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Leases

Partially updated January 2024

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About the Leases guide

PwC is pleased to offer our updated *Leases* guide. The FASB's new standard on leases, ASC 842, is effective for all entities. This guide discusses lessee and lessor accounting under ASC 842. The first four chapters provide an introduction and guidance on determining whether an arrangement is (or contains) a lease and how to classify and account for lease and nonlease components. This guide also discusses the modification, remeasurement, and termination of a lease, sale and leaseback transactions, leveraged lease transactions, as well as other topics. Chapter 9 addresses the effective date and transition. Presentation is addressed in the *Financial statement presentation* guide.

This guide summarizes the applicable accounting literature, including relevant references to and excerpts from the FASB's Accounting Standards Codification (the Codification). It also provides our insights and perspectives, interpretative and application guidance, illustrative examples, and discussion on emerging practice issues.

This guide should be used in combination with a thorough analysis of the relevant facts and circumstances, review of the authoritative accounting literature, and appropriate professional and technical advice.

References to US GAAP

Definitions, full paragraphs, and excerpts from the FASB's Accounting Standards Codification are clearly labelled. In some instances, guidance was cited with minor editorial modification to flow in the context of the PwC Guide. The remaining text is PwC's original content.

References to other PwC guidance

This guide provides general and specific references to chapters in other PwC guides to assist users in finding other relevant information. References to other guides are indicated by the applicable guide abbreviation followed by the specific section number. The other PwC guides referred to in this guide, including their abbreviations, are:

- *Business combinations and noncontrolling interests (BCG)*
- *Bankruptcies and liquidations (BLG)*
- *Consolidation (CG)*
- *Financial statement presentation (FSP)*
- *Financing transactions (FG)*
- *Income taxes (TX)*
- *Loans and investments (LI)*
- *Revenue from contracts with customers (RR)*

- *Transfers and servicing of financial assets (TS)*

Summary of significant changes

Following is a summary of the noteworthy revisions. Additional updates may be made to keep pace with significant developments.

Revisions made in January 2024

LG 9, Presentation and disclosure

- ***LG 9.2.3*** *was moved to* ***FSP 6.8.16, LG 9.3.3*** *was moved to* ***FSP 6.8.17,*** *and the remaining content in* ***LG 9*** *was moved to* ***FSP 14*** *now that ASC 842 is effective for all entities***.**

LG 10, *Effective date and transition*

The content in **LG 10** was moved to **LG 9.**

Revisions made in May 2023

LG 3, *Classification*

- **LG 3.2.1.1** was added to reflect the issuance of ASU 2023-01, *Common Control Arrangements*.

- Example LG 3-3 in **LG 3.3.3.1** was updated to illustrate a lessee-sublessor's determination of the lease term of a sublease (as a sublessor), and how that evaluation affects its consideration of the lease term of its head lease (as a lessee).

LG 8, *Other topics*

- **LG 8.11** was added to describe guidance on amortization of leasehold improvements, and for leases between entities under common control, how that guidance is affected by the issuance of ASU 2023-01, *Common Control Arrangements*.

Table of contents

Chapter 5: Modification and remeasurement of a lease—updated June 2021

Chapter 6: Sale and leaseback transactions—updated June 2021

Chapter 7: Leveraged leases–updated May 2023

Chapter 8: Other topics — updated October 2023

Chapter 1: Introduction–updated May 2023

1.1 Background

For many reporting entities, leasing is an important way to obtain access to property. It allows lessees to finance the use of necessary assets, often simplifies the disposal of used property, and reduces a lessee's exposure to the risks inherent in asset ownership.

The FASB issued ASU 2016-02 in February 2016, which was amended in some respects by subsequent Accounting Standards Updates (collectively the "leases standard" or "ASC 842"). Although the project began as a joint project with the IASB, the boards diverged in some key areas. Most significantly, the boards did not agree on whether all leases should be accounted for using the same model. After significant deliberation, the IASB decided that lessees should apply a single model to all leases, which is reflected in IFRS 16, *Leases*, released in January 2016. The FASB decided that lessees should apply a dual model. Under the FASB model, lessees will classify a lease as either a finance lease or an operating lease, while a lessor will classify a lease as either a sales-type, direct financing, or operating lease.

Under the FASB model, a lessee should classify a lease based on whether the arrangement is effectively a purchase of the underlying asset. Leases that transfer control of the underlying asset to a lessee are classified as finance leases (and as a sales-type lease for the lessor); lessees will classify all other leases as operating leases. In an operating lease, a lessee obtains control of only the use the underlying asset, but not the underlying asset itself.

A lease may meet the lessor finance lease criteria even when control of the underlying asset is not transferred to the lessee (e.g., when the lessor obtains a residual value guarantee from a party other than the lessee). Such leases should be classified as a direct finance lease by the lessor and as an operating lease by the lessee. See LG 3 for information on the dual model under US GAAP.

The dual model does not affect a lessee's initial recognition of assets and liabilities on its balance sheet, but differentiates how a lessee should recognize lease expense in the income statement. The accounting for lessors is largely unchanged under the FASB and IASB models.

Figure LG 1-1 includes a description of some of the most significant differences between the guidance in ASC 842 and IFRS 16.

Figure LG 1-1
Summary of key differences between ASC 842 and IFRS 16

Topic	Difference
Lessee accounting	ASC 842 requires a lessee to classify a lease as either a finance or operating lease. Interest and amortization expense are recognized for finance leases while only a single lease expense is recognized for operating leases, typically on a straight-line basis. Under IFRS 16, lessees will account for all leases in a manner similar to finance leases.

Topic	Difference
Lessor accounting	Under ASC 842, a sale and related profit are recognized upon the commencement of a lease only when the arrangement transfers control of the underlying asset to the lessee, i.e., in a sales-type lease, but not in a direct financing lease. Also, lessors may elect to combine certain nonlease components into the associated lease component. Under IFRS 16, selling profit is recognized on direct financing leases when performance obligations, defined in IFRS 15, *Revenue from Contracts with Customers*, have been met. Under IFRS 16, generally lessors may not combine lease and nonlease components. Additionally, under ASC 842, a lessor must reassess lease classification when a lessee exercises a contractual extension or termination option not previously included in the lease term. Under IFRS 16, a lessor may not reassess classification when the lessee exercises an existing contractual option to change the lease term.
Statement of cash flows	ASC 842 requires lessees to report the single expense associated with an operating lease as an operating activity. Under IFRS 16, lessees account for all leases similar to a financed purchase, with payments reported as a financing or operating activity in the statement of cash flows, in accordance with IAS 7, *Statement of Cash Flows*.
Remeasurement of variable lease payments	The initial measurement of lease-related assets and liabilities is similar under ASC 842 and IFRS 16; however, subsequent changes in lease payments that vary with a rate or index (e.g., rents that increase for changes in an inflation index) are accounted for differently. Under ASC 842, such changes are recognized as variable payments, unless the lessee is otherwise required to remeasure the lease liability (e.g., as a result of reassessing the lease term). Under IFRS 16, lease assets and liabilities are remeasured whenever the cash flow changes.
Sale and leaseback accounting	Under ASC 842, a seller-lessee would recognize the full gain from a sale and leaseback transaction that qualifies as a sale. IFRS 16 limits the recognition of gains from sale and leaseback transactions.
Transition	ASC 842 required a modified retrospective approach to each lease that existed at the date of initial application as well as leases entered into after that date. A reporting entity must have elected whether the date of initial application is the beginning of the earliest comparative period presented in the financial statements, or the beginning of the period of adoption. In the latter case, the reporting entity would not adjust the comparative periods. ASC 842 did not permit a full retrospective approach. IFRS 16 allowed a reporting entity to elect a full retrospective approach, or a simplified approach, but not the modified retrospective approach.

Topic	Difference
Other	◻ IFRS 16 has guidance excluding certain leases of low value assets from its recognition and measurement guidance ◻ IFRS 16 has similar but not identical disclosure requirements ◻ The accounting for subleases differs in some respects

1.2 High-level overview

The FASB concluded that a lessee's obligation to make lease payments meets the definition of a liability because it involves a present obligation that arises from a past event and the obligation is expected to result in an outflow of economic benefits. The "past event" arises when the lessee signs the lease and the lessor makes the underlying leased asset available to the lessee. The "present obligation" arises because the lessee cannot typically avoid making the contractual payments.

The boards also believe that a lessee's right to use the underlying asset during the lease term meets the definition of an asset. Despite legally owning the asset, the lessor typically cannot use the underlying asset or even access the underlying asset without the lessee's consent.

These two conclusions form the core principles of ASC 842.

Excerpt from the Summary of ASU 2016-02

The core principle of Topic 842 is that a lessee should recognize the assets and liabilities that arise from leases. All leases create an asset and a liability for the lessee in accordance with FASB Concepts Statement No. 6, *Elements of Financial Statements*, and, therefore, recognition of those lease assets and lease liabilities represents an improvement over previous GAAP, which did not require lease assets and lease liabilities to be recognized for most leases.

1.2.1 Definition and scope

A lease conveys the right to use an underlying asset for a period of time in exchange for consideration. At the inception of an arrangement, the parties should determine whether the contract is or contains a lease by assessing both of the following:

- Whether there is an identified asset
- Whether the contract conveys the right to control the use of the identified asset in exchange for consideration for a period of time

Often, it may be easy to determine that an arrangement contains a lease. Other times, it may be difficult to distinguish between a lease and an arrangement to buy or sell goods or services. See LG 2 for information on evaluating whether an arrangement is a lease or contains a lease.

The leases standard does not require lessees to reflect lease assets and liabilities on the balance sheet for arrangements with a lease term of 12 months or less. See LG 2.2.1 for additional information on this short-term lease measurement and recognition exemption. In addition, certain arrangements are outside the scope of the leases standard, including:

- Leases of inventory or of construction in progress
- Leases of intangible assets, including licenses of internal-use software
- Leases to explore for or use natural resources
- Leases of biological assets
- Service concession arrangements within the scope of ASC 853, *Service Concession Arrangements*

As discussed in LG 7, ASC 842 does not recognize a leveraged lease. However, lessors should continue to account for leveraged leases existing at the application date of the leases standard using the guidance in ASC 840, *Leases,* provided such leases are not modified on or after the application date of ASC 842.

1.2.2 Lessee classification

Under ASC 842, leases are subject to a dual accounting model, under which different types of leases have different accounting treatment subsequent to the initial recognition of lease assets and liabilities. The principal distinction between the two types of leases is in the resulting income statement recognition. As discussed in LG 4, a lessee with a finance lease is required to apply a financing model in which the expense resulting from the lease declines during the lease term. Operating leases, on the other hand, result in lease expense typically recognized on a straight-line basis, by amortizing the leased asset more slowly than a finance leased asset.

1.2.3 Lessor classification

Lessors are also required to classify leases. Sales-type and direct financing leases are recognized by a lessor as lease receivables, with interest income that is typically front-loaded (i.e., income per period declines during the lease term). The distinction between a sales-type and a direct financing lease is that in a sales-type lease, the lessee obtains control of the underlying asset and the lessor recognizes selling profit and sales revenue upon lease commencement. In order to align lessor accounting with the principles in the revenue recognition guidance in ASC 606, a lessor is precluded from recognizing selling profit or sales revenue at lease commencement for a lease that does not transfer control of the underlying asset to the lessee.

An operating lease results in the recognition of lease income on a straight-line basis, while the underlying leased asset remains on the lessor's balance sheet and continues to depreciate.

1.3 Comparison of ASC 842 and ASC 840

Figure LG 1-2 summarizes the significant differences between ASC 842 and the previous guidance in ASC 840.

Figure LG 1-2

Changes to lease accounting under ASC 842

Topic	ASC 842 guidance	Observations
Definition of a lease	An arrangement is a lease or contains a lease only when such arrangement conveys the right to "control" the use of an "identified asset" to a customer and the customer obtains substantially all its economic benefits	Under ASC 840, an arrangement can contain a lease even without control of the use of the asset if the customer takes substantially all of the output over the term of the arrangement. Determining whether an arrangement contains a lease is likely to be more important since virtually all leases will require recognition of an asset and liability by a lessee. It will also make the allocation of contractual consideration between lease and nonlease components a critical element of the accounting analysis for many reporting entities.
Lessee accounting	There are no bright lines and there is one additional criterion regarding the specialized nature of the underlying asset for lease classification	The lack of explicit bright lines will increase the level of judgment required when classifying a lease – particularly for certain highly structured transactions. Despite the removal of the bright lines, the guidance in ASC 842-10-55-2 acknowledges that one reasonable approach to determining whether the lease is for a major portion of the asset's remaining economic life and whether lease payments represent substantially all of the asset's fair value is the 75% and 90% thresholds, respectively, applicable in ASC 840.
	Lessees will recognize a right-of-use asset and a lease liability for virtually all leases	Reflecting nearly all leases on the balance sheet is the biggest change, and one of the key objectives of the guidance in ASC 842.
	Expense will be recognized on a straight-line basis for an operating lease. This is accomplished by increasing the amortization of the right-of-use asset as the imputed interest on the liability declines over the lease term. Recognition of expense for a finance lease will be similar to capital leases in ASC 840.	Under ASC 840, operating leases are off-balance sheet. Under ASC 842, the accounting for an operating lease will backload amortization of the right-of-use asset, potentially increasing the risk of an impairment. Once impaired, the right-of-use asset in an operating lease will be amortized on a straight-line basis, which will result in an expense recognition pattern similar to a finance lease.

Topic	ASC 842 guidance	Observations
Lessor accounting	The classification criteria are similar to that for lessees, with an additional requirement to assess collectibility to support classification as a direct financing lease. Also, in order to derecognize the asset and record revenue, collection of payments due must be probable for sales-type leases. To recognize upfront revenue and profit in a sales-type lease, the lessee will need to obtain control over the leased asset. Leases otherwise classified as a sales-type or direct financing lease must be accounted for as an operating lease if they contain variable lease payments that don't relate to a rate or index and would result in recognition of a day-one loss. This accounting model is similar to ASC 840.	Under ASC 840, to achieve sales-type lease accounting for real estate, title must automatically transfer to the lessee by the end of the lease term. This condition has been removed from the guidance in ASC 842. In ASC 840, the difference between a sales-type lease and a direct finance lease is the presence of upfront profit. When present, the arrangement is a sales-type lease. Under ASC 842, the key distinction is based on control. As a practical matter, this will likely depend on whether the lease payments criterion has been met in part due to a third-party residual value guarantee. When this is the case, assuming payments are collectible, the lease is classified as a direct financing lease.
Lease versus nonlease components	A contract may contain lease and nonlease components. Under ASC 842, components include only those items or activities that transfer a good or service to the lessee. A lessee may choose not to separate nonlease components from their associated lease components. If this election is made, all cash flows associated with the nonlease component would be allocated to the associated lease component. A lessor may elect to combine nonlease and associated lease components when the timing and pattern of transfer of the components are identical, and the lease classification would have been an operating lease absent the combination. If elected, the combined components would be accounted for under ASC 842 only if the nonlease component is not predominant. The right to use land is considered a separate lease component unless the accounting effect of accounting for it separately would be immaterial.	Under ASC 840, property taxes and insurance are considered executory costs. Under ASC 842, property taxes and insurance are not considered as components of a contract as they are not for a service provided by the lessor to the lessee, and are therefore a part of contract payments if the contract requires the lessee to reimburse the lessor for those costs. Under ASC 840, land is separately classified when the fair value of the land is 25% or more of the combined fair value of the land and building.

Topic	ASC 842 guidance	Observations
Inception date versus commencement date	Under ASC 842, the determination of whether or not a contract is a lease or contains a lease is done at the inception date. Lease classification is determined, and the lease is recognized and measured, at the lease commencement date.	Under ASC 840, assumptions relevant to classification and measurement are determined at lease inception. Recognition of rent expense or capital lease assets and liabilities begin at the commencement date.
Initial direct costs	Under ASC 842, initial direct costs are defined as incremental costs of a lease that would not have been incurred if the lease had not been obtained.	Under ASC 840, incremental direct costs can include internal costs as well as external costs such as legal fees, even if incurred before the lease was obtained. Therefore, certain incremental costs previously eligible for capitalization will be expensed under ASC 842.
Build-to-suit arrangements	Ownership during construction period is based on a control model.	ASC 840 guidance is based on a risks and rewards model, but contains several complex prescriptive provisions designed to assess lessee ownership during construction. The ASC 842 model has eliminated these prescriptive rules and replaced them with a model based on control. Under ASC 840, build-to-suit accounting applies only to lessees. Under ASC 842, build-to-suit accounting also applies to lessors.
Sale and leaseback transactions	Under ASC 842, a sale and leaseback transaction will qualify as a sale only if: □ it meets the sale guidance in the revenue standard, □ the leaseback is not a finance lease for a lessee or a sales-type lease for a lessor, and □ if there is a repurchase option, ○ the repurchase price is at the underlying asset's fair value at the time of exercise and ○ alternative assets that are substantially the same as the transferred asset are readily available in the marketplace.	Under ASC 840, sale and leaseback accounting is applicable only to lessees. This includes detailed and specialized guidance applicable to sale and leasebacks involving real estate. Under ASC 842, sale and leaseback accounting will apply to lessees and lessors. A "failed" sale is treated as a financing by both the lessee and lessor (i.e., the seller has not sold the asset but has essentially mortgaged it). There is no specialized guidance for sale and leasebacks of real estate. However, a sale and leaseback for real estate that includes a repurchase option will likely fail sale accounting (as it did before ASC 842) because all real estate is unique and no other asset would be substantially the same. Sale and leaseback transactions involving equipment frequently have fixed price repurchase options – often at the request of the seller-lessee for commercial reasons. Such transactions will not qualify

Topic	ASC 842 guidance	Observations
		as a sale under the new standard. However, sale and leaseback accounting applied for transactions executed prior to the application date of ASC 842 will not need to be reevaluated. Existing “failed” sale and leaseback transactions will be evaluated under the new standard and may qualify for sale and leaseback accounting on transition.
Lessee reassessment	A lessee is required to reassess the lease term if a triggering event occurs that is under the lessee’s control or an option is exercised/not exercised as planned or an event written in the contract occurs that obligates the lessee to exercise/not exercise an extension or termination option. A change to the lease term will lead to a reassessment of lease classification and remeasurement of the lease liability and right-of-use asset. Assumptions such as the discount rate, fair value of the underlying asset, and variable rents based on a rate or index will be updated as of the remeasurement date.	ASC 840 does not require a reassessment of lease classification unless the lease is modified or an option is exercised. Under ASC 842, a lessee will need to monitor for triggering events on an ongoing basis.
Modification	A lease modification is a change to the contractual terms and conditions of a lease that was not part of the original lease. A modification that grants the lessee an additional right of use priced at market is a separate lease that is then classified at the lease modification date. For all other modifications, entities may have to reassess whether the arrangement contains a lease, reallocate contract consideration between the lease and nonlease components, reassess lease classification, and remeasure the lease liability and right-of-use asset prospectively. Assumptions such as the discount rate, fair value of the underlying asset, and variable rents based on a rate or index will be updated as of the modification date.	Lease modifications under ASC 840 can be complex and difficult to differentiate from a termination of a lease contract. A renewal or extension is considered a new lease. All other changes are subject to a two-step evaluation of the lease.

1.4 Disclosures

The leases standard includes extensive disclosure requirements intended to enable users of financial statements to understand the amount, timing, and judgments related to a reporting entity's accounting for leases and the related cash flows. The leases standard requires disclosure of both qualitative and quantitative information about leases. See FSP 14 for information on disclosures.

1.5 Transition and effective date

P Entities other than public business entities are required to adopt ASC 842 in annual reporting periods beginning after December 15, 2021 and interim periods within annual reporting periods beginning after December 15, 2022. Earlier application is permitted.

The leases standard is required to be applied to leases in existence as of the date of initial application using a modified retrospective transition approach; a full retrospective transition approach is not permitted. Reporting entities may elect to apply the transition approach either (a) as of the beginning of the earliest period presented in the financial statements – in which case it would adjust its comparative periods or (b) as of the beginning of the period of adoption – in which case it would not adjust its comparative periods.

The transition guidance includes optional provisions intended to reduce the burden of the implementation of the leases standard. Most significantly, the classification of existing leases and whether an arrangement contains a lease do not need to be reassessed. However, the relief provisions can only be adopted as a package. That is, a reporting entity cannot elect to reassess whether an existing arrangement contains a lease upon transition, but at the same time not reassess classification of existing leases. Lessees may also apply hindsight with respect to judgments around lease renewal options and purchase options.

As a result, lessees and lessors may generally carryforward their existing accounting balances when adopting the new guidance. See LG 9 for additional information about transition and the effective date of the leases standard.

Finally, transferors and transferees of easements and rights-of-way that had not previously accounted for such rights as leases (due, in part, to ambiguous accounting guidance), may continue to account for those existing arrangements as they had, until such arrangements are modified. The easements entered into or modified on or after the effective date must be evaluated under ASC 842. See LG 2.3.2.1 for additional information about evaluating easements.

1.6 Implementation guidance

Figure LG 1-3 includes topics addressed in the implementation guidance and illustrative examples accompanying the leases standard. It also references the section in this guide where each topic is discussed in more detail.

Figure LG 1-3
Topics addressed in the leases standard implementation guidance

Topic	Location of discussion in guide
Definition of a lease	LG 2.3
Lease classification	LG 3
Lease term, including options to renew or terminate the lease, or to purchase the leased asset	LG 3.3.3
Initial recognition – lessee	LG 4.2
Initial recognition – lessor	LG 4.3
Discount rates	LG 3.3.4.6
Initial direct costs	LG 4.1 and LG 4.2
Subsequent recognition and measurement – lessee	LG 4.4
Subsequent recognition and measurement – lessor	LG 4.5
Modification, remeasurement, and termination of a lease	LG 5
Subleases	LG 8.2
Sale and leaseback transactions (including build-to-suit transactions)	LG 6

Chapter 2: Scope—updated January 2023

2.1 Leases scope overview

A leasing arrangement conveys the use of an asset from one party to another without transferring ownership. The leasing arrangement may take various forms. Some arrangements are clearly within the scope of lease accounting, for example, a legal form lease that provides an explicit contractual right to use a building for a specified period of time in exchange for consideration. However, the right to use an asset can also be conveyed through arrangements that are not leases in legal form. For example, a hospital may execute an arrangement to purchase consumables and services from a vendor through an arrangement that entitles the hospital to receive free medical equipment for a period of time. Although not a lease in legal form, the rights to the medical equipment may be within the scope of lease accounting.

ASC 842, *Leases,* identifies arrangements that are to be accounted for as leases. This chapter discusses how to identify which arrangements, or components within an arrangement, should be accounted for under ASC 842. ASC 842 specifically excludes arrangements for the right to use a natural resource and arrangements that transfer the right to use certain assets other than property, plant, or equipment from its scope. See LG 2.2 for additional information on the scope of ASC 842.

This chapter also discusses how to identify the components to be evaluated for lease accounting and how to differentiate the lease and nonlease components.

Arrangements with a special purpose entity that contain a lease may require the lessee to consolidate the special purpose entity under the variable interest entity model. See CG 2 for additional information.

2.2 Exceptions to applying lease accounting

A reporting entity should consider the application of lease accounting in ASC 842 to all arrangements that meet the definition of a lease, as discussed in LG 2.3, with the exception of the following:

- Leases of intangible assets subject to ASC 350
- Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources subject to the guidance contained in ASC 930 and ASC 932.
- Leases of biological assets (such as bearer plants and animals)
- Leases of inventory
- Leases of assets under construction

ASC 350 defines intangible assets as “assets (not including financial assets) that lack physical substance.” ASC 805-20-55-37 indicates that air use rights are an example of a contract-based intangible asset. Many arrangements that provide subsurface rights (i.e., rights to use space below the earth’s surface) are similar to air use rights. We believe rights to any spaces that cannot be inhabited or accessed by human beings, such as air rights or rights to construct a pipeline underground, lack physical substance and thus could be accounted for as intangible assets outside the scope of ASC 842.

The ASC 842 Glossary discusses the items subject to the leases of inventory exclusion.

Partial definition from ASC 842 Glossary

The term inventory embraces goods awaiting sale (the merchandise of a trading concern and the finished goods of a manufacturer), goods in the course of production (work in process), and goods to be consumed directly or indirectly in production (raw materials and supplies). This definition of inventories excludes long-term assets subject to depreciation accounting, or goods which, when put into use, will be so classified.

We believe the scope exclusion for leases related to exploration is limited, and should apply to circumstances in which the customer has the substantive ability to mine or explore the applicable area. The customer's rights and substantive ability to explore and/or mine the site should be evaluated at contract inception, and upon reassessment triggers (see LG 5.3.1). For example, a site that was originally leased for mining purposes may "lose" its scope exclusion once mining on that site has ceased, even if the lessee extends the lease and continues to use the site in order to stage mining operations at nearby sites. Similarly, an arrangement allowing a customer to use an adjacent parcel of land to access the mining site would not be subject to this scope exception, but should be evaluated to determine whether the arrangement is or contains a lease.

2.2.1 Short-term lease exemption for lessees

As discussed in ASC 842-20-25-2, a lessee may elect not to apply the recognition requirements of ASC 842 to short-term leases. This election should be made by class of underlying asset. If a lessee chooses to elect this short-term lease measurement and recognition exemption, it should recognize the lease payments in net income on a straight-line basis over the lease term. Variable lease payments should be recorded in the period in which the obligation for the payment is incurred.

The ASC 842 Glossary defines a short-term lease.

Definition from ASC 842 Glossary

Short-Term Lease: A lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

Leases often include options to either extend the term of the lease (commonly referred to as a renewal option) or to terminate the lease prior to the contractually defined lease expiration date (commonly referred to as a termination option). The existence of either a renewal or termination option requires lessees and lessors to determine, at lease commencement, the length of the lease term. As discussed in LG 3.3.3.1, renewal or termination options that are reasonably certain of exercise (or non-exercise) by the lessee are included in the lease term. Therefore, a one-year lease with a renewal option that the lessee is reasonably certain to exercise is not a short-term lease. See LG 3.3.3.1 for information on determining the term of a lease.

A lessee should reassess whether a short-term lease continues to qualify for the short-term lease measurement and recognition exemption when certain events occur. See LG 5.4 for more information.

2.3 *Definition of a lease*

In a lease, one party obtains the right to use an asset legally owned by another party for a period of time. It is this right of use that distinguishes a lease from other executory contracts. The rights of a lessee are different from those of an owner of an asset or a party to a service agreement that does not transfer a right of use. Nonetheless, a lessee does have certain rights that receive accounting recognition as an asset (with a corresponding liability for the obligation to make payments for that right of use) because a lessee has control over an economic resource and is benefiting from the use of the asset.

ASC 842-10-15-3 defines a lease as follows.

ASC 842-10-15-3

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

A lease conveys the right to use an identified asset for a period of time. Arrangements that are truly perpetual in nature would not meet the definition of a lease because there is no defined period of use. These arrangements are more akin to acquiring an asset, and therefore, would be outside the scope of ASC 842.

Reporting entities may need to consider if certain arrangements are truly perpetual in nature. "Pay as you go" arrangements may provide the right to use an asset indefinitely. However, if the arrangement can be terminated by the customer at any time by merely stopping payment, the perpetual provision may not be substantive, and entities would need to evaluate the lease term. See LG 3.3.3.1 for information on determining the term of a lease.

The right to control the use of an asset may not necessarily be documented, in form, as a lease agreement. Often, the right to use an identified asset is embedded in an arrangement that may appear to be a supply arrangement or service contract. Therefore, a reporting entity should consider all of the terms of an arrangement to determine whether it contains a lease.

When performing the analysis to determine if an arrangement contains an embedded lease, multiple arrangements may be considered to be a single transaction. If two or more arrangements are entered into at the same time, a reporting entity should consider whether the analysis should be performed on each contract or the combination of contracts. ASC 842-10-25-19 specifies the criteria to consider in making this determination.

ASC 842-10-25-19

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

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

b. The amount of consideration to be paid in one contract depends on the price or performance of the other contract.

c. The rights to use underlying assets conveyed in the contracts (or some of the rights of use conveyed in the contracts) are a single lease component in accordance with paragraph 842-10-15-28.

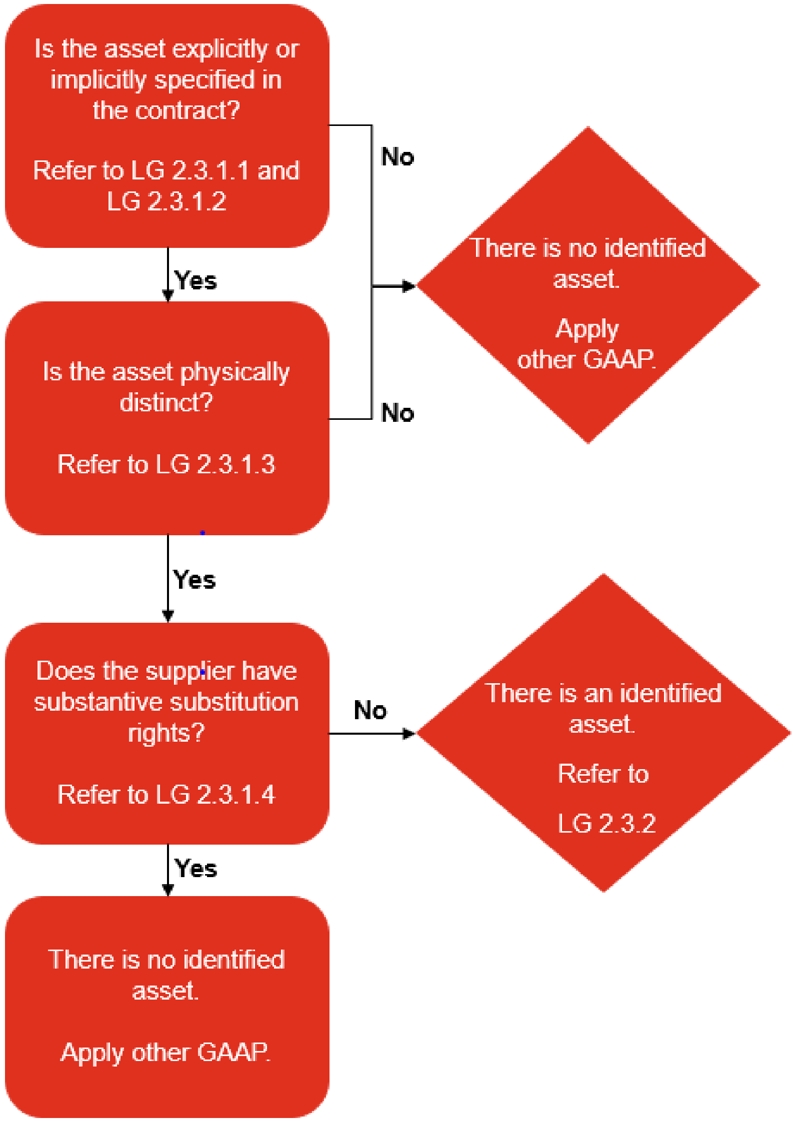
If a combination of contracts is determined to contain a lease, the same combined transaction should be used for purposes of lease classification, recognition and measurement in accordance with the guidance in ASC 842.

See LG 2.6 for discussion on when to perform the determination as to whether an arrangement is a lease.

2.3.1 Use of an identified asset

To meet the definition of a lease, an arrangement must require use of an explicitly or implicitly identified asset that is physically distinct. Figure LG 2-1 highlights key considerations in determining whether there is an identified asset. Each consideration is discussed further in the sections that follow.

Figure LG 2-1
Determining whether there is an identified asset



2.3.1.1 *Explicitly specified asset*

If a contract explicitly specifies the asset to be used (e.g., by serial number or a specified floor of a building), the contract contains an identified asset unless the supplier has substantive substitution rights. See LG 2.3.1.4 for discussion of substitution rights.

2.3.1.2 *Implicitly specified asset*

A contract that does not explicitly specify an asset to be used to fulfill the contract may implicitly specify the asset, for example, when the asset is made available for use. When a supplier must use an asset (i.e., plant, property and equipment) in order to fulfill the obligations in the contract, then there might be an implicitly specified asset (subject to determining whether there are substantive substitution rights). See LG 2.3.1.4.

Example LG 2-1 and Example LG 2-2 illustrate the identification of implicitly specified assets.

EXAMPLE LG 2-1

Bank data center contract

Commercial Bank enters into a lease for a portion of its data center with Supplier Corp. The lease contract does not explicitly specify the equipment to be used to fulfill the contract; however, as a result of security measures in place for its customer data, Commercial Bank imposes specific restrictions on the equipment to be used. Although Supplier Corp has multiple data centers that are interchangeable and can service multiple customers at one time, the arrangement with Commercial Bank specifies the type of equipment to be used to fulfill its contract and imposes restrictions on access and substitution for the duration of the contract.

Does the contract specify an asset to be used to fulfill the contract?

Analysis

Yes. Although the assets used to fulfill the contract are not explicitly specified, the assets are implicitly specified as a result of the contractual requirements and specifications mandated by Commercial Bank.

EXAMPLE LG 2-2

Automobile hood ornament contract

Supplier Corp enters into a contract to provide Automobile Manufacturer with hood ornaments for its cars. The contract does not explicitly specify the equipment to be used to fulfill the contract. Supplier Corp designs and custom builds a die in the shape of Automobile Manufacturer's logo specifically to produce the hood ornaments. Automobile Manufacturer is involved in ensuring the machine meets their specific standards.

Does the contract specify an asset to be used to fulfill the contract?

Analysis

Although the die is not explicitly specified in the arrangement, the contract is reliant on the die and therefore it is implicitly specified. While Supplier Corp is not contractually required to use a specific die, it is not feasible to utilize a different die. Therefore, the asset used to fulfill the contract would be the specialized die.

2.3.1.3 Physically distinct

An identified asset must be physically distinct. A physically distinct asset may be an entire asset or a portion of an asset. For example, a building is generally considered physically distinct. One floor within the building may also be considered physically distinct if it can be used independent of the other floors (e.g., point of entry or exit, access to lavatories). Similarly, the use of a static or electronic billboard on the facade of a stadium may be considered physically distinct from the use of the stadium as a whole if the location of the billboard is specified as a condition of the contract. Naming rights to a sports stadium typically involve co-branding and shared promotion, along with the right for the sponsoring entity to place its logo on the stadium. These rights are generally considered intangible assets and are outside the scope of the leasing guidance.

Certain assets may lend themselves to use by more than one party and need to be carefully evaluated to determine if they are physically distinct. For example, a contract providing the use of a portion that is less than substantially all of the capacity in a pipeline to transport natural gas is not physically distinct because it cannot be distinguished from other concurrent users of the pipeline. A portion of an asset that is not physically distinct is not an identified asset unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset. See LG 2.3.2.1 for additional information on evaluating whether the contract provides substantially all of the economic benefits from use of an asset.

Another example is a tenant that rents one floor in a multi-story office building. The floor of the building to be used by the individual tenant may be physically distinct. However, the tenant would also need to consider its right to use the land on which the building is located. While the land on which the entire building is located is physically distinct, the portion of the land that the tenant has the right to use, is not physically distinct. A tenant's right to use a non-physically distinct portion of the land would be an identified asset only if such right is for substantially all of the capacity of the land. For example, if the tenant had the right to use nine floors in a ten-story building, it would be reasonable to conclude that the land in the arrangement is also an identified asset. Provided the other criteria for a lease were met, the tenant would have a lease of both the building and the land and would need to evaluate whether they represent separate lease components. In contrast, if the tenant had the right to use only two floors of the ten story building, it would only have a lease of the building and not of the underlying land. See LG 2.5 for additional information on identifying components within a lease.

A portion of a pipeline (such as a lateral pipeline) could be physically distinct if an entity can separate (e.g., through use of a valve) and use the portion of the asset independent of the mainline pipeline. "Last mile" assets (i.e., the end of a single, contiguous asset) would be evaluated in the same way. If the last mile is mechanically separable from the remainder of the asset (e.g., there is a switch that permits an entity to shut off the flow of electricity or signal to a power or telephone line), the asset would be considered physically distinct.

When thinking about whether an asset is physically distinct, entities may need to consider the nature of the asset and evaluate how the asset was designed to be used. This evaluation could include the type of functionality the asset will provide and to what parties it will be provided. For example, consider an arrangement that conveys the right to use a specific space on a cell phone tower to a customer. The primary use of the cell tower is to sell or rent space on the tower to cell phone carriers. As a result, the specific hosting locations on the cell tower are physically distinct.

In contrast, arrangements that provide use of a specific spot on an electric utility pole to a third party (i.e., a cell phone carrier) generally would not be considered physically distinct. The portion of a utility pole to be used by a third party generally cannot be physically or mechanically separated from the remainder of the pole. Further, the primary use of a utility pole is to support electrical wires and transport electricity (i.e., to permit the utility company to provide its core service). As the primary purpose is not to serve as a hosting device for third-party assets, it may be reasonable to conclude that the utility pole attachments would not be considered physically distinct.

2.3.1.4 *Substantive substitution rights*

The existence of substitution rights may result in the determination that a specific asset has not been identified. If an asset is implicitly specified because the supplier does not have any alternative assets available to fulfill the contract, substitution rights do not exist. If, however, an asset is explicitly specified in a contract, but the supplier has a contractual right to substitute that asset, the entities would need to evaluate the criteria in ASC 842-10-15-10 to determine if the substitution rights are substantive.

ASC 842-10-15-10

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

a. The supplier has the practical ability to substitute alternative assets throughout the period of use (for example, the customer cannot prevent the supplier from substituting an asset, and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time).

b. The supplier would benefit economically from the exercise of its right to substitute the asset (that is, the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).

When both of these criteria are met, the asset is not an identified asset irrespective of whether it is specified in the underlying contract.

Provisions that permit an alternative means for fulfilling a contract under certain circumstances may indicate that the customer does not have the right to use an identified asset. For example, a large manufacturing entity may enter into an agreement with a customer that specifies a particular model of equipment to be used to fulfill the contact. Although the model number is specified, if the manufacturer has several interchangeable pieces of equipment and can use any one of them to satisfy its obligations under the contract, the arrangement may not include an identified asset. Similarly, a contract that permits a supplier to outsource its obligation to deliver a product or service may not meet the identified asset criterion.

As discussed in ASC 842-10-15-14, a supplier's right to replace a specified asset during the term of an arrangement if it is not working properly or becomes defective is not considered a substantive substitution right (i.e., an identified asset would still exist) and would not by itself preclude the arrangement from being considered a lease. Likewise, a provision that contractually permits or requires a supplier to substitute other assets on or after a specified date does not preclude the arrangement from being considered a lease prior to the substitution date.

Question LG 2-1 discusses how customer approval affects substitution rights.

Question LG 2-1

Is a substitution right that requires customer approval considered substantive?

PwC response

No. A substitution right in a contract that allows substitution only with customer approval is not considered substantive.

Supplier has practical ability to substitute the asset

In addition to having a substitution right, a supplier must have a replacement asset that can perform the functions required under the arrangement. Contractual language is not sufficient alone; the parties to the contract should also consider the practical ability of the supplier to substitute the asset and to execute the substitution within a reasonable amount of time. This evaluation should be performed based on information available at contract inception and should exclude consideration of future events that are not considered likely to occur.

To evaluate whether the supplier has the practical ability to substitute the asset, all relevant factors, such as those discussed below, should be considered together.

- Whether similar assets that can be used to satisfy the arrangement are readily available
- Whether any obstacles to substitution, such as cost or physical feasibility exist (e.g., if the asset is located on the customer's premises)

Supplier can benefit from exercising substitution right

In addition to having the practical ability to substitute one asset for another, the supplier must also benefit economically from the substitution (e.g., the benefit must exceed the cost of substitution) for it to be considered substantive. A supplier may be able to articulate the benefits of substitution and related costs, and it may even have a history of when substitutions have occurred to help guide its analysis. The customer, on the other hand, is likely to find this assessment more challenging.

For a customer, this analysis is similar to how it might consider the economic factors when evaluating whether purchase and renewal options are reasonably certain. See LG 3.3.3.1 for information on that analysis. In the case of substitution rights, the analysis primarily considers factors from the supplier's perspective. Examples of factors to consider include:

- Transportation costs of relocating one asset to a location where it can be used to satisfy the arrangement or to move the output from the production location to the customer
- Foregone production resulting from down time necessary to switch assets and other disruptions to the supplier's and/or customer's business
- Costs to convert an asset that may not have produced identical output
- Reduced production costs or increased production volume resulting from a more efficient version of an asset

There is no specific measurement threshold to be met; judgment is required to determine how significant the supplier's economic benefits should be for the substitution right to be substantive, thereby precluding lease accounting.

Generally, a supplier will be in a better position to determine whether it can benefit from exercising a substitution right, but it may be obvious to a customer that the substitution right benefits the supplier when there is a clear economic incentive and the barriers to substitution are minimal. When the customer does not have adequate transparency to the practicality or economics of supplier substitution rights, it should assume that the substitution right is not substantive and that the arrangement contains an identified asset. When an asset resides on a customer's premises, a supplier generally does not have a substantive substitution right because the costs and potential disruption would be significant.

Additionally, the assessment as to whether a substitution right is substantive should be based on facts and circumstances that exist at the inception of the contract. Any circumstances that are not likely to occur during the period of use would be disregarded in the analysis. While a supplier may use substitution rights to manage its assets, and historically substitutes assets across its portfolio, the parties should consider whether it is likely that a specific asset will be substituted while in use by a customer. For example, a car rental company that frequently substitutes cars while they are under contract to customers may be unable to support an assertion that substitution of a particular car under rental is likely to occur, because a typical car rental period is short. Thus, it may be difficult to apply an entity-wide assertion that substitution rights are substantive.

Consideration should also be given to whether the future events that might occur are within the supplier's ability to influence. ASC 842-10-15-11 discusses future events that, at inception, are not considered likely to occur during the period of use. An example is a provision in a contract that allows the supplier to substitute the asset for new technology when it is available, but the technology is not substantially developed at inception of the contract. This would not be considered a substantive substitution right. Similarly, rights to substitute the asset predicated on government approval, changes in regulations, or expected changes in customers' usage may not be substantive substitution rights. The analysis is performed at the inception of the arrangement and does not consider hypothetical or contingent changes. Rights that allow for the replacement of certain parts, or the asset as a whole, as a result of loss or wear and tear are not considered substantive substitution rights.

Example LG 2-3 illustrates a substitution rights that is substantive.

EXAMPLE LG 2-3

Supplier with substantive substitution rights

Warehousing Corp owns a large warehouse that can be subdivided into numerous subsections by inserting removable walls. It leases out different portions of storage space to its customers based on their respective needs.

Manufacturing Corp contracts with Warehousing Corp to reserve 1,000 square feet of space to store its excess inventory for a three-year period. The contract states that Manufacturing Corp's inventory will be stored in a specified location in the warehouse. However, Warehousing Corp has the right to shift Manufacturing Corp's inventory to another location within its warehouse at its discretion, subject to the requirement to provide 1,000 square feet for the three-year period.

Warehousing Corp frequently reorganizes its space to meet the needs of new contracts. The cost of reallocating space is low compared to the benefits of being able to accommodate as many customers as possible in the warehouse.

Does the contract contain an identified asset?

Analysis

No. While the contract explicitly specifies the location where Manufacturing Corp's inventory will be stored, the asset is not identified because Warehousing Corp has a substantive substitution right. Warehousing Corp has agreed to provide a specific amount of storage space within its warehouse at a specific location. However, Warehousing Corp has the unilateral right to relocate Manufacturing Corp's inventory. It would benefit by relocating the customer's inventory and can do so without significant cost. As such, Warehousing Corp's substitution rights are considered substantive, and there is not an identified asset.

Example LG 2-4 illustrates a substitution right that is not substantive.

EXAMPLE LG 2-4

Supplier without substantive substitution rights

Warehousing Corp owns a large warehouse that can be subdivided into numerous subsections by inserting removable walls. It leases out different portions of storage space to its customers based on their respective needs.

Manufacturing Corp contracts with Warehousing Corp to reserve 1,000 square feet of space to store its excess inventory for a three-year period. Warehousing Corp has the right to shift Manufacturing Corp's inventory to another location within its warehouse at its discretion, subject to the requirement to provide 1,000 square feet for the three-year period. However, Manufacturing Corp specified in its contract that its materials must be stored at a specific temperature.

Warehousing Corp frequently reorganizes its space to meet the needs of new contracts; however, Warehousing Corp only has one location in its warehouse with a cooling system capable of maintaining the required temperatures based on the layout of its HVAC system.

Does the contract contain an identified asset?

Analysis

Yes. The asset is identified because Warehousing Corp does not have a substantive substitution right. Warehousing Corp has agreed to provide a specific level of capacity within its warehouse at a specific location within the warehouse and does not have the unilateral right to relocate Manufacturing Corp's inventory without significant cost of installing additional cooling systems or modifying its HVAC system.

Supplier with a substitute right after a particular date

A supplier's substitution right is not substantive (and, thus, there could be an identified asset) when a substitution right exists for only a portion of the contract term. ASC 842-10-15-13 provides guidance on this situation.

ASC 842-10-15-13

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

Example LG 2-5 analyzes a substantive substitution right only after a particular date.

EXAMPLE LG 2-5

Supplier with substitution right after a particular date

Warehousing Corp owns a large warehouse that can be subdivided into numerous subsections by inserting removable walls. It leases different portions of storage space to its customers based on their respective needs.

Manufacturing Corp contracts with Warehousing Corp to reserve 1,000 square feet of space to store its excess inventory for a three-year period. The contract states that Manufacturing Corp's inventory will be stored in a specified location in the warehouse. Within the first year of the arrangement, Warehousing Corp has the right to move Manufacturing Corp's inventory to a different 1,000 square foot location within its warehouse at its discretion.

Does Warehousing Corp have a substantive substitution right?

Analysis

The substantive substitution right does not exist throughout the period of use. As such, Manufacturing Corp could have a lease of the warehouse space beginning in year two of the agreement, provided the other criteria are met.

Arrangement term that exceeds the economic life of the identified asset

The term of an arrangement may exceed the economic life of the identified asset. The accounting term of a lease cannot exceed the economic life of the underlying asset subject to the lease. When an arrangement is longer than the economic life of the identified asset, the supplier may be required to use a comparable asset at a future date that may be specified in the arrangement, or at the end of the economic life of the original asset. Such arrangements could include a lease of the first identified asset as well as a forward starting lease of a second asset when the first asset is replaced.

2.3.2 Right to control the use of an identified asset

Once a reporting entity concludes that the asset to be used is identified, the parties to the transaction must then evaluate whether the customer controls the use of that asset throughout the period of use.

An arrangement is not a lease if it does not convey control over the use of an asset to the customer. A contract that does not convey control to the customer, even when the asset to be used to fulfill the contract is explicitly identified, is subject to the guidance applicable to a service or supply arrangement.

ASC 842-10-15-4 provides the requirements for a customer to have control over an asset.

ASC 842-10-15-4

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

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

b. The right to direct the use of the identified asset (see paragraphs 842-10-15-20 through 15-26).

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

Utilizing all of an asset's output may indicate that the customer is obtaining substantially all of the economic benefit; however, this alone is not enough to demonstrate control of the asset. The customer must also have the right to direct the use of the asset. Both criteria must be met to qualify for lease accounting.

The assessment of whether a reporting entity has control over an asset should consider the period of use of that asset. The period of use is defined in the ASC 842 Glossary as follows.

Definition from the ASC 842 Glossary

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

Control over use of an asset can be for a consecutive period, nonconsecutive periods, or a portion of the term of the contract. In Example LG 2-6, a facility is used for two months each year over a five-year period; the period of use refers to those specified time periods within the year, not the entire year. ASC 842-10-15-5 provides guidance on a customer obtaining control for a portion of the term of a contract.

ASC 842-10-15-5

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

Example LG 2-6 illustrates an arrangement in which control is obtained in nonconsecutive periods.

EXAMPLE LG 2-6

Contract for a nonconsecutive period of use

Customer Corp enters into a contract with Supplier Corp that grants Customer Corp exclusive rights to use a specific grain storage facility over a five-year period in the months of September and October. During these months, Customer Corp has the right to decide which crops are placed in storage and when to remove them. Supplier Corp provides the loading and unloading services for the warehouse activities. During the other ten months each year, Supplier Corp has the right to determine how the warehouse will be used.

Which party has the right to control the use of the identified asset during the period of use?

Analysis

Customer Corp has the right to control the use of the identified asset during the period of use because it has the power to determine how the warehouse will be used during the contractually-defined usage periods. The analysis should focus on the rights and economics of the use of the warehouse for the specified usage periods (September and October). During the period of use, Customer Corp has the rights to determine how much of a crop to place in storage, and the timing of placing and removing it from storage. These rights are more significant to the economics of the use of the asset than the loading and unloading services performed by Supplier Corp during the same period. Customer Corp receives all of the economic benefit from use of the asset during those specified time periods. The total period of time that the warehouse will be used to fulfil the contract is 10 months (2 months per year over the five-year period).

2.3.2.1 *Right to obtain substantially all the economic benefits*

The first criterion in the control assessment is the right to the economic benefits derived from the asset. To be a lease, the arrangement must convey the right to obtain substantially all of the potential economic benefits that can be obtained from directing the use of the asset throughout the period of use. As discussed in LG 2.3.2, the period of use could be consecutive or nonconsecutive periods of time. A customer would not control an asset if another party has the right to more than an insignificant portion of the potential economic benefits. This is not a probability analysis as to who is likely to receive the benefits; the assessment should focus on the contractual rights of the respective parties. Specifically, the rights to the output and other economics derived from use of the asset should be considered. If a customer does not have contractual rights to all of the existing capacity of the asset, and the arrangement does not grant the customer an option to acquire any additional capacity, the arrangement is unlikely to be a lease. However, if the customer has the option to increase the volume of the output it consumes before it is given to additional customers (right of first refusal), the arrangement likely meets this criterion.

If the asset produces more than one type of output or benefit, this assessment should be made based on the fair value of the contractual rights. In other words, the assessment should be performed based on the potential economic returns associated with those contractual rights. The assessment should be based on the asset as it exists at the time of entering into the arrangement by considering the capacity level at which the asset is expected to operate, maintenance schedules, and type of physical asset. The standard does not define “economic benefits” but it does provide examples of ways the benefits can be obtained.

Excerpt from ASC 842-10-15-17

A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding, or subleasing the asset.

A customer may derive economic benefits from its use of an asset by producing goods for its own use or resale, providing services, or enhancing the value of other assets. The parties to the contract should consider the economic benefits that can be derived from the use of the asset but not benefits that are derived solely from ownership of the asset (e.g., proceeds from the sale of the asset).

A customer that contracts for the right to use an asset generally has a specific purpose or use of the asset in mind. However, assets can often function and produce various outputs during their operation in addition to what was initially contracted. Economic benefits should include cash flows derived from both the primary outputs and by-products. For example, a supplier that owns equipment to produce customized parts for its customer (an automobile company) may simultaneously sell the scrap metal to a third party. When evaluating whether it is obtaining substantially all of the economic benefits from use of the underlying equipment, the customer should consider the economics of the supplier selling the scrap metal in addition to the manufactured parts.

In some industries, there are unique attributes associated with an asset's operation that may or may not be considered output of the asset but need to be considered for purposes of the economic benefit test. For example, renewable energy credits (RECs) produced by a solar generation facility have economic value and should be considered an economic output in the leasing analysis because they are a benefit relating to the use of the asset. Since the RECs are dependent on the output of a specified power plant, they should be factored into the benefits derived from operation of that asset.

Question LG 2-2 discusses the economic benefit of an asset when its output is sold to separate parties.

Question LG 2-2

If an owner of a solar facility sells its energy production and renewable energy credits to separate parties, which party has the right to obtain substantially all of the economic benefits of the solar facility?

PwC response

It depends. If both the energy production and the RECs are deemed to be more than insignificant to the total economics, then neither party would have the right to obtain substantially all of the economic benefits and lease accounting would not apply.

Some arrangements require the customer to share a portion of the cash flows derived from the use of the asset with the supplier or another party. These arrangements may not prevent the customer from having the right to the economic benefits derived from the asset; rather, they may contain additional consideration for the use of the asset. A common example is a payment from the customer to the supplier based on a percentage of the sales derived from use of the asset.

Agreements for the use of assets for which a customer cannot derive economic benefits on its own without other resources may still meet the definition of a lease if the customer meets the criteria necessary to direct the use of the asset. For example, a contract for the use of an asset of such a specialized nature that the supplier must operate it may still be deemed a lease if the customer has the ability to dictate when it runs, or has the ability to let it sit idle. In this case, the customer retains the right to direct the use of the asset during the term of the arrangement and can effectively prevent another party from obtaining the economic benefits.

Unit of account

In order to assess whether a customer obtains substantially all of the economic benefits from the use of an identified asset, the customer must first identify the parties that have the right to use the asset. As discussed in LG 2.3.2.1, certain agreements provide the customer with exclusive use of the identified asset during the period of use, while other arrangements provide for use of the asset by multiple parties. Determining whether more than one party has the right to use an identified asset requires identification of the unit of account. Identifying the unit of account may be straight forward for some arrangements. However, for certain contracts, like land easements, this determination may be more challenging.

Example LG 2-7 illustrates how to identify the unit of account in certain land easement agreements.

EXAMPLE LG 2-7

Easements – unit of account

On January 1, Tower Company enters into an arrangement to obtain the right to access farmland owned by Landowner for 40 years. The contract provides the right for Tower Company to access a specific plot of land measuring 10 acres. The contract also provides Tower Company with the right to construct a tower on an identified subsection of the 10-acre plot.

In accordance with the contract, Landowner has the ability to use the space not occupied by Tower Company's assets for its own purposes, as long as the activities of Landowner do not interfere with the operation of Tower Company's tower. Landowner does not have the ability to access the specified portion of the plot of land where the tower will be built.

What is the unit of account for assessing whether the agreement is or contains a lease?

Analysis

In this fact pattern, we believe there are two units of account.

The contract provides for surface land rights and conveys different rights between the site for the tower and the remainder of the acreage. Tower Company has exclusive use of the parcel where the tower will be constructed and shared access to the remaining property. Therefore, the agreement contains two units of account.

Tower Company would need to evaluate both the subsection of the land where the tower will be built and the remaining space not occupied by the tower to determine if either meets the definition of a lease. The agreement specifies the location of both units of account. As such, each is considered an identified asset. Tower Company has exclusive use of the specified parcel where the tower will be built, and thus has the ability to both (1) direct how this identified asset is used and (2) obtain substantially all of the economic benefits from it. As such, Tower Company has the right to control the use of that parcel of land, and the agreement contains a lease. Use of the remaining portion of the 10-acre land parcel is shared between Tower Company and Landowner. As such, Tower Company would need to evaluate whether it has the right to control the use of that portion of the land.

Tower Company would determine the stand alone selling prices for each unit of account at inception and would allocate consideration based on those amounts. Tower Company would recognize the consideration allocated to the tower site when the lease begins.

In some arrangement, assets that will be used to fulfill the contract may not be determined until a later date. ASC 842-10-15-9 addresses these arrangements (sometime referred to as “floating” leases).

ASC 842-10-15-9

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

If, for example, the subsection of land on which the tower will be constructed is not determined until June 30 (six months after the January 1 inception), there would still be two units of account at inception, and consideration would be allocated to each unit of account based on stand-alone selling prices at that date. However, because the lease would not commence until June 30 when the subsection is identified, any amounts allocated to the lease component would not be recognized until June 30.

Accounting for arrangements that (1) involve the right to use an asset to be specified in the future and (2) contain more than one unit of account, can be challenging. The application of the model depends on the facts and circumstances of each arrangement, which should be carefully evaluated.

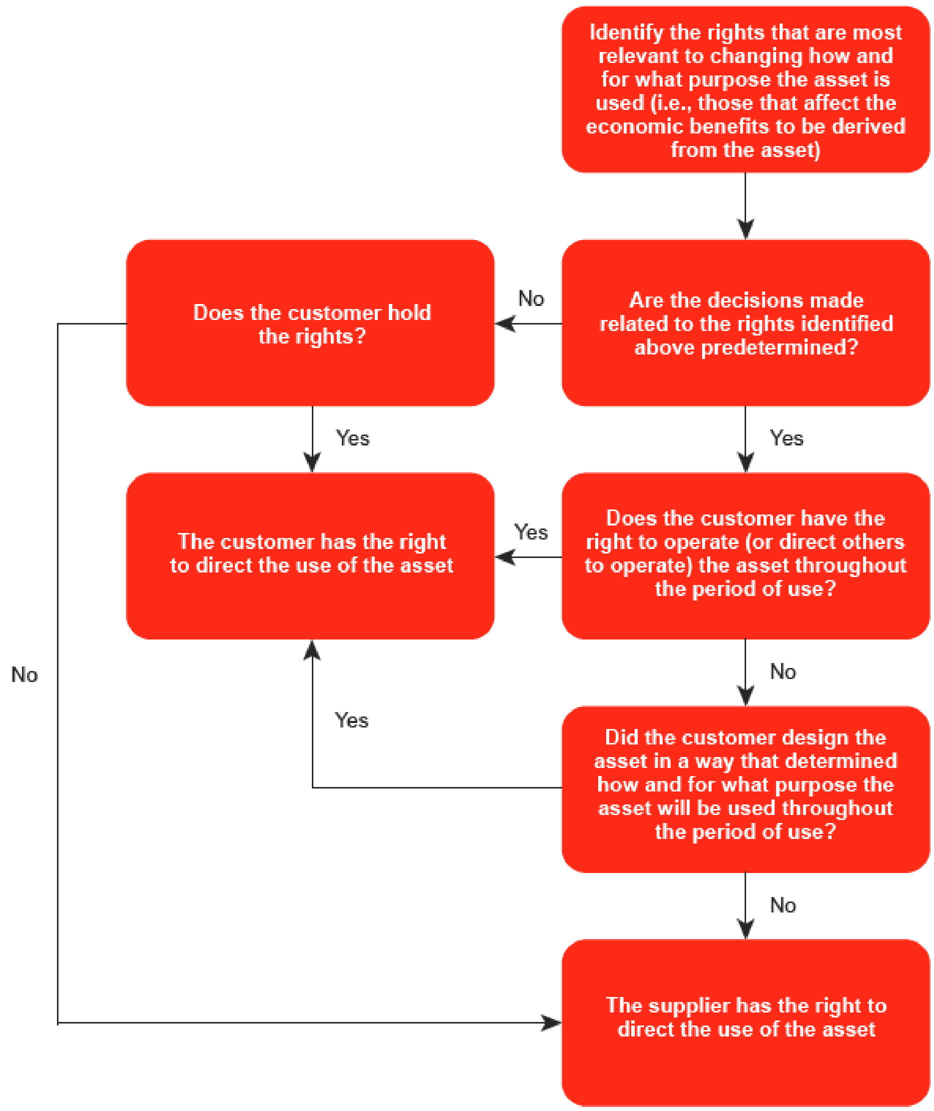
In ASC 842-10-65-1 (gg), the FASB provided guidance on an optional transition practical expedient to not evaluate under ASC 842 existing or expired land easements that were not previously accounted for as leases under ASC 840. Instead, reporting entities that elect this practical expedient would continue their current accounting for land easements that existed prior to the entity’s adoption date. All land easements arrangements entered into or modified after a reporting entity’s adoption date are required to be evaluated under ASC 842. This practical expedient can be elected independent of all other practical expedients. See LG 9 for further discussion of practical expedients and transition considerations.

2.3.2.2 Right to direct the use of the identified asset

The second criterion in the control assessment is the right to direct the use of the identified asset. Decisions about how and for what purpose an asset will be used are the most relevant factors to consider when assessing which party directs the use of the identified asset. A reporting entity should give the most weight to the factors that have the greatest impact on the economic benefit to be derived from that asset.

Figure LG 2-2 illustrates the analysis that should be used to determine which party has the right to direct the use of an identified asset.

Figure LG 2-2
Analysis of which party has the right to direct the use of an identified asset



ASC 842 includes guidance for determining which party has the right to direct the use of an identified asset under two broad scenarios: either all relevant decisions about how and for what purpose the asset is used during the period of use are predetermined, or they are not.

Under either scenario, the customer will generally be deemed to have the right to direct the use of the asset if, during the period of use, the customer may operate the asset, or may direct others do so without the supplier having the right to change that right. Operating an asset takes different forms depending on the nature of the asset. Determining whether a customer operates an asset may be straightforward when an asset requires active operations (e.g., construction equipment). Other assets require little active operation (e.g., storage containers) or are completely automated (e.g., a solar panel); and it may be more difficult to determine whether a customer operates such asset. However, a customer's right to turn an asset on or off, to disconnect an asset from other assets, or to "pull the plug" (other than solely for safety or protective concerns) would generally be considered a right to operate the asset.

The next step is to identify all the "relevant" decisions that could be made during the period of use that can change how and for what purpose the asset is used. As described in ASC 842-10-15-24, a decision is considered "relevant" when they affect the economic benefits that could be derived from using the asset. Examples of these rights are outlined in ASC 842-10-15-25.

ASC 842-10-15-24

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

ASC 842-10-15-25

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

a. The right to change the type of output that is produced by the asset (for example, deciding whether to use a shipping container to transport goods or for storage, or deciding on the mix of products sold from a retail unit)

b. The right to change when the output is produced (for example, deciding when an item of machinery or a power plant will be used)

c. The right to change where the output is produced (for example, deciding on the destination of a truck or a ship or deciding where a piece of equipment is used or deployed)

d. The right to change whether the output is produced and the quantity of that output (for example, deciding whether to produce energy from a power plant and how much energy to produce from that power plant).

Direct operations during the period of use

In some arrangements, the decisions related to how and for what purpose an asset is used, as outlined in ASC 842-10-15-25, are already specified in the contract before the lease term commences. Since these decisions are predetermined and are not made during the period of use, they are ignored as long as any relevant decisions could occur during the period of use. For example, the ability to change "where the output is produced," as described in ASC 842-10-15-25 (c) may not apply to assets that are not portable. As such, that factor is ignored in this evaluation. Predetermined decisions are only considered when there are no relevant decision-making rights that could be made during the period of use. This principle is supported by an IFRS Interpretations Committee (a committee of the International Accounting Standards Board) decision published at its January 2020 meeting.

(Although the US and IFRS Leases standards are not converged, the guidance on the right to determine how and for what purpose an asset is used is identical, and as such we believe that the Committee's interpretation should be applied.)

The Committee considered a submission describing a voyage charter agreement in which the following conditions were predetermined in the contract:

- A specified ship would be used to transport a specified quantity of a customer's coal to a single destination. Neither the quantity nor the cargo could be changed
- The quantity equaled the ship's capacity
- The contract designated three load ports. There was a predetermined number of voyages from each of the three load ports to the single destination (e.g., 10 trips from port A, seven from port B, and three from port C). The revenue per trip was fixed; accordingly, the total revenue to the lessor, and cost to the lessee, was fixed per the contract
- The total number of voyages was predetermined, and would fully consume the ship's capacity during the period of use
- The supplier operated and maintained the ship

During the period of use, the customer could only choose the order in which the trips from each load port would occur. The facts assume that the order of the trips affected the economics derived from the use of the ship during the period of use. Since a relevant decision exists during the period of use, the Committee noted that all the predetermined decisions (which appear to be more impactful on the economics than the order in which the trips occur) should be ignored. Similarly, the supplier's obligation to operate and maintain the ship is not relevant to determining which party had the right to direct the use of the asset during the period of use. Accordingly, in the fact pattern considered, the customer was deemed to direct the use of the ship during the period of use.

The right to determine how and for what purpose an asset is used is different than how those decisions are implemented. For example, when a customer outsources operation of an asset to an outside service provider, it may continue to direct how and for what purpose the asset is used; the outsourcing (i.e., physically operating the asset subject to the customer's direction) does not typically influence the economic benefits that can be derived from the asset.

Similarly, if a customer must either approve, or could veto, a supplier's decision, the customer is the decision maker, notwithstanding the supplier's advice and know-how. That the supplier was hired for its expertise, and proposed the decision, is similar to the functions of a customers' expert employee.

In evaluating the ability to change what an asset is used for during the period of use, or how, when, whether, and where the asset is used, one might encounter some decisions that are: (1) predetermined, or (2) directed by the customer, or (3) directed by the supplier, or any combination thereof. When evaluating which party has the right to direct the use of the underlying asset during the period of use, predetermined decisions are ignored (e.g., the site where an asset may be used); rather, the entities must consider whether the customer or the supplier directs the remaining relevant decisions that, in total, more significantly affect the economic benefits derived from the asset during the period of use.

Predetermined operations

If the contract explicitly states how and for what purpose an asset will be used throughout the term of the arrangement, and neither party can change how and for what purpose the asset is used during the period of use, then different factors should be considered to determine which party is directing the use of the asset as discussed in ASC 842-10-15-20(b).

Excerpt from ASC 842-10-15-20

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

a. …

b. The relevant decisions about how and for what purpose the asset is used are predetermined (see paragraph 842-10-15-21) and at least one of the following conditions exists:

c. The customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use without the supplier having the right to change those operating instructions.

d. The customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

A reporting entity should consider whether any variability is created during the operation of the asset, in order to determine whether there are any relevant decisions that are made during the period of use. If so, the design of the asset is not used to determine which party directs the right to use the asset during the period of use.

Design of the asset

For certain types of assets, their design is the primary factor in determining the resulting economics. This is especially true when the design establishes how and when an asset is to be used. For example, a customer that contracts to buy electricity from a supplier's windfarm that is responsible for locating the site and the number of turbines to be used to generate the electricity it purchases, may have the right to direct the use of the asset because there are no relevant decisions that could be made during the period of use that can be derived from the asset (i.e., because the electrical output is dependent on how often the wind blows in a location selected by the customer). How the asset is to be used and for what purpose has been predetermined through the selection of the site and design of the asset.

In certain cases, the level of a customer's involvement in the design of the asset may be unclear. In that case, whether the customer was the sole decision maker for the most significant design decisions should be considered to determine whether the customer made the decisions that established the design of the asset. If the decisions were jointly made by the customer and the supplier, then it will be presumed that the customer did not make the decisions that pre-determined the design of the asset.

Other considerations

As discussed in ASC 842-10-15-23, an owner/supplier's protective right to inspect their asset to ensure it is being operated properly and maintained sufficiently should not be a factor in determining who controls the asset. These rights are not decision making rights.

2.3.2.3 Examples — right to control the use of an identified asset

Example LG 2-8, Example LG 2-9, Example LG 2-10, Example LG 2-11, Example LG 2-12, and, Example LG 2-13 illustrate the determination of which party has the right to control the use of an identified asset.

EXAMPLE LG 2-8

Consideration of dispatch rights

Customer Corp contracts with Supplier Corp to manufacture parts in a facility on Customer Corp's property. Customer Corp designed the facility and stipulates its specifications. Supplier Corp owns the facility and leases the land from Customer Corp. Customer Corp specifies how many parts it needs and when it needs the parts to be available. Supplier Corp operates the machinery and makes all operating decisions including how and when the parts are to be produced, as long as it meets the contractual requirements to deliver the specified number on the specified date.

Which party has the right to control the use of the identified asset (i.e., building and equipment) during the period of use?

Analysis

Customer Corp does not direct the use of the asset that most significantly drives the economic benefits because Supplier Corp determines how and when the building and equipment are operated once the contract is signed. Therefore, Supplier Corp has the right to control the use of the identified asset during the period of use. Although Customer Corp stipulates the product to be provided and has input into the initial decisions regarding the use of the asset through its involvement in the design of the asset, Customer Corp does not have dispatch rights (i.e., the right to control the output at a given time). As such, Customer Corp does not have decision making rights over the asset during the period of use. This arrangement would be a supply agreement, not a lease.

Determining whether a supplier or a customer has dispatch rights in a supply arrangement can be challenging. The evaluation should be based on the specific facts and circumstances of the arrangement. In making this assessment, companies should consider the following factors:

- Can the product be inventoried and stored by the supplier? A supplier's nominal ability to control the production schedule may not be substantive when it is impractical to store the output.

- What is the typical lead time on orders? A short lead time may be indistinguishable from a dispatch right.

- How long is the interval between orders? Very short intervals may be indistinguishable from a dispatch right.

- Does the customer provide sufficient notice for orders such that a supplier can decide when to produce the required quantity or do customer orders dictate timing and level of the supplier's production?

EXAMPLE LG 2-9

Illustration of dispatch rights

Customer Corp enters into contract to purchase energy from Supplier Corp; Supplier Corp owns a pre-constructed natural gas-fired power generation facility. Customer Corp has contracted for power from the asset on an as-needed basis to fulfill its power needs during peak periods of demand, but not on a constant basis. Customer Corp will notify Supplier Corp when to generate power to satisfy its needs. Customer Corp contracts for the right to all of the plant's capacity (100% of the electricity that can be generated) and therefore is entitled to all of the output. Customer Corp may allow the plant to sit idle at times of low demand.

Supplier Corp is responsible for operating and maintaining the asset throughout the term of the contract.

Which party has the right to control the use of the identified asset during the period of use?

Analysis

Customer Corp directs the use of the asset during the term of the contract through its right to dictate when the asset should operate and produce energy; the economics are most significant when the plant is operating and generating electricity. Since Customer Corp controls the decision to operate the asset (even though Customer Corp does not physically operate the facility), it has the right to direct the use of the asset that most significantly affects the economic benefits derived from its use, and therefore Customer Corp controls the identified asset during the term of the contract. In contrast to Example LG 2-8, Customer Corp is making decisions about the use of the asset during the period of use.

EXAMPLE LG 2-10

Illustration of lack of dispatch rights

Customer Corp enters into contract to purchase energy from Supplier Corp; Supplier Corp owns a pre-constructed natural gas-fired power generation facility. Customer Corp was not involved in the design of the facility. Customer Corp has contracted for power from the asset on a full-time basis. Customer Corp will purchase all of the plant's capacity (100% of the electricity that can be generated) and therefore is entitled to all of the output.

Supplier Corp is responsible for operating and maintaining the asset throughout the term of the contract.

Which party has the right to control the use of the identified asset during the period of use?

Analysis

It depends. The contract is for full-time operation; therefore, Customer Corp does not have dispatch rights. The parties must identify any relevant decisions that could be made during the period of use. In this fact pattern, whether and where the output is produced is predetermined by the terms of the contract and the nature of the asset. The parties should evaluate whether either party can change how much output is generated, and when it is generated. If Customer Corp makes those decisions, then it has the right to direct the use of the asset during the period of use. If Supplier Corp makes those decisions, (or if those decisions are predetermined by the terms of the contract), then Customer Corp does not have the right to direct the use of the identified asset.

EXAMPLE LG 2-11

Contract for the use of gas pipelines

Customer Inc enters into a five-year agreement with Supplier LP for 100% of the capacity of a specified natural gas pipeline. Supplier LP operates and maintains the pipeline. Customer Inc pays a fixed capacity charge each month. When Customer Inc chooses to use the capacity, it also pays a variable amount for each unit of natural gas transported. Supplier LP cannot use the pipeline capacity to transport natural gas for any other customer.

Which party has the right to control the use of the identified asset during the period of use?

Analysis

Customer Inc has the right to control the use of the identified pipeline during the period of use. Customer Inc makes the relevant decisions about how and for what purpose the pipeline will be used by determining when and how much natural gas will be transported through the pipeline. Customer Inc also has the right to obtain substantially all of the economic benefits from the transportation of natural gas through the pipeline because no one else can use the pipeline during the period of use.

EXAMPLE LG 2-12

Contract for use of manufacturing lines

Manufacturing Co enters into an arrangement with Supplier Corp for use of Supplier Corp's manufacturing lines over a five-year period. Manufacturing Co notifies Supplier Corp when the lines are to be used based on Manufacturer Co's production needs. Supplier Corp does not have substantive substitution rights and cannot use the manufacturing lines for any other purpose.

Which party has the right to control the use of the identified asset during the period of use?

Analysis

It depends. If the ordering process is in substance a dispatch right (e.g., the manufacturing lines are only used to produce Manufacturing Co's product on the basis of, and only to the extent of, purchased orders issued by Manufacturing Co during the contract period), the arrangement would contain a lease since Manufacturer Co is making the relevant decisions that impact how and for what purpose the manufacturing lines are used. In this scenario, (a) Manufacturer Co would receive substantially all of the economic benefit from the exclusive use of the identified manufacturing lines, and (b) Manufacturer Co would have the ability to determine when, whether, and how often the lines would be used based on its purchase orders.

If, however, the ordering process is not in substance a dispatch right (i.e., Supplier Corp has flexibility to determine the capacity at which to run the manufacturing lines when purchase orders are received), Manufacturer Co may merely be ordering product, and the arrangement would not contain a lease because Manufacturer Co would not be making relevant decisions that impact how and for what purpose the asset is used.

EXAMPLE LG 2-13

Contract for use of an airplane over a three-year period

Sports Franchise enters into a contract with Supplier Corp for airplane transportation on an identified asset for Sports Franchise's players for a three-year period. Sports Franchise provides the dates of travel and the arrival and departure locations at least one week in advance of each trip, which is not predetermined in the contract terms. Sports Franchise will pay Supplier Corp a fixed fee per month for use of the airplane.

Supplier Corp provides the airplane, crew, and pilot for each flight.

Which party has the right to control the use of the identified asset during the period of use?

Analysis

Sports Franchise has the right to control the asset because it can decide how and when the plane will be utilized during the period of use. Although Supplier Corp can make operational decisions about the flight plan, it is Sports Franchise who determines when the plane will fly. The frequency and distance traveled are more relevant to the overall economic benefits to be derived from the airplane than the specific routes of each individual trip.

In addition to the lease, the contract contains other nonlease components, such as the services provided by the pilot and crew, fuel, maintenance, and parking the airplane when not in use. See LG 2.4 for further information on lease and nonlease components.

Additionally, ASC 842 contains the following example of a contract for network services that is not a lease.

