example, ASC 360).

Because of different tax law requirements, the accounting for sale and leaseback transactions may result in temporary differences. That could be the case if, for example, a sale and leaseback transaction meets the current tax law requirements for sales by a seller-lessee but fails the sale accounting requirements above, creating temporary differences. For instance, a seller-lessee would recognize current taxable income but would recognize a deferred tax asset for the future inclusion of book income.

# CHAPTER 8 — PRESENTATION AND DISCLOSURES




## 8.1 OVERVIEW

During the project leading to the release of ASC 842, many users told the FASB that the disclosure requirements in the legacy lease guidance did not provide enough information to understand an entity's leasing activities. As a result, ASC 842 includes enhanced disclosure requirements, including an overall disclosure objective and expanded disclosure requirements for leases.

Consistent with the disclosure requirements in ASC 606 on revenue from contracts with customers, the FASB did not provide explicit materiality requirements. Instead, an entity considers the disclosure objective, which is to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. It then determines the level of detail and emphasis needed on various disclosure requirements to satisfy the disclosure objective. The more extensive the entity's leasing activities, the more comprehensive the disclosures must be.

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 balance sheet presentation and disclosure requirements in ASC 842. Presentation of lease expense for operating leases and amortization and interest expense for finance leases in the income statement is generally consistent with prior U.S. GAAP, and the presentation of cash flows arising from leases in the statement of cash flows is driven by the presentation of lease expense in the income statement.

Meanwhile, the FASB retained most aspects of the lessor accounting model found in prior U.S. GAAP. Therefore, a lessor's presentation of leases in the balance sheet, income statement, and statement of cash flows generally is unchanged. But many users indicated they needed more information about a lessor's leasing activities and associated risks, including credit risk related to lease receivables, and residual asset risk for the unguaranteed residual assets. ASC 842 therefore includes enhanced disclosures about a lessor's leasing activities.

# 8.2 PRESENTATION

## 8.2.1 Summary of Lessee Presentation Requirements

**FASB REFERENCES**

ASC 210-10-45, ASC 230-10-50-4, and ASC 842-20-45-1 through 45-5

The table summarizes the presentation requirements in the financial statements for lessees.

<table>
<tr><th></th><th>LESSEE PRESENTATION REQUIREMENTS</th></tr>
<tr><td>Balance Sheet</td><td><ul><li>Present separately from each other and from other assets and liabilities:<ul><li>Finance lease ROU assets and operating lease ROU assets</li><li>Finance lease liabilities and operating lease liabilities.</li></ul></li><li>If not presented separately, disclose which line items in the balance sheet include the ROU assets and lease liabilities. Also, a lessee is precluded from presenting:<ul><li>Finance lease ROU assets in the same line item as operating lease ROU assets</li><li>Finance lease liabilities in the same line item as operating lease liabilities.</li></ul></li><li>Classify ROU assets the same way 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.</li></ul></td></tr>
<tr><td>Income Statement</td><td><ul><li>For finance leases, present interest expense on the lease liability and amortization of the ROU asset the same way the entity presents other interest expense and depreciation (amortization) of similar assets, respectively.</li><li>ASC 842 does not discuss presentation of variable lease payments for finance leases. We believe that presentation as either lease expense or interest expense may be appropriate.</li><li>For operating leases, include lease expense in income from continuing operations the same way as other operating expenses and, based on the nature of the lease, classify within cost of sales; selling, general, and administrative expense; or another expense line item.</li></ul></td></tr>
<tr><td>Cash Flow Statement</td><td><ul><li>For finance leases, classify repayments of the principal portion of the lease liability within financing activities and classify interest in accordance with requirements relating to interest paid in ASC 230 on cash flows (typically in operating activities).</li><li>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 must be classified within investing activities.</li><li>For all leases, classify variable lease payments and short-term lease payments not included in the lease liability within operating activities.</li><li>The establishment of ROU assets and lease liabilities at lease commencement (or that change because of reassessment events or lease modifications (see Sections 5.7 and 5.8, respectively)) is disclosed as noncash investing and financing activities in accordance with ASC 230-10-50-4.</li></ul></td></tr>
</table>

## 8.2.2 Lessee Presentation Requirements Explained

### 8.2.2.1 Balance Sheet

The FASB did not mandate separate presentation of lease amounts in the balance sheet. However, it determined that providing the carrying amount of a lessee's ROU assets and lease liabilities separately for finance and operating leases and separately from other assets and liabilities gives users important information about an entity's use of lease arrangements in its business activities and about the relationship between the lessee's lease liabilities and ROU assets. In reaching that conclusion, the FASB noted that:

- There are differences between leased assets and owned nonfinancial assets (for example, there is typically no residual asset risk for a lease but there are risks associated with replacing the lease at the end of its term based on market conditions).
- A lease liability is a unique class of liability that links to a corresponding asset and has features, such as options and variable lease payments, that may differ from other liabilities.
- Lessees measure ROU assets for operating and finance leases differently after the commencement date. Further, lease costs for operating and finance leases differ in terms of recognition and presentation in the income statement.
- Presenting finance and operating leases in the same line item in the balance sheet would be misleading because of the different underlying economics. For example, finance lease liabilities are like debt, while operating lease liabilities are not debt-like but are operating in nature and generally treated differently in bankruptcy.

While the FASB did not prescribe where lessees must present ROU assets (that are not presented separately), paragraph BC265 of ASU 2016-02 notes some board members think that presenting operating lease assets together with PP&E may be inappropriate, given the FASB's conclusion that *"operating leases convey rights and carry risks substantially different from"* those of owned PP&E.