Example 10—Contract for Network Services

ASC 842-10-55-124

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

ASC 842-10-55-125

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

ASC 842-10-55-126

Customer does not control the use of the servers because Customer's only decision-making rights relate to deciding on the level of network services (the output of the servers) before the period of use—the level of network services cannot be changed during the period of use without modifying the contract. For example, even though Customer produces the data to be transported, that activity does not directly affect the configuration of the network services and, thus, it does not affect how and for what purpose the servers are used. Supplier is the only party that can make decisions about the use of the servers during the period of use. Supplier has the right to decide how data are transported using the servers, whether to reconfigure the servers, and whether to use the servers for another purpose. Accordingly, Supplier controls the use of the servers in providing network services to Customer. There is no need to assess whether the servers are identified assets because Customer does not have the right to control the use of the servers.

This example describes how entities would assess which party has the right to control the use of an asset when it is evident that the customer has the right to obtain substantially all the output of the asset and the asset cannot be substituted. In this example, the assets are located on Customer's premises, and Customer presumably has the right to substantially all the output. ASC 842-10-55-126 concludes that Supplier controls the assets, notwithstanding that Customer appears to have the right to direct the use of the assets. Like Example LG 2-9, it appears that Customer has the ability to use the network assets on demand (i.e., dispatch rights), because Customer's usage pattern would determine the timing and volume of the assets' usage. For example, Customer determines when to transmit data and how much data is stored or transmitted.

The analysis as to which party has the right to control the use of an asset requires judgment. It may be appropriate to follow the principle in this example when the following circumstances are present:

- The supplier uses multiple assets to fulfill its obligations to the customer.

- The assets have more than one capability (i.e., each asset can perform several tasks).

- The assets' capabilities overlap, such that the supplier can make genuine decisions about how to deploy the multiple assets to fulfill its overall obligations to the customer. For example, throughout the usage period of the agreement, the supplier could decide whether and when to use either Server A or Server B to store data or to run network security tests, and the supplier could decide whether and when to reconfigure Servers A or B to enhance efficiency.

- The supplier's decisions are not subordinate to the customer's explicit or implicit approval. For example, if the customer's usage pattern could impede the supplier from exercising its decisions about which of the multiple assets could be used to perform a particular task, the supplier may not have the substantive right to direct the use of that asset. Accordingly, this example would more likely apply when the supplier uses the assets to fulfill a broader promise to the customer (as opposed to when the customer is contracting for the direct output of the particular asset).

When these circumstances do not exist, an entity should consider whether the arrangement more closely resembles the contract to purchase electricity on an on-demand basis in Example LG 2-9.

We believe this example was written to demonstrate only the particular decision as to which party has the right to direct the use of an asset; it does not address whether there are other components within an arrangement that should be accounted for as lease components. For example, the servers in the example may not be leased, but a different conclusion might be reached for the communication equipment (e.g., modems, routers) within the arrangement.

2.4 Separating lease and nonlease components

Lease contracts may contain nonlease components that should be accounted for using other accounting models (e.g., common area maintenance or services such as security). Only the components that are integral to the right to use an underlying asset are considered lease components. ASC 842 requires a reporting entity to allocate the contractual consideration between components of the arrangement. Distinguishing between lease and nonlease components is also important because it is not always appropriate to record assets and liabilities associated with the nonlease components.

Lessors and lessees follow different allocation methods among the components. For example, by granting a customer the right to use an asset, a supplier is performing a revenue generating activity and the recognition should be consistent with the framework in ASC 606. A customer using that asset would not follow revenue recognition guidance.

This section discusses:

- How to identify separate lease and nonlease components

- How to allocate consideration to the components for a lessor and a lessee

If two or more arrangements are entered into at the same time, ASC 842-10-25-19 provides guidance regarding whether those contracts should be considered together.

If contracts are combined based on the criteria in ASC 842-10-25-19, the conclusion regarding whether the arrangement is or contains a lease could be different than assessing each contract individually. Any component considered to be a lease element, regardless of whether it is in an individual or combined contract, should be classified, recognized, and measured in accordance with the guidance in ASC 842.

When analyzing a contract that contains multiple pieces of equipment, a customer should consider whether the arrangement contains one lease component or more than one. See LG 2.5 for information regarding the accounting for multiple units of account within a lease that are all deemed to be separate lease components.

2.4.1 Identifying lease and nonlease components

Contracts may involve payments for lease components, nonlease components, and items that are not considered contract components. The identification of these elements is important because consideration in the contract (as defined in ASC 842) is allocated only to the lease and nonlease components.

To be considered a component, an activity must transfer a good or service. The transfer of the right to use an asset in a leasing arrangement is considered a component similar to the delivery of an asset or providing services.

Lease components are elements of the arrangement that provide the customer with the right to use an identified asset. The right to use an underlying asset is a separate lease component if (1) the lessee can benefit from the right to use the underlying asset either on its own or together with other resources that are readily available, and (2) the right to use the underlying asset is neither highly dependent on nor highly interrelated with other rights to use other underlying assets in the arrangement.

Not all activities related to a lease are subject to the guidance in ASC 842. For example, a supplier may lease a truck and also operate the leased asset on behalf of a customer (i.e., provide a driver). The service of providing a driver is not related to securing the use of the truck and is not a lease component. Only items that contribute to securing the output of the asset are lease components. In this example, only the use of the truck is considered a lease component. Similarly, costs incurred by a supplier to provide maintenance on an underlying asset, as well as the materials and supplies consumed as a result of the use of the asset, are not lease components.

Nonlease components are distinct elements of a contract that are not related to securing the use of the leased asset. Arrangements that include both lease and nonlease components are common in real estate transactions. For example, if the landlord/lessor of a property provides common area maintenance (CAM) of leased office space, such as cleaning and landscape services, the CAM involves delivery of a separate service and is not considered a cost of securing the office building. As such, it is considered a nonlease component.

Nonlease services can be included in equipment leases as well. For example, as part of a lease of specialized equipment to a hospital, a medical device supplier may also provide operational or maintenance services. Even if the equipment is considered a lease, the operational or maintenance services are nonlease components presuming they are distinct (i.e., capable of generating an economic benefit separate from the lease of the equipment). See RR 3.3 for additional information.

Excerpt from ASC 842-10-15-30

Components of a contract include only those items or activities that transfer a good or service to the lessee. Consequently, the following are not components of a contract and do not receive an allocation of the consideration in the contract:

a. Administrative tasks to set up a contract or initiate the lease that do not transfer a good or service to the lessee

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

Costs related to property taxes and insurance do not involve the transfer of a good or service and accordingly are not contract components. As such, these costs do not represent payments for goods and services and are simply part of total consideration. Payments for property taxes that are levied based on legal ownership (i.e., regardless of which party uses the asset) and insurance when a lessor is the primary beneficiary of the insurance policy would be incurred by the lessor of the underlying asset whether or not the underlying asset is leased. Although these payments may be based on a specific underlying (e.g., real estate taxes), they do not represent components and instead simply reflect another form of consideration under the contract. Such amounts are allocated to their lease and nonlease components following the guidelines described in LG 2.4.2 and LG 2.4.3.

ASC 842 requires lessors to record gross revenues and expenses associated with activities or costs that do not transfer a good or service to the lessee (e.g., real estate taxes, insurance) when such amounts are paid by the lessor and subsequently reimbursed by the lessee, because the costs are the lessor's costs of owning the asset. This will result in many lessors recording higher gross revenues and expenses than they did under the previous leasing guidance.

See FSP 14 for additional discussion of presentation requirements under ASC 842.

ASC 842-10-15-39A requires lessors to exclude lessor costs from variable payments (and, therefore, from variable lease revenue), when the costs are required to be paid by a lessee directly to a third party.

The guidance also permit lessors, as an accounting policy election, to not evaluate whether certain sales taxes and other similar taxes are costs of the lessor or costs of the lessee. Instead, lessors should account for those amounts as if they were costs of the lessee and should exclude the amounts from contract consideration.

Figure LG 2-3 illustrates common examples of lease components, nonlease components, and items that would not be considered contract components. The nature of payment for each of the items may be fixed, variable (e.g., based on a third-party invoice), or a combination of fixed and variable (e.g., a fixed amount adjusted for future price changes). The nature of the payment does not dictate the determination of whether the item is a component.

Figure LG 2-3

Examples of components and non-components

Examples of lease components	▫ Building* ▫ Land* ▫ A piece of equipment
Examples of nonlease components	▫ Operating the leased asset on behalf of the lessee ▫ Training lessee personnel to operate the asset ▫ Repair or maintenance of the leased asset ▫ Security services ▫ Consumables/supplies ▫ Management services
Examples of non-components	▫ Administrative tasks to initiate the lease ▫ Reimbursement of lessor's costs (including property taxes, interest, and insurance)

**See LG 2.5 for evaluation of contracts that relate to buildings and land.*

2.4.2 *Determining contract consideration*

Once lease and nonlease components have been identified, the next step is to determine contract consideration to be allocated to the identified components. Not all payments will be included in contract consideration. ASC 842-10-15 provides guidance for determining what to include in contract consideration for both lessors and lessees.

ASC 842-10-15-35

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

a. Any fixed payments (for example, monthly service charges) or in substance fixed payments, less any incentives paid or payable to the lessee, other than those included in paragraph 842-10-30-5

b. Any other variable payments that depend on an index or a rate, initially measured using the index or rate at the commencement date.

ASC 842-10-15-39

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

a. The lessor's efforts to transfer one or more goods or services that are not leases

b. An outcome from transferring one or more goods or services that are not leases.

2.4.3 *Allocating consideration to lease and nonlease components*

Once contract consideration has been determined, it needs to be allocated to the lease and nonlease components. ASC 842-10-15-28 through ASC 842-10-15-42 provide guidance for lessees and lessors on how to allocate contract consideration once all contract components have been identified.

Figure LG 2-4 and Figure LG 2-5 summarize how certain payments are treated in determining contract consideration and allocating it to lease and nonlease components for lessors and lessees.

Figure LG 2-4

Determining and allocating contract consideration - lessor

Payment type	Include in consideration	Allocation to components
Fixed payment	Yes	Allocate to lease and nonlease components, generally based on relative standalone price
Variable payment that depends on a rate or index, based on the rate or index at commencement date	Yes	Allocate to lease and nonlease components, generally based on relative standalone price

Payment type	Include in consideration	Allocation to components
Variable payment not based on rate or index that relates exclusively to nonlease components (see LG 2.4.6.1 for details)	Determine amount of variable payments to include using the guidance in ASC 606	Allocate to specific nonlease components, if doing so results in an allocation that is consistent with the allocation objective in ASC 606. Otherwise, allocate to all components based on relative standalone price
Variable payments not based on rate or index that relate to lease component, either in part or in full (see LG 2.4.6.1 for details), and changes in variable payments based on a rate or index, that occur after lease commencement	Not included in consideration at lease commencement for initial measurement	When variability is eliminated (i.e., payment amount is known), allocate on the same basis as the initial allocation of consideration

See LG 2.4.4 and LG 2.4.6.1 for further details on how lessors should apply this guidance.

Figure LG 2-5

Determining and allocating contract consideration - lessee

Payment type	Include in consideration	Allocation to components
Fixed payments	Yes	Allocate to lease and nonlease components, generally based on relative standalone price
Variable payments that depend on an index or rate	Yes, using the index or rate at the inception date	Allocate to lease and nonlease components, generally based on relative standalone price
Other variable payments	Not included in consideration at lease inception for initial measurement	When variability is eliminated (i.e., payment amount is known), allocate on the same basis as the initial allocation of consideration

See LG 2.4.5 and LG 2.4.6.2 for further details on how lessees should apply this guidance.

2.4.4 *Lessor allocation of contract consideration*

By satisfying a contract that contains lease and nonlease components, lessors generate revenue. Therefore, once the contract components have been identified, it is appropriate for lessors to follow the relevant guidance in ASC 606 to determine how to allocate contractual consideration between the components. See RR 5 for guidance on this allocation method.

If an arrangement includes variable consideration, the amount of total consideration allocated to the lease and nonlease components may vary based on the nature of the variable payments and the components to which they relate. See LG 2.4.6.1 for information.

2.4.4.1 Component practical expedient for lessors

The guidance in ASC 842-10-15-42A allows lessors to elect to aggregate nonlease components that otherwise would have been accounted for under the revenue recognition standard with the associated lease component, if the following conditions are met:

- The timing and pattern of transfer for the nonlease component and the associated lease component are the same

- The stand-alone lease component would be classified as an operating lease if accounted for separately

A lessor recognizes revenues under an operating lease over the lease term, generally on a straight-line basis. Therefore, the first condition noted above only applies when the performance obligation for the nonlease component is also satisfied over time. Refer to RR 6.3 for more information on performance obligations satisfied over time. Also, that condition would only apply if the lease and nonlease components would be recognized over identical time periods, i.e., the condition would not apply when providing the components begins, or ends, at different dates. For example, we do not believe a lessor can apply this expedient to a three-year lease of equipment which includes a one-year maintenance component (whereas they may be able to apply this expedient if the maintenance contract was also for three years).

If this practical expedient is elected, and the nonlease component is aggregated with the associated lease component, the lessor would account for the combined component as follows:

- If the nonlease components are the predominant characteristic, account for the combined component under the revenue standard. In doing so, the lessor would (a) recognize revenue consistent with the method assessed when applying the "timing and pattern of transfer" criterion to use the expedient and (b) account for all variable payments, including those related to the lease, under the revenue guidance.

- If the nonlease components are not the predominant characteristic, account for the combined component as an operating lease under the leases standard. All variable payments, including those related to any good or service, would be accounted for as variable lease payments.

Lessors will need to apply judgment to determine the predominant characteristic of the combined component. The lessor should consider whether the lessee would ascribe more value to the non-lease component in the arrangement. We believe that often, the predominant characteristic will be readily discernable and could be determined qualitatively. When that is not the case, a lessor may need to evaluate the arrangement quantitatively to conclude that the nonlease component is predominant.

If elected, the practical expedient will need to be applied to all contracts that qualify for the practical expedient as of the date of the election.

See LG 3.3.4 for considerations for applying this practical expedient when assessing lease classification. See LG 9 for further discussion of applying this practical expedient during transition.

2.4.5 *Lessee allocation of contract consideration*

ASC 842 provides guidance for lessees to allocate contractual consideration between multiple components. Consistent with other allocation models, such as the revenue recognition model in ASC 606, this guidance emphasizes maximizing the use of observable inputs.

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 ASC 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.

Estimating standalone prices will require judgment when identical goods or services are not readily available in the marketplace. Assets do not need to be identical for their inputs to be considered observable. Inputs are not required to be supplier specific or identical; similar leased products in the market can be useful observable data points provided the information is both consistent and comparable. For example, a lessee may be able to estimate market rents for a new lease from similar, though not identical, lease arrangements, by estimating the impact of the differences between the two arrangements. A good or service that is unique to a supplier may not have market comparisons. In this circumstance, a lessee should gather as much information from the supplier regarding their basis for establishing the price in the arrangement. While knowing an asset's sale price may provide the lessee helpful information, the allocation of consideration should be based on the standalone price of the right-of-use asset, not the standalone price of the underlying asset.

A lessee should maximize the use of observable data and utilize the best available information to determine its allocation. Estimates are permitted when necessary, but only if observable standalone pricing or observable inputs are not available. Estimates must be applied consistently across similar arrangements and like assets. If an arrangement includes variable consideration, whether the variable consideration is included in total contract consideration and allocated to the lease and nonlease components depends on the nature of the variable payments. See LG 2.4.6 for information.

Question LG 2-3 addresses how a lessee should allocate payments for property taxes and insurance.

Question LG 2-3

Should a lessee that pays property taxes and insurance for an underlying asset directly to the billing authority include those payments in its computation of contract consideration to be allocated to components of the contract?

PwC response

Including payments made by a lessee for property taxes and insurance in contract consideration will depend on whether the lessee is required to pay a fixed or variable amount.

If a lessee is required to pay a fixed amount of property taxes and insurance related to the leased asset, such payments should be included in contract consideration and allocated to the lease and nonlease components. If a lessee is required to pay the actual amounts for property taxes and insurance (i.e., a variable amount rather than fixed payments) such payments should be excluded from contract consideration and instead recorded as incurred by the lessee. When recorded, the variable amounts would be allocated to the lease and nonlease components on the same basis as the initial allocation of contract consideration.

If a lessee is required to pay for property taxes and insurance, it does not matter whether the lessee directly pays a third party on the lessor's behalf or reimburses the lessor. Insurance and property taxes on the underlying asset are not separate lease or non-lease components. The lessee should account for such payments as additional consideration in the arrangement, subject to allocation, and not as insurance or property tax expense. See LG 2.5 for additional information.

2.4.5.1 Component practical expedient for lessees

A lessee may elect an accounting policy, by asset class, to include both the lease and nonlease components as a single component and account for it as a lease. Making this election relieves the lessee of the obligation to allocate contract consideration to the lease and nonlease components, although it may increase the total lease liability to be recorded on its balance sheet. Refer to LG 9 for further discussion of applying this practical expedient during transition.

In describing the rationale for this practical expedient, paragraphs BC149 and BC 150 of the Basis for Conclusions to ASU 2016-02 indicate that the Board focused on whether lessees should separate services from lease components. It is unclear whether the Board intended to allow lessees to combine purchases of other goods that are not services (e.g., inventory), with lease components. We believe a lessee applying this practical expedient should combine the nonlease component only when it would otherwise recognize the cost associated with both the lease and nonlease components in a similar fashion (i.e., either when both are capitalized or when both are expensed). For example, in a contract manufacturing arrangement, a lessee could combine the procurement of raw materials and the lease of production equipment when both components are included in the lessee's inventory costing system and capitalized into the measurement of inventory costs. However, we do not believe a lessee should combine, for example, chemicals purchased for resale into the lease of a pipeline from the chemical supplier, as doing so would distort the lessee's reporting of inventory and cost of sales.

2.4.5.2 Accounting effects of a lessee electing the component practical expedient

Electing the practical expedient to combine lease and associated nonlease components as a single lease component has additional accounting effects for the lessee. This election will increase payments allocated to the lease components but it does not change the fair value used for classifying the underlying asset. As such, the election increases the possibility that the lease would be classified as a finance lease under the lease payments criterion.

With the adoption of ASC 842, the guidance in ASC 420-10, Exit or Disposal Cost Obligations, was modified to remove leases from its scope. While ASC 420-10 continues to apply to costs to terminate a contract that is not a lease, it would not apply to nonlease components that the lessee has elected to combine with lease components under the lessor expedient. See PPE 6.4.3 and PPE6.4.3A for more information on the application of ASC 420 on contract termination costs related to leases.

2.4.6 Allocation of variable consideration

The allocation models for variable consideration are intended to incorporate the allocation concepts in ASC 606 while preserving the accounting model applicable to variable lease payments in ASC 842. The key difference between the two models is that variable payments, other than those that depend on an index or rate, are recognized under ASC 842 only as they are earned. In contrast, variable consideration under ASC 606 is estimated (subject to a constraint) and included in the initial allocation of consideration. The discussion below highlights how to deal with this difference when an arrangement includes lease and nonlease components.

As discussed in LG 2.4.1, before determining how to allocate consideration, it is important for lessees and lessors to identify the contract components. Variable consideration for costs that are not contract components (e.g., real estate taxes, insurance) are excluded from total consideration and would be recorded as incurred by the lessee. ASC 842-10-15-40A clarifies the accounting by lessors for variable payments that relate to both a lease and a nonlease component. The amendment requires lessors to allocate certain variable payments to the lease and nonlease components when the changes in facts and circumstances on which the variable payment is based occur. After the allocation, the amount of variable payments allocated to the lease component would be recognized in profit or loss in accordance with the leases guidance, and the amount of variable payments allocated to nonlease components would be recognized in accordance with other guidance, such as the revenue recognition guidance.

2.4.6.1 Allocating variable consideration for lessors

Figure LG 2-4 summarizes the allocation of consideration for lessors. When determining contract consideration for lease and nonlease components, variable payments not based on an index or a rate should only be considered provided they relate solely to nonlease goods and services. If they do, the variable payments should be estimated and, provided they meet the transaction price allocation objective specified in ASC 606, allocated to the nonlease components.

If, however, the variable payments relate even partially to the lease component, they are recognized when the underlying variability is resolved and are allocated to the lease and nonlease components on the same basis as the initial allocation of consideration. A lessor would recognize the amount allocated to lease components in accordance with the guidance in ASC 842, and the amount allocated to nonlease components in accordance with other applicable literature (typically ASC 606). ASC 842-10-15-39 through ASC 842-10-15-40A provide guidance on allocating variable payments to nonlease components.

ASC 842-10-15-39

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

a. The lessor's efforts to transfer one or more goods or services that are not leases

b. An outcome from transferring one or more goods or services that are not leases.

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

ASC 842-10-15-39A

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

ASC 842-10-15-40

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

ASC 842-10-15-40A

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

In light of the different models applicable to lease- and nonlease-related variable consideration, the first step in accounting for variable lease payments is to determine whether the payments relate, even partially, to a lease element. To do this, we believe it would be appropriate to analyze the factors that drive the variability of the payments. To practically analyze this, the factors that determine the amount and whether the variable payment is made should be understood. These factors could be physical factors, such as machine hours, equipment usage time, or number of items sold. They could also be based on economic factors, such as sales revenues and profits.

If it is determined the variable payments relate partially or fully to the lease component, the variable payments are excluded from the allocation for initial measurement. They are instead subsequently allocated between the lease and nonlease components when the underlying event occurs and then recognized in accordance with ASC 842-10-15-40. Variable payments that are exclusively related to the nonlease component are included in the allocation for initial measurement.

If allocating the variable consideration entirely to the nonlease component is consistent with the transaction price allocation objective in ASC 606, the variable payment should be allocated entirely to the nonlease component. The transaction price allocation objective is explained in ASC 606-10-32-28 through ASC 606-10-32-29, and ASC 606-10-32-40.

ASC 606-10-32-28

The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

ASC 606-10-32-29

To meet the allocation objective, an entity shall allocate the transaction price to each performance obligation identified in the contract on a relative standalone selling price basis in accordance with paragraphs 606-10-32-31 through 32-35, except as specified in paragraphs 606-10-32-36 through 32-38 (for allocating discounts) and paragraphs 606-10-32-39 through 32-41 (for allocating consideration that includes variable amounts).

ASC 606-10-32-40

An entity shall allocate a variable amount (and subsequent changes to that amount) entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b) if both of the following criteria are met:

a. The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service).

b. Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective in paragraph 606-10-32-28 when considering all of the performance obligations and payment terms in the contract.

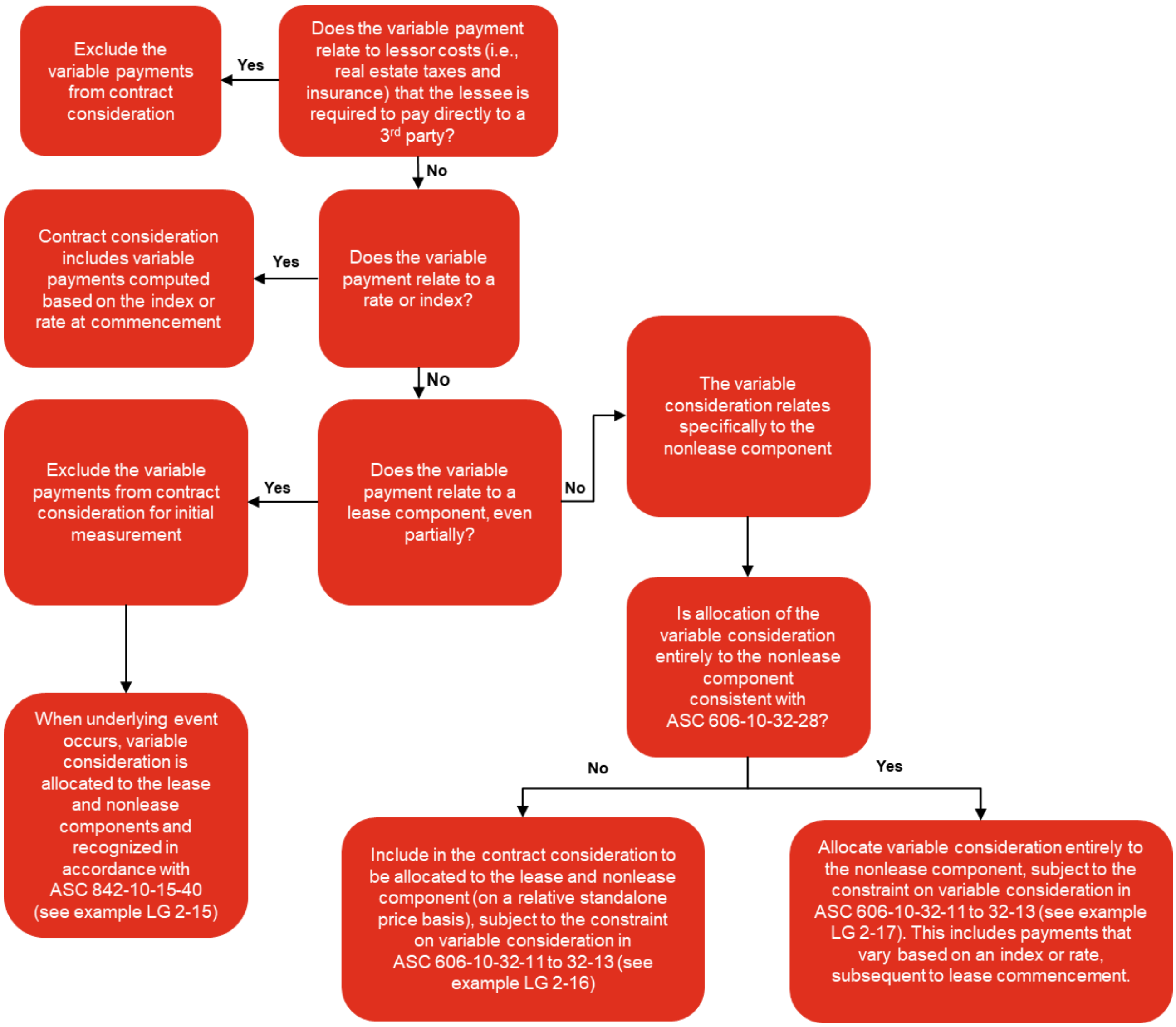
If the transaction price allocation objective is not met, the variable payment should be included in the initial contract consideration and allocated to the lease and nonlease components based on their relative standalone selling prices.

It is common for suppliers in certain industries to structure transactions with significant variable payments. Suppliers in these industries are willing to accept variability in payments because they believe such arrangements will be profitable overall, and variable payments can make an arrangement attractive to the customer. In certain instances, transactions with significant variable payments may qualify as a transfer of control under ASC 606 and may also meet the classification criteria as a sales-type lease in accordance with ASC 842-10-25-2 through ASC 842-10-25-3 (see LG 3.3 for lease classification criteria). In these instances, the leases standard should be applied. Under ASC 842, variable payments that do not depend on an index or rate and are at least partially related to the lease asset, are not considered until the contingency is resolved. This may lead to the recognition of an initial loss by the lessor (even if the overall arrangement is expected to be profitable). The discount rate used to record a lease receivable cannot be less than zero. As such, a lessor would not be permitted to use a rate less than zero to avoid recognition of an initial loss. In response to concerns raised in the post implementation review, the FASB published ASU 2021-05, which upon adoption requires a lessor to classify a lease with variable lease payments (that do not depend on an index or a rate) as an operating lease at the lease commencement date if classifying the lease as a sales-type lease (or direct financing lease) would result in recognition of a selling loss. See LG 9.10 for the effective date and transition requirements of ASU 2021-05.

Figure LG 2-6 illustrates the decision process for the allocation of variable consideration for lessors.

Figure LG 2-6

Lessor allocation of variable consideration



Example LG 2-14, Example LG 2-15 and Example LG 2-16 illustrate how to allocate variable consideration between lease and nonlease components. Figure LG 2-7 summarizes the key distinctions between the facts and conclusions in each example.

EXAMPLE LG 2-14

Variable consideration is excluded from allocation – contract for sale of medical equipment and consulting services (sales-type lease)

Customer Co, a medical facility, contracts with Supplier Corp to lease specialized medical equipment over a five-year period. Prior to leasing the specialized medical equipment from Supplier Corp, Customer Co treated 5,000 patients per year using an older version of the equipment. Supplier Corp asserts that the new medical equipment is more efficient than the older version and will allow Customer Co to treat additional patients.

Supplier Corp will also provide consulting services to assist Customer Co with optimizing operations and reducing inefficiencies at its medical facility. Supplier Corp believes that the consulting services will both reduce costs and further increase the number of patients Customer Co can treat using the new equipment. The number of hours Supplier Corp will provide each year as part of these consulting services is fixed at inception of the contract.

The parties agree that Customer Co will make fixed annual payments of $400,000 and will make an incremental payment based on the number of patients treated using the new equipment. Specifically, for each patient treated in excess of an established threshold of 6,000 per year, Customer Co will make an incremental payment to Supplier Corp of $100 per patient.

Supplier Corp believes that Customer Co will treat 7,000 patients each year, and therefore will be required to make an incremental payment of $100,000 (1,000 patients in excess of threshold × $100 per patient) per year. Total expected annual payments are $500,000 ($400,000 fixed + $100,000 variable).

Supplier Corp expects that even without the consulting services, Customer Co would realize a significant increase in the number of patients it could treat as a result of the new, more efficient equipment and would be required to make at least part of the incremental payment.

The medical equipment has a useful life of five years and is not expected to have a residual value at the end of the lease term. The lease of the medical equipment has met the classification criteria as a sales-type lease since the lease term is for a major part of the useful life of the asset.

The standalone selling price of the equipment is $2,000,000 (cost basis of $1,900,000) and the standalone selling price for the consulting services is estimated to be $26,000 per year.

In the first year of the arrangement, Customer Co treats 7,000 patients using the new equipment.

Supplier Corp has adopted ASU 2021-05.

Supplier Corp has elected not to aggregate lease and nonlease components in accordance with ASC 842-10-15-42A.

How should Supplier Corp account for this arrangement at lease commencement and in the first year?

Analysis

The equipment lease and consulting services are separate lease and nonlease components, respectively. The variable payments do not depend on an index or rate. In addition, Supplier Corp believes that it will be entitled to at least part of the variable payments regardless of whether the consulting services are provided. Therefore, the variable payments relate, at least partially, to the lease component. Consequently, the variable consideration should be excluded from the allocation of consideration used for initial measurement, and will be allocated to both the lease and nonlease components when the underlying event occurs.

An allocation of the fixed payment over the term of the lease would be made as follows:

	Standalone price (A)	Relative % (A/$2,130,000) (B)	Fixed Payments ($400,000 × 5 years) (C)	Allocated payment (B × C)
Medical equipment	$2,000,000	93.9%	$2,000,000	$1,877,934
Consulting services (5 years)	130,000	6.1%	$2,000,000	122,066
Total	**$2,130,000**	**100%**		**$2,000,000**

At the lease commencement date, because the variable payments that do not depend on an index or rate should be excluded from the allocation of consideration used for initial measurement, Supplier Corp would incur a net loss since allocated payments are lower than the cost basis of the equipment (allocated payment of $1,877,934 is less than the cost basis of $1,900,000). In light of the day-one loss, Supplier Corp would classify and account for the lease as an operating lease in accordance with ASU 2021-05.

In the first year of the arrangement, Supplier Corp would allocate the fixed and variable payments of $500,000 ($400,000 fixed and $100,000 variable) based on the relative standalone selling price of the lease and nonlease components at lease inception, as shown below.

	Relative %	Fixed payment allocated	Variable payment allocated	Total allocated payment
Medical equipment	93.9%	$375,587	$93,897	$469,484
Consulting services (5 years)	6.1%	24,413	6,103	30,516
Total		**$400,000**	**$100,000**	**$500,000**

Fixed payments allocated to the medical equipment lease would be recognized in accordance with ASC 842, typically on a straight-line basis. Since the lease is classified as operating lease, the annual straight-line lease income attributable to the medical equipment lease is $375,587 ($1,877,934/5). Fixed payments allocated to the consulting services would be recognized using the guidance in ASC 606. Variable payments would be recognized pursuant to the guidance in ASC 842-10-15-40 when the variability is resolved.

EXAMPLE LG 2-15

Variable consideration is included in the allocation – contract for sale of medical equipment and consulting services (sales-type lease)

Customer Co, a medical facility, contracts with Supplier Corp to lease specialized medical equipment over a five-year period. Prior to leasing the specialized medical equipment from Supplier Corp, Customer Co treated 5,000 patients per year using an older version of the equipment. Supplier Corp believes that the new equipment will provide for better patient care, but it is not expected to significantly impact the number of patients that Customer Co can treat.

Supplier Corp will also provide consulting services to assist Customer Co with optimizing operations and reducing inefficiencies at its medical facility. Supplier Corp believes that the consulting services will both reduce costs and further increase the number of patients Customer Co can treat using the new equipment. The number of hours Supplier Corp will provide each year as part of these consulting services is fixed at inception of the contract.

The parties agree that Customer Co will make fixed annual payments of $400,000 and will make an incremental payment based on the number of patients treated using the new equipment. Specifically, for each patient treated in excess of an established threshold of 6,000 per year, Customer Co will make an incremental payment to Supplier Corp of $100 per patient. Increases in the number of patients Customer Co can treat will result primarily from the optimization of processes as a result of the consulting services. Absent those services, it is unlikely that the 6,000 patient threshold would be met.

Supplier Corp believes that Customer Co will treat 7,000 patients each year, and therefore will be required to make an incremental payment of $100,000 (1,000 patients in excess of threshold × $100 per patient) per year. Total expected annual payments are $500,000 ($400,000 fixed + $100,000 variable).

The medical equipment has a useful life of five years and is not expected to have a residual value at the end of the lease term. The lease of the medical equipment has met the classification criteria as a sales-type lease since the lease term is for a major part of the useful life of the asset.

The standalone selling price of the equipment is $2,000,000 (cost basis of $1,900,000) and the standalone selling price for the consulting services is estimated to be $26,000 per year.

In the first year of the arrangement, Customer Co treats 7,000 patients using the new equipment.

The Company has adopted ASU 2021-05.

How should Supplier Corp account for this arrangement at lease commencement and in the first year?

Analysis

The equipment lease and consulting services are separate lease and nonlease components, respectively. The variable payments relate exclusively to the nonlease component.

In this example, Supplier Corp concludes that the variable payments relate specifically to an outcome from Supplier Corp's performance of its consulting services. Therefore, Supplier Corp evaluates the payments in accordance with ASC 606-10-32-5 through ASC 606-10-32-13. Supplier Corp estimates, using the most likely amount method, that (a) it will be entitled to receive the $500,000 in variable payments and (b) it is probable that including this amount in the transaction price will not result in a significant revenue reversal, the $500,000 would be included in consideration in the contract. Supplier Corp allocates the variable payments to the lease and nonlease components based on relative standalone selling price, as the transaction price allocation objective is not met (please refer to Example LG 2-16 for an example of how to allocate consideration when the transaction price allocation objective in ASC 606-10-32-28 is met). See RR 5 for information on allocating variable consideration.

	Standalone price (A)	Relative % (A/$2,130,000) (B)	Fixed Payments ($400,000 × 5 years) (C)	Variable Payments ($100,000 × 5 years) (D)	Total Allocated payment B × (C + D)
Medical equipment	$2,000,000	93.9%	$2,000,000	$500,000	$2,347,500
Consulting services (5 years)	130,000	6.1%	$2,000,000	$500,000	$152,500
Total	**$2,130,000**	**100%**			**$2,500,000**

The total allocated lease payments are $2,347,500. The annual payments attributable to the lease component are $469,500 ($2,347,500/5). For simplicity, it is presumed that all annual lease payments, including the expected variable consideration, are received at the beginning of each year of the lease. The rate implicit in the lease was determined to be 8.72% and the lease receivable is $2,000,000.

Since the lease with variable payments meets the classification criteria as a sales-type lease and does not result in day-one loss, Supplier Corp would classify and account for this lease as a sales-type lease. The adoption of ASU 2021-05 does not impact the accounting model since the arrangement does not give rise to a day-one loss. Supplier Corp would remove the asset from its balance sheet and record a receivable equal to the present value of the lease payments calculated using the rate implicit in the lease.

Supplier Corp would record the following journal entry on the lease commencement date.

Dr. Lease receivable	$2,000,000	
Dr. Cost of sales	$1,900,000	
Cr. Revenue		$2,000,000
Cr. Medical equipment asset		$1,900,000

In the first year of the arrangement, Supplier Corp would allocate the total $500,000 payment based on the relative standalone selling price of the lease and nonlease components at lease inception.

	Relative % (A)	Payment (B)	Allocated lease payment (A × B)
Medical equipment	93.9%	$500,000	$469,500
Consulting services (5 years)	6.1%	$500,000	30,500
Total	**100%**		**$500,000**

At the beginning of the first year of the arrangement, Supplier Corp would record the following entry to record receipt of the fixed medical equipment lease payment and variable incremental patient payment based on expected patient volume.

Dr. Cash	$500,000	
Cr. Lease receivable		$469,500
Cr. Deferred service revenue		$30,500

Interest paid to Supplier Corp at the beginning of year 2 would be accrued during year 1 (via a debit to the lease receivable and credit to interest income). At the beginning of the second year of the arrangement, Supplier Corp would record the following entry to record receipt of the fixed medical equipment lease payment, variable incremental patient payment based on expected patient volume, and interest on the lease receivable.

Dr. Cash	$500,000	
Dr. Lease receivable	$133,460	
Cr. Lease receivable		$469,500
Cr. Deferred service revenue		$30,500
Cr. Interest income		$133,460

EXAMPLE LG 2-16

Allocating variable consideration – contract for sale of medical equipment and consulting services (sales-type lease)

Customer Co, a medical facility, contracts with Supplier Corp to lease specialized medical equipment over a five-year period. Prior to leasing the specialized medical equipment from Supplier Corp, Customer Co treated 5,000 patients per year using an older version of the equipment. Supplier Corp believes that the new equipment will provide for better patient care, but it is not expected to significantly impact the number of patients that Customer Co can treat.

Supplier Corp will also provide consulting services to assist Customer Co with optimizing operations and reducing inefficiencies at its medical facility. Supplier Corp believes that the consulting services will both reduce costs and further increase the number of patients Customer Co can treat using the new equipment. The number of hours Supplier Corp will provide each year as part of these consulting services is fixed at inception of the contract.

The parties agree that Customer Co will make fixed annual payments of $400,000 and will make an incremental payment based on the number of patients treated using the new equipment. Specifically, for each patient treated in excess of an established threshold of 6,000 per year, Customer Co will make an incremental payment to Supplier Corp of $100 per patient. Increases in the number of patients Customer Co can treat will result primarily from the optimization of processes as a result of the consulting services. Absent those services, it is unlikely that the 6,000 patient threshold would be met.

Supplier Corp believes that Customer Co will treat 7,000 patients each year, and therefore will be required to make an incremental payment of $100,000 (1,000 patients in excess of threshold × $100 per patient) per year. Total expected annual payments are $500,000 ($400,000 fixed + $100,000 variable).

The medical equipment has a useful life of five years and is not expected to have a residual value at the end of the lease term. The lease of the medical equipment has met the classification criteria as a sales-type lease since the lease term is for a major part of the useful life of the asset.

The standalone selling price of the equipment is $2,000,000 (cost basis of $1,900,000) and the standalone selling price for the consulting services is estimated to be $100,000 per year ($500,000 over the term of the contract).

In the first year of the arrangement, Customer Co treats 7,000 patients using the new equipment.

The Company has adopted ASU 2021-05.

How should Supplier Corp account for this arrangement at lease commencement and in the first year?

Analysis

The equipment lease and consulting services are separate lease and nonlease components, respectively. The variable payments relate exclusively to the nonlease component (consulting services).

Supplier Corp determined that it should allocate the variable payments entirely to the nonlease component (consulting services) and the fixed payments entirely to lease component (the equipment lease) because doing so would be consistent with the transaction price allocation objective in ASC 606-10-32-28.

The fixed payments of $2,000,000 ($400,000 × 5 years) would be allocated to the lease component. Since the lease meets the classification criteria as a sales-type lease, Supplier Corp would classify and account for this lease as a sales-type lease. The adoption of ASU 2021-05 does not impact the accounting model. Supplier Corp would remove the asset from its balance sheet and record a receivable equal to the present value of those fixed lease payments.

Supplier Corp would record the following journal entry on the lease commencement date.

Dr. Lease receivable	$2,000,000	
Dr. Cost of sales	$1,900,000	
Cr. Revenue		$2,000,000
Cr. Medical equipment asset		$1,900,000

In the first year of the arrangement, Supplier Corp would allocate the $400,000 fixed lease payment entirely to the medical equipment lease and the $100,000 variable payment to the consulting services; the revenue from services provided would be recognized using the guidance in ASC 606.

In the first year of the arrangement, Supplier Corp would record the following entry to record receipt of the fixed medical equipment lease payment and variable incremental patient payment.

Dr. Cash	$500,000	
Cr. Lease receivable		$400,000
Cr. Service revenue		$100,000
To record receipt of the fixed medical equipment lease payment and variable incremental patient payment		

This example depicts one fact pattern when the transaction price allocation objective under ASC 606 would be considered met (i.e., stand-alone selling price for the consulting services is equal to the expected variable payment for the services provided under the contract). We believe there are other fact patterns when the objective would also be met. Consider a circumstance when the fixed payments are $2,250,000 and the expected variable payments are $250,000. Allocating 100% of the variable payments and $250,000 of the fixed payments to the consulting services would also meet the allocation objective under ASC 606 because the payments allocated to both components of the contract would be consistent with their stand-alone selling prices.

Figure LG 2-7

A comparison of examples LG 2-14 through LG 2-16

Example	Variable payment depend on a rate or index?	Variable payment relate at least partially to lease component?	Allocation of fixed payment to lease component and variable payment to nonlease component meet transaction price allocation objective?	Fixed payment allocated to	Variable payment allocated to
Example LG 2-14	No	Yes	N/A	Both lease and nonlease	Both lease and nonlease, but only upon occurrence of the underlying event
Example LG 2-15	No	No	No	Both lease and nonlease	Both lease and nonlease, at contract inception
Example LG 2-16	No	No	Yes	Lease	Nonlease

2.4.6.2 *Allocating variable consideration for lessees*

A lessee allocates consideration in a contract to lease and nonlease components based on their relative standalone prices. Only consideration that is discussed in ASC 842-10-15-35 is included in the allocable consideration.

ASC 842-10-15-35

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

a. Any fixed payments (for example, monthly service charges) or in substance fixed payments, less any incentives paid or payable to the lessee, other than those included in paragraph 842-10-30-5

b. Any other variable payments that depend on an index or a rate, initially measured using the index or rate at the commencement date.

Variable payments that do not depend on an index or rate should be excluded from lease payments at lease commencement for initial measurement. Subsequent to initial measurement, these variable payments are recognized when the event determining the amount of variable consideration to be paid occurs. However, variable payments that are based on achieving a specified target would be recognized at the time the achievement of the target is considered probable in accordance with ASC 842-20-55-1.

These payments, when recognized, will be allocated to the lease and nonlease components based on their relative standalone prices at lease inception. This concept is illustrated in ASC 842-10-55-140. Variable payments that depend on an index or a rate are included in the allocable consideration and allocated based on the relative standalone prices of the lease and nonlease components.

The lessor-specific guidance in ASC 842-10-15-39, under which a lessor ascribes certain variable payments solely to a nonlease component, as illustrated in Example LG 2-16, does not apply to lessees. A lessee must allocate all payments to all lease and nonlease components based on their relative standalone prices unless they elect the lessee component practical expedient described in LG 2.4.5.1.

2.4.7 *Lessor accounting for an arrangement that includes a "free" lease*

Suppliers often sell goods to customers in arrangements that require payment only when items are purchased, for example, on a per unit basis. Those suppliers may also provide related equipment to the customer at no additional charge. Examples include the following:

- A supplier of corn flour provides a tortilla maker to its customers for no contractual charge. The customer pays the supplier only for flour purchased without a minimum purchase obligation, and there are no other fees in the arrangement.

- A medical device manufacturer supplies a hospital with medical equipment for no contractual consideration. The equipment can only be used with disposables that the customer must purchase from the supplier, but the contract contains no minimum purchases.

In many such cases, the arrangement contains a lease of the free equipment as evaluated under the guidance in ASC 842-10-15. Nonetheless, suppliers have asked whether they are required to allocate consideration to the "free" lease component. Some have pointed to the definition of lease in the ASC 842 glossary to support the notion that a "free" lease does not meet the definition of a lease as there is ostensibly no consideration.

ASC 842-10 Glossary

Lease

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

We believe that a supplier-lessor should generally allocate consideration to all lease and nonlease components within an arrangement. The component practical expedient for lessors (refer to LG 2.4.4.1) would typically not apply since the pattern of transfer for the equipment would be at a point in time and the services are performed over time. Notwithstanding this view, we believe it may be acceptable to allocate consideration solely to the nonlease component when an arrangement meets all of the following conditions:

a. The contract only includes variable payments not based on an index or rate; that is, the contract contains no fixed payments (including fixed payments for other services), and no in-substance fixed payments (e.g., minimum purchase requirements, take-or-pay provisions)

b. The consumables are priced at (or below) their stand-alone selling price

c. The consumable price would be no different if the equipment were not provided

d. The "free" equipment is insignificant

Determining whether "free" equipment is insignificant will require careful consideration of the rights and obligations in the arrangement. For example, a contract that permits the lessor to repossess the equipment (e.g., if a customer defaults or fails to meet supplier purchase or usage expectations) may be in conflict with an assertion that the equipment is insignificant. If a supplier concludes that the "free" lease is insignificant, it would be accounted for as an abandoned asset and written off through earnings when control transfers to the customer. Deferring and amortizing the cost of the equipment over time would be inconsistent with the supplier's assertion that the equipment is insignificant.

2.5 Components within a lease

Lease accounting should be applied at the lowest component. Therefore, after determining the lease and nonlease components, a reporting entity should consider whether the lease contains more than one lease component. This is done by identifying the units of account.

A reporting entity should identify whether the customer is contracting for a number of separate deliverables or contracting for one deliverable that may incorporate a number of different assets. This analysis is similar to the one used to determine a performance obligation in ASC 606. Components of a contract that could be utilized exclusive of the remainder of the contract components should be accounted for separately, as discussed in ASC 842-10-15-28. Both of the criteria discussed in this guidance must be met in order to separate lease components. Note that while these criteria are considered when evaluating multiple lease components, they are not considered when determining whether a lease exists.

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.

The separate lease components should be determined by considering the nature and interdependency of the individual assets covered by the arrangement. The legal form of the arrangement is generally not relevant to this analysis; a master lease for multiple assets is no more likely to be a single lease component than one with multiple leases. If the assets are functionally independent of one another, the arrangement includes multiple units of account; each should be evaluated individually to determine whether it is a lease. Conversely, if the assets covered by an arrangement are designed to function together, those assets represent a single component. For example, if a customer leases computers and monitors from a technology supplier and the monitors are not tailored to the computer (each can operate without the other by connecting to a competitor supplier's products) the arrangement should be accounted for as two lease components. While a computer and a monitor do not function without each other, they do not need to function with one specific counterpart; any readily available competitor product can be used without impacting functionality.

Another factor to consider is how specialized the asset is. If use of the asset depends on additional assets tailored to facilitate its use, this indicates that there is a single lease component made up of multiple assets. If a technology supplier develops a monitor that can be inserted into a computer for storage, portability, and to charge the battery, the computer and monitor are likely one lease component because they are dependent on each other for full functionality.

In many real-estate leases, the lessee leases the building and the land that the building sits on. In a single tenant building, determination of the lease components may be straight forward. However, lessees in a multi-tenant, multiple-story building will also need to evaluate whether there is a land lease in the agreement. This assessment will typically depend on the significance of the tenant's rights under the contract, as a tenant in a multi-tenant building has the right to use a non-physically distinct portion of the land on which the building is located. In this scenario, the tenant's right to use a non-physically distinct portion of the land would only be considered an identified asset if the tenant had the rights to substantially all of the capacity of the land (as discussed in LG 2.3.2.1). For example, if the tenant was leasing nine floors of a ten-story building, it would be reasonable to conclude that the right to use the land in the arrangement is an identified asset. The arrangement would then contain a land lease component provided the other criteria for a lease were met.

In arrangements that contain a land lease component, both the lessor and the lessee should consider whether the land should be viewed as a separate lease component from the building. In general, lessors and lessees should view the lease of land as a separate lease component unless the accounting effect of doing so would be insignificant. For example, if separating the land component would have no impact on lease classification of any lease component or the amount recognized for the land lease component would be insignificant, the land component would not need to be separated from the building component.

Example LG 2-17 illustrates how to evaluate components within an arrangement and whether those components are lease or nonlease components.

EXAMPLE LG 2-17

Lease of a fully furnished office building

Customer Corp rents an office building from Landlord Corp for a term of 15 years. The rental contract stipulates that the office is fully furnished and has a newly installed and tailored HVAC system. It also requires Landlord Corp to perform all property maintenance during the term of the arrangement. Customer Corp makes one monthly rental payment and does not pay for the maintenance separately.

The office building has a useful life of 40 years and the HVAC system and office furniture each has a life of 15 years.

What are the units of account in the lease?

Analysis

There are at least three components in the arrangement – the building assets (office and HVAC), the office furniture, and the maintenance agreement.

The office and HVAC system are one lease component because they cannot function independently of each other. The HVAC system was designed and tailored specifically to be integrated into the office building and cannot be removed and used in another building without incurring substantial costs. These building assets are a lease component because they are identified assets for which Customer Corp directs the use.

The office furniture functions independently and can be used on its own. It is also a lease component because it is a group of distinct assets for which Customer Corp directs the use.

The maintenance agreement is a nonlease component because it is a contract for service and not for the use of a specified asset.

Customer Corp will also need to consider whether separating the land would have been significant. This could be the case when, if evaluated separately, the building would be classified as a finance lease while the land would be classified as an operating lease. See LG 3 for additional information on lease classification.

To properly account for the lease components, Customer Corp will need to determine the standalone selling price (i.e., market rents) of the use of the building assets, the use of the office furniture, and the maintenance services. If the sum of the standalone selling prices exceeds the monthly payment, the implicit discount provided for bundling the three components should be allocated between the service and each of the lease elements based on their relative standalone selling prices.

Question LG 2-4 discusses whether a lease contains more than one lease component.

Question LG 2-4

Should a reporting entity account for each floor or suite of a building subject to a single lease agreement as a separate lease component?

PwC response

It depends. A reporting entity should apply the guidance in ASC 842-10-15-28. In many cases, individual floors or suites in an office building could be used by unrelated tenants with no or little modification to the building layout, and use of a floor or suite by one tenant may not affect the use of an adjacent floor or suite by a different tenant. Generally, such a lease would meet the criteria to be separated into discrete lease components for each individual floor or suite, effectively similar to a master lease of separate assets.

Assuming the leases commence at the same date, and are co-terminus, accounting for each floor or suite as a separate lease at lease commencement may have no accounting consequence. However, if the agreement is subsequently modified such that the leases of the individual spaces are no longer co-terminus, it may become necessary for the reporting entity to identify the lease payments that would have been allocated to the respective spaces at the original commencement date of the lease (or as of the last remeasurement event, if later). See LG 5.5.1 for additional guidance on accounting for modifications that partially terminate a lease.

2.5.1 Portfolio exception

A reporting entity may elect to utilize a portfolio approach, under which it does not have to consider the lease components to apply lease accounting. Lessees and lessors may use the portfolio approach for leases provided its application does not create a material difference when compared to accounting for leases at the individual asset level. In addition to the materiality considerations, we would expect that a reporting entity that applies the exception would be able to demonstrate that the leases being grouped have similar characteristics. The leases should have comparable conditions regarding such clauses as default, extensions, purchase options, and lease term. Common examples of leases that may meet this criteria are office equipment (copiers, computers, phone systems with multiple handsets, etc.) or vehicle fleets that have single start and end dates.

2.5.2 Reallocation of consideration

Under specific circumstances a lessee should reallocate the consideration paid between components as discussed in ASC 842-10-15-36.

ASC 842-10-15-36

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

a. A remeasurement of the lease liability (for example, a remeasurement resulting from a change in the lease term or a change in the assessment of whether a lessee is or is not reasonably certain to exercise an option to purchase the underlying asset) (see paragraph 842-20-35-4)

b. The effective date of a contract modification that is not accounted for as a separate contract (see paragraph 842-10-25-8).

See LG 5 for information on lease modifications and remeasurement. A lessee should not reallocate consideration simply as a result of changes in prices used to determine the proportionate allocations, unless there is an indication that the initial allocation was inaccurate based on information that was available at the time.

2.6 Reassessment of whether a contract contains a lease

The determination of whether an arrangement is, or contains, a lease is performed at the inception of the arrangement, which is different from when the lease classification and measurement is performed. See LG 3.2.1 for information on the timing of performing the classification and measurement analysis. Once it is determined that an arrangement is, or contains, a lease, that determination should only be reassessed if the legal arrangement is modified. Changes to assumptions such as market-based factors do not trigger a reassessment.

Chapter 3: Lease classification–updated May 2023

3.1 Lease classification overview

Under ASC 842, virtually all leases will require balance sheet recognition as a right-of-use asset and lease liability. However, lease classification will impact the amount and timing of lease income and expense.

This chapter discusses the different types of leases, lease classification criteria, and the effect of various features and terms on lease classification under ASC 842. The accounting for leases is discussed in LG 4.

3.2 Overview of lease classification

The terms of a lease arrangement determine how a lease is classified and the resulting income statement recognition. When the terms of a lease effectively transfer control of the underlying asset, the lease represents an in substance financed purchase (sale) of an asset and the lease is classified as a finance lease by the lessee and a sales-type lease by the lessor. When a lease does not effectively transfer control of the underlying asset to the lessee, but the lessor obtains a guarantee for the value of the asset from a third party, the lessor would classify a lease as a direct financing lease. All other leases are classified as operating leases. See LG 7 for information on leveraged leases, a specific model applicable to certain direct financing leases that were entered into before the adoption of ASC 842. While leveraged leases were eliminated under ASC 842, leveraged leases that existed at the adoption of ASC 842 were grandfathered.

Figure LG 3-1 summarizes the accounting by lessees for the different types of leases.

Figure LG 3-1
Overview of lease accounting by lessees

Statement	Finance lease	Operating lease
Balance sheet	□ Record a right-of-use asset and a lease liability	□ Record a right-of-use asset and a lease liability
Income statement	□ Interest expense is determined using the effective interest method. Amortization is recorded on the right-of-use asset (usually on a straight-line basis). The periodic expense at the beginning of the lease term will generally be greater than the corresponding cash payments, but will decline over the lease term as the lease liability is reduced □ Interest and amortization expense should generally be presented separately in the income statement □ The right-of-use asset is tested for impairment in accordance with ASC 360	□ Lease expense is recorded on a straight-line basis over the lease term by adding interest expense determined using the effective interest method to the amortization of the right-of-use asset. Unlike a finance lease, amortization of the right-of-use asset is calculated as the difference between the straight-line expense and the interest expense on the lease liability for a given period □ Lease expense is presented as a single line item in operating expense in the income statement □ The right-of-use asset is tested for impairment in accordance with ASC 360
Statement of cash flows	□ Repayments of principal should be classified as financing activities □ Interest on the lease liability should be classified in accordance with guidance related to interest in ASC 230 □ Variable lease payments should be classified as operating activities	□ Operating lease payments should be classified as operating activities □ Operating lease payments that are capitalized as a cost bringing another asset to intended use should be classified as investing activities

Figure LG 3-2 summarizes the accounting by lessors for the different lease types (excluding leveraged leases, which are discussed in LG 7) and Question LG 3-1 discusses how leases between related parties should be classified.

Figure LG 3-2
Overview of lease accounting by lessors

Statement	Sales-type lease	Direct financing lease	Operating lease
Balance sheet	▫ The underlying asset is derecognized and the net investment in the lease (the sum of the present value of the future lease payments and unguaranteed residual value) is recorded ▫ The net investment in the lease is increased by interest income and decreased by payments collected	▫ The underlying asset is derecognized and the net investment in the lease (the sum of the present value of the future lease payments and unguaranteed residual value) is recorded ▫ The net investment in the lease is increased by interest income and decreased by payments collected	▫ The underlying asset remains on the balance sheet ▫ The underlying asset continues to be depreciated over its useful life, which could extend beyond the lease term
Income statement	▫ Selling profit or loss* is recorded at lease commencement ▫ Interest income is recorded based on the effective rate of interest in the lease	▫ Selling profit is deferred and selling loss* is recorded at lease commencement ▫ Interest income is recorded based on the effective rate of interest in the lease	▫ Lease revenue and depreciation expense are presented on a gross basis in the income statement
Statement of cash flows	▫ Cash receipts from all leases should be classified as operating activities except for entities within the scope of ASC 946 (see ASC 842-30-45-5).		

* Under these lease classification criteria, lease arrangements with variable lease payments may be classified by lessors as a sales-type or direct-financing lease. This may lead to the recognition of a selling loss (i.e., a day-one loss) by the lessor even when the overall arrangement is expected to be profitable. In response to concerns raised in the post implementation review, in order to avoid recognition of such day-one loss under ASC 842, the FASB issued ASU 2021-05, *Lessors—Certain Leases with Variable Lease Payments*, which upon adoption requires a lessor to classify a lease with variable lease payments (that do not depend on an index or a rate) as an operating lease at the lease commencement date if classifying the lease as a sales-type lease or direct financing lease would result in recognition of a day-one loss. See LG 9.10 for the effective date and transition requirements of ASU 2021-05. See Example LG 4-9 for an illustration of a lease with significant variable payments.

3.2.1 *Leases between related parties*

Question LG 3-1

How should leases between related parties be classified?

PwC response

Leases between related parties should be classified like all other leases, as discussed in ASC 842-10-55-12. The classification should be based on the terms of the contract, without adjustment for provisions that may have been impacted by the related party relationship.

ASC 842-10-55-12

Leases between related parties should be classified in accordance with the lease classification criteria applicable to all other leases on the basis of the legally enforceable terms and conditions of the lease. In the separate financial statements of the related parties, the classification and accounting for the leases should be the same as for leases between unrelated parties.

The lessee and lessor should look only to legally enforceable rights when classifying the lease. In identifying the legally enforceable rights, it would be reasonable to start with a review of the written contract. However, due to the relationship between the two parties, the legal lease provisions in the written contract may be uneconomic or a detailed contract may not exist at all. If this is the case, it would be helpful to involve legal counsel to understand if there are legal rights that exist outside of a written contract. For example, within office space leased from a related party under a nonrenewable, one-year managed service arrangement, a lessee may install leasehold improvements with an economic life of five years. This may indicate that the lessee expects to use the space longer than the one-year lease term and therefore the written contract terms of the arrangement may be considered uneconomic. Furthermore, that may be a reasonable expectation given that management of the lessee and lessor often include the same decision makers. Therefore, in this case it could be helpful to involve legal counsel.

Related party leases are often embedded within other arrangements (e.g., a managed service arrangement). In those cases, the arrangement may include multiple components, including both lease and non-lease components. Therefore, once total contract consideration has been determined based on the legally enforceable rights in the arrangement, it must be allocated between the multiple components in order to determine the appropriate lease payments to be used for lease classification. The total contract consideration is allocated to each component based on relative standalone price for each component. See LG 2.4 for further details on components.

3.2.1.1 *New guidance - Leases between entities under common control*

In March 2023, the FASB issued ASU 2023-01, *Common Control Arrangements*. The guidance provides entities within the scope of ASC 842-10-65-1(b) (that is, entities that are not public business entities, not-for-profit bond obligors, or employee benefit plans that file or furnish financial statements with or to the SEC) a practical expedient to use written terms and conditions for determining whether a lease exists and, if so, the classification and accounting for that lease.

An entity applying the practical expedient would not be required to determine whether those written terms and conditions are legally enforceable. If no written terms and conditions exist, an entity would apply ASC 842 based on the legally enforceable terms of an arrangement. If an entity determines that a lease does not exist, other GAAP would apply. The practical expedient may be applied on an arrangement-by-arrangement basis.

The new guidance is effective for all entities in fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted for both interim and annual financial statements that have not yet been made available for issuance. If an entity adopts the new guidance in an interim period, it should adopt the guidance as of the beginning of the fiscal year that includes that interim period.

Entities adopting the new guidance concurrently with adopting ASC 842 may follow the same transition requirements used to apply ASC 842. All other entities are required to apply the new guidance using one of the following two methods:

- Prospectively to arrangements that commence or are modified on or after the date that the entity first applies the new guidance, or

- Retrospectively to the beginning of the period in which the entity first applied ASC 842, but only for arrangements still in place at the date of adoption.

Under either adoption method, an entity is permitted to document any existing unwritten terms and conditions of an arrangement between entities under common control before the first date interim or annual financial statements are issued in accordance with this guidance.

When an arrangement previously considered to be a lease continues to be a lease after applying the guidance in this ASU, the entities should account for any changes in the lease resulting from application of the practical expedient as a lease modification. Refer to LG 5 for additional information on accounting for lease modifications.

If an arrangement previously not considered a lease becomes a lease after applying this ASU, an entity should account for the arrangement as a new lease.

The ASU also provides guidance related to accounting for leasehold improvements associated with common control leases. Refer to LG 8.11 for additional information on amortization of leasehold improvements.

3.2.2 Lease commencement

ASC 842 requires the determination of whether an arrangement contains a lease at lease inception. Classification and initial measurement of right-of-use assets and lease liabilities are determined at the lease commencement date, which is defined in the ASC 842 Glossary.

Definition from ASC 842 Glossary

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

Right-of-use assets and lease liabilities are not recognized before lease commencement because prior to that date, the lessor has not yet performed under the arrangement. To illustrate, assume a lessee and lessor enter into a lease arrangement on January 1, but the lessor does not make the underlying asset available for use by the lessee until April 1 of the same year. At lease inception (January 1), the arrangement would be assessed to confirm that it contains a lease, but the initial lease classification assessment and measurement of the right-of-use asset and lease liability would occur on April 1.

Although the lease commencement date may be defined in a lease agreement, the accounting assessment should be made on the date that the lessor makes the underlying asset available for use to the lessee. For example, in many real estate leases, a lessee may obtain control over the use of the underlying asset well before it begins to use the leased asset to facilitate the completion of leasehold or other improvements. Determining when a lessor has made the underlying asset available for a lessee's use is the key to correctly determining the commencement date. Some factors to consider are whether the asset is complete, whether a lessee has the unfettered right to enter the property and the nature of any significant improvement work being performed on the asset. The commencement date specified in the lease contract or the date when lease payments begin are not typically strong indicators of when a lessee has obtained control of the leased asset. For example, if the commencement date per the legal terms of lease agreement for a single floor in an office building has occurred and the lessee has the ability to access the floor, but does not yet control how, when, or whether the space may be used, the lease has not commenced. This could occur when a lessor permits the lessee early access to a property (e.g., to install lessee improvements) while, simultaneously, the lessor continues its own work. The lease has not commenced because the lessor has not relinquished control of the underlying asset to the lessee.

There may be instances when control of the underlying asset has been obtained by a lessee prior to lease commencement (e.g., when a lessee is involved in the construction of the underlying asset). In such cases, the lessee may be required to reflect its control over the asset prior to construction completion. Once construction is completed the lessee should account for the transaction as a sale and leaseback. See LG 6.3.2.6 for additional information.

Although lease classification is determined at the lease commencement date, in certain circumstances a reporting entity may need to reassess classification at a later date. See LG 5.3.

3.2.3 Lease components

A reporting entity must identify whether an arrangement contains multiple lease and nonlease components. See LG 2.4 for information on identifying separate lease components in a contract.

A reporting entity must individually assess the classification of each separate lease component. For example, if a reporting entity determines that a contract includes two separate lease components, the reporting entity should assess the classification of each one separately. In some cases, the classification of separate components in a single lease arrangement could differ.

A single lease component may include the right to use multiple underlying assets. When classifying a lease component with multiple underlying assets, identifying the economic life and estimating the fair value of the lease component will require judgment. See LG 3.3.3.3 and LG 3.3.4.5, respectively, for additional information.

3.2.4 Master lease agreements

A master lease agreement is a contractual arrangement that governs the terms and conditions of multiple underlying assets. Accordingly, while the terms and conditions are contractually defined at lease inception, each underlying asset subject to the agreement should be evaluated individually at the commencement of each individual lease (i.e., when the lessor makes the underlying asset available for use by the lessee). Generally, a master lease agreement will result in multiple lease commencement dates because the terms and conditions within the agreement apply to different underlying assets that are made available for use by the lessee on different dates.

3.3 Lease classification criteria

Lease classification is governed by five criteria. Although the guidance considers whether a lease is economically similar to the purchase of a nonfinancial asset from the perspective of control, the classification approach is substantially similar to previous guidance. If any of the five criteria in ASC 842-10-25-2 are met, a lessee should classify the lease as a finance lease and the lessor would classify the lease as a sales-type lease. If none of the criteria are met, a lessor would classify a lease as a direct financing lease if the criteria in ASC 842-10-25-3b are met. All other leases should be classified as an operating lease by both the lessee and lessor.

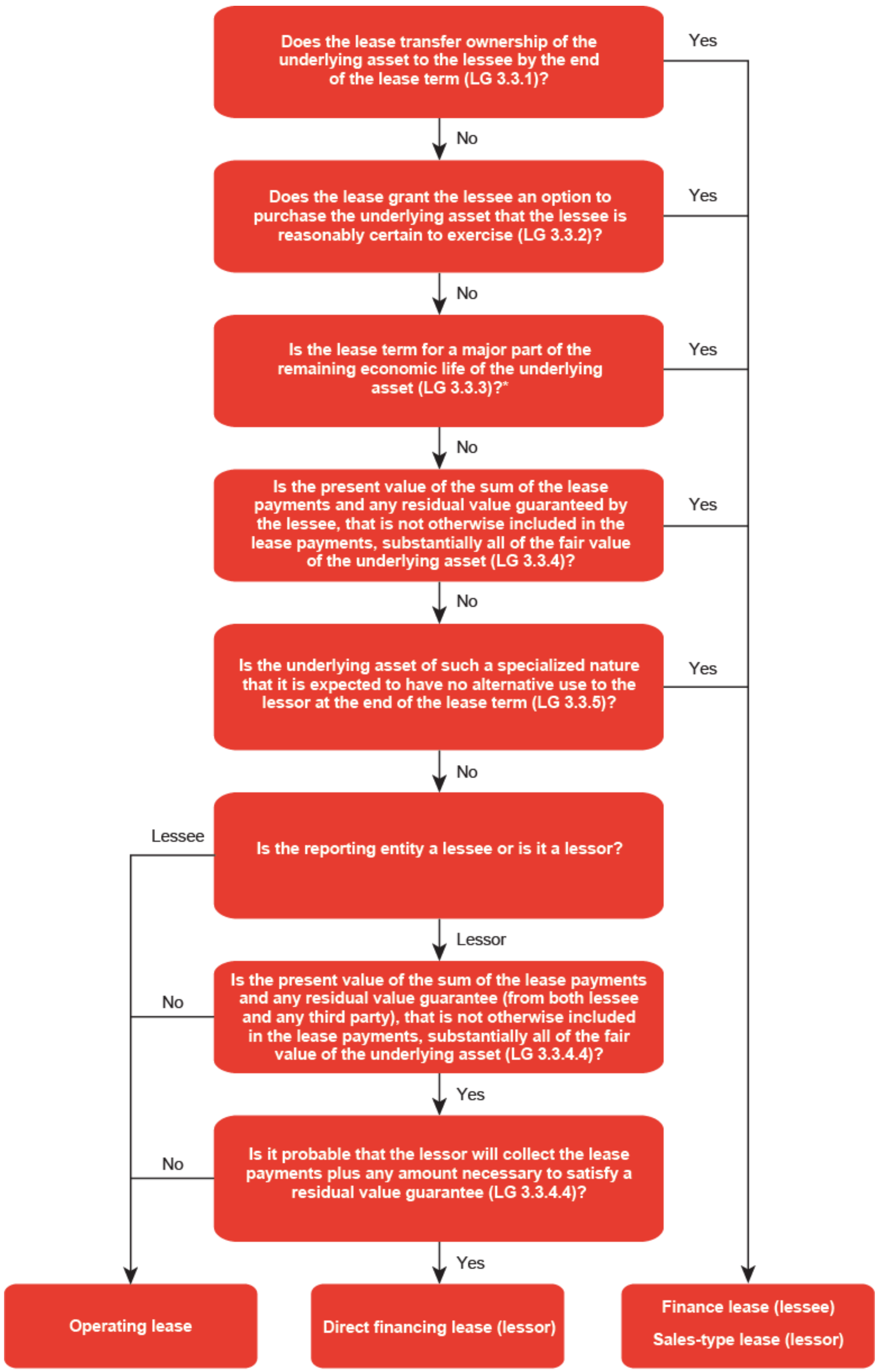
Although lessors are generally subject to the same classification criteria as lessees, additional considerations relevant to any revenue generating activity – such as the collectibility of amounts due under the lease – may impact the timing and recognition of selling profit or loss, or income over the lease term. Furthermore, under the lease classification criteria, lease arrangements with variable lease payments may be classified by lessors as a sales-type or direct-financing lease. This may lead to the recognition of a selling loss (i.e., a day-one loss) by the lessor even when the overall arrangement is expected to be profitable. In response to concerns raised in the post implementation review, in order to avoid recognition of such day-one loss under ASC 842, the FASB issued ASU 2021-05 which upon adoption requires a lessor to classify a lease with variable lease payments (that do not depend on an index or a rate) as an operating lease at the lease commencement date if classifying the lease as a sales-type lease or direct financing lease would result in recognition of a day-one loss. See LG 9.10 for the effective date and transition requirements of ASU 2021-05. See Example LG 4-9 for an illustration of a lease with significant variable payments.

A reporting entity that elects the exception for short-term leases would not apply the lease classification criteria. See LG 2.2.1 for information on the short-term lease measurement and recognition exemption.

Figure LG 3-3 provides the lease classification criteria contained in ASC 842-10-25-2 and ASC 842-10-25-3.

Figure LG 3-3

Lease classification criteria



*This criterion does not apply when the commencement of the lease falls near the end of the economic life of the underlying asset.

Each of these types of leases are discussed in the following sections.

Question LG 3-2

If a lessee classifies a lease as a finance lease, must the lessor do so as well?

PwC response

Generally, yes. The lessee and the lessor apply the same basic classification criteria; however, differences in assumptions used to classify the lease (e.g., discount rate and the impact of renewal or purchase options) could give rise to classification differences. Lessor classification may also be impacted by factors unrelated to the lessee. For example, a lessor may obtain residual value insurance from a third party and include that guarantee in its lease payments. This could result in the lessor classifying the lease as a direct financing lease while the lessee classifies it as operating.

Furthermore, under the lease classification criteria, lease arrangements with variable lease payments may be classified by lessors as a sales-type or direct-financing lease. This may lead to the recognition of a selling loss (i.e., a day-one loss) by the lessor even when the overall arrangement is expected to be profitable. In response to concerns raised in the post implementation review, in order to avoid recognition of such day-one loss under ASC 842, the FASB issued ASU 2021-05 which upon adoption requires a lessor to classify a lease with variable lease payments (that do not depend on an index or a rate) as an operating lease at the lease commencement date if classifying the lease as a sales-type lease or direct financing lease would result in recognition of a day-one loss. See LG 9.10 for the effective date and transition requirements of ASU 2021-05. See Example LG 4-9 for an illustration of a lease with significant variable payments.

Question LG 3-3

Can the classification criteria be applied to a group of leased assets (i.e., a portfolio approach)?

PwC response

Yes. However, the results must not be materially different than classifying the underlying assets on an asset by asset basis. As a result, this approach would likely only be permitted in situations where the lease applies to a group of homogenous assets that have identical or nearly identical lease terms.

Question LG 3-4

Do the lease classification criteria in ASC 842-10-25-2 and ASC 842-10-25-3 apply to leases of land?

PwC response

Yes. Leases of land should be classified like any other lease; that is, evaluated based on the lease classification criteria in ASC 842-10-25-2 and ASC 842-10-25-3. Consequently, long-term leases of land may be classified as finance leases.

3.3.1 Transfer of ownership

A lease is classified as a finance lease by a lessee and as a sales-type lease by a lessor if ownership of the underlying asset transfers to the lessee by the end of the lease term. This criterion is also met if the lessee is required to pay a nominal fee for the legal transfer of ownership. However, if a lessee can choose not to pay the nominal fee (resulting in the lessee having the option not to purchase the underlying asset), the provision would not meet the transfer of ownership criterion because it would be considered an option to purchase the underlying asset. See LG 3.3.2 for information on the accounting for options to purchase the underlying asset.

It may be difficult to distinguish between a finance lease (subject to the guidance in ASC 842) and a financed purchase (sale) of an asset (subject to the guidance of ASC 606). Under ASC 606, the transfer of legal title to a buyer is an important indicator when determining whether an entity has transferred control of an asset to a customer, but that fact is not determinative in isolation. A question arises as to whether an arrangement should first be evaluated under ASC 606 or ASC 842. For example, since transfer of title does not automatically govern whether an entity has transferred control of an asset to a customer, it is not clear which standard should govern the accounting when title is not transferred to the customer at the beginning of the arrangement. Similarly, it is unclear which standard should govern when an arrangement does transfer legal title to the customer, but that transfer is not, in isolation, determinative as to whether a sale has occurred.

We believe that reporting entities should generally apply ASC 842, except when legal title transfers at the beginning of an arrangement. This may result in an entity classifying a lease as a sales-type (finance) lease, but, nevertheless, the transaction would be accounted for under ASC 842. Reporting entities should first apply the guidance in ASC 606 when legal title is transferred to the customer at the beginning of an arrangement. However, per ASC 606, an entity that transfers a good and retains a substantive forward repurchase obligations or call option (that is, a repurchase right) should not recognize revenue when the good is initially transferred to the customer because the repurchase right limits the customer’s ability to control the good. If the repurchase price is less than the original sales price of the asset and the arrangement is not part of a sale-leaseback transaction, the arrangement would be subject to the accounting and lease classification guidance under ASC 842.

3.3.2 Purchase options

If a lease contains an option to purchase the underlying asset and the option is reasonably certain to be exercised by the lessee, the lessee and lessor should classify the lease as a finance lease and a sales-type lease, respectively. An option may be reasonably certain to be exercised by the lessee when a significant economic incentive exists. For example, this may exist when the price of the option is favorable relative to the expected fair value of the underlying asset at the date the option becomes exercisable or when certain economic penalties exist that compel the lessee to elect to exercise its option. See LG 3.4 for additional information on the impact of economic factors on the application of the reasonably certain threshold.

3.3.2.1 Purchase option prices

A purchase option, whether fixed price or formula driven, should be evaluated to determine if it represents a significant economic incentive such that the lessee is reasonably certain to exercise it. Generally, an option to purchase a leased asset at a price greater than or equal to an asset’s fair value at lease commencement would not give rise to a significant economic incentive based on price. Additional consideration is required when a fixed-price option allows the lessee to buy the asset at a price that is less than the fair value of the asset at the lease commencement date. Both the lessee and lessor should consider all relevant factors, including the nature of the leased asset and the length of time before the option becomes exercisable, which may impact the likelihood that the lessee would exercise the option. For example, an option to purchase real estate at a price below the commencement date fair value is more likely to be considered reasonably certain of exercise than a similar option on equipment since real estate is generally expected to appreciate in value over the lease term whereas equipment is more likely to depreciate in value.

See LG 3.4 for additional information on the application of the reasonably certain threshold.

3.3.3 Lease term test

If the lease term is for a major part of the remaining economic life of the underlying asset, the lessee has effectively obtained control of the underlying asset and should classify the lease as a finance lease; the lessor should classify the lease as a sales-type lease. While ASC 842 does not require the use of bright lines, one approach to applying this indicator is to consider a lease term to be for a major part if it is equal to or greater than 75% of the underlying asset's remaining economic life. As land has an indefinite life, this criterion would not apply to leases of land.

Leases that commence at or near the end of the underlying asset's economic life are exempt from applying this particular lease classification criterion. When determining if a lease has commenced at or near the end of the underlying asset's economic life, use to date and the remaining economic life of the underlying asset at lease commencement should be considered. The FASB has indicated that one reasonable approach to determining the applicability of this exception is to conclude that a lease that commences in the final 25% of an asset's economic life is at or near the end of the underlying asset's economic life. While there may be differing views in practice, we believe this exception should apply whenever entities are required to classify a lease, e.g., when a lease is modified and the modification is not accounted for as a separate lease. We believe that, for classification purposes, the "commencement date" for an existing lease that is modified is the date the modification is executed.

See LG 3.3.3.2 for additional information on determining the estimated economic life of a leased asset.

3.3.3.1 Determining the term of the lease

Leases often include options to either extend the term of the lease (commonly referred to as a "renewal option") or to terminate the lease prior to the contractual lease expiration date (commonly referred to as a "termination option").

As discussed in ASC 842-10-30-1, a lessee or lessor should consider all relevant contractual provisions, including renewal and termination options, to determine the term of the lease. Only renewal or termination options that are reasonably certain of exercise by the lessee should be included in the lease term. Additionally, if a renewal option is controlled by the lessor, the lessee and lessor must include that renewal period in determining the lease term.

ASC 842-10-30-1

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

a. Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option

b. Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option

c. Periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor.

Unlike a renewal option controlled by the lessor, periods covered by a renewal option controlled or effectively controlled by a third party may or may not be included in the lease term. Judgment must be applied to determine whether an option controlled or effectively controlled by a third party should be reflected in the lease term.

The assessment of whether it is reasonably certain that a lessee will exercise an option should be based on the facts and circumstances at lease commencement. The assessment should not be based solely on the lessee's intentions, past practices, or estimates. It should focus on the factors that create an economic incentive for the lessee, including contract-, asset-, entity-, or market-based factors.

We believe that a lease that is cancellable only upon the occurrence of a remote contingency should be considered noncancellable for lease classification purposes.

If significant enough, a penalty for cancellation may result in a conclusion that continuation of the lease appears, at lease commencement, to be reasonably certain. If so, it should be considered noncancellable for any periods in which the penalty exists.

Question LG 3-5

How should a lessee consider its past practices in assessing whether it is reasonably certain to exercise an option to renew a lease or to purchase an underlying asset?

PwC response

A lessee should not rely solely on past practice, but should consider the economics underlying its negotiated arrangement. The FASB acknowledged that optional terms may not meet the conceptual definition of a liability, and therefore, the measurement of a lease liability should include options only when the lessee has economically little choice but to exercise the option. However, a lessee's past practices (e.g., its history of retaining assets for a particular length of time before replacing them) may be in response to factors that would commercially compel the lessee to renew the lease or to exercise a purchase option.

To determine whether a renewal option is reasonably certain of exercise, a lessee and lessor should compare the renewal rents with the expected fair market rents for equivalent property under similar terms and conditions. In general, a renewal option with renewal rents that are equal to or greater than the rents in the initial lease term is not considered to be reasonably certain of exercise; however, this presumption could be overcome if the economic penalties the lessee would suffer by not exercising the renewal option are significant. Any step-down in rents in a renewal period should give rise to a presumption (which can be overcome) that the renewal option is reasonably certain of exercise by the lessee. See LG 3.4 for factors to consider when determining whether renewal, termination, or purchase options are reasonably certain of exercise.

Question LG 3-6

How should a lessee and lessor determine the lease term in an arrangement that has no explicit end date?

PwC response

A lessee and lessor should evaluate the enforceable rights and obligations in the contract. Any period that may not be cancelled by the lessee should be included. Additionally, any provisions that allow the lessee to extend the lease (i.e., renewal options) should be evaluated to determine whether the lessee is reasonably certain to exercise them. For example, a lease agreement may provide a lessee with the right to use an underlying asset on a daily basis (no stated end date) that the lessee may return at any point subsequent to the first day of use. The noncancellable period of this type of lease would be a single day and each subsequent day would be considered a daily renewal option that should be included in the lease term if determined to be reasonably certain of exercise by the lessee after considering all relevant contract-, asset-, entity-, and market-based factors.

Question LG 3-7

How should a lessee and lessor determine the lease term in an arrangement that can be canceled by either party?

PwC response

A lessee and lessor should first evaluate whether both parties have the unilateral right to terminate the arrangement (i.e., symmetrical termination rights). If termination rights are symmetrical, the lessee and lessor should determine if terminating the lease would result in either party incurring more than an insignificant penalty, as defined in ASC 842-10-20. If the termination rights are symmetrical with no more than an insignificant penalty, the lease term is limited to the period up to the time those symmetrical rights are exercisable. If termination rights are not symmetrical or either party would incur more than an insignificant economic penalty, the lessee and lessor should follow the framework discussed above.

When evaluating whether the lessee or lessor would incur more than an insignificant economic penalty, they should consider not only cash payments required to be made upon exercise of the termination options, but also other penalties, such as the cost of abandoning leasehold improvements or the disruption caused by relocating employees (see LG 3.4 for other examples of termination penalties). We believe arrangements such as these will be most prevalent in related party agreements. See LG 3.2 for other related party leasing considerations.

Question LG 3-8

Would a lease with a nonconsecutive term totaling 365 days or less be considered a short-term lease if the overall agreement spans a period more than 12 months?

PwC response

Yes. We believe the determination of short-term, as defined in ASC 842-10-20, should be evaluated on the basis of aggregate nonconsecutive periods. See LG 2.2.1 for information on the short-term lease measurement and recognition exemption.

Question LG 3-9

Is a lease with a fiscal funding clause (a clause included in some leases with federal, state, and local government that gives the lessee the right to cancel if funds are not appropriated in future years) considered noncancellable?

PwC response

Generally, yes. A fiscal funding clause should be evaluated to determine whether it is more than remote that a lessee will exercise the clause. If it is determined that a lessee's exercise of a fiscal funding clause is more than remote, only the periods for which exercise is remote should be included in the lease term. In evaluating these provisions, the factors to be considered may include (1) a lessor's experience relative to other similar leases with the same lessee and/or with similar lessees and governmental agencies, (2) technological obsolescence, and (3) whether the leased asset is essential to continued normal operation of the governmental unit.

Example LG 3-1, Example LG 3-2, Example LG 3-3, and Example LG 3-4 illustrate the effect of renewal options on the lease term.

EXAMPLE LG 3-1

Lease term – ground lease with a renewal option

Lessee Corp enters into a 15-year ground lease agreement. The lease grants Lessee Corp an option to renew the lease for an additional 15 years. The ground rents adjust to current market rates for equivalent unimproved land upon exercise of the renewal option.

Lessee Corp plans to construct a building on the leased land. The cost of the building is significant and its estimated life is 30 years.

What is the lease term?

Analysis

The lease term is 30 years. The loss of the building after year 15 as a result of non-renewal of the ground lease provides Lessee Corp a significant incentive to renew the ground lease for another 15 years.

EXAMPLE LG 3-2

Lease term – building lease with a renewal option

Lessee Corp enters into an agreement to lease an office building for 10 years. The lease grants Lessee Corp the option to renew the lease for an additional 10 years. The rental costs adjust to current market rents for equivalent office space upon exercise of the renewal option.

What is the lease term?

Analysis

Since the rents at the beginning of the renewal period will adjust to market rents, the renewal option does not create an economic incentive for Lessee Corp to exercise its option. Therefore, assuming the asset is neither unique nor specialized and no other economic incentives exist, Lessee Corp will likely conclude, at the lease commencement date, that the option is not reasonably certain of exercise. Accordingly, the lease term would be 10 years.

EXAMPLE LG 3-3

Lease term – third party is not reasonably certain to exercise a renewal option

Lessee Corp leases an asset for a 10-year noncancellable period with two 5-year renewal options (the "head lease") from Lessor Corp. Lessee Corp subleases the leased asset to Sublessee also for a noncancellable period of 10 years with two 5-year renewal options. Lessee Corp (as sublessor) determines Sublessee is not reasonably certain to exercise its options to extend the sublease. Lessee Corp also determines it is not reasonably certain that it will exercise any renewal options in the head lease.

How should Lessee Corp (as sublessor) determine the term of the head lease, considering the renewal options held by Sublessee?

Analysis

Including optional renewal periods could impact both classification and measurement of Lessee Corp's lease of the asset. The guidance in ASC 842-10-30-1 (see LG 3.3.3.1 above) states that the lease term includes "periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor."

One might infer that this guidance requires the lessee to include *all* optional periods it must exercise due to circumstances outside the lessee's control (e.g., a renewal right over the asset granted by the Lessee to Sublessee). However, Lessee Corp is not required to include the renewal periods in the lease term merely because Sublessee holds renewal rights. Instead, Lessee Corp must assess whether non-renewal by Sublessee imposes an economic penalty sufficient to provide a significant economic incentive for Sublessee to exercise its renewal options. If so, the optional renewal periods would be included in lease term by Lessee Corp in evaluating its lease and sublease. If not, Lessee Corp would classify and measure its lease based on the noncancellable lease term.

In this example, the term of the head lease would be 10 years because (1) Lessor Corp cannot control whether Lessee Corp will exercise the extension option and (2) Lessee Corp concluded it is not reasonably certain that it will exercise any renewal options in the head lease.

Reassessing lease term

Subsequent to lease commencement, Lessee Corp would follow reassessment guidance for lessors to evaluate changes occurring during the sublease term (see LG 5.7). In accordance with lessor guidance on reassessment, Lessee Corp (as sublessor) would not reassess whether Sublessee is reasonably certain to renew the sublease until Sublessee actually exercises a renewal option not already included in the lease term. Until then, Lessee Corp would also not reassess the term of the head lease for the actions of Sublessee (e.g., if Sublessee began installing leasehold improvements, indicating it is likely to exercise a renewal option) as those actions are outside of Lessee Corp's control. Lessee Corp would follow reassessment guidance applicable to lessees to evaluate changes, including those resulting from triggering events that are within its own control occurring during the head lease term (see LG 5.3.1).

EXAMPLE LG 3-4

Lease term –third party is reasonably certain to exercise a renewal option

Lessee Corp leases an asset for a 10-year noncancellable period with two 5-year renewal options (the "head lease") from Lessor Corp. Lessee Corp subleases the leased asset to Sublessee also for a noncancellable period of 10 years with two 5-year renewal options. At lease commencement, Lessee Corp (as sublessor) determines Sublessee is reasonably certain to exercise its options to extend the sublease.

How should Lessee Corp (as sublessor) determine the term of the head lease?

Analysis

The term of the head lease would be 20 years because Lessee Corp (as sublessor) concluded Sublessee is reasonably certain to exercise its options to extend the sublease. Lessee Corp's obligation to supply the asset as sublessor results in Lessee Corp similarly concluding the renewal options in the head lease are reasonably certain of exercise.

We believe the same conclusion would be reached if the asset were specialized and, instead of subleasing the asset, Lessee Corp intended to use the asset to fulfill a revenue contract with a third party. That is, Lessee Corp must evaluate whether or not it is reasonably certain that it will use the asset to fulfill the revenue contract during the renewal periods.

Example LG 3-5 illustrates how to determine a lease term for lease portfolios where a lessee can terminate a percentage of the individual leases early.

EXAMPLE LG 3-5

Lease term –Lease portfolios where a lessee can terminate a percentage of the individual leases early

Lessee Corp. leases a portfolio of 100 automobiles from Lessor Corp. Each automobile can be used and operated independent of the other automobiles. Therefore, the arrangement is considered leases of multiple assets. The lease term is three years; however, Lessee Corp has the option to return 40 of the automobiles after 2 years. Lessee Corp. believes that it is reasonably certain that it will return 40 automobiles after 2 years.

The automobiles are similar and there is no higher likelihood that any individual automobile will be returned early. In other words, it is 60% likely that each automobile will be kept for the full lease term and conversely it is 40% likely that each automobile will be returned early.

What lease term should be used for each automobile?

Analysis

Lessee Co. should use a three- year lease term for 60 of the automobiles and a two-year lease term for 40 of the automobiles. Lessor Corp. should use the same lease terms.

3.3.3.2 Determining the estimated economic life

The ASC 842 Glossary provides the following definition of economic life.

Definition from ASC 842 Glossary

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

Determining the estimated economic life of an underlying asset may be similar to establishing the depreciable life of an asset. Depreciable lives may therefore provide a starting point to estimate economic lives for comparable assets. Whether an asset is owned or rented should not affect the length of its economic life.

Determining the estimated economic life of a new asset may be easier than determining the estimated economic life of equipment that has previously been owned or leased. A lessor or lessee should consider the remaining life of the underlying asset at lease commencement.

Example LG 3-6 and Example LG 3-7 illustrate how to determine the estimated economic life.

EXAMPLE LG 3-6

Estimated economic life – economic life of a new asset (manufacturing equipment)

Lessee Corp is in the business of manufacturing electrical devices for sale in retail hardware stores. Lessee Corp normally purchases equipment used in its manufacturing process from a third-party original equipment manufacturer (OEM) and assigns a 15-year useful life to the manufacturing equipment. Similar equipment must be replaced after 15 to 20 years of use (assuming normal repairs and maintenance during the usage period), after which it is typically scrapped.

In an effort to manage cash flows, Lessee Corp enters into a 10-year arrangement with the OEM to lease a new piece of manufacturing equipment. The new equipment is similar in nature to the equipment Lessee Corp normally purchases; if Lessee Corp were purchasing the equipment outright, it would assign a 15-year useful life for depreciation purposes.

What is the estimated economic life of the equipment for purposes of classifying the lease?

Analysis

Since the manufacturing equipment needs to be replaced at some point between 15 and 20 years, the estimated economic life should fall within that range. The midpoint of the range (i.e., 17.5 years) may be a reasonable estimate of the equipment's economic life assuming a more precise method of estimating the underlying asset's economic life does not exist.

EXAMPLE LG 3-7

Estimated economic life – economic life of a used asset (real estate)

Lessee Corp enters into a 10-year lease with Lessor Corp for the use of a warehouse. The warehouse is 40 years old at lease commencement. Lessee Corp has purchased other warehouses and typically depreciates them over 40 years.

What is the estimated economic life for purposes of classifying the lease?

Analysis

If Lessee Corp simply looks to the age of the warehouse, it may conclude that the building has no further economic life. However, this is not a reasonable assumption at lease commencement given Lessee Corp's intent to lease the building for 10 years.

The remaining economic life of the building should be estimated based on its condition at lease commencement and Lessee Corp's estimate of how long the building will be usable in the future assuming normal repairs and maintenance. The assessment should be based on the underlying asset, not the lease term. Lessee Corp may conclude that the building has a future economic life in excess of the 10-year lease term depending on the building's condition.

When classifying a lease, a lessor similarly should consider the remaining economic life of the underlying asset considering its condition, even if that life exceeds the useful life over which it depreciates the asset.

3.3.3.3 Economic life involving multiple assets

As discussed in ASC 842-10-25-5, a reporting entity should determine which asset represents the predominant asset when a lease component contains multiple underlying assets. Only the remaining estimated economic life of the predominant asset should be considered when classifying the lease component.

Example 13 in ASC 842-10-55-146 through ASC 842-10-55-149 illustrates the application of this guidance to a lease of a turbine plant. The leased turbine plant consists of the turbine, the building that houses the turbine, and the land under the building. The example concludes that these assets collectively represent a single lease component. Considering the lessee entered into the lease to obtain the power-generation capabilities of the turbine, and the land and building would have little to no use or value to the lessee without the turbine, the turbine represents the predominant asset in the lease component. Accordingly, the remaining economic life of the turbine should be used when evaluating the classification of the lease component.

3.3.4 *Lease payment tests*

This criterion (commonly referred to as the "lease payments criterion") is met if the present value of the sum of lease payments and any residual value guaranteed by the lessee that has not already been included in lease payments in accordance with ASC 842-10-30-5(f) equals or exceeds substantially all of the fair value of the underlying asset. Although the FASB did not include bright lines in ASC 842, it has indicated that one approach to applying this indicator is to consider payments equal to or greater than 90% of the underlying asset's fair value.

ASC 842-10-30-5 lists the six types of lease payments to be included in the measurement of aggregate lease payments used for lease classification purposes.

ASC 842-10-30-5

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

a. Fixed payments, including in substance fixed payments, less any lease incentives paid or payable to the lessee (see paragraphs 842-10-55-30 through 55-31).

b. Variable lease payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date.

c. The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise that option (assessed considering the factors in paragraph 842-10-55-26).

d. Payments for penalties for terminating the lease if the lease term (as determined in accordance with paragraph 842-10-30-1) reflects the lessee exercising an option to terminate the lease.

e. Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction. However, such fees shall not be included in the fair value of the underlying asset for purposes of applying paragraph 842-10-25-2(d).

f. For a lessee only, amounts probable of being owed by the lessee under residual value guarantees (see paragraphs 842-10-55-34 through 55-36).

If a lease includes nonlease components, their values and associated payments should be separated and excluded for purposes of lease classification, unless a lessee makes an accounting policy election not to separate nonlease components for the particular asset class. See LG 2.4 for information on multiple element arrangements and the allocation of consideration to lease and nonlease components.

Question LG 3-10

Are the costs associated with removing leasehold improvements installed by the lessee (i.e., a lessee's obligation to return an underlying asset to its original condition) considered lease payments?

PwC response

No. The costs associated with a lessee's obligation to return an underlying asset to its original condition generally would not meet the definition of a lease payment (defined in ASC 842-10-30-5), and should not be included when assessing lease classification or in the measurement of the lessee's lease liability. Since the costs are associated with removing the lessee's owned assets, these costs should be accounted for using the guidance in ASC 410, *Asset Retirement and Environmental Obligations*.

Question LG 3-11

Are the costs a lessee incurs to dismantle and remove the lessor's underlying asset at the end of the lease term considered lease payments?

PwC response

These payments are incurred by the lessee to remove the lessor's assets and consequently they would be subject to the guidance in ASC 842 (not ASC 410). However, these costs meet the definition of variable lease payments under ASC 842 because the ultimate amount payable will vary based on changes in factors after lease commencement. Because the payments are not based on an index or rate, they should not be included as a lease payment when assessing classification or in the measurement of the lessee's lease liability.

Question LG 3-12

Should lease payments include nonmonetary consideration (e.g., common stock of a lessee)?

PwC response

Generally, yes. We believe noncash consideration should be included in lease payments, measured at fair value on the lease commencement date. However, there are certain forms of noncash consideration that are explicitly excluded from lease payments, such as a lessee's guarantee of a lessor's debt.

Question LG 3-13

Should lease payments include deposits paid by a lessee to a lessor?

PwC response

It depends. Provisions in a lease agreement commonly require a lessee to pay a deposit to a lessor at or before the lease commencement date to financially protect the lessor in the event the lessee damages or does not properly maintain the underlying asset. If the asset is not damaged and is properly maintained, the lessor is required to reimburse the lessee for the full amount of the deposit at the end of the lease.

If a deposit paid by a lessee to a lessor is refundable, we do not believe the deposit is a lease payment. Rather, the payment should be accounted for as a deposit asset and liability by a lessee and lessor, respectively. Deposits should be evaluated to determine whether it is probable all or a portion of the deposit will be returned to the lessee at or before the end of the lease term. When an amount on deposit is less than probable of being returned to the lessee, it should be recognized in the same manner as a variable lease payment (i.e., a period cost).

If a deposit paid by a lessee to a lessor is nonrefundable, we believe the deposit is a lease payment. For example, if a lessee is required to pay a lessor a deposit at or before the lease commencement date to demonstrate its commitment to lease the underlying asset, the deposit should be accounted for as a fixed lease payment.

Question LG 3-14

Should a lessor account for sales tax and other similar taxes collected from a lessee as contract consideration?

PwC response

It depends. As an accounting policy election, a lessor may account for sales tax and other similar taxes collected from a lessee as lessee costs. If this policy is elected, a lessor would exclude these costs from contract consideration and variable consideration and present revenue net of these costs. If elected, adequate disclosure of the policy election is required. This policy election cannot be applied to a lessor's gross receipts taxes.

Question LG 3-15

How should a lessor account for costs that are explicitly required to be paid by a lessee on the lessors' behalf?

PwC response

It depends. A lessor should exclude from variable payments all lessor costs that are explicitly required to be paid directly by a lessee on behalf of the lessor to a third party. Examples include property taxes and insurance. A lessor would report revenue net of these amounts. Costs that are not part of contract consideration that are paid by a lessor to a third party and reimbursed by the lessee are considered lessor costs and would be accounted for as variable payments by the lessee. The lessor would therefore report these amounts gross on the income statement. ASC 842-10-15-40A only relate to costs associated with the lease, and not lease payments themselves.

Question LG 3-16

Are payments related to non-performance-related default covenants considered lease payments for lease classification purposes?

PwC response

No, any payments that must be made as a result of non-performance are not considered when assessing lease classification. These payments are considered variable lease payments.

3.3.4.1 *Fixed lease payments*

Fixed lease payments are payments required under the lease. They can be either a fixed amount paid at various intervals in a lease (e.g., a five-year equipment lease with annual lease payments of $2,000) or they can be payments that change over time at known amounts (e.g., lease payments of $2,000 per month at lease commencement that increase annually by $250 per month).

The exercise price of a purchase option should be included in the calculation of lease payments for purposes of lease classification and measurement when exercise is reasonably certain. See LG 3.4 for information on the application of the reasonably certain threshold.

ASC 842-10-30-5 requires lease incentives to be recorded as a reduction of fixed payments when determining lease payments. See LG 3.3.4.2 for information on lease incentives.

Example LG 3-8 illustrates how to determine the fixed lease payments.

EXAMPLE LG 3-8

Lease payments – determining the fixed payments

Lessee Corp and Lessor Corp enter into a 10-year lease of an office building for fixed annual lease payments of $100,000. Per the terms of the lease agreement, annual fixed lease payments to Lessor Corp comprise $85,000 for rent and $15,000 for real estate taxes.

What are the fixed lease payments for purposes of classifying the lease?

Analysis

The fixed lease payments are $100,000. Although real estate taxes are explicitly stated in the lease contract, they do not represent a separate nonlease component as they do not provide a separate good or service. The right to use the office building is the only component. The annual lease payments of $100,000 represent payments related to that single lease component.

See Example LG 3-9 for information on variable payments for real estate taxes. See LG 2.4 for additional information on identifying lease and nonlease components in a contract.

Leasehold improvements

Payments made by lessees for improvements to the underlying asset (e.g., upgrades to lighting, flooring, pantries) should be recorded as prepaid rent and included in fixed lease payments if the payment relates to an asset of the lessor. Determining whether payments made by a lessee for improvements to the underlying asset should be accounted for as lease payments to a lessor or as leasehold improvements of the lessee requires judgment. There is diversity in practice and there are a number of models in use to make the determination. While other models may be acceptable, we believe the following model closely follows the economics.

Generally, if a lease does not specifically require a lessee to make an improvement, the improvement should be considered an asset of the lessee. Payments for lessee assets should be excluded from lease payments when evaluating lease classification and measuring the right-of-use asset and lease liability. However, if the lease requires the lessee to make an improvement, the uniqueness of the improvement to the lessee's intended use should be considered. Improvements that are not specialized and for which it is probable they could be utilized by a subsequent tenant would likely be considered assets of the lessor. Other factors to consider include whether the improvement increases the fair value of the underlying asset from the standpoint of the lessor and the economic life of the improvement relative to the lease term.

If a lessee is required to complete a lessor asset improvement, but the improvement has not been completed as of the lease commencement date, an estimate of the costs to construct the asset, net of any funding to be provided by the lessor, should be included in lease payments for purposes of classification and measurement. Any subsequent difference between the estimated and actual cost of the improvement should be accounted for as variable lease payments. See LG 3.3.4.3.

See LG 3.3.4.2 for information on lessor reimbursement for leasehold improvements.

3.3.4.2 Lease incentives

As discussed in ASC 842-10-55-30, a lease agreement may include incentives to encourage a lessee to sign the lease, such as an up-front cash payment to a lessee, payment of lessee costs (such as moving expenses), or the assumption by a lessor of a lessee's preexisting lease. When a lessor assumes a lessee's preexisting lease with a third party, the lessee and lessor should independently estimate any loss associated with the assumption as illustrated in ASC 842-10-55-30(b).

Excerpt from ASC 842-10-55-30(b)

For example, the lessee's estimate of the lease incentive could be based on a comparison of the new lease with the market rental rate available for similar underlying assets or the market rental rate from the same lessor without the lease assumption. The lessor should estimate any loss on the basis of the total remaining costs reduced by the expected benefits from the sublease of use of the assumed underlying asset.

Like other amounts included in lease payments, lease incentives are included in the calculation of consideration in the contract, which must be allocated when multiple components exist (e.g., lease and nonlease components). However, irrespective of the allocation, lease incentives always reduce the consideration in the contract for a lessee and lessor.

For a lessee, the reduction to fixed lease payments will affect lease classification and the initial measurement of the right-of-use asset and lease liability. For a lessor, the reduction will affect lease classification and the measurement of lease income on a straight-line basis (if classified as an operating lease) or the net investment in the lease (if classified as a sales-type or direct financing lease).

Reimbursement for leasehold improvements

Lessor reimbursement for some (or all) of the costs a lessee incurs to complete leasehold improvements is a common example of a lease incentive. These payments may be calculated as a certain amount per square foot or a fixed amount regardless of the level of improvements undertaken by a lessee.

To determine whether a payment from the lessor to the lessee represents a lease incentive, a reporting entity must determine whether it represents a lessee or a lessor asset. See LG 3.3.4.1 for additional information about making that determination. If an improvement represents a lessee asset, the lessor payment is a lease incentive that should be recorded as a reduction to fixed lease payments. On the other hand, when a lessee pays for an improvement that is a lessor asset, the expenditure is prepaid rent rather than a lease incentive; the reimbursement is a reduction to prepaid rent. If a lessee was not fully reimbursed, the difference between the costs incurred and the reimbursements received would be included in lease payments.

If a lessor agrees to pay a fixed or formula-based amount to the lessee once the lessee provides evidence of the expenditures and the contract does not specify the nature of the improvements to be completed, it is reasonable to conclude that the improvements represent lessee assets. However, if the amount a lessee will receive is based on the actual costs incurred on improvements that are specified in the contract, judgment will be required to determine whether the improvements represent lessee or lessor assets.

When lessor reimbursement for lessee assets (i.e., a lease incentive) occurs subsequent to lease commencement, the lessee and lessor must determine whether the lease incentive is considered fixed or variable. If the incentive is subject to a cap and it is reasonably certain the lessee will use some or all of the amount available for reimbursement by the lessor, we believe the portion of the incentive that is reasonably certain of use should be treated as an in substance fixed lease payment (i.e., reduction to lease payments). A leasehold improvement allowance that is negotiated between a lessee and lessor creates an economic incentive for the lessee to use the full amount of the allowance. Therefore, negotiated lease incentives are generally considered reasonably certain of use because a lessee is economically incentivized to use the entire incentive that it negotiated.

For lessees, at lease commencement, if an allowance for lessee assets represents an in substance fixed lease payment, we believe a lessee should estimate the timing and amount of the payments not yet received and include them in lease payments when classifying the lease and measuring the lease liability, which in turn would get reflected in the right-of-use asset. See LG 3.3.4.3 for further discussion on in substance fixed lease payments.

Similarly, a lessor should estimate the timing and amount of the payments not yet paid when classifying the lease and measuring the net investment in the lease if classified as a sales-type or direct finance lease. If classified as an operating lease, although there is no impact to any amounts recorded at lease commencement, the reduction to lease payments is included in the calculation of lease income that will be recorded on a straight-line basis over the lease term.

See LG 5.3.2 for information on the subsequent accounting for estimated lease incentives.

If an incentive is determined to be variable at lease commencement, we believe a lessee should account for the lease incentive as variable rent when the contingency is resolved. Therefore, the incentive does not impact lease classification or initial measurement of the lease liability.

Question LG 3-17

How should a lessee account for in substance fixed lease incentives that will be used to construct lessee assets when all other lease payments are entirely variable?

PwC response

We believe that at lease commencement, the lessee must measure the lease liability and right-of-use asset in accordance with ASC 842-20-30-1. Because the lease payments (other than the incentive) are entirely variable, this would result in the recognition of a receivable rather than a liability. This would also result in a negative right-of-use asset (prior to considering the impact of any prepaid rents or initial direct costs), which would be classified as a liability. The liability would then be amortized on a straight-line basis over the lease term as a reduction to rent expense.

3.3.4.3 Variable lease payments

Variable lease payments, or contingent payments, are defined in the ASC 842 Glossary and further discussed in the Basis for Conclusions in ASU 2016-02.

Definition from ASC 842 Glossary

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

ASU 2016-02 BC205

Some or all of the lease payments for the right to use an asset can be variable. That variability can arise because lease payments are linked to:

a. Price changes due to changes in an external market rate or the value of an index. For example, lease payments might be adjusted for changes in a benchmark interest rate or the Consumer Price Index.

b. The lessee’s performance derived from the underlying asset. For example, a lease of retail property may specify that lease payments are based on a specified percentage of sales made from that property.

c. The use of the underlying asset. For example, a car lease may require the lessee to make additional lease payments if the lessee exceeds a specified mileage.

Variable lease payments that depend on an index or a rate should be included in the calculation of lease payments when classifying a lease and in the measurement of the lease liability. Variable lease payments should be calculated at lease commencement, using the index or rate at lease commencement; no increases or decreases to future lease payments during the lease term should be assumed.

Variable lease payments other than those that depend on an index or a rate should not be included in lease payments for purposes of classification and measurement of the lease, unless those payments are in substance fixed lease payments.

If a lease includes a renewal option that the lessee is reasonably certain to exercise and the payments during the renewal period are based on the fair market rents at the beginning of the renewal period, we believe the renewal period rents should be treated similar to variable lease payments that depend on an index or rate. This approach is consistent with IFRS 16.28, which says that variable lease payments that depend on an index or rate include payments that vary to reflect changes in market rental rates.

Subsequent to the lease commencement date, when the actual payments in the renewal period are known, the lessee would not remeasure the lease payments. Rather, any changes would be a period cost during the period in which they are incurred. The lessor would record the changes as earned during the period they occur.

See LG 5.3.1 for information on when to remeasure lease payments, including the impact of variable lease payments on remeasurement.

Example LG 3-9, Example LG 3-10, and Example LG 3-11 illustrate when to include variable lease payments in the calculation of lease payments when classifying a lease.

EXAMPLE LG 3-9

Lease payments – variable lease payments tied to an index

Lessee Corp enters into an agreement with Lessor Corp to lease office space for a term of 60 months. Lease payments during year one of the lease are $10,000 per month. Each year, lease payments increase by an amount equivalent to the percentage increase in the Consumer Price Index (CPI). For example, if the CPI increases by 3%, lease payments during year two of the lease would increase 3% to $10,300 per month. If the CPI decreases or remains consistent, lease payments remain at the rate in effect during the previous year.

What are the lease payments for purposes of classifying the lease?

Analysis

Increases in lease payments are tied to the percentage change in the CPI and movements in the CPI subsequent to lease commencement are unknown. As such, only the initial lease payments of $10,000 per month would be included in the calculation of lease payments when classifying the lease.

See Example LG 4-6 for an example of the initial measurement of a lease with a variable lease payment tied to an index.

EXAMPLE LG 3-10

Lease payments – variable lease payments tied to real estate taxes

Lessee Corp and Lessor Corp enter into a 10-year lease of an office building for fixed annual lease payments of $85,000. Per the terms of the lease agreement, Lessee Corp is required to pay Lessor Corp an amount equal to all real estate taxes associated with the building during the lease term. Real estate taxes are expected to be $15,000 for the first year of the lease.

What are the lease payments for purposes of classifying the lease?

Analysis

The lease payments are $85,000. Although the terms of the lease require Lessee Corp to pay Lessor Corp an amount equal to the real estate taxes, real estate taxes vary on an annual basis. As such, they would be considered variable lease payments that are not dependent on an index or a rate. As a result, they should be excluded from lease payments for purposes of classification and measurement.

As discussed in Example LG 3-8, real estate taxes do not represent a separate lease component. See LG 2.4 for additional information on identifying lease and nonlease components.

EXAMPLE LG 3-11

Lease payments – variable lease payments tied to fair market value

Lessee Corp enters into a five-year noncancellable office lease with Lessor Corp. The lease contains a 5-year renewal option that Lessee Corp is reasonably certain to exercise. The lease payments are fixed at $600k annually for each of the first five years. The annual lease payments for the renewal option will be set at the beginning of the renewal period based upon the fair market rent at the beginning of the renewal period.

Should the lease liability include amounts related to the renewal period even though the amount of the annual lease payments for that period is unknown at the lease commencement date?

Analysis

Yes. Similar to variable lease payments that depend on an index or rate, lease payments during the renewal period should be included in lease payments when classifying and measuring the lease at lease commencement. The renewal period rents should be based on the market rental rate at lease commencement (i.e., $600k per year), not the estimated market rental rate at the beginning of the renewal period.

In substance fixed lease payments

Variable lease payments that are considered in substance fixed lease payments should be included in the calculation of lease payments for classification and measurement. ASC 842-10-55-31 provides guidance on in substance fixed lease payments.

Excerpt from ASC 842-10-55-31

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

a. Payments that do not create genuine variability (such as those that result from clauses that do not have economic substance)

b. The lower of the payments to be made when a lessee has a choice about which set of payments it makes, although it must make at least one set of payments.

Variable lease payments based on performance or use are excluded from the calculation of lease payments for classification and measurement. This is true even if there is a high probability of some payment for usage during the lease term. Accordingly, a reporting entity would not include payments that vary solely on the basis of future use or performance in lease payments, regardless of the probability of occurrence (except in cases where the arrangement contains a guaranteed minimum payment or penalty that effectively amounts to a floor for lease payments).

Some lease payments are contingent in form, but are in effect, unavoidable; for example, payments due to clauses that lack economic substance or that provide a choice of payment type, but no ability to avoid a payment.

For example, consider a 10-year lease that provides for an increase in rent beginning in year six, which is calculated as five times the change in the CPI over the prior five-year period, with any increase in rent capped at 5%. It is reasonable to conclude a 5% rent increase commencing in the sixth year of the lease term is unavoidable; therefore, the 5% rent increase should be included in lease payments by the lessee and lessor.

There is often some portion of a contingent lease payment that is highly probable of being paid (e.g., some level of payment will generally be required in a lease that provides for percentage rent based on sales derived from the output of the leased asset). However, because the payment provision creates genuine variability, the total payment should be considered a variable lease payment and excluded from the lease payments.

A lease may include protective rights that impact the amount of lease payments due. Protective rights are generally rights that protect a lessee from the requirement to make payments during periods when the underlying asset is not available for use. For example, lease payments due may be substantially reduced during periods of excessive downtime for maintenance or inspection, when a lessor defaults on its obligations, or when weather conditions render the underlying asset unavailable to the lessee. The effect of protective rights should be disregarded when determining lease payments for purposes of classification and measurement.

Example LG 3-12, Example LG 3-13, Example LG 3-14, and Example LG 3-15 illustrate how to determine if variable lease payments are considered in substance fixed lease payments.

EXAMPLE LG 3-12

Lease payments – payments tied to sales

Lessee Corp enters into a 10-year lease for retail office space with Lessor Corp. The annual lease payments are $20,000 plus an amount equal to 5% of Lessee Corp's sales. Lessee Corp's annual sales have exceeded $200,000 since it began operations and are projected to grow at a rate of 10% annually.

What are the lease payments for purposes of classifying the lease?

Analysis

The lease payments for purposes of classifying the lease are the fixed annual lease payments of $20,000.

Although there is a high probability of some variable lease payments being made in light of Lessee Corp's historical results and projections, the variable lease payments are based exclusively on, and vary with, the performance of the underlying asset and do not represent in substance fixed lease payments.

EXAMPLE LG 3-13

Lease payments – in substance fixed lease payments

Lessee Corp enters into a five-year lease for office space with Lessor Corp. The initial base rent is $10,000 per month. Rents increase by the greater of 1% of Lessee Corp's generated sales or 3% of the previous rental rate on each anniversary of the lease commencement date.

What are the lease payments for purposes of classifying the lease?

Analysis

The lease payments for purposes of classifying the lease are the fixed monthly payments of $10,000 plus the minimum annual increase of 3%.

Lessee Corp is required to pay no less than a 3% increase regardless of the level of sales activity; therefore, this minimum level of increase is an in substance fixed lease payment.

EXAMPLE LG 3-14

Lease payments – payments tied to use of medical device consumables

Lessee Corp enters into a three-year lease for a medical device with Lessor Corp. Annual fixed lease payments are $100,000. Lessee Corp is also required to purchase at least $1 million of consumables to be used in the operation of the medical device by the end of the lease term. If Lessee Corp does not order $1 million of consumables, it is required to make a shortfall payment equal to the difference between the total consumables purchased and $1 million.

The measurement and allocation of contract consideration are not addressed in this example. For simplicity, assume all payments are allocated to the lease component (i.e., the medical device).

What are the lease payments for purposes of classifying the lease?

Analysis

The lease payments for purposes of classifying the lease include both the $300,000 fixed lease payments (3 years × $100,000 per year) and the in substance fixed lease payment of $1 million for consumables.

Although the payment for consumables varies based on use, because Lessee Corp is required to make payments of at least $1.3 million regardless of its consumable use, the $1 million minimum payment is an in substance fixed lease payment.

See Question LG 3-18 for information on the differences between payments included in lease payments and payments included in contract consideration. See LG 2.4 for information on measuring and allocating contract consideration to identified lease and nonlease components.

EXAMPLE LG 3-15

Lease payments – protective rights

Lessee Corp enters into a 5-year lease for equipment with Lessor Corp. The arrangement provides that Lessor Corp will maintain the equipment and operate it in accordance with instructions provided by Lessee Corp.

Payments due from Lessee Corp to Lessor Corp are based on the daily operation of the equipment (i.e., performance-based rates assigned to the nature of the activities performed each day throughout the term of the contract) as follows:

- Each day the equipment is available for use and operated by Lessor Corp, Lessee Corp must pay $1,000;

- Each day the equipment is available for use and Lessor Corp is available to operate the equipment, but the asset is not utilized as instructed by Lessee Corp, Lessee Corp must pay $750;

- Each day the equipment is (a) unavailable for use at the request of Lessor Corp (e.g., maintenance, required inspections), (b) unavailable for use due to events outside of both Lessee Corp and Lessor Corp's control (e.g., weather conditions), or (c) available for use, but Lessor Corp is not available to operate the equipment, Lessee Corp must pay $500. If the aggregate days the equipment is not operational due to (a), (b), or (c) exceeds 15 in a year, no payment is due from Lessee Corp for non-operational days exceeding the 15 day maximum. Based on historical experience with similar contracts, it is probable the total number of nonoperational days will exceed the 15 day maximum.

What are the lease payments for purposes of classifying the lease?

Analysis

Daily fixed payments are $750.

The daily rate of $750 represents the lowest amount the lessee would pay the lessor when the underlying asset is available for use. The additional $250 the lessee would pay when it uses the asset is a variable payment based on usage, and, therefore, is excluded from lease payments. The $500 payment level (and $0 payment) only apply when the lessor is unable to make the asset available for the lessees use, i.e., they result from a protective right. Payments (or payment reductions) resulting from a protective right are not considered in determining lease payments. Thus, any reductions in rent below $750 are (negative) variable payments. Variable payments are excluded from lease payments even though Lessee Corp and Lessor Corp concluded it is probable that the total number of nonoperational days will exceed the 15 day maximum, resulting in days when Lessee Corp is not required to make payments to Lessor Corp.

The daily rate of $750 represents the lowest contractual rate that is not the result of a protective right (i.e., it is the in substance daily fixed payment). Accordingly, the total annual consideration in the contract is $273,750 ($750 per day × 365 days), which should be allocated between the lease and nonlease components. Only the payments allocated to the lease should be considered for purposes of classifying the lease.

3.3.4.4 *Residual value guarantees*

The ASC 842 Glossary provides the following definition of a residual value guarantee.

Definition from ASC 842 Glossary

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

A residual value guarantee provides a lessor with certainty (subject to credit risk) that the fair value of the underlying asset subject to lease will not decline below a certain amount. Lessees may be motivated to provide such guarantees in order to obtain a lease that may not otherwise be available to them or to obtain more favorable pricing for the leased asset. Lessors may also secure residual value guarantees from a third party to reduce or eliminate their risk in the residual value of the asset.

Residual value guarantees provided by a lessee

If the present value of the lease payments and any residual value guarantees provided by the lessee guarantees a lessor the recovery of substantially all of the fair value of its underlying asset, the arrangement is a finance lease for the lessee and sales-type lease for the lessor.

Lessees and lessors should include the full amount of the potential payment payable under a residual value guarantee in fixed lease payments when evaluating lease classification under ASC 842-10-25-2 (d) (i.e., the lease payments criterion). While the terms of certain residual value guarantees may eliminate virtually all of the lessor's risk in the underlying asset, the likelihood of loss by the lessor is not a factor that should be considered when classifying a lease.

The requirement to include the full amount of the potential payment payable under a residual value guarantee differs from the measurement guidance, which requires that lessees and lessors consider only the present value of any payment under a lessee residual value guarantee that is probable of being owed.

A lessee may choose to obtain residual value insurance from an unrelated third party to protect against any exposure created by the provision of a residual value guarantee to a lessor. For example, if the residual value of the underlying asset was lower than the guaranteed amount at the end of a lease, the third party would make the necessary payments to satisfy the lessee's residual value guarantee to the lessor. When third-party insurance is for the benefit of the lessor, a lessee may not reduce lease payments when measuring the lease unless the lessor explicitly releases the lessee from their obligation under the residual value guarantee, including any obligation should the third party default. Additionally, any payments by a lessee to acquire third party residual value insurance are executory costs, which should not be included in lease payments.

If a lease contains a provision that provides the lessor with the right to require the lessee to purchase the underlying asset by the end of the lease term, the stated purchase price should be included in lease payments. This is because the purchase price is effectively a residual value guarantee that the lessee is required to pay (i.e., the payment of the purchase price is outside of the lessee's control). See Question LG 3-18 for further discussion.

Question LG 3-18

Should a lessee consider a residual value guarantee in the lease classification determination differently than how it considers the guarantee when measuring its lease liability?

PwC response

Yes. The probability of having to satisfy a residual value guarantee is not considered for purposes of lease classification, but is considered when measuring a lease liability. To illustrate, a lessee may provide a guarantee that the leased property will have a value that is no less than $100 at the end of the lease. The lessee believes it is probable it will owe $15 under this guarantee. In such a situation, it would include the present value of the full residual value guarantee amount (i.e., $100) when determining how to classify the lease, but it would include only the present value of the amount it is probable of owing (i.e., $15) when measuring its lease liability.

Residual value guarantees obtained from a third party

If a residual value guarantee is provided by a third party unrelated to the lessor, and none of the other criteria in ASC 842-10-25-2 are met, the lessor should evaluate whether the lease should be classified as a direct financing lease. A lessor would classify a lease as a direct financing lease if the lease meets both of the criteria in ASC 842-10-25-3(b).

ASC 842-10-25-3

When none of the criteria in paragraph 842-10-25-2 are met:

a. A lessee shall classify the lease as an operating lease.

b. A lessor shall classify the lease as either a direct financing lease or an operating lease. A lessor shall classify the lease as an operating lease unless both of the following criteria are met, in which case the lessor shall classify the lease as a direct financing lease:

   1. The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments in accordance with paragraph 842-10-30-5(f) and/or any other third party unrelated to the lessor equals or exceeds substantially all of the fair value of the underlying asset.

   2. It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.

For a lease to be classified as a direct financing lease, the lease payments and any amount necessary to satisfy a residual value guarantee should be probable of collection at lease commencement. If the lessor determines collection is not probable, the lease should be classified as an operating lease. See LG 3.3.4.7 for information on collectibility.

Example LG 3-16 illustrates the effect of a residual value guarantee on lease classification.

EXAMPLE LG 3-16

Residual value guarantee – third party

Lessor Corp enters into a lease of non-specialized construction equipment with Lessee Corp. The fair value of the equipment at lease commencement is $500,000. Lessee Corp does not provide a residual value guarantee.

Lessor Corp estimates that the fair value of the construction equipment at the end of the lease will be $150,000. While Lessor Corp acknowledges the value of the asset may decline below $150,000 in the future, Lessor Corp concludes there is less than a 1% chance of the value falling below $100,000. Therefore, to protect its investment, Lessor Corp obtains residual value insurance from a third party covering any loss incurred by Lessor Corp if the value declines to between $150,000 to $100,000. That is, if the residual value falls below $150,000, Lessor is covered for the first $50,000 of loss. The risk of loss associated with the value of the equipment falling below $100,000 is retained by Lessor Corp.

Assume Lessor Corp has already evaluated the lease classification criteria and concluded the lease is not a sales-type lease.

How should Lessor Corp classify the lease?

Analysis

Lessor Corp should classify the lease as an operating lease. When determining whether the present value of the lease payments and the residual value guarantee amount to substantially all the fair value of the underlying asset, Lessor Corp would consider the nominal amount of retained risk of $100,000, rather than the fair value of its retained risk. Assuming that the present value of the $100,000 unguaranteed residual value is great enough, the present value of the lease payments and the guaranteed residual will not amount to substantially all the fair value of the underlying asset. In that case, and considering that at lease commencement, the lease did not meet any of the criteria to be classified as a sales-type lease, the lease would not meet the criteria to be classified as a direct finance lease.

The same conclusion would be reached if the residual value guarantee was provided by Lessee Corp as opposed to a third party.

Loan guarantees and loans to the lessor

ASC 842-10-30-6 specifically excludes lessee guarantees of the lessor's debt from the definition of lease payments and does not address loans by the lessee to the lessor. Consistent with long-standing practice, we believe that a lessee's guarantee of the lessor's debt or a loan to the lessor may, in some circumstances, be considered a residual value guarantee and should be treated as such in the assessment of lease classification.

For example, if the lessor's debt is nonrecourse, or the lessor has no significant assets other than the underlying leased assets, the substance of the lessee's remaining guarantee at the expiration of the lease term may be a guarantee of the residual value of the underlying assets. This is because there is little substantive difference between a payment by the lessee to the lessor's nonrecourse lender pursuant to a loan guarantee and a direct payment by the lessee to the lessor under a residual value guarantee.

Portfolio level residual value guarantees

ASC 842-10-55-9 and ASC 842-10-55-10 discuss portfolio level residual value guarantees.

ASC 842-10-55-9

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

ASC 842-10-55-10

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

Generally, when assessing the classification criteria, a lessor should not include residual value guarantees when it applies to a portfolio of leased assets (unless they represent a single lease component) because the classification analysis is performed on an asset by asset basis and it is not possible to determine the amount of the guaranteed residual value for each individual asset.

A pooled residual value guarantee covering multiple leases can rarely be included in the assessment of the lease payments criterion when determining lease classification. The guidance in ASC 842-10-55-10 was largely carried forward from ASC 840. Under limited circumstances, however, the "portfolio effect" observed in ASC 842-10-55-9 may not exist for groups of leased assets that are similar. Consequently, and consistent with how practice evolved in this area under ASC 840, we believe it may be acceptable for a lessor to consider a pooled residual value guarantee in the assessment of the lease payments criterion if the following characteristics exist:

- Each of the leases commence at the same time
- The ends of the lease terms are contemporaneous
- The leased assets are physically similar to one another
- The variability around the expected residual values is expected to be highly correlated

The classification of a lease that includes a residual value guarantee that applies to a portfolio of leased assets by a lessee is not addressed by ASC 842. Generally, we believe a lessee should include the full amount of the potential payment payable under a residual value guarantee to each of the individual assets (unless they represent a single lease component) because the classification analysis is performed on an asset by asset basis and it is not possible to determine the amount of the guaranteed residual value for each individual asset. We believe this would apply, for example, to a single residual value guarantee in a lease of a building and the underlying land, as the building and land are always separate lease components (refer to LG 2.5 for guidance on determining lease components). However, under limited circumstances, if the four characteristics noted above are present, it may be acceptable for a lessee to include a ratable allocation of the potential payment payable under the residual value guarantee to the individual assets within the portfolio.

3.3.4.5 Fair value of the underlying asset

The lease payments criterion requires a lessee and lessor to compare the present value of lease payments and any residual value guaranteed by the lessee to the fair value of the underlying asset. The ASC 842 Glossary provides the following definition of fair value.

Definition from ASC 842 Glossary

Fair value (second definition): 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.

This criterion requires the comparison of the lease payments to the fair value of the lease component (i.e., the underlying asset), not to the fair value of the right to use the asset subject to the lease arrangement. This is an important distinction because most leases are for a period shorter than the economic life of the underlying asset, therefore, the fair value of the asset and the right to use the asset will differ. Additionally, when a lease component includes multiple underlying assets, the fair value should be for the group, which may differ from the sum of the fair values of the individual assets.

Other factors, such as tax credits, may impact fair value. A lease arrangement may allow a lessor to retain certain tax credits related to the underlying asset; for example, tax credits related to the construction and ownership of the underlying asset. Tax credits are typically associated with the ownership of, not the use of, the underlying asset. Therefore, tax credits retained by the lessor should be excluded from the determination of fair value.

Fees paid to special-purpose entity owners should be excluded from the fair value of the underlying asset as discussed in ASC 842-10-30-5. However, these fees should be included as lease payments.

Excerpt from ASC 842-10-30-5(e)

Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction… shall not be included in the fair value of the underlying asset for purposes of applying paragraph 842-10-25-2(d).

ASC 842-30-55-17A includes an exception to the guidance in ASC 842-10-30-5(e) for lessors (that are not manufacturers or dealers) that allows them to use the cost of the underlying leased asset (subject to applicable volume or trade discounts) instead of fair value when assessing lease classification and measuring the lease. Thus, qualifying lessors can capitalize acquisition and delivery costs, including sales taxes, associated with the underlying asset. Because fair value, when applying the exception in ASC 842-30-55-17A, equals the qualifying lessor's cost, no selling profit or loss is recognized at lease inception for sales-type and direct financing leases.

ASC 842-30-55-17A

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

ASC 842-10-55-3 provides guidance regarding the classification of a lease when it is not practicable for a reporting entity to determine the fair value of the underlying asset.

ASC 842-10-55-3

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

Lessees and lessors should generally be able to estimate the fair value of an underlying asset. As suggested in ASC 842-10-55-3, any assertion that it is not practicable to arrive at such estimates would be based on facts and circumstances of the specific transaction at that point in time, and not based on a model or a policy. Given the ubiquitous use of fair value measurements throughout other accounting topics, it would be unusual for lessees or lessors to be unable to do so for purposes of classifying leases. For example, we believe entities will often be able to estimate the fair value of a portion of an asset by reference to the fair value of the entire asset, as adjusted for distinct features of the leased asset, when those significantly affect the comparison. See PwC's *Fair value measurements* guide for further discussion of fair value measurements.

Question LG 3-19

Can a lessee recognize a right-of-use asset that exceeds the fair value of the underlying asset?

PwC response

ASC 842 does not specifically preclude a lessee from recording a right-of-use asset that exceeds the fair value of the underlying asset. However, it would be unusual for a lessee to knowingly pay more than fair value for an asset. Consequently, in these circumstances, a lessee should question the factors considered in the measurement of the right-of-use asset. For example, a lessee should reconsider the discount rate, the identification of lease and nonlease components, the allocation of consideration to the components, and the fair value of the underlying asset.

3.3.4.6 Discount rate

Lessees and lessors should discount lease payments at the lease commencement date using the rate implicit in the lease. If the information necessary to determine the rate implicit in the lease is not readily available, a lessee should use its incremental borrowing rate.

Rate implicit in the lease

The rate implicit in the lease is defined in the ASC 842 Glossary.

Partial definition from ASC 842 Glossary

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.

A lessor may be required to calculate different discount rates when classifying a lease. When evaluating the lease payments criterion to determine whether the lease is a sales-type lease, the rate implicit in the lease should include initial direct costs if, at lease commencement, the fair value of the underlying asset equals its carrying value. However, if the fair value of the underlying asset does not equal its carrying value, the rate implicit in the lease should exclude initial direct costs.

If the lease is not classified as a sales-type lease, a lessor should include initial direct costs when calculating the rate implicit in the lease to determine whether the lease is a direct finance lease or an operating lease. In this case, initial direct costs should be included regardless of whether or not the fair value of the underlying asset is equal to its carrying value.

If a lessee can ascertain the fair value of the underlying asset, the residual value estimated by the lessor, and initial direct costs incurred by the lessor, it can calculate the lessor's implicit rate. For example, it may be possible for a lessee to calculate the rate implicit in the lease if (a) the lease includes an automatic transfer of title or a bargain purchase option because the lessor's estimated residual value would be zero, and (b) the lessee concludes that any reasonable amount of initial direct costs would have an insignificant effect on the rate. A lessee may also be able to obtain the necessary information directly from the lessor. However, such information is rarely available to the lessee considering the sensitive nature of the information to the lessor and the potential impact it could have on existing or future lease negotiations. Accordingly, lessees and lessors will often use a different discount rate for the same lease.

Although a lessee might be able to reasonably estimate the elements required to calculate the rate implicit in the lease, it may not do so. If the rate implicit in the lease is not readily determinable, a lessee must use its incremental borrowing rate for purposes of classifying the lease and measuring the right-of-use asset and lease liability.

Question LG 3-20

When calculating the rate implicit in the lease, should the fair value of the residual asset be limited to the lease commencement date fair value of the underlying asset?

PwC response

Yes. Long standing practice has been that a lessor's estimate of the residual value of leased property should not exceed the fair value of the leased property at lease inception. However, a literal read of the definitions of "lease receivable" and "unguaranteed residual asset" in ASC 842 may suggest it is appropriate to not limit the estimated residual value to the underlying asset's fair value at lease commencement. This interpretation would result in a rate implicit in the lease that would consider future inflation in the asset's fair value. This would cause most leases to be classified as operating, even those designed to be sales. It also, in the case of a sales-type lease, would result in the recognition of estimated future increases in the value of the asset at the commencement date of the lease. We do not believe these would be appropriate results. Consequently, we believe current practice should continue and the estimated residual value of a leased asset should not exceed its fair value at lease commencement.

Question LG 3-21

Would it be appropriate for a lessor to use a negative discount rate?

PwC response

No. The FASB confirmed that they did not intend for the rate implicit in the lease to be less than zero.

Incremental borrowing rate

The ASC 842 Glossary provides the following definition of incremental borrowing rate.

Definition from ASC 842 Glossary

Incremental Borrowing Rate: 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.

ASC 842 requires a lessee to use a secured rate. Accordingly, the use of unsecured funding sources may not be considered, even when a lessee is not reasonably able to borrow all the funds necessary on a secured basis. The standard does not dictate the nature of the assets collateralizing the borrowing. We believe any form of collateral can be used to determine the incremental borrowing rate, as long as the borrowing is fully collateralized. Even though lessees must use a rate that is fully collateralized, a fully collateralized rate is not the same as a risk-free rate. Accordingly, lessees (other than nonpublic business entity lessees that elect to use a risk-free discount rate—see *Private company considerations* section below), must consider their particular credit characteristics (e.g., their credit profile) when determining their incremental borrowing rate for each lease.

The incremental borrowing rate is based on a borrowing with a term that is similar to the term of the associated lease. Therefore, when an entity is establishing the incremental borrowing rate based on a borrowing, it should ensure that the borrowing has similar payment terms as in the lease. For example, if the lease requires monthly payments, the borrowing should also have monthly payment terms. If the borrowing does not have monthly payments, then the appropriate adjustments to the rate should be made to make sure it approximates the payment terms in the lease.

When a lease includes renewal, termination, or purchase options, it is not clear whether options that are not determined to be reasonably certain of exercise (i.e., options not included in the lease term at the lease commencement date) should be considered. We believe a lessee may make an accounting policy election to either include or exclude options that are not reasonably certain of exercise when determining the term of the borrowing. While the lease term determined at lease commencement (i.e., exclusive of any options not reasonably certain of exercise) is an acceptable term to consider when determining the incremental borrowing rate, we believe the existence of options to renew or terminate a borrowing arrangement would affect the rate a lender would charge irrespective of whether or not the options are reasonably certain of exercise. Accordingly, we believe the consideration of all options in an arrangement, whether reasonably certain of exercise or not, is appropriate when determining the incremental borrowing rate and consistent with the definition and principal of the rate.

Question LG 3-22

Is a lessee limited by a loan-to-value ratio when determining the incremental borrowing rate?

PwC response

No. The loan-to-value ratio would be relevant if the collateral was limited to the right-of-use asset. However, since we believe the standard permits the use of any collateral for determining the incremental borrowing rate and the lessee must assume its borrowing is 100% collateralized, the loan-to-value ratio is irrelevant.

Question LG 3-23

Should a lessee assume the collateralized borrowing is recourse or non-recourse?

PwC response

A lessee should assume the lender has recourse to the other assets of the lessee. This assumption may result in a lower incremental borrowing rate when the lessee has sufficient other assets (e.g., a high credit quality corporation). However, if the entity has little to no other assets (e.g., a special purpose entity with no other significant assets), this assumption may have little to no impact. In either scenario, lessee specific facts and circumstances should be considered when determining the incremental borrowing rate.

Example LG 3-17 illustrates how a lessee might determine the incremental borrowing rate.

EXAMPLE LG 3-17

Incremental borrowing rate – renewal option

Lessee Corp enters into a lease of equipment with Lessor Corp. Lease payments are $100,000 per year (payable in equal monthly installments). The lease has a noncancellable term of 3 years with a 2 year renewal option. At lease commencement, Lessee Corp concludes the renewal option is not reasonably certain of exercise (i.e., the lease term is 3 years).

At lease commencement, Lessee Corp obtains the following rate quotes from its third-party lender to borrow on a fully collateralized basis:

- 5% interest rate to borrow $300,000 for a 3-year term (payable in equal monthly installments)
- 5.5% interest rate to borrow $300,000 for a 3-year term with an option to borrow an additional $200,000 at the end of 3 years for an additional 2 years (payable in equal monthly installments).

Assume Lessee Corp concludes the rates are reasonable and consistent with prevailing market rates and its historical borrowings.

Which rate should Lessee Corp conclude represents the incremental borrowing rate?

Analysis

It depends. If Lessee Corp's accounting policy is to utilize the lease term at the lease commencement date (i.e., 3 years), the incremental borrowing rate of 5% would be appropriate.

If Lessee Corp's accounting policy is to utilize the lease term inclusive of the renewal option, the incremental borrowing rate of 5.5% would be appropriate. This rate considers that a lender would adjust the rate to reflect the option in the arrangement to renew the borrowing for an additional 2 years even though the renewal option was not determined to be reasonably certain of exercise at the lease commencement date. Generally, the inclusion of a renewal option will increase the incremental borrowing rate, resulting in the recognition of a smaller right-of-use asset and lease liability.

Regardless of the accounting policy election made, Lessee Corp should apply the policy consistently to all leases.

Portfolio discount rate

Lessees and lessors may apply a single discount rate to a portfolio of leases if they can conclude that its application does not create a material difference when compared to individually determined discount rates applied to each of the leases in the portfolio. While a reporting entity is not required to quantitatively demonstrate immateriality, it should be able to demonstrate that the leases in the portfolio have similar characteristics, such that it is reasonable to expect that the application of the portfolio-level discount rate will not materially differ from the application of discrete discount rates at the individual lease level. When assessing materiality, reporting entities should also consider whether a small change in the discount rate could result in different lease classification, such as when the lease payments are close to substantially all of the fair value of the underlying assets. Example LG 3-18 demonstrates this concept.

EXAMPLE LG 3-18

Discount rate – portfolio discount rate

Lessee Corp enters into 20 separate leases with Lessor Corp for a fleet of similar vehicles; each vehicle is of similar make and model, although certain features may vary (e.g., interior, radio, electronics). Each lease has a term of three years. Depending on the vehicle's particular features, annual fixed lease payments range from $3,750 to $4,000. There are no purchase options or renewal options.

Can Lessee Corp and Lessor Corp apply a single discount rate to the portfolio of leases?

Analysis

Assuming the underlying assets are similar, have similar lease terms, the value and range of lease payments do not vary greatly, interest rates have remained stable throughout the evaluation period, and that the lease payments do not approach substantially all of the fair value of the underlying assets, it is reasonable to conclude that the application of a single portfolio-level discount rate would not create a material difference in classification when compared to applying individually determined discount rates to each of the leases in the portfolio.

Question LG 3-24

Would it be appropriate for a subsidiary to use the incremental borrowing rate of its parent?

PwC response

It depends. We believe it may be acceptable for a subsidiary to use its parent's incremental borrowing rate if the subsidiary can demonstrate that the lessor looked to the parent's credit standing when negotiating lease terms. This would be evident if the parent guarantees the subsidiary's lease. Using a reasonable lender standard (i.e., what knowledge would a reasonable lender have when pricing debt), we believe this assertion can also be substantiated when one of the following factors are present:

- The parent has a central treasury function with cash pooling arrangements between the parent and all subsidiary lessees; the parent regularly "sweeps" cash in and out to centrally manage liquidity
- The lease is contractually linked to other general parent obligations
- The lease includes covenants that are tied to the creditworthiness of the parent
- The parent's internal funding arrangements provide a full backstop for the lease obligation of the subsidiary lessee

Private company considerations

ASC 842-20-30-3 provides a practical expedient for entities that are not public business entities, which allows a lessee to use a risk-free rate for a period comparable to the lease term. Since a risk-free rate is lower than an incremental borrowing rate for a specific entity, it will result in a higher lease liability and right-of-use asset. Use of a risk-free rate is an accounting policy election and was originally required to be applied consistently for all leases upon election. However, in response to concerns raised in the post implementation review, to provide more flexibility and reduce implementation costs, in November 2021, the FASB issued ASU 2021-09, *Discount Rate for Lessees That Are Not Public Business Entities*. Upon adoption, ASU 2021-09 permits entities other than public business entity lessees to apply this election to leases by class of underlying asset, rather than to all leases. Lessees choosing this election should, nevertheless, use the rate implicit in the lease when it is readily determinable. See FSP 14.2.3.1 for disclosure requirements, and LG 9.11 for the effective date and transition requirements, of ASU 2021-09.

The expedient to use a risk-free rate may only be elected by lessees that are not public business entities. Other lessees may not use a risk-free rate in lease classification or measurement.

3.3.4.7 Collectibility (lessors)

Lessors are required to evaluate whether lease payments, and any amount necessary to satisfy a residual value guarantee, are probable of collection, as discussed in ASC 842-30-25-3 for sales-type leases. A sales-type lease is similar to a sale of the underlying asset. As such, when there is significant concern regarding the collectibility of payments due under the terms of the contract, sale treatment may be delayed.

ASC 842-30-25-3

The guidance in paragraphs 842-30-25-1 through 25-2 notwithstanding, if collectibility of the lease payments, plus any amount necessary to satisfy a residual value guarantee provided by the lessee, is not probable at the commencement date, the lessor shall not derecognize the underlying asset but shall recognize lease payments received–including variable lease payments–as a deposit liability until the earlier of either of the following:

a. Collectibility of the lease payments, plus any amount necessary to satisfy a residual value guarantee provided by the lessee, becomes probable. If collectibility is not probable at the commencement date, a lessor shall continue to assess collectibility to determine whether the lease payments and any amount necessary to satisfy a residual value guarantee are probable of collection.

b. Either of the following events occurs:

    1. The contract has been terminated, and the lease payments received from the lessee are nonrefundable.

    2. The lessor has repossessed the underlying asset, it has no further obligation under the contract to the lessee, and the lease payments received from the lessee are nonrefundable.

The term “probable” is defined in US GAAP as “likely to occur,” and is generally interpreted as at least a 75% likelihood. A lessor’s assessment of probability of collection should be performed at lease commencement and reflect both the lessee’s ability and intent to pay as amounts become due considering all relevant facts and circumstances. See RR 2.6.1.5 for additional information on assessing the probability of collection.

If a lessor concludes at lease commencement that the lease meets the criteria to be classified as a sales-type lease, but collection of lease payments or any amount due to satisfy a residual value guarantee is not probable, the lessor should not derecognize the asset or recognize any selling profit. Any lease payments received should be recorded as a deposit liability until either of the criteria outlined in ASC 842-30-25-3 occurs. See LG 4.3.1 for guidance addressing how to account for a lease once the collectibility criteria are met.

Direct financing leases should be classified as an operating lease if lease payments, plus any amount necessary to satisfy a residual value guarantee, including third party guarantees, are not probable of collection at lease commencement. The lessor cannot classify the lease as a direct financing lease because the conversion of the lessor’s asset risk to credit risk (which occurs when a lessor effectively transfers the risks and rewards of ownership of the underlying asset to the lessee) is nonsubstantive.

Even when a lease is classified as an operating lease, the lessor should still assess the collectibility of payments. At lease commencement, if a lessor determines that operating lease payments are not probable of collection, the recognition of lease income is limited to the lesser of the following:

- Lease income that would have been recorded to date (i.e., straight-line rental income), plus variable lease payments
- Lease payments, including variable lease payments, received to date

3.3.5 Underlying asset is of a specialized nature

A lease of an underlying asset that 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 should be classified as a sales-type or direct financing lease by the lessor. This is because a lessor would be expected to price the lease to ensure it receives a return of its initial investment plus interest from the lessee. For example, if a lessor invests in the construction of a gas pipeline that will connect land owned by the lessee to a main pipeline and the pipeline has no alternative use beyond the lessee’s need to transport gas, the lessor would be expected to price the lease to ensure a return during the noncancellable term of the lease.

The evaluation of whether an underlying asset is expected to have an alternative use to the lessor at the end of the lease term should consider any contractual restrictions and practical limitations on the lessor’s ability to change or redirect the use of the underlying asset, as discussed in ASC 842-10-55-7.

ASC 842-10-55-7

In assessing whether an underlying asset has an alternative use to the lessor at the end of the lease term in accordance with paragraph 842-10-25-2(e), an entity should consider the effects of contractual restrictions and practical limitations on a lessor’s ability to readily direct that asset for another use (for example, selling it or leasing it to an entity other than the lessee). A contractual restriction on a lessor’s ability to direct an underlying asset for another use must be substantive for the asset not to have an alternative use to the lessor. A contractual restriction is substantive if it is enforceable. A practical limitation on a lessor's ability to direct an underlying asset for another use exists if the lessor would incur significant economic losses to direct the underlying asset for another use. A significant economic loss could arise because the lessor either would incur significant costs to rework the asset or would only be able to sell or re-lease the asset at a significant loss. For example, a lessor may be practically limited from redirecting assets that either have design specifications that are unique to the lessee or that are located in remote areas. The possibility of the contract with the customer being terminated is not a relevant consideration in assessing whether the lessor would be able to readily direct the underlying asset for another use.

3.4 Application of the "reasonably certain" threshold

Reasonably certain should be considered a high threshold. While there are no bright lines, the FASB has indicated that the threshold is similar to "reasonably assured" in existing GAAP, which implies a probability of 75%. An assessment of whether a lessee is reasonably certain to exercise a renewal, termination, or purchase option should consider the substance rather than the legal form of the contract.

An entity should assess whether it is reasonably certain that the lessee will exercise an option by considering all factors relevant to that assessment, including contract-, asset-, market-, and entity-based factors. Certain factors, such as economic penalties, may make exercise of a renewal, termination, or purchase option reasonably certain of exercise. Factors to consider include:

- Whether the purpose or location of the asset is unique
- The availability of comparable replacement assets
- For real estate leases, the cost of moving to another location and any related disruption to operations
- For equipment leases, the cost of any disruption to operations that would be experienced by changing equipment
- The contractual terms associated with extending or terminating the lease term; for example, the lease payments during a renewal period, any termination payments, and whether those payments are fixed, variable, or contingent
- The importance of the leased asset to the lessee's operations; for example, a headquarters building might be so closely associated with the lessee's image that it makes the possibility of relocation remote, or a particular facility or unit of equipment might be so integral to a manufacturing process that either purchase or continuation of the lease is reasonably certain
- Leasehold improvements or other assets whose value would be impaired if the lessee were to relocate or cease use of the leased asset
- Punitive tax consequences when an option is exercised (or not exercised) to purchase the underlying asset, renew the lease term, or terminate the lease prior to the stated expiration date

Depending on the information available, a lessor and a lessee may arrive at different conclusions as to whether certain options appear reasonably certain to be exercised. Lessors will typically have less knowledge of lessee-specific factors, which may impact their analysis.

See LG 3.3.2 and LG 3.3.3 for information on economic penalties and purchase, renewal, and termination options. See LG 3.3.4.4 for information on how guarantees impact the assessment of this criterion. See ASC 842-10-55-26 for additional examples of economic factors to consider.

3.5 *Lessee classification examples*

Lessee classification is based on whether a lease is effectively a financed purchase or an arrangement to obtain usage rights to an asset for a specified period. If one or more of the classification criteria in ASC 842-10-25-2 are met, the lease should be classified as a finance lease by the lessee. If none of the criteria are met, the lease should be classified as an operating lease. The following examples illustrate some of the items that lessees will need to consider when evaluating lease classification:

- Finance leases: Example LG 3-19 and Example LG 3-20
- Operating leases: Example LG 3-21, Example LG 3-22, and Example LG 3-23

EXAMPLE LG 3-19

Lease classification – non-specialized digital imaging equipment lease (lessee)

Lessee Corp enters into a lease of non-specialized digital imaging equipment with Lessor Corp. The following table summarizes information about the lease and the leased assets.

Lease term	5 years, no renewal option
Economic life of the equipment	6 years
Purchase option	None
Annual lease payments	$1,100
Payment date	Annually on January 1
Lessee Corp's incremental borrowing rate	7% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp.
Other	◻ Title to the asset remains with Lessor Corp upon lease expiration ◻ The fair value of the equipment is $5,000; Lessee Corp does not guarantee the residual value of the equipment at the end of the lease term ◻ Lessee Corp pays for all maintenance of the equipment separate from the lease ◻ There are no initial direct costs incurred by Lessee Corp ◻ Lessor Corp does not provide any incentives

How should Lessee Corp classify the lease?

Analysis

Lessee Corp should assess the lease classification using the criteria outlined in ASC 842-10-25-2 and ASC 842-10-25-3.

Criteria	Analysis
Transfer of ownership	Ownership of the asset does not transfer to Lessee Corp by the end of the lease term.
Purchase option which the lessee is reasonably certain to exercise	The lease does not contain a purchase option.
Lease term is for the major part of the remaining economic life of the asset	Lessee Corp is utilizing the asset for approximately 83% of the economic life of the asset (5-year lease/6-year economic life), which is deemed to be a major part.
Sum of present value of lease payments and any residual value guarantee by the lessee amounts to substantially all of the fair value of the underlying asset	The present value of the lease payments (discounted at Lessee Corp's incremental borrowing rate of 7%) is $4,825. Therefore, the present value of the lease payments amounts to approximately 97% of the fair value of the leased asset ($4,825/$5,000), which is substantially all of the fair value of the leased asset.
Specialized nature	The digital imaging equipment is non-specialized and could be used by another party without major modifications.

Lessee Corp should classify the lease as a finance lease because the lease term is for the major part of the economic life of the equipment and the present value of the lease payments amounts to substantially all of the fair value of the underlying asset.

See Example LG 4-2 for an illustration of the initial recognition and measurement of this type of lease.

EXAMPLE LG 3-20

Lease classification – real estate lease with a purchase option (lessee)

Lessee Corp enters into a property (land and building) lease with Lessor Corp. The following table summarizes information about the lease and the leased asset.