**BDO INSIGHTS — APPROACHES FOR DETERMINING CURRENT LEASE LIABILITIES**

As summarized in Section 8.2.2.1, lease liabilities are classified as current and noncurrent in the balance sheet and subject to the same classification considerations as other financial liabilities, so lessees presenting a classified balance sheet must follow the presentation requirements in ASC 210. Lessees present as noncurrent lease liabilities the difference between the total and current portion of lease liabilities. We believe the following approaches are acceptable for determining current lease liabilities:

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

We also believe the approach selected 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.

### 8.2.2.2 Income Statement

In the FASB's view, finance leases are economically like the financed acquisition of other nonfinancial assets, so a lessee must present amortization of the ROU asset and interest on the lease liability in separate line items, consistent with how an entity presents depreciation (amortization) of similar assets and other interest expense. In contrast, operating leases grant (impose) different rights (obligations) on the lessee such that they are not the same as acquisitions of nonfinancial assets. Also, for operating leases, a lessee recognizes a single lease cost generally on a straight-line basis over the lease term. To the extent that cost is not capitalized as part of the cost of another asset, the lessee includes the single lease cost in its income from continuing operations.

### 8.2.2.3 Cash Flow Statement

The requirements for presenting cash outflows in the statement of cash flows link to the presentation of expenses arising from a lease in the income statement and are generally consistent with prior U.S. GAAP.

**EXAMPLE 8-1: STATEMENT OF CASH FLOW PRESENTATION — LESSEES**

**FACTS**

- Lessee enters a 10-year lease for heavy machinery for its operations. Payments start at $100,000 and increase by 5% annually. There are no initial direct costs, lease incentives, or prepaid lease payments.
- Lessee classifies the lease as operating and recognizes straight-line lease expense of $125,779 annually ([A]).
- The rate implicit in the lease is not readily determinable. Lessee uses its incremental borrowing rate of 6%.

**CONCLUSION AND ANALYSIS**

- Assuming no modifications, reassessments, or impairments, Lessee accounts for the lease throughout the lease term as shown in the table (see also Chapter 5).

| | LEASE LIABILITY | | | | | ROU ASSET | | |
|---|---|---|---|---|---|---|---|---|
| | BEGINNING BALANCE | INTEREST (6%) [B] | PAYMENT [C] | ENDING BALANCE | AMORTIZATION OF LIABILITY [B] + [C] | BEGINNING BALANCE | AMORTIZATION [A] - [B] | ENDING BALANCE |
| Year 1 | 904,337 | 54,260 | (100,000) | 858,598 | (45,740) | 904,337 | (71,519) | 832,819 |
| Year 2 | 858,598 | 51,516 | (105,000) | 805,114 | (53,484) | 832,819 | (74,263) | 758,556 |
| Year 3 | 805,114 | 48,307 | (110,250) | 743,170 | (61,943) | 758,556 | (77,472) | 681,084 |
| Year 4 | 743,170 | 44,590 | (115,763) | 671,998 | (71,172) | 681,084 | (81,189) | 599,895 |
| Year 5 | 671,998 | 40,320 | (121,551) | 590,767 | (81,231) | 599,895 | (85,459) | 514,436 |
| Year 6 | 590,767 | 35,446 | (127,628) | 498,585 | (92,182) | 514,436 | (90,333) | 424,103 |
| Year 7 | 498,585 | 29,915 | (134,010) | 394,491 | (104,094) | 424,103 | (95,864) | 328,239 |
| Year 8 | 394,491 | 23,669 | (140,710) | 277,450 | (117,041) | 328,239 | (102,109) | 226,130 |
| Year 9 | 277,450 | 16,647 | (147,746) | 146,352 | (131,099) | 226,130 | (109,132) | 116,998 |
| Year 10 | 146,352 | 8,781 | (155,133) | — | (146,352) | 116,998 | (116,998) | — |

- Lessee uses the above information to prepare its statement of cash flows. One acceptable presentation is for Lessee to add back the ROU asset amortization as a noncash rent expense and separately present the change in lease liability. However, other presentations may be acceptable (for example, presenting a single net line item, consistent with presentation of the single operating lease expense in the income statement). In this example, other line items are omitted, and Lessee has only one lease.

| | YEAR 1 | YEAR 2 | YEAR 3 | YEAR 4 | YEAR 5 | YEAR 6 | YEAR 7 | YEAR 8 | YEAR 9 | YEAR 10 |
|---|---|---|---|---|---|---|---|---|---|---|
| Net income | XX | XX | XX | XX | XX | XX | XX | XX | XX | XX |
| Noncash rent expense | 71,519 | 74,263 | 77,472 | 81,189 | 85,459 | 90,333 | 95,864 | 102,109 | 109,132 | 116,998 |
| Change in lease liability | (45,740) | (53,484) | (61,943) | (71,172) | (81,231) | (92,182) | (104,094) | (117,041) | (131,099) | (146,352) |
| Net cash from operations | XX | XX | XX | XX | XX | XX | XX | XX | XX | XX |

### 8.2.3 Summary of Lessor Presentation Requirements

**FASB REFERENCES**

ASC 842-30-45-1 through 45-7 and ASC 942-230-45-4

The table summarizes the presentation requirements in the financial statements for lessors.