Lease term	10 years
Renewal option	Five 5-year renewal options If exercised, the annual lease payments are reset to then current market rents.
Economic life of the property	40 years
Fair value of the leased property	$5,000,000
Purchase option	Lessee Corp has an option to purchase the property at the end of the lease term for $3,000,000.
Annual lease payments	The first annual lease payment is $500,000, with increases of 3% per year thereafter.
Payment date	Annually on January 1
Incentive	Lessor Corp gives Lessee Corp a $200,000 incentive for entering into the lease (payable at the beginning of year 2), which is to be used for normal tenant improvements.
Discount rate	Since both the lease payments required during the lease and the purchase option price are fixed, Lessee Corp can combine these cash flows with its estimate of the property's fair value to determine that the interest rate Lessee Corp incurs during the lease is 9.04%. However, because Lessee Corp cannot be sure of Lessor Corp's estimate of fair value or whether Lessor Corp realized any investment tax credits with respect to the property, this rate is not the rate implicit in the lease. Consequently, Lessee Corp compares the rate to other evidence of its borrowing rates in similar circumstances, and concludes that this rate is a reasonable estimate of its incremental borrowing rate.
Other	□ Title to the property remains with Lessor Corp upon lease expiration □ Lessee Corp does not guarantee the residual value of the real estate asset □ Lessee Corp pays for all maintenance, taxes, and insurance on the property separate from the lease □ There are no initial direct costs incurred by Lessee Corp

How should Lessee Corp classify the lease?

Analysis

Lessee Corp should assess the lease classification using the criteria outlined in ASC 842-10-25-2 and ASC 842-10-25-3.

Criteria	Analysis
Transfer of ownership	Ownership of the asset does not transfer to Lessee Corp by the end of the lease term.
Purchase option which the lessee is reasonably certain to exercise	The lease contains an option to purchase the property for $3,000,000, which is below the fair value of the real estate asset at lease commencement and its expected value at the date of exercise. Options to purchase real estate at a price below commencement date fair value are generally considered to be reasonably certain of exercise since real estate generally appreciates in value; therefore, a significant economic incentive to exercise the purchase option exists.
Lease term is for the major part of the remaining economic life of the asset	The lease term is 10 years. The five 5-year renewal options available to Lessee Corp are not reasonably certain of exercise (at lease commencement) because the renewal options require rent to be reset to market rates when exercised. Therefore, Lessee Corp is utilizing the asset for 25% of the economic life of the asset (10-year lease/40-year economic life), which is not deemed to be a major part.
Sum of present value of lease payments and any residual value guarantee by the lessee amounts to substantially all of the fair value of the underlying asset	The lease payments net of the incentive Lessor Corp pays Lessee Corp are $5,531,940 (see below for a schedule of payments). The present value of the lease payments (discounted at the rate Lessor Corp charges in the lease of approximately 9.04%) is $3,737,510. Because the purchase option is reasonably certain of being exercised, it should be included as a lease payment at the end of the lease term. Using the 9.04% rate Lessor Corp charges Lessee Corp, the present value of the purchase option is $1,262,490. Therefore, the present value of the lease payments represents 100% of the fair value of the leased asset (($3,737,510 + $1,262,490)/$5,000,000).
Specialized nature	Although the property is in a specific location, it could be used by another party without major modifications.

The following table shows the schedule of lease payments.

Date	Amount
Year 1	500,000
Year 2 *(515,000 – 200,000 lease incentive)*	315,000
Year 3	530,450
Year 4	546,364
Year 5	562,754
Year 6	579,637
Year 7	597,026
Year 8	614,937
Year 9	633,385
Year 10	652,387
Total	**$5,531,940**

Lessee Corp should classify the lease as a finance lease because, at lease commencement, the fixed price purchase option available to Lessee Corp at the end of the initial lease term (i.e., after 10 years) is reasonably certain to be exercised by Lessee Corp. As a result, Lessee Corp has effectively obtained control of the underlying asset. The lease also has payments equal to substantially all of the fair value of the underlying asset.

See Example LG 4-3 for an illustration of the initial recognition and measurement of this type of lease.

EXAMPLE LG 3-21

Lease classification – automobile lease (lessee)

Lessee Corp leases an automobile from Lessor Corp. The following table summarizes information about the lease and the leased asset.

Lease term	3 years, no renewal option
Economic life of the automobile	6 years
Purchase option	Lessee Corp has the option to purchase the automobile at fair market value upon expiration of the lease.
Monthly lease payments	$500
Payment date	Beginning of the month
Lessee Corp's incremental borrowing rate	6% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp.
Other	◻ Title to the automobile remains with Lessor Corp upon lease expiration ◻ The fair value of the automobile is $30,000; Lessee Corp does not guarantee the residual value of the automobile at the end of the lease term ◻ Lessee Corp pays for all maintenance of the automobile separate from the lease ◻ There are no initial direct costs incurred by Lessee Corp ◻ Lessor Corp does not provide any incentives

How should Lessee Corp classify the lease?

Analysis

Lessee Corp should assess the lease classification using the criteria outlined in ASC 842-10-25-2 and ASC 842-10-25-3.

Criteria	**Analysis**
Transfer of ownership	Ownership of the asset does not transfer to Lessee Corp by the end of the lease term.
Purchase option which the lessee is reasonably certain to exercise	At lease commencement, it is not reasonably certain that Lessee Corp will exercise the purchase option. Lessee Corp does not have a significant economic incentive to exercise the purchase option because the option is at fair value at the expiration of the lease.

Criteria	Analysis
Lease term is for the major part of the remaining economic life of the asset	Lessee Corp is utilizing the asset for 50% of the economic life of the asset (3-year lease/6-year economic life), which is not deemed to be a major part.
Sum of present value of lease payments and any residual value guarantee by the lessee amounts to substantially all of the fair value of the underlying asset	The present value of the lease payments (discounted at Lessee Corp's incremental borrowing rate of 6% because the rate charged in the lease is not readily determinable) is $16,518. Therefore, the present value of the lease payments amounts to approximately 55% of the fair value of the leased asset ($16,518/$30,000), which is not deemed to be substantially all of the fair value of the leased asset.
Specialized nature	The automobile is non-specialized and could be used by another party without major modifications.

Lessee Corp should classify the lease as an operating lease because none of the criteria in ASC 842-10-25-2 and ASC 842-10-25-3 have been met.

See Example LG 4-4 for an illustration of the initial recognition and measurement of this type of lease.

EXAMPLE LG 3-22

Lease classification – copier with lease and nonlease components (lessee)

Lessee Corp leases a copier from Lessor Corp. The following table summarizes information about the lease and the leased asset.

Lease term	3 years, no renewal option
Economic life of the copier	5 years
Purchase option	None
Annual lease payments	$500, which includes Lessor maintenance for the term of the lease. Lessor Corp normally leases the same copier for $475 per year and offers a maintenance contract for $75 per year.
Payment date	Annually on January 1
Lessee Corp's incremental borrowing rate	5.5% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp.

Other	◻ Title to the copier remains with Lessor Corp upon lease expiration ◻ The fair value of the copier is $2,000; Lessee Corp does not guarantee the residual value of the copier at the end of the lease term ◻ Lessee Corp pays $100 in legal fees related to the negotiation of the lease, which are treated as initial direct costs ◻ Lessor Corp does not provide any incentives

Lessee Corp has not made an accounting policy election to not separate the lease and nonlease components for this class of asset.

How should Lessee Corp classify the lease?

Analysis

Lessee Corp should first separate the contract into its lease and nonlease components. Per ASC 842-10-15-33, a lessee should allocate the consideration in a contract to the lease and nonlease components based on their relative standalone price, as shown here.

	Standalone price (A)	**Allocated % (A/$550) = (B)**	**Annual lease payment (C)**	**Allocated lease payment (B × C) = D**
Annual copier lease payment	$475	86.36%	$ 500	$432
Annual maintenance contract fee	75	13.64%	500	68
Total	**$550**	**100.00%**		**$500**

Lessee Corp should then assess the lease classification using the criteria outlined in ASC 842-10-25-2 and ASC 842-10-25-3.

Criteria	**Analysis**
Transfer of ownership	Ownership of the asset does not transfer to Lessee Corp by the end of the lease term.
Purchase option which the lessee is reasonably certain to exercise	The lease does not contain a purchase option.
Lease term is for the major part of the remaining economic life of the asset	Lessee Corp is utilizing the asset for 60% of the economic life of the asset (3-year lease/5-year economic life), which is not deemed to be a major part.

Criteria	Analysis
Sum of present value of lease payments and any residual value guarantee by the lessee amounts to substantially all of the fair value of the underlying asset	The present value of the lease payments allocated to the lease component (discounted at Lessee Corp's incremental borrowing rate of 5.5%) is $1,229. Therefore, the present value of the lease payments amounts to approximately 61% of the fair value of the leased asset ($1,229/$2,000), which is not deemed to be substantially all of the fair value of the leased asset.
Specialized nature	The copier is non-specialized and could be used by another party without major modifications.

Lessee Corp should classify the lease as an operating lease because none of the criteria in ASC 842-10-25-2 and ASC 842-10-25-3 have been met.

See Example LG 4-5 for an illustration of the initial recognition and measurement of this type of lease.

EXAMPLE LG 3-23

Lease classification – lease payments tied to an index (lessee)

Lessee Corp enters into a lease of equipment with Lessor Corp. The following table summarizes information about the lease and the leased assets.

Lease term	4 years, no renewal option
Economic life of the equipment	7 years
Purchase option	None
Annual lease payments	The first annual payment is $1,500. The annual payment increases each subsequent year by an amount equal to the prior year rent multiplied by the Prime Rate. For example, if the Prime Rate is 3%, then the lease payment would be $1,545 ($1,500 + ($1,500 × 3%)).
Payment date	Annually on January 1
Lessee Corp's incremental borrowing rate	8% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp.

Other	▫ Title to the asset remains with Lessor Corp upon lease expiration ▫ The fair value of the equipment is $10,000; Lessee Corp does not guarantee the residual value of the equipment at the end of the lease term ▫ Lessee Corp pays for all maintenance of the equipment separate from the lease ▫ There are no initial direct costs incurred by Lessee Corp ▫ Lessor Corp does not provide any incentives

Prime rate at the lease commencement date is 3%. The Prime Rate is expected to increase .25% each year (i.e., the Prime Rate is expected to be 3.25% at the beginning of year 2).

How should Lessee Corp classify the lease?

Analysis

Lessee Corp should assess the lease classification using the criteria outlined in ASC 842-10-25-2 and ASC 842-10-25-3.

Criteria	Analysis
Transfer of ownership	Ownership of the asset does not transfer to Lessee Corp by the end of the lease term.
Purchase option which the lessee is reasonably certain to exercise	The lease does not contain a purchase option.
Lease term is for the major part of the remaining economic life of the asset	Lessee Corp is utilizing the asset for 57% of the economic life of the asset (4-year lease/7-year economic life), which is not deemed to be a major part.
Sum of present value of lease payments and any residual value guarantee by the lessee amounts to substantially all of the fair value of the underlying asset	The variable lease payment should be included in fixed lease payments using the Prime rate at lease commencement. The total payments are $6,275. The present value of the lease payments (discounted at Lessee Corp's incremental borrowing rate of 8%) is $5,595. Therefore, the present value of the lease payments amounts to approximately 56% of the fair value of the leased asset ($5,595/$10,000), which is not deemed to be substantially all of the fair value of the leased asset.
Specialized nature	The equipment is non-specialized and could be used by another party without major modifications.

The following table shows the schedule of lease payments.

Date	Amount
Year 1	$1,500
Year 2	1,545
Year 3	1,591
Year 4	1,639
Total	**$6,275**

Lessee Corp should classify the lease as an operating lease because none of the criteria in ASC 842-10-25-2 and ASC 842-10-25-3 have been met.

See Example LG 4-6 for an illustration of the initial recognition and measurement of this type of lease.

3.6 Lessor classification examples

A lessor should determine lease classification based on whether the lease effectively represents a financing or a sale, as opposed to simply conveying usage rights, by determining whether the lease transfers substantially all of the risks and rewards of ownership of the underlying asset. Generally, this approach yields a conclusion that is consistent with existing US GAAP for direct financing leases, sales-type leases, and operating leases.

At lease commencement, a lessor should not recognize selling profit and revenue if the lease does not also transfer control of the underlying asset to the lessee. While this represents a change from existing US GAAP, it aligns with the concept of what constitutes a sale in the new revenue recognition standard.

The following examples illustrate some of the items that lessors will need to consider when classifying leases:

- Sales type lease: Example LG 3-24 and Example LG 3-25
- Operating lease: Example LG 3-26

EXAMPLE LG 3-24

Lease classification – non-specialized digital imaging equipment lease (lessor)

Lessor Corp enters into a lease of non-specialized digital imaging equipment with Lessee Corp. The following table summarizes information about the lease and the leased assets.

Lease term	5 years, no renewal option
Economic life of the equipment	6 years
Purchase option	None
Annual lease payments	$1,100
Payment date	Annually on January 1
Fair value of the leased equipment	$5,000
Lessor Corp's carrying value of the leased equipment	$4,500
Rate implicit in the lease	7.04%
Other	▫ Title to the asset remains with Lessor Corp upon lease expiration ▫ Lessee Corp does not guarantee the residual value of the equipment at the end of the lease term and Lessor Corp does not obtain any third-party residual value insurance ▫ Estimated fair value of the equipment at the end of the lease term is $250 ▫ Lessee Corp pays for all maintenance of the equipment separate from the lease ▫ There are no initial direct costs incurred by Lessee Corp ▫ Lessor Corp does not provide any incentives

How should Lessor Corp classify the lease?

Analysis

Lessor Corp should assess the lease classification using the criteria outlined in ASC 842-10-25-2 and ASC 842-10-25-3.

Criteria	Analysis
Transfer of ownership	Ownership of the asset does not transfer to Lessee Corp by the end of the lease term.
Purchase option which the lessee is reasonably certain to exercise	The lease does not contain a purchase option.
Lease term is for the major part of the remaining economic life of the asset	Lessee Corp is utilizing the asset for approximately 83% of the economic life of the asset (5-year lease/6-year economic life), which is deemed to be a major part.
Sum of present value of lease payments and any residual value guarantee by the lessee amounts to substantially all of the fair value of the underlying asset	The present value of the lease payments (discounted at the rate Lessor Corp charges in the lease of 7.04%) is $4,822. Therefore, the present value of the lease payments amounts to approximately 96% of the fair value of the leased asset ($4,822/$5,000), which is deemed to be substantially all of the fair value of the leased asset.
Specialized nature	The digital imaging equipment is non-specialized and could be used by another party without major modifications.

Lessor Corp should classify the lease as a sales-type lease because the lease term is for a major part of the economic life of the equipment and the present value of the lease payments amounts to substantially all of the fair value of the underlying asset. Accordingly, Lessee Corp has obtained control of the underlying asset, which is economically similar to Lessor Corp selling the asset to Lessee Corp.

See Example LG 4-7 for an illustration of the initial recognition and measurement of this type of lease.

EXAMPLE LG 3-25

Lease classification – real estate lease with a purchase option (lessor)

Lessor Corp enters into a property (land and building) lease with Lessee Corp. The following table summarizes information about the lease and the leased asset.

Lease term	10 years
Renewal option	Five 5-year renewal options If exercised, the annual lease payments are reset to then current market rents.
Economic life	40 years
Fair value of the property	$5,000,000

Lessor Corp's carrying value of the leased property	$5,000,000
Purchase option	Lessee Corp has an option to purchase the property at the end of the lease term for $3,000,000.
Annual lease payments	The first annual payment is $500,000, with increases of 3% per year thereafter.
Payment date	Annually on January 1
Incentive	Lessor Corp gives Lessee Corp a $200,000 incentive for entering into the lease (payable at the beginning of year 2), which is to be used for normal tenant improvements.
Rate implicit in the lease	Approximately 9.04%
Other	□ Title to the property does not automatically transfer to Lessee Corp upon lease expiration □ Lessee Corp does not guarantee the residual value of the real estate asset □ Lessee Corp pays for all maintenance, taxes, and insurance on the property separate from the lease □ There are no initial direct costs incurred by Lessor Corp

How should Lessor Corp classify the lease?

Analysis

Lessor Corp should assess the lease classification using the criteria outlined in ASC 842-10-25-2 and ASC 842-10-25-3.

Criteria	Analysis
Transfer of ownership	Ownership of the asset does not transfer to Lessee Corp by the end of the lease term.
Purchase option which the lessee is reasonably certain to exercise	The lease contains an option to purchase the property for $3,000,000, which is below the fair value of the real estate asset at lease commencement and its expected value at the date of exercise. Options to purchase real estate at a price below commencement date fair value are generally considered to be reasonably certain of exercise since real estate generally appreciates in value. Thus, a significant economic incentive to exercise the purchase option exists.
Lease term is for the major part of the remaining economic life of the asset	The lease term is 10 years; the five 5-year renewal options available to Lessee Corp are not reasonably certain of exercise (determined at lease commencement) because they require

Criteria	Analysis
	rent to be reset to market rates at the time of exercise. Therefore, Lessee Corp is utilizing the asset for 25% of the economic life of the asset (10-year lease/40-year economic life), which is not deemed to be a major part.
Sum of present value of lease payments and any residual value guarantee by the lessee amounts to substantially all of the fair value of the underlying asset	The lease payments net of the incentive Lessor Corp pays Lessee Corp are $5,531,940 (see below for a schedule of payments). The present value of the lease payments (discounted at the rate Lessor Corp charges in the lease of approximately 9.04%) is $3,737,510. Because the purchase option is reasonably certain of being exercised, it should be included as a lease payment at the end of the lease term. Using the rate Lessor Corp charges Lessee Corp (approximately 9.04%), the present value of the purchase option is $1,262,490. Therefore, the present value of the lease payments equals 100% of the fair value of the leased asset (($3,737,510 + $1,262,490)/$5,000,000).
Specialized nature	Although the property is in a specific location, it could be used by another party without major modifications.

The following table shows the schedule of lease payments.

Date	Amount
Year 1	500,000
Year 2 *(515,000 – 200,000 lease incentive)*	315,000
Year 3	530,450
Year 4	546,364
Year 5	562,754
Year 6	579,637
Year 7	597,026
Year 8	614,937
Year 9	633,385
Year 10	652,387
Total	**$5,531,940**

Lessor Corp should classify the lease as a sales-type lease because at lease commencement, Lessee Corp is reasonably certain to exercise its fixed-price purchase option at the end of the initial lease term (i.e., after 10 years). As a result, Lessee Corp has effectively obtained control of the underlying asset, which is economically similar to Lessor Corp selling the underlying asset to Lessee Corp. Due to the exercise price of the option, the lease would also result in payments equal to substantially all of the fair value of the underlying asset.

See Example LG 4-8 for an illustration of the initial recognition and measurement of this type of lease.

EXAMPLE LG 3-26

Lease classification – automobile lease (lessor)

Lessor Corp leases an automobile to Lessee Corp. The following table summarizes information about the lease and the leased asset.

Lease term	3 years, no renewal option
Economic life of the automobile	6 years
Fair value of the automobile	$30,000
Lessor Corp's carrying value of the automobile	$30,000
Purchase option	Lessee Corp has the option to purchase the automobile at fair market value upon expiration of the lease.
Monthly lease payments	$500
Payment date	Beginning of the month
Rate implicit in the lease	9.56%
Other	▫ Title to the automobile remains with Lessor Corp upon lease expiration ▫ The expected residual value of the automobile at the end of the lease term is $19,000; Lessee Corp does not guarantee the residual value of the automobile at the end of the lease term ▫ Lessee Corp pays for all maintenance of the automobile separately from the lease ▫ There are no initial direct costs incurred by Lessor Corp ▫ Lessor Corp does not provide any incentives

How should Lessor Corp classify the lease?

Analysis

Lessor Corp should assess the lease classification using the criteria outlined in ASC 842-10-25-2 and ASC 842-10-25-3.

Criteria	Analysis
Transfer of ownership	Ownership of the asset does not transfer to Lessee Corp by the end of the lease term.
Purchase option which the lessee is reasonably certain to exercise	At lease commencement, Lessee Corp is not reasonably certain to exercise the purchase option because it is at fair market value, which does not provide a significant economic incentive.
Lease term is for the major part of the remaining economic life of the asset	Lessee Corp is utilizing the asset for 50% of the economic life of the asset (3-year lease/6-year economic life), which is not deemed to be a major part.
Sum of present value of lease payments and any residual value guarantee by the lessee amounts to substantially all of the fair value of the underlying asset	The present value of the lease payments (discounted at the rate Lessor Corp charges in the lease of 9.56%) is $15,720. Therefore, the present value of the lease payments amounts to approximately 52% of the fair value of the leased asset ($15,720/$30,000), which is not deemed to be substantially all of the fair value of the leased asset.
Specialized nature	The automobile is non-specialized and could be used by another party without major modifications.

Lessor Corp should classify the lease as an operating lease because none of the criteria in ASC 842-10-25-2 or ASC 842-10-25-3 have been met.

See Example LG 4-10 for an illustration of the initial recognition and measurement of this type of lease.

Chapter 4: Accounting for leases—updated June 2021

4.1 Accounting for leases overview

This chapter addresses the initial and subsequent accounting for a lease by a lessor and a lessee, including impairment and derecognition.

While lease classification does not impact the initial recognition of leases on the balance sheet for a lessee, how a lease is classified will determine how lease expense is recognized in the income statement subsequent to initial recognition. For a lessor, the initial and subsequent recognition of a lease depends on its classification. LG 4.2 and LG 4.3 discuss the initial recognition and measurement for a lessee and a lessor. LG 4.4 and LG 4.5 discuss the impact of lease classification on the accounting subsequent to initial recognition. LG 4.6 and LG 4.7 discuss the impairment model to be used by lessees and lessors. Lease classification is discussed in LG 3.

The modification, remeasurement, and termination of a lease are discussed in LG 5.

4.2 Initial recognition and measurement – lessee

The leases standard requires lessees to record a right-of-use asset and a lease liability for all leases other than those that, at lease commencement, have a lease term of 12 months or less. A reporting entity can elect an accounting policy by class of underlying asset not to record such short-term leases on the balance sheet. See LG 2.2.1 for information on the short-term lease measurement and recognition exemption.

Similar to accounting policies in other areas of GAAP, reporting entities may be able to establish reasonable capitalization thresholds below which assets and liabilities related to a lease are not recognized. When establishing an appropriate capitalization threshold, a lessee should evaluate all relevant quantitative and qualitative factors impacting both the financial statements and the footnote disclosures, including quantitative information about a lessee's lease costs. This could result in a lower capitalization threshold than would be determined based on the financial statement effects alone.

We do not believe it is appropriate for a lessee to net the right-of-use asset and lease liability when establishing a capitalization threshold. We believe all financial statement line items should be evaluated individually and in the aggregate when establishing an appropriate threshold.

The following sections discuss the initial recognition and measurement of the right-of-use asset and lease liability for finance leases and operating leases.

4.2.1 Measuring the lease liability

On the lease commencement date, a lessee is required to measure and record a lease liability equal to the present value of the remaining lease payments, discounted using the rate implicit in the lease (or if that rate cannot be readily determined, the lessee's incremental borrowing rate). Lease payments used in measuring the lease liability are amounts due to the lessor excluding any payments that a lessee makes at or before lease commencement. As discussed in LG 3.3.4, there are six items that should be factored into measuring lease payments. Lease arrangements should be thoroughly reviewed to ensure that all applicable payments are being considered.

With some exceptions, the lease payments used to measure the lease liability should be the same as those used to determine lease classification. Two of these exceptions are:

- To classify a lease, a lessee should use all lease payments (i.e., including payments made at or before the commencement date), whereas only the remaining payments due should be used to measure the lease liability at lease commencement

- For lease classification purposes, the entire potential payment under a residual value guarantee should be included in the lease payments. The lease liability recorded at lease commencement should only include amounts probable of being owed by the lessee under residual value guarantees

See LG 3.3.4.6 and LG 3.3.4 for information on determining the discount rate and lease payments for lease classification purposes.

4.2.2 Measuring the right-of-use asset

ASC 842-20-30-5 provides guidance on measuring the right-of-use asset at the commencement date.

ASC 842-20-30-5

At the commencement date, the cost of the right-of-use asset shall consist of all of the following:

a. The amount of the initial measurement of the lease liability

b. Any lease payments made to the lessor at or before the commencement date, minus any lease incentives received

c. Any initial direct costs incurred by the lessee (as described in paragraphs 842-10-30-9 through 30-10).

The items added to the lease liability to determine the costs of the right-of-use asset are discussed in the following sections.

4.2.2.1 Payments/incentives occurring at or before commencement

Lease payments made prior to lease commencement (for use of the underlying asset) should be recorded as prepaid rent. This prepaid amount should then be reclassified to the right-of-use asset on the lease commencement date. Thus, the right-of-use asset is increased for any lease payments made by a lessee at or before the lease commencement date. See LG 3.3.4.2 for information on lease incentives.

4.2.2.2 Initial direct costs

Initial direct costs should be recorded as an increase in the lessee's right-of-use asset but should not be recorded as part of the lease liability.

Initial direct costs are incremental costs of a lease that would not have been incurred had the lease not been executed. Costs directly or indirectly attributable to negotiating and arranging the lease (e.g., external legal costs to draft or negotiate a lease or an allocation of internal legal costs) are not considered initial direct costs.

Figure LG 4-1 provides examples of costs included and excluded from initial direct costs.

Figure LG 4-1
Examples of costs included and excluded from initial direct costs

Included	Excluded
▫ Certain substantive incentive-based commissions (including payments to employees acting as selling agents) ▫ Lease documentation preparation costs incurred after the execution of the lease (e.g., regulatory and other filing fees) ▫ Legal fees that are contingent on successful execution of the lease ▫ Certain payments to existing tenants to move out ▫ Consideration paid for a guarantee of a residual asset by an unrelated third party	▫ Employee salaries (including commissions that are in-substance salaries) ▫ Internal engineering costs ▫ Negotiating lease term and conditions (including the preparation of drafts) ▫ Legal fees for services rendered before the execution of the lease ▫ Advertising ▫ Other origination efforts ▫ Depreciation ▫ Costs related to an idle asset

Any costs that would have been incurred even if the lessee or the lessor failed to execute the lease are not incremental costs and should be excluded from initial direct costs. Determining whether a payment is an incremental cost may depend on the facts and circumstances. For example, ASC 842-10-55-240 through ASC 842-10-55-242 provides an example in which external legal fees are excluded from initial direct costs because the lessee would be required to pay its attorneys for negotiating the lease even if the lease were not executed. However, when a lessee and lessor execute a legally-binding lease commitment prior to drafting the lease agreement, legal fees for drafting may be incremental costs that can be accounted for as initial direct costs.

Sales tax payments

Some leases of equipment require that the lessee make sales tax payments directly to a taxing authority. The specifics of each arrangement vary greatly by jurisdiction. Certain sales taxes may be considered lessee costs. If this is the case, the sales tax payment is not a lease payment. We believe that a lessee must carefully assess when the legal obligation arises for the sales tax in order to determine if the amount should be recorded as an initial direct cost.

If a legal obligation that requires the lessee to pay sales tax arises at lease commencement, it should be accounted for as a liability and an initial direct cost. For example, if a lessee enters into a 5-year lease with a rent payment of $100 per year and is obligated to pay $8 as sales tax per year to the taxing authority whether or not the lease is cancelled, the lessee should record $40 ($8 per year × 5 years, ignoring present value for example purposes) as a separate liability (i.e., not a lease liability) and initial direct costs at the lease commencement date.

If the legally obligating event to pay sales tax occurs over time, sales tax should be accounted for as incurred. For example, if the rent is billed every month (whether at the beginning or end of the month), sales tax should be expensed in that month, except that sales tax for any rent billed at commencement date should be accounted for as an initial direct cost.

Question LG 4-1 addresses minimum annual guarantee payment arrangements.

Question LG 4-1

Lessee Corp enters into a five-year real estate lease with a minimum annual guarantee (MAG) payment structure in each year of the lease. The MAG amount is contractually set for the first year and is known at lease commencement. For each subsequent year, the MAG amount is reset based on a percentage of sales in the prior year. The reset MAG amount can go up and down compared to the prior year. There is no floor.

How should Lessee Corp account for the MAG payment structure?

PwC response

We believe the first year's MAG amount is the only in-substance fixed payment in the arrangement. Therefore, at commencement, Lessee Corp should calculate the lease liability and right-of-use asset based on the present value of the first year's MAG amount. We further believe that Lessee Corp should account for all payments resulting from future MAG resets similar to variable lease payments that do not depend on an index or a rate. Although the MAG is established at the end of the preceding year, it is not incurred until the subsequent year. Therefore, Lessee Corp should recognize future MAG resets in the period in which the obligation for those payments is incurred. Since the only fixed payment is the first year's MAG at lease commencement, Lessee Corp will not have a lease liability on its books for the remaining lease term after the first year. The right-of-use asset will be amortized over the entire lease term.

4.2.2.3 Examples – lessee initial recognition and measurement

Example LG 4-1, Example LG 4-2, Example LG 4-3, Example LG 4-4, Example LG 4-5, and Example LG 4-6 illustrate the measurement of a right-of-use asset and a lessee's accounting for leases.

EXAMPLE LG 4-1

Measuring the right-of-use asset

Lessee Corp and Lessor Corp execute a 10-year lease of a railcar with the following terms on January 1, 20X9:

- The lease commencement date is February 1, 20X9.
- Lessee Corp must pay Lessor Corp the first monthly rental payment of $10,000 upon execution of the lease.
- Lessor Corp will pay Lessee Corp a $50,000 cash incentive to enter into the lease payable upon lease execution.

Lessee Corp incurred $1,000 of initial direct costs, which are payable on February 1, 20X9.

Lessee Corp calculated the initial lease liability as the present value of the remaining unpaid lease payments discounted using its incremental borrowing rate because the rate implicit in the lease could not be readily determined; the initial lease liability is $900,000.

How would Lessee Corp measure the right-of-use asset and record this lease?

Analysis

Lessee Corp would measure the right-of-use asset as follows:

Initial measurement of lease liability	$900,000
Lease payments made to Lessor Corp before the commencement date (i.e., before the first lease payment)	10,000
Lease incentive received from Lessor Corp at lease execution date	(50,000)
Initial direct costs	1,000
Initial measurement of right-of-use asset	$861,000

On January 1, 20X9 (the lease execution date), Lessee Corp would record the following journal entries:

Dr. Prepaid rent	$10,000	
Cr. Cash		$10,000

To record the initial lease payment due at lease inception

Dr. Cash	$50,000	
Cr. Lease incentive		$50,000

To record receipt of the lease incentive from the lessor.

On February 1, 20X9 (the lease commencement date), Lessee Corp would record the following journal entries:

Dr. Right-of-use asset	$900,000	
Cr. Lease liability		$900,000

To record the right-of-use asset and lease liability

Dr. Lease incentive	$50,000	
Cr. Right-of-use asset		$50,000

To reclassify the lease incentive as an offset to the right-of-use asset

Dr. Right-of-use asset	$10,000	
Cr. Prepaid rent		$10,000

To reclassify the prepaid rent as an offset to the right-of-use asset

Dr. Right-of-use asset	$1,000	
Cr. Accrued expenses		$1,000

To record the initial direct costs

EXAMPLE LG 4-2

Finance lease initial recognition – non-specialized digital imaging equipment lease (lessee)

Lessee Corp enters into a lease of non-specialized digital imaging equipment with Lessor Corp on January 1, 20X9. The following table summarizes information about the lease and the leased assets.

Lease term	5 years, no renewal option
Remaining economic life of the leased equipment	6 years
Purchase option	None
Annual lease payments	$1,100
Payment date	Annually on January 1 (first payment made at lease commencement)
Lessee Corp's incremental borrowing rate	7% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp.
Other	□ Title to the asset remains with Lessor Corp upon lease expiration □ The fair value of the equipment is $5,000 at commencement; Lessee Corp does not guarantee the residual value of the equipment at the end of the lease term □ Lessee Corp pays for all maintenance of the equipment separate from the lease □ There are no initial direct costs incurred by Lessee Corp □ Lessor Corp does not provide any incentives

How would Lessee Corp measure and record this lease at commencement?

Analysis

Based on the facts Lessee Corp could reasonably conclude that the lease is a finance lease as the lease term is a major part of the remaining economic life of the equipment (see LG 3.3 for lease classification criteria).

Lessee Corp would first calculate the lease liability as the present value of the four remaining unpaid annual fixed lease payments of $1,100 discounted at Lessee Corp's incremental borrowing rate of 7%; this amount is $3,725.

The right-of-use asset is equal to the lease liability plus the $1,100 rent paid on the lease commencement date.

Lessee Corp would record the following journal entry on the lease commencement date.

Dr. Right-of-use asset	$4,825	
Cr. Lease liability		$3,725
Cr. Cash		$1,100

See Example LG 4-11 for an illustration of the subsequent measurement and recognition for this fact pattern.

EXAMPLE LG 4-3

Finance lease recognition – real estate lease with a purchase option (lessee)

Lessee Corp enters into a property (land and building) lease with Lessor Corp on January 1, 20X9. The following table summarizes information about the lease and the leased asset.

Lease term	10 years
Renewal option	Five 5-year renewal options If exercised, the annual lease payments are reset to then current market rents
Remaining economic life	40 years
Fair value of the leased property at commencement	$5,000,000
Purchase option	Lessee Corp has an option to purchase the property at the end of the lease term for $3,000,000. Lessee Corp is reasonably certain to exercise this option.
Annual lease payments	The first annual lease payment is $500,000, with increases of 3% per year thereafter (see schedule of lease payments below).
Payment date	Annually on January 1 (first payment made at lease commencement)

Incentive	Lessor Corp gives Lessee Corp a $200,000 incentive for entering into the lease (payable at the beginning of year 2), which is to be used for normal tenant improvements.
Lessee Corp's incremental borrowing rate	9.04% The rate that Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp.
Other	◻ Title to the property does not automatically transfer to Lessee Corp upon lease expiration ◻ Lessee Corp does not guarantee the residual value of the real estate asset ◻ Lessee Corp pays for all maintenance, taxes, and insurance on the property separate from the lease ◻ There are no initial direct costs incurred by Lessee Corp

The schedule of lease payments (excluding the purchase option) is shown below.

Date	**Amount**
Year 1 (paid at commencement)	$500,000
Year 2 ($515,000 – $200,000 lease incentive)	315,000
Year 3	530,450
Year 4	546,364
Year 5	562,754
Year 6	579,637
Year 7	597,026
Year 8	614,937
Year 9	633,385
Year 10	652,387
Total	**$5,531,940**

How would Lessee Corp measure and record this lease at commencement?

Analysis

Based on the facts Lessee Corp could reasonably conclude that the lease is a finance lease because the fixed price purchase option is reasonably certain to be exercised (see LG 3.3 for lease classification criteria).

Lessee Corp would first calculate the lease liability as the present value of the remaining unpaid annual lease payments, less the lease incentive paid in year 2, plus the exercise price of the purchase option using a discount rate of 9.04%.

PV of annual lease payments, less lease incentive	$3,237,510
PV of purchase option at end of lease term	1,262,490
Total lease liability	$4,500,000

The right-of-use asset is equal to the lease liability plus the $500,000 rent paid on the lease commencement date ($5,000,000).

Lessee Corp would record the following journal entry on the lease commencement date.

Dr. Right-of-use asset	$5,000,000	
Cr. Lease liability		$4,500,000
Cr. Cash		$500,000

See Example LG 4-12 for an illustration of the subsequent measurement and recognition for this fact pattern.

EXAMPLE LG 4-4

Lessee operating lease recognition – automobile lease

Lessee Corp leases an automobile from Lessor Corp on January 1, 20X9. The following table summarizes information about the lease and the leased asset.

Lease term	3 years, no renewal option
Remaining economic life of the automobile	6 years
Purchase option	Lessee Corp has the option to purchase the automobile at fair market value upon expiration of the lease.
Monthly lease payments	$500 (first payment made at lease commencement)
Payment date	Beginning of the month
Lessee Corp's incremental borrowing rate	6% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp.
Other	▫ Title to the automobile remains with Lessor Corp upon lease expiration

	□ The fair value of the automobile is $30,000 at commencement; Lessee Corp does not guarantee the residual value of the automobile at the end of the lease term □ Lessee Corp pays for all maintenance of the automobile separate from the lease □ There are no initial direct costs incurred by Lessee Corp □ Lessor Corp does not provide any incentives

How would Lessee Corp measure and record this lease at commencement?

Analysis

Based on the facts Lessee Corp could reasonably conclude that this lease is an operating lease as none of the criteria for finance lease classification are met (see LG 3.3 for lease classification criteria).

Lessee Corp would first calculate the lease liability as the present value of the remaining unpaid monthly fixed lease payments discounted at Lessee Corp's incremental borrowing rate of 6%; this amount is $16,018.

The right-of-use asset is equal to the lease liability plus the $500 rent paid on the lease commencement date ($16,518). Lessee Corp would record the following journal entry on the lease commencement date.

Dr. Right-of-use asset	$16,518	
Cr. Cash		$500
Cr. Lease liability		$16,018

See Example LG 4-13 for an illustration of the subsequent measurement and recognition for this fact pattern.

EXAMPLE LG 4-5

Lessee operating lease recognition

Lessee Corp leases a copier from Lessor Corp on January 1, 20X9. The following table summarizes information about the lease and the leased asset.

Lease term	3 years, no renewal option
Remaining economic life of the copier	5 years
Purchase option	None
Annual lease payments	$500, which includes Lessor Corp maintenance for the term of the lease

	Lessor Corp normally leases the same copier for $475 per year and offers a maintenance contract for $75 per year.
Payment date	Annually on January 1 (first payment made at lease commencement)
Lessee Corp's incremental borrowing rate	5.5% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp.
Other	Title to the copier remains with Lessor Corp upon lease expiration The fair value of the copier is $2,000 at commencement; Lessee Corp does not guarantee the residual value of the copier at the end of the lease term Lessee Corp pays $100 in legal fees related to filing the executed lease with the regulatory authorities, which are treated as initial direct costs Lessor Corp does not provide any incentives

Lessee Corp has not made an accounting policy election to not separate the lease and nonlease components for this class of asset.

How would Lessee Corp measure and record this lease at commencement?

Analysis

The arrangement contains a copier lease (lease component) and maintenance (nonlease component). An allocation of the annual $500 fixed payment between the copier lease and maintenance would be made as follows:

	Standalone price (A)	**Relative % (A/$550) = (B)**	**Annual fixed payment (C)**	**Allocated annual payment (B × C)**
Annual copier lease payment	$475	86.4%	$500	$432
Annual maintenance contract fee	75	13.6%	$500	68
Total	**$550**	**100%**		**$500**

Based on the facts Lessee Corp could reasonably conclude that the lease is an operating lease as none of the criteria for finance lease classification are met (see LG 3.3 for classification criteria).

Lessee Corp would first calculate the lease liability as the present value of the remaining unpaid annual allocated lease payment amount of $432 discounted at Lessee Corp's incremental borrowing rate of 5.5%; this amount is $798.

The right-of-use asset is the sum of the lease liability, plus the $432 lease payment made on the lease commencement date and the initial direct costs paid by Lessee Corp ($100); this amount is $1,330 ($798 + $432+ $100).

Lessee Corp would record the following journal entry on the lease commencement date.

Dr. Right-of-use asset	$1,330	
Cr. Lease liability		$798
Cr. Cash		$532

EXAMPLE LG 4-6

Lessee operating lease recognition – lease payments tied to an index

Lessee Corp enters into a lease of equipment with Lessor Corp on January 1, 20X9. The following table summarizes information about the lease and the leased assets.

Lease term	4 years, no renewal option
Remaining economic life of the leased equipment	7 years
Purchase option	None
Annual lease payments	The first annual payment is $1,500 The annual payment increases each year by the prime rate on January 1st. For example, if the prime rate is 3% on January 1, 201X, then the lease payment for year two would be $1,545 ($1,500 + ($1,500 × 3%)).
Payment date	Annually on January 1 (first payment made at lease commencement)
Lessee Corp's incremental borrowing rate	8% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp.
Other	▫ Title to the asset remains with Lessor Corp upon lease expiration ▫ The fair value of the equipment is $10,000 at commencement; Lessee Corp does not guarantee the residual value of the equipment at the end of the lease term ▫ Lessee Corp pays for all maintenance of the equipment separate from the lease ▫ There are no initial direct costs incurred by Lessee Corp ▫ Lessor Corp does not provide any incentives

Prime rate at the lease commencement date is 3%. The lease payments based on the prime rate at commencement are:

Date	Amount
Lease commencement	$1,500
Year 2	1,545
Year 3	1,591
Year 4	1,639
Total	$6,275

How would Lessee Corp measure and record this lease at commencement?

Analysis

Based on the facts, Lessee Corp could reasonably conclude that the lease is an operating lease as none of the criteria for finance lease classification are met (see LG 3.3 for classification criteria).

Lessee Corp would first calculate the lease liability as the present value of the remaining unpaid fixed lease payments plus the variable lease payment (based on the Prime rate at the lease commencement date) discounted at Lessee Corp's incremental borrowing rate of 8%; this amount is $4,096. Even if the Prime rate is expected to increase each year, the lease payments must be calculated using the rate at lease commencement and the rate will only be updated upon certain lease remeasurement events (see LG 5).

The right-of-use asset is equal to the lease liability plus the first lease payment made at lease commencement ($5,596).

Lessee Corp would record the following journal entry on the lease commencement date.

Dr. Right-of-use asset	$5,596	
Cr. Lease liability		$4,096
Cr. Cash		$1,500

4.3 Initial recognition and measurement – lessor—updated September 2021

As discussed in LG 3, leases are classified by a lessor as either a sales-type, direct financing, or operating lease. While lessees are required to record a lease liability and right-of-use asset for all leases, the model applied by lessors depends on the type of the lease. The following sections discuss initial recognition for the lessor.

4.3.1 Sales-type lease

A lessor should classify a lease that meets any of the criteria in ASC 842-10-25-2 as a sales-type lease (see LG 3.3 for lease classification criteria). In a sales-type lease, the lessor transfers control of the underlying asset to the lessee. Accordingly, the lessor should derecognize the leased asset and record its net investment in the lease at lease commencement (consistent with the principle of a sale in ASC 606). As discussed in ASC 842-30-30-1, the net investment in the lease consists of the lease receivable and the unguaranteed residual asset.

The unguaranteed residual asset is the present value of the lessor's estimated value of the leased asset returned to it at the end of the lease term, less a residual value guarantee, if any. There is no unguaranteed residual asset for the lessor when the lessee retains the underlying asset at the end of the lease term, as would be the case when a lease either transfers ownership to the lessee or a purchase option is reasonably assured of exercise.

ASC 842-30-30-1 describes the measurement of a lessor's net investment in a sales-type lease.

ASC 842-30-30-1

At the commencement date, for a sales-type lease, a lessor shall measure the net investment in the lease to include both of the following:

a. The lease receivable, which is measured at the present value, discounted using the rate implicit in the lease, of:

    1. The lease payments (as described in paragraph 842-10-30-5) not yet received by the lessor

    2. The amount the lessor expects to derive from the underlying asset following the end of the lease term that is guaranteed by the lessee or any other third party unrelated to the lessor. The unguaranteed residual asset at the present value of the amount the lessor expects to derive from the underlying asset following the end of the lease term that is not guaranteed by the lessee or any other third party unrelated to the lessor, discounted using the rate implicit in the lease.

The lessor should recognize any profit or loss arising from the sale of the underlying asset (through the lease). See LG 4.3.1.1. for more details.

Initial direct costs should be recognized as an expense unless the fair value of the underlying asset equals its carrying amount (i.e., there is no selling profit or loss). When there is no selling profit or loss, the initial direct costs should be deferred and recognized over the lease.

4.3.1.1 Sales type lease — Selling profit/loss

At the lease commencement date, the lessor is required to calculate the selling profit or loss as (1) the fair value of the underlying asset (or the sum of lease receivable and any prepaid lease payments by lessee, if lower); minus (2) the carrying amount of the underlying asset net of any unguaranteed residual asset; minus (3) any deferred initial direct costs of the lessor. The sales price in a sales-type lease is assumed to be the fair value of the underlying asset unless the present value of the lease payments is lower than the fair value of the asset. This could be the case when the lease has an unguaranteed residual asset that reduces the receivable recognized at lease commencement. This should not have a significant impact on the selling profit or loss, however, because the present value of the unguaranteed residual asset is also subtracted from the carrying amount of the underlying asset (i.e., a cost of sales). See Example LG 4-7 for an illustration of how to calculate selling profit when a lease contains an unguaranteed residual value.

Variable payments

It is common for suppliers in certain industries to structure transactions with significant variable payments. Suppliers in these industries are willing to accept variability in payments because they believe such arrangements would be profitable overall and lower fixed payments can make an arrangement attractive to the customer.

There are instances when transactions with variable payments may qualify as a transfer of control to the customer under the new revenue recognition standard (ASC 606). Such transactions may also qualify as a sales-type lease under the new leases guidance. This is because the revenue standard states that the transfer of title is only one of the indicators for control being transferred to a customer.

Whether a transaction with variable payments is subject to the revenue guidance or the leases guidance may impact when revenue is recognized by a supplier. Under the leases standard, variable payments that do not depend on an index or rate are not recognized until the contingency is resolved. Under the new revenue recognition standard, variable payments may be recognized as revenue upfront (when earned) provided certain conditions are met.

When a transaction with variable payments qualifies as both a sale under the new revenue recognition standard and a sales-type lease under the new leases standard, the leases standard should be applied. This may lead to the recognition of a selling loss (i.e., a day-one loss) by the lessor even if the overall arrangement is expected to be profitable. In response to concerns raised in the post implementation review, the FASB published ASU 2021-05, which upon adoption requires a lessor to classify a lease with variable lease payments (that do not depend on a rate or index) as an operating lease at the lease commencement date if classifying the lease as a sales-type lease (or direct financing lease) would result in recognition of a selling loss. Operating lease lessors can elect an optional practical expedient to aggregate nonlease components that otherwise would have been accounted for under the new revenue standard with the associated lease component and account for the combined component under the revenue standard if certain conditions are met. See LG 9.11 for the effective date and transition requirements of ASU 2021-05. See Example LG 4-9 for an illustration of a lease with variable payments. See LG 2.4.4.1 for the component practical expedient available to lessors.

Presentation

Lease classification does not determine how selling profit or loss should be presented in a lessor's income statement. Presentation should be determined by the lessor's business model; when leases are used as an alternative means of realizing value from the goods that it would otherwise sell, a sales-type lease should be recorded as revenue and cost of goods sold. See FSP 14.3.2.1 for information on the presentation of selling profit or loss in the statement of comprehensive income.

4.3.1.2 Initial direct costs in a sales-type lease

The guidance for identifying initial direct costs is the same for a lessor as it is for a lessee. Additionally, the term "initial direct costs" under the new leases guidance is the same as incremental costs of obtaining a contract under the new revenue guidance. The two terms are intended to be applied in the same manner in terms of which costs get capitalized.

Initial direct costs may be more significant for a lessor because they are usually the party that solicits lessees as part of their sales activities, are often the party to engage attorneys to prepare the legal documents, and often pay commissions incurred in connection with execution of a lease. See LG 4.2.2.2 for information on initial direct costs and Figure LG 4-1 for the examples of costs included and excluded from initial direct costs.

A lessor should expense the initial direct costs associated with a sales-type lease unless the fair value of the underlying asset equals its carrying amount (i.e., there is no selling profit or loss). This accounting is similar to the accounting for a seller's costs in a contract for similar goods. See RR 11.2 for information on a seller's accounting for contract costs.

Initial direct costs incurred in connection with a sales-type lease with no selling profit or loss should be deferred and recognized over the lease term using a method that produces a constant periodic rate of return on the lease when combined with the interest income on the lease receivable and the residual asset (i.e., in the same manner as for a direct financing lease).

In arrangements that include both lease and nonlease components, the initial direct costs should be allocated to the various components and accounted for in accordance with the guidance applicable to each component. Initial direct costs may be treated differently depending upon the nature of the nonlease components.

4.3.1.3 Sales-type lease — Collectibility not probable

ASC 842-30-25-3 to ASC 842-30-25-6 describes how a lessor should recognize and measure a sales-type lease when collectibility of the lease receivable is not probable at the commencement date.

ASC 842-30-25-3

The guidance in paragraphs 842-30-25-1 through 25-2 notwithstanding, if collectibility of the lease payments, plus any amount necessary to satisfy a residual value guarantee provided by the lessee, is not probable at the commencement date, the lessor shall not derecognize the underlying asset but shall recognize lease payments received—including variable lease payments—as a deposit liability until the earlier of either of the following:

a. Collectibility of the lease payments, plus any amount necessary to satisfy a residual value guarantee provided by the lessee, becomes probable. If collectibility is not probable at the commencement date, a lessor shall continue to assess collectibility to determine whether the lease payments and any amount necessary to satisfy a residual value guarantee are probable of collection.

b. Either of the following events occurs:

    1. The contract has been terminated, and the lease payments received from the lessee are nonrefundable.

    2. The lessor has repossessed the underlying asset, it has no further obligation under the contract to the lessee, and the lease payments received from the lessee are nonrefundable.

ASC 842-30-25-4

When collectibility is not probable at the commencement date, at the date the criterion in paragraph 842-30-25-3(a) is met (that is, the date at which collectibility of the lease payments plus any amount necessary to satisfy a residual value guarantee provided by the lessee is assessed as probable), the lessor shall do all of the following:

a. Derecognize the carrying amount of the underlying asset

b. Derecognize the carrying amount of any deposit liability recognized in accordance with paragraph 842-30-25-3

c. Recognize a net investment in the lease on the basis of the remaining lease payments and remaining lease term, using the rate implicit in the lease determined at the commencement date

d. Recognize selling profit or selling loss calculated as:

   1. The lease receivable; plus

   2. The carrying amount of the deposit liability; minus

   3. The carrying amount of the underlying asset, net of the unguaranteed residual asset.

ASC 842-30-25-5

When collectibility is not probable at the commencement date, at the date the criterion in paragraph 842-30-25-3(b) is met, the lessor shall derecognize the carrying amount of any deposit liability recognized in accordance with paragraph 842-30-25-3, with the corresponding amount recognized as lease income.

When collectibility of the lease receivable from a sales-type lease is not probable at the original commencement date, the lessor should defer the recognition of the sale until collectibility becomes probable. This is consistent with the collectibility guidance in ASC 606, which similarly states that a supplier should defer recognition of a sale to a customer if collectibility of the consideration is not probable.

In such circumstances, a lessor should not derecognize the underlying assets at the lease commencement date, and should not recognize a net investment in the lease and selling profit or loss (other than initial direct costs). Instead, it should recognize all lease payments received as a deposit liability until the earlier of when collectibility becomes probable or the contract is terminated or completed and the lease payments it received are nonrefundable. Initial direct costs associated with the lease should be expensed at the original lease commencement date. During this period, the lessor should not recognize interest expense on the deposit liability, and it should continue to depreciate the underlying asset.

When collectibility subsequently becomes probable, a lessor should derecognize the carrying amount of the underlying asset and deposit liability from its balance sheet and recognize the net investment in the lease as well as any selling profit or loss. After making these adjustments, a lessor should follow the subsequent measurement guidance for a sales-type lease (see LG 4.5.1).

If the collectibility of lease payments or guaranteed residual value do not become probable before the contract is terminated, or it repossesses the underlying asset and the lease payments are nonrefundable, a lessor should derecognize the carrying amount of any deposit liability recognized with the corresponding amount recognized as lease income. The lessor should continue to apply the impairment guidance in ASC 360 to the underlying asset.

ASC 842-30-25-6

If collectibility is probable at the commencement date for a sales-type lease or for a direct financing lease, a lessor shall not reassess whether collectibility is probable. Subsequent changes in the credit risk of the lessee shall be accounted for in accordance with the impairment guidance applicable to the net investment in the lease in paragraph 842-30-35-3.

If the collectibility of lease payments and any residual value guarantee is deemed to be probable at the commencement date, any subsequent deterioration in the lessee's credit quality will not require a lessor to change its accounting or classification of a lease. However, the lessor's net investment in the lease would be subject to the financial instruments impairment guidance in ASC 310 and any deterioration in the credit quality of the lessee should be captured through an impairment charge. However, a lessor should consider the guidance for credit losses in ASC 326, *Financial Instruments - Credit Losses*, once that guidance is adopted. See LG 4.7 for further discussion on impairment.

4.3.1.4 Examples – lessor accounting for sales-type leases

Example LG 4-7 and Example LG 4-8 illustrate a lessor's accounting for a sales-type lease.

EXAMPLE LG 4-7

Sales-type lease recognition – non-specialized digital imaging equipment lease (lessor)

Lessor Corp enters into a lease of non-specialized digital imaging equipment with Lessee Corp on 1/1/X9. Lessor Corp is a manufacturer of digital imaging equipment that uses both direct sales and leases as a means of selling its products. The following table summarizes information about the lease and the leased assets.

Lease term	5 years, no renewal option
Remaining economic life of the leased equipment	6 years
Purchase option	None
Annual lease payments	$1,100
Payment date	Annually on January 1 (first payment is made at lease commencement)
Fair value of the leased equipment at commencement	$5,000
Lessor Corp's carrying value of the leased equipment	$4,500

Rate implicit in the lease	7.04%
Other	□ Title to the asset remains with Lessor Corp upon lease expiration □ Lessee Corp does not guarantee the residual value of the equipment at the end of the lease term and Lessor Corp does not obtain any third-party residual value insurance □ Estimated fair value of the equipment at the end of the lease term is $250 □ Lessee Corp pays for all maintenance of the equipment separate from the lease □ There are no initial direct costs incurred by Lessor Corp □ Lessor Corp does not provide any incentives

How would Lessor Corp measure and record this lease at commencement?

Analysis

Based on the facts Lessor Corp could reasonably conclude that the lease is a sales-type lease as the lease term is a major part of the remaining economic life of the equipment (see LG 3 for lease classification criteria).

Lessor Corp would first determine the total net investment in the lease as the present value of the lease receivable and the unguaranteed residual asset.

- □ The present value of the lease receivable is equal to the present value of the remaining lease payments discounted at 7.04%; this amount is $3,722.
- □ The present value of the unguaranteed residual asset discounted at 7.04% is $178.
- □ Lessor Corp's net investment in the lease is $3,900 (the sum of the lease receivable ($3,722) and the unguaranteed residual asset ($178)).

To determine the selling profit or loss arising from the lease, Lessor Corp would calculate the difference between the fair value of the underlying asset (or the lease receivable plus any proceeds received at or before lease commencement, if lower) and the carrying amount of the underlying asset net of any unguaranteed residual asset. Since the present value of the lease receivable plus the upfront proceeds ($4,822) is lower than the fair value of the underlying asset ($5,000), the selling profit is calculated as follows:

Present value of the lease receivable	$3,722
Plus, the lease payment received at lease commencement	1,100
Less, the carrying value of leased asset ($4,500) net of unguaranteed residual asset ($178)	(4,322)
Selling profit	$500

Lessor Corp would record revenue at lease commencement equal to the lease receivable amount plus the lease payment received at lease commencement ($4,822). Cost of goods sold would be recorded as the difference between the carrying value of the leased asset ($4,500) and the discounted value of the unguaranteed residual asset ($178).

Lessor Corp would record the following journal entry on the lease commencement date.

Dr. Lease receivable	$3,722	
Dr. Cash	$1,100	
Dr. Unguaranteed residual asset	$178	
Dr. Cost of goods sold	$4,322	
Cr. Property, plant and equipment (leased asset)		$4,500
Cr. Revenue		$4,822

See Example LG 4-15 for an illustration of the subsequent measurement and recognition for this fact pattern.

EXAMPLE LG 4-8

Sales-type lease recognition – real estate with a purchase option (lessor)

Lessor Corp enters into a property (land and building) lease with Lessee Corp on January 1, 20X9. The following table summarizes information about the lease and the leased asset.

Lease term	10 years
Renewal option	Five 5-year renewal options If exercised, the annual lease payments are reset to then current market rents.
Remaining economic life	40 years
Fair value of the leased property at commencement	$5,000,000
Lessor Corp's carrying value of the leased property	$5,000,000
Purchase option	Lessee Corp has an option to purchase the property at the end of the lease term for $3,000,000. Lessee Corp is reasonably certain to exercise this option.
Annual lease payments	The first annual payment is $500,000, with increases of 3% per year thereafter (see schedule below).

Payment date	Annually on January 1 (first payment is made at lease commencement)
Incentive	Lessor Corp gives Lessee Corp a $200,000 incentive for entering into the lease (payable at the beginning of year 2), which is to be used for normal tenant improvements.
Rate implicit in the lease	Approximately 9.04%
Other	□ Title to the property does not automatically transfer to Lessee Corp upon lease expiration □ Lessee Corp does not guarantee the residual value of the real estate asset □ Lessee Corp pays for all maintenance, taxes, and insurance on the property separate from the lease □ There are no initial direct costs incurred by Lessor Corp

The schedule of lease payments (excluding the purchase option exercise price) is shown below.

Date	Amount
Lease commencement	$500,000
Year 2 ($515,000 – $200,000 lease incentive)*	315,000
Year 3	530,450
Year 4	546,364
Year 5	562,754
Year 6	579,637
Year 7	597,026
Year 8	614,937
Year 9	633,385
Year 10	652,387
Total	$5,531,940

**See FSP 14 for presentation considerations for the lease incentive receivable.*

Lessor Corp uses leases for the purposes of providing financing, therefore it presents any selling profit or loss in a single line item in the income statement. See FSP 14.3.2.1 for information on the presentation of selling profit or loss in the statement of comprehensive income.

How would Lessor Corp measure and record this lease at commencement?

Analysis

Based on the facts Lessor Corp could reasonably conclude that the lease is a sales-type lease because it grants Lessee Corp a fixed price purchase option to purchase the asset underlying the lease and Lessee Corp is reasonably certain to exercise that purchase option (see LG 3.3 for classification criteria).

Lessor Corp would first determine the total net investment in the lease by calculating the present value of the lease receivable and the unguaranteed residual asset.

- The present value of the lease receivable is $4,500,000. This is the present value of the remaining fixed lease payments, less the lease incentives payable to Lessee Corp, plus the exercise price of the purchase option discounted at approximately 9.04%, the rate implicit in the lease. The exercise price of the purchase option is included in the lease receivable because it is reasonably certain that Lessee Corp will exercise the option.

- Since it is reasonably certain that Lessee Corp will exercise its purchase option, Lessor Corp does not expect to derive any additional value from the underlying asset; therefore, the unguaranteed residual asset value is zero.

- Lessor Corp's net investment in the lease is $4,500,000 (the sum of the lease receivable ($4,500,000) and the unguaranteed residual asset ($0)).

Lessor Corp would record the following journal entry on the lease commencement date.

Dr. Lease receivable	$4,500,000	
Dr. Cash	$500,000	
Cr. Property, plant and equipment (leased asset)		$5,000,000

Example LG 4-9 illustrates a lessor's accounting for a lease with variable lease payments that result in a day-one loss under a sales-type lease classification (assuming the lessor has adopted ASU 2021-05).

EXAMPLE LG 4-9

Lessor's accounting for a lease with variable lease payments that result in a day-one loss under a sales-type lease classification (assuming the lessor has adopted ASU 2021-05)

Lessor Corp will install an x-ray machine in a hospital (customer/lessee) and maintain it for a period of five years. Lessor Corp can substitute the x-ray machine only in the event of malfunction, which is expected to be infrequent. The customer will make all operational decisions (e.g., decide in which department the x-ray machine will be used, hours of its operation) and its employees will operate the machine. The customer will be responsible for providing all of the consumables needed (e.g., x-ray films, chemicals). The customer will bear the risk of loss in the event of damage or theft and will be responsible for purchasing insurance to protect against physical loss of the machine.

As is customary in this industry, Lessor Corp does not intend to repossess the machine at the end of the term. Consequently, the customer may decide to continue to use the machine or scrap it after the five-year period.

The supply of x-ray machines is part of Lessor Corp's ongoing major or central operations. Other facts of the arrangement are:

Lease term	5 years (noncancellable)
Remaining economic life	5 years
Payments from the customer	$5/click of the x-ray machine to take an x-ray Fixed maintenance fee of $2,000/year for 5 years (payable at the end of each month)
Variable payments estimate during the term of the arrangement	$125,000
Fair value of the leased asset at commencement	$100,000
Lessor Corp's carrying value of the leased asset	$80,000
Estimated fair value of the leased asset at the end of 5 years	$0
Standalone price for leasing a similar asset for 5 years	$100,000
Standalone price for maintenance for 5 years	$10,000
Inception date and commencement date	January 1
Other	Collectibility of payments from the customer is probable

Lessor Corp has not made an accounting policy election to not separate the lease and nonlease components for this class of asset.

Lessor Corp has adopted ASU 2021-05, *Lessors – Certain Leases with Variable Lease Payments*.

How should Lessor Corp account for the lease component at commencement date?

Analysis

The arrangement contains two components - a lease component (the lease of the x-ray machine) and a nonlease component (the maintenance services).

The lease component qualifies as a sales-type lease because the lease term is for the major part of the remaining economic life of the X-ray machine (see LG 3.3 for lease classification criteria).

Contract consideration is $10,000 ($2,000 × 5), which is the fixed amount for maintenance over the five years. Contract consideration excludes the $5/click because it relates to the lease component and is a variable payment that does not depend on an index or a rate. Therefore, Lessor Corp would allocate the contract consideration between the components under the new leases guidance as follows:

Component	**Standalone price (A)**	**Allocation % (A/$110,000) (B)**	**Allocation of contract consideration (B*$10,000)**
Lease	$100,000	90.91%	$9,091
Maintenance	10,000	9.09%	909
Total	$110,000	100%	$10,000

The lease would be classified as a sales-type lease since the lease term equals the remaining economic life of the asset. However, in this example, the application of sales-type lease accounting would result in a day-one loss of $70,909 at commencement ($9,091 consideration allocated to the lease minus $80,000 carrying value of the leased asset) since the only fixed payments required under the contract total $10,000. As such, the lease must be classified as operating under ASU 2021-05, which this example assumes has been adopted by Lessor Corp.

As the lease is classified as an operating lease, Lessor Corp will continue to reflect the x-ray machine on its balance sheet at its carrying value and depreciate it in accordance with Lessor Corp's normal depreciation policy. See LG 4.5.2 for the subsequent accounting for an operating lease.Direct financing lease

4.3.2 *Direct financing lease*

When a lease is not a sales-type lease but meets the criteria to be classified as a direct financing lease (see LG 3.3 for lease classification criteria), the lease transaction effectively converts the lessor's risk arising from the underlying asset (that is, asset risk) into credit risk. Consequently, the most faithful representation of a lessor's involvement in a lease that transfers substantially all of the risks and rewards incidental to ownership of the underlying asset to a lessee is to recognize the lessor's financial net investment in the lease and recognize financial (interest) income on that net investment over the lease term.

As described in ASC 842-30-25-7, a lessor should derecognize the leased asset underlying a direct financing lease and record a net investment in the lease at lease commencement. The net investment in the lease should be measured in the same manner as a sales-type lease adjusted for selling profit and initial direct costs. See LG 4.3.1 for information on measuring the net investment in a sales-type lease. Any selling profit and initial direct costs should be deferred and included in the net investment in the lease. These amounts should be recognized over the lease term in a manner that will produce, when combined with the interest income on the lease receivable and the residual asset, a constant periodic rate of return on the lease (see ASC 842-30-55-31 through ASC 842-30-55-39 for an illustrative example). Selling losses should not be deferred. See LG 4.3.2.1 for the accounting for selling losses due to variable lease payments.

4.3.2.1 Direct financing lease — Initial measurement

ASC 842-30-30-2 provides guidance of the measurement of the net investment in a direct financing lease. (Note that ASC 842-30-30-1(a) and ASC 842-30-30-1(b) are reproduced in LG 4.3.1.)

ASC 842-30-30-2

At the commencement date, for a direct financing lease, a lessor shall measure the net investment in the lease to include the items in paragraph 842-30-30-1(a) through (b), reduced by the amount of any selling profit.

Selling profit is not recognized at the commencement of a direct financing lease because it does not transfer control of the underlying asset to the lessee. This treatment is consistent with the principle of a sale in ASC 606. However, when a lease meets the criteria to be classified as a direct financing lease, it transfers substantially all the risks and rewards of ownership of the underlying asset to one or more third parties and effectively converts the lessor's risk arising from the underlying asset into credit risk. Therefore, the most faithful representation of a lessor's involvement in such a lease is to recognize the lessor's financial net investment in the lease (excluding selling profit) and recognize selling profit as interest income on that net investment.

The different ways of measuring the net investment in a lease for a sales-type lease and a direct financing lease (i.e., a sales-type lease includes the selling profit recognized at commencement) results in the same total income but differences in the timing of income recognition. Another difference in the initial measurement of a net investment in a sales-type lease versus that recorded for a direct financing lease is the accounting for initial direct costs. In a sales-type lease, initial direct costs ordinarily are expensed as incurred and are excluded in the computation of the rate implicit in the lease. In a direct financing lease (and in a sales-type lease when the fair value of the underlying asset equals its carrying amount), the initial direct costs are deferred and included in the net investment in the lease and thus are included in the calculation of the rate implicit in the lease.

As discussed in LG 4.3.1.3, in a sales-type lease, collectibility only impacts sale recognition. In a direct financing lease, however, collectibility impacts lease classification. As described in LG 3.3.4.7, when collectibility of lease payments or the residual value guarantee is not probable at lease commencement, a lessor should classify the lease as an operating lease, even though it would otherwise have met the criteria for classification as a direct financing lease. The classification of such leases are not reassessed when there is a subsequent improvement in the lessee's credit quality (i.e., these operating leases remain classified as operating leases even when the collectibility subsequently become probable). See LG 4.3.3.1 for the recognition and measurement of an operating lease when collectibility is not probable.

An arrangement with variable lease payments that is classified as a direct financing lease may lead to a selling loss or a day-one loss even if the overall arrangement is expected to be profitable. In response to concerns raised in the post implementation review, the FASB published ASU 2021-05, which upon adoption requires a lessor to classify a lease with variable lease payments (that do not depend on a rate or index) as an operating lease at the lease commencement date if classifying the lease as a direct financing lease (or sales-type lease) would result in recognition of a selling loss. See LG 9.11 for the effective date and transition requirements of ASU 2021-05.

4.3.3 Operating lease — lessor

An operating lease is neither a sale nor financing of an asset. In addition, upon adoption of ASU 2021-05, ASC 842 also requires a lessor to classify a lease with variable lease payments (that do not depend on a rate or index) as an operating lease at the lease commencement date if classifying the lease as a sales-type or a direct financing lease would result in recognition of a selling loss. If a lease is classified as operating, the lessor should keep the asset underlying the lease on its balance sheet and continue to depreciate the asset based on its estimated useful life. Rental revenue from lease payments should be recognized on a straight-line basis (or another systematic basis if that basis is more representative of the pattern in which income is earned from the underlying asset over the term of the respective lease). See LG 9.11 for the effective date and transition requirements of ASU 2021-05. Based on the definition of lease payments in ASC 842-10-30-5(f), a lessor should not include any residual value guarantee from a lessee as a lease payment. A lessor should record an unbilled rent receivable, which is the amount by which straight-line rental revenue exceeds rents currently billed in accordance with the lease.

Excerpt from ASC 842-10-30-5

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

…

f. For a lessee only, amounts probable of being owed by the lessee under residual value guarantees (see paragraphs 842-10-55-34 through 55-36).

Questions often arise as to whether a lessor should recognize uneven rent payments on some basis other than straight-line if the rent increases are designed to reflect estimated future market rents. Although these type of rent increases are common in real estate leases, we believe that the income should be recorded on a straight-line basis even in these situations.

4.3.3.1 Operating lease — Collectibility is not probable

ASC 842-30-25-12 describes the recognition and measurement for a lessor in an operating lease when collectibility of the lease payments plus any amount necessary to satisfy the residual value guarantee is not probable at the commencement date.

ASC 842-30-25-12

If collectibility of the lease payments plus any amount necessary to satisfy a residual value guarantee (provided by the lessee or any other unrelated third party) is not probable at the commencement date, lease income shall be limited to the lesser of the income that would be recognized in accordance with paragraph 842-30-25-11(a) through (b) or the lease payments, including variable lease payments, that have been collected from the lessee.

ASC 842-30-25-13

If the assessment of collectibility changes after the commencement date, any difference between the lease income that would have been recognized in accordance with paragraph 842-30-25-11(a) through (b) and the lease payments, including variable lease payments, that have been collected from the lessee shall be recognized as a current-period adjustment to lease income.

The initial recognition and measurement for an operating lease is not impacted by the collectibility of the payments from the lessee. The lessor continues to recognize the underlying asset on its balance sheet and continues to depreciate the asset based on its estimated useful life. However, subsequent to initial recognition, a lessor's lease income is limited to the lesser of the straight-line rental income (or another systematic basis if that basis is more representative of the pattern in which income is earned from the underlying asset over the term of the respective lease) or the lease payments that have been collected from the lessee.

When the collectibility of the lease payments subsequently becomes probable, the lessor should recognize the difference between the cumulative lease income recognized to date and the amount that would have been recognized had the lessor followed the measurement guidance for an operating lease without the limitation described in ASC 842-30-25-12. The amount is recorded as an adjustment to lease income in the period in which collectibility is first deemed probable. After such adjustment, the lessor should follow the general guidance for subsequent measurement of an operating lease (see LG 4.5.2). Lessors are required to continually assess collectibility over the lease term (see LG 8.9 for subsequent accounting considerations).

4.3.3.2 Examples – lessor accounting for operating leases

Example LG 4-10 illustrates a lessor's accounting for an operating lease.

EXAMPLE LG 4-10

Lessor operating lease recognition – automobile lease

Lessor Corp leases an automobile to Lessee Corp on January 1, 20X9. The following table summarizes information about the lease and the leased asset.

Lease term	3 years, no renewal option
Remaining economic life of the automobile	6 years
Fair value of the automobile at commencement	$30,000
Lessor Corp's carrying value of the automobile at commencement	$30,000
Purchase option	Lessee Corp has the option to purchase the automobile at fair market value upon expiration of the lease.
Monthly lease payments	$500 for the first year

	$550 for the second year $600 for the third year
Payment date	Beginning of the month (first payment is made at lease commencement)
Rate implicit in the lease	8%
Other	▫ Title to the automobile remains with Lessor Corp upon lease expiration ▫ The expected residual value of the automobile at the end of the lease term is $19,000; Lessee Corp does not guarantee the residual value of the automobile at the end of the lease term ▫ Lessee Corp pays for all maintenance of the automobile separate from the lease ▫ There are no initial direct costs incurred by Lessor Corp ▫ Lessor Corp does not provide any incentives

How would Lessor Corp measure and record this lease at commencement?

Analysis

Based on the facts Lessor Corp could reasonably conclude that the lease is an operating lease as none of the criteria for sales-type or direct financing lease treatment have been met (see LG 3.3 for classification criteria). Since the lease is classified as an operating lease, no asset or liability would be recorded at lease commencement. Lessor Corp would keep the automobile on its books as an asset and depreciate it in accordance with its normal depreciation policy.

See Example LG 4-16 for an illustration of the subsequent measurement and recognition for this fact pattern.

4.4 Subsequent recognition and measurement – lessee

Over the lease term, a lessee must amortize the right-of-use asset and record interest expense on the lease liability created at lease commencement. The income statement recognition and classification are based on how the lease is classified. See LG 3 for information on lease classification.

4.4.1 Finance leases

Finance leases are accounted for in a manner similar to financed purchases. The right-of-use asset is amortized to amortization expense. Interest expense is recorded in connection with the lease liability.

Figure LG 4-2 describes how expenses are recognized for finance leases.

Figure LG 4-2
Lessee finance lease expense recognition

Expense classification	Income statement recognition pattern
Amortization expense	Straight-line recognition over the shorter of the useful life of the asset or the lease term
Interest expense	Interest method

Example LG 4-11 illustrates the subsequent measurement of a right-of-use asset and lease liability.

EXAMPLE LG 4-11

Finance lease subsequent measurement and recognition – non-specialized digital imaging equipment lease (lessee)

Lessee Corp enters into a lease of non-specialized digital imaging equipment with Lessor Corp on January 1, 20X9. The following table summarizes information about the lease and the leased assets.

Lease term	5 years, no renewal option
Remaining economic life of the leased equipment	6 years
Purchase option	None
Annual lease payments	$1,100
Payment date	Annually on January 1 (first payment made at lease commencement)
Lessee Corp's incremental borrowing rate	7% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp.
Other	□ Title to the asset remains with Lessor Corp upon lease expiration □ The fair value of the equipment is $5,000 at commencement; Lessee Corp does not guarantee the residual value of the equipment at the end of the lease term □ Lessee Corp pays for all maintenance of the equipment separate from the lease □ There are no initial direct costs incurred by Lessee Corp □ Lessor Corp does not provide any incentives

How would Lessee Corp measure the right-of-use asset and lease liability over the lease term?

Analysis

Based on the facts Lessee Corp could reasonably conclude that the lease is a finance lease as the lease term is a major part of the remaining economic life of the equipment (see LG 3.3 for lease classification criteria).

At commencement, Lessee Corp would first calculate the lease liability as the present value of the four remaining unpaid annual fixed lease payments of $1,100 discounted at Lessee Corp's incremental borrowing rate of 7%; this amount is $3,725.

The right-of-use asset is equal to the lease liability plus the $1,100 rent paid on the lease commencement date ($4,825).

Lessee Corp would amortize the right-of-use asset on a straight-line basis over the lease term because the remaining economic life is greater than the lease term.

	Amortization	**Right-of-use asset**
Lease commencement		$4,825
Year 1	$965	3,860
Year 2	965	2,895
Year 3	965	1,930
Year 4	965	965
Year 5	965	0
	$4,825	

Interest expense on the lease liability would be calculated using a rate of 7%, the same discount rate used to initially measure the lease liability. The lease liability would change as follows (assuming beginning of year payments):

	Payment	**Principal paid**	**Interest paid**	**Interest expense**	**Lease liability (end of year)**
Lease commencement					$3,725
Year 1	*			$261	3,986
Year 2	1,100	839	261	202	3,088
Year 3	1,100	898	202	139	2,127
Year 4	1,100	961	139	73	1,100
Year 5	1,100	1,027	73	0	0
	$4,400	**$3,725**	**$675**	**$675**	

**No payment is reflected in Year 1 because the first payment was made at lease commencement and is not included in the lease liability.*

Adding the amortization and interest expense from the two charts above, the total expense recorded per period is higher in earlier periods and decreases throughout the lease term (from $1,226 in year 1 to $965 in year 5).

4.4.1.1 *Finance lease with a purchase option*

When a lease is classified as a finance lease because it contains a purchase option that the lessee is reasonably certain to exercise, the lessee has an additional payment to make related to the exercise of the purchase option. This additional lease payment should be included in the lease liability as a payment occurring at the date the lessee expects to exercise the purchase option, which is typically at the end of the lease term. Interest expense will be calculated on the full amount of the lease liability, which includes the present value of the purchase option payment. Because it is reasonably certain that the lessee will obtain the asset at the end of the lease term, the right-of-use asset should be amortized over the useful life of the asset, rather than over the lease term.

Example LG 4-12 illustrates the measurement of a finance lease with a purchase option.

EXAMPLE LG 4-12

Finance lease subsequent measurement and recognition – real estate lease with a purchase option (lessee)

Lessee Corp enters into a property (land and building) lease with Lessor Corp on January 1, 20X9. The following table summarizes information about the lease and the leased asset.

Lease term	10 years
Renewal option	Five 5-year renewal options If exercised, the annual lease payments are reset to then current market rents
Remaining economic life	40 years
Fair value of the leased property at commencement	$5,000,000
Purchase option	Lessee Corp has an option to purchase the property at the end of the lease term for $3,000,000. Lessee Corp is reasonably certain to exercise this option.
Annual lease payments	The first annual lease payment is $500,000, with increases of 3% per year thereafter (see schedule of lease payments below).
Payment date	Annually on January 1 (first payment made at lease commencement)
Incentive	Lessor Corp gives Lessee Corp a $200,000 incentive for entering into the lease (payable at the beginning of year 2), which is to be used for normal tenant improvements.
Lessee Corp's incremental borrowing rate	9.04% The rate that Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp.

Other	▫ Title to the property does not automatically transfer to Lessee Corp upon lease expiration ▫ Lessee Corp does not guarantee the residual value of the real estate asset ▫ Lessee Corp pays for all maintenance, taxes, and insurance on the property separate from the lease ▫ There are no initial direct costs incurred by Lessee Corp

The schedule of lease payments (excluding the purchase option) is shown below.

Date	**Amount**
Year 1 (paid at commencement)	$500,000
Year 2 ($515,000 – $200,000 lease incentive)	315,000
Year 3	530,450
Year 4	546,364
Year 5	562,754
Year 6	579,637
Year 7	597,026
Year 8	614,937
Year 9	633,385
Year 10	652,387
Total	**$5,531,940**

How would Lessee Corp measure the right-of-use asset and lease liability over the lease term?

Analysis

Based on the facts Lessee Corp could reasonably conclude that the lease is a finance lease because it grants Lessee Corp a fixed price purchase option that Lessee Corp is reasonably certain to exercise (see LG 3.3 for lease classification criteria).

At commencement, Lessee Corp would first calculate the lease liability as the present value of the remaining unpaid annual lease payments, less the lease incentive paid in year 2, plus the exercise price of the purchase option using a discount rate of 9.04%; the amount is $4,500,000.

The right-of-use asset is equal to the lease liability plus the $500,000 rent paid on the lease commencement date ($5,000,000).

Since the purchase option is reasonably certain to be exercised, Lessee Corp would amortize the right-of-use asset over the economic life of the underlying asset (40 years). Annual amortization expense would be $125,000 ($5,000,000/40 years).

Interest expense on the lease liability would be calculated as shown in the following table. This table includes all expected cash flows during the lease term, including the lease incentive paid by Lessor Corp and Lessee Corp's purchase option. See Example LG 4-3 for a schedule of payments.

Payment		Interest expense	Lease liability (end of year)
Lease commencement			$4,500,000
Year 1	$0*	$406,840	4,906,840
Year 2	315,000**	415,143	5,006,983
Year 3	530,450	404,718	4,881,251
Year 4	546,364	391,912	4,726,800
Year 5	562,754	376,466	4,540,511
Year 6	579,637	358,098	4,318,972
Year 7	597,026	336,497	4,058,443
Year 8	614,937	311,323	3,754,829
Year 9	633,385	282,206	3,403,650
Year 10	652,387	248,737	3,000,000
Year 10[1]	3,000,000	—	—
	$8,031,940	**$3,531,940**	

** No payment is reflected in Year 1 because the Year 1 payment was made at lease commencement and is not included in the lease liability.*

*** In Year 2, a payment of $515,000 was made but the lease incentive of $200,000 was also received.*

[1] *Exercise of purchase option at the end of term*

Although the lease was for 10 years, the asset had an economic life of 40 years. When Lessee Corp exercises its purchase option at the end of the 10-year lease, it would have fully extinguished its lease liability but continue depreciating the asset over the remaining useful life.

4.4.2 *Operating leases — lessee*

Operating lease expense is recorded in a single financial statement line item on a straight-line basis over the lease term. This differs from finance lease expense recognition which is typically higher in the earlier years of a lease and declines over time.

The lessee could compute the periodic straight-line expense at the lease commencement date based on the sum of the following, divided by the lease term:

- The total lease payments under the lease plus
- Any initial direct costs incurred by the lessee, less
- Any lease incentives received from the lessor

In Example LG 4-13, the amortization of the right-of-use asset is described as the difference between the straight-line lease expense, as computed above, and the accretion of interest on the lease liability each period. In order to calculate the amortization of the right-of-use asset, "interest" must be calculated each period on the lease liability. However, there is no amount recorded as interest expense. The "interest" amount is used to accrete the lease liability and to amortize the right-of-use asset.

Rather than calculate the periodic amortization of the right-of-use asset, the guidance in ASC 842 describes how to measure the right-of-use asset at each reporting date. ASC 842-20-35-3 describes the measurement of the right-of-use asset at any point in time after the lease commencement date, as follows:

- The balance of the lease liability, adjusted for
- Any prepaid or accrued lease payments,
- Any unamortized initial direct costs, and
- The remaining balance of any lease incentives received.

Both of these approaches result in the same balance for a right-of-use asset.

Example LG 4-13 illustrates a lessee's subsequent measurement and recognition of an operating lease.

EXAMPLE LG 4-13

Lessee operating lease subsequent measurement and recognition – automobile lease

Lessee Corp leases an automobile from Lessor Corp on January 1, 20X9. The following table summarizes information about the lease and the leased asset.

Lease term	3 years, no renewal option
Remaining economic life of the automobile	6 years
Purchase option	Lessee Corp has the option to purchase the automobile at fair market value upon expiration of the lease.
Monthly lease payments	$500 (first payment made at lease commencement)
Payment date	Beginning of the month
Lessee Corp's incremental borrowing rate	6% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp.

Other	□ Title to the automobile remains with Lessor Corp upon lease expiration □ The fair value of the automobile is $30,000 at commencement; Lessee Corp does not guarantee the residual value of the automobile at the end of the lease term □ Lessee Corp pays for all maintenance of the automobile separate from the lease □ There are no initial direct costs incurred by Lessee Corp □ Lessor Corp does not provide any incentives

How would Lessee Corp measure the right-of-use asset and lease liability over the lease term?

Analysis

Based on the facts Lessee Corp could reasonably conclude that this lease is an operating lease as none of the criteria for finance lease classification are met (see LG 3.3 for lease classification criteria).

At commencement, Lessee Corp would first calculate the lease liability as the present value of the remaining unpaid monthly fixed lease payments discounted at Lessee Corp's incremental borrowing rate of 6%; this amount is $16,018.

The right-of-use asset is equal to the lease liability plus the $500 rent paid on the lease commencement date ($16,518).

Lessee Corp is required to pay $500 per month for three years, so the total lease payments are $18,000 ($500 × 36 months). Lessee Corp would then calculate the straight-line lease expense to be recorded each period by dividing the total lease payments by the total number of periods. The monthly straight-line expense would be $500 ($18,000 ÷ 36 months). The rental payment and the straight-line expense are equal as the lease does not contain any escalation provisions or other required or optional payments.

Lessee Corp would calculate the amortization of the lease liability as shown in the following table. This table is shown on an annual basis for simplicity; the schedule would be calculated on a monthly basis to reflect the frequency of the lease payments.

	Payment	**"Interest" on the lease liability***	**Lease liability**
Lease commencement			$16,018
Year 1	$5,500**	$820	11,338
Year 2	6,000	500	5,838
Year 3	6,000	162	—
	$17,500	**$1,482**	

**Although these amounts are labelled as "interest," there is no interest expense recorded in the income statement. These amounts are calculated on the lease liability on a monthly basis in order to determine the ending balance of the lease liability; however, there is only one straight-line lease expense recorded in the income statement. See LG 4.4.2 for additional information.*

***This amount excludes the first month's payment since it was made at lease commencement and is not included in the lease liability.*

The amortization of the right-of-use asset is calculated as the difference between the straight-line lease expense ($500 per month) and the interest calculated on the lease liability. The following table shows this calculation. This table is shown on an annual basis for simplicity; the schedule would be calculated on a monthly basis to reflect the frequency of the lease payments.

	Straight-line expense (A)	Interest on lease liability (B)	Amortization (A – B)	Right-of-use asset
Commencement				$16,518
Year 1	$6,000	$820	$5,180	11,338
Year 2	6,000	500	5,500	5,838
Year 3	6,000	162	5,838	—
	$18,000	$1,482	$16,518	

Example LG 4-14 discusses timing of lease cost recognition in contract manufacturing arrangements.

EXAMPLE LG 4-14

Contract manufacturing arrangements

Customer Corp enters into a 5-year contract manufacturing agreement with Supplier Corp. Other facts of the arrangement are:

- Customer Corp has exclusive use of Supplier Corp's manufacturing facility for five years
- Customer Corp will issue non-cancellable purchase orders to Supplier Corp periodically throughout the five-year period
- Customer Corp is not required to order a minimum volume of products over the five-year period although Customer Corp expects to use substantially all of the manufacturing capacity during the term of the arrangement
- Price per unit of the manufactured product is specified in the agreement
- Supplier Corp ships the products free on board destination to Customer Corp's facility and Customer Corp is contractually obligated to pay Supplier Corp upon delivery of products Example LG 4-1 discusses timing of lease cost recognition in contract manufacturing arrangements. Customer Corp's facility

- Customer Corp has identified a lease component (i.e., the right to use Supplier Corp's manufacturing facility) and non-lease components in the arrangement

Assume that Customer Corp has appropriately determined that the contract manufacturing arrangement contains a lease under ASC 842.

When should Customer Corp recognize the lease cost associated with the lease component?

Analysis

We believe payments by Customer Corp to Supplier Corp allocated to the lease component are variable lease payments and should be recognized in the period when the manufactured product is delivered. In other words, it would not be appropriate to recognize a lease cost in a period when there is no delivery of the manufactured product. Note that this issue arises only when it is concluded that Customer Corp directs the use of Supplier Corp's manufacturing facility. See LG 2.3.2.2 for a discussion of dispatch rights.

4.5 Subsequent recognition and measurement – lessor—updated September 2021

The subsequent measurement of sales-type, direct financing, and operating leases differs significantly. As discussed in LG 4.3, in sales-type and direct financing leases, lessors replace the underlying asset on their balance sheet with a net investment in the lease, while in operating leases, lessors retain the underlying asset on their balance sheet.

For sales-type and direct financing leases, lessors record interest income on the net investment in addition to any selling profit or loss; however, the timing for recognizing any selling profit or loss differs. In a sales-type lease that transfers control to the lessee, selling profit or loss should be recognized at lease commencement. In a direct financing lease, a selling loss is recognized at lease commencement, but selling profit is deferred and recognized over the lease term. As discussed in LG 4.3.1.1 (for a sales-type lease) and LG 4.3.2.1 (for a direct financing lease), upon adoption of ASU 2021-05, ASC 842 requires a lessor to classify a lease with variable lease payments that do not depend on a rate or index as an operating lease at the lease commencement date if classifying the lease as a sales-type or direct financing lease would result in recognition of a selling loss. See LG 9.11 for the effective date and transition requirements of ASU 2021-05.

In operating leases, lessors record lease income on a straight-line basis over the lease term.

A lessor should recognize variable lease payments in the period in which they are earned for a lease classified as sales-type, direct financing, or operating.

4.5.1 Lessor sales-type leases and direct financing lease

The lessor in both a sales-type lease and direct financing lease should measure its net investment in a lease on an amortized cost basis subsequent to initially recording the lease.

For sales-type leases, in which a transfer of control occurs, any selling profit or loss is recognized at the commencement date (see LG 4.3.1.1 for the accounting for selling losses due to variable lease payments). Therefore, the only income statement effect during the lease term results from recognizing interest income on the lease receivable and accretion on the unguaranteed residual asset.

For direct financing leases, a transfer of control does not occur, so selling profit is not recognized at the commencement date, but is instead recognized over the lease term (a selling loss is recognized at the commencement date). Therefore, any deferred profit is recognized in addition to the interest income on the lease receivable and accretion on the unguaranteed residual asset. For a direct financing lease, a selling loss is recognized at lease commencement (see LG 4.3.2.1 for the accounting for selling losses due to variable lease payments).

Interest on the lease receivable is calculated by multiplying the rate implicit in the lease by the outstanding receivable balance each period. The receivable is increased for accrued interest and reduced by cash payments received from the lessee.

The unguaranteed residual asset is recorded at its present value and accreted to its final expected value at the expiration of the lease term also using the rate implicit in the lease.

Example LG 4-15 illustrates the subsequent measurement and recognition of a sales-type lease.

EXAMPLE LG 4-15

Sales-type lease subsequent measurement and recognition – non-specialized digital imaging equipment lease (lessor)

Lessor Corp enters into a lease of non-specialized digital imaging equipment with Lessee Corp on 1/1/X9. Lessor Corp is a manufacturer of digital imaging equipment that uses both direct sales and leases as a means of selling its products. The following table summarizes information about the lease and the leased assets.

Lease term	5 years, no renewal option
Remaining economic life of the leased equipment	6 years
Purchase option	None
Annual lease payments	$1,100
Payment date	Annually on January 1 (first payment is made at lease commencement)
Fair value of the leased equipment at commencement	$5,000
Lessor Corp's carrying value of the leased equipment	$4,500
Rate implicit in the lease	7.04%

Other	▫ Title to the asset remains with Lessor Corp upon lease expiration ▫ Lessee Corp does not guarantee the residual value of the equipment at the end of the lease term and Lessor Corp does not obtain any third-party residual value insurance ▫ Estimated fair value of the equipment at the end of the lease term is $250 ▫ Lessee Corp pays for all maintenance of the equipment separate from the lease ▫ There are no initial direct costs incurred by Lessor Corp ▫ Lessor Corp does not provide any incentives

How would Lessor Corp account for the leasing transaction after lease commencement?

Analysis

Based on the facts Lessor Corp could reasonably conclude that the lease is a sales-type lease as the lease term is a major part of the remaining economic life of the equipment (see LG 3.3 for lease classification criteria).

At commencement, Lessor Corp would first determine the total net investment in the lease as the present value of the lease receivable and the unguaranteed residual asset.

- The present value of the lease receivable is equal to the present value of the remaining lease payments discounted at 7.04%; this amount is $3,722.
- The present value of the unguaranteed residual asset discounted at 7.04% is $178.
- Lessor Corp's net investment in the lease is $3,900 (the sum of the lease receivable ($3,722) and the unguaranteed residual asset ($178)).

Since control has been deemed to have transferred to Lessee Corp, profit is recognized by Lessor Corp at lease commencement. The selling profit is calculated as follows:

Present value of the lease receivable	$3,722
Plus, the lease payment received at lease commencement	1,100
Less, the carrying value of leased asset ($4,500) net of unguaranteed residual asset ($178)	(4,322)
Selling profit	$500

Lessor Corp would record revenue at lease commencement equal to the lease receivable amount plus the lease payment received at lease commencement ($4,822). Cost of goods sold would be recorded as the difference between the carrying value of the leased asset ($4,500) and the discounted value of the unguaranteed residual asset ($178).

In order to account for the transaction after lease commencement, Lessor Corp would first schedule out the cash flows on the lease receivable as shown in the following table.

	Payment	Interest income	Lease receivable
Lease commencement			$3,722
Year 1	*	$262	3,984
Year 2	1,100	203	3,087
Year 3	1,100	140	2,127
Year 4	1,100	73	1,100
Year 5	1,100	—	—
	$4,400	**$ 678**	

** In year 1, payment was made at lease commencement, so it is not included in the lease receivable.*

Interest paid to Lessor Corp at the beginning of year 2 would be accrued during year 1 (via a debit to lease receivable and credit to interest income).

Lessor Corp would also record accretion on the residual asset. Like the interest on the lease receivable, the accretion on the residual asset would be recorded during year 1 (via a debit to the residual asset and credit to income).

	Accretion	Residual asset
Lease commencement		$178
Year 1	$13	191
Year 2	13	204
Year 3	14	218
Year 4	15	233
Year 5	17	250
	$72	

Upon the expiration of the lease, Lessor Corp would reclassify the $250 net investment (which consists solely of the residual asset based on the Lessor Corp's business model) as PP&E or inventory. The $250 represents Lessor Corp's best estimate of the value of the asset established at the beginning of the lease.

4.5.2 *Lessor operating leases*

Since a lessor in an operating lease does not derecognize the underlying asset, it should continue to depreciate the asset in accordance with its normal depreciation policy. The lessor should record lease income on a straight-line basis over the lease term (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). The difference between the cash received and the straight-line lease income recognized is recorded as rent receivable. If cash flows are higher than the lease income, deferred rent is recorded on the balance sheet. See LG 8.9 for the impact of collectibility of lease payments on a lessor's pattern of revenue recognition for an operating lease.

Example LG 4-16 illustrates the subsequent measurement and recognition of operating lease for lessors.

EXAMPLE LG 4-16

Lessor operating lease subsequent measurement and recognition – automobile lease

Lessor Corp leases an automobile to Lessee Corp on January 1, 20X9. The following table summarizes information about the lease and the leased asset.

Lease term	3 years, no renewal option
Remaining economic life of the automobile	6 years
Fair value of the automobile at commencement	$30,000
Lessor Corp's carrying value of the automobile at commencement	$30,000
Purchase option	Lessee Corp has the option to purchase the automobile at fair market value upon expiration of the lease.
Monthly lease payments	$500 for the first year $550 for the second year $600 for the third year
Payment date	Beginning of the month (first payment is made at lease commencement)
Rate implicit in the lease	8%
Other	□ Title to the automobile remains with Lessor Corp upon lease expiration □ The expected residual value of the automobile at the end of the lease term is $19,000; Lessee Corp does not guarantee the residual value of the automobile at the end of the lease term

- Lessee Corp pays for all maintenance of the automobile separate from the lease
- There are no initial direct costs incurred by Lessor Corp
- Lessor Corp does not provide any incentives

How would Lessor Corp account for the leasing transaction after lease commencement?

Analysis

Based on the facts Lessor Corp could reasonably conclude that this lease is an operating lease as none of the criteria for sales-type or direct financing lease treatment have been met (see LG 3.3 for lease classification criteria). As this is an operating lease, Lessor Corp would not record a net investment and would retain the automobile in property, plant, and equipment on its balance sheet, and it would continue to depreciate the asset.

Lessor Corp would likely determine that the most appropriate income recognition pattern is straight-line over the economic useful life of the asset (as no other 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). As such, Lessor Corp would calculate the straight-line rental income per period by dividing the total rent payments to be made over the lease term by the total number of periods. In this example, the straight-line income Lessor Corp would record is $550 per month calculated as follows.

	Monthly rent	**Annual total**
Year 1	$500	$6,000
Year 2	550	6,600
Year 3	600	7,200
		$19,800
Number of periods		36
Straight-line rent per period		$550

Lessor Corp would record the excess between the $550 monthly rental income and the actual rental payments required by the lease agreement in year one as deferred rent receivable on the balance sheet. Subsequently, any difference between the actual rental payments and the $550 monthly rental would reduce the deferred rent receivable. The following table shows the calculation of the deferred rent receivable at the end of each year. For the sake of simplicity, this table is shown on an annual basis; the actual schedule would be calculated on a monthly basis to match the frequency of lease payments.

	Cash payments (A)	Straight-line income (B)	Increase (decrease) (B – A)	Deferred rental receivable balance
Commencement				$ —
Year 1	$6,000	$6,600	$600	600
Year 2	6,600	6,600	—	600
Year 3	7,200	6,600	(600)	—
	$19,800	**$19,800**	**$ —**	

Lessor Corp would continue to depreciate the underlying asset over the economic useful life of the asset.

4.6 Impairment – lessee

A lessee's right-of-use asset is subject to the same asset impairment guidance in ASC 360 applied to other elements of property, plant, and equipment. See PPE4 for further guidance on impairments of tangible and intangible assets.

4.6.1 Impairment-finance leases (lessee)

If a lessee records an impairment charge on a right-of-use asset associated with a finance lease, it should revise the amortization expense by calculating a new straight-line amortization based on the revised asset value.

4.6.2 Impairment — operating lease (lessee)

As noted in LG 4.4.2, the amortization of an operating lease right-of-use asset generally increases over the lease term. As a result, throughout the lease term, the net book value of a right-of-use asset resulting from an operating lease is typically greater than it would have been had the lease been classified as a finance lease. Because of this higher value, a right-of-use asset arising from an operating lease may have a higher risk of impairment. Refer to PPE 5.2.7 for right-of-use asset impairment considerations.

If there is an impairment charge for a right-of-use asset associated with an operating lease, it would not impact the value of the recorded lease liability absent a modification to the lease terms or a reassessment of options to renew. As discussed in LG 5.3.1, an impairment resulting from market-based factors that are not within the lessee's control is not, in itself, a trigger for the lessee to reassess the lease term or an option to purchase the underlying asset.

Once the right-of-use asset for an operating lease is impaired, lease expense will no longer be recognized on a straight-line basis. A lessee should continue to amortize the lease liability using the same effective interest method as before the impairment charge. The right-of-use asset, however, should be subsequently amortized on a straight-line basis. The resulting accounting is similar to the accounting a lessee would apply to a finance lease (see LG 4.4.1), however, the lease is still classified as an operating lease, and a lessee should continue to follow operating lease presentation and disclosure guidance.

4.7 Impairment – lessor

A lessor's evaluation and accounting for an impairment will depend on the lease classification. Sales-type and direct financing leases are financial assets, whereas the underlying asset in an operating lease is property, plant and equipment.

4.7.1 *Impairment — Sales-type and direct financing leases (lessor)*

A lessor should assess its entire net investment in the lease for impairment and recognize any impairment loss in accordance with the loan impairment guidance in ASC 310 until ASC 326 adopted. Once ASC 326 is adopted, that guidance should be applied to the net investment in the lease. See LI 7 for guidance.

The net investment in a sales type lease consists of the sum of the following:

- **Lease receivable**, which is the present value of the lease payments and the guaranteed residual value of the asset

- **Unguaranteed residual asset**, which is the expected unguaranteed residual value of the asset at the end of the lease term

For direct financing leases, the net investment includes these same amounts reduced by the amount of any deferred selling profit.

Both the lease receivable and the unguaranteed residual asset must be considered when assessing the net investment in the lease for impairment.

4.7.1.1 *Impairment — lease receivable*

When evaluating the loss allowance for the lease receivable portion of the net investment in the lease, the lessor can only consider the lessee's right to use the asset during the lease term as collateral for the lease receivable and not the right to the residual asset. This is because in most cases, the only asset that is available to the lessee is its right to use the leased asset during the lease term. Generally, the lessee has no right over the residual asset, unless the lessee has purchase option that it is reasonably certain of being exercised or title is transferred at the end of the lease term.

While not an exhaustive list, a lessor should consider the following in developing its estimate of expected credit losses related to the lease receivable:

- The lessee's credit risk as it relates to its ability to pay the cash flows during the lease

- The lessee's credit risk as it relates to its ability to pay lessee-provided residual value guarantees

- The lessee's credit risk as it relates to amounts due on exercise of a purchase option reasonably certain of being exercised

- The mitigating impact of cash flows associated with guaranteed and unguaranteed residual values of the leased asset

4.7.1.2 Impairment — unguaranteed residual asset

The amount used to assess impairment of the unguaranteed residual asset would be an assumed lump sum payment related to the expected residual value at the end of the lease term. This could be, for example, the sale of the asset at auction.

4.7.2 Impairment — operating leases (lessor)

Lessors should follow the guidance in ASC 360 regarding the impairment of long-lived assets for assets subject to an operating lease. See PPE 5 for further guidance on the impairment of tangible and intangible assets.

Chapter 5: Modification and remeasurement of a lease—updated June 2021

5.1 Modification and remeasurement of a lease overview

This chapter addresses the accounting for modifications, including termination, of a lease contract. It also addresses the accounting for lease remeasurements for reassessment events that are not modifications.

Depending on the facts and circumstances, a lease modification may be accounted for by the lessee and lessor as either (1) two contracts – the original contract and a separate new contract, or (2) one modified contract. The separate new contract in (1) should be evaluated for whether it contains a lease. Similarly, the one modified contract should be evaluated for whether it contains a lease. When a lease modification is accounted for as one modified lease, the lessee and lessor must reconsider the lease classification and remeasure the lease.

ASC 842 also describes other circumstances in which a lessee must reconsider certain assumptions made at the lease commencement date (e.g., whether exercise of a renewal or purchase option is reasonably certain) and remeasure the lease liability and adjust the related right-of-use asset. In some of those cases, ASC 842 requires a lessee to reassess the classification of a lease.

A lessee is required to remeasure its lease liability and adjust the related right-of-use asset upon the occurrence of the following:

- Lease modifications not accounted for as a separate contract
- A triggering event within the lessee's control that changes the certainty of a lessee exercising an option to renew or terminate the lease, or purchase the underlying asset
- An event written in the contract occurs that obligates the lessee to exercise or not exercise an extension or termination option
- A change to the amount probable of being owed by the lessee under a residual value guarantee
- The resolution of a contingency upon which variable lease payments are based such that those payments become fixed

A bankruptcy filing may be a remeasurement trigger for a lessee although changes in circumstances before the bankruptcy filing that are within the lessee's control may trigger a remeasurement before such filing. See BLG 1.2 for information about voluntary and involuntary bankruptcy filings.

In March 2020, the FASB issued ASU 2020-04, *Reference Rate Reform (Topic 848), Facilitation of the Effects of Reference Rate Reform on Financial Reporting*, that provides temporary relief from contract modification requirements related to reference rate reform. Under this guidance, both lessees and lessors may elect an optional practical expedient to not apply modification accounting to all contract modifications that replace a reference rate if certain criteria are met. For more details, see chapters 1, 2, and 4 of PwC's *Reference rate reform* guide.

A lessor is not required to remeasure a lease unless the lease contract is modified.

5.2 Accounting for a lease modification – lessee

A lessee and lessor may amend the terms of a lease for a variety of reasons. The ASC 842 Glossary defines a lease modification.

Definition from ASC 842 Glossary

Lease Modification: A change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease (for example, a change to the terms 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).

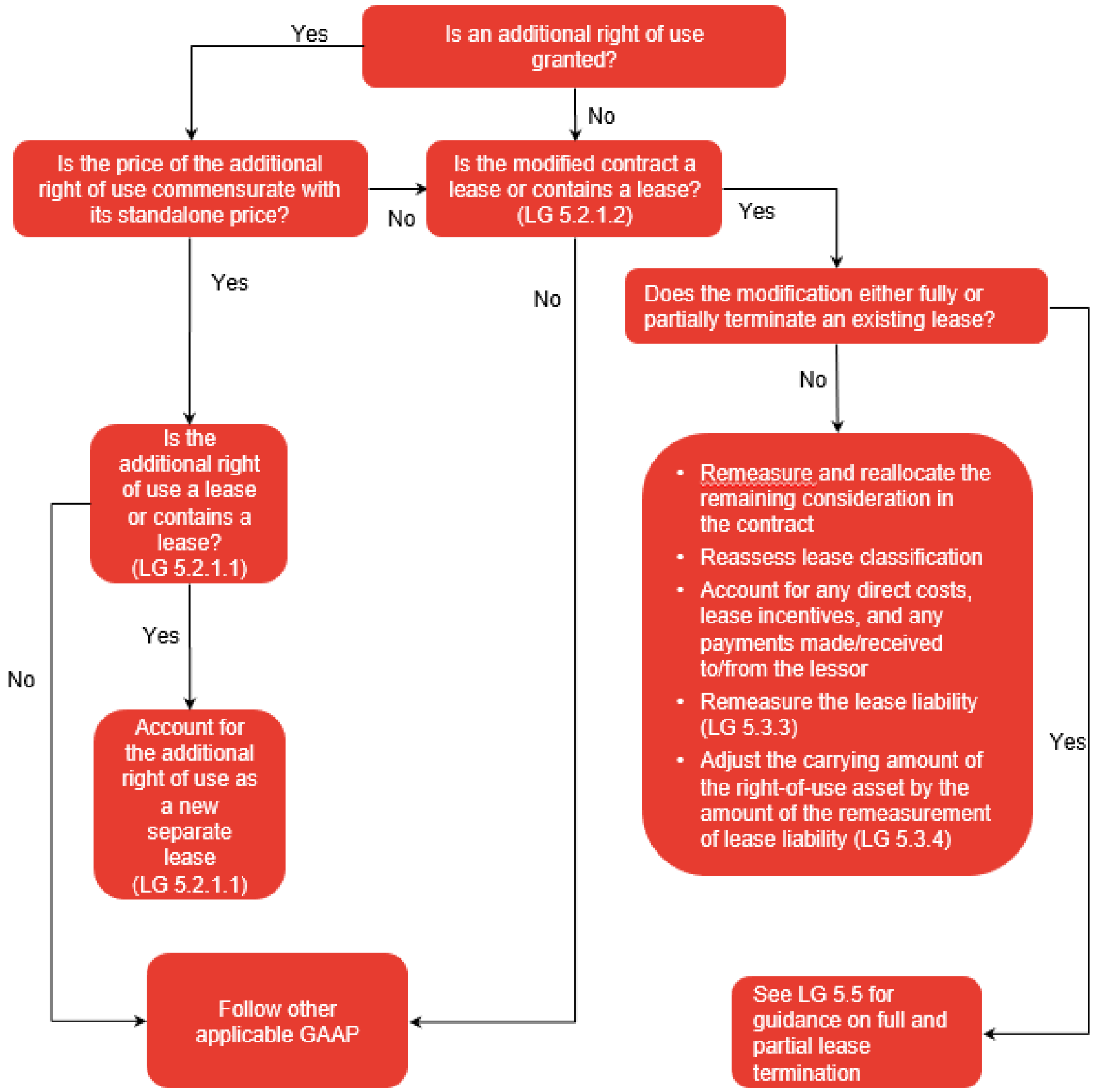
The following are examples of lease terms which may be amended after the lease commencement date:

- A lease extension
- Early termination of the lease
- A change in the timing of lease payments
- Leasing additional space in the same building

5.2.1 *Lessee accounting for a lease modification*

As illustrated in Figure LG 5-1, a lessee's accounting treatment of a lease modification depends on the type of modification made to the lease. A lease modification can result in either a separate new contract that is accounted for separate from the original contract or a single modified contract.

Figure LG 5-1
Lessee analysis of a change in a lease



A lessee should account for any direct costs, lease incentives, or other payments made by the lessee or lessor in connection with a lease modification in the same manner as those items would be accounted for in connection with a new lease. See LG 4.2.2.2 for information on direct costs. See LG 3.3.4.2 for information on lease incentives.

5.2.1.1 Separate new contract — lessee

ASC 842-10-25-8 provides guidance on whether a lessee should account for a lease modification as a new contract (separate from the existing contract).

ASC 842-10-25-8

An entity shall account for a modification to a contract as a separate contract (that is, separate from the original contract) when both of the following conditions are present:

a. The modification grants the lessee an additional right of use not included in the original lease (for example, the right to use an additional asset).

b. The lease payments increase commensurate with the standalone price for the additional right of use, adjusted for the circumstances of the particular contract. For example, the standalone price for the lease of one floor of an office building in which the lessee already leases other floors in that building may be different from the standalone price of a similar floor in a different office building, because it was not necessary for a lessor to incur costs that it would have incurred for a new lessee.

An additional right of use is granted when the lease contract is modified to give the lessee a right to use an additional underlying asset that was not included in the original lease. For example, when the floor space under lease is increased or a lessee receives the right to use a new standalone asset. A modification to increase the lease term is not considered an additional right of use.

Accounting for the separate new contract

When a lessee concludes that a lease modification should be accounted for as a new contract that is separate and apart from the original lease, the new contract should be evaluated for whether it is a lease or contains an embedded lease (see LG 2.3 for the definition of a lease). If the new contract is a lease or contains an embedded lease, the new lease should be accounted for as any other new lease (classified as finance or operating and measured accordingly). See LG 3 for information on lease classification and LG 4 for information on lease measurement.

The new lease is recorded on the commencement date of the new lease, which is the date the lessee has access to the leased asset. For example, if a lessee modifies a lease to use additional space in a building, the new lease should be recorded once that space is available for use. See LG 3.2.1 for information on lease commencement.

Example LG 5-1 illustrates a lessee's accounting for a modification as a separate new lease.

EXAMPLE LG 5-1

Modification that is a separate new lease

Lessee Corp enters into a 5-year lease for 2,000 square feet of warehouse space with Lessor Corp for $10,000 per month.

At the end of year one, Lessee Corp and Lessor Corp agree to amend their lease contract to include an additional 1,000 square feet of warehouse space in the same building for the remaining four years of the lease. Lessee Corp will pay an additional $6,000 per month for the additional space. The additional $6,000 is in line with the current market rate to lease 1,000 square feet of warehouse space in that particular building at the date that the modification is agreed to. Lessee Corp will make one monthly payment of $16,000 per month after the modification. There is no other change in the terms and conditions. The contract for the additional 1,000 square feet of space, and the combined 3,000 square feet of space meet the definition of a lease.

How should Lessee Corp account for this lease modification?

Analysis

Lessee Corp should account for the lease modification as a separate contract because the modification granted Lessee Corp an additional right of use at a price that is commensurate with the standalone price for the additional space. Based on the facts, since the new contract meets the definition of a lease, at the new lease's commencement date, Lessee Corp would have two separate leases as follows:

- The original lease for 2,000 square feet for four remaining years
- A new lease for the additional 1,000 square feet for four years

The accounting for the original lease is not impacted by the modification. The new lease would be accounted for as any other new lease, i.e., classified as finance or operating and measured accordingly. See LG 3 for information on lease classification and LG 4 for information on lease measurement.

5.2.1.2 *Single modified contract — lessee*

If a lease modification is not accounted for as a separate contract, a lessee should reassess whether the contract contains a lease. If the modified contract is a lease or contains an embedded lease, a lessee should reallocate contract consideration, reassess the lease classification, remeasure the lease liability, and adjust the right-of-use asset. For information about the definition of a lease, see LG 2.3. For information on determining lease classification see LG 3. For information on remeasuring the lease liability and adjusting the right-of-use asset see LG 5.3.3 and LG 5.3.4.

A modified lease could have multiple components. For example, if a lease is modified such that an additional right of use is granted (e.g., additional space is leased) but the modification is not recorded as a separate new contract, there will be two separate lease components in the new modified lease. See Example 17 beginning at ASC 842-10-55-168 for additional information.

A lease may be denominated in a currency that is not the same as a lessee's functional currency. See LG 8.8 for information regarding what exchange rate a lessee should use to remeasure a right-of-use asset into the lessee's functional currency when there is a lease modification that is not accounted as a separate new lease.

5.3 *Accounting for lease remeasurement – lessee— updated September 2021*

A lessee should reallocate the contract consideration among the lease and nonlease components, remeasure its lease liability, and adjust the related right-of-use asset upon the occurrence of certain events. How the lease liability is remeasured and the right-of-use asset adjusted will depend on the reason for the lease remeasurement; in some cases, it will result in an entry to profit or loss. A lessee may also need to do one or more of the following depending on the reason for lease remeasurement:

- Reassess whether a contract is (or contains) a lease
- Reallocate contract consideration
- Reassess the lease classification
- Update the discount rate used to remeasure the lease liability
- Account for initial direct costs, lease incentives, and any other payment made or received 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 (see LG 4.2.2).

Figure LG 5-2 provides an overview of the circumstances that could lead to lease remeasurement.

Figure LG 5-2

Accounting for a lease remeasurement

	Reassess for definition of a lease (LG 2)	**Reallocate contract consideration (LG 2.4.3 and LG 5.3.3)**	**Update discount rate (LG 3.3.4.6)**	**Reassess classification (LG 3)**	**Remeasure the lease liability and adjust the right-of-use asset (LG 5.3.3 and LG 5.3.4)**
Contract modification: Lease contract is modified in such a way that the combined contract is accounted for as one lease (LG 5.2)	●	●	●	●	●
Change in lease term: An event occurs that gives the lessee a significant economic incentive to exercise, or not exercise, a renewal option (LG 5.3.1) or an event written in the contract occurs that obligates the lessee to exercise or not exercise an extension or termination option		●	●	●	●

	Reassess for definition of a lease (LG 2)	**Reallocate contract consideration (LG 2.4.3 and LG 5.3.3)**	**Update discount rate (LG 3.3.4.6)**	**Reassess classification (LG 3)**	**Remeasure the lease liability and adjust the right-of-use asset (LG 5.3.3 and LG 5.3.4)**
Change in purchase option assessment: An event occurs that gives the lessee a significant economic incentive to exercise, or not exercise, a purchase option (LG 5.3.1)		●	●	●	●
Contingency resolution: A contingency on which variable payments are based is met such that the variable payments become fixed (LG 5.3.1)		●			●
Change in RVG: Amounts owed under a residual value guarantee become probable (LG 5.3.1)		●			●

When reassessing lease classification for the events noted in Figure LG 5-2, a lessee should consider the terms and conditions as of that date. In other words, the lessee should reassess lease classification using the fair value and remaining economic life of the underlying asset on the reassessment date. As discussed in ASC 842-10-15-6, a lessee must reassess whether a contract is (or contains) a lease only if the provisions of the contract are changed.

A lease may be denominated in a currency that is not the same as a lessee's functional currency. See LG 8.8 for information regarding what exchange rate a lessee should use to remeasure a right-of-use asset into the lessee's functional currency when a lease is required to be remeasured.

5.3.1 *Lease remeasurement — lessee*

A lessee should remeasure the lease liability and adjust the right-of-use asset upon the occurrence of any of the events described in ASC 842-10-35-4.

Excerpt from ASC 842-10-35-4

A lessee shall remeasure the lease payments if any of the following occur:

a. . . .

b. A contingency upon which some or all of the variable lease payments that will be paid over the remainder of the lease term are based is resolved such that those payments now meet the definition of lease payments. For example, an event occurs that results in variable lease payments that were linked to the performance or use of the underlying asset becoming fixed payments for the remainder of the lease term. However, a change in a reference index or a rate upon which some or all of the variable lease payments in the contract are based does not constitute the resolution of a contingency subject to (b) (see paragraph 842-10-35-5 for guidance on the remeasurement of variable lease payments that depend on an index or a rate).

c. There is a change in any of the following:

    1. The lease term, as described in paragraph 842-10-35-1. A lessee shall determine the revised lease payments on the basis of the revised lease term.

    2. The assessment of whether the lessee is reasonably certain to exercise or not to exercise an option to purchase the underlying asset, as described in paragraph 842-10-35-1. A lessee shall determine the revised lease payments to reflect the change in the assessment of the purchase option.

    3. Amounts probable of being owed by the lessee under residual value guarantees. A lessee shall determine the revised lease payments to reflect the change in amounts probable of being owed by the lessee under residual value guarantees.

Question LG 5-1 and Question LG 5-2 discuss how consumer price index provisions may or may not result in a lease remeasurement.

Question LG 5-1

Lessee Corp enters into a five-year lease with payments that increase based on increases in the Consumer Price Index (CPI), but cannot decrease (i.e., the increase creates a new floor for lease payments). As CPI increases, should a lessee remeasure a lease liability to include the impact of the increase to date?

PwC response

No, a lessee should not remeasure a lease liability when payments increase based on a change in CPI. Based on an exception in the leases standard, the change to a reference index upon which some or all of the variable lease payment is based does not constitute the resolution of a contingency. The lease payments continue to be variable as they may increase based on future changes in the CPI. The payments are not fixed and therefore do not meet the definition of lease payments.

Question LG 5-2

Lessee Corp enters into a five-year lease with payments that increase based on increases to the CPI, capped at a cumulative increase of 7%. When CPI reaches the cap, should lease payments be adjusted to include the 7% increase?

PwC response

Yes. The lease payments become fixed because additional increases in CPI will not change the payment amount (because CPI is capped at 7%); therefore, the payments meet the definition of lease payments.

Question LG 5-3 discusses the accounting by a lessee for reimbursing the lessor for capital improvements.

Question LG 5-3

Lessor Corp and Lessee Corp enter into a 5-year operating lease of real estate on January 1, 20X1. The lease permits Lessor Corp to pass on depreciation costs to Lessee Corp for capital improvements made to the building during the lease term. The capital improvements are not an additional performance obligation promised by Lessor Corp to Lessee Corp and therefore are not part of the common area maintenance nonlease component or a separate nonlease component. On January 1, 20X2, Lessor Corp completes a roof replacement project at a total cost of $100,000 with a useful life of 10 years. Under the lease provisions, Lessee Corp will be responsible to pay additional rent of $10,000 per year ($100,000/10 years) during the four- year remaining lease term. How should Lessee Corp account for the obligation to pay the additional rent to Lessor Corp?

PwC response

The amount of consideration due to Lessor Corp over the remainder of the lease term upon completion of the roof replacement is a variable rent provision that Lessee Corp does not recognize at commencement. Once the amount is determinable upon completion of the roof replacement, we believe Lessee Corp should account for the additional payment as a resolution of a contingency. The lease liability should be remeasured to include the additional fixed payments when they become known (see LG 5.3.3 for more details about remeasurement of lease liability) with a corresponding adjustment to the right-of-use asset (see LG 5.3.4 for more details about right-of-use asset adjustments).

When there is a change in the lease term or probability of exercising an option based on the occurrence of any of the events described in ASC 842-10-35-1, in connection with remeasuring the lease liability and adjusting the right-of-use asset, a lessee should also reassess the lease classification.

ASC 842-10-35-1

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

a. There is a significant event or a significant change in circumstances that is within the control of the lessee that directly affects whether the lessee is reasonably certain to exercise or not to exercise an option to extend or terminate the lease or to purchase the underlying asset.

b. There is an event that is written into the contract that obliges the lessee to exercise (or not to exercise) an option to extend or terminate the lease.

c. The lessee elects to exercise an option even though the entity had previously determined that the lessee was not reasonably certain to do so.

d. The lessee elects not to exercise an option even though the entity had previously determined that the lessee was reasonably certain to do so.

ASC 842-10-55-28

Examples of significant events or significant changes in circumstances that a lessee should consider in accordance with paragraph 842-10-35-1 include, but are not limited to, the following:

a. Constructing significant leasehold improvements that are expected to have significant economic value for the lessee when the option becomes exercisable

b. Making significant modifications or customizations to the underlying asset

c. Making a business decision that is directly relevant to the lessee's ability to exercise or not to exercise an option (for example, extending the lease of a complementary asset or disposing of an alternative asset)

d. Subleasing the underlying asset for a period beyond the exercise date of the option.

A change in market-based factors alone (e.g., increases in market rents such that rents during renewal period would now be considered a bargain or change in the current price to purchase a comparable asset) should not trigger reassessment of the lease term or a lessee option to purchase the underlying asset. A lessee is not required to continually reassess the lease term absent a significant event or change in circumstances.

5.3.2 Change in timing or amount of payment for a lease incentive

Lease incentives for a lessee may be structured in different ways. For example, incentive amounts may be fixed or variable subject to a cap; they may be paid to the lessee upfront or over time. Often, incentives are negotiated to reimburse the lessee for amounts spent by the lessee to furnish or improve the leased property, up to a maximum negotiated amount. The amount and timing of the incentive may depend on the pace at which the lessee furnishes or improves the leased asset. Although the amount and timing of the incentive paid to the lessee could vary after lease commencement, it is generally very unlikely that a lessee would forgo any incentive it negotiated to receive from the lessor. Accordingly, we believe the lessee should treat the incentive in this scenario as an "in substance fixed payment" from the lessor to the lessee. We believe a lessee should estimate the timing of the maximum contractual incentive not yet received and record it as a negative lease payment. This would impact lease classification and the amount recognized for the lease liability and right-of-use asset at lease commencement.

Subsequent to lease commencement, if the actual receipt of the cash from the lessor differs in either timing or amount from the original estimate used to record the lease incentive, we believe the lessee should analogize to the remeasurement guidance for a lessee and remeasure the lease liability (and hence the right-of use asset) using the same discount rate used at the lease commencement date.

See Example LG 5-9 for an illustration.

5.3.3 *Remeasurement of lease liability*

A lease liability should be remeasured on the effective date of the reassessment event or modification (the date that the modification is approved by both the lessee and lessor) as if the lease were a new lease that commences on that date.

Before remeasuring the lease liability, a lessee must first reallocate the remaining contract consideration between the lease and nonlease components using the relative standalone price of each component on the remeasurement date if the remeasurement is due to one of the following:

- Lease contract is modified in such a way that the combined contract is accounted for as one lease
- An event that is within the control of the lessee occurs that gives the lessee a significant economic incentive to exercise, or not exercise a renewal option or purchase option or an event written in the contract occurs that obligates the lessee to exercise or not exercise an extension or termination option

However, if the remeasurement is due to either (1) a contingency on which variable payments are based is met such that the variable payment become fixed or (2) amounts owed under a residual value guarantee become probable, the reallocation of remaining consideration can be done in two ways. A lessee can make an accounting policy choice to either use:

- the same basis as the initial allocation of the consideration in the contract (or the latest modification not accounted for as a separate contract), or
- the relative standalone price of each component on the remeasurement date.

A lessee should apply its policy consistently for all remeasurements. See LG 2.4.3 for information regarding the allocation of consideration.

ASC 842-20-35-4 and ASC 842-20-35-5 provide guidance on the remeasurement of a lease liability.

ASC 842-20-35-4

After the commencement date, a lessee shall remeasure the lease liability to reflect changes to the lease payments as described in paragraphs 842-10-35-4 through 35-5. A lessee shall recognize the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset. However, if the carrying amount of the right-of-use asset is reduced to zero, a lessee shall recognize any remaining amount of the remeasurement in profit or loss.

ASC 842-20-35-5

If there is a remeasurement of the lease liability in accordance with paragraph 842-20-35-4, the lessee shall update the discount rate for the lease at the date of remeasurement on the basis of the remaining lease term and the remaining lease payments unless the remeasurement of the lease liability is the result of one of the following:

a. A change in the lease term or the assessment of whether the lessee will exercise an option to purchase the underlying asset and the discount rate for the lease already reflects that the lessee has an option to extend or terminate the lease or to purchase the underlying asset.

b. A change in amounts probable of being owed by the lessee under a residual value guarantee (see paragraph 842-10-35-4(c)(3)).

c. A change in the lease payments resulting from the resolution of a contingency upon which some or all of the variable lease payments that will be paid over the remainder of the lease term are based (see paragraph 842-10-35-4(b)).

The discount rate should not be updated if there is a remeasurement due to a change in lease term or purchase option if the discount rate at lease commencement already reflected the options. As discussed in LG 3.3.4.6, the lessee must make a policy election to determine the discount rate either based on the lease term used for accounting purposes or based on the initial lease term plus any extension, termination, and/or purchase options available to the lessee, even when they are not reasonably certain of exercise. For example, if a lessee with a five-year lease with a three-year renewal option used a discount rate at lease commencement that already considered the three-year renewal option, the discount rate should not be adjusted upon remeasurement.

For lease payments that vary based on a rate or index, the lessee should determine the lease payments using the rate or index in effect at the lease remeasurement date. For example, a lessee with lease payments based on LIBOR should determine the future lease payments using the LIBOR spot rate on the lease remeasurement date.

The lease liability should be recorded at the remeasured amount with an adjustment to the right-of-use asset.

5.3.4 Right-of-use asset adjustment

The right-of-use asset will need to be adjusted upon a modification that decreases the lessee's right of use. This may occur, for example, when the floor space under lease is decreased or a lessee no longer has the right to use a standalone asset. A modification to shorten the lease term is not considered a decrease in the right of use. A decrease in the right of use is treated as either a full or partial termination of the lease. See LG 5.5 for information on the right-of-use asset adjustment in these cases.

For all other changes (e.g., those that give an additional right of use, extend or shorten the lease term, or increase or decrease lease payments), the lessee should adjust the right-of-use asset by an amount equal to the adjustment to the lease liability. Because the original lease is not considered terminated (since the lessee continues to have the right to use the asset identified in the original lease), the lessee generally should not recognize a gain or loss as a result of the modification. However, if the carrying amount of the right-of-use asset is reduced to zero, a lessee should recognize any remaining amount of the remeasurement in net income.

5.3.5 Lease expense subsequent to remeasurement

The determination of lease expense subsequent to remeasurement will depend on the new lease classification and whether that classification has changed.

5.3.5.1 *Finance lease upon remeasurement*

If a lease is classified as a finance lease upon remeasurement (regardless of the classification before remeasurement), a lessee should calculate interest expense on the lease liability based on the discount rate at the remeasurement date. The right-of-use asset amortization expense should be determined by calculating a new straight-line amortization amount using the revised right-of-use asset value and lease term. When the lease liability is remeasured and the right-of-use asset is adjusted, amortization of the right-of-use asset should be adjusted prospectively from the date of remeasurement.

5.3.5.2 *Operating lease upon remeasurement*

If there is no change to the classification of an operating lease upon remeasurement, a lessee should calculate the single lease expense after the remeasurement as follows:

$$\frac{\text{Future undiscounted cash flows + (the right-of-use asset after the remeasurement – the lease liability after the remeasurement)}}{\text{Remaining lease term}}$$

If a lease originally classified as a finance lease is remeasured and classified as an operating lease, any difference between the carrying amount of the right-of-use asset after recording the remeasurement adjustment and the carrying amount of the right-of-use asset that would have resulted from initially classifying the lease as an operating lease should be accounted for like a rent prepayment or a lease incentive. See LG 4.2.2.1 for information on accounting for rent prepayments and lease incentives.

5.3.6 *Illustrative examples of lease remeasurement*

Example LG 5-2, Example LG 5-3, Example LG 5-4, Example LG 5-5, Example LG 5-6, Example LG 5-7, Example LG 5-8 and Example LG 5-9 illustrate how to remeasure a lease for a lease modification or other event.

EXAMPLE LG 5-2

Remeasurement of an operating lease with variable lease payments - no change to lease classification

On January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease property to be used as a retail store. The following table summarizes information about the lease and the leased property:

Lease commencement date	January 1, 20X1
Initial lease term	5 years
Renewal option	3 years
Remaining economic life of the leased property	35 years
Purchase option	None
Annual lease payments for the initial term	$100,000

Annual lease payments for the renewal option	$114,400
Lease increase based on changes in the Consumer Price Index (CPI)	▫ The annual lease payment in the base term will increase based on the annual increase in the CPI at the end of the preceding year. For example, the payment due on 01/01/X2 will be based on the CPI available at 12/31/X1. ▫ The CPI at lease commencement is 120.
Payment date	Annually on January 1
Lessee Corp's incremental borrowing rate	5% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp
Other	▫ Title to the property remains with Lessor Corp upon lease expiration ▫ The fair value of the property is $4 million at commencement ▫ Lessee Corp incurs $10,000 as initial direct costs ▫ Lessor Corp does not provide any incentives

At the lease commencement date, Lessee Corp did not have a significant economic incentive to exercise the renewal option. In the first quarter of 20X4, Lessee Corp installed unique tenant improvements into the retail store with an estimated five-year economic life. Lessee Corp determined that it would only recover the cost of the improvements if it exercises the renewal option, creating a significant economic incentive to extend.

The following table summarizes information pertinent to the lease remeasurement.

Remeasured lease term	5 years; 2 years remaining in the initial term plus 3 years in the renewal period
Lessee Corp's incremental borrowing rate on the remeasurement date	6% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp
Remaining economic life of the leased property	32 years
Fair value of the leased property at remeasurement date	$3.8 million
CPI on the remeasurement date	125
Right-of-use asset immediately before the remeasurement	$199,238
Lease liability immediately before the remeasurement	$195,238

How would Lessee Corp account for the remeasurement?

Analysis

Installing the improvements was a significant event controlled by Lessee Corp, which is now reasonably certain that it will exercise its renewal option based on the significant economic incentive to extend. Lessee Corp would therefore be required to reassess lease classification and remeasure the lease in the first quarter of 20X4.

Based on the facts at lease commencement, Lessee Corp could reasonably conclude that the lease was an operating lease since none of the criteria for a finance lease were met (see LG 3.3 for lease classification criteria). At the remeasurement date, Lessee Corp would reassess lease classification and could reasonably conclude that the lease is still an operating lease since none of the criteria for a finance lease are met (see LG 3.3 for lease classification criteria).

Balance sheet impact

To remeasure the lease liability, Lessee Corp would first calculate the present value of the future lease payments for the new lease term (using the updated discount rate of 6%). The following table shows the present value of the future lease payments based on an updated CPI of 125. Since the initial lease payments were based on a CPI of 120, the CPI has increased by 4%. As a result, Lessee Corp would increase the future lease payments by 4% for those payments in the initial lease term (years 4 and 5). As shown in the table, the revised lease liability would be $490,597.

	Year 4	**Year 5**	**Year 6**	**Year 7**	**Year 8**	**Total**
Lease payment	$104,000	$104,000	$114,400	$114,400	$114,400	$551,200
Discount	0	5,887	12,584	18,348	23,784	60,603
Present value	$104,000	$98,113	$101,816	$96,052	$90,616	$490,597

To calculate the adjustment to the lease liability, Lessee Corp would compare the recalculated and original lease liability balances on the remeasurement date.

Revised lease liability	$490,597
Original lease liability	195,238
	$295,359

Lessee Corp would record the following journal entry to adjust the lease liability.

Dr. Right-of-use asset	$295,359	
Cr. Lease liability		$295,359

After the adjustment, the right-of-use asset will be equal to $494,597 (original balance of $199,238 + $295,359).

Income statement impact

The single lease expense would be recalculated using the following formula.

$$\frac{\text{Future undiscounted cash flows at the remeasurement date + (the right-of-use asset after the remeasurement – the lease liability after the remeasurement)}}{\text{Remaining lease term}}$$

$$\frac{\$551{,}200 + (\$494{,}597 - \$490{,}597)}{5} = \$111{,}040 \text{ single lease expense}$$

The annual single lease expense of $111,040 would be recognized for the remaining term of the lease.

EXAMPLE LG 5-3

Remeasurement of finance lease for a change in expected purchase option exercise - no impact to lease classification

On January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease manufacturing equipment. The following table summarizes information about the lease and the leased asset:

Lease commencement date	January 1, 20X1
Lease term	5 years with no renewal option
Remaining economic life of the equipment	6 years
Annual lease payments	$100,000
Payment date	Annually on January 1
Purchase option	Lessee Corp can purchase the equipment from Lessor Corp at the end of the lease term for $30,000; this is not considered a bargain purchase option
Lessee Corp's incremental borrowing rate	5% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp
Other	▫ Title to the asset does not automatically pass to Lessee Corp upon lease expiration ▫ The fair value of the asset is $500,000 at commencement. Lessee Corp does not

	guarantee the residual value of the equipment at the end of the lease term □ There are no initial direct costs incurred by Lessee Corp □ Lessor Corp does not provide any incentives

At the lease commencement date, it was not reasonably certain that Lessee Corp would exercise the purchase option because the lease for the manufacturing facility (where the leased equipment is used) was ending in five years. Since Lessee Corp was not certain if it would continue to occupy its current manufacturing location after five years, there was a reasonable possibility that the equipment under lease would no longer be used after that time because the equipment was designed specifically for the current facility.

On January 1, 20X3, Lessee Corp negotiated a modification to the manufacturing facility lease agreement to extend that lease for another ten years. As a result of that modification, Lessee Corp is now reasonably certain that it will exercise the purchase option in the equipment lease (in three years).

The following table summarizes information pertinent to the lease remeasurement.

Remeasurement date	January 1, 20X3
Lessee Corp's incremental borrowing rate on January 1, 20X3	3% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp
Remaining economic life of the leased equipment	4 years
Fair value of the leased equipment at remeasurement date	$300,000
Right-of-use asset immediately before the remeasurement	$272,757
Lease liability immediately before the remeasurement	$285,941

How would Lessee Corp account for the remeasurement?

Analysis

Making the modification to the manufacturing facility lease agreement was a significant event controlled by Lessee Corp, which is now reasonably certain that it will exercise its purchase option in the equipment lease. Lessee Corp would therefore be required to reassess lease classification and remeasure the equipment lease on January 1, 20X3 (the beginning of year 3 of the lease).

Based on the facts at lease commencement, Lessee Corp could reasonably conclude that the lease was a finance lease as the lease term was a major part of the remaining economic life of the equipment (see LG 3.3 for lease classification criteria). At the remeasurement date, Lessee Corp would reassess lease classification and based on the facts could reasonably conclude that the lease is still a finance lease as the lease term is a major part of the remaining economic life of the equipment.

Balance sheet impact

To remeasure the lease liability, Lessee Corp would first calculate the present value of the future lease payments for the lease term plus the purchase option using the updated discount rate of 3%, which includes the assumed exercise of the purchase option and a term of 3 years (i.e., the remaining term of the lease). The following table shows the future lease payments including the payment of $30,000 at the end of the original lease term to exercise the purchase option. As shown in the table, the revised lease liability would be $318,801.

	Year 3 lease payment	**Year 4 lease payment**	**Year 5 lease payment**	**Purchase option payment**	**Total**
Lease payment	$100,000	$100,000	$100,000	$30,000	$330,000
Discount	0	2,913	5,740	2,546	11,199
Present value	$100,000	$97,087	$94,260	$27,454	$318,801

To calculate the adjustment to the lease liability, Lessee Corp would compare the recalculated and original lease liability balances on the remeasurement date.

Revised lease liability	$318,801
Original lease liability	285,941
	$32,860

Lessee Corp would record the following journal entry to adjust the lease liability.

Dr. Right-of-use asset	$32,860	
Cr. Lease liability		$32,860

After the adjustment, the right-of-use asset will be equal to $305,617 (original balance of $272,757 + $32,860).

Income statement impact

Lessee Corp would calculate the interest expense (based on discount rate of 3%) on the lease liability from the remeasurement date as follows.

Year	Remaining cash payments	Annual lease payment	Liability balance after annual payment	Interest expense
3	$330,000	$100,000	$218,801	$6,564
4	$230,000	$100,000	$125,365	$3,760
5	$130,000	$100,000	$29,126	$874

The revised straight-line amortization of the right-of-use asset should be recalculated as shown in the following table.

Right-of-use asset immediately before the remeasurement	$272,757
Adjustment to the right-of-use asset	32,860
Adjusted right-of-use asset balance	$305,617
Remaining economic life at the remeasurement date*	4 years
Recalculated annual right-of-use asset amortization	$76,404

**Remaining economic life of the asset is used as opposed to remaining lease term because it is assumed that the purchase option will be exercised.*

EXAMPLE LG 5-4

Remeasurement of a finance lease for a change in the probability of payment for a residual value guarantee - lease classification not required to be reassessed

On January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease manufacturing equipment. The following table summarizes information about the lease and the leased asset:

Lease commencement date	January 1, 20X1
Lease term	5 years with no renewal option
Remaining economic life of the equipment	6 years
Annual lease payments	$100,000
Payment date	Annually on January 1
Lessee Corp’s incremental borrowing rate	5%

	The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp
Other	▫ Title to the asset does not automatically pass to Lessee Corp upon lease expiration ▫ The fair value of the asset is $500,000 at commencement. Lessee Corp has guaranteed that the residual value of the manufacturing equipment will be at least $15,000 at the end of the lease term ▫ There are no initial direct costs incurred by Lessee Corp ▫ Lessor Corp does not provide any incentives

At the lease commencement date, it was not probable that Lessee Corp would make a payment under the residual value guarantee. On January 1, 20X3, a change in technology made the technology in the leased equipment outdated. As a result, Lessee Corp now expects a decline in the fair value of the equipment and at the end of the lease term, payment of $10,000 is probable under the residual value guarantee.

The following table summarizes information pertinent to the lease remeasurement.

Remeasurement date	January 1, 20X3
Remaining economic life of the leased equipment	4 years
Fair value of the leased equipment at remeasurement date	$200,000
Right-of-use asset immediately before the remeasurement	$272,757
Lease liability immediately before the remeasurement	$285,941

How would Lessee Corp account for the remeasurement?

Analysis

Since Lessee Corp now determines that it is probable that it will have to make a payment under the residual value guarantee, Lessee Corp would be required to remeasure the lease on the date of the change (i.e., January 1, 20X3) including the residual value guarantee amount probable of being paid at the end of year 5 (i.e., $10,000).

Based on the facts Lessee Corp could reasonably conclude that the lease was a finance lease at lease commencement as the lease term is a major part of the remaining economic life of the equipment (see LG 3.3 for lease classification criteria). However, Lessee Corp should not reassess the lease classification based on the guidance in ASC 842-10-25-1.

Balance sheet impact

To remeasure the lease liability, Lessee Corp would first calculate the present value of the future lease payments for the lease term (using the discount rate of 5% determined at lease commencement) plus the residual value guarantee. The following table shows the future lease payments, including the payment of $10,000 at the end of year 5 for the residual value guarantee. As shown in the table, the revised lease liability would be $294,579.

	Year 3 lease payment	**Year 4 lease payment**	**Year 5 lease payment**	**Residual value guarantee payment**	**Total**
Lease payment	$100,000	$100,000	$100,000	$10,000	$310,000
Discount	0	4,762	9,297	1,362	15,421
Present value	$100,000	$95,238	$90,703	$8,638	$294,579

To calculate the adjustment to the lease liability, Lessee Corp would compare the recalculated and original lease liability balances on the remeasurement date.

Revised lease liability	$294,579
Original lease liability	285,941
	$8,638

Lessee Corp would record the following journal entry to adjust the lease liability.

Dr. Right-of-use asset	$8,638	
Cr. Lease liability		$8,638

After the adjustment, the right-of-use asset will be equal to $281,395 (original balance of $272,757 + $8,638).

Income statement impact

Lessee Corp would calculate the interest expense on the lease liability from the remeasurement date as follows.

Year	Remaining cash payments	Annual lease payment	Liability balance	Interest expense
3	$310,000	$100,000	$194,579	$9,729
4	$210,000	$100,000	$104,308	$5,215
5	$110,000	$100,000	$9,524	$476

The revised straight-line amortization of the right-of-use asset should be recalculated as shown in the following table.

Right-of-use asset immediately before the remeasurement	$272,757
Adjustment to the right-of-use asset	8,638
Adjusted right-of-use asset balance	$281,395
Remaining lease term at the remeasurement date	3 years
Recalculated annual right-of-use asset amortization	$93,798

EXAMPLE LG 5-5

Accounting for a modified operating lease that extends the lease term - no change to lease classification

On January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease property to be used as a retail store. The following table summarizes information about the lease and the leased property:

Lease commencement date	January 1, 20X1
Lease term	5 years with no renewal option
Remaining economic life of the leased property	35 years
Purchase option	None
Annual lease payments	$100,000
Payment date	Annually on January 1
Lessee Corp's incremental borrowing rate	5% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp
Other	▫ Title to the asset remains with Lessor Corp upon lease expiration

	- The fair value of the property is $4 million at commencement - Lessee Corp incurs $10,000 as initial direct costs - Lessor Corp does not provide any incentives

On January 1, 20X4, Lessee Corp and Lessor Corp amend the original lease contract to extend the term of the lease for an additional three years.

The following table summarizes information pertinent to the lease modification.

Modification date	January 1, 20X4
Modified annual lease payments	$110,000
Lessee Corp's incremental borrowing rate on January 1, 20X4	6% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp
Remaining economic life of the leased property	32 years
Fair value of the property at the modification date	$3.8 million
Right-of-use asset immediately before the modification	$199,238
Lease liability immediately before the modification	$195,238

Assume that any additional right of use, the original contract, and the modified contract meet the definition of a lease.

How would Lessee Corp account for the lease modification?

Analysis

Determine if the lease modification is a separate new contract

As the modification does not grant an additional right of use, Lessee Corp would conclude that that the modification is not a separate new contract. Since the modified contract meets the definition of a lease, Lessee Corp would account for one new modified lease as of January 1, 20X4.

Reassess lease classification based on the terms of the modified lease

Based on the facts at lease commencement, Lessee Corp could reasonably conclude that the lease was an operating lease since none of the criteria for a finance lease are met (see LG 3.3 for lease classification criteria). At the modification date, Lessee Corp could reasonably conclude that the lease continues to be an operating lease since none of the criteria for a finance lease are met.

Account for the modified lease

Lessee Corp would remeasure the lease as of the modification date as follows:

Balance sheet impact

The lease liability is remeasured by calculating the present value of the remaining future lease payments for the modified lease term using Lessee Corp's current discount rate of 6%. The modified lease has five years remaining (two years remaining in the initial term plus three years added with the modification). The modified lease liability would be $491,162 as shown in the table below.

	Year 4	**Year 5**	**Year 6**	**Year 7**	**Year 8**	**Total**
Lease payment	$110,000	$110,000	$110,000	$110,000	$110,000	$550,000
Discount	0	6,226	12,100	17,642	22,870	58,838
Present value	$110,000	$103,774	$97,900	$92,358	$87,130	$491,162

To calculate the adjustment to the lease liability, Lessee Corp would compare the recalculated and original lease liability balance on the modification date.

Revised lease liability	$491,162
Original lease liability	195,238
	$295,924

Lessee Corp would record the following journal entry to adjust the lease liability.

Dr. Right-of-use asset	$295,924	
Cr. Lease liability		$295,924

After the adjustment, the right-of-use asset will be equal to $495,162 (original balance of $199,238 + $295,924).

Income statement impact

Lessee Corp would recalculate the single lease expense using the following formula.

$$\frac{\text{Future undiscounted cash flows at the remeasurement date + (the right-of-use asset immediately after the remeasurement - the lease liability immediately after the remeasurement)}}{\text{Remaining lease term}}$$

The amounts are as follows:

$$\frac{\$550{,}000 + (\$495{,}162 - \$491{,}162)}{5} = \$110{,}800 \text{ single lease expense}$$

Lessee Corp would recognize annual single lease expense of $110,800 for the remaining term of the lease.

EXAMPLE LG 5-6

Accounting for a modified operating lease with a decrease in lease term - no change to lease classification

On January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease property to be used as a retail store. The following table summarizes information about the lease and the leased property:

Lease commencement date	January 1, 20X1
Lease term	5 years with no renewal option
Remaining economic life of the leased property	35 years
Purchase option	None
Annual lease payments	$100,000
Payment date	Annually on January 1
Lessee Corp's incremental borrowing rate	5% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp
Other	□ Title to the asset remains with Lessor Corp upon lease expiration □ The fair value of the property is $4 million at commencement □ Lessee Corp incurs $10,000 as initial direct costs

On January 1, 20X2, Lessee Corp and Lessor Corp amend the original lease contract to decrease the term of the lease to three years and increase the annual lease payments to $110,000

The following table summarizes information pertinent to the lease modification.

Modification date	January 1, 20X2
Revised remaining lease term	2 years
Modified annual lease payments	$110,000
Lessee Corp's incremental borrowing rate on January 1, 20X2	6% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp
Remaining economic life of the leased property	34 years
Fair value of the property at the modification date	$4 million
Right-of-use asset immediately before the modification	$380,325
Lease liability immediately before the modification	$372,325

Assume that any additional right of use, the original contract, and the modified contract meet the definition of a lease.

How would Lessee Corp account for the lease modification?

Analysis

Determine if the lease modification is a separate new contract

As the modification does not grant an additional right of use, Lessee Corp would determine that the modification is not a separate new contract. Since the modified contract meets the definition of a lease, Lessee Corp would account for one new modified lease as of January 1, 20X2.

Reassess lease classification based on the terms of the modified lease

Based on the facts at commencement date, Lessee Corp could reasonably conclude that the lease was an operating lease since none of the criteria for a finance lease were met (see LG 3.3 for lease classification criteria). At lease modification date, Lessee Corp could reasonably conclude that the lease continues to be an operating lease since none of the criteria for a finance lease are met.

Account for the modified lease

Lessee Corp would remeasure the lease as of the modification date as follows:

Balance sheet impact

Lessee Corp would remeasure the lease liability on the date of the modification by calculating the present value of the remaining two future lease payments for the modified lease term using Lessee

Corp's current discount rate of 6%. The modified lease liability would be $213,774, as shown in the table below.

	Year 2	Year 3	Total
Lease payment	$110,000	$110,000	$220,000
Discount	0	6.226	6,226
Present value	$110,000	$103,774	$213,774

Although the lease liability has been decreased as a result of the modification, it is not a partial termination of the lease because there was no change to the underlying asset being leased. Therefore, to calculate the adjustment to the lease liability, Lessee Corp would compare the recalculated and original lease liability balances on the modification date.

Original lease liability	$372,325
Revised lease liability	213,774
	$158,551

Lessee Corp would record the following journal entry to adjust the lease liability.

Dr. Lease liability	$158,551	
Cr. Right-of-use asset		$158,551

After the adjustment, the right-of-use asset will be equal to $221,774 (original balance of $380,325 - $158,551).

Income statement impact

Lessee Corp would recalculate the single lease expense using the following formula.

$$\frac{\text{Future undiscounted cash flows at the remeasurement date + (the right-of-use asset immediately after the remeasurement - the lease liability immediately after the remeasurement)}}{\text{Remaining lease term}}$$

The amounts are as follows:

$$\frac{\$220{,}000 + (\$221{,}774 - \$213{,}774)}{2} = \$114{,}000 \text{ single lease expense}$$

Lessee Corp would recognize annual single lease expense of $114,000 for the remaining term of the lease.

EXAMPLE LG 5-7

Accounting for a change in consideration in an operating lease - no change in lease classification

On January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease property to be used as a retail store. The following table summarizes information about the lease and the leased property:

Lease commencement date	January 1, 20X1
Initial lease term	5 years (includes a termination option available after year 3 with a termination penalty which is not reasonably certain of exercise at commencement date)
Remaining economic life of the leased property	35 years
Purchase option	None
Annual lease payments	$100,000
Payment date	Annually on January 1
Lessee Corp's incremental borrowing rate	5% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp
Other	◻ Title to the asset remains with Lessor Corp upon lease expiration ◻ The fair value of the property is $4 million at commencement ◻ Lessee Corp incurs $10,000 as initial direct costs

On January 1, 20X4, Lessee Corp considers terminating the lease and relocating to another location. To entice Lessee Corp to remain in its location, Lessor Corp agrees to amend the original lease contract to reduce the annual lease payments in the last two years to $90,000. The termination penalty in the contract remains the same. Lessee Corp ultimately concludes that it will remain in the lease through the initial lease term.

The following table summarizes information pertinent to the lease modification.

Modification date	January 1, 20X4
Modified annual lease payments	$90,000
Lessee Corp's incremental borrowing rate on January 1, 20X4	4% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp

Remaining economic life of the leased property	32 years
Fair value of the leased property at the modification date	$3.7 million
Right-of-use asset immediately before the modification	$199,238
Lease liability immediately before the modification	$195,238

Assume that any additional right of use, the original contract and the modified contract meet the definition of a lease.

How would Lessee Corp account for the lease modification?

Analysis

Determine if the lease modification is a separate new contract

As the modification does not grant an additional right of use, Lessee Corp would determine that the modification is not a separate new contract. Since the modified contract meets the definition of a lease, Lessee Corp would account for one new modified lease as of January 1, 20X4.

Reassess lease classification based on the terms of the modified lease

At lease commencement, since Lessee Corp is reasonably certain to not exercise the termination option, a lease term of five years was used. Based on the facts Lessee Corp could reasonably conclude that the lease was an operating lease at lease commencement since none of the criteria for a finance lease are met (see LG 3.3 for lease classification criteria). At the lease modification date, Lessee Corp could reasonably conclude that the lease continues to be an operating lease since none of the criteria for a finance lease are met.

Account for the modified lease

Lessee Corp would remeasure the lease as of the modification date as follows:

Balance sheet impact

Lessee Corp would remeasure the lease liability on the date of the modification by calculating the present value of the remaining future lease payments for the modified lease term using Lessee Corp's current discount rate of 4%. The modified lease liability would be $176,538, as shown in the table below.

	Year 4	**Year 5**	**Total**
Lease payment	$90,000	$90,000	$180,000
Discount	0	3,462	3,462
Present value	$90,000	$86,538	$176,538

To calculate the adjustment to the lease liability Lessee Corp would compare the recalculated and original lease liability balances on the modification date.

Revised lease liability	$176,538
Original lease liability	195,238
	($18,700)

Lessee Corp should record the following journal entry to adjust the lease liability.

Dr. Lease liability	$18,700	
Cr. Right-of-use asset		$18,700

After the adjustment, the right-of-use asset will be equal to $180,538 (original balance of $199,238 - $18,700).

Income statement impact

Lessee Corp would recalculate the single lease expense using the following formula.

$$\frac{\text{Future undiscounted cash flows at the remeasurement date + (the right-of-use asset immediately after the remeasurement - the lease liability immediately after the remeasurement)}}{\text{Remaining lease term}}$$

The amounts are as follows:

$$\frac{\$180{,}000 + (\$180{,}538 - \$176{,}538)}{2} = \$92{,}000 \text{ single lease expense}$$

Lessee Corp would recognize annual single lease expense of $92,000 for the remaining term of the lease.