<table>
<tr><th colspan="2">LESSOR PRESENTATION REQUIREMENTS</th></tr>
<tr><td>Balance Sheet</td><td>▶ For sales-type and direct financing leases:<br>• Present lease assets (the aggregate of the lessor’s net investment in sales-type and direct financing leases) separately from other assets<br>• Classify lease assets as current or noncurrent like how similar assets are classified.<br>▶ For operating leases, present the underlying asset subject to an operating lease in accordance with other topics (for example, ASC 360 on PP&E).</td></tr>
<tr><td>Income Statement</td><td>▶ For all leases, present income arising from leases separately or disclose which line items in the income statement include lease income.<br>▶ For sales-type and direct financing leases, present profit or loss recognized at the commencement date in a manner that best reflects the lessor’s business model. For example:<br>• Present revenue and cost of goods sold in separate line items if the lessor uses leases as an alternative means of realizing value from goods it would otherwise sell (for example, manufacturers and dealers) so that income and expenses from sold and leased items are presented consistently. Revenue recognized is the lesser of the underlying asset’s fair value at the commencement date or the sum of the lease receivable and any prepaid lease payments. Cost of goods sold is the underlying asset’s carrying amount at the commencement date minus the unguaranteed residual asset.<br>• Present profit or loss in a single line item if the lessor uses leases to provide finance (for example, financial institutions).</td></tr>
<tr><td>Cash Flow Statement</td><td>▶ Classify cash receipts from leases within operating activities, regardless of lease classification. However, lessors within the scope of ASC 942, Financial Services — Depository and Lending, should classify principal payments received under sales-type and direct financing leases within investing activities, consistent with ASC 942-230-45-4.</td></tr>
</table>

**PRESENTATION FOR REIMBURSEMENTS OF LESSOR COSTS**

Some leases, such as for real estate, require the lessee to reimburse the lessor for costs incurred related to property taxes, insurance, and maintenance services. As discussed in Section 3.2, lessor costs, such as property taxes and insurance, that protect the lessor's asset are not a component of the contract, while maintenance services represent a nonlease component. A lessor accounts for lessor costs paid by the lessor and reimbursed by the lessee on a gross basis (see Section 3.4.1.2), and such reimbursements are allocated between the lease and nonlease components consistently with the initial (or most recent) allocation of the consideration in the contract unless the variable payments can be allocated only to the lease component (see Section 3.4.3). If a lessor elected the practical expedient not to separate (see Section 3.4.2) and the lease component is predominant, there is a single lease component, and the tenant reimbursements must be presented within lease income (unless any nonlease components do not meet the conditions to be combined and an appropriate allocation is made). Additional disclosures factually discussing the reimbursements may be appropriate in the notes.

## 8.2.4 Lessor Presentation Requirements Explained

### 8.2.4.1 Balance Sheet

As discussed in Sections 6.4 and 6.5, the net investment in the lease comprises the lease receivable, the unguaranteed residual asset and, for direct financing leases, any deferred selling profit. The FASB decided against requiring a lessor to separately present the components of the net investment in the lease on balance sheet, so a lessor must present a single net investment in sales-type and direct financing leases separately from other assets. As a result, and as discussed in Section 8.3.3, some disclosures of those components are necessary to provide users with information about the lessor's exposure to credit risk (for the lease receivable) and asset risk (relating to the unguaranteed residual asset). The net investment in a lease is also subject to the current and noncurrent presentation requirements in a classified balance sheet.

For operating leases, the lessor presents the underlying assets and related depreciation in accordance with other topics (for example, ASC 360). Further, assets subject to operating leases must be disclosed separately from owned assets that are held and used by the lessor because they are subject to different risks (see Section 8.3.3). Any rent receivable, deferred rent revenue (that results from the requirement to recognize rents on a straight-line basis), and prepaid initial direct costs are also subject to current and noncurrent presentation requirements.

### 8.2.4.2 Income Statement

ASC 842 provides guidance on presentation in the income statement for sales-type and direct financing leases and not for operating leases. For sales-type and direct financing leases, the FASB noted that lessors' business models vary. For example, lessors such as banks and other financial institutions use leasing to provide financing to lessees. Others, such as manufacturers or dealers, use leasing as an alternative means of realizing value from assets they would otherwise sell (for example, medical equipment manufacturers). Accordingly, ASC 842 permits presentation of the profit recognized at the commencement date as either gross or net based on the lessor's business model.

ASC 842 does not provide specific guidance on the presentation of variable lease payments received for direct financing or sales-type leases. We believe that presentation as either lease income or interest income may be appropriate.

### 8.2.4.3 Cash Flow Statement

Lessors must classify all cash receipts from leases as operating activities in the statement of cash flows, regardless of classification because, in the FASB's view, leasing is generally part of a lessor's revenue-generating activities. However, lessors within the scope of ASC 942 present cash from leases in accordance with that topic.

# 8.3 DISCLOSURE REQUIREMENTS

## 8.3.1 Disclosure Objective Applicable to Lessees and Lessors

**FASB REFERENCES**

ASC 842-20-50-1 through 50-2 and ASC 842-30-50-1 through 50-2

The objective of the disclosure requirements in ASC 842 is to allow users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. Further, a lessee or lessor must consider the level of detail necessary to satisfy that disclosure objective and how much emphasis to place on each requirement. The entity must 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, judgment is required to determine the level of disclosures necessary for an entity. As a guiding principle, paragraph 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 entities for which leasing is a significant portion of their business.

Therefore, in preparing its notes to the financial statements, an entity should consider the steps below.

Consider information relevant to users' understanding of the amount, timing, and uncertainty of cash flows from leases → Consider the level of detail necessary based on the significance of the entity's leasing activities → Provide the required disclosures about the entity's leases in sufficient detail to meet the disclosure objective

Entities must make appropriate disclosures for each annual reporting period for which an income statement is presented and in each year-end balance sheet. Entities do not have to repeat disclosures if the information is already presented in the financial statements as required by other accounting guidance.

Although most of the disclosures required by ASC 842 affect only an entity's annual financial statements, lessors must provide a table disclosing lease income for each interim and annual reporting period. Otherwise, entities must look to ASC 270 on interim disclosure requirements for additional guidance.

ASC 842 does not distinguish between public business entities and other entities, so the disclosure principle and related requirements apply to all entities.

### 8.3.2 Lessee Disclosure Requirements

**FASB REFERENCES**

ASC 230-10-50-3, ASC 842-20-50-1 through 50-10, ASC 842-20-55-11 through 55-12, ASC 842-20-55-53, and ASC 842-40-50-1 through 50-2

The table summarizes the disclosure requirements in the notes to the financial statements for lessees.

| LESSEE DISCLOSURE REQUIREMENTS | |
|---|---|
| **Qualitative Disclosures** | ▶ Disclose information about the nature of its leases (and subleases, as applicable), including:<br>• A general description of those leases.<br>• The basis, terms, and conditions on which variable lease payments are determined.<br>• The existence, 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.<br>• The existence, terms, and conditions of lessee residual value guarantees.<br>• The restrictions or covenants imposed by leases; for example, those relating to dividends or incurring additional financial obligations.<br>▶ Provide 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.<br>▶ Disclose the significant assumptions and judgments made, including:<br>• The determination of whether a contract contains a lease (see Chapter 2).<br>• The allocation of consideration in a contract between lease and nonlease components (see Sections 3.1 through 3.3).<br>• The determination of the discount rate for the lease (see Section 4.6). |
| **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 arising from lease transactions. Those amounts include:<br>• Finance lease cost, segregated between amortization of ROU assets and interest on lease liabilities<br>• Operating lease cost<br>• Short-term lease cost, excluding expenses relating to leases with a lease term of one month or less<br>• Variable lease cost<br>• Sublease income disclosed on a gross basis separately from finance or operating lease expense<br>• Net gain or loss recognized from sale and leaseback transactions<br>• Amounts segregated between those for finance and operating leases for:<br>— Cash paid for amounts included in the measurement of lease liabilities segregated between operating and financing cash flows<br>— Supplemental noncash information on lease liabilities arising from obtaining ROU assets<br>— Weighted-average remaining lease term based on the remaining lease term and the lease liability balance for each lease as of the reporting date |

| LESSEE DISCLOSURE REQUIREMENTS | |
|---|---|
| | — Weighted-average discount rate based on the discount rate for the lease used to calculate the lease liability balance for each lease, and remaining balance of lease payments for each lease as of the reporting date.<br>• Disclose a maturity analysis of undiscounted lease liabilities (commonly referred to as the "five-year table") separately for finance leases and operating leases, with a reconciliation of undiscounted cash flows to the finance and operating lease liabilities recognized in the balance sheet.<br>▶ While the FASB illustrated those quantitative disclosures in Example 6 of ASC 842-20-55-53 in a tabular format, that format is not required. |
| **Policy Elections and Practical Expedients** | ▶ Disclose policy election for short-term leases, if elected (see Section 5.4).<br>• If the short-term lease expense does not reasonably reflect the lessee's short-term lease commitments, disclose that fact and the amount of those commitments.<br>▶ If elected, disclose the practical expedient for not separating lease components and nonlease components and to which asset classes the election applies (see Section 3.3.2).<br>▶ If elected, disclose the accounting policy on using the risk-free discount rate for the lease and to which class or classes of underlying assets the election applies (see Section 4.6.3). |
| **Related Party Leases** | ▶ Disclose lease transactions between related parties in accordance with ASC 850.<br>▶ For common control leases (see Sections 2.5 and 5.6.3.2), when the useful life of leasehold improvements to the common control group exceeds the related lease term, disclose the following:<br>• The unamortized balance of the leasehold improvements at the balance sheet date<br>• The remaining useful life of the leasehold improvements to the common control group.<br>• The remaining lease term. |
| **Sale and Leaseback Transactions** | ▶ If a seller-lessee enters a sale and leaseback transaction (see Section 7.2), it provides the lessee-required disclosures for the leaseback.<br>▶ 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 requires disclosure of supplemental noncash information on lease liabilities arising from obtaining ROU assets. ASC 230-10-50-3 requires disclosure of information about all of an entity's investing and financing activities during a period that affects recognized assets or liabilities but that do not result in cash receipts or cash payments in the period. Therefore, we believe that all material noncash changes to ROU assets — both increases and decreases — must be disclosed either on the face of the statement of cash flows or in the related notes. The initial recognition of an ROU asset must therefore be included in that disclosure, along with:

- Any lease modification that grants an additional ROU asset or removes an ROU asset (see Section 5.8)
- 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 5.7).

**EXAMPLE 8-2: LESSEE DISCLOSURE EXAMPLE**

Susie's Stitch-n-Sew is a national retailer of fabrics and other craft materials, and it primarily leases its retail locations. We have not presented a statement of financial position but have assumed that Susie's has presented the following captions:

- Operating lease ROU assets
- Fixed assets, net
- Current portion of operating lease liabilities
- Long-term operating lease liabilities
- Current portion of long-term debt
- Long-term debt

We have also not presented a statement of comprehensive income but have assumed that Susie's has presented cost of sales; selling, general, and administrative (SG&A) expense; depreciation and amortization expense; and interest expense.

The guidance in ASC 842 applies for all periods presented.

**Note X. Leases**

Susie's has historically entered into numerous lease arrangements under which we are the lessee. Specifically, of our 250 retail locations, 240 are subject to operating leases and five are subject to finance leases. We also lease our corporate headquarters facility, as well as various warehouses and regional offices. We are a party to an additional 12 leases in which we previously operated a retail location but which are now subleased to third parties. We have elected the short-term lease practical expedient related to leases of various equipment used in our retail locations.