EXAMPLE LG 5-8

Accounting for a modified finance lease – lease classification changes to an operating lease

On January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease manufacturing equipment. The following table summarizes information about the lease and the leased equipment:

Lease commencement date	January 1, 20X1
Lease term	10 years with no renewal option
Remaining economic life of the leased equipment	12 years
Purchase option	None

Annual lease payments	$100,000
Payment date	Annually on January 1
Lessee Corp's incremental borrowing rate	5% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp
Other	□ Title to the asset remains with Lessor Corp upon lease expiration □ The fair value of the property is $1.2 million at commencement □ Lessee Corp incurs $10,000 as initial direct costs

On January 1, 20x4, Lessee Corp and Lessor Corp amend the original lease contract to decrease the remaining term of the lease to four years and increase the annual lease payments to $110,000.

The following table summarizes information pertinent to the lease remeasurement required upon the change from a finance to an operating lease.

Modification date	January 1, 20x4
Remeasured remaining lease term	4 years
Modified annual lease payments	$110,000
Lessee Corp's incremental borrowing rate on the remeasurement date	6% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp
Remaining economic life of the leased equipment	9 years
Fair value of the leased equipment at the modification date	$900,000
Right-of-use asset immediately before the remeasurement	$574,548
Lease liability immediately before the remeasurement	$607,569

Assume that any additional right of use, the original contract, and the modified contract meet the definition of a lease.

How would Lessee Corp account for the remeasurement?

Analysis

Determine if the lease modification is a separate new contract

As the modification does not grant an additional right of use, Lessee Corp would determine that the modification is not a separate new contract. Since the modified contract meets the definition of a lease, Lessee Corp would account for one new modified lease as of January 1, 20X4.

Reassess lease classification based on the terms of the modified lease

Based on the facts at lease commencement date, Lessee Corp could reasonably conclude that the lease was a finance lease as the lease term was a major part of the remaining economic life of the equipment (see LG 3.3 for lease classification criteria). At the lease modification date, Lessee Corp could reasonably conclude that the lease is an operating lease since none of the criteria for a finance lease are met.

Account for the modified lease

Lessee Corp would remeasure the lease as of the modification date as follows:

Balance sheet impact

To remeasure the lease liability, Lessee Corp would first calculate the present value of the future lease payments for the new lease term (using the updated discount rate of 6%). As shown in the table, the revised lease liability would be $404,031.

	Year 4	**Year 5**	**Year 6**	**Year 7**	**Total**
Lease payment	$110,000	$110,000	$110,000	$110,000	$440,000
Discount	0	6,226	12,100	17,462	35,969
Present value	$110,000	$103,774	$97,900	$92,358	$404,031

To calculate the adjustment to the lease liability, Lessee Corp would compare the recalculated and original lease liability balances on the remeasurement date.

Revised lease liability	$404,031
Original lease liability	607,569
	($203,538)

Lessee Corp would record the following journal entry to adjust the lease liability.

Dr. Lease liability	$203,538	
Cr. Right-of-use asset		$203,538

After the adjustment, the right-of-use asset will be equal to $371,010 (original balance of $574,548 - $203,538).

Income statement impact

The single lease expense would be recalculated using the following formula.

$$\frac{\text{Future undiscounted cash flows at the remeasurement date + (the right-of-use asset after the remeasurement - the lease liability immediately after the remeasurement)}}{\text{Remaining lease term}}$$

$$\frac{\$440{,}000 + (\$371{,}010 - 404{,}031)}{4} = \$101{,}745 \text{ single lease expense}$$

The annual single lease expense of $101,745 would be recognized for the remaining term of the lease.

EXAMPLE LG 5-9

Remeasurement due to change in timing of leasehold incentive receivable

On January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease a building. The following table summarizes information about the lease and the leased property:

Lease commencement date	January 1, 20X1
Lease term	5 years with no renewal option
Remaining economic life of the leased property	30 years
Purchase option	None
Annual lease payments	$1,000,000
Payment date	January 1
Lessee Corp's incremental borrowing rate	5% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp
Lease incentive	Lessor Corp agrees to reimburse Lessee Corp up to $300,000 for leasehold improvements completed within the first two years of the lease
Other	□ Title to the asset remains with Lessor Corp upon lease expiration □ Lessee Corp incurs no initial direct costs

It is unlikely Lessee Corp would forgo any lease incentive it negotiated to receive from Lessor Corp. Lessee Corp expects that it will complete the improvements two years after lease commencement.

Lessee Corp finishes the leasehold improvements in one year (as opposed to the original estimate of two years) and utilizes the entire lease incentive of $300,000. The payment for the lease incentive was received on 12/31/X1. The following table summarizes information pertinent to leasehold improvements completion date.

Remaining lease term	4 years
Right-of-use asset immediately before leasehold improvements completion date	$3,497,534
Lease liability immediately before leasehold improvements completion date	$3,437,534

How should Lessee Corp account for the difference in timing from the original estimate?

Analysis

Since it is unlikely Lessee Corp would forgo any lease incentive it negotiated to receive from Lessor Corp, Lessee Corp would account for the incentive as an in-substance fixed payment to be received from Lessor Corp. Lessee Corp would consider the lease incentive as a negative lease payment two years after lease commencement since Lessee Corp expects that is when it will complete the improvements.

Based on the facts, Lessee Corp could reasonably conclude that the lease is an operating lease at lease commencement since none of the criteria for a finance lease are met (see LG 3.3 for lease classification criteria).

When measuring the lease liability at lease commencement, Lessee Corp would include the lease incentive as a negative lease payment based on the expected timing of completion of leasehold improvements (i.e., two years after commencement date). The lease liability at commencement would be $4,273,842 calculated as follows:

	1/1/X1	**1/1/X2**	**12/31/X2**	**1/1/X3**	**1/1/X4**	**1/1/X5**	**Total**
Lease payment	$1,000,000	$1,000,000	(300,000)	$1,000,000	$1,000,000	$1,000,000	$4,700,000
Discount	0	(47,619)	27,891	(92,971)	(136,162)	(177,298)	(426,158)
Present value	$1,000,000	$952,381	(272,109)	$907,029	$863,838	$822,702	$4,273,842

When the timing of the receipt of the lease incentive changes from the original estimate at commencement, the lease liability must be remeasured using the discount rate at lease commencement. In this example, the lease liability is remeasured at 12/31/x1 (concurrent with the receipt of the incentive payment).

To remeasure the lease liability, Lessee Corp would first calculate the present value of the future lease payments for the remaining lease term (using the original discount rate of 5%). As shown in the following table, the revised lease liability would be $3,723,248.

	1/1/X2	1/1/X3	1/1/X4	1/1/X5	Total
Lease payment	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$4,000,000
Discount	0	47,619	92,971	136,162	276,752
Present value	$1,000,000	$952,381	$907,029	$863,838	$3,723,248

To calculate the adjustment to the lease liability, Lessee Corp would compare the recalculated and original lease liability balances on the remeasurement date.

Revised lease liability	$3,723,248
Original lease liability	3,437,534
	($285,714)

Lessee Corp would record the following journal entry to adjust the lease liability.

Dr. Cash (for lease incentive received)	$300,000	
Cr. Right-of-use asset		$14,286
Cr. Lease liability		$285,714

After the adjustment, the right-of-use asset will be equal to $3,483,248 (original balance of $3,497,534 - $14,286).

The single lease expense would be recalculated using the following formula.

$$\frac{\text{Future undiscounted net cash flows at the remeasurement date + (the right-of-use asset immediately after the remeasurement - the lease liability immediately after the remeasurement)}}{\text{Remaining lease term}}$$

$$\frac{\$4{,}000{,}000 + (\$3{,}483{,}248 - \$3{,}723{,}248)}{4} = \$940{,}000 \text{ single lease expense}$$

Question LG 5-4 discusses amortization of a right-of-use asset that has been impaired and subsequently modified or remeasured.

Question LG 5-4

If a lessee impairs a right-of-use asset in an operating lease and then either modifies the lease such that the modification is not considered a new lease or a remeasurement event occurs, should the lessee continue to amortize the ROU asset on a straight-line basis?

PwC response

Yes. We believe the lessee should continue to amortize the right-of-use asset on a straight-line basis if an impairment of a right-of-use asset in an operating lease is subsequently followed by a lease modification that is not considered a new lease or a remeasurement event occurs. See LG 4.6.2 for more details about right-of-use asset amortization upon an impairment.

5.4 Reassessment of the short-term lease exemption

A lessee should reassess whether a short-term lease continues to qualify for the short-term lease measurement and recognition exemption when any of the following events occur:

- The lease term changes because it becomes reasonably certain that the lessee will exercise its renewal option such that, after the change, the remaining lease term extends more than 12 months from the end of the previously-determined lease term

- The lease term changes because it becomes reasonably certain that the lessee will not exercise a termination option such that, after the change, the remaining lease term extends more than 12 months from the end of the previously determined lease term

- The lessee becomes reasonably certain to exercise its option to purchase the underlying asset

If the lease no longer meets the requirements for the short-term lease measurement and recognition exemption, the lessee should apply the guidance discussed in LG 3 to determine the lease classification.

See LG 2.2.1 for information on the short-term lease measurement and recognition exemption.

5.5 Accounting for a lease termination – lessee—updated September 2021

When a lease is terminated in its entirety, there should be no remaining lease liability or right-of-use asset. Any difference between the carrying amounts of the right-of-use asset and the lease liability should be recorded in the income statement as a gain or loss; if a termination penalty is paid, that amount should be included in the gain or loss on termination.

If a lessee continues to use the asset for a period of time after the lease termination is agreed upon, the termination should be accounted for as a lease modification based on the modified lease term (through the planned lessee exit date). For example, if the lessee and lessor agree to terminate a lease in six months with a termination penalty, the lease should be accounted for as a modified lease with a six-month term.

Terminating the lease of one asset before the end of the lease term and leasing a similar asset from the same lessor may not always be considered a full termination of the original lease. In some cases, it may be treated as a modification. For example, if a lessee negotiates to terminate a lease of one floor of a building and concurrently negotiates a new lease of a different floor in the same building, this would be accounted for as a modification if the new lease was not priced at market. This is an important distinction to make because the accounting can vary significantly. A lease termination results in a gain or loss charged to the income statement immediately. A modification does not result in an immediate charge to the income statement, unless the modification is a considered a partial termination (see LG 5.5.1). In that case, there would be some impact to the income statement. However, the income statement impact will not be the same as it would be for a full lease termination.

5.5.1 Accounting for a partial lease termination — lessee

A modification of a lease may result in a partial termination of the lease. Examples of events that result in a partial termination include terminating the right to use one or more underlying assets and decreasing the leased space. A decrease in lease term is not considered a partial termination event. A partial termination should be recorded by adjusting the lease liability and right-of-use asset. The right-of-use asset should be decreased on a basis proportionate to the partial termination of the existing lease. The difference between the decrease in the carrying amount of the lease liability resulting from the modification and the proportionate decrease in the carrying amount of the right-of-use asset should be recorded in the income statement.

There are two ways to determine the proportionate reduction in the right-of-use asset. It can be based on either the reduction to the right-of-use asset or on the reduction to the lease liability. For example, if a lessee decreases the amount of space it is leasing in an office building by 45% and as a result, the lease liability decreases by 50%, the right-of-use asset could be decreased by either 45% or 50%. See Example 18 beginning at ASC 842-10-55-177 and Example LG 5-10 for examples of lessee accounting for partial lease terminations.

A lessee should treat its selected method as an accounting policy election by class of underlying asset. The policy should be applied consistently to all modifications that decrease the scope of a lease.

Example LG 5-10 illustrates a lessee's accounting for modification of an operating lease without a change in lease classification.

EXAMPLE LG 5-10

Accounting for a modified operating lease with a partial termination - no change to lease classification

On January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease property to be used as a warehouse. The following table summarizes information about the lease and the leased property:

Lease commencement date	January 1, 20X1
Lease term	5 years with no renewal option
Leased property	100,000 square feet of warehouse space
Remaining economic life of the leased property	30 years

Purchase option	None
Annual lease payments	$100,000
Payment date	January 1
Lessee Corp's incremental borrowing rate	5% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp
Other	□ Title to the leased property remains with Lessor Corp upon lease expiration □ Fair value of the leased property at commencement $2.5 million □ Lessee Corp incurs $10,000 initial direct costs

On January 1, 20X2, Lessee Corp and Lessor Corp amend the original lease contract to decrease the leased space from 100,000 square feet to 50,000 square feet, effective immediately. Commensurate with the reduction in leased space, the annual lease payment will be reduced from $100,000 a year to $50,000 a year. Lessee Corp is also required to pay Lessor Corp a one-time termination penalty of $30,000 along with its next lease payment.

The following table summarizes information pertinent to the lease modification.

Modification date	January 1, 20X2
Remaining lease term	4 years
Revised leased property	50,000 square feet
Revised annual lease payments	$50,000
Termination penalty	$30,000
Lessee Corp's incremental borrowing rate on January 1, 20X2	6% The rate Lessor Corp charges Lessee Corp in the lease is not readily determinable by Lessee Corp
Remaining economic life of the leased property	29 years
Fair value of the leased property at the modification date	$1.25 million
Right-of-use asset immediately before the modification	$380,325
Lease liability immediately before the modification	$372,325

Lessee Corp has historically accounted for the lease of 100,000 square feet as one lease component. Lessee Corp has previously made an accounting policy election to calculate the reduction in the right-of-use asset in proportion to the reduction to the right of use (i.e., decrease in leased space). Assume that any additional right of use, the original contract, and the modified contract meet the definition of a lease.

How would Lessee Corp account for the lease modification?

Analysis

Determine if the lease modification is a separate new contract

As the modification does not grant an additional right of use, Lessee Corp would determine that the modification is not a separate new contract. Since the modified contract meets the definition of a lease, Lessee Corp would account for one new modified lease as of January 1, 20X4.

Determine if the modification is a partial termination

Since Lessee Corp surrenders control of 50,000 square feet of space immediately the modification is a partial termination.

Reassess lease classification based on the terms of the modified lease

Based on the facts at lease commencement, Lessee Corp could reasonably conclude that the lease was an operating lease since none of the criteria for a finance lease were met. At the lease modification date, Lessee Corp could reasonably conclude that the lease continues to be an operating lease since none of the criteria for a finance lease are met (see LG 3.3 for lease classification criteria).

Account for the modified lease

Lessee Corp would remeasure the lease as of the modification date as follows:

Balance sheet impact

Lessee Corp would remeasure the lease liability on the date of the modification by calculating the present value of the remaining four future lease payments, including the termination penalty, for the modified lease term using Lessee Corp's current discount rate of 6%. The modified lease liability would be $213,651, as shown in the following table.

	Year 2	**Year 3**	**Year 4**	**Year 5**	**Total**
Lease payment	$80,000	$50,000	$50,000	$50,000	$230,000
Discount	0	2,830	5,500	8,019	16,349
Present value	$80,000	$47,170	$44,500	$41,981	$213,651

To calculate the adjustment to the lease liability, Lessee Corp would compare the recalculated and original lease liability balances on the modification date.

Original lease liability	$372,325
Revised lease liability	213,651
	$158,674

The lessee has an accounting policy choice for remeasuring the right-of-use asset either (a) based on the change in lease liability; or (b) based on the remaining right of use. The remeasurement of the right-of-use asset under both these approaches is illustrated below.

(a) Remeasuring the right-of-use asset based on the change in lease liability

Under the policy election to remeasure the right-of-use asset in proportion to the change in lease liability, the post-modification right-of-use asset is $218,241 (pre-modification right-of-use asset of $380,325 multiplied by 42.6% reduction in lease liability ($158,674 divided by $372,325)). To calculate the adjustment to the right-of-use asset, Lessee Corp would compare the recalculated and original right-of-use asset balances on the modification date as follows.

Original right of use asset	$380,325
Revised right of use asset	218,241
	$162,084

Lessee Corp would record the following journal entry to adjust the lease liability and right-of-use asset, with the difference between the adjustment to the lease liability and right-of-use asset being recorded to the income statement.

Dr. Lease liability	$158,674	
Dr. Loss	3,410	
Cr. Right of use asset		$162,084

Income statement impact

Lessee Corp would recalculate the single lease expense using the following formula.

$$\frac{\text{Future undiscounted cash flows at the remeasurement date + (the right-of-use asset immediately after the remeasurement - the lease liability immediately after the remeasurement)}}{\text{Remaining lease term}}$$

$$\frac{\$230{,}000 + (\$218{,}241 - \$213{,}651)}{4} = \$58{,}648 \text{ single lease expense}$$

Lessee Corp would recognize single annual lease expense of $58,648 for the remaining term of the lease.

(b) Remeasuring the right-of-use asset based on the remaining right of use

Under the accounting policy election to remeasure the right-of-use asset in proportion to the remaining right of use (i.e., decrease in leased space), the post-modification right-of-use asset is $190,163 (pre-modification right-of-use asset of $380,325 multiplied by the 50% reduction in leased space). To calculate the adjustment to the right-of-use asset, Lessee Corp would compare the recalculated and original right-of-use asset balances on the modification date as follows.

Original right of use asset	$380,325
Revised right of use asset	190,163
	$190,162

The adjustment to the lease liability is $186,162 (pre-modification lease liability of $372,325 multiplied by the 50% reduction in leased space).

Lessee Corp would record the following journal entry to adjust the lease liability and right-of-use asset, with the difference between the adjustment to the lease liability and right-of-use asset being recorded to the income statement.

Dr. Lease liability	$186,162	
Dr. Loss	4,000	
Cr. Right of use asset		$190,162

Next, Lessee Corp would adjust the lease liability to equal the present value of the remaining future lease payments (as calculated above). The adjustment would be calculated as follows:

Present value of remaining future lease payments	$213,651
Lease liability balance (after adjustment from the journal entry above)	$186,163
	$27,488

Lessee Corp would record the following journal entry:

Dr. Right of use asset	$27,488	
Cr. Lease liability		$27,488

After this entry, the post-modification right-of-use asset would be $217,651 and the post-modification lease liability would be $213,651.

Income statement impact

Lessee Corp would recalculate the single lease expense using the following formula.

$$\frac{\text{Future undiscounted cash flows at the remeasurement date + (the right-of-use asset immediately after the remeasurement - the lease liability immediately after the remeasurement)}}{\text{Remaining lease term}}$$

$$\frac{\$230{,}000 + (\$217{,}651 - \$213{,}651)}{4} = \$58{,}500 \text{ single lease expense}$$

Lessee Corp would recognize single annual lease expense of $58,500 for the remaining term of the lease.

A comparison of the income statement and balance sheet impact under the two alternative policy choices is below.

	Balance sheet		Income statement*	
Remeasuring right-of-use asset based on	**Revised lease liability**	**Revised right-of-use asset**	**Loss recorded at modification date**	**Annual lease expense for remaining lease term**
Change in lease liability	$213,651	$218,241	$3,410	$58,648
Remaining right of use	$213,651	$217,651	$4,000	$58,500

* Note the total income statement impact for either method should be the same over the <u>entire</u> lease term, the difference is timing over when the amounts are recognized. In this example, the total income statement impact for each method does not match exactly due to rounding.

When a lessee and lessor agree to early terminate a portion of the leased asset (e.g., a floor of a building or a portion of a warehouse) against payment of a termination penalty by the lessee to the lessor, the lessee should apply modification accounting to the remaining lease. That is, termination accounting should not be applied, and the lessee should allocate the termination penalty to the remaining lease. If there are multiple components in the remaining lease, the lessee should allocate the termination penalty to these components based on their relative standalone price at the contract modification date. The subsequent accounting will depend on the classification of the remaining lease components.

There may be a situation when a lessee and lessor have multiple lease contracts with each other and they agree that the lessee will early exit one lease in six months against payment of a termination penalty and simultaneously modify another lease. In this instance, the lessee should apply modification accounting to all the leases and allocate the termination penalty and the remaining contract consideration for all the leases to all the lease components based on their relative standalone price at the modification date. The subsequent accounting will depend on the classification of each of the lease components.

When a lessee and a lessor have multiple leases between them and agree to early terminate one lease with immediate exit by the lessee from the leased property against payment of a termination penalty without amending any of the other leases, the lessee should apply termination accounting to the early terminated lease. That is, the lessee should expense the entire termination penalty. However, if in addition to agreeing to early terminate one lease with immediate exit by the lessee from the leased property, the lessee and lessor also modify another lease, we believe the lessee should allocate the termination penalty and the remaining contract consideration for the leases that will continue to all the lease components, including the terminated lease, based on their relative standalone price at the modification date. The subsequent accounting for the remaining lease components will depend on their classification.

Example LG 5-11 illustrates recognition of a termination penalty by a lessee due to a lease modification when the lease term of one lease is extended and another lease with the same lessor is early terminated with immediate exit by the lessee from the property at the lease amendment date.

EXAMPLE LG 5-11

Accounting for a concurrent early lease termination of one lease and a lease extension of another lease between the same lessee and lessor - no change to lease classification

Lessee Corp is 2 years into a 7-year operating lease for an office building and 3 years into a 5-year operating lease for a warehouse with Lessor Corp. Lessor Corp and Lessee Corp agree to concurrently amend the two leases such that Lessee Corp will (a) extend the term of office building lease by three more years (i.e., a total remaining lease term of eight years), (b) vacate the warehouse immediately at the amendment date, and (c) pay Lessor Corp a termination penalty of $2 million at the lease amendment date. Lessee Corp will continue to classify the office building lease as an operating lease after the amendment.

The remaining rents under the warehouse lease are above market at the lease amendment date. The fair value of the amount that would need to be paid to someone to assume the warehouse lease is $2.5 million.

Assume that the present value of the remaining lease payments on the office building lease at the lessee's discount rate on the lease amendment date is $10 million and the fair value of the comparable market rents is $9 million.

How should Lessee Corp account for the lease amendments?

Analysis

The leases standard does not address the scenario in this example. We believe in this fact pattern, $12 million ($2 million termination payment for the warehouse lease + $10 million present value of remaining rent on the office building lease) should be allocated to both the lease termination and the amendment . The amount allocated to the warehouse lease should be expensed at the amendment date and the amount allocated to the office building lease should be recognized as straight-line rent expense during the remaining eight-year lease term. The allocation is as follows:

(in million$)	Fair value (A)	Relative % (A/$11.50) (B)	Actual amount (C)	Allocated amount (B × $12.0) (D)
Warehouse lease termination payment	$2.5	21.7%	$2.0	$2.6
Office building lease remaining lease payments	9.0	78.3%	$10.0	9.4
Total	**$11.50**	**100%**	**$12.0**	**$12.0**

Based on the above, Lessee Corp would expense $2.6 million as termination for the warehouse lease and recognize $9.4 million as straight-line rent expense during the remaining eight-year lease term for the office building lease.

5.5.2 *Purchase of a leased asset during the lease term — lessee*

A lessee's accounting for the purchase of an underlying asset is described in ASC 842-20-40-2.

ASC 842-20-40-2

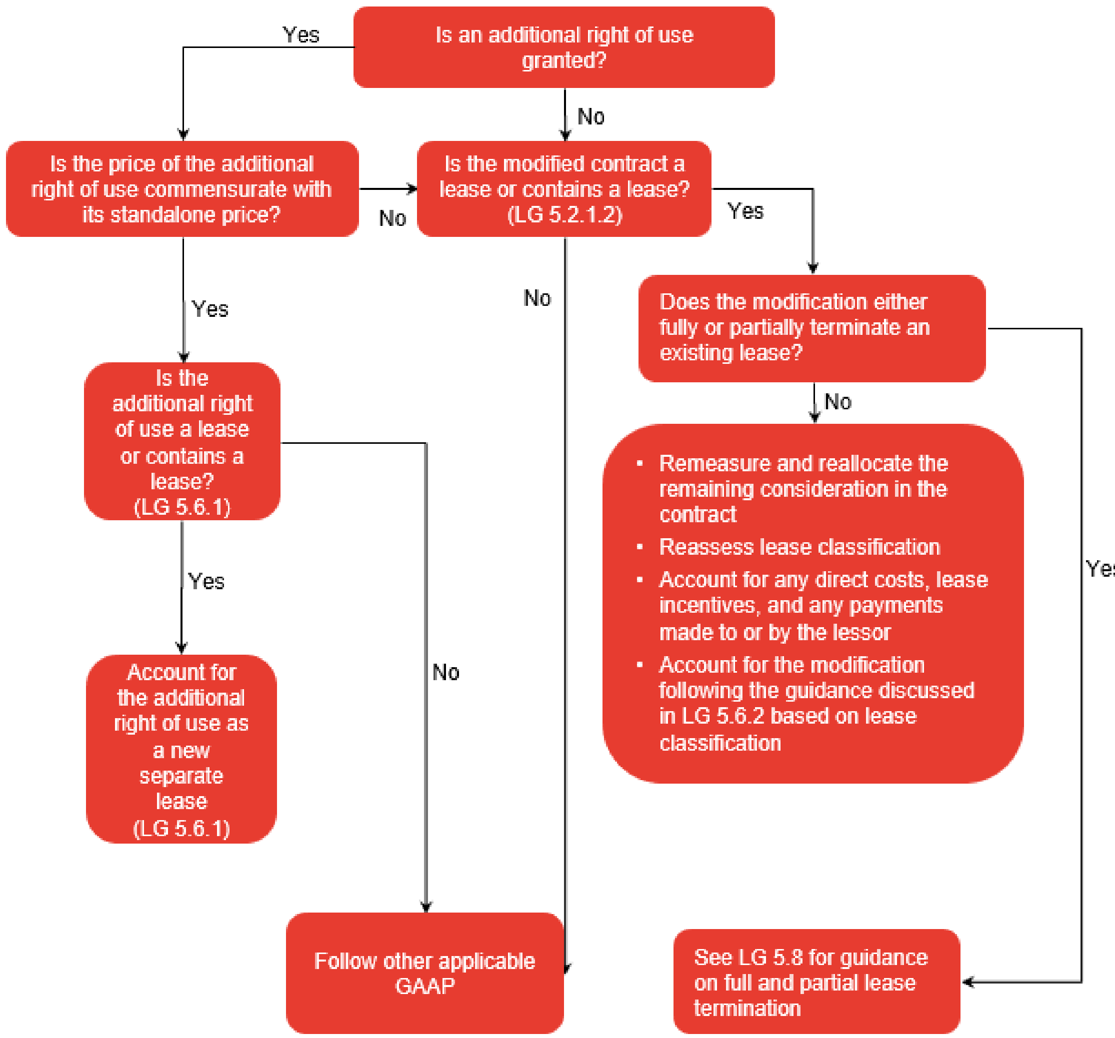
The termination of a lease that results from the purchase of an underlying asset by the lessee is not the type of termination of a lease contemplated by paragraph 842-20-40-1 but, rather, is an integral part of the purchase of the underlying asset. If the lessee purchases the underlying asset, any difference between the purchase price and the carrying amount of the lease liability immediately before the purchase shall be recorded by the lessee as an adjustment of the carrying amount of the asset. However, this paragraph does not apply to underlying assets acquired in a business combination, which are initially measured at fair value in accordance with paragraph 805-20-30-1.

5.6 *Accounting for a lease modification – lessor—updated September 2021*

A lessor's accounting for a lease modification depends on the type of modification made to the lease. Depending on the changes made to the lease contract, a lease modification can result in either a separate new contract (i.e., accounted for separate from the original contract) or a new modified contract.

Figure LG 5-3 illustrates the steps to determine the accounting for a change made to a lease.

Figure LG 5-3
Lessor's accounting for a lease modification



A lessor should account for all 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.

5.6.1 *Separate new contract — lessor*

A lessor should apply the same accounting as a lessee for a modification that results in a separate new contract. See LG 5.2.1.1 for more information on a lessee's accounting for a separate new contract.

5.6.2 *Single modified lease — lessor*

If a lease modification is not accounted for as a separate contract, a lessor should reassess the modified contract for whether it is a lease or contains a lease. If the modified contract is a lease or contains an embedded lease, a lessor should account for as a single new lease from the effective date of the modification. Since the modified lease is recorded as a single new lease, the lease classification should be reassessed based on the modified terms. We believe a lessor should use the relative standalone selling prices at the modification date to allocate the remaining contract consideration among the applicable contract components at the modification date. See LG 2.3 for information about the definition of a lease. See LG 2.4.3 for information on the allocation of contract consideration to components. The accounting treatment depends on the lease type before and after the modification. See LG 3 for information on lease classification.

5.6.2.1 Direct financing lease prior to the modification

The accounting for the modification of a direct financing lease will depend on how the lease is classified after it is modified.

Figure LG 5-4 summarizes the accounting for the modification of a direct financing lease.

Figure LG 5-4

Accounting for the modification of a direct financing lease

Modified lease classification	Lessor accounting	Example
Direct financing lease	The net investment in the modified lease does not change at the modification date. The lessor should 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, net of any deferred selling profit, immediately before the effective date of the modification plus any capitalized initial direct costs incurred in conjunction with the modification	Example LG 5-10
Sales-type lease	The lessor should account for the modified lease in accordance with ASC 842-30. The commencement date of the modified lease is the effective date of the modification. In order to calculate the selling profit or loss on the lease, the fair value of the underlying asset is its fair value at the effective date of the modification and its carrying amount is the carrying amount of the net investment in the original lease immediately before the effective date of the modification. Initial direct costs incurred in conjunction with a modification should be expensed unless the fair value of the underlying asset at the modification date equals its carrying amount (i.e., there is no selling profit). In that case, the initial direct costs would be deferred and recognized over the lease term using a method that produces a constant periodic rate of return on the lease when combined with the interest income on the lease receivable and the residual asset. In applying the lease classification criteria, it is possible for lease arrangements with variable lease payments to be classified by a lessor as a sales-type	Example LG 5-11

Modified lease classification	Lessor accounting	Example
	lease. This may lead to the recognition of a selling loss (i.e., day-one loss) by the lessor even if the overall arrangement is expected to be profitable. In response to concerns raised in the post implementation review, the FASB published ASU 2021-05, which upon adoption requires a lessor to classify a lease with variable lease payments (that do not depend on an index or a rate) as an operating lease at the lease commencement date if classifying the lease as a sales-type lease (or direct financing lease) would result in recognition of a selling loss. See LG 9.11 for the effective date and transition requirements of ASU 2021-05. See Example LG 4-9 for an illustration of a lease with variable payments.	
Operating lease	The lessor should recognize the underlying asset at the carrying amount of the net investment in the original lease immediately before the effective date of the modification. Initial direct costs incurred in conjunction with the modification are initially capitalized and then recognized as an expense on the same basis as lease income.	Example LG 5-12

Example LG 5-12, Example LG 5-13 and Example LG 5-14 illustrate the accounting for the modification of a direct financing lease.

EXAMPLE LG 5-12

Modification of a direct financing lease that does not impact classification

On January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease non-specialized digital imaging equipment. The following table summarizes information about the lease and the leased equipment at lease commencement.

Lease commencement date	January 1, 20X1
Lease term	5 years, no renewal option
Remaining economic life of the leased equipment	10 years
Purchase option	None
Annual lease payments	$195,000
Payment date	January 1
Fair value of the leased equipment at commencement	$1,200,000
Lessor Corp's carrying value of the leased equipment at commencement	$1,200,000

Estimated residual value	$400,000
Residual value guarantee	$300,000 residual value guarantee is provided by a third party unrelated to Lessee Corp or Lessor Corp
Rate implicit in the lease	5.0%
Other	Title to the asset remains with Lessor Corp upon lease expiration

At the end of year 1 of the lease, Lessor Corp agrees to modify the lease to extend the lease by one year. The key information at the modification date is shown in the following table.

Modification date	December 31, 20X1
Remaining modified lease term	5 years, no renewal option
Remaining economic life	9 years
Purchase option	None
Annual lease payment	$168,000
Payment date	January 1
Fair value of the leased equipment at the modification date	$1,000,000
Lessor Corp's carrying amount of net investment in the lease on the modification date	$1,055,201 (interest income of $50,201 was recorded in the first year of the lease)
Estimated residual value	$360,000
Residual value guarantee	$275,000 residual value guarantee is provided by a third party unrelated to Lessee Corp or Lessor Corp
Rate implicit in the modified lease	6.75%

The modified lease consideration is at a discount to the current market rate for the additional term for this particular lease contract. Collectibility of lease payments is probable. Any additional right of use, the original contract and the modified contract meet the definition of a lease.

How would Lessor Corp account for the lease modification?

Analysis

Determine if the lease modification is a separate new contract

As the modification does not grant an additional right of use (an increase in lease term is not considered an additional right of use), Lessor Corp would determine that the modification is not a separate new contract. Since the modified contract meets the definition of a lease, Lessor Corp should account for one new modified lease as of December 31, 20X1.

Reassess lease classification based on the terms of the modified lease

Based on the facts at lease commencement, Lessor Corp could reasonably conclude that the lease was not a sales-type lease because none of the criteria in ASC 842-10-25-2 were met (see LG 3.3 for lease classification criteria). Lessor Corp could further reasonably conclude that the lease was a direct]financing lease because the sum of the present value of the lease payments and the present value of the residual asset guaranteed by the third-party guarantor was substantially all of the fair value of the leased equipment and collectibility of the lease payments was probable. Therefore, Lessor Corp would initially recognize a net investment in the lease of $1,200,000 and derecognized the carrying value of the equipment of $1,200,000.

At the lease modification date, Lessor Corp would base its lease classification reassessment on the equipment fair value as of the modification date and discount rate implicit in the modified lease (6.75%). Lessor Corp could reasonably conclude that the lease is not a sales-type lease because none of the criteria in ASC 842-10-25-2 are met (see LG 3.3 for lease classification criteria). Lessor Corp could further reasonably conclude that the lease is a direct financing lease because the sum of the present value of the lease payments and the present value of the residual asset guaranteed by the third-party guarantor is substantially all of the fair value of the leased equipment and collectibility of the lease payments is probable.

Account for the modified lease

To account for the modified lease, Lessor Corp would carry forward the net investment in the lease immediately before the effective date of the modification ($1,055,201); this would be the opening balance of the net investment in the modified lease. To retain the same net investment in the lease while the lease payments, lease term, and estimated residual value have changed, Lessor Corp must adjust the discount rate for the lease from the rate implicit in the modified lease of 6.75% to the rate that when applied to the total remaining lease payments and the estimated residual value produces a present value equal to the initial net investment of $1,055,201, which is 4.66%. Prospectively, Lessor Corp would recognize interest income on the lease based on 4.66%.

EXAMPLE LG 5-13

Modification of a direct financing lease that changes lease classification to a sales-type lease

On January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease non-specialized digital imaging equipment. The following table summarizes information about the lease and the leased equipment at lease commencement.

Lease commencement date	January 1, 20X1
Lease term	5 years, no renewal option
Remaining economic life of the leased equipment	10 years
Purchase option	None
Annual lease payments	$195,000
Payment date	January 1
Fair value of the leased equipment at commencement	$1,200,000
Lessor Corp's carrying value of the leased equipment at commencement	$1,200,000
Estimated residual value	$400,000
Residual value guarantee	$300,000 residual value guarantee is provided by a third party unrelated to Lessee Corp or Lessor Corp
Rate implicit in the lease	5.0%
Other	Title to the asset remains with Lessor Corp upon lease expiration

At the end of year 2 of the lease, Lessor Corp agrees to modify the lease to extend the lease term by three years. The key information at the modification date is as shown in the following table.

Modification date	January 1, 20X3
Remaining modified lease term	6 years, no renewal option
Remaining economic life	7 years
Purchase option	None
Annual lease payment	$190,000
Payment date	January 1
Fair value of the leased equipment at the modification date	$1,000,000
Lessor Corp's carrying amount of net investment in the lease on the modification date	$903,169 (interest income of $93,169 was recorded in the first 2 years of the lease)

Estimated residual value	$100,000
Residual value guarantee	$75,000 residual value guarantee is provided by a third party unrelated to Lessee Corp or Lessor Corp
Rate implicit in the modified lease	8.49%

The modified lease consideration is at a discount to the current market rate for the additional term for this particular lease contract. The collectibility of lease payments is probable. Any additional right of use, the original contract, and the modified contract meet the definition of a lease.

How would Lessor Corp account for the lease modification?

Analysis

Determine if the lease modification is a separate new contract

As the modification does not grant an additional right of use (an increase in lease term is not considered an additional right of use), Lessor Corp would determine that the modification is not a separate new contract. Since the modified contract meets the definition of a lease, Lessor Corp would account for one new modified lease as of January 1, 20X3.

Reassess lease classification based on the terms of the modified lease

Based on the facts at lease commencement, Lessor Corp could reasonably conclude that the lease was not a sales-type lease because none of the criteria in ASC 842-10-25-2 were met (see LG 3.3. for lease classification criteria). Lessor Corp could further reasonably conclude that the lease was a direct financing lease because the sum of the present value of the lease payments and the present value of the residual asset guaranteed by the third-party guarantor was substantially all of the fair value of the leased equipment and collectibility of the lease payments is probable. Therefore, Lessor Corp would initially recognize a net investment in the lease of $1,200,000 and derecognized the carrying value of the equipment of $1,200,000.

At the lease modification date, Lessor Corp could reasonably conclude that the lease is a sales-type lease because the remaining lease term of six years represents a major part of the remaining economic life of seven years (see LG 3.3. for lease classification criteria).

Account for the modified lease

To account for the modified lease, Lessor Corp would recognize a net investment in the sales-type lease of $1,000,000 (the fair value of the equipment on that date) and derecognize the net investment in the original direct financing lease of $903,169. The difference between these two amounts ($96,831) is the selling profit. See LG 4.3.1.1 for further details on accounting for selling profit.

After the modification, Lessor Corp would account for the lease in accordance with ASC 842-30, as it would any other sales-type lease.

EXAMPLE LG 5-14

Modification of a direct financing lease that changes lease classification to an operating lease

On January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease non-specialized digital imaging equipment. The following table summarizes information about the lease and the leased equipment at lease commencement.

Lease commencement date	January 1, 20X1
Lease term	5 years, no renewal option
Remaining economic life of the leased equipment	10 years
Purchase option	None
Annual lease payments	$195,000
Payment date	January 1
Fair value of the leased equipment at commencement	$1,200,000
Lessor Corp's carrying value of the leased equipment at commencement	$1,200,000
Estimated residual value	$400,000
Residual value guarantee	$300,000 residual value guarantee is provided by a third party unrelated to Lessee Corp or Lessor Corp
Rate implicit in the lease	5.0%
Other	Title to the asset remains with Lessor Corp upon lease expiration

At the end of year 1 of the lease, Lessor Corp agrees to modify the lease to shorten the lease term by two years. The key information at the modification date is shown in the following table.

Modification date	January 1, 20X2
Remaining modified lease term	2 years, no renewal option
Remaining economic life	9 years
Purchase option	None
Annual lease payment	$190,000

Payment date	January 1
Fair value of the leased equipment at the modification date	$1,000,000
Lessor Corp's carrying amount of net investment in the lease on the modification date	$1,055,201 (interest income of $50,201 was recorded in the first year of the lease)
Estimated residual value	$700,000
Residual value guarantee	No residual value guarantee is provided
Rate implicit in the modified lease	5.43%

The modified lease consideration is at a discount to the current market rate for the additional term for this particular lease contract. Collectibility of lease payment is probable. Any additional right of use, the original contract, and the modified contract meet the definition of a lease.

How would Lessor Corp account for the lease modification?

Analysis

Determine if the lease modification is a separate new contract

As the change in lease term is not an additional right of use, Lessor Corp would determine that the modification is not a separate new contract. Since the modified contract meets the definition of a lease, Lessor Corp would account for one new modified lease as of January 1, 20X2.

Reassess lease classification based on the terms of the modified lease

Based on the facts at lease commencement, Lessor Corp could reasonably conclude that the lease was not a sales-type lease because none of the criteria in ASC 842-10-25-2 were met (see LG 3.3 for lease classification criteria). Lessor Corp could further reasonably conclude that the lease was a direct financing lease because the sum of the present value of the lease payments and the present value of the residual asset guaranteed by the third-party guarantor was substantially all of the fair value of the leased equipment and collectibility of the lease payments was probable. Therefore, Lessor Corp would initially recognize a net investment in the lease of $1,200,000 and derecognized the carrying value of the equipment of $1,200,000.

At the lease modification date, Lessor Corp could reasonably conclude that the modified lease as an operating lease because it does not meet any of the criteria to be classified as a sales-type lease or direct financing lease (see LG 3.3 for lease classification criteria).

Account for the modified lease

Lessor Corp would account for the modified lease by derecognizing the net investment in the lease of $1,055,201 and recognizing the equipment at the same amount. If collectibility of the lease payments is probable, Lessor Corp would recognize the remaining lease payments on a straight-line basis over the two-year modified lease team and record depreciation on the equipment.

5.6.2.2 *Operating lease prior to the modification — lessor*

The accounting for the modification of an operating lease will depend on how the lease is classified after it is modified.

Figure LG 5-5 summarizes the accounting for the modification of an operating lease.

Figure LG 5-5
Accounting for the modification of an operating lease

Modified lease classification	Lessor accounting	Example
Direct financing lease	The net investment in the lease on the modification date equals the lessor's carrying value of the asset adjusted for any accrued rent asset or liability on that date. Any selling profit and initial direct costs incurred in conjunction with the modification are deferred and included in the measurement of the initial net investment in the modified lease. Any unamortized initial direct costs associated with the original lease may continue to be included in the measurement of the initial net investment in the modified lease.	
Sales-type lease	The net investment in the lease on the modification date will equal fair value of the asset. Selling profit/loss would be adjusted for any prepaid or accrued rent on that date and any initial direct costs incurred in conjunction with the modification. In applying the lease classification criteria, it is possible for lease arrangements with variable lease payments to be classified by a lessor as a sales-type lease. This may lead to the recognition of a selling loss (i.e., day-one loss) by the lessor even if the overall arrangement is expected to be profitable. In response to concerns raised in the post implementation review, the FASB published ASU 2021-05, which upon adoption requires a lessor to classify a lease with variable lease payments (that do not depend on an index or a rate) as an operating lease at the lease commencement date if classifying the lease as a sales-type lease (or direct financing lease) would result in recognition of a selling loss. See LG 9.11 for the effective date and transition requirements of ASU 2021-05. See Example LG 4-9 for an illustration of a lease with variable payments.	Example LG 5-16
Operating lease	No gain or loss is recognized as a result of the modification. A new straight-line lease income is calculated based on the remaining payments adjusted for any prepaid or accrued rent at the date the modification is recorded. Any initial direct costs incurred in conjunction with the modification are initially capitalized and then recognized as an expense on the same basis as lease income.	Example LG 5-15

Example LG 5-15 and Example LG 5-16 illustrate the accounting for the modification of an operating lease and a sales-type lease, respectively.

EXAMPLE LG 5-15

Modification of an operating lease that does not impact lease classification

On January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease property to be used as a retail store. The following table summarizes information about the lease and the leased property at lease commencement.

Lease commencement date	January 1, 20X1
Lease term	5 years, no renewal option
Purchase option	None
Annual lease payments	$500,000 in the first 2 years and $510,000 in each year thereafter
Payment date	January 1
Remaining economic life of the leased property	40 years
Fair value of the leased property at commencement	$7,000,000
Other	Title to the asset remains with Lessor Corp upon lease expiration

On January 1, 20X4, Lessee Corp and Lessor Corp amend the original lease contract to increase the term of the lease for an additional three years. The key information at the modification date is shown in the following table.

Modification date	January 1, 20X4
Remaining modified lease term	5 years, no renewal option
Purchase option	None
Annual lease payments	$507,000 for the next two years and $509,000 for the three years added to the term
Payment date	January 1
Accrued rent asset	$8,000
Remaining economic life of the leased property	37 years
Fair value of the leased property at the modification date	$6,750,000

Estimated residual value	$50,000
Rate implicit in the modified lease	3.28%

The increase in lease consideration is at a discount to the current market rate for the additional term for this particular lease contract. Collectibility of lease payments is probable. Any additional right of use, the original contract, and the modified contract meet the definition of a lease.

How would Lessor Corp account for the lease modification?

Analysis

Determine if the lease modification is a separate new contract

Since there is no additional right of use (an increase in lease term is not considered an additional right of use), Lessor Corp would determine that the modification is not a separate new contract. As the modified contract meets the definition of a lease, Lessor Corp would account for one new modified lease as of January 1, 20X4.

Reassess lease classification based on the terms of the modified lease

Based on the facts at lease commencement, Lessor Corp could reasonably conclude the lease was an operating lease because it did not meet any of the criteria to be classified as a sales-type lease or as a direct financing lease (see LG 3.3 for lease classification criteria). At the lease modification date, Lessor Corp could reasonably conclude that the modified lease is an operating lease because it does not meet any of the criteria to be classified as a sales-type lease or as a direct financing lease.

Account for the modified lease

Lessor Corp would recognize the lease payments to be received under the modified lease, net of its accrued rent asset balance immediately before the modification, on a straight-line basis over the remaining five-year lease term as shown below.

1/1/X4	$507,000
1/1/X5	507,000
1/1/X6	509,000
1/1/X7	509,000
1/1/X8	509,000
Total payments	$2,541,000
Less: accrued rent asset	($8,000)
Net payments	$2,533,000

Lessor Corp would recognize annual straight-line income of $506,600 ($2,533,000 ÷ 5 years).

EXAMPLE LG 5-16

Modification of an operating lease that changes lease classification to a sales-type lease

On January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease non-specialized digital imaging equipment. The following table summarizes information about the lease and the leased equipment at lease commencement.

Lease commencement date	January 1, 20X1
Lease term	5 years, no renewal option
Purchase option	None
Annual lease payments	$150,000 in the first year with a 4% increase each year thereafter
Payment date	January 1
Remaining economic life of the leased equipment	10 years
Carrying value and fair value of the equipment at lease commencement	$1,300,000

At the beginning of year 4 of the lease, Lessee Corp and Lessor Corp agree to extend the lease term for four additional years. The key components at the modification date are shown in the following table.

Modification date	January 1, 20X4
Remaining modified lease term	6 years, no renewal option
Purchase option	None
Annual lease payments	$173,000
Payment date	Annually on January 1
Accrued rent asset	$19,229
Remaining economic life of the leased equipment	7 years
Lessor Corp's carrying value of the leased equipment	$910,000
Fair value of the equipment at the modification date	$1,000,000
Estimated residual value	$50,000
Rate implicit in the modified lease	3.28%

The modified lease consideration is at a discount to the current market rate for the additional term for this particular lease contract. Any additional right of use, the original contract, and the modified contract meet the definition of a lease.

How would Lessor Corp account for the lease modification?

Analysis

Determine if the lease modification is a separate new contract

Since the change in lease term is not an additional right of use, Lessor Corp would not account for the modification as a new lease, separate from the original five-year lease. As the modified contract meets the definition of a lease, Lessor Corp would account for one new modified lease as of January 1, 20X4.

Reassess lease classification based on the terms of the modified lease

Based on facts at lease commencement, Lessor Corp could reasonably conclude that the lease was an operating lease because none of the criteria in ASC 842-10-25-2 were met (see LG 3.3 for lease classification criteria). Lessor Corp would calculate a straight-line rental revenue amount of $162,490 annually. At lease modification, Lessor Corp could reasonably conclude that the modified lease is a sales-type lease since the modified lease is for a major part of the remaining economic life of the equipment.

Account for the modified lease

Lessor Corp would record a selling profit based on the following:

Lease receivable	$959,000
Less: carrying value of the leased asset at the modification date	(910,000)
Plus: present value of the unguaranteed residual value	41,000
Less: accrued rent asset balance before the modification	(19,229)
Selling profit	$70,771

The net investment in the modified lease is $1,000,000 (lease receivable plus unguaranteed residual value).

After the modification, Lessor Corp would account for the lease in accordance with ASC 842-30, as it would any other sales-type lease, using the discount rate for the lease at the modification date.

5.6.2.3 *Sales-type lease prior to the modification*

The accounting for the modification of a sales-type lease will depend on how it is classified after it is modified.

Figure LG 5-6 summarizes the accounting for the modification of a sales-type lease.

Figure LG 5-6
Accounting for the modification of a sales-type lease

Modified lease classification	Lessor accounting	Example
Direct financing lease	The net investment in the modified lease does not change at the modification date. The lessor should 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, net of any deferred selling profit immediately before the effective date of the modification plus any capitalized initial direct costs incurred in conjunction with the modification.	The accounting is the same as shown in Example LG 5-10
Sales-type lease	Same as a direct financing lease	The accounting is the same as shown in Example LG 5-10
Operating lease	The lessor should recognize the underlying asset at the carrying amount of the net investment in the original lease immediately before the effective date of the modification. Any initial direct costs incurred in conjunction with the modification are expensed on the same basis as the lease income.	The accounting is the same as shown in Example LG 5-12

5.7 Accounting for lease remeasurement – lessor

A lessor is not subject to lease remeasurement guidance similar to the remeasurement guidance for a lessee. A lessor should account for the exercise by a lessee of an option to extend or terminate the lease or to purchase the underlying asset as a lease modification unless the exercise of that option by the lessee is consistent with the assumptions that the lessor made in accounting for the lease at the commencement date of the lease (or the most recent effective date of a modification that is not accounted for as a separate contract).

Question LG 5-9 discusses the accounting by a lessor for reimbursement of capital improvements.

Question LG 5-5

Lessor Corp and Lessee Corp enter into a 5-year operating lease of real estate on January 1, 20X1. The lease permits Lessor Corp to pass on depreciation costs to Lessee Corp for capital improvements made to the building during the lease term. The capital improvements are not an additional performance obligation promised by Lessor Corp to Lessee Corp. On January 1, 20X2, Lessor Corp completes a roof replacement project at a total cost of $100,000. Lessor Corp has determined the useful life of the improvement to be 10 years. On January 1, 20X2 Lessor Corp determines that Lessee Corp will be responsible to pay additional rent of $10,000 per year ($100,000/10 years) during the four- year remaining lease term. When should Lessor Corp recognize revenue from the additional rent it will collect from Lessee Corp?

PwC response

The amount of consideration due to Lessor Corp over the remainder of the lease term is determinable upon completion of the roof replacement. However, since the capital improvement is not a separate component, we believe Lessor Corp should record the additional rent associated with the capital improvement over the remaining lease term consistent with satisfaction of Lessor Corp's obligation to continue to provide Lessee Corp the usage of the underlying asset over the lease term (i.e., on a straight-line basis over the reminder of the lease term, or $10,000 annually).

5.8 Accounting for a lease termination – lessor—updated September 2021

A lessor's accounting for the underlying asset at the end of the lease term is described in ASC 842-30-35-5.

ASC 842-30-35-5

At the end of the lease term, a lessor shall reclassify the net investment in the lease to the appropriate category of asset (for example, property, plant, and equipment) in accordance with other Topics, measured at the carrying amount of the net investment in the lease. The lessor shall account for the underlying asset that was the subject of a lease in accordance with other Topics.

If a lease is fully terminated prior to the end of the lease term, a lessor should follow the guidance in ASC 842-30-40-2.

ASC 842-30-40-2

If a sales-type lease or a direct financing lease is terminated before the end of the lease term, a lessor shall do all of the following:

a. Test the net investment in the lease for impairment in accordance with Topic 310 on receivables and recognize any impairment loss identified

b. Reclassify the net investment in the lease to the appropriate category of asset in accordance with other Topics, measured at the sum of the carrying amounts of the lease receivable (less any amounts still expected to be received by the lessor) and the residual asset

c. Account for the underlying asset that was the subject of the lease in accordance with other Topics.

If a lessee continues to use the asset or a portion of the asset for a period time after the lease termination is agreed upon, the termination should be accounted for as a lease modification based on the modified lease term (through the planned exit date). For example, if the lessee and lessor agree to terminate a lease in six months with a termination penalty, the lease should be accounted for as a modified lease with a six-month term.

Question LG 5-6 discusses the accounting by a lessor for a termination penalty paid by a lessee due to a modification of two leases between them with immediate exit of one property by the lessee at the lease modification date.

Question LG 5-6

Lessor Corp is 2 years into a 7-year operating lease for an office building and 3 years into a 5-year operating lease for a warehouse with Lessee Corp. Lessor Corp and Lessee Corp agree to concurrently amend the two leases such that Lessee Corp will (a) extend the term of office building lease by three more years (i.e., a total remaining lease term of eight years), (b) vacate the warehouse immediately at the amendment date, and (c) pay Lessor Corp a termination penalty of $2 million at the lease amendment date. Lessee Corp will continue to classify the office building lease as an operating lease after the amendment.

How should Lessor Corp account for these lease amendments?

PwC response

While this fact pattern is not addressed exactly in the leases standard, we believe the guidance in ASC 842-10-25-15 can be applied by analogy.

Under ASC 842-10-25-15, if an operating lease is modified and the modification is not accounted for as a separate contract, a lessor should account for the modification as a termination of the existing lease and creation of a new lease at the modification date. If the new lease created is an operating lease, the lessor should include any prepaid or accrued rent balance from the original lease as part of the lease payments for the modified lease.

Based on an analogy to ASC 842-10-25-15, we believe Lessor Corp should account for the $2 million payment received from Lessee Corp for the warehouse lease termination as prepaid rent and include it as part of the lease payments for the modified office building lease. Lessor Corp would subsequently recognize $2 million lease income on a straight-line basis over the remaining eight-year lease term.

Question LG 5-7 discusses the income statement recognition by a lessor for a payment made to a lessee to induce the lessee to terminate an operating lease before the end of the lease term when the payment meets the definition of initial direct cost.

Question LG 5-7

Lessor Corp makes a payment to Lessee Corp to induce Lessee Corp to terminate the lease before the end of the lease term so that Lessor Corp may enter into a new lease with a different lessee. The new lease with the new lessee is classified as operating by Lessor Corp and Lessor Corp determines the payment made by Lessor Corp to Lessee Corp meets the definition of an initial direct cost.

Should Lessor Corp recognize the payment to Lessee Corp as an expense or as a reduction in revenue in its income statement if Lessor Corp determines that the payment to Lessee Corp meets the definition of initial direct cost?

PwC response

Lessor Corp needs to first determine whether the payment made by Lessor Corp to Lessee Corp meets the definition of an initial direct cost (see LG 4.2.2.2 for initial direct costs). If it does, based on the guidance ASC 842-30-25-11(c), Lessor Corp should recognize the initial direct cost as an expense, and not as a reduction in revenue in its income statement, over the term of the new lease on the same basis as lease income in its income statement (which is generally on a straight-line basis).

Chapter 6: Sale and leaseback transactions— updated June 2021

6.1 Sale and leaseback transactions: chapter overview

This chapter discusses the specific accounting considerations applicable to sale and leaseback transactions. Different accounting outcomes can exist depending on the structure of the transaction. In addition, the accounting treatment can be complex. It is important to understand the accounting guidance and key considerations when evaluating a sale and leaseback transaction.

Determining whether a sale has occurred in the context of a sale and leaseback transaction is very important and determines the initial and subsequent accounting. This chapter details the accounting for both when the transaction qualifies as a sale and when it does not from both the seller-lessee's and buyer-lessor's perspectives.

See FSP 14 for information on the disclosure requirements for sale and leaseback transactions by both seller-lessees and buyer-lessors.

6.2 Sale and leaseback transactions: introduction

In a sale and leaseback transaction, one party (the seller-lessee) sells an asset it owns to another party (the buyer-lessor) and simultaneously leases back all or a portion of the same asset for all, or part of, the asset's remaining economic life. The seller-lessee transfers legal ownership of the asset to the buyer-lessor in exchange for consideration, and then makes periodic rental payments to the buyer-lessor to retain the use of the asset.

Sale and leaseback transactions occur in a number of situations and are economically attractive for seller-lessees as they can be used to:

- Generate cash flows
- Effectively refinance at a lower rate due to the transfer of tax ownership and related tax benefits
- Reduce exposure to the risks of owning assets
- Result in less financing reflected on the balance sheet than under a traditional mortgage
- Provide temporary transition space to a seller-lessee that is relocating to a new property

Reporting entities often enter into sale and leaseback transactions with appreciated assets, such as real estate, as well as large-ticket assets, such as airplanes, rail cars, and freight ships.

While some transactions are easily identified as sales and leasebacks, certain arrangements required to be accounted for as a sale and leaseback may not be as obvious. For example, when a lease will not commence until after an asset is constructed, the lessee may obtain control of the underlying asset during the construction period, prior to lease commencement. This arrangement may be subject to sale and leaseback accounting.

6.2.1 Sale and leaseback-sublease transactions

A sale and leaseback-sublease occurs when a seller-lessee enters into a sale and leaseback of an underlying asset that is subject to an existing operating lease or is subleased (or intended to be subleased) by the seller-lessee to another party under an operating lease. For example, an entity may purchase a vehicle and lease it to a third party under an operating lease. If the entity then sells the vehicle to a bank and leases it back under an operating lease, the entity is now a lessee-sublessor and subject to sale and leaseback accounting, as described in this chapter.

6.3 Sale and leaseback: determining whether a sale has occurred—updated September 2021

A transaction is accounted for as a sale of an underlying asset and a leaseback of that underlying asset only if the initial transaction qualifies as a sale in accordance with ASC 606, *Revenue from Contracts with Customers* (the "revenue standard").

To qualify as a sale of an asset under the revenue standard, the seller-lessee needs to ensure the customer (in this case, the buyer-lessor) obtains control of the asset. ASC 842-40-25-1 references the revenue standard for purposes of evaluating whether the transfer of an asset should be accounted for as a sale.

ASC 842-40-25-1

An entity shall apply the following requirements in Topic 606 on revenue from contracts with customers when determining whether the transfer of an asset shall be accounted for as a sale of the asset:

a. Paragraphs 606-10-25-1 through 25-8 on the existence of a contract

b. Paragraph 606-10-25-30 on when an entity satisfies a performance obligation by transferring control of an asset.

Sale and leaseback transactions must also be evaluated to determine whether the classification of the leaseback or the existence of a seller-lessee repurchase option prevent accounting for the transfer of the asset as a sale. See LG 6.3.4 for information on the impact of lease classification on qualification as a sale and LG 6.3.5 for information on repurchase rights and obligations and renewal rights in a sale and leaseback transaction.

6.3.1 Sale and leaseback: Existence of a contract

The first step is to identify the contract. A contract can be written, oral, or implied by an entity's customary business practices. Generally, any agreement that creates legally enforceable rights and obligations meets the definition of a contract.

ASC 606-10-25-1 lists the criteria that must be met for a reporting entity to conclude that a contract exists.

Excerpt from ASC 606-10-25-1

An entity shall account for a contract with a customer… only when all of the following criteria are met:

a. The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations.

b. The entity can identify each party's rights regarding the goods or services to be transferred.

c. The entity can identify the payment terms for the goods or services to be transferred.

d. The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).

e. It is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer.

See RR 2.6 for information on identifying and evaluating the existence of a contract.

6.3.2 Sale and leaseback: Control indicators

When evaluating if control has been transferred to the buyer-lessor in a sale and leaseback transaction, ASC 842 requires a reporting entity to look to the five transfer of control indicators in the revenue standard, which are:

- The reporting entity has a present right to payment
- The customer has legal title
- The customer has physical possession
- The customer has the significant risks and rewards of ownership
- The customer has accepted the asset

This is a list of indicators, not criteria. Not all of the indicators need to be met for a reporting entity to conclude that control has transferred to the buyer-lessor in a sale and leaseback transaction; the factors should be evaluated collectively to determine whether the buyer-lessor has obtained control. This assessment should be focused primarily on the buyer-lessor's perspective. Judgment will be required to determine whether a sale has occurred. The conclusion will be based on the facts and circumstances of the transaction. See RR 6.2 for information on determining whether control of an asset has been transferred.

The sections that follow describe how each of the indicators are applied in the context of a sale and leaseback transaction.

6.3.2.1 *Sale and leaseback: Present right to payment*

A buyer-lessor's present obligation to pay could indicate that the seller-lessee has transferred the ability to direct the use of the asset and the buyer-lessor has obtained substantially all of the remaining benefits from the asset. The seller's motivation in a typical sale and leaseback transaction is to generate liquidity. Accordingly, the buyer-lessor typically pays the agreed upon purchase price for the asset upfront, in which case this indicator would be satisfied. In instances where the buyer-lessor does not make an upfront payment, the seller-lessee will need to further evaluate whether a present right to payment exists.

6.3.2.2 *Sale and leaseback: Buyer-lessor has legal title*

The party that has legal title is typically the party that can direct the use of and receive the benefits from an asset. The benefits of holding legal title include the ability to sell an asset, exchange it for another good or service, or use it to secure or settle debt, all of which indicate that the holder has control.

While not determinative in isolation, we believe the transfer of legal title to a buyer is an important indicator when distinguishing between whether a transaction results in a sale or a lease of an asset.

6.3.2.3 *Sale and leaseback: Buyer-lessor has physical possession*

Physical possession of an asset typically gives the holder the ability to direct the use of and obtain benefits from that asset; therefore, it is an indicator of which party controls the asset. However, physical possession does not, on its own, determine which party has control. A reporting entity should consider the facts and circumstances of each arrangement to determine whether physical possession coincides with the transfer of control.

In a typical sale and leaseback transaction, the buyer-lessor obtains legal title to the asset concurrent with commencement of the leaseback term. The buyer-lessor obtains the rights of ownership and is deemed to have physical possession of the asset, but grants the seller-lessee a right-of-use interest (i.e., a lease) in the underlying asset.

6.3.2.4 *Buyer-lessor has significant risks and rewards of ownership*

A seller-lessee that has transferred risks and rewards of ownership of an asset has typically transferred control to the buyer-lessor, but not in all cases. Both parties to the arrangement will need to determine whether control has transferred in the event the seller-lessee has retained some of the risks or rewards of ownership.

Judgment may be required when determining if the buyer-lessor has obtained the significant risks and rewards of ownership or if certain risks have been retained by the seller-lessee that would preclude the buyer-lessor from controlling the asset.

6.3.2.5 *Sale and leaseback: Buyer-lessor has accepted the asset*

Whether the buyer-lessor has accepted the asset, as with all indicators of transfer of control, should be viewed from the buyer-lessor's perspective. Whether the buyer-lessor has formally accepted the asset should be taken into consideration along with the other indicators that control has been obtained by the buyer-lessor in a sale and leaseback transaction. See RR 6.5 for information about customer acceptance.

6.3.2.6 *Prospective lessee obtains control prior to commencement*

Depending on the terms of an arrangement, a prospective lessee may obtain control of an underlying asset prior to lease commencement. If a lessee obtains control of an underlying asset before the lease commencement date, the transaction should be accounted for as a sale and a leaseback. When assessing control, a key factor to consider is whether the lessee has obtained legal title to the asset; however, this factor is not necessarily determinative, as discussed in ASC 842-40-55-2.

ASC 842-40-55-1

A lessee may obtain legal title to the underlying asset before that legal title is transferred to the lessor and the asset is leased to the lessee. If the lessee controls the underlying asset (that is, it can direct its use and obtain substantially all of its remaining benefits) before the asset is transferred to the lessor, the transaction is a sale and leaseback transaction that is accounted for in accordance with this Subtopic.

Excerpt from ASC 842-40-55-2

If the lessee obtains legal title, but does not obtain control of the underlying asset before the asset is transferred to the lessor, the transaction is not a sale and leaseback transaction.

Example LG 6-1, Example LG 6-2, and Example LG 6-3 illustrate the assessment of whether a lessee has obtained control of the underlying asset prior to lease commencement.

EXAMPLE LG 6-1

Sale and leaseback transaction – lessee obtains control prior to lease commencement

Contractor Corp wants to lease a new vehicle for five years. The vehicle manufacturer is not willing to enter into lease arrangements, so Contractor Corp identifies a bank that is willing to purchase the vehicle and enter into a lease under an agreement that Contractor Corp expects to classify as an operating lease.

Contractor Corp purchases the vehicle from the manufacturer, takes possession and obtains legal title. Shortly thereafter, Contractor Corp sells the vehicle to the bank. The sale agreement requires the bank to reimburse Contractor Corp for all costs incurred to acquire the vehicle from the manufacturer and provides the bank with legal title to the vehicle. Concurrent with the sale, Contractor Corp and the bank enter into a five-year lease of the vehicle.

Should Contractor Corp account for the transaction as a sale and leaseback?

Analysis

Because Contractor Corp purchased the vehicle from the manufacturer, obtained legal title, accepted the asset, had physical possession of the asset, and had the significant risks and rewards of ownership, Contractor Corp obtained control of the asset prior to selling the asset to the buyer- lessor (the bank). Although Contractor Corp intended to lease the vehicle and only temporarily obtained control, the transaction should be accounted for as a sale and leaseback because Contractor Corp obtained control of the underlying asset prior to lease commencement.

EXAMPLE LG 6-2

Sale and leaseback transaction – lessee obtains title, but not control prior to lease commencement

Contractor Corp wants to lease a new vehicle for five years. The vehicle manufacturer is not willing to enter into lease arrangements, so it arranges for a lease between Contractor Corp and a bank. Contractor Corp expects to classify the lease as an operating lease. For tax reasons, Contractor Corp obtains legal title, immediately transfers it to the bank, and concurrently enters into a five-year lease of the vehicle with the bank.

Should Contractor Corp account for the transaction as a sale and leaseback?

Analysis

No. Contractor Corp should account for the transaction as a lease arrangement with the bank and not a sale and leaseback. Contractor Corp obtained legal title to the asset prior to the lessor (the bank) and prior to the commencement of the lease, but did not obtain control of the underlying asset. Although Contractor Corp had temporary title, it did not obtain the significant risks and rewards of ownership and none of the other indicators of control were present.

EXAMPLE LG 6-3

Sale and leaseback transaction – lessee sells or transfers its purchase option

Lessee Corp holds an option to purchase an asset and sell or transfer the option (without obtaining title of the asset) to Lessor Corp provided Lessor Corp will exercise the purchase option and lease the asset to Lessee Corp. Lessor Corp, a third party, exercises the purchase option and leases the asset to Lessee Corp.

Should Lessee Corp and Lessor Corp account for the transaction as a sale and leaseback?

Analysis

There are mixed views on accounting for this type of transaction. To be in the scope of sale and leaseback accounting, Lessee Corp should have control of the underlying asset before the purchase option is exercised by Lessor Corp. To do this, Lessee Corp and Lessor Corp should analyze various factors, such as the substance of the purchase option, whether it is exercisable immediately, and whether the option strike price is at the current fair value. The transfer of an immediately exercisable option at a fixed price would presumably be within the scope of the sale leaseback rules. In contrast, the transfer of an option whose strike price is at prevailing fair value at the time of exercise may not fall within the sale leaseback rules, particularly when substantially similar assets are readily available in the marketplace. The evaluation is judgmental and needs to be based on facts and circumstances.

6.3.3 *Lessee involvement in construction of leased asset*

When a prospective lessee is involved in the construction or design of an underlying asset prior to lease commencement (commonly referred to as a "build-to-suit" lease), the lessee should evaluate whether it controls the asset during the construction period. Generally, the evaluation of whether a lessee controls an asset under construction is similar to the evaluation in the revenue recognition standard to determine whether a performance obligation is satisfied over time.

ASC 842-40-55-5 lists several examples that demonstrate when a lessee has obtained control during the construction period.

ASC 842-40-55-5

If the lessee controls the underlying asset being constructed before the commencement date, the transaction is accounted for in accordance with this Subtopic. Any one (or more) of the following would demonstrate that the lessee controls an underlying asset that is under construction before the commencement date:

a. The lessee has the right to obtain the partially constructed underlying asset at any point during the construction period (for example, by making a payment to the lessor).

b. The lessor has an enforceable right to payment for its performance to date, and the asset does not have an alternative use (see paragraph 842-10-55-7) to the owner-lessor. In evaluating whether the asset has an alternative use to the owner-lessor, an entity should consider the characteristics of the asset that will ultimately be leased.

c. The lessee legally owns either:

    1. Both the land and the property improvements (for example, a building) that are under construction

    2. The non-real-estate asset (for example, a ship or an airplane) that is under construction.

d. The lessee controls the land that property improvements will be constructed upon (this includes where the lessee enters into a transaction to transfer the land to the lessor, but the transfer does not qualify as a sale in accordance with paragraphs 842-40-25-1 through 25-3) and does not enter into a lease of the land before the beginning of construction that, together with renewal options, permits the lessor or another unrelated third party to lease the land for substantially all of the economic life of the property improvements.

e. The lessee is leasing the land that property improvements will be constructed upon, the term of which, together with lessee renewal options, is for substantially all of the economic life of the property improvements, and does not enter into a sublease of the land before the beginning of construction that, together with renewal options, permits the lessor or another unrelated third party to sublease the land for substantially all of the economic life of the property improvements.

The list of circumstances above in which a lessee controls an underlying asset that is under construction before the commencement date is not all inclusive. There may be other circumstances that individually or in combination demonstrate that a lessee controls an underlying asset that is under construction before the commencement date.

There have been questions raised as to the meaning of “at any point during the construction period”. Those questions focus on whether the provision requires the lessee to have the right to obtain the asset either (1) at all times during the construction period (which could include contingent events that are only triggered upon events within the lessee's control) or (2) only based on some contingency or stated event. We believe a lessee would be considered the owner of the asset during the construction period if the lessee has the right to obtain the partially-constructed asset at some point during the construction period (i.e., a call/purchase option). If the lessee does not have the right at all times, ownership of the asset would be imputed at the point in time that the lessee has the right to obtain the partially-constructed asset (e.g., when a purchase option becomes exercisable).

We believe a lessee's call option that becomes exercisable solely due to the passage of time would cause the lessee to have control of the partially-constructed asset immediately. If the option is contingent upon any other event, and that event is within the lessor's control or based on the occurrence of an external event, control does not pass to the lessee until the contingency is resolved.

There may be circumstances in which the purchase option becomes exercisable only upon contingent events occurring, such as when the lessee or the lessor is in default. In these cases, the lessee would generally be considered to have the right to obtain the partially-constructed asset if the contingent event were within the control of the lessee. All facts and circumstances should be considered carefully. For example, a lease that provides a lessee the right to acquire the partially-constructed asset if the lessee is in default may be considered within the control of the lessee. However, a lessee default under the lease contract may result in economic consequences to the lessee, such as triggering cross defaults in the lessee's other arrangements. The right to acquire the partially-constructed asset in this circumstance may not be considered substantive.

The existence of a lessee-provided indemnification for preexisting environmental contamination does not, in isolation, result in the lessee obtaining control of the underlying asset prior to lease commencement regardless of the likelihood of loss as a result of the indemnity.

The list of circumstances provided by ASC 842-40-55-5 is not all inclusive; there may be other circumstances that individually or in combination demonstrate that a lessee controls an underlying asset under construction before the lease commencement date. As additional circumstances have not yet substantially developed in practice, entities will be required to carefully evaluate the facts and circumstances of each arrangement. For example, we believe if a lessee is required to make lease payments regardless of whether the lessor completes construction of the asset (i.e., a date-certain lease) and the lease is expected to be classified as a finance lease, the lessee has obtained control of the asset from lease inception, rather than the lease commencement date. Additionally, we believe a lessee that is required to fund substantially all (i.e., 90% or more) of the costs of construction that are probable of being incurred during the construction period may have obtained control. However, we do not believe this example is similar to the prescriptive rules in ASC 840. For example, we do not believe a lessee has obtained control of the asset under construction solely because it is required to pay the first costs of construction or is responsible for cost overruns that are unlimited when such cost overruns are not probable of representing substantially all of the costs of construction.

We believe a put option held by the lessor to put the asset under construction to the lessee should be assessed to determine whether the lessor has a significant economic incentive to exercise its put right consistent with the guidance regarding repurchase agreements in the new revenue standard. If an incentive exists, the lessee would be assumed to control the construction in process and would be considered the owner of the asset during the construction period. For further guidance, refer to RR 8.7.

Example LG 6-4 and Example LG 6-5 illustrate the assessment of whether a lessee has obtained control of the underlying asset under construction prior to lease commencement. See ASC 842-40-55-39 through ASC 842-40-55-44 for additional examples.

EXAMPLE LG 6-4

Sale and leaseback transaction – lessee obtains control of construction in progress

University would like to construct a new library on a parcel of land next to its campus. University acquires the parcel of land and enters into an agreement with Developer Corp, an independent third party, under which Developer Corp will lease the parcel of land from University, construct the library, and lease the completed library to University. Both the ground lease to Developer Corp and the library lease to University have 20-year lease terms. Rental rates on both leases are consistent with prevailing market rents for similar leased assets. The economic life of the library is 40 years.

Does University control the underlying asset during the construction period?

Analysis

University controls the underlying asset during the construction period because the ground lease to Developer Corp is for a term that is less than substantially all of the economic life of the property improvements (20-year ground lease/40-year economic life = 50%). Accordingly, University should account for the underlying asset during the construction period similar to any other owned asset under construction (i.e., under ASC 360, *Property, Plant, and Equipment*). Additionally, any construction costs paid for by Developer Corp should be recorded by University as a financial liability.

In symmetry with University's accounting, Developer Corp should not recognize the asset under construction. Rather, Developer Corp should account for any payments it makes during the construction period as a collateralized loan to the lessee in accordance with ASC 310, *Receivables*.

EXAMPLE LG 6-5

Sale and leaseback transaction – lessee does not obtain control of construction in process (real estate)

Law Firm enters into an arrangement with Developer Corp to lease an office building for 10 years contingent upon Developer Corp completing construction of the asset in accordance with the construction plan. The construction plan includes Law Firm-specific improvements necessary for Law Firm to begin operations at the lease commencement date. The budgeted cost of construction is $10 million. The useful life of the asset is 40 years. Law Firm is obligated to reimburse Developer Corp for increases in the cost of steel from the inception date of the arrangement to the completion date of the construction project up to a maximum of $250,000. During the construction period, Law Firm has access to the building in order to inspect the progress of the construction and to make discretionary improvements.

During the construction period, Law Firm reimburses Developer Corp for $200,000 due to increases in the cost of steel during the construction period. In addition, Law Firm incurred $100,000 of additional construction costs related to discretionary tenant improvements, including branding elements.

Does Law Firm control the underlying asset during the construction period?

Analysis

Law Firm did not obtain control of the underlying asset during the construction period, therefore it should account for the transaction as a lease arrangement with Developer Corp. Although Law Firm had access to the asset, incurred costs related to both structural and normal tenant improvements, and had financial risks related to the construction of the asset, Law Firm did not obtain control of the asset under construction before the lease commencement date (i.e., the construction completion date). Except for the payment for increases in the cost of steel, Developer Corp does not have an enforceable right to payment unless and until construction is completed. Law Firm's exposure to steel costs is insignificant relative to the overall construction budget. In addition, none of the other indicators of control in ASC 842-40-55-5 are present.