As of December 31, 20X9, we have entered into eight leases for additional retail locations and one lease for an additional warehouse, none of which have commenced. Although some of the retail locations are under construction, we do not control the building during construction and are thus not deemed to be the owner during construction.

All of our retail leases include multiple optional renewal periods. Upon opening a new retail location, we typically install brand-specific leasehold improvements with a useful life of approximately eight years. To the extent that the initial term of the related lease is less than the useful life of the leasehold improvements, we conclude that it is reasonably certain that a renewal option will be exercised, so that renewal period is included in the lease term and the related payments are reflected in the ROU asset and lease liability. Generally, we do not consider any additional renewal periods to be reasonably certain of being exercised because comparable locations could generally be identified within the same trade areas for comparable lease rates.

All of our leases include fixed rental payments but many also include variable rental payments. Specifically, several leases in some markets require rent payments that are calculated as a percentage of sales in that location. We also commonly enter into leases under which the lease payments increase at predetermined dates based on the change in the CPI. While most of our leases are gross leases, several leases require that we make separate payments to the lessor based on the lessor's property and casualty insurance costs and the property taxes assessed on the property, as well as a portion of the common area maintenance associated with the property. We have elected the practical expedient not to separate lease and nonlease components for all building leases.

During 20X9, 20X8 and 20X7, we recognized rent expense associated with our leases as follows (in millions):

| | 20x9 | 20x8 | 20x7 |
|---|---|---|---|
| Operating lease cost: | | | |
| Fixed rent expense | $ 23.7 | $ 22.6 | $ 20.5 |
| Variable rent expense | 3.8 | 3.6 | 3.4 |
| Finance lease cost: | | | |
| Amortization of ROU assets | 2.5 | 2.4 | 2.2 |
| Interest expense | 2.0 | 2.1 | 2.0 |
| Short-term lease cost | 0.2 | 0.2 | 0.3 |
| Sublease income | (1.3) | (1.1) | (1.2) |
| Net lease cost | $ 30.9 | $ 29.8 | $ 27.2 |
| | | | |
| Lease cost — Cost of sales | $ 4.2 | $ 4.0 | $ 4.1 |
| Lease cost — SG&A | 22.2 | 21.3 | 18.9 |
| Lease cost — Depreciation and amortization | 2.5 | 2.4 | 2.2 |
| Lease cost — Interest expense | 2.0 | 2.1 | 2.0 |
| Net lease cost | $ 30.9 | $ 29.8 | $ 27.2 |

Amounts recognized as ROU assets related to finance leases are included in fixed assets, net in the accompanying statement of financial position, while related lease liabilities are included in current portion of long-term debt and long-term debt. As of December 31, 20x9 and 20x8, ROU assets and lease liabilities related to finance leases were as follows (in millions):

| | 20x9 | 20x8 |
|---|---|---|
| Finance lease ROU assets | $ 17.6 | $ 17.0 |
| Finance lease liabilities: | | |
| Current portion of long-term debt | 2.2 | 2.2 |
| Long-term debt | 15.3 | 15.1 |

During the years ended December 31, 20x9, 20x8 and 20x7, we had the following cash and noncash activities associated with our leases (in millions):

| | 20x9 | 20x8 | 20x7 |
|---|---|---|---|
| Cash paid for amounts included in the measurement of lease liabilities: | | | |
| Operating cash flows from operating leases | $ 26.0 | $ 25.7 | $ 24.8 |
| Operating cash flows from finance leases | 2.0 | 2.1 | 2.0 |
| Financing cash flows from finance leases | 2.0 | 1.9 | 1.9 |
| Noncash investing and financing activities: | | | |
| Additions to ROU assets obtained from: | | | |
| New operating lease liabilities | $ 18.7 | $ 20.3 | $ 16.2 |
| New finance lease liabilities | — | 3.4 | — |

The future payments due under operating and finance leases as of December 31, 20x9, is as follows (in millions):

| | Operating | Finance |
|---|---|---|
| Due in 20x0 | $ 22.6 | $ 2.2 |
| 20x1 | 23.9 | 3.8 |
| 20x2 | 24.7 | 3.6 |
| 20x3 | 25.3 | 3.6 |
| 20X4 | 24.0 | 3.6 |
| All years thereafter | 8.3 | 2.1 |
| | 128.8 | 18.9 |
| Less effects of discounting | (35.9) | (3.6) |
| Lease liabilities recognized | $ 92.9 | $ 15.3 |

As of December 31, 20x9 and 20x8, the weighted-average remaining lease term for our operating leases is 4.8 and 4.9 years, respectively, while the weighted-average remaining lease term for our finance leases is 5.3 and 5.6 years, respectively.

Because we generally do not have access to the rate implicit in the lease, we use our incremental borrowing rate as the discount rate. The weighted average discount rate associated with operating leases as of December 31, 20x9 and 20x8, is 4.2% and 4.0%, respectively, while the weighted-average discount rate associated with finance leases is 3.9% and 3.8%, respectively.

The incremental borrowing rate is the rate of interest we would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment. In determining that rate, the company considers prevailing economic conditions at the commencement date, as well as factors such as company-specific credit risk, term of the lease and options, and the effect of collateralization based on the nature and quality of the underlying asset.

### 8.3.3 Lessor Disclosure Requirements

**FASB REFERENCES**

ASC 842-30-50-1 through 50-14 and ASC 842-40-50-1

Considering the disclosure objective discussed in Section 8.3.1, and to help entities achieve that objective, ASC 842 requires that a lessor disclose quantitative and qualitative information about:

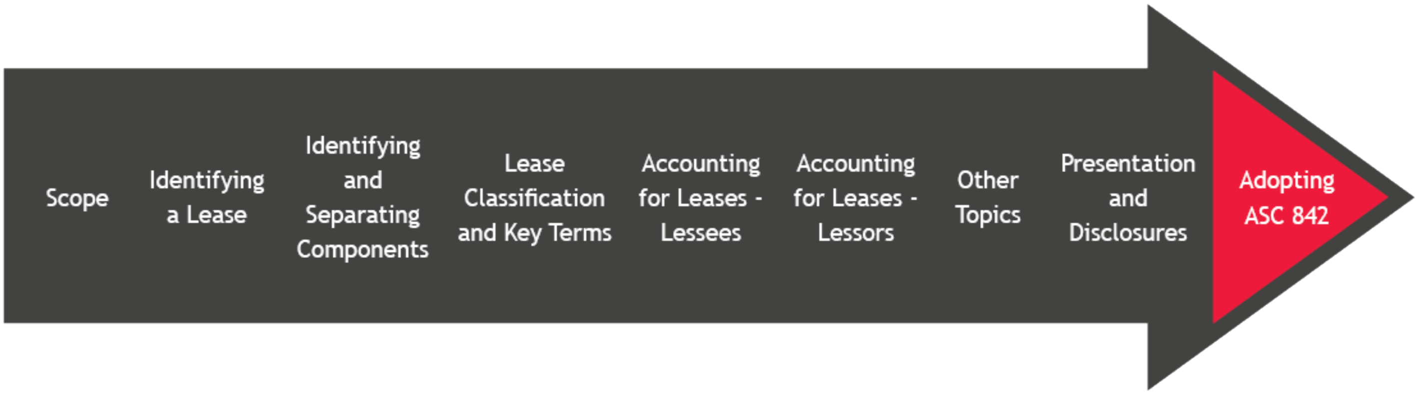
- Its leases
- The significant judgments made in applying ASC 842
- The amounts recognized in the financial statements for those leases.

The table summarizes those disclosure requirements.

| LESSOR DISCLOSURE REQUIREMENTS | |
|---|---|
| **Qualitative Disclosures** | ▶ Information about the nature of its leases, including:<br>• A general description of those leases<br>• The basis, terms, and conditions on which variable lease payments are determined<br>• The existence, terms, and conditions of options to extend or terminate the lease<br>• The existence, terms, and conditions of options for a lessee to purchase the underlying asset.<br>▶ Information about significant assumptions and judgments made, including:<br>• The determination of whether a contract contains a lease (see Chapter 2)<br>• The allocation of consideration in a contract between lease and nonlease components (unless a lessor elects the practical expedient and all nonlease components in the contract qualify for that practical expedient) (see Section 3.4)<br>• The determination of the amount the lessor expects to derive from the underlying asset following the end of the lease term.<br>▶ Information about how the lessor manages its risk associated with the residual value of its leased assets, including:<br>• Risk management strategy for residual assets<br>• Carrying amount of residual assets covered by residual value guarantees (excluding guarantees considered lease payments under ASC 842-30-30-1(a)(2))<br>• Any other means by which the lessor reduces its residual asset risk; for example, buyback agreements and variable lease payments for use in excess of specified limits. |
| **Quantitative Disclosures** | ▶ For each annual **and interim** reporting period, disclose **in tabular format**:<br>• For sales-type and direct financing leases:<br>– Profit or loss recognized at the commencement date (disclosed on a gross or net basis, as discussed in Section 8.2.3)<br>– Interest income (either in aggregate or separated by components of the net investment in the lease).<br>• For operating leases, the lease income relating to lease payments<br>• Lease income relating to variable lease payments not included in the measurement of the lease receivable. |

| LESSOR DISCLOSURE REQUIREMENTS | |
|---|---|
| | ▶ Disclose the components of the lessor’s aggregate net investment in sales-type and direct financing leases (that is, the carrying amount of its lease receivables, unguaranteed residual assets, and any deferred selling profit on direct financing leases).<br>▶ For sales-type and direct financing leases:<br>• Explain significant changes in the balance of unguaranteed residual assets and deferred selling profit on direct financing leases<br>• Disclose a maturity analysis (commonly referred to as the “five-year table”) of undiscounted lease receivables, with a reconciliation of undiscounted cash flows to lease receivables.<br>▶ Operating Leases:<br>• Disclose a maturity analysis (commonly referred to as the “five-year table”) of undiscounted lease payments to be received, which must be presented separately from the maturity analysis for sales-type and direct financing leases<br>• Provide disclosures required by ASC 360 on PP&E separately for underlying assets under operating leases from owned assets. |
| **Policy Elections and Practical Expedients** | ▶ An entity that elects the practical expedient not to separate nonlease components from associated lease components (including an entity that accounts for the combined component entirely in ASC 606 on revenue from contracts with customers) must disclose by class of underlying asset (see Section 3.4.2):<br>• Accounting policy election and the class or classes of underlying assets for which it has elected to apply the practical expedient<br>• The nature of:<br>– The lease components and nonlease components combined as a result of applying the practical expedient<br>– Any nonlease components that are accounted for separately from the combined component because they do not qualify for the practical expedient<br>• The topic (ASC 842 or ASC 606) the entity uses to account for the combined component.<br>▶ A lessor that elects to exclude from the consideration in the contract and from variable payments not included in the consideration in the contract all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific lease revenue-producing transaction and collected by the lessor from the lessee (see Section 3.4.1.3) should disclose its election and comply with the disclosure requirements in ASC 235-10-50-1 through 50-6. |
| **Related Party Leases** | ▶ Disclose any lease transactions between related parties in accordance with ASC 850 on related-party disclosures. |
| **Sale and Leaseback Transactions** | ▶ The buyer-lessor provides the disclosures applicable to lessors for the leaseback. |
| **Leveraged Leases** | ▶ Although ASC 842 removed leveraged lease accounting, leases that met the definition of a leveraged lease under ASC 840 that commenced before the effective date of ASC 842 are grandfathered. As such, entities that continue to have leveraged leases must continue to provide disclosures as required by ASC 842-50. |