6.3.3.1 Sale of CIP with a lease for completed building

In certain cases an entity may have begun constructing an asset prior to selling it to a developer. The developer will continue work on the construction in progress (CIP) and will lease the asset back to the seller once construction is complete. As this concept is not specifically addressed by ASC 842, a number of views have evolved regarding whether this type of transaction is in the scope of the sale and leaseback rules. We believe each of the following views is supportable:

- **Any sale of CIP is in scope:** This view does not consider the stage of completion or the amount of costs incurred. Even if $1 of soft costs, such as planning and architecture, are incurred, the transaction is subject to the sale and leaseback rules.

- **Any sale of CIP that includes a physical asset is in scope:** This view does not consider how much construction has been done but rather focuses on if there is a physical asset being sold (such as a poured foundation or steel beams). This view would not include a sale if only soft costs or land clearing costs were incurred because these costs do not result in a physical asset.

- **Only CIP that represents the underlying leased asset is in scope:** Under this view, an entity should qualitatively determine when the CIP is representative of the underlying asset that will ultimately be leased back upon the completion of construction. This analysis will require judgment and should consider quantitative thresholds used elsewhere in GAAP to help with the overall qualitative assessment. For example, if the fair value of the CIP represents 10% or more of the expected value of the completed construction, this would be an indicator that the CIP represents the underlying leased asset.

- **Only CIP that is substantially similar to the completed construction project should be in the scope:** This view qualitatively determines when the CIP is substantially similar to the underlying asset that will ultimately be leased back upon the completion of construction. This analysis will require judgment and should consider quantitative thresholds used elsewhere in GAAP. For example, if the fair value of the CIP sold represents 90% or more of the expected value of the completed construction, this would be an indicator that the CIP is substantially similar to the underlying leased asset.

An entity should establish an accounting policy based on any of the views above and apply it consistently to all similar transactions.

6.3.3.2 *Lessee controls the asset under construction*

If a lessee controls the underlying asset under construction before the lease commencement date, the lessee should account for the underlying asset during the construction period similar to any other asset under construction that it controls. For example, if a lessee determines that it controls an underlying real estate asset under construction, the lessee should account for the real estate asset under construction in accordance with ASC 360, *Property, Plant, and Equipment*. Any costs of construction paid for by the lessor should be recognized by the lessee as a financial liability.

Similar to the lessee's accounting, a lessor that has not obtained control of the underlying asset should account for payments it makes during the construction period as a collateralized loan to the lessee in accordance with ASC 310, *Receivables*. In other words, the accounting between the lessee and lessor should be symmetrical. A lessor should not recognize the asset under construction.

Once a lessee is the deemed owner of the asset under construction, the arrangement is within the scope of the sale and leaseback guidance and both the lessee and the lessor should evaluate whether the transaction represents a qualified sale and leaseback or a financing arrangement. Initially, the evaluation should occur as of the date the lessee is determined to have obtained control. Generally, once a lessee has obtained control of an underlying asset under construction, it is unlikely that control will transfer to the lessor before construction of the underlying asset has been completed. Unless, and until, the lessee transfers control of the underlying asset to the lessor, the lessee will continue to be the deemed the accounting owner of the underlying asset.

If the transaction otherwise meets the criteria to qualify for sale and leaseback accounting, as discussed in LG 6.4, the lessee should recognize the sale of the asset when it transfers control of the underlying asset to the lessor.

See LG 6.5 for additional information on the accounting for failed sale and leaseback transactions.

Question LG 6-1 describes the lessee's accounting for the land when the lessee is the deemed owner of an asset under construction on the land.

Question LG 6-1

What are the accounting implications for land when the lessee is deemed to be the accounting owner of the building under construction but the land on which the building being constructed is either owned by the lessor, or is leased by the lessor from an unrelated third party?

PwC response

The land on which the building is being constructed would typically meet the definition of a lease (see LG 2.3) and both the lessee and lessor would need to account for the land lease under ASC 842. The commencement date of the land lease would usually be the date on which construction activities begin. Note that if the lessee was not the deemed owner of the building under construction, the land lease would typically commence at the construction completion date.

Example LG 6-6 illustrates a lessor's derecognition of construction in progress when the lessee is the deemed owner during construction.

EXAMPLE LG 6-6

Sale and leaseback transaction – lessor's accounting for derecognition of construction-in-progress when lessee is the deemed the owner during construction

Landlord Corp is constructing a building that is expected to cost $100 million. During the construction period, Landlord Corp enters into an agreement to lease the building to Lessee Corp once construction is complete. The agreement includes an option for Lessee Corp to purchase the construction in progress at any point during the construction period at its then prevailing fair value. Due to the purchase option, Lessee Corp is the deemed owner of the building under construction at the agreement's effective date. Landlord Corp incurred $15 million in construction costs with a fair value of $18 million at the agreement effective date.

How should Landlord Corp measure the receivable from Lessee Corp upon derecognition of the construction-in progress at the agreement effective date?

Analysis

If Landlord Corp does not have an obligation to complete the construction, we believe it should recognize an $18 million receivable with a gain of $3 million ($18 million - $15 million) upon derecognition of the construction in progress. However, if Landlord Corp has an obligation to complete construction, we believe, consistent with Question 2-3 in Chapter 2 of the *Revenue from contracts with customers* guide, Landlord Corp should initially measure the receivable at $15 million plus the proportionate profit earned to date based on percentage of construction completion.

6.3.3.3 Lessee does not control the asset under construction

If a lessee does not obtain control of the underlying asset under construction, the transaction is not subject to the sale and leaseback guidance. In those circumstances, the lessee should apply judgment to determine how to account for costs it incurs during construction. Such costs, for example, may relate to its own assets, such as leasehold improvements, or they may relate to the right to use the lessor's assets. If such costs relate to leasehold improvements, the lessee should generally account for those costs in accordance with ASC 360. Payments made by the lessee for the right to use the asset should be accounted for as lease payments under ASC 842, regardless of when the payments occur or the form of such payments. For example, if the lessee pays for (or contributes) construction materials to construct the lessor's asset, such payments are included in lease payments.

Example LG 6-7 illustrates the application of this guidance.

EXAMPLE LG 6-7

Sale and leaseback transaction – construction costs incurred by a lessee that does not obtain control of construction in process (real estate)

Law Firm enters into an arrangement with Developer Corp to lease an office building for 10 years contingent upon Developer Corp completing construction of the asset in accordance with the construction plan. The construction plan includes Law Firm-specific improvements necessary for Law Firm to begin operations at the lease commencement date. The budgeted cost of construction is $10 million. The useful life of the asset is 40 years. Law Firm is obligated to reimburse Developer Corp for increases in the cost of steel from the inception date of the arrangement to the completion date of the construction project up to a maximum of $250,000. During the construction period, Law Firm has access to the building in order to inspect the progress of the construction and to make discretionary improvements.

Law Firm reimburses Developer Corp for $200,000 due to increases in the cost of steel during the construction period. In addition, Law Firm incurred $100,000 of additional construction costs related to discretionary tenant improvements, including branding elements.

How should Law Firm account for the costs incurred during the construction period?

Analysis

The $200,000 of construction cost overruns paid by Law Firm are lease payments because they were required per the terms of the lease agreement in order for the lessee to obtain the right to use the underlying asset and do not represent payment for a good or service provided to Law Firm. Accordingly, Law Firm should recognize such costs as prepaid rent. See LG 4.2.2 for information on the accounting for prepaid rent.

Law Firm should account for the $100,000 of construction costs incurred as lessee assets (i.e., leasehold improvements) that would be depreciated over the shorter of their useful lives or the lease term.

6.3.4 *Impact of lease classification on qualification as a sale*

In evaluating a potential sale and leaseback, whether a sale has occurred can be impacted by the classification of the lease. If a leaseback is classified as a finance lease (seller-lessee) or a sales-type lease (buyer-lessor), then no sale has occurred and the transaction should be accounted for as a failed sale and leaseback. This is because a finance lease is effectively a purchase of an asset and a sales-type lease is effectively a sale of an asset, not a lease. Accordingly, the transaction would result in the seller-lessee effectively transferring control of the asset to the buyer-lessor (i.e., a sale) and immediately reacquiring control (i.e., a purchase). See LG 3 for information on lease classification. See LG 6.5 for information on the accounting for failed sale and leaseback transactions.

Question LG 6-2 describes the accounting when the leaseback of a building is a finance lease and the leaseback of the underlying land is an operating lease in a sale and leaseback transaction involving land and building.

Question LG 6-2

A seller-lessee sells land and building and simultaneously leases them back from the buyer-lessor. The building leaseback is classified as a finance lease, and the land leaseback is classified as an operating lease. Does the finance leaseback of the building preclude sale and leaseback accounting for the land?

PwC response

No. Under ASC 842-10-15-29 the right to use the land and building are separate components. Therefore, in this example, the finance leaseback of the building will not preclude sale and leaseback accounting for the land. However, if the land leaseback is classified as a finance lease, it would be unusual for the building leaseback to be classified as anything other than a finance lease because of the retained control of the underlying land.

6.3.5 *Repurchase rights and obligations in a sale and leaseback*

A repurchase right gives the seller-lessee the right (or obligation) to repurchase the asset after it has been sold to the buyer-lessor. There are three forms of repurchase rights.

- A seller-lessee's obligation to repurchase and the buyer-lessor's obligation to sell the asset (a forward)
- A seller-lessee's right to repurchase the asset (a call option)
- A buyer-lessor's right to require the seller-lessee to repurchase the asset (a put option)

An arrangement to repurchase the asset that is negotiated between the buyer-lessor and seller-lessee after control of the asset has been transferred to the buyer-lessor is not a repurchase agreement because the buyer-lessor is not obligated to resell the asset as part of the initial transaction. The subsequent decision to repurchase the asset does not affect the buyer-lessor's ability to direct the use of or obtain the benefits of the asset. See RR 8.7 for additional guidance on repurchase rights. Additional consideration should be given to the substance of the arrangement. If the substance of the arrangement suggests that the repurchase agreement was contemplated as part of the initial sales transaction, it may be considered a repurchase right and should be evaluated accordingly.

As discussed in RR 8.7, certain sale transactions that contain a put or call option that cannot be recognized as sales are accounted for as leases to the customer. However, if such a failed sale is accompanied by a leaseback, it should be accounted for as a financing arrangement because the seller retains the right to use the asset. See LG 6.5 for further information on how to account for a failed sale and leaseback transaction.

6.3.5.1 *Repurchase options, fixed price renewal options and forwards*

The guidance for repurchase rights in the revenue standard should be applied to sale and leaseback transactions with certain clarifications unique to sale and leaseback transactions. In the revenue standard, sale recognition is precluded when the party that would be the seller-lessee has a substantive repurchase option or obligation with respect to the underlying asset. If so, the buyer-lessor has not obtained control. A non-substantive repurchase option does not preclude sale accounting. See RR 8.7 for additional guidance on repurchase rights.

Excerpt from ASC 606-10-55-68

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

Despite the prohibition in the revenue guidance, the existence of a repurchase option does not always preclude recognition of a sale in a sale and leaseback arrangement. ASC 842-40-25-3 provides specific guidance on evaluating a repurchase option in a sale and leaseback transaction. A repurchase option does not preclude sale and leaseback accounting if both of the following criteria are met.

- The repurchase option is exercisable by the seller-lessee only at the then-prevailing fair value of the asset

- Alternative assets are readily available in the marketplace, which are substantially the same as the underlying asset

If the underlying asset is real estate or integral equipment as defined in ASC 978 (i.e., any physical structure or equipment attached to the real estate that cannot be removed and used separately without incurring significant cost), the transaction would fail to meet the second criteria regardless of the exercise price of the repurchase option because each location is unique; therefore, alternative real estate assets or integral equipment that are readily available in the marketplace will not be considered substantially the same as the underlying real estate asset or integral equipment.

Judgment may be required to determine whether other types of non-real estate assets are considered substantially the same as the underlying asset. Generally, if alternative assets are readily available in the marketplace, which are substantially the same as the underlying asset, the seller-lessee would be indifferent as to whether it (1) repurchased the asset it previously sold and leased back, or (2) purchased another asset that is substantially the same in the marketplace. Accordingly, we believe the less generic the underlying asset, the more difficult it would be to assert that alternative assets readily available in the marketplace are substantially the same as the underlying asset.

Arrangements with a fixed price repurchase option d0 not qualify as a sale because the exercise price will not necessarily reflect the then-prevailing fair value of the asset. If an arrangement has a fixed price renewal option that extends to substantially all of the economic life of the asset, the entity may need to evaluate whether the fixed price renewals are economically similar to a fixed price repurchase option that would preclude sale accounting. As this concept is not addressed by ASC 842, a number of views have evolved. One view is that a renewal option is fundamentally not the same as a repurchase option and would therefore not preclude sale accounting. Another view is that a fixed price renewal option that extends to substantially all of the economic life of the asset is equivalent to a fixed repurchase option that would preclude sale accounting. We believe this analysis should be based on facts and circumstances and may involve consideration of the pricing of the arrangement in the renewal period.

6.3.5.2 Buyer-lessor has a put option

A put option allows a buyer-lessor to require the seller-lessee to repurchase the underlying asset at its discretion. Generally, a put option indicates that the seller-lessee has relinquished control over the asset. However, the revenue standard precludes sale accounting when a buyer-lessor has a significant economic incentive to exercise a put option.

ASC 606-10-55-72

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

The seller-lessee must assess the contract at inception to determine whether the buyer-lessor has a significant economic incentive to exercise its put option. It should consider all relevant factors in its assessment, including the following:

- How the repurchase price compares to the expected market value of the asset at the date of repurchase
- The amount of time until the right expires

A buyer-lessor has a significant economic incentive to exercise a put option when the repurchase price is expected to significantly exceed the market value of the asset at the time of repurchase. See RR 8.7 for additional information.

If it is determined that the buyer-lessor has a significant economic incentive to exercise a put option, no sale has occurred and the sale and leaseback transaction should be accounted for as a financing arrangement. If the buyer-lessor does not have a significant economic incentive to exercise a put option, then sale accounting is not precluded. See LG 6.5 for further discussion of how to account for a failed sale and leaseback transaction.

6.3.5.3 Seller-lessee has a right of first offer

Some sale-leaseback agreements may provide the seller-lessee with a "right of first offer," which allows the seller-lessee to make an offer to purchase the underlying asset at the end of the lease term based on a current valuation of the asset before the buyer-lessor may solicit offers from third parties. We believe that a sale-leaseback agreement containing a right of first offer should be carefully analyzed to determine whether the buyer-lessor is economically or contractually compelled to accept the offer. For example, a buyer-lessor may conclude it is (1) economically compelled if it is required to pay a substantive penalty if it does not accept the offer or (2) contractually compelled to accept the offer per the terms of the lease agreement.

If the buyer-lessor is not compelled to accept the seller-lessee's offer, the right of first offer would typically not prevent sale accounting. If the buyer-lessor is compelled to accept the offer, the right of first offer is effectively a repurchase option held by the seller-lessee, which may, prevent the transaction from qualifying as a sale. See LG 6.3.5.1 for more information on the evaluation of a seller-lessee repurchase option.

A right of first offer may also economically or contractually compel the seller-lessee to make an offer to acquire the underlying asset. If the seller-lessee is compelled to make an offer, the right of first offer is effectively a buyer-lessor put option. See LG 6.3.5.2 for more information on the evaluation of a buyer-lessor put option.

6.3.5.4 *Seller-lessee has a contingent repurchase option*

Some sale and leaseback agreements may provide the seller-lessee with a repurchase option which allows the seller-lessee the right to repurchase the underlying asset if a specific contingent event occurs. The specific contingent event may be in the seller-lessee's control, in the buyer-lessor's control, or outside either party's control. Examples of contingent events include significant damage or destruction of the leased asset and a lessor's change of control. We believe all facts and circumstances should be considered to determine if a contingent repurchase option is similar in substance to an unconditional repurchase option or a put option held by the buyer-lessor under the new revenue standard. For further guidance, refer RR 8.7.1.1 for conditional call options.

6.4 *When the transaction qualifies as a sale*

If the buyer-lessor obtains control of the asset, the sale (by the seller-lessee) or purchase (by the buyer-lessor) and the leaseback should be accounted for separately, with the lease being accounted for in accordance with ASC 842.

ASC 842-40-25-4

If the transfer of the asset is a sale in accordance with paragraphs 842-40-25-1 through 25-3, both of the following apply:

a. The seller-lessee shall:

   1. Recognize the transaction price for the sale at the point in time the buyer-lessor obtains control of the asset in accordance with paragraph 606-10-25-30 in accordance with the guidance on determining the transaction price in paragraphs 606-10-32-2 through 32-27

   2. Derecognize the carrying amount of the underlying asset

   3. Account for the lease in accordance with Subtopic 842-20.

b. The buyer-lessor shall account for the purchase in accordance with other Topics and for the lease in accordance with Subtopic 842-30.

The accounting considerations for the purchase and sale transaction, as well as the leaseback, are discussed in the following section.

6.4.1 *Accounting by the seller-lessee*

The seller-lessee should derecognize the underlying asset and recognize a gain or loss on sale as appropriate. If the transaction is at market terms, the presence of the leaseback does not affect the recognition of a gain or loss on sale. Therefore, if a seller-lessee leases back an entire asset or a portion of the asset (e.g., one floor of a multi-floor office building), the gain or loss generated from the sale is not affected.

A seller-lessee should account for the gain or loss generated from a sale and leaseback transaction consistent with the guidance in the revenue standard, similar to a sale without a leaseback.

See LG 6.4.4 for a discussion of accounting for a transaction entered into at off-market terms.

Example LG 6-8 and Example LG 6-9 illustrate how a seller-lessee would account for a gain or loss on sale generated from a sale and leaseback transaction.

EXAMPLE LG 6-8

Sale and leaseback transaction – gain on sale

A seller-lessee enters into a sale and leaseback transaction of its corporate headquarters with a buyer-lessor for a market value sales price of $20 million. The seller-lessee leases back the asset for ten years in exchange for $200,000 per year in rental payments. The seller-lessee's net carrying amount of the asset at the date of sale is $15 million. Assume the leaseback is classified as an operating lease for purposes of this example.

How should the seller-lessee account for the asset sale?

Analysis

The sale results in a gain on sale of $5 million ($20 million sales price - $15 million carrying amount of asset). Since the sale and leaseback transaction is at market value and the leaseback is classified as an operating lease, the presence of the leaseback does not impact the accounting for the sale; the seller-lessee should recognize the gain on sale of $5 million in the period in which the sale is recognized.

EXAMPLE LG 6-9

Sale and leaseback transaction – loss on sale

A seller-lessee enters into a sale and leaseback transaction of its corporate headquarters with a buyer-lessor for a market value sales price of $20 million. The seller-lessee leases back the asset for ten years in exchange for $200,000 per year in rental payments. The seller-lessee's net carrying amount of the asset at the date of sale is $25 million. Assume the leaseback is classified as an operating lease.

How should the seller-lessee account for the asset sale?

Analysis

The sale results in a loss on sale of $5 million ($20 million sales price - $25 million carrying amount of asset). Since the sale and leaseback transaction is at market value, the presence of the leaseback does not impact the accounting for the sale; the seller-lessee should recognize the loss on sale of $5 million in the period in which the sale is recognized (assuming an impairment of the asset was not required to be recorded in an earlier period).

6.4.2 Accounting by the buyer-lessor

To determine the appropriate accounting treatment, a buyer-lessor should determine if the transaction meets the definition of a business combination under ASC 805, Business Combinations, or if the transaction will be accounted for as an asset acquisition. The buyer-lessor should value the tangible property independently from the terms of the leaseback and should value and account for the leaseback in the same manner as any other lease. See LG 3 and LG 4 for guidance on lease classification and the accounting for leases, respectively. See PwC's Business combinations and *noncontrolling interests* guide for information on accounting related to business combinations and asset acquisitions.

6.4.3 Costs in a sale and leaseback transaction

The seller-lessee will incur costs in connection with a sale and leaseback transaction. Transaction costs that the seller-lessee would have had to pay to a third party if the asset were sold outright (e.g., absent a leaseback) should be accounted for as part of the sale transaction. These seller expenses reduce the gain (or increase the loss) on the sale. Any additional costs due to the leaseback should be evaluated to determine if they should be deferred as initial direct costs. See LG 4.2.2.2 for information about the evaluation of initial direct costs.

In some cases, the seller-lessee may be required to pay costs incurred by the buyer-lessor in connection with purchasing the asset, financing the acquisition of the asset, or entering into the sale and leaseback transaction. The seller-lessee will need to use judgment to determine if these costs should be accounted for as a reduction of the sales price or as a cost associated with the leaseback.

Certain transactions may occur in which a seller-lessee sells an asset for an amount that is less than its fair value. See Example LG 6-10. In this situation, the seller-lessee should apply the guidance for sale and leaseback transactions entered into at off-market terms, as discussed in LG 6.4.4.

The buyer-lessor's accounting for transaction costs depends on whether the transaction is considered a business combination or an asset acquisition. If the transaction is considered a business combination, transaction costs are expensed as incurred; if considered an asset acquisition, transaction costs are capitalized. The buyer-lessor should defer any debt acquisition costs (e.g., costs relating to the financing) and initial direct costs of entering into the lease (e.g., negotiating and arranging the lease). See LG 4.3.1.2 for information on initial direct costs.

If a sale and leaseback transaction does not qualify for sale accounting, it is considered a failed sale and leaseback and should be accounted for as a financing transaction. All transaction costs incurred by the seller-lessee and buyer-lessor should be evaluated to determine if they should be accounted for as debt issuance or debt origination costs, respectively. See FG 1.2.2 for information on debt issuance costs. See LI 4.4 for information on debt origination fees and costs.

When debt origination costs are capitalized by a buyer-lessor in a failed sale and leaseback transaction that subsequently qualifies as a sale, the buyer-lessor should record the underlying asset (e.g., property, plant, and equipment) or net investment in the lease at the carrying amount of the financial asset (e.g., loan receivable) when the lease is classified as an operating lease or direct financing lease, respectively. Regardless of the classification, the initial measurement of the asset recognized when the buyer-lessor obtains control of the underlying asset (i.e., when the transaction qualifies as a sale) should include any unamortized debt origination costs. See LG 6.5.2 for information on the accounting for a failed sale and leaseback by a buyer-lessor.

6.4.4 *Off-market sale and leaseback transactions*

Sale and leaseback transactions entered into at off-market terms should be adjusted so that the sale is recorded at fair value. A reporting entity should determine whether the sale and leaseback is an off-market transaction by considering either of the following, whichever is more readily determinable:

- The sale price compared to the fair value of the underlying asset
- The present value of the contractual lease payments compared to the present value of fair market value lease payments

The use of observable prices and observable information should be maximized when making this assessment. For example, if comparable sales of assets similar to an underlying asset exist, an observable fair value for the underlying asset can be determined at the time of the transaction. The observable fair value should be used to determine the gain or loss and any related adjustment, rather than basing an adjustment on an estimate of market rental rates if comparable rental rates are not readily available.

If part of the consideration includes amounts related to the settlement of preexisting contracts or other arrangements, those other arrangements should be considered before determining whether the transaction was entered into at off-market terms. Similarly, if the sales proceeds or lease payments include variable amounts (e.g., contingent consideration), the variable amounts should be estimated and included in the evaluation.

When the sale of an asset is not at fair value or the lease payments are not at market rates, the seller-lessee and buyer-lessor should make adjustments so that the sale is recognized at fair value, as discussed in ASC 842-40-30-2.

ASC 842-40-30-2

If the sale and leaseback transaction is not at fair value, the entity shall adjust the sale price of the asset on the same basis the entity used to determine that the transaction was not at fair value in accordance with paragraph 842-40-30-1. The entity shall account for both of the following:

a. Any increase to the sale price of the asset as a prepayment of rent

b. Any reduction of the sale price of the asset as additional financing provided by the buyer-lessor to the seller-lessee. The seller-lessee and the buyer-lessor shall account for the additional financing in accordance with other Topics.

As discussed in ASC 842-40-30-4, if a sale and leaseback transaction is between related parties, the adjustments required by ASC 842-40-30-2 should not be made; however, the lessee and lessor should disclose the related party transaction in accordance with ASC 850, Related Party Disclosures.

6.4.4.1 *Seller-lessee: transaction with off-market terms*

A seller-lessee may sell an asset for an amount that is different than the fair value of the asset. If the sales proceeds are less than the fair value of the asset, the difference should be recognized as prepaid rent. If the sales proceeds are higher than the fair value of the asset, the excess should be considered additional borrowing.

An off-market adjustment must also be considered when assessing the classification of the leaseback. It is possible that the adjustment could cause an otherwise operating lease to be classified as a finance lease, precluding sale accounting altogether.

Sale price or leaseback payments are less than fair value

The stated sale price of an underlying asset may be less than its fair value, or the present value of the contractual leaseback payments may be less than the present value of market rental payments. A seller-lessee should increase the initial leaseback right-of-use asset for the difference between the sale price and fair value, similar to prepaid rent. This would have the effect of increasing the gain or reducing the loss on sale.

Example LG 6-10 illustrates the seller-lessee's accounting when the stated sale price of an underlying asset is less than its fair value.

EXAMPLE LG 6-10

Sale and leaseback transaction – seller-lessee sells underlying asset for less than fair value

A seller-lessee purchases manufacturing equipment at a price of $5.5 million, which equals fair value. Shortly after buying the equipment, the seller-lessee sells it to a buyer-lessor for $5 million. The seller-lessee leases back the equipment for 10 years in exchange for annual rent payments of $400,000, payable at the beginning of each year. The seller-lessee's incremental borrowing rate is 6%.

How should the seller-lessee account for the difference between the property's sales price and its fair value?

Analysis

The seller-lessee sold the underlying asset for $5 million, which is less than its fair value of $5.5 million. The seller-lessee should account for the difference as an adjustment to the initial leaseback right-of-use asset, similar to the accounting for a prepayment of rent. The adjustment also increases the sale price to $5.5 million (for accounting purposes), and as a result, the seller-lessee would not record a loss on sale.

The right-of-use asset is initially equal to the lease liability. The lease liability is $3,120,676, calculated by determining the present value of the contractual lease payments of $4,000,000 at 6%. The off-market adjustment of $500,000 is added to the right-of-use asset. Because the off-market adjustment is accounted for similar to a prepayment of rent to the buyer-lessor (i.e., a day-one payment), it should not be discounted.

The seller-lessee should record the following journal entry to record this transaction.

Dr. Cash	$5,000,000	
Dr. Right-of-use asset	$3,620,676	
Cr. Equipment		$5,500,000
Cr. Lease liability		$3,120,676

Sale price or leaseback payments are greater than fair value

The stated sale price of an underlying asset may be greater than its fair value, or the present value of contractual leaseback payments may be greater than the present value of market rental payments.

A seller-lessee should account for the excess of the sale price or leaseback payments over the fair value of the asset as additional financing from the buyer-lessor separate from the lease liability. The initial measurement of the right-of-use asset is not impacted by recording the adjustment as additional financing. The seller-lessee's total rental payments should be allocated between the lease liability and the additional buyer-lessor financing. If the rent payments contain variable consideration, we believe amounts allocated to the additional buyer-lessor financing should be accounted for by analogy to the interest method described in ASC 310. See LG 2.4.5 for information on the allocation of payments between lease liability and financing. See LI 6.5.1.2 for information on accounting for variable rate loans, which we believe should be applied in these fact patterns.

Example LG 6-11 illustrates the accounting by the seller-lessee when the sale price of an underlying asset is greater than its fair value.

EXAMPLE LG 6-11

Sale and leaseback transaction – seller-lessee sells underlying asset for a price that is greater than fair value

A seller-lessee sells a building with a remaining economic life of 40 years to an unrelated buyer-lessor for a price of $30 million. The seller-lessee's net carrying amount of the building is $20 million. Simultaneously, the seller-lessee enters into a lease contract with the buyer-lessor for the right to use the asset for 10 years, with annual rental payments of $1 million payable at the end of each year.

The buyer-lessor obtains control of the asset in accordance with the requirements in the revenue standard and therefore the transaction is accounted for as a sale and leaseback by both the seller-lessee and buyer-lessor. Initial direct costs of the transaction are ignored for purposes of this example.

Comparable sales figures of recent transactions for similar properties are readily available. Based on those comparable sales, the estimated fair value of the underlying asset is $28 million. Both the seller-lessee and buyer-lessor determine that these comparable sales provide better evidence to assess whether the transaction is priced off-market than determining the market rental payments of the leaseback. Since the sales price of the underlying asset is not at fair value, both the seller-lessee and buyer-lessor are required to make adjustments to recognize the sale and leaseback transaction at fair value.

The leaseback is classified as an operating lease by both the seller-lessee and buyer-lessor and the seller-lessee's incremental borrowing rate is 6% (the buyer-lessor's interest rate implicit in the leaseback is not known to the seller-lessee).

How should the seller-lessee account for the amount by which the sales price of the property exceeds its fair value?

Analysis

The seller-lessee sold the building for $30 million, which is greater than its fair value of $28 million. The difference should be recorded by the seller-lessee as additional financing from the buyer-lessor separate from the lease liability.

The right-of-use asset is equal to the lease liability. The lease liability is $5,360,087, calculated as the present value of the contractual lease payments of $10 million at 6% ($7,360,087), less the $2 million off-market adjustment. The financial liability is equal to the difference between the sales price and the fair value of $2 million. The gain on sale is the difference between the sale price ($30 million) and carrying value ($20 million), less the off-market adjustment of $2 million.

The seller-lessee should record the following journal entry to record this transaction.

Dr. Cash	$30,000,000	
Dr. Right-of-use asset	$5,360,087	
Cr. Building		$20,000,000
Cr. Lease liability		$5,360,087
Cr. Financial liability		$2,000,000
Cr. Gain on sale		$8,000,000

Each annual rental payment of $1,000,000 would be allocated pro rata between the lease liability and the financial liability. The amount allocated to the financial liability would be $271,736 ($1,000,000 × [$2,000,000/$7,360,087]). The remaining $728,264 of the total rental payment would be allocated to the lease. The seller-lessee will recognize $728,264 as lease expense each year of the leaseback. The $271,736 represents payment of the financial liability and interest expense. Interest expense is calculated as $120,000 in year 1, declining to $15,381 in year 10 based on an amortization schedule using the 6% incremental borrowing rate.

See LG 4.4.2 for information on operating lease expense recognition.

6.4.4.2 *Buyer-lessor: transaction with off-market terms*

The buyer-lessor may purchase an asset for an amount that is different from the fair value of the asset. If the sales proceeds (i.e., purchase price) are less than the fair value of the asset, the difference should be recognized as prepaid rent. If the sales proceeds are higher than the fair value of the asset, the excess should be considered a loan to the lessee.

Sale price or leaseback payments are less than fair value

The stated sale price of an underlying asset may be less than its fair value, or the present value of the contractual leaseback payments may be less than the present value of market rental payments. A buyer-lessor should account for such a difference as a prepayment of rent by the seller-lessee, which should be recognized as lease income along with the contractual leaseback payments. See LG 4.2.2.1 for details on the accounting for the prepayment of rent. The buyer-lessor should record the underlying asset at its fair value.

Sale price or leaseback payments are greater than fair value

The stated sale price of underlying asset may be greater than its fair value, or the present value of the contractual leaseback payments may be greater than the present value of market rental payments. A buyer-lessor should account for the excess of the sale price or leaseback payments over the fair value as additional financing (i.e., a loan receivable) to the seller-lessee and record the underlying asset at its fair value. The buyer-lessor's total leaseback payment should be allocated between the lease and additional financing. If the leaseback payment contains variable consideration, amounts allocated to the additional financing should be accounted for in accordance with ASC 310. See LG 2.4.4 for information on the allocation of leaseback payments between the lease and additional financing. See LI 6.5.1.2 for information on accounting for variable rate loans.

Example LG 6-12 illustrates the buyer-lessor's accounting when the sale price of an underlying asset has been increased (i.e., is greater than its fair value).

EXAMPLE LG 6-12

Sale and leaseback transaction – buyer-lessor buys an underlying asset for an amount greater than fair value

A seller-lessee sells a building with a remaining economic life of 40 years to an unrelated buyer-lessor for a price of $30 million. The seller-lessee's net carrying amount of the building is $20 million. Simultaneously, the seller-lessee enters into a lease contract with the buyer-lessor for the right to use the asset for 10 years, with annual rental payments of $1 million payable at the end of each year.

The buyer-lessor obtains control of the asset in accordance with the requirements in the revenue standard and therefore the transaction is accounted for as a sale and leaseback by the buyer-lessor and the seller-lessee. Initial direct costs of the transaction are ignored for purposes of this example.

Comparable sales figures of recent transactions for similar properties are readily available. Based on those comparable sales, the estimated fair value of the underlying asset is $28 million. The buyer-lessor determines that these comparable sales provide better evidence to assess whether the transaction is priced off-market than determining the market rental payments of the leaseback. Since the sales price of the underlying asset is not at fair value, the buyer-lessor is required to make an adjustment to recognize the sale and leaseback transaction at fair value.

The leaseback is classified as an operating lease by the buyer-lessor. The buyer-lessor's interest rate implicit in the leaseback is 8%.

How should the buyer-lessor account for the amount by which the sales price of the property exceeds its fair value?

Analysis

The buyer-lessor acquired the building for $30 million, which is greater than its fair value of $28 million; therefore, there is an excess of sale price as compared to the fair value of the underlying asset of $2 million.

The buyer-lessor should account for the purchase, including the additional financing to the seller-lessee, as follows.

Dr. Building	$28,000,000	
Dr. Loan receivable	$2,000,000	
Cr. Cash		$30,000,000

Each annual leaseback payment of $1,000,000 would be allocated between the lease income and the loan receivable by the buyer-lessor. To calculate the repayment of principal, the $1,000,000 annual lease payments would be allocated using the percentage derived by taking the excess of $2,000,000 divided by $6,710,081 (which is the present value of ten lease payments of $1,000,000 discounted at 8%). This yields a percentage of 29.8%, in which case the annual lease payment of $1,000,000 would be allocated as follows.

Debt service	$298,059
Lease income	$701,941

The buyer-lessor would recognize $701,941 as lease income each period of the leaseback. Interest income on the loan receivable would be calculated as $160,000 in year 1, declining to $22,078 in year 10 based on an amortization schedule using the 8% implicit interest rate.

6.5 *Failed sale and leaseback transaction*

When a sale and leaseback transaction does not qualify for sale accounting, the transaction must be accounted for as a financing transaction by the seller-lessee and a lending transaction by the buyer-lessor, as discussed in ASC 842-40-25-5.

ASC 842-40-25-5

If the transfer of the asset is not a sale in accordance with paragraphs 842-40-25-1 through 25-3, both of the following apply:

a. The seller-lessee shall not derecognize the transferred asset and shall account for any amounts received as a financial liability in accordance with other Topics.

b. The buyer-lessor shall not recognize the transferred asset and shall account for the amounts paid as a receivable in accordance with other Topics.

6.5.1 *Accounting for a failed sale and leaseback by a seller-lessee*

To account for a failed sale and leaseback transaction as a financing arrangement, the seller-lessee does not derecognize the underlying asset; the seller-lessee continues depreciating the asset as if it was the legal owner. The sales proceeds received from the buyer-lessor should be recognized as a financial liability.

6.5.1.1 *Allocation of the leaseback payments by a seller-lessee*

A seller-lessee will make rental payments under the leaseback. These payments should be allocated between interest expense and principal repayment of the financial liability. To determine the amount allocated to interest expense, the seller-lessee should use its incremental borrowing rate. However, a seller-lessee may need to adjust the interest rate initially or during the course of the leaseback, as discussed in ASC 842-40-30-6.

ASC 842-40-30-6

The guidance in paragraph 842-40-25-5 notwithstanding, the seller-lessee shall adjust the interest rate on its financial liability as necessary to ensure that both of the following apply:

a. Interest on the financial liability is not greater than the principal payments on the financial liability over the shorter of the lease term and the term of the financing. The term of the financing may be shorter than the lease term because the transfer of an asset that does not qualify as a sale initially may qualify as a sale at a point in time before the end of the lease term.

b. The carrying amount of the asset does not exceed the carrying amount of the financial liability at the earlier of the end of the lease term or the date at which control of the asset will transfer to the buyer-lessor (for example, the dates at which a repurchase option expires if that date is earlier than the end of the lease term).

Interest on the financial liability greater than the principal payments on the financial liability will cause the carrying amount of the financial liability to increase rather than decrease ("negative amortization"). This generally occurs when a seller-lessee's incremental borrowing rate results in an allocation of interest expense that exceeds the seller-lessee's rental payments to the buyer-lessor. When the use of a lessee's incremental borrowing rate results in negative amortization of the financial liability at the end of the amortization period (the shorter of the lease term or the term of the financing), the seller-lessee should instead use an imputed interest rate that will eliminate the negative amortization. See Example LG 6-12.

A projected net book value of the underlying asset that exceeds the carrying amount of the financial liability at the earlier of (1) the end of the lease term or (2) the date the buyer-lessor obtains control of the asset would have the effect of deferring a loss until that time. Similar to adjusting the interest rate to ensure that negative amortization does not occur, a seller-lessee that determines a loss will result from the application of its incremental borrowing rate should use the imputed interest rate. Generally, the imputed interest rate should be the rate that would result in the net carrying value of the underlying asset and the carrying amount of the financial liability being equal at the earlier of the end of the lease term or the date the buyer-lessor obtains control of the asset. See ASC 842-40-55-31 through ASC 842-40-55-38 for a detailed example of a failed sale and leaseback transaction requiring adjustment to the seller-lessee's incremental borrowing rate due to a projected built-in loss. If an imputed interest rate was used in this circumstance, the rate should not be subsequently lowered if there is an impairment of the underlying asset.

If a seller-lessee accounts for a sale and leaseback transaction as a financing arrangement because there is a repurchase option, unless the purchase option price is fixed and exercise is determined to be reasonably certain at lease commencement, the effective interest rate applied to the financial liability will typically require adjustment when it becomes probable that the repurchase option will be exercised. This is because the effective interest rate determined at lease commencement did not factor in the price of the purchase option. Accordingly, the seller-lessee should adjust the effective interest rate such that the carrying value of the financial liability upon exercise of the option is equivalent to the exercise price of the purchase option. If the repurchase option price is not fixed, the seller-lessee should estimate the exercise price and reflect any subsequent revisions as adjustments to the effective interest rate.

The carrying amount of the asset should not be changed as a result of a financing transaction; therefore, the asset should not be written up upon exercise of the repurchase option.

6.5.1.2 Buyer-lessor obtains control of the asset

A sale may occur at any point in time when the buyer-lessor obtains control of the asset during or at the end of a leaseback period. When the sale is ultimately recognized in a previously failed sale and leaseback transaction, the seller-lessee should recognize any remaining balance of the financial liability as the proceeds on the final sale of the underlying asset. The gain or loss equals the difference between those proceeds and the carrying amount of the underlying asset.

If the buyer-lessor obtains control of the underlying asset prior to the end of the leaseback period, the date that control transfers to the buyer-lessor is the lease commencement date for purposes of the seller-lessee initially measuring the right-of-use asset and lease liability.

Example LG 6-13, Example LG 6-14, Example LG 6-15, and Example LG 6-16 illustrate the accounting by the seller-lessee both when the buyer-lessor does and does not obtain control prior to the end of the leaseback term.

EXAMPLE LG 6-13

Failed sale and leaseback – buyer-lessor does not obtain control of the underlying asset prior to the end of the leaseback term

A seller-lessee sells a building for $950,000 cash and agrees to lease the building back for five years. Consider the following facts about this transaction:

- The net carrying amount of the building as of the date of sale is $800,000
- The annual leaseback payment is $100,000
- Annual depreciation expense is $80,000
- The seller-lessee does not guarantee the residual value of the asset at the end of the leaseback term
- The seller-lessee has a repurchase option that allows it to buy the building at the then-prevailing fair market value at any time during the lease term

- The seller-lessee's incremental borrowing rate is 9.3% and the interest rate implicit in the leaseback is not known

How should the seller-lessee account for the sale and leaseback of the building?

Analysis

Because the seller-lessee has a repurchase option and there are no alternative buildings that are substantially the same and readily available in the marketplace, the buyer-lessor does not obtain control of the building prior to the end of the leaseback term. The transaction does not qualify for sale accounting and should be accounted for as a financing. The net carrying amount of the asset would remain on the seller-lessee's books and the seller-lessee would continue to record annual depreciation expense of $80,000.

The cash proceeds received from the buyer-lessor would be recorded as a financial liability and the annual lease payments allocated between interest expense and a reduction of the financial liability. Interest expense should be calculated by multiplying the beginning balance of the financial liability by the incremental borrowing rate of 9.3%. In year 1, the seller-lessee would record interest expense of $88,350 ($950,000 × 9.3%). The reduction of the financial liability is calculated as the difference between the annual leaseback payment and the allocation of interest expense ($100,000 payment – interest expense of $88,350 = $11,650).

At the end of the fifth year, the leaseback and repurchase option expire and the buyer-lessor would obtain control of the asset. At that time, the seller-lessee would recognize the sale of the asset and any gain that resulted from removing the underlying asset and financial liability from its books.

The financing method is illustrated below:

Period	**Net carrying amount**	**Asset value**	**Accumulated depreciation**	**Financial liability**	**Reduction of obligation**	**Interest expense**
Inception	$800,000	$1,200,000	$400,000	$950,000	$ –	$ –
Year 1	720,000	1,200,000	480,000	938,350	11,650	88,350
Year 2	640,000	1,200,000	560,000	925,617	12,733	87,267
Year 3	560,000	1,200,000	640,000	911,699	13,918	86,082
Year 4	480,000	1,200,000	720,000	896,487	15,212	84,788
Year 5	400,000	1,200,000	800,000	879,860	16,627	83,373

Use of the incremental borrowing rate would not produce unusual results (e.g., a built-in loss or negative amortization). At the end of the five-year leaseback term, the seller-lessee would recognize the sale of the building with a gain of $479,860 (financial liability of $879,860 – $400,000 net carrying amount). The interest rate should not be decreased in order to eliminate recognition of the end-of-transaction gain.

EXAMPLE LG 6-14

Failed sale and leaseback – buyer-lessor does not obtain control of the underlying asset prior to the end of the leaseback term

A seller-lessee sells a building for $950,000 cash and agrees to lease the building back for five years. Consider the following facts about this transaction:

- The net carrying amount of the building as of the date of sale is $800,000
- The annual leaseback payment is $75,000
- Annual depreciation expense is $80,000
- The seller-lessee does not guarantee the residual value of the asset at the end of the leaseback term
- The seller-lessee has a repurchase option that allows it to buy the building at the then-prevailing fair market value at any time during the lease term
- The seller-lessee's incremental borrowing rate is 9.3% and the interest rate implicit in the leaseback is not known

How should the seller-lessee account for the sale and leaseback of the building?

Analysis

Because the seller-lessee has a repurchase option and there are no alternative buildings that are substantially the same and readily available in the marketplace, the buyer-lessor does not obtain control of the building prior to the end of the leaseback term. The transaction would not qualify for sale accounting and should be accounted for as a financing.

In this case, application of the financing method based on the seller-lessee's incremental borrowing rate of 9.3% yields the following:

Period	Net carrying amount	Asset value	Accumulated depreciation	Financial liability	Increase of liability	Interest expense
Inception	$800,000	$1,200,000	$400,000	$950,000	$ –	$ –
Year 1	720,000	1,200,000	480,000	963,350	13,350	88,350
Year 2	640,000	1,200,000	560,000	977,942	14,592	89,592
Year 3	560,000	1,200,000	640,000	993,891	15,949	90,949
Year 4	480,000	1,200,000	720,000	1,011,323	17,432	92,432
Year 5	400,000	1,200,000	800,000	1,030,376	19,053	94,053

Use of the seller-lessee's incremental borrowing rate results in annual interest expense in excess of annual lease payments of $75,000, which increases the financial liability over the term of the lease (i.e., negative amortization). Since negative amortization is prohibited, the seller-lessee should impute the interest rate that eliminates the negative amortization.

In this example, an imputed interest rate of approximately 7.89% results in interest expense of $75,000, which is equivalent to the annual lease payment. Because the interest expense no longer exceeds the annual lease payment, there would not be any negative amortization.

Application of the financing method based on the imputed interest rate of approximately 7.89% is illustrated below:

Period	Net carrying amount	Asset value	Accumulated depreciation	Financial liability	Increase of liability	Interest expense
Inception	$800,000	$1,200,000	$400,000	$950,000	$ –	$ –
Year 1	720,000	1,200,000	480,000	950,000	–	75,000
Year 2	640,000	1,200,000	560,000	950,000	–	75,000
Year 3	560,000	1,200,000	640,000	950,000	–	75,000
Year 4	480,000	1,200,000	720,000	950,000	–	75,000
Year 5	400,000	1,200,000	800,000	950,000	–	75,000

At the end of the five-year leaseback term, the seller-lessee would recognize the sale of the building with a gain of $550,000 (financial liability of $950,000 – $400,000 net carrying amount).

EXAMPLE LG 6-15

Failed sale and leaseback – buyer-lessor does not obtain control of the underlying asset prior to the end of the leaseback term

A seller-lessee sells a building for $950,000 cash and agrees to lease the building back for five years. Consider the following facts about this transaction:

- The net carrying amount of the building as of the date of sale is $800,000
- The annual leaseback payment is $200,000
- Annual depreciation expense is $80,000
- The seller-lessee does not guarantee the residual value of the asset at the end of the leaseback term
- The seller-lessee has a repurchase option that allows it to buy the building at the then-prevailing fair market value at any time during the lease term

- The seller-lessee's incremental borrowing rate is 9.3% and the interest rate implicit in the leaseback is not known

How should the seller-lessee account for the sale and leaseback of the building?

Analysis

Because the seller-lessee has a repurchase option and there are no alternative buildings that are substantially the same and readily available in the marketplace, the buyer-lessor does not obtain control of the building prior to the end of the leaseback term. The transaction does not qualify for sale accounting and should be accounted for as a financing.

In this case, application of the financing method based on the seller-lessee's incremental borrowing rate of 9.3% is illustrated below:

Period	Net carrying amount	Asset value	Accumulated depreciation	Financial liability	Reduction of liability	Interest expense
Inception	$800,000	$1,200,000	$400,000	$950,000	$ –	$ –
Year 1	720,000	1,200,000	480,000	838,350	111,650	88,350
Year 2	640,000	1,200,000	560,000	716,317	122,033	77,967
Year 3	560,000	1,200,000	640,000	582,934	133,383	66,617
Year 4	480,000	1,200,000	720,000	437,147	145,787	54,213
Year 5	400,000	1,200,000	800,000	277,802	159,345	40,655

Use of the seller-lessee's incremental borrowing rate results in a financial liability of $277,802, which is less than the asset's carrying amount of $400,000; therefore, a built-in loss exists. Since a built-in loss is prohibited, the seller-lessee would increase the interest rate until the financial liability equaled the expected carrying value of the asset. In this example, an imputed interest rate of approximately 11.93% is required.

The financing method based on the imputed interest rate of 11.93% is illustrated below:

Period	Net carrying amount	Asset value	Accumulated depreciation	Financial liability	Reduction of liability	Interest expense
Inception	$800,000	$1,200,000	$400,000	$950,000	$ –	$ –
Year 1	720,000	1,200,000	480,000	863,297	86,703	113,297
Year 2	640,000	1,200,000	560,000	766,255	97,043	102,957
Year 3	560,000	1,200,000	640,000	657,638	108,618	91,384

Period	Net carrying amount	Asset value	Accumulated depreciation	Financial liability	Reduction of liability	Interest expense
Year 4	480,000	1,200,000	720,000	536,069	121,570	78,430
Year 5	400,000	1,200,000	800,000	400,000	136,068	63,932

Since the financial liability and net carrying amount of the asset are equal on the date the buyer-lessor obtains control, the seller-lessee would recognize the sale of the building with no gain or loss.

EXAMPLE LG 6-16

Failed sale and leaseback – seller-lessee sells asset and buyer-lessor obtains control of the underlying asset prior to the end of the leaseback term

A seller-lessee sells a building for $950,000 cash and agrees to lease the building back for five years. Consider the following facts about this transaction:

- The net carrying amount of the building as of the date of sale is $800,000
- The annual leaseback payment is $100,000
- Annual depreciation expense is $80,000
- The seller-lessee does not guarantee the residual value of the asset at the end of the leaseback term
- The seller-lessee has a repurchase option that allows it to buy the building at the then-prevailing fair market value at any time during the lease term
- The seller-lessee's incremental borrowing rate is 9.3% and the interest rate implicit in the leaseback is not known

Assume the lease contract is modified at the end of the third year to remove the seller-lessee's repurchase option. As a result, the buyer-lessor obtains control of the asset at the end of the third year.

How should the seller-lessee account for the sale and leaseback of the building?

Analysis

Because the seller-lessee has a repurchase option and there are no alternative buildings that are substantially the same and readily available in the marketplace, the buyer-lessor does not obtain control of the building at the transaction effective date. The transaction would not qualify for sale accounting and should be accounted for as a financing at the transaction effective date.

At the end of the third year, due to the modification, the buyer-lessor obtains control of the asset. At that time, the seller-lessee would recognize the sale of the asset and any gain that resulted from removing the underlying asset and financial liability from its books.

Application of the financing method for this scenario is illustrated below:

Period	Net carrying amount	Asset value	Accumulated depreciation	Financial liability	Reduction of liability	Interest expense
Inception	$800,000	$1,200,000	$400,000	$950,000	$ –	$ –
Year 1	720,000	1,200,000	480,000	938,350	11,650	88,350
Year 2	640,000	1,200,000	560,000	925,617	12,733	87,267
Year 3	560,000	1,200,000	640,000	911,699	13,918	86,082

At the end of the third year when the repurchase option is removed, the seller-lessee would assess the classification of the lease because the lease was contractually modified. If classified as an operating lease, the seller-lessee would remove the financial liability and asset from its books and recognize a gain of $351,699 ($911,699 financial liability – $560,000 net carrying amount). The date of transfer of control is considered the lease commencement date. However, if the seller-lessee classified the lease as a finance lease, no sale has occurred and the transaction would continue to be accounted for as a failed sale and leaseback. See LG 6.3.4 for information on the impact of lease classification on qualification as a sale.

6.5.1.3 Accounting by the seller-lessee when the leaseback is for a portion of the asset

When a failed sale and leaseback transaction involves a seller-lessee that leases back only a portion of the asset, there are additional accounting considerations. Since the asset is not derecognized by the seller-lessee, there may be leases associated with other portions of the asset. These leases must be accounted for by the seller-lessee, and rental income should be imputed for the other leases, offset by additional imputed debt service.

Example LG 6-17 illustrates how a seller-lessee should account for a leaseback of a portion of an underlying asset when there are other leases in place.

EXAMPLE LG 6-17

Seller-lessee sells an asset and leases back a portion of the asset

A seller-lessee sells a shopping center in which it occupies the anchor store to a buyer-lessor and leases back only its store location. Consider the following facts about this transaction:

- The shopping center is one legal asset
- The shopping center is sold at fair value and the leaseback rentals reflect market rental rates
- The seller-lessee has a repurchase option
- There are no alternative assets that are substantially the same and readily available in the marketplace

How should the seller-lessee account for the sale and leaseback of the building?

Analysis

Because the seller-lessee has a repurchase option and there are no alternative assets that are substantially the same and readily available in the marketplace, the transaction would not qualify for sale accounting. It should be accounted for as a financing transaction. The net carrying amount of the asset would remain on the seller-lessee's books and the seller-lessee would continue to record annual depreciation expense.

The cash proceeds received from the buyer-lessor would be recorded as a financial liability. The rental payments made to the buyer-lessor for use of the anchor store would be re-characterized as debt service on the financing. In addition, since the seller-lessee does not have use of the other stores (which are retained on its balance sheet), it should impute rental income for the lease of the stores offset by additional imputed debt service.

The transaction should not be accounted for as a partial sale and partial financing.

It may be difficult to apply the imputed revenue model, previously described, when the asset involved in the sale and leaseback transaction is not fully utilized at the transaction date. When applying the imputed revenue model, a seller-lessee should consider the amount of asset usage and time necessary to lease vacancies. If the buyer-lessor is expected to lease the asset to third parties, we believe it is acceptable for the seller-lessee to impute rental income based on rents due from actual tenants; however, it may be difficult for the seller-lessee to apply this approach as it is no longer the legal owner of the asset and may not have access to the necessary information. Accordingly, we also believe it is acceptable for the seller-lessee to impute estimated market rental income as if the buyer-lessor is leasing all of the other stores from the seller-lessee (and subletting the stores to other tenants). However, the specific facts and circumstances, including the expected time necessary to lease the vacant space, should be considered when applying this alternative approach. For example, if 20% of the stores in the strip shopping center were vacant at the time of the sale and leaseback transaction and it typically requires several months to lease vacant space, it would be inappropriate to assume that the buyer-lessor was immediately leasing 100% of such vacant space from the seller-lessee at a market rental rate.

6.5.2 Accounting for a failed sale and leaseback by a buyer-lessor

To account for a failed sale and leaseback transaction as a financing arrangement, the buyer-lessor records the initial payment to the seller-lessee as a financial asset (i.e., a loan receivable).

As the seller-lessee makes rental payments, the buyer-lessor should allocate the payments between interest income and principal repayments on the financial asset.

To determine the amount allocated to interest income, the buyer-lessor should utilize an interest rate based on the guidance in ASC 835, Interest, specifically, ASC 835-30-25-12 through ASC 835-30-25-13. Accordingly, the buyer-lessor's interest rate may not be the same as the seller-lessee's rate, particularly when the seller-lessee has adjusted its interest rate to avoid negative amortization or a built-in-loss. Variable payments should be accounted for in accordance with ASC 310. See LI 6.5.1.2 for information on accounting for variable rate loans.

6.5.2.1 Accounting by the buyer-lessor when it obtains control of the asset

A buyer-lessor may obtain control of the asset at any time, including at the end of the leaseback period. If a sale is ultimately recognized in a failed sale and leaseback transaction, the remaining balance of the financial asset represents the cost of the underlying asset that the buyer-lessor purchases.

Example LG 6-18 and Example LG 6-19 illustrate the accounting for a failed sale and leaseback by the buyer-lessor, including the accounting by the buyer-lessor when control is obtained.

EXAMPLE LG 6-18

Failed sale and leaseback – buyer-lessor obtains control of the underlying asset at the end of the leaseback term

A seller-lessee sells a building for $950,000 cash and agrees to lease the building back for five years. Consider the following facts about this transaction:

- The net carrying amount of the building as of the date of sale is $800,000
- The annual leaseback payment is $100,000
- Annual depreciation expense is $80,000
- The seller-lessee does not guarantee the residual value of the asset at the end of the leaseback term
- The seller-lessee has a repurchase option that allows it to buy the building at the then-prevailing fair market value at any time during the lease term
- The buyer-lessor's interest rate implicit in the leaseback is 9%

How should the buyer-lessor account for the sale and leaseback of the building?

Analysis

Because the seller-lessee has a repurchase option and there are no alternative buildings that are substantially the same and readily available in the marketplace, the buyer-lessor does not obtain control of the underlying asset prior to the end of the leaseback term. The transaction would not qualify for sale accounting and should be accounted for as a lending transaction by the buyer-lessor. The asset would not be recorded by the buyer-lessor and the original purchase price of $950,000 would be recorded as a financial asset.

The annual leaseback payments from the seller-lessee of $100,000 would be allocated between interest income and principal repayments on the financial asset. Because the cash flows supporting the financial asset are the same as the cash flows underlying the leaseback, applying the guidance to determine the appropriate interest rate in ASC 835 results in a rate similar to the rate implicit in the leaseback, or 9%. In year 1, for example, the buyer-lessor would record interest income of $85,500 (calculated by multiplying the beginning balance of the financial asset, $950,000 by 9%). The principal repayment is calculated as the difference between the annual leaseback payment and the allocation of interest income ($100,000 payment – interest income of $85,500 = $14,500).

At the end of the fifth year, the leaseback and repurchase option expire and the buyer-lessor would obtain control of the asset. At that time, the buyer-lessor would recognize the purchase of the asset and remove the financial asset from its books.

Application of the financing method is illustrated below:

Period	Lease payment	Financial asset	Principal repayment	Interest income
Inception	$ –	$950,000	$ –	$ –
Year 1	100,000	935,500	14,500	85,500
Year 2	100,000	919,695	15,805	84,195
Year 3	100,000	902,468	17,227	82,773
Year 4	100,000	883,690	18,778	81,222
Year 5	100,000	863,222	20,468	79,532

At the end of the five-year leaseback term, the buyer-lessor would record its purchase of the asset at a purchase price of $863,222, the remaining balance of the financial asset at that time.

EXAMPLE LG 6-19

Buyer-lessor obtains control of the underlying asset prior to the end of the leaseback term

A seller-lessee sells a building for $950,000 cash and agrees to lease the building back for five years. Consider the following facts about this transaction:

- The net carrying amount of the building as of the date of sale is $800,000
- The annual leaseback payment is $100,000
- Annual depreciation expense is $80,000
- The seller-lessee does not guarantee the residual value of the asset at the end of the leaseback term
- The seller-lessee has a repurchase option that allows it to buy the building at the then-prevailing fair market value at any time during the lease term
- The buyer-lessor's interest rate implicit in the leaseback is 9%

Assume the lease contract is modified at the end of the third year to remove the seller-lessee's repurchase option. As a result, the buyer-lessor obtains control of the asset at the end of the third year.

How should the buyer-lessor account for the sale and leaseback of the building?

Analysis

Because the seller-lessee has a repurchase option and there are no alternative buildings that are substantially the same and readily available in the marketplace, the buyer-lessor does not obtain control of the building at the transaction effective date. The transaction would not qualify for sale accounting and should be accounted for as a financing at the transaction effective date.

At the end of the third year, due to the modification, the buyer-lessor obtains control of the asset. At that time, the buyer-lessor would recognize the purchase of the asset and remove the financial asset from its books.

Application of the financing method for this scenario is illustrated below:

Period	Lease payment	Financial asset	Principal repayment	Interest income
Inception	$ –	$950,000	$ –	$ –
Year 1	100,000	935,500	14,500	85,500
Year 2	100,000	919,695	15,805	84,195
Year 3	100,000	902,468	17,227	82,773

At the end of the third year, the buyer-lessor would record its purchase of the asset at a purchase price of $902,468, the remaining balance of the financial asset at that time. Any unamortized debt origination costs are inherently in the purchase price of the asset (i.e., the initial carrying amount of the property, plant, and equipment).

The buyer-lessor would classify the lease as an operating lease when control transfers (i.e., the lease commencement date).

If the lease were classified as a direct finance lease, the buyer-lessor would record the net investment in the lease at the carrying amount of the financial asset (i.e., $902,468). The buyer-lessor would subsequently recognize income based on the rate that produces a constant periodic rate of return on the net investment in the lease. See LG 4.3.2 for information on the accounting for direct finance leases.

6.6 Impact of sale and leaseback transactions on business combinations

In a business combination, an acquiree may have previously applied sale and leaseback accounting in a transaction with a third party that was separate from the business combination. Refer to BCG 4.3.3.7 for the accounting impact of sale and leaseback transactions on business combinations.

Chapter 7: Leveraged leases–updated May 2023

7.1 Leveraged leases overview

Leveraged leases are those leases that meet the criteria in ASC 840-10-25-43(c). The guidance on leveraged leases has not been carried forward into the leasing standard. Instead, ASC 842-10-65-1(z) grandfathers the accounting for leveraged leases existing at its effective date. Accordingly, a lessor should continue to apply the guidance in ASC 840 to leveraged leases that commenced prior to the effective date of ASC 842. See LG 9 for information on effective date and transition.

Because ASC 842 does not allow a new lease to be accounted for as a leveraged lease, any new lease should be accounted for as either operating, sales-type, or direct financing leases, as required under ASC 842.

7.2 Definition and characteristics of a leveraged lease

The Glossary in ASC 842-50 defines a leveraged lease.

Definition from ASC 842-50-20

Leveraged Lease: From the perspective of a lessor, a lease that was classified as a leveraged lease in accordance with the leases guidance in effect before the effective date and for which the commencement date is before the effective date.

Prior to the adoption of ASC 842, a lease was considered a leveraged lease if the terms of the arrangement met specified criteria. It had to qualify as a direct financing lease under ASC 840-10-25-43(b) and meet the criteria specific for leveraged leases in ASC 840-10-25-43(c) (see LG 7.2.1).

Excerpt from ASC 840-10-25-43

If the lease at inception meets any of the four lease classification criteria in paragraph 840-10-25-1 and both of the criteria in the preceding paragraph, it shall be classified by the lessor as a sales-type lease, a direct financing lease, a leveraged lease, or an operating lease as follows:

a. Sales-type lease...

b. Direct financing lease. A lease is a direct financing lease if it meets all of the following conditions:

    1. It meets any of the criteria in paragraph 840-10-25-1 and both of the criteria in the preceding paragraph.

    2. It does not give rise to manufacturer's or dealer's profit (or loss) to the lessor.

    3. It does not meet the criteria for a leveraged lease in (c).

c. Leveraged lease. Leases that meet the criteria of sales-type leases set forth in (a) shall not be accounted for as leveraged leases but shall be accounted for as prescribed in paragraph 840-30-25-6. A lease is a leveraged lease if it has all of the following characteristics:

    1. It meets the criteria in (b)(1) and (b)(2) for a direct financing lease.

2. It involves at least three parties: a lessee, a long-term creditor, and a lessor (commonly called the equity participant).

3. The financing provided by the long-term creditor is nonrecourse as to the general credit of the lessor (although the creditor may have recourse to the specific property leased and the unremitted rentals relating to it). The amount of the financing is sufficient to provide the lessor with substantial leverage in the transaction.

4. The lessor's net investment (see paragraph 840-30-25-8) declines during the early years once the investment has been completed and rises during the later years of the lease before its final elimination. Such decreases and increases in the net investment balance may occur more than once.

Leveraged lease classification applies only to lessors. Lessees should account for leveraged leases in the same manner as nonleveraged leases and classify them as operating or finance leases, as appropriate. The grandfathering of leveraged leases, therefore, does not affect lessees; they should apply the applicable transition guidance to their leases upon adopting ASC 842.

7.2.1 Classification criteria for leveraged leases

Leveraged leases have the following characteristics:

- The terms of the lease meet the criteria to be classified as a direct financing lease, as defined in ASC 840

- The lease involves at least three parties: a lessee, a long-term creditor, and a lessor

- The financing provided by the long-term creditor is nonrecourse to the general credit of the lessor and must provide the lessor (the equity investor) substantial leverage in the transaction

- The lessor's net investment in the leveraged lease declines during the early years of the lease term and subsequently rises

7.2.1.1 Classification as a direct financing lease under ASC 840

The definition of a direct financing lease under ASC 842 differs from its definition under ASC 840. Classification as a direct financing under ASC 840 was only possible when the lease did not give rise to profit or loss to the lessor at lease inception, i.e., the cost (or carrying value, if different) and fair value of the leased asset must be equal. If cost (or carrying value, if different) did not equal fair value at lease inception, the lessor could not classify the lease as a direct financing lease and it would be ineligible for leveraged lease accounting; rather, it would be classified as either a sales-type or operating lease, as appropriate. Unless the asset is acquired contemporaneously with the execution of the lease, the lessor's cost (or carrying value, if different), and fair value of the underlying asset subject to a lease, are typically not the same at lease inception and, therefore, classification as a direct financing lease or leveraged lease under ASC 840 was rare. An example of a situation when a lease may have qualified as a direct financing lease is when a bank acquired a building from a third party and leased it under a capital lease (as defined by ASC 840) to the lessee. In this case, the cost and fair value of the real estate (land and building) would likely be the same given the purchase and concurrent sales-type lease.

7.2.1.2 "Down-and-up pattern" of a leveraged lease

To qualify as a leveraged lease, the lessor's net investment in the leveraged lease must decline during the early years of the lease term and subsequently rise. Income from a leveraged lease is recognized by the lessor by applying a level rate of return to the net investment, but only in the periods that the net investment is positive. Because the calculated return is an after-tax amount, the cash flows from accelerated tax benefits are included in the overall leveraged lease cash flows. These cash flows occur in the early years of the lease and result in a rapid recovery of (i.e., decline in) the net investment, often causing the net investment to turn negative. The lessor will ultimately "reinvest" in the leveraged lease through the repayment of deferred tax liabilities, causing the net investment to increase in the later periods of the lease. This typical "down-and-up pattern" in the net investment causes a substantial portion of the income to be recognized in the early periods of the lease, which is a recognition pattern that is far more accelerated than a typical loan amortization (i.e., effective interest) pattern.

While the "down-and-up pattern" of a leveraged lease is typically created by the tax-related cash flows, ASC 840-10-25-43(c)(4) does not require that the pattern be created from the tax-related cash flows. Moreover, it does not require that the net investment in the leveraged lease go negative (in which case the balance of the deferred tax credit would exceed the pretax investment in the leveraged lease) at any point during the lease term. When the "down-and-up pattern" results from non tax-related cash flows, judgment may be required to determine whether the "down-an-up pattern" is sufficient to qualify for leveraged lease accounting.

7.2.1.3 Applying leveraged lease classification to partnerships

The classification criteria in ASC 840-10-25-43(c), which requires that the lessor's net investment, as defined, decline during the early years and rise during the later years of the lease, was generally not met in a partnership because the income tax benefits of the transaction are not realized by the partnership entity.

Generally, partnerships as lessors in an otherwise leveraged lease-type transaction did not account for the lease as a leveraged lease in situations when income tax benefits resulting from the transaction (e.g., investment tax credits (ITCs) and the use of accelerated depreciation) were not available to the entity, but, instead, were realized directly by the partners.

ASC 740-10-25-46 describes two methods to account for ITCs: the "flow-through method" and the "deferral method." The deferral method, under which the tax credit is reflected in net income over the life of the acquired property, besides being described in ASC 740-10-25-46 as "considered preferable," is more consistent with the income recognition model for a leveraged lease. Refer to TX 3.3.5.2 for more information about these two methods. If a partner's investment in the lease, as defined, would have met the requirements of ASC 840-10-25-43(c) because of the partner's ability to reflect the related income tax benefits, and the partner accounts for the ITC under the "deferral method," (as opposed to the "flow-through method"), the partner may have used leveraged-lease accounting to record its share of partnership income.

7.2.2 Economic rationale for leveraged leases

Historically, leveraged leases were attractive to lessees that were unable to take advantage of the tax benefits typically associated with owning property, such as accelerated depreciation and investment tax credits. Lessors would typically obtain nonrecourse financing for 65% to 80% of the cost of the leased asset (tax regulations required the lessor to have a minimum of 20% of the cost of the leased asset “at-risk”). This typically enabled lessors to claim all the tax benefits of owning the asset, including deductions for interest expense on the nonrecourse financing, despite a relatively small investment.

The tax benefits associated with investing in the asset are typically realized relatively early in the lease term. Given the early return of investment, a lessor in a leveraged lease was able to offer a lessee a lower cost of borrowing than the lessee might have been able to obtain in a financed purchase transaction.

Changes in tax regulations related to depreciation and investment tax credits, as well as the reduction in corporate tax rates during the 1980’s reduced the tax benefits of leveraged leases to lessors, as well as their attractiveness to investors. Accordingly, many existing leveraged leases are in the later part of their lease terms.

7.2.3 Presentation and income recognition of leveraged leases

The balance sheet presentation (as described in ASC 840-30-30-14) and income recognition pattern for a leveraged lease (as described in ASC 840-30-35-33 through ASC 840-30-35-36) are both unique models.

Leveraged leases are presented as a net asset on the lessor’s balance sheet. The net asset equals the sum of the total rents receivable from the lessee and the estimated residual value of the asset at the expiration of the lease less the debt service associated with the nonrecourse debt, all reduced by unearned income. This net presentation is attractive to lessors as it enhances its investment return on assets.

The accounting treatment prescribed for leveraged leases requires one overall method of income recognition (level rate of return for those years when net investment in the lease is positive, based upon the after-tax cash flows projected at the inception of the leveraged lease) for all components of income to be realized, including investment tax credit.

Although the accounting for leveraged leases is inherently inconsistent with accounting for other collateralized financings, the FASB decided to allow lessors to continue to apply the leveraged lease model because of the relatively small population of leveraged leases, the relative age of the lease arrangements, and the fact that this accounting model is only applicable to lessors. A leveraged lease may no longer be grandfathered if the lessor modifies or changes the characteristics of the lease, as described in LG 7.3.1.

7.2.3.1 Leveraged lease: presentation of investment tax credit

The examples included in ASC 842-50-55-6 through ASC 842-50-55-15 indicate the inclusion of ITC amortization with income tax expense. There is, however, a large body of practice that reflects ITC amortization as part of pretax revenue. Disclosure of the method applied is recommended.

The examples in ASC 842-50-55-6 through ASC 842-50-55-15 indicate that the unamortized balance of deferred ITC would be presented in the lessor's balance sheet as a component of "unearned and deferred income" deducted in arriving at the net investment in the leveraged lease included among assets. This presentation is consistent with the discussion in ASC 255-10-55-8.

The treatment of deferred investment tax credits as a temporary difference is discussed in TX 3.3.5.

7.3 Changes to a leveraged lease arrangement

Once a lessor adopts ASC 842, it may only continue to apply leveraged lease accounting to leases grandfathered at the transition date. A lessor should account for any leveraged lease that is modified on or after the effective date of ASC 842 as a new lease as of the effective date of the modification in accordance with the guidance in ASC 842-10 and ASC 842-30. See LG 3 for information on lease classification.

A leveraged lease arrangement may be changed in one or more ways during the lease term, including through the following events or actions:

- Lessor actions that change the fundamental characteristics of a leveraged lease transaction, for example, refinancing the nonrecourse debt
- An agreement by the lessor and lessee to modify or restructure the provisions of the lease
- Changes in the assumptions regarding the total amount or projected timing of related cash flows

Depending on the type of change in the leveraged lease, the lessor may be required to:

- Reassess the lease classification in accordance with ASC 840-10-35-4 and discontinue accounting for the lease as a leveraged lease if the characteristics required for leveraged lease accounting are no longer present
- Discontinue the use of leveraged lease accounting and account for the modified arrangement as a new lease under ASC 842
- Recalculate the net investment in the leveraged lease and record a gain or loss in the period of the change, without reassessing the classification of the lease

7.3.1 Changes to the fundamental characteristics

As noted in LG 7.2, an arrangement must have certain characteristics to qualify for leveraged lease accounting. A lessor may change aspects of the fundamental structure of an existing lease without necessarily changing the provisions of the agreement with the lessee. If, as a result of such changes, one or more of the defining characteristics of a leveraged lease are no longer present, the lessor may be required to discontinue leveraged lease accounting and reclassify the lease. If a lessor is required to discontinue leveraged lease accounting, it should classify the lease on the date it is changed as either an operating, sales-type, or direct financing lease based on the guidance in ASC 842.

Examples of changes that could cause a lessor to discontinue leverage lease accounting include:

- A lessor repays all of the nonrecourse debt, such that the transaction no longer has a long-term creditor
- A lessor repays a portion of the nonrecourse debt, such that the amount of nonrecourse debt no longer represents “substantial leverage” in the transaction
- A lessor replaces the nonrecourse debt with recourse debt

7.3.1.1 Leveraged lease: requirement for a long-term creditor

In addition to other criteria, a leveraged lease transaction must have a long-term creditor that provides the lessor with substantial leverage in the transaction, as discussed in ASC 840-10-25-43(c). That guidance does not define the required duration that the long-term creditor must remain in the transaction to qualify as a leveraged lease and does not define how much debt would provide "substantial leverage." Historically, "long-term" was interpreted as nonrecourse financing being present for a majority of the lease term.

When a lessor changes any aspect of the nonrecourse debt payment pattern, it should evaluate whether the repayment causes the lease to fail the requirement to have a long-term creditor necessary to continue to classify the lease as a leveraged lease.

7.3.1.2 Leveraged lease: requirement for substantial leverage

When a lessor repays all or a portion of the nonrecourse debt, it should also consider whether the arrangement, as altered, provides the lessor with substantial leverage. As discussed above, most leveraged leases were originally structured to provide as much as 80% leverage in the transaction. However, historically, a lease that was initially financed with more than 50% debt at lease commencement was generally accepted to have had enough leverage to have qualified for leveraged lease accounting, provided that the debt outstanding remained significant throughout the duration of the nonrecourse debt. When nonrecourse debt amortizes ratably over its term, this requirement is typically met.

As noted above, whenever a lessor changes any aspect of the nonrecourse debt payment pattern, it should evaluate its specific facts and circumstances to determine whether this requirement continues to be met such that the arrangement continues to qualify for leveraged lease accounting.

7.3.1.3 Leveraged lease: requirement for nonrecourse debt

To be considered nonrecourse debt, the lender may only have recourse to the following interests in the lease:

- Unremitted rents
- Variable rents not included in the lease receivable (i.e., contingent rents as defined by ASC 840)
- The underlying asset
- A residual value guarantee from the lessee

If the lessor refinances the nonrecourse debt with debt that has other recourse features, the refinancing would disqualify the lessor from applying leveraged lease accounting. In general, the financing may not have features under which non-rental amounts due to the lessor are subordinate to the financing. Examples of such non-rental amounts include amounts remitted to the lessor to pay for executory costs (e.g., property insurance) or for services the lessor provides to the lessee.

7.3.2 *Modifications to a leveraged lease*

A lessor and lessee may negotiate changes to a leveraged lease. For example, the lessor may reduce or restructure the rents or enter into a new arrangement to lease the asset to a new lessee. The guidance in ASC 842-10-65-1(z), however, does not allow a lease to be accounted for as a leveraged lease if the terms of the lease are modified on or after the effective date of ASC 842. The lessor should classify any such lease as a new lease as of the modification date, and classify the lease as either an operating, sales-type, or direct financing lease based on the guidance in ASC 842. See LG 3 for information on lease classification.