# CHAPTER 9 — ADOPTING ASC 842




## 9.1 OVERVIEW

Except for ASU 2023-01, ASC 842 is now effective for all entities. ASU 2023-01 simplifies the lease identification and assessment of and accounting for common control arrangements for nonpublic entities[8] (see Section 9.1.1). It also changes how to amortize and account for the transfer of leasehold improvements for all lessees in common control leases (see Section 9.1.2).

ASU 2023-01 is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. However, early adoption (including in an interim period) is allowed. If an entity adopts the ASU in an interim period, it must adopt that guidance as of the beginning of the fiscal year that includes that interim period.

### 9.1.1 Common Control Arrangements — Terms and Conditions to Consider

**FASB REFERENCES**

ASC 842-10-65-7

Private company stakeholders raised concerns about applying ASC 842 to common control arrangements such as arrangements between sister entities controlled by a common owner. Concerns included determining whether a common control arrangement is or contains a lease based on the legally enforceable terms and conditions.

ASU 2023-01 provides nonpublic entities a practical expedient to use the written terms and conditions of a common control arrangement to determine whether a lease exists and, if so, to classify and account for that lease. Under the practical expedient, an entity assesses whether the written terms and conditions convey the **practical** right (rather than an enforceable right) to control the use of an identified asset for a period of time in exchange for consideration to determine whether a lease exists. If a lease exists, the entity classifies and accounts for 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 entity cannot apply the practical expedient (see Section 2.5) 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. However, as part of the transition, an entity might choose to document the unwritten terms and conditions of existing common control arrangements. Such

[8] *See* note 2, *supra*.

documentation must be completed before the entity's first interim or annual financial statements in which ASU 2023-01 is applied are available to be issued.

**BDO INSIGHTS — PRACTICAL EXPEDIENT ADOPTION CONSIDERATIONS**

When using the transition relief described above, private entities should document the terms and conditions of common control arrangements that were in effect and considered in applying ASC 840. Any revision to those terms and conditions that change the scope of the lease or the consideration for the lease should be accounted for as modifications (at the effective date of such modification), rather than considered part of adoption.

The transition requirements depend on an entity's adoption status for ASC 842. Because ASC 842 is now effective for all entities, entities that adopted ASC 842 after the issuance of ASU 2023-01 adopted the amendments in ASU 2023-01 during their implementation of ASC 842. Accordingly, ASU 2023-01 remains relevant only for entities that adopted ASC 842 before ASU 2023-01 was issued. Those entities can apply the amendments either:

- Prospectively to arrangements that commence or are modified on or after the date the entity first applies the practical expedient (see Section 2.5).
- Retrospectively to the beginning of the period when the entity first applied ASC 842, but the amendments do not apply to common control arrangements no longer in place at the adoption date of ASU 2023-01.

See ASC 842-10-65-7 for further guidance on adopting ASU 2023-01.

### 9.1.2 Leasehold Improvements Amortization — Common Control Leases

**FASB REFERENCES**

ASC 842-10-65-8

ASU 2023-01 states that:

- A lessee amortizes leasehold improvements associated with a common control lease over the useful life of those improvements to the common control group, regardless of the lease term, if the lessee controls the use of the underlying asset through a lease. If the lessor obtained the right to control the underlying asset's use through a lease with another entity outside the common control group, the amortization period cannot exceed the group's amortization period.
- 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 a transfer between entities under common control through an adjustment to equity (or net assets for a not-for-profit entity).

See Section 5.6.3.2 for further discussion of the requirements.

**BDO INSIGHTS — AMENDMENTS APPLY TO ALL ENTITIES**

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

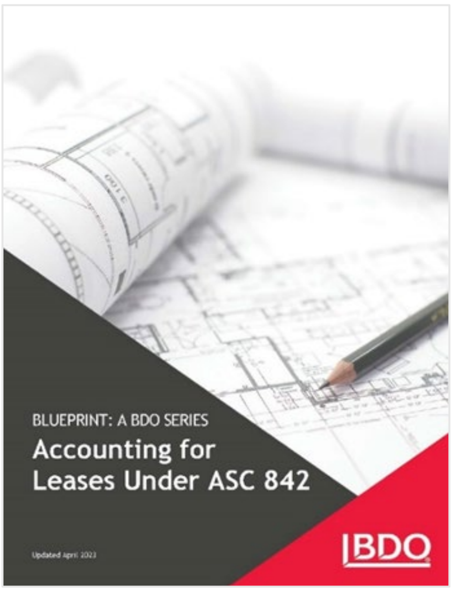
As in Section 9.1.1, the transition requirements depend on an entity's adoption status for ASC 842. Because ASC 842 is now effective for all entities, ASU 2023-01 remains relevant only for entities that adopted ASC 842 before ASU 2023-01 was issued. Those entities can apply the amendments either:

- Prospectively to all new leasehold improvements recognized on or after the date the entity first applies ASU 2023-01.
- Prospectively to all new and existing leasehold improvements recognized on or after the date the entity first applies ASU 2023-01, with any remaining unamortized balance of existing leasehold improvements amortized over their remaining useful life to the common control group determined at that date.

- Retrospectively to the beginning of the period in which the entity first applied ASC 842 for leasehold improvements that exist at the adoption date of ASU 2023-01, with any leasehold improvements that otherwise would not have been amortized or impaired recognized through a cumulative-effect adjustment to the opening balance of retained earnings at the adoption date of ASC 842.

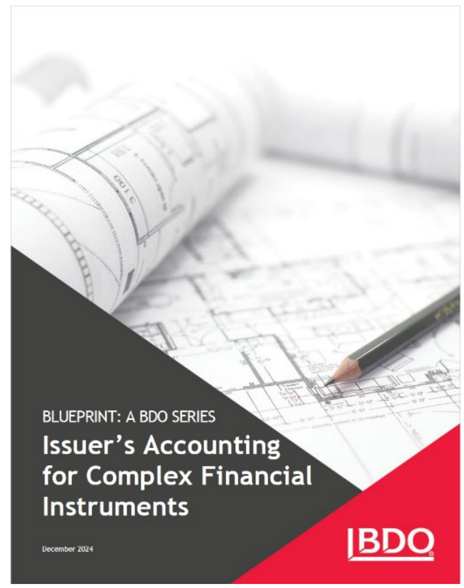
# APPENDIX A — OTHER BDO BLUEPRINTS

Other BDO Blueprints and publications are available on BDO's Accounting, Reporting, and Compliance Hub (ARCH).



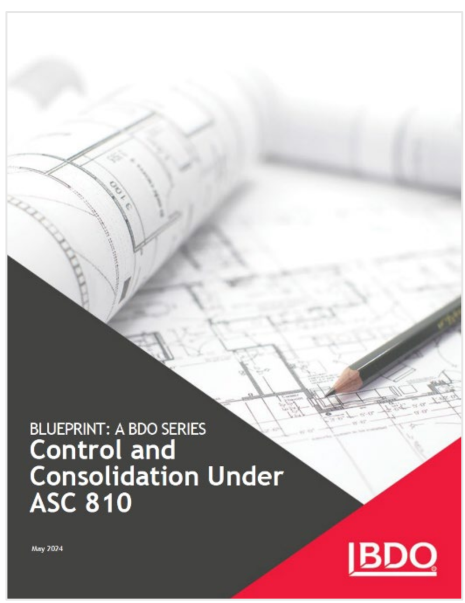

Accounting for Leases Under ASC 842


Revenue Recognition Under ASC 606




Issuer's Accounting for Complex Financial Instruments


Share-based Payments Under ASC 718




Control and Consolidation Under ASC 810


Business Combinations Under ASC 805

# APPENDIX B — SUMMARY OF SIGNIFICANT CHANGES

This edition of the Practice Aid makes several changes to the April 2023 edition. It removes most references to the legacy U.S. GAAP guidance, ASC 840, *Leases*, significantly reduces the discussion of adoption dates and transition to ASC 842, adds codification paragraph references, and renumbers examples. The table lists the substantive changes made in this edition.

| SECTION | DESCRIPTION OF CHANGE |
|---|---|
| 2.3 | Adds BDO Insights on identifying a lease in a multiparty arrangement, including whether an intermediary has obtained a lease. |
| 3.3.1.3 | Adds a section to discuss various CAM payment arrangements and the accounting by a lessee depending on the nonseparation practical expedient election. |
| 3.6 | Adds BDO Insights to discuss the interaction of the contract combination guidance with the contract modification guidance. |
| 4.3 | Adds BDO Insights on considering the economic life of the underlying asset when determining the lease term. |
| 4.4 | Removes example on accounting for contingent lease incentives and adds a section to expand the discussion on accounting for contingent lease incentives neither received nor receivable at the commencement date, including updated examples. |
| 4.6.1 | Adds BDO Insights to clarify that the use of the rate implicit in the lease by lessees is rare. |
| 5.4 | Reorganizes the section on short-term leases by creating subsections, adding BDO Insights on day 2 considerations for the short-term lease accounting policy, and adding a subsection on application of the short-term lease accounting policy at the lease component level. |
| 5.5.1 | Adds BDO Insights about considerations related to onerous leases before the commencement date. |
| 5.5.2 | Adds BDO Insights on accounting by a lessee when the initial measurement of an ROU asset is less than zero. |
| 5.8 | Reorganizes the section discussing accounting for lease modifications by lessees by creating subsections and adding BDO Insights on lease modification practice issues, including:<br>▶ The effective date of a lease modification (section 5.8.1)<br>▶ Whether a contract modification is substantive (section 5.8.1)<br>▶ Whether a modified contract is or contains a lease (section 5.8.1)<br>▶ Modification considerations associated with an additional ROU (section 5.8.1)<br>▶ A lease termination and new lease with the same lessor (section 5.8.2). |

| SECTION | DESCRIPTION OF CHANGE |
|---|---|
| 5.9.4 | Adds section to discuss accounting considerations for ROU assets included in a disposal group that is held for sale. |
| 6.7 | Reorganizes the section discussing accounting for lease modifications by lessors by creating subsections and adding BDO Insights on lease modification practice issues, including:<br>▶ The effective date of a lease modification (section 6.7.1)<br>▶ Whether a contract modification is substantive (section 6.7.1)<br>▶ Whether a modified contract is or contains a lease (section 6.7.1)<br>▶ Modification considerations associated with an additional ROU (section 6.7.1). |
| 7.3 | Removes discussion on leases in business combinations (or acquisitions by not-for-profit entities) and refers to BDO Blueprint on business combinations. |

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