As noted in LG 7.2, leveraged lease classification applies only to lessors. Accordingly, whenever a leveraged lease is modified, notwithstanding that the lessor should account for the modified agreement as a new lease, the lessee may not have to do so. Rather, the lessee should account for the modification in accordance with the guidance in ASC 842-10-25-8. See LG 5 for information on lease modifications.

7.3.2.1 *Leveraged lease: replacing the lessee*

When the original lease agreement is replaced by a new agreement with a different lessee, the original leveraged lease is considered terminated. As discussed in LG 7.3, since ASC 842 does not permit new leveraged leases, the lessor should classify the new lease as operating, sales-type, or direct financing based on the guidance in ASC 842. See LG 3 for information on lease classification.

7.3.2.2 *Discontinuing the use of leveraged lease accounting*

As previously noted, changes to a leveraged lease may require a lessor to account for the lease as a new lease. To apply the guidance in ASC 842, the lessor should separately account for each of the components of its net investment that had been subject to leveraged lease accounting in accordance with the applicable GAAP for that component. Accordingly, the lessor should separately report the property subject to the new lease and the nonrecourse debt (i.e., the lessor will gross-up its balance sheet). While ASC 840-30-40-7 contains specific guidance on how a lessor should measure the leased property upon termination of a lease, that guidance was superseded by ASC 842. See LG 5.8 for guidance on how the lessor should measure the leased property upon termination of a lease.

Due to the unique income recognition pattern for leveraged leases, deferred taxes included in the net investment in the leveraged lease are accounted for in a manner prescribed by ASC 842-50-35-4. When a lessor discontinues use of leveraged lease accounting, it should also adjust any associated deferred tax assets or liabilities to reflect the amount it would have recognized had it accounted for those deferred taxes in accordance with ASC 740. The adjustment should be recognized in income tax expense in the period in which leveraged lease accounting is discontinued.

7.3.3 *Leveraged lease: changes in the underlying assumptions*

ASC 842-50-35-6 requires a lessor to review the estimated residual value and all other important assumptions used to determine the estimated total net income from the leveraged lease on at least an annual basis. The projected timing of income tax cash flows generated by the lease is an important assumption that should also be reviewed annually, or more frequently if events or circumstances indicate a change in the timing has occurred or might occur.

Changes in important assumptions require a lessor to recognize immediate gains or losses and change its scheduled income recognition, prospectively. However, changes to assumptions alone would not typically require a lessor to reassess lease classification.

Examples of changes in other important assumptions that would likely change the total estimated net income from a leveraged lease include:

- A change in the estimated amount of federal or state income taxes to be paid over the term of the lease
- A change in enacted income tax rates, as well as those that result from a change in state apportionment factors. (As noted in ASC 842-50-35-14, although interest and penalties assessed by the IRS change the estimated total net income from the lease, practice as well as the leveraged lease literature has excluded interest and penalties from the leveraged lease accounting.)
- A change in assumptions regarding the deductibility of certain transaction-related expenses
- Decreases in estimated residual value judged to be other-than-temporary; an upward adjustment of estimated residual value is not allowed
- Other changes in the amount or timing of lease-related cash flows, for example, changes in the amount or timing of rent collections

As required by ASC 842-50-35-6, the rate of return and the allocation of income to positive investment years should be recalculated from the inception of the lease. The change in the net investment as of the date the arrangement is modified should be recognized as a gain or loss in the current period. The collectability of restructured lease payments and realization of the residual value should also be assessed. However, as discussed in ASC 842-50-35-8, the lessor should not record an upward adjustment to the leased property's residual value even if the amount of the lessee's residual value guarantee is increased; this would be similar to recognizing a gain contingency, which is prohibited. The pretax gain or loss recognized should be included in income from continuing operations before income taxes in the same line item in which leveraged lease income is recognized. The tax effect of the recognized pretax gain or loss should be included in the income tax line item.

7.3.3.1 Leveraged lease: change in timing of income tax cash flows

ASC 842-50-35-6(c) requires lessors to recalculate the rate of return from a leveraged lease when the projected timing of income tax cash flows changes. As required by ASC 842-50-35-11, only changes in the timing of the tax benefits that are directly related to a leveraged lease require the lessor to recalculate the rate of return in the leveraged lease. Changes in timing that result from an alternative minimum tax (AMT) credit or a net operating loss (NOL) carryforward of the lessor do not require a recalculation, because such changes are not directly related to that lease.

While a change in timing that is not directly related to the leveraged lease transaction would not, by itself, trigger a requirement to recalculate the rate of return in the leveraged lease, the leveraged lease literature requires that, if a recalculation is required for other reasons, the recalculation should include an update of all assumptions used in the leveraged lease. Accordingly, any such recalculation must include the actual or expected changes in timing of all cash flows, including those due to AMT credits and NOL carryforwards, if significant.

Issues related to AMT credits are addressed in ASC 842-50-35-16 through ASC 842-50-35-20. In particular, an entity should include assumptions regarding the effect of the AMT, considering its consolidated tax position in leveraged lease transactions. These assumptions require, at a minimum, annual review, and any change that affects estimated after-tax net income should be accounted for in the manner prescribed.

An enterprise whose tax position frequently varies between AMT and regular tax would not be required to recalculate each year unless there was an indication that the original assumptions regarding total after-tax net income from the lease were no longer valid. In that circumstance, the enterprise would be required to revise the leveraged lease computations in any period in which total net income from the leveraged lease changes due to the effect of the AMT on cash flows for the lease.

As noted in LG 7.2.2, a lessor typically realizes the tax benefits associated with leveraged leases relatively early in the lease term. However, historically, taxing authorities often challenged lessors' tax positions related to leveraged leases, including both the amounts and the timing of the accelerated tax benefits. As such, there may be some uncertainty about a lessor's tax positions related to its leveraged leases. See TX 15 for more information about accounting for uncertainty in income taxes.

If, during the lease term, the expected timing of income tax cash flows is revised, the leveraged lease would be recalculated. The recalculation should incorporate:

- actual cash flows up to the date of the recalculation;
- projected cash flows between the date of the recalculation and the date of any projected settlement;
- a projected settlement amount on the date of the projected settlement; and
- projected cash flows following the date of the projected settlement.

ASC 842-50-35-8 through ASC 842-50-35-9 require the lessor to account for changes in the estimated timing of income tax cash flows.

ASC 842-50-35-9

The projected timing of income tax cash flows generated by the leveraged lease is an important assumption and shall be reviewed annually, or more frequently, if events or changes in circumstances indicate that a change in timing has occurred or is projected to occur. The income effect of a change in the income tax rate shall be recognized in the first accounting period ending on or after the date on which the legislation effecting a rate change becomes law.

ASC 842-50-35-10

A revision of the projected timing of the income tax cash flows applies only to changes or projected changes in the timing of income taxes that are directly related to the leveraged lease transaction. For example, a change in timing or projected timing of the tax benefits generated by a leveraged lease as a result of any of the following circumstances would require a recalculation because that change in timing is directly related to that lease:

a. An interpretation of the tax law

b. A change in the lessor's assessment of the likelihood of prevailing in a challenge by the taxing authority

c. A change in the lessor's expectations about settlement with the taxing authority.

The changes referred to in ASC 842-50-35-10(b) and ASC 842-50-35-10(c) require a recalculation in two situations involving a change in timing of tax-related cash flows.

The first situation is when there is a change in the amount of an expected settlement with the tax authorities, for example, when the expected settlement changes from a 70/30 settlement (that is, a settlement in which the lessor would retain 70% of the timing benefit that is claimed on the tax return and would concede 30% of that benefit) to a 60/40 settlement. This represents only a change in timing of tax-related cash flows because the lost leveraged lease income will be re-recognized over the remaining lease term. For example, assume that the IRS disallows a portion of a lessor's depreciation deductions, and the lessor enters into a settlement that reflects payment of the related back taxes to the IRS. The tax basis to the lessor of the leased property would be increased accordingly, and the lessor would enjoy the benefit of the additional tax deductions later in the lease term. The total net income from the lease would not change; however, the rate of return inherent in the leveraged lease would be lower. As a result, the lost income would be recycled.

The second situation is when only the timing of the expected settlement changes, for example, when the lessor originally expected a 70/30 settlement to occur in a one period, but then changed the expected settlement date to one year later. Some lessors may be anticipating settling their tax exposures over a period of time. For example, they might expect to settle with the IRS for certain open years prior to settling for other (later) open years. If so, the projected cash flows should reflect the multiple settlements as they are expected to occur.

The recalculation should not incorporate interest and penalties that have been assessed or that are expected to be assessed. Such interest and penalties should be accounted for outside the leveraged lease model, in accordance with ASC 740.

To determine the estimated tax cash flows to be reflected in the recalculation, the lessor should follow the guidance in ASC 740. As described in TX 15.3.1.8, uncertain tax positions that relate only to the timing of when an item is included on a tax return are automatically deemed to have met the recognition threshold for purposes of applying the guidance in ASC 740. Therefore, if it can be established that the only uncertainty is when an item is taken on a tax return, such positions have satisfied the recognition step for purposes of the guidance in ASC 740, and any uncertainty related to timing should be assessed as part of measurement. In these situations, the amounts to be included in the recalculation of the leveraged lease should reflect the largest amount of benefit that is greater than 50% likely of being realized. See TX 15.4 for more information on measuring the tax benefit to be recorded on uncertain tax positions.

Because taxable income for most states is based on federal taxable income, lessors should consider the effects that estimated changes in the timing of federal income tax cash flows will have on the related state income tax cash flows.

Advance payments and deposits made to the taxing authorities should not be considered cash flows of the leveraged lease; rather, they should be included in any recalculation as of the actual settlement date or the expected settlement date.

Example LG 7-1 illustrates how a lessor should consider changes in estimates in timing of income tax cash flows used to remeasure a leveraged lease.

EXAMPLE LG 7-1

Change in the estimated timing of income tax cash flows

A leveraged lessor used its original leveraged lease calculation to recognize income from a leveraged lease. The original calculation reflected income tax-related cash flows consistent with the filing position taken on the lessor's tax return. At the beginning of year 4, however, the taxing authorities questioned the timing of certain tax deductions in the lessor's filing position. Accordingly, the lessor recalculated the leveraged lease cash flows and recorded an adjustment to the net investment in the leveraged lease.

The original leveraged lease calculation was based on the following amounts:

Year	Tax deduction	Tax benefit at a 40% rate
1	$142,857	$57,143
2	244,898	97,960
3	187,075	74,830
4	153,061	61,224
5	119,048	47,619
6	53,061	21,224
7	0	0
8	0	0
9	0	0
10	0	0
Total	$900,000	$360,000

The taxing authorities have asserted that depreciation deductions should be taken as follows:

Year	Tax deduction
1	$50,000
2	100,000
3	100,000
4	100,000
5	100,000
6	100,000
7	100,000
8	100,000
9	100,000
10	50,000
	$900,000

According to the taxing authorities, the entity has taken excess depreciation deductions of $324,830 during the first three years of the lease and underpaid income taxes (excluding interest and penalties) by $129,932 (for the latter, assume an income tax rate of 40%). This example ignores interest and penalties as they are accounted for outside the leveraged lease model.

The entity believes that it will eventually enter into a negotiated settlement with the taxing authorities. The settlement is expected to reflect a compromise, whereby the entity and the taxing authorities will agree that the entity will retain a negotiated portion of the benefits that are reflected in the timing of the deductions; the remaining benefit inherent in the timing of the deductions will be disallowed. As a result of the disallowance, the entity will have to make a payment for the back taxes owed. After the settlement, the entity will be able to take the remaining depreciation, including the amount that was disallowed in connection with the settlement.

How should the lessor evaluate the change in expected income tax cash flows?

Analysis

When the lessor determines that the timing of the income tax cash flows pertaining to the leveraged lease are uncertain (assumed to be at the beginning of the fourth year of the leveraged lease), the lessor must determine whether a recalculation of the leveraged lease is required. Since the previous leveraged lease calculation was based on the assumption that income tax cash flows were consistent with the position taken on the tax return, a recalculation will be required if the income tax cash flows that are determined in accordance with the guidance of ASC 740 now differ from those taken on the tax return.

In the first step of the recognition and measurement process under the guidance of ASC 740, the lessor would conclude that the uncertainty only relates to the timing of the deductions and income for tax purposes. Accordingly, the recognition threshold would be reached and the lessor would proceeds to step 2 to determine the appropriate measurement.

Based on the expected settlement with the IRS, the lessor considers various possible outcomes:

Scenario	Portion of timing benefits retained	Portion of timing benefits disallowed
	%	%
A	100	0
B	90	10
C	80	20
D	70	30
E	60	40
F	40	60
G	20	80
H	0	100

The entity would assign probabilities to each of the possible outcomes. The individual probabilities and the cumulative probabilities are as follows:

Scenario	Probability	Cumulative probability
	%	%
A	5	5
B	10	15
C	15	30
D	15	45
E	25	70
F	20	90
G	10	100
H	0	100

Under ASC 740, the accounting is based on the scenario that reflects the most advantageous result that has a cumulative probability of at least 50% (more likely than not.) Scenario E is the first scenario with a cumulative probability that exceeds 50%. Accordingly, the lessor would recalculate the leveraged lease, based on the cash flows implied by scenario E.

The entity projects that at the end of year seven it will make a $60,000 payment to the taxing authorities to settle the tax dispute. The amount is determined as follows: at the end of year 7, the entity will have taken all $900,000 in depreciation deductions, including the $250,000 of deductions that the taxing authorities challenged. Scenario E is based on the assumption that the taxing authorities will allow 60% of the aggressive deductions and disallow 40%. Therefore, the amount of disallowed deductions will be $100,000 [$250,000 x 40%], and the taxes payable will be $40,000, based on an income tax rate of 40%.

The entity projects the following depreciation deductions after the projected settlement:

Year	Tax deduction
8	$40,000
9	40,000
10	20,000

These amounts coincide with the disallowed deductions. Mechanically, they are equivalent to 60% of the amount in the table relating to the original leveraged lease calculation plus 40% of the amount in the table relating to the deductions originally asserted by the taxing authorities.

Finally, the entity will use the following income tax-related cash flows to recalculate the leveraged lease.

Year	Tax deduction	Tax benefit at a 40% rate
1	$142,857	$57,143
2	244,898	97,960
3	187,075	74,830
4	153,061	61,224
5	119,048	47,619
6	53,061	21,224
7	(100,000)	(40,000)
8	40,000	16,000
9	40,000	16,000
10	20,000	8,000
	$900,000	$360,000

7.4 Leveraged leases acquired in a business combination

A leveraged lease acquired in a business combination should retain its original lease classification provided it is not modified and it was eligible for grandfathering under ASC 842. The net investment in the leveraged lease is recorded at its fair value on the acquisition date, which normally approximates the present value of expected cash flows. Upon acquisition, the acquirer should measure the net investment in the leveraged lease at its fair value and separately recognize its component parts (i.e., the net rentals receivables, estimated residual value, and unearned income) on a gross basis.

A separate liability would be recorded in purchase accounting for pre-acquisition interest and penalties determined in accordance with ASC 740. The effects of any subsequent adjustment of the pre-acquisition liability would be determined in accordance with ASC 740.

The post-acquisition leveraged lease accounting would be based on income tax cash flows that are determined in accordance with ASC 740. If the acquirer expects to enter into a settlement with the taxing authorities relating to payment of back taxes for deductions taken earlier than may be appropriate under the tax laws, the leveraged lease cash flows typically include the following components:

- The benefit of tax deductions that the lessor anticipates taking on its tax return up to the date of a projected settlement with the taxing authorities;

- A projected settlement amount on the date of the projected settlement; and

- Projected cash flows following the date of the projected settlement.

Since the tax-related cash flows required by ASC 740 may be different from the cash flows that a market participant would use to determine the fair value of a leveraged lease, the rate that is used in the leveraged lease accounting would not necessarily be the same as the rate that was used to determine the fair value of the leveraged lease on the acquisition date.

Interest and penalties that accrue on an acquired leveraged lease after its acquisition should be recognized in expense, outside the leveraged lease model. If, after the acquisition, circumstances change the timing of the estimated income tax-related cash flows, the lessor should recalculate the leveraged lease and reflect the cumulative catch-up adjustment in net income. The lessor should also adjust the liability for post-acquisition interest and penalties, as appropriate, and record the effects of the adjustment in expense.

See ASC 842-50-55-27 through ASC 842-50-55-33 for an illustration. See BCG 4.3.3.7 for additional information on the accounting for leases acquired in a business combination.

Chapter 8: Other topics — updated October 2023

8.1 Chapter overview - leases

This chapter discusses the following topics:

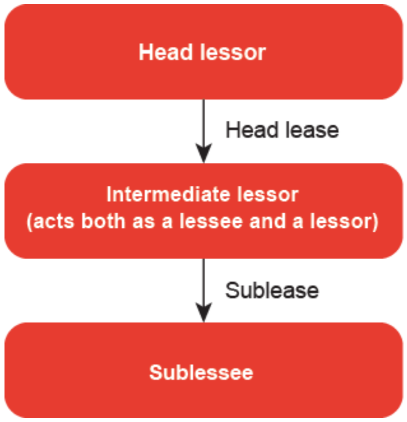
- Subleases
- Sales of leased assets
- Sales of lease receivables and unguaranteed residual assets
- Sales of equipment with guaranteed minimum resale amount
- Business combinations
- Remeasurement of right-of-use asset to functional currency
- Lessor operating leases – impact of collectibility on revenue and receivables
- Application of CECL to leasing
- Leasehold improvements

Lessors may execute lease transactions using limited partnerships, joint ventures, and trusts. Special-purpose lessor entities are also frequently used to structure leases, including synthetic leases. These lessor entities, as well as similar entities employed by a lessee, should be evaluated to determine whether they should be consolidated by the lessor or lessee. See PwC's *Consolidation* guide for more information.

8.2 Accounting for subleases

In a sublease, an entity is both a lessee and a lessor for the same underlying asset. In a sublease a lessee subleases the underlying asset to a third-party sublessee; the entity is then referred to as the intermediate lessor (or sublessor). In a sublease transaction, the lease between the original lessee and lessor (referred to as the head lease) remains in effect. Figure LG 8-1 illustrates a typical sublease arrangement.

Figure LG 8-1
Typical sublease arrangement



Subleases can arise for many reasons–for example, when a lessee no longer requires leased space and subleases the excess to another party. Another example is when an intermediate lessor leases hardware to its customer (sublessee) bundled with additional goods and services. A lease from the lessee back to the head lessor is typically not accounted for as a sublease.

See FSP 14.2.3, FSP 14.2.4, and FSP 14.3.2.3 for information on the disclosure requirements for subleases.

8.2.1 *Accounting by the intermediate lessor*

Subleases of right-of-use assets are within the scope of ASC 842 and should be accounted for in the same way as other leases. The intermediate lessor should separately account for the head lease and sublease unless it is relieved of its primary obligation under the head lease. Typically, a lessee would not be relieved of its obligations under the head lease unless it is contractually replaced in the head lease with the sub lessee. See LG 8.2.1.2 for additional information. See LG 3 and LG 4 for information on the classification and accounting for the head lease prior to the intermediate lessor entering into a sublease.

As discussed in ASC 842-10-25-6, an intermediate lessor should determine the classification of the sublease based on the underlying asset, rather than the right-of-use asset arising from the head lease.

ASC 842-10-25-6

When classifying a sublease, an entity shall classify the sublease with reference to the underlying asset (for example, the item of property, plant, or equipment that is the subject of the lease) rather than with reference to the right-of-use asset.

8.2.1.1 *Intermediate lessor retains head lease primary obligation*

ASC 842-20-35-14 discusses the accounting for the head lease when an intermediate lessor enters into a sublease and the intermediate lessor is not relieved of its primary obligation under the head lease. Figure LG 8-2 summarizes the accounting for various lease types. ASC 842-20-35-15 specifies that the intermediate lessor should use the rate implicit in the lease to classify the sublease and also measure the net investment in a sublease classified as a sales-type or direct financing lease. If such rate cannot be readily determined, the intermediate lessor should use the discount rate that it originally used to account for the head lease.

Figure LG 8-2
Accounting for a head lease and related sublease when the intermediate lessor is not relieved of its primary obligation under the head lease

Lease classification	Intermediate lessor accounting treatment
Sublease is classified as an operating lease	□ Regardless of whether it is an operating or finance lease, the intermediate lessor should continue to account for the head lease as before commencement of the sublease. □ If the total remaining lease cost (on the head lease) for the term of the sublease is more than the anticipated sublease income for that same period, this is an indicator that the carrying amount of the right-of-use asset associated with the head lease may not be recoverable. The right-of-use asset should be assessed for impairment in accordance with ASC 360-10-35-21; we believe the lease provisions (e.g., the term of the head lease and sublease) should be considered when assessing whether there is an impairment. See PPE 5.2.7 and LG 4.6 for guidance on the impairment of a right-of-use asset.
The original lease is a finance lease and the sublease is a sales-type or direct financing lease	□ The original right-of-use asset should be derecognized in accordance with the sales-type lease/direct financing lease derecognition guidance in ASC 842-30-40-1 (see LG 5.7) and the original lease liability should be accounted for as before commencement of the sublease. □ The intermediate lessor should evaluate its net investment in the sublease for impairment in accordance with the guidance in ASC 842-30-35-3. See LG 4.7 for information on the impairment of a net investment in a lease.
The original lease is an operating lease and the sublease is a sales-type or direct financing lease	□ The original right-of-use asset should be derecognized in accordance with the sales-type lease/direct financing lease derecognition guidance in ASC 842-30-40-1 (see LG 5.7) and the original lease liability should be accounted for based on the accounting for a lease liability in a finance lease (see LG 4). Note that since the sublease met one of the conditions for a sales type or direct financing lease and the head lease did not, the intermediate lessor should evaluate whether the original assumptions relating to the head lease have changed. □ The right-of-use asset should be evaluated for impairment prior to derecognition using the guidance in ASC 360. See PPE 5.2.7 and LG 4.6 for information on the impairment of right-of-use assets. □ After derecognizing the right-of-use asset, the net investment in the sublease is subject to the impairment guidance in ASC 842-30-35-3. See LG 4.7 for information on the impairment of a net investment in a lease.

As discussed in FSP 14.3.2, ASC 842-10-15-39A, provides lessors an election to exclude certain lessor costs that are directly remitted by a lessee to a third party from consideration in the contract. A lessor that elects this policy would exclude those payments from gross presentation. We believe an intermediate lessor should similarly present any variable lessor costs, such as property taxes and insurance, that are directly paid by the sublessee to the third-party biller on a net basis (i.e., no effect on the intermediate lessor's income statement). However, we do not believe this ASU applies to an intermediate lessor when a sublessee makes fixed or variable rent payments to the head lessor (rather than to the third-party biller) on behalf of the intermediate lessor (i.e., the intermediate lessor should separately recognize sublease income and expense under the head lease).

Accounting for the head lease

Subletting a leased asset may trigger remeasurement of the lessee-sublessor's head lease and may also require the lessee-sublessor to reassess lease classification of the head lease. For example, upon entering into a sublease, the intermediate lessor should consider the lease term (as defined by Topic 842) of the sublease relative to the head lease. The intermediate lessor may need to update the head lease term so that it is not shorter than the sublease term. See LG 5.3 for information on the remeasurement and re-assessment of classification of a lease by a lessee.

8.2.1.2 Intermediate lessor is relieved of head lease primary obligation

ASC 842-20-40-3 provides guidance on accounting for a head lease and sublease when the intermediate lessor is relieved of its primary obligation under the original lease.

Excerpt from ASC 842-20-40-3

If the nature of a sublease is such that the original lessee is relieved of the primary obligation under the original lease, the transaction shall be considered a termination of the original lease. … Any consideration paid or received upon termination that was not already included in the lease payments (for example, a termination payment that was not included in the lease payments based on the lease term) shall be included in the determination of profit or loss to be recognized in accordance with paragraph 842-20-40-1. If a sublease is a termination of the original lease and the original lessee is secondarily liable, the guarantee obligation shall be recognized by the lessee in accordance with paragraph 405-20-40-2.

See LG 5.5 for more details regarding termination of a lease.

8.2.2 Accounting by the head lessor

As described in ASC 842-30-35-7, a head lessor should continue to account for a lease that an intermediate lessor has subleased, sold, or transferred as it did before such transaction. However, if the lease is replaced by a new agreement with a new lessee, the head lessor should account for the change in lessee as a termination of the original lease and the commencement of a new lease. See LG 5.8 for more details regarding termination of a lease.

8.2.3 Accounting by the sublessee

A sublessee would account for the arrangement similarly to any new arrangement that it enters which is, or contains, a lease. As discussed in LG 3.3.4.6, lessees should discount lease payments at the lease commencement date using the rate implicit in the lease; if the information necessary to determine the rate implicit in the lease is not readily available, a lessee should use its incremental borrowing rate.

While a sublessee should determine its incremental borrowing rate as it would in any lease, questions have arisen about how a sublessee should determine (and whether it can determine) the rate implicit in the lease. This is because there is more than one lessor in a sublease: should the sublessee determine the head lessor's rate implicit in the head lease (based on the head lessor's return on the underlying asset), or the intermediate lessor's rate implicit in the sublease (based on the intermediate lessor's return on its right-of-use asset, rather than the underlying asset)?

We believe a sublessee should determine a discount rate similarly to how it would do so in any lease. A lessee must use the rate implicit in the lease to measure a lease liability when that rate is readily determinable. Typically, a lessee does not have all the requisite information to readily determine the rate implicit in any lease and it should, therefore, use its incremental borrowing rate to measure the lease liability. However, when the sublease and head lease terms are identical, (e.g., the intermediate lessor and sublessee are common control entities, and the sublease and head lease are coterminous), the sublessee should use the rate implicit in the lease as the rate is readily determinable.

8.3 Sale of leased assets

A reporting entity may lease an asset in which it owns an interest (e.g., the lessee owns an interest in a partnership that owns the underlying asset). If the reporting entity sells its interest in the leased asset (e.g., sells its interest in the partnership that owns the underlying asset), but continues to lease the asset, the accounting treatment depends on whether the lease is modified in connection with the sale, as discussed in ASC 842-40-55-9.

- If the preexisting lease is modified in connection with the sale, the seller-lessee should account for the transaction in accordance with the sale and leaseback guidance. See LG 6 for information on sale and leaseback transactions.

- If the preexisting lease is not modified in connection with the sale, then the seller-lessee should account for the sale using other GAAP.

While the guidance in ASC 842-40-55-8 refers to a circumstance in which the reporting entity acquires its ownership interest and enters into the lease at or near the same time, we believe this guidance should be applied regardless of the length of time between the acquisition date of the ownership interest and the lease.

A sale or spinoff of a subsidiary that leases the property to its parent is a sale and leaseback whether the intercompany lease is modified or not. See LG 6 for information on sale and leaseback transactions.

ASC 842-40-55-10 provides additional guidance for when arrangements involve leases between parties under common control.

8.4 Sale of lease receivables and residual assets

The sale of a lease receivable (the right to receive lease payments and guaranteed residual values at lease commencement) should be accounted for under the provisions of ASC 860, Transfers and

Servicing. ASC 860 does not address, however, a sale of the unguaranteed residual asset in sales-type and direct financing leases. We believe such sales, including the sale of residual values guaranteed after commencement, should be accounted for under ASC 842, which refers to the sale guidance in ASC 606 (see LG 8.4.2 for more details).

8.4.1 *Accounting for the sale of a lease receivable*

To account for the sale of a lease receivable, a lessor should evaluate the derecognition requirements of ASC 860 to determine whether a transfer of a lease receivable qualifies as a sale (refer to TS 3). If it does not, a lessor should follow the secured borrowing guidance in ASC 860 (refer to TS 5). If it does, ASC 842-30-35-4 provides guidance on a lessor's accounting for the retained unguaranteed residual asset.

ASC 842-30-35-4

If a lessor sells substantially all of the lease receivable associated with a sales-type or a direct financing lease and retains an interest in the unguaranteed residual asset, the lessor shall not continue to accrete the unguaranteed residual asset to its estimated value over the remaining lease term. The lessor shall report any remaining unguaranteed residual asset thereafter at its carrying amount at the date of the sale of the lease receivable and apply Topic 360 on property, plant, and equipment to determine whether the unguaranteed residual asset is impaired.

8.4.2 *Sale of residual asset in a direct financing or sales-type lease*

There is no specific guidance in ASC 842 on what model to apply to the sale of a residual asset that is either unguaranteed or guaranteed after the lease commencement date. (As noted in LG 8.4, a residual asset that was guaranteed at the lease commencement date is a financial asset, accounted for under the provisions of ASC 860.) Since an unguaranteed residual is not a financial asset, ASC 860 does not apply. We believe the guidance in ASC 842-40-25-1 addressing the sale of nonfinancial assets should be applied to this type of transaction. Under that guidance, sale recognition is permitted provided the requirements in ASC 606 for a sale are met. In other words, to determine when an unguaranteed residual asset subject to a lease or a residual asset guaranteed after commencement should be derecognized, the lessor should apply the guidance in:

- ASC 606-10-25-1 through ASC 606-10-25-8 to determine the existence of a contract, and

- ASC 606-10-25-30 to determine when the entity satisfies a performance obligation by transferring control of an asset.

8.4.3 *Purchase of an interest in the residual value of a leased asset*

Residual assets may be guaranteed or unguaranteed. A residual asset that is guaranteed at lease commencement is considered a financial asset under ASC 860. An unguaranteed residual asset, or one that was guaranteed subsequent to lease commencement, is not a financial asset.

8.4.3.1 *Purchase of an unguaranteed residual asset*

ASC 842-30-40-4 refers to ASC 360 for guidance on a third-party's acquisition of an interest in the unguaranteed residual value of an asset from the lessor. As discussed in ASC 360-10-25-4, the third party should record the interest as an asset on the date it is acquired; the interest should be initially measured using the guidance in ASC 360-10-30-3 and ASC 360-10-30-4.

ASC 360-10-30-3

An interest in the residual value of a leased asset recognized under paragraph 360-10-25-4 shall be measured initially at the amount of cash disbursed, the fair value of other consideration given, and the present value of liabilities assumed.

ASC 360-10-30-4

The fair value of the interest in the residual value of the leased asset at the date of the agreement shall be used to measure its cost if that fair value is more clearly evident than the fair value of assets surrendered, services rendered, or liabilities assumed.

ASC 360-10-35-14 provides guidance on the subsequent accounting for an interest in the unguaranteed residual value of a leased asset. It should be carried at its acquisition cost until it is sold (or otherwise disposed of). If there is an other-than-temporary decline in the value, it should be written down to fair value with a loss recognized equal to the amount of the write-down.

ASC 360-10-35-14

An entity acquiring an interest in the residual value of any leased asset, irrespective of the classification of the related lease by the lessor, shall not recognize increases to the asset's estimated value over the remaining term of the related lease, and the asset shall be reported at no more than its acquisition cost until sale or disposition. If it is subsequently determined that the fair value of the residual value of a leased asset has declined below the carrying amount of the acquired interest and that decline is other than temporary, the asset shall be written down to fair value, and the amount of the write-down shall be recognized as a loss. That fair value becomes the asset's new carrying amount, and the asset shall not be increased for any subsequent increase in its fair value before its sale or disposition.

8.4.3.2 Purchase of guaranteed residual asset

If the future residual value of a leased asset is guaranteed at lease commencement by either the lessee or another party, it is considered a financial asset under ASC 860. Therefore, such guaranteed residual value would be accreted to the guaranteed amount by the purchaser if the transfer of the guaranteed residual value qualifies as a sale under the derecognition requirements of ASC 860 (refer to TS 3). If it does not, a purchaser should follow the secured borrowing guidance in ASC 860 (refer to TS 5). If the residual is guaranteed after the lease commencement date, it is considered the same as an unguaranteed residual asset by the purchaser and accounted for as discussed in LG 8.4.3.1.

8.5 Sales of equipment with guaranteed minimum resale amount

ASC 842-30-55-2 through ASC 842-30-55-4 address the accounting for sales incentive programs in which the manufacturer contractually guarantees that the purchaser will receive a minimum resale amount at the time the equipment is disposed of (contingent on certain requirements).

ASC 842-30-55-2

The manufacturer provides the guarantee by agreeing to do either of the following:

a. Reacquire the equipment at a guaranteed price at specified time periods as a means to facilitate its resale

b. Pay the purchaser for the deficiency, if any, between the sales proceeds received for the equipment and the guaranteed minimum resale value.

There may be dealer involvement in these types of transactions, but the minimum resale guarantee is the responsibility of the manufacturer.

ASC 842-30-55-3

A sales incentive program in which an entity (for example, a manufacturer) contractually guarantees that it has either a right or an obligation to reacquire the equipment at a guaranteed price (or prices) at a specified time (or specified time periods) as a means to facilitate its resale should be evaluated in accordance with the guidance on satisfaction of performance obligations in paragraph 606-10-25-30 and the guidance on repurchase agreements in paragraphs 606-10-55-66 through 55-78. If that evaluation results in a lease, the manufacturer should account for the transaction as a lease using the principles of lease accounting in Subtopic 842-10 and in this Subtopic.

ASC 842-30-55-4

A sales incentive program in which an entity (for example, a manufacturer) contractually guarantees that it will pay a purchaser for the deficiency, if any, between the sales proceeds received for the equipment and the guaranteed minimum resale value should be accounted for in accordance with Topic 460 on guarantees and Topic 606 on revenue from contracts with customers.

If the transaction is not accounted for as a sale, the manufacturer-guarantor continues to recognize the asset. ASC 460, Guarantees, would not be applicable because that guidance does not apply to a guarantee on a guarantor's own asset.

8.5.1 Sale of asset with guaranteed residual under an operating lease

ASC 842-30-55-6 through ASC 842-30-55-9 describe the accounting for the sale of equipment with a guaranteed minimum resale amount subject to an operating lease.

ASC 842-30-55-6

If the transaction qualifies as an operating lease, the net proceeds upon the equipment's initial transfer should be recorded as a liability in the manufacturer's balance sheet.

ASC 842-30-55-7

The liability is then subsequently reduced on a pro rata basis over the period to the first exercise date of the guarantee to the amount of the guaranteed residual value at that date with corresponding credits to revenue in the manufacturer's income statement. Any further reduction in the guaranteed residual value resulting from the purchaser's decision to continue to use the equipment should be recognized in a similar manner.

ASC 842-30-55-8

The equipment should be included in the manufacturer's balance sheet and depreciated following the manufacturer's normal depreciation policy.

ASC 842-30-55-9

The Impairment or Disposal of Long-Lived Assets Subsections of Subtopic 360-10 on property, plant, and equipment provide guidance on the accounting for any potential impairment of the equipment.

If the customer elects to sell the equipment to a third party, the recorded liability should be reduced by the amount, if any, paid by the manufacturer to the customer. With the sale of the asset, the manufacturer has no remaining obligation to the customer. Therefore, the manufacturer should remove any remaining liability, derecognize the equipment from its balance sheet, and recognize any resulting gain or loss in net income in the period of the sale.

If the customer chooses to sell the equipment back to the manufacturer, the recorded liability should be derecognized. If there is a difference between the recorded liability and the amount paid to the customer, the difference should be recognized as a gain or loss in the period of the sale. The manufacturer should not adjust the carrying value of the asset.

8.5.2 Evaluating residual value guarantees as potential derivatives

Residual value guarantees that are subject to the accounting guidance in ASC 842 are not in the scope of the guidance in ASC 815, *Derivatives and Hedging*. This applies to residual value guarantees that are required to be used by the lessee or the lessor to classify the lease. Residual value guarantees not used to classify the lease must be evaluated under ASC 815. This could include, for example, a residual value guarantee that the lessor obtained from a third party subsequent to lease commencement. Accounting by the third-party guarantor is also not subject to the guidance in ASC 842; the third-party guarantor should consider other accounting guidance.

8.6 Leases acquired in a business combination

The accounting for a lease acquired in a business combination depends on whether the acquiree is the lessee or lessor. See LG 7.4 for information on the accounting for a leveraged lease acquired in a business combination.

8.6.1 Acquiree in a business combination is a lessee

ASC 842-10-55-11 requires the acquiring entity in a business combination to retain the acquiree's previous lease classification unless the lease is modified. (We generally believe that the acquirer should reassess classification of an acquired lease in an asset acquisition.) If the lease is modified and the modification is not accounted for as a separate new lease, the modification is evaluated in accordance with the guidance on lessee lease modifications. See LG 5.2 for information. ASC 805-20-30-24 (as amended by ASC 842) provides guidance on the recognition and measurement of leases acquired in a business combination in which the acquiree is the lessee.

8.6.1.1 *Acquirer assesses renewal or purchase options differently*

Notwithstanding that an acquiring entity should retain the acquiree's previous lease classification, an acquirer's assumptions as to whether it is reasonably certain to exercise an extension or purchase option are independent of an acquiree's prior assumptions. For example, when an acquiree originally classified a lease as an operating lease pre-acquisition, because it concluded that it was not reasonably certain to exercise a purchase option, an acquirer may still conclude that it is reasonably certain to exercise the purchase option. In that case, the acquirer would continue to classify the lease as an operating lease, in accordance with ASC 842-10-55-11, even though it should include the purchase option in the measurement of the lease liability. We believe the acquirer should then recognize the lease cost over the useful life of the asset rather than over the lease term. This is consistent with the Board's conclusion, per BC 218, "… that a purchase option is the ultimate option to extend the lease term." As such, the purchase option should be accounted for in the same way as an extension option for a term equal to the remaining useful life of the underlying asset at the purchase option date.

We believe that there are two acceptable approaches for subsequently recognizing lease expense:

- Approach 1: Recognize expense over the remaining useful life of the asset on a straight-line basis. Under this approach, the periodic expense remains constant throughout the useful life of the asset. The periodic amortization of the asset before the purchase option is exercised should equal the single lease expense recognized, less the interest on the lease liability consistent with the recognition pattern of an operating lease. When the purchase option is exercised, the asset should be reclassified to property, plant, and equipment, and it should be subsequently depreciated as an owned asset over its remaining useful life.

- Approach 2: Amortize the asset on an "other than straight line basis, as permitted by ASC 842 when that is more representative of the pattern in which benefit is expected to be derived from the right-to-use the underlying asset. Under this approach, a lessee would recognize a single lease expense as an operating lease, but it would compute the single lease expense as an amount necessary to amortize the right-of-use asset over the remaining lease term to the balance that it would have had if it were a finance lease. A lessee would typically recognize more lease expense before the purchase option is exercised than in Approach 1. After the purchase option is exercised, the asset should be reclassified to property, plant, and equipment, and the remaining net book value should be subsequently depreciated as an owned asset over its remaining useful life.

ASC 805-20-30-24

For leases in which the acquiree is a lessee, the acquirer shall measure the lease liability at the present value of the remaining lease payments, as if the acquired lease were a new lease of the acquirer at the acquisition date. The acquirer shall measure the right-of-use asset at the same amount as the lease liability as adjusted to reflect favorable and unfavorable terms of the lease when compared with market terms.

As discussed in ASC 805-20-25-28B, an acquirer may elect to apply the short-term lease measurement and recognition exemption to leases that have a remaining lease term of 12 months or less at the acquisition date. In addition to not recording the lease on the balance sheet, under this exception, the acquirer would not recognize an intangible asset if the terms of an operating lease are favorable relative to market terms or a liability if the terms are unfavorable relative to market terms. See LG 2.2.1 for information on the short-term lease measurement and recognition exemption, BCG 4.3.3.5

for information on favorable and unfavorable contracts, and BCG 4.3.3.7 for information on lease arrangements.

ASC 842-20-35-13 provides guidance on the amortization of leasehold improvements acquired in a business combination.

ASC 842-20-35-13

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

8.6.1.2 Acquirer's policy to combine lease and nonlease component differs

As discussed in LG 2.4.5.1, lessees may elect an accounting policy to not separate lease and nonlease components, and account for both as a single lease component. The election to not separate lease and nonlease components, and ascribe all the consideration to the lease component, may result in classifying the lease as a finance lease. However, as noted in LG 8.6, ASC 842-10-55-11 requires the acquiring entity in a business combination to retain the acquiree's previous lease classification unless the lease is modified. A question arises as to how this guidance should be applied when an acquirer and acquiree elected different accounting policies regarding separation of lease and nonlease components.

We believe that an acquirer, generally, must conform an acquiree's accounting policy elections to its own upon a business combination. Therefore, the acquirer would measure the assumed lease liability in accordance with its own election to separate or not separate lease and nonlease components. However, we believe that with respect to lease classification, the acquirer should retain the acquiree's lease classification in accordance with the guidance in ASC 842-10-55-11, notwithstanding that the acquiree had a different pre-acquisition policy regarding separating lease and nonlease components.

8.6.1.3 Acquisition of a related party lease with off-market terms

As discussed in LG 3.2 ASC 842-10-55-12 requires entities to account for related party leases based on their legally enforceable terms and conditions. Related parties, therefore, do not adjust their related party lease accounting for off-market terms or conditions. However, as discussed in LG 8.6.1.1, per the guidance in ASC 805, the carrying amount of a right-of-use asset acquired in a business combination is adjusted to reflect favorable or unfavorable market terms. The related party guidance in ASC 842 does not address whether it applies in a business combination in which either the acquirer or acquiree, and the lessor, are related parties. We believe that the acquirer in a business combination should follow the guidance in ASC 805-20-30-24; it should measure the lease liability at the present value of the remaining lease payments (consistent with related party lease guidance in ASC 842) but should adjust the measurement of the right-of-use asset for favorable or unfavorable terms.

8.6.2 Acquiree in a business combination is a lessor

ASC 805-20-30-25 provides guidance on the recognition and measurement of sales-type and direct financing leases acquired in a business combination.

ASC 805-20-30-25

For leases in which the acquiree is a lessor of a sales-type lease or a direct financing lease, the acquirer shall measure its net investment in the lease as the sum of both of the following (which will equal the fair value of the underlying asset at the acquisition date):

a. The lease receivable at the present value, discounted using the rate implicit in the lease, of the following, as if the acquired lease were a new lease at the acquisition date:

   1. The remaining lease payments

   2. The amount the lessor expects to derive from the underlying asset following the end of the lease term that is guaranteed by the lessee or any other third party unrelated to the lessor.

b. The unguaranteed residual asset as the difference between the fair value of the underlying asset at the acquisition date and the carrying amount of the lease receivable, as determined in accordance with (a), at that date.

The acquirer shall take into account the terms and conditions of the lease in calculating the acquisition-date fair value of an underlying asset that is subject to a sales-type lease or a direct financing lease by the acquiree-lessor.

A customer relationship intangible or other nonlease-related assets associated with the lease may also be recognized.

When the acquiree in a business combination is a lessor in a lease classified as an operating lease, the underlying asset would be recognized and measured at fair value unencumbered by the related lease. In other words, the leased property (including any acquired tenant improvements) would be measured at the same amount, regardless of whether an operating lease is in place. An intangible asset or liability may also be recognized if the lease contract terms are favorable or unfavorable as compared to market terms. In addition, in certain circumstances, an intangible asset may be recognized at the acquisition date for the value associated with the existing lease (referred to as an "in-place" lease) and for any value associated with the relationship the lessor has with the lessee. Further, a liability may be recognized for any unfavorable renewal options or unfavorable written purchase options if the exercise is beyond the control of the lessor. See BCG 4.3.3.7 for more information.

8.7 Sales-type lease for a failed sale with a repurchase option

A transaction to sell an asset may not meet the definition of a sale in ASC 606 if the seller fails to transfer control. This may happen when there is a call option to repurchase the asset for an amount that is less than its original selling price. In this circumstance, ASC 606-10-55-68 requires the seller to account for the arrangement as a lease in accordance with ASC 842 rather than a sale.

ASC 606-10-55-68

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

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

b. A financing arrangement in accordance with paragraph 606-10-55-70, if the entity can or must repurchase the asset for an amount that is equal to or more than the original selling price of the asset.

It is possible for a "failed sale" transaction under ASC 606 to be classified as a sales-type lease under ASC 842 because it meets, for example, the economic life or the present value criterion. Sales-type lease accounting requires the seller/lessor to recognize selling profit or loss at the commencement date as follows:

- If the seller/lessor uses leases as an alternative means of realizing value from the goods that it would otherwise sell, the seller/lessor should present revenue and cost of goods sold relating to the sales-type lease in separate line items so that income and expenses from sold and leased items are presented consistently.

- If the seller/lessor uses leases for the purposes of providing financing, the seller/lessor should present the profit or loss in a single line item.

Thus, even though a seller/lessor might not be able to recognize a sale under ASC 606, it is possible for the seller/lessor to recognize selling profit upfront (via revenue and cost of sales or as a single line item depending upon the seller/lessor's business model) if the seller/lessor accounts for the transaction as a sales-type lease under ASC 842.

See LG 3 for more details on lease classification, LG 4.3.1 for initial recognition and measurement of a sales-type lease by a lessor, and LG 6.3.5 for repurchase rights and obligations in a sale.

8.8 Remeasurement of right-of-use asset to functional currency

A lease may be denominated in a currency that is not the same as a lessee's functional currency. As discussed in ASC 842-20-55-10, a lease liability is a monetary liability and a right-of-use asset is a nonmonetary asset. Therefore, a lease liability should be remeasured using the current period exchange rate at the reporting date with any changes recognized in the income statement. However, the right-of-use asset should be measured at the historical exchange rate at the commencement date and is not affected by subsequent changes in the exchange rate.

ASC 842-20-55-10

The right-of-use asset is a nonmonetary asset while the lease liability is a monetary liability. Therefore, in accordance with Subtopic 830-10 on foreign currency matters, when accounting for a lease that is denominated in a foreign currency, if remeasurement into the lessee's functional currency is required, the lease liability is remeasured using the current exchange rate, while the right-of-use asset is remeasured using the exchange rate as of the commencement date.

As discussed in LG 4.4.2, operating lease expense is a single line item in the income statement that is the sum of right-of-use asset amortization and accretion of the lease liability. We believe remeasurement of operating lease expense into a lessee's functional currency involves measuring the right-of-use asset amortization at the historical exchange rate and the lease liability accretion at the average exchange rate for the applicable period using the guidance under ASC 830-10, *Foreign Currency Matters*.

Questions have arisen regarding what exchange rate a lessee should use to remeasure a right-of-use asset into the lessee's functional currency when there is a lease modification that is not accounted as a separate new lease or when the lease is required to be remeasured (see LG 5.2 for lease modification accounting and LG 5.3 for lease remeasurement accounting by a lessee). Based on discussions with the SEC staff, the following approaches are acceptable as an accounting policy choice, which should be disclosed by a lessee:

- Single exchange rate approach: Under this approach, the old lease is essentially "terminated" and a new lease is recognized by remeasuring the entire right-of-use asset using the exchange rate at (1) the lease modification date that is not accounted for as a new lease, or (2) the lease remeasurement date when the lease remeasurement is due to a change in the lease term or change in assessment of exercise of a lessee option to purchase the underlying asset. However, if the remeasurement is due to (a) a change in the amount probable of being owed under a residual value guarantee, or (b) resolution of a contingency that results in variable lease payments becoming fixed, the historical exchange rate should be used to remeasure the entire right-of-use asset.

- Layered approach: Under this approach, a lessee should remeasure only the additional right-of-use asset due to a modification that is not accounted for as a new lease or any type of lease remeasurement using the exchange rate at the modification or remeasurement date.

Example LG 8-1 illustrates application of the two approaches.

EXAMPLE LG 8-1

Remeasurement of right-of-use asset to functional currency

A US dollar functional currency lessee enters into a lease in euros. The lease liability and right-of-use asset is 1,000 euros on the commencement date. At that date, the exchange rate is 1$ = 1 euro, so the lessee records a lease liability and right-of-use asset of $1,000.

At the end of the first reporting period, the exchange rate moves to $1.2 = 1 euro. There are no lease payments in this period. Under ASC 830, at the end of the first reporting period, the lessee remeasures the lease liability to $1,200 (1.2 * 1,000) and recognizes a foreign currency transaction loss of $200

($1,200 - $1,000) in current period earnings. Since the right-of-use asset is a nonmonetary asset, it is not adjusted under ASC 830 and its functional currency balance remains at $1,000.

At the end of the second reporting period, the exchange rate moves to $1.8 = 1 euro. There are no lease payments in this period. Under ASC 830, at the end of the second reporting period, the lessee remeasures the lease liability to $1,800 (1.8 * 1,000) and recognizes a foreign currency transaction loss of $600 ($1,800 - $1,200) in current period earnings. The right-of-use asset remains at $1,000. Additionally, at the end of the second reporting period, the lessee and the lessor modify the rent payment resulting in an increase in the lease liability from 1,000 to 1,150 euro.

How would the lessee account for the change in lease terms?

Analysis

Single exchange rate approach

The old lease is essentially terminated and a new lease is recognized. The lessee would remeasure both the right-of-use asset and the lease liability based on the current exchange rate at the end of the second reporting period and record the following journal entry:

Dr. Right-of-use asset	$1,070 (1,150*1.8 - $1,000)	
Cr. Lease liability		$270 (1,150*1.8 - $1,800)
Cr. Gain		$800

Under this approach, in the second reporting period, the lessee (1) records a net foreign currency transaction gain of $200 (difference between $600 loss and $800 gain in that period), and (2) recovers the entire cumulative foreign currency transaction loss that was recognized in the first and second reporting periods (cumulative $800 loss in the first and second reporting periods versus $800 gain in the second reporting period).

Layered approach

The lessee has an existing right-of-use asset of $1,000, which as a nonmonetary asset cannot be remeasured to the current exchange rate. As part of the modification, the lessee has essentially acquired an additional right-of-use asset of 150 euro, which it would remeasure into its functional currency on the modification date. The lessee would make the following journal entry:

Dr. Right-of-use asset	$270 (1.8 * 150)	
Cr. Lease liability		$270 (1.8*[1,150 - 1,000])

8.9 Lessor operating leases – impact of collectibility assessment

Under ASC 842, a lessor's pattern of revenue recognition for an operating lease is impacted by its assessment of the collectibility of lease payments. If collectibility is probable at commencement, lease income is generally recognized on an accrual basis (generally on a straight-line basis) over the term of the lease. Otherwise, lease income is limited to the lesser of (1) income that would have been recognized if collectibility was probable, or (2) lease payments collected (i.e., a cash basis).

Collectibility should be reassessed during the lease term. If collectibility is no longer probable (i.e., the lease subsequently becomes "troubled"), and cumulative cash receipts are less than lease income recognized to date, the excess lease income would be reversed. If collectibility changes back to probable, any difference between the lease income that would have been recognized if collectibility was always probable and the income actually recognized to date is recognized as current period lease income, assuming the original agreement has not been modified or replaced. Probability in this context is assessed based on the credit standing of the lessee, and as such, collection issues arising from disputes over the calculation of variable rents should not be considered in a lessor's evaluation of collectibility.

The new leases standard does not address whether, after performing a probability assessment under ASC 842, lessors can continue to record a general reserve under ASC 450, Contingencies, for operating lease receivables that are probable of collection. At its July 17, 2019 Board meeting, the FASB clarified that lessors may elect an accounting policy to record a general reserve under ASC 450 for a portfolio of operating lease receivables that are probable of collection. This election does not need to be consistent with the accounting policy applied under the prior leases guidance, ASC 840.

If a lessor elects to record a general reserve, it may either be recorded as a reduction in revenue or as bad debt expense. A lease that subsequently becomes troubled would need to be removed from the general reserve pool and the associated lease receivable written-off. We believe the following methods can be used to write off the lease receivable.

- If a lessor elects to apply the general reserve model and elects to record the reserve as a reduction in revenue, the lessor should remove a troubled lease from the general pool by writing it off through lease income.

- If a lessor elects to apply a general reserve model and elects to record the reserve as bad debt expense, the lessor can elect one of two acceptable policies to remove a troubled lease from the general reserve pool:

  - Discrete calculation: Write off the gross receivable from the troubled lease through lease income. Separately recalculate the general reserve exclusive of the troubled lease, recognizing the change in bad debt expense.

  - Net presentation: Write off the existing lease receivables balance net of the general allowance attributable to that lease through lease income.

Example LG 8-2 illustrates the application of the gross and net presentation alternatives.

EXAMPLE LG 8-2

Application of the gross and net presentation alternatives

A lessor has several operating leases (after the adoption of ASC 842). The lessor believes collection of lease receivables is probable and applies a general reserve for the aggregate receivables that was recorded to bad debt expense. As of December 31, 20X1, the lessor had a $1,000 deferred operating lease receivables balance (due to straight-lining of lease income) and a $50 general allowance against the entire portfolio of the outstanding receivables balance. On June 30, 20X3, the lessor determined that one of the leases in the portfolio, Lease X, was no longer probable of collection. At that time, the allowance for doubtful accounts attributable to Lease X was $6 and the outstanding gross lease receivable balance for Lease X was $100. As substantially all of the lease payments are not deemed collectible for Lease X, ASC 842 requires the lessor to recognize revenue only as cash is received.

Analysis

How would the lessor write off the lease receivable?

Gross presentation

The lessor would write off the gross receivable for Lease X through lease income and reverse the previously-recorded general allowance attributable to Lease X with a contra expense. The journal entries would be as follows:

Dr. Lease income	$100	
Cr. Lease receivable		$100
Dr. Allowance for doubtful accounts	$6	
Cr. Bad debt expense		$6

Net presentation

The lessor would write-off the lease receivable balance for Lease X, net of the allowance, through lease income. The journal entry would be as follows:

Dr. Lease income	$94	
Dr. Allowance for doubtful accounts	$6	
Cr. Lease receivable		$100

If the assessment of collectibility subsequently changes from not probable to probable (without a lease modification), the lessor would book a cumulative adjustment to lease income to re-establish the accrued deferred operating lease receivable as though the cash basis of accounting had never been applied.

8.10 Application of CECL to leasing

ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326)*, the current expected credit loss (CECL) impairment model, is applicable to net investments in leases associated with sales-type and direct financing leases. See LI 13 for information about the effective date of ASU 2016-13 and related releases.

Operating lease receivables are not in the scope of the CECL impairment guidance. See FSP 8.9 for the impact of collectibility on operating leases.

The FASB recognized that these net investments include both financial elements (e.g., rental payments, residual value guarantee) and non-financial elements (e.g., unguaranteed residual), but concluded that applying a single impairment model to the recognized lease asset was preferable to assessing different elements of a single asset under different impairment models. Receivables arising from operating leases are not within the scope of CECL.

The CECL model requires recognition of an allowance for credit losses on the date that a sales-type or direct financing lease receivable is recognized, either through origination or acquisition. A variety of techniques may be used to estimate the allowance, but the lessor's estimate of expected credit losses must include a measure of the expected risk of credit loss even if that risk is remote. The CECL model also requires the measurement of credit losses to be on a collective (pool) basis when individual assets share similar risk characteristics.

The initial measurement of the allowance for credit losses is as follows:

- For leases that are originated, the initial measurement of the allowance for credit losses will be recorded through earnings. The allowance would be released with an offset to earnings if estimated collections improve.

- For leases acquired either though a business combination or an asset purchase, we believe the lessor should assess whether the acquired leases would be considered purchased financial assets with credit deterioration (PCD) as defined in ASC 326. To the extent a lease is not considered PCD, the initial measurement of the allowance for credit losses would be reported in current earnings (similar to an originated lease). If a lease is considered PCD, the initial measurement of the allowance for credit losses will create a basis adjustment to the amortized cost basis of the net investment in the lease. This "gross up" will impact the calculation of lease income over the life of the lease. The allowance would be released with an offset to earnings if estimated collections improve, similar to the treatment for originated assets. See LI 9 for additional information on PCD assets.

The CECL model requires assessments of allowance amounts to determine whether they should be written off against the amortized cost basis of the receivables. Receivables (and allowance accounts) are written off either in full or in part when such amounts are deemed uncollectible. Each element of a lease receivable (financial or non-financial) could cause a write-off. Companies may need to establish policies and procedures to determine when receivables (and allowance balances) should be written off.

Sometimes a lessor may transfer the receivable associated with future rental payments but retain ownership of the underlying leased asset. The lessor should apply the guidance in ASC 860 to determine whether such transfer would be accounted for as a sale resulting in derecognition of the receivable. When the transfer of the receivable is accounted for as a sale, and the asset remaining relates to the unguaranteed residual value, the leasing guidance states that the lessor should begin applying ASC 360 to determine whether the unguaranteed residual asset is impaired, (i.e., the CECL model would no longer be applicable). We believe this guidance should not be extended to address situations when the lessor has not transferred receivables and the net investment of the lease consists of mainly the estimated residual value of the leased asset simply as a result of a lessee making payments. In these situations, we believe it is appropriate to continue applying the credit loss model in ASC 326 until the leased asset is obtained by the lessor at the end of the lease.

8.11 Leasehold improvements

In accordance with ASC 842-20-35-12, leasehold improvements are amortized over the shorter of the useful life of those leasehold improvements or the remaining lease term. However, if the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee should amortize a leasehold improvement to the end of its useful life.

ASC 842-20-35-12

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

There is an exception for leasehold improvements related to common control leases, further discussed in LG 8.11.1.

Leasehold improvements are subject to the long-lived asset impairment guidance in ASC 360. See PPE 5.2 for impairment guidance.

8.11.1 Leasehold improvements related to common control leases

In March 2023, the FASB issued ASU 2023-01, *Leases Topic (842): Common Control Arrangements*, which requires a lessee in a common control lease to amortize related leasehold improvements over their useful lives to the common control group regardless of the lease term.

Common control leases often have short lease terms (e.g., one year) even when the commonly controlled lessee makes significant leasehold improvements with a useful life significantly longer than the lease term. The ASU was issued to address concerns by stakeholders that fully amortizing leasehold improvements over a period shorter than the useful life of the improvements may result in financial reporting that does not faithfully represent the economics or the common control nature of those improvements. One reason is because the lessee may continue to use the leased asset after the initial lease term by either extending the existing lease or entering into a new lease. Unlike transactions involving entities that are not under common control, the decision on that continued use is often controlled by a single party in the control group. Further, if the lessee ceases to use the leased asset, the leasehold improvement will often benefit another party within the control group.

While the ASU does not define “common control,” we believe it would be assessed in a similar manner to how it is discussed in BCG 7.1.1.

The guidance in ASU 2023-01 applies regardless of the lease term used for accounting purposes and for as long as the lessee controls the use of the underlying leased asset through a lease. (See LG 3.2 for details on how to determine the lease term for a common control lease.) However, if the common control lessor leases the right-of-use asset from a lessor that is not part of the same common control group and subleases the right-of-use asset to the common control lessee, the amortization period would be limited to the lease term associated with the head lease of the underlying asset. Example LG 8-3 illustrates this concept.

EXAMPLE LG 8-3

Amortizing leasehold improvements in a common control lease

Lessee Co. leases a building from a lessor within the same common control group and uses a lease term of two years for accounting purposes. It installs leasehold improvements with a useful life of five years to the common control group. Over what period should the leasehold improvements be amortized?

Analysis

Lessee Co. should amortize the leasehold improvements over five years; it would not be limited to the two-year lease term (as leasehold improvements in leases not with a common control entity would be).

If Lessee Co. ceases to control the use of the underlying leased asset before the end of the leasehold improvements' useful life to the common control group (i.e., before year five), it must account for the improvements as being transferred to the lessor. In this case, Lessee Co. would derecognize the remaining carrying amount of the leasehold improvements with a corresponding adjustment to equity (or net assets for not-for-profit entities).

8.11.1.1 Impairment of leasehold improvements in common control leases

Common control leasehold improvements are subject to the long-lived asset impairment guidance in ASC 360-10-40-4, considering the useful life to the common control group. See PPE 5.2 for impairment guidance.

8.11.1.2 Changes to common control group

If after the commencement date, the lessee and lessor become part of the same common control group or are no longer within the same common control group, any change in the required amortization period for the leasehold improvements should be accounted for prospectively as a change in accounting estimate in accordance with ASC 250-10-45-17.

8.11.1.3 Transition and effective date of ASU 2023-01

ASU 2023-01 is effective for all entities in fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted for both interim and annual financial statements that have not yet been made available for issuance. If an entity adopts the new guidance in an interim period, it should adopt as of the beginning of the fiscal year that includes that interim period.

Entities adopting the new guidance concurrently with ASC 842 may follow the same transition requirements used to apply ASC 842 or may use either of the prospective approaches described below. All other entities are required to apply the new guidance using one of the following methods:

- Prospectively to all new leasehold improvements recognized on or after the date that the entity first applies ASU 2023-01

- Prospectively to all new and existing leasehold improvements recognized on or after the date that the entity first applies ASU 2023-01, with any remaining unamortized balance of existing leasehold improvements amortized over their remaining useful lives 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 date of adoption 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 beginning of the earliest period presented

8.11.1.4 Disclosure

When the useful life of the leasehold improvements to the common control group exceeds the related lease term, a lessee is required to disclose the following information:

- The unamortized balance of the leasehold improvements at the balance sheet date
- The remaining useful life of the leasehold improvements to the common control group
- The remaining lease term

Chapter 9: Effective date and transition—updated January 2023

9.1 Effective date and transition overview

Adopting the leases standard could be a significant undertaking. Some reporting entities will need a significant amount of lead time to make the necessary changes to their systems and processes. The standard includes some practical expedients to ease the burden of transition.

This chapter discusses the effective date and transition guidance, including transition-related disclosures.

9.2 Effective date

Figure LG 9-1 summarizes the effective dates for adopting the leases standard. Early adoption is permitted for both public and nonpublic business entities.

Figure LG 9-1
Leases standard effective dates

Type of entity	Effective date
Public business entities A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or over-the-counter market (except for those entities that have not yet issued financial statements or made financial statements available for issuance as of June 3, 2020 reflecting adoption of ASC 842). An employee benefit plan that files or furnishes financial statements to the SEC	▫ Fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018
A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or over-the-counter market that have not yet issued financial statements or made financial statements available for issuance as of June 3, 2020 reflecting adoption of ASC 842.	▫ Fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019
All other entities not included above	▫ Fiscal years beginning after December 15, 2021 and interim periods within fiscal years beginning after December 15, 2022

9.3 Overall transition and practical expedients

Upon adoption of the leases standard, lessees and lessors are required to apply a modified retrospective transition approach. Reporting entities are permitted to choose one of two methods to recognize and measure leases within the scope of the leases standard:

- **Adjust comparative periods:** Apply the leases standard to each lease that existed at the beginning of the earliest comparative period presented in the financial statements, as well as leases that commenced after that date. Under this method, prior comparative periods presented are adjusted. For leases that commenced prior to the beginning of the earliest comparative period presented, a cumulative effect adjustment is recognized at that date. The period from the beginning of the earliest comparative period up until immediately before the effective date is referred to as the "look-back period."

- **Do not adjust comparative periods:** Apply the guidance to each lease that had commenced as of the beginning of the reporting period in which the entity first applies the leases standard (referred to as the "application date" or the "effective date" under this method) with a cumulative-effect adjustment as of that date. Prior comparative periods would not be adjusted under this method. An entity that applies this method must provide the required disclosures under ASC 840 for all periods to which ASC 840 is applied.

Regardless of the transition method selected, the transition guidance in ASC 842 does not apply to leases that are entered into prior to the effective date of ASC 842 but have a commencement date after the effective date of ASC 842. In these cases, the leases accounting model in ASC 842 should be applied at the commencement date of the lease.

Application of the modified retrospective transition approach under both of these methods to each lease type is discussed in the following sections.

A lessee must apply the recognition requirements in the leases standard to all leases (even for leased assets that are considered abandoned). However, a lessee may elect not to apply the recognition requirements in the leases standard to short-term leases (a lease that at commencement date has a lease term of 12 months or less and does not contain a purchase option that the lessee is reasonably certain to exercise).

Question LG 9-1 and Question LG 9-2 discuss application of lease recognition requirements to short-term leases.

Question LG 9-1

Is a lease that has a remaining term at the application date of 12 months or less but whose lease term at the commencement date is greater than 12 months eligible for the short-term election?

PwC response

No. A short-term lease is defined by the lease term at the commencement date of the lease. Therefore, if the lease has a lease term at the commencement date that is greater than 12 months, it is not eligible for the short-term leases policy election even if the remaining lease term at the application date is 12 months or less.

Question LG 9-2

Does the leases standard need to be applied to leases that exist as of the beginning of the earliest comparative period presented but expire or terminate before the effective date?

PwC response

It depends. For reporting entities that choose to apply the transition method in which prior comparative periods are adjusted, we believe leases that exist as of the beginning of the earliest period presented and expire or terminate before the effective date are subject to the new standard in a reporting entity's comparative financial statements upon adoption. For example, a calendar year-end private company with an effective date beginning on January 1, 2022 choosing to adjust the comparative period and adopting the leases standard on 1/1/2022 should apply the new standard to a lease that existed on 1/1/2021 and expired in 2021.

For reporting entities that choose not to adjust prior comparative periods, the leases standard does not need to be applied to leases that terminate prior to the effective date.

9.3.1 Practical expedients

ASC 842 provides various optional transition practical expedients. A reporting entity is required to disclose the use of any of the practical expedients. In summary, these include:

- a package of practical expedients to not reassess:
  - whether a contract is or contains a lease
  - lease classification
  - initial direct costs
- a practical expedient to use hindsight when determining lease term
- a practical expedient to not reassess certain land easements

Each of these expedients is explained in more detail in subsequent sections.

9.3.1.1 Package of practical expedients

ASC 842-10-65-1 provides a group of optional practical expedients that must be elected as a package and applied by a reporting entity to all of its leases consistently regardless of whether the entity is a lessee or lessor.

ASC 842-10-65-1(f)

An entity may elect the following practical expedients, which must be elected as a package and applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a lessor), when applying the pending content that links to this paragraph to leases that commenced before the effective date:

1. An entity need not reassess whether any expired or existing contracts are or contain leases
2. An entity need not reassess the lease classification for any expired or existing leases (for example, all existing leases that were classified as operating leases in accordance with Topic 840 will be classified as operating leases, and all existing leases that were classified as capital leases in accordance with Topic 840 will be classified as finance leases).
3. An entity need not reassess initial direct costs for any existing leases.

Definition of a lease

In most cases, reporting entities that choose not to apply these practical expedients will reach the same conclusions as they did under prior GAAP regarding whether a contract is a lease. In the limited circumstances where differences exist, the guidance in ASC 842 is likely to result in a nonlease conclusion when previous GAAP would have concluded a contract was a lease. The practical expedients should not be applied to grandfather incorrect assessments determined under prior GAAP. Reporting entities should ensure that an analysis of contracts for embedded leases has been performed under ASC 840 before using the practical expedient to carry over the conclusions upon adoption of ASC 842.

EITF Issue 01-8, *Determining Whether an Arrangement is a Lease,* provided guidance for determining whether an arrangement contains a lease under previous GAAP. The transition provisions of EITF Issue 01-8 explained that its provisions were effective for arrangements (a) agreed to or committed to, (b) modified, or (c) acquired in a business combination initiated after the beginning of a reporting entity's first reporting period beginning after May 28, 2003. As a result, arrangements at or before the effective date of EITF Issue 01-8 were grandfathered and companies were not required to determine if such arrangements were or contained leases under ASC 840.

The leases standard does not address whether or not arrangements that were grandfathered under EITF Issue 01-8 would continue to be grandfathered when a reporting entity adopts the leases standard. We believe a reporting entity electing the package of practical expedients would not be required to reassess whether arrangements grandfathered under EITF Issue 01-8 are or contain leases. However, if a reporting entity does not elect the package of practical expedients, we believe the entity should assess all arrangements that were outstanding as of the application date to determine if they are or contain leases under the new leases guidance, even if such arrangements were previously grandfathered under EITF Issue 01-8.

Upon adoption of the new leases guidance, a lessor that chooses to adjust comparative periods needs to consider the interaction of the effective date of the new revenue recognition guidance in ASC 606. A lessor that chooses to adjust comparative periods should apply the guidance in ASC 606 to contracts with customers that were previously in the scope of ASC 840 but no longer meet the definition of a lease under ASC 842 at the date of initial application of ASC 606 in the comparative periods. The lessor should apply the guidance in ASC 605 to such contracts in the comparative periods before the initial application date of ASC 606. Note that this only applies to financial statements issued after the adoption of the new leases guidance.

Lease classification

Upon adoption of the leases standard, a reporting entity is required to determine the appropriate lease classification for each lease subject to the standard, unless it elects the practical expedients. Although lessees with operating leases that adopt the package of practical expedients will still be required to recognize leases on the balance sheet, lessees and lessors that elect the practical expedients will generally not need to reconsider how they classified leases that commenced before the effective date. Reconsideration would occur only if required by other lease guidance.

It is possible for a lease to be classified differently under the leases standard than it was under legacy guidance (e.g., leases previously classified as operating leases may now be classified as financing, sales-type, or direct financing leases and vice versa) but instances of such a difference in classification are expected to be infrequent.

Given that the practical expedients allow reporting entities to avoid reconsidering lease classification, we expect that many lease arrangements will retain their original classification and therefore, the accounting for a change in classification is not discussed in this guide. Readers should refer to ASC 842-10-65-1 for guidance.

Irrespective of whether the package of practical expedients is elected, reporting entities will need to apply the new leases guidance after the effective date, which may result in a subsequent change in lease classification in certain cases. For example, if after the effective date a triggering event occurs that results in a reassessment of the lease term, the classification of the lease may change under ASC 842. See LG 5 for information on lease reassessment.

Question LG 9-3 discusses when to reassess lease classification upon transition to ASC 842.

Question LG 9-3

If a reporting entity does not elect the package of practical expedients, should the entity reassess lease classification under the leases standard as of the lease commencement date or at the application date?

PwC response

We believe a reporting entity should reassess lease classification as of the commencement date of the lease or the last time the lease classification was required to be reassessed (e.g., due to a modification). For a reporting entity that is not electing the package of practical expedients, the objective is to achieve the lease classification that would have occurred had ASC 842 always been in effect. This can only occur if classification is assessed as of the most recent date that reassessment would have been required.

Initial direct costs

The definition of initial direct costs under the leases standard is narrower than the previous guidance. A reporting entity with unamortized initial direct costs that do not qualify for capitalization under the leases standard that elects the practical expedients may incur more amortization in future periods than if they had not elected the practical expedients. Nevertheless, a reporting entity may find that the cost of reassessing unamortized initial direct costs does not justify any perceived benefit.

Question LG 9-4 discusses when to reassess initial direct costs upon transition to ASC 842.

Question LG 9-4

Does a reporting entity need to reassess unamortized initial direct costs at transition to determine if they meet the new definition of initial direct costs in ASC 842?

PwC response

If a reporting entity elects the package of practical expedients in ASC 842-10-65-1(f) for all leases as of the effective date, it does not need to reassess whether initial direct costs meet the new definition at the initial application date. Otherwise, a reporting entity will need to reassess the initial direct costs under the new leases guidance and should account for the balances that no longer meet the definition as explained in the subsequent section.

Consequences of not electing the package of practical expedients

Reporting entities that do not elect the package of practical expedients will need to reassess all arrangements to determine if they meet the definition of a lease or contain an embedded lease under the new leases guidance. They will also need to assess lease classification using the new criteria for all contracts that meet the definition of a lease under the new guidance and determine whether or not certain prior expenditures meet the new narrower definition of initial direct costs. This includes all leases acquired in a business combination.

When the reporting entity does not apply the package of practical expedients, it will need to reallocate consideration as of the lease commencement date for any contract that contains a lease component in order to reassess lease classification. If the entity is not electing the hindsight practical expedient, this allocation would start with the same lease payment data as used under ASC 840 (for example, reflecting the same lease term as what was used under ASC 840). The lease payment data should be updated to include amounts allocated to lease components under ASC 842 (for example, property taxes and insurance related to the leased asset should be included in the contract consideration and allocated to lease components). Classification is then reassessed as of the lease commencement date. If the classification of the lease component does not change, then the measurement of the lease upon adoption of ASC 842 would use ASC 840's definition of payments; in other words, the entity would revert to the amounts allocated to lease components under ASC 840.

When a reporting entity makes an accounting policy election to not separate nonlease components other than executory costs from the associated lease component at transition, a reallocation for nonlease components is not required in transition, as discussed in LG 9.4.1.2. When a reporting entity elects to account for nonlease components other than executory costs as part of the lease component, it is more likely that lease classification will change (due to a potential increase in the amounts considered to be lease payments).

If a reporting entity does not elect the package of practical expedients in ASC 842-10-65-1(f), any unamortized initial direct costs at the initial application date that do not meet the new definition of initial direct costs in ASC 842 should generally be written off as an adjustment to equity at the application date (or to earnings when incurred for leases that commenced during the look-back period when comparative periods are adjusted) in accordance with ASC 842-10-65-1(p) and ASC 842-10-65-1(v)(3). However, for lessees with capital leases under ASC 840 that remain as finance leases under

ASC 842, only such initial direct costs not included in the measurement of a capital lease asset under ASC 840 should be written off in accordance with ASC 842-10-65-1(r)(3). Similarly, for lessors with direct financing leases under ASC 840 that are either direct financing leases or sales-type leases under ASC 842, any unamortized initial direct costs capitalized as part of the lessor's net investment in the lease in accordance with ASC 840 would not be written off, per ASC 842-10-65-1(x)(1).

9.3.1.2 Hindsight practical expedient

Upon transition, a reporting entity is permitted to elect to use hindsight with respect to determining the lease term (e.g., they may consider the actual outcome or updated expectations of lease renewals, termination options, and purchase options) and in assessing any impairment of right-of-use assets for existing leases.

ASC 842-10-65-1(g)

An entity also may elect a practical expedient, which must be applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a lessor) to use hindsight in determining the lease term (that is, when considering lessee options to extend or terminate the lease and to purchase the underlying asset) and in assessing impairment of the entity's right-of-use assets. This practical expedient may be elected separately or in conjunction with either one or both of the practical expedients in (f) and (gg).

As noted, this provision may be elected on its own or together with either or both practical expedients, or the land easements practical expedient, but represents a policy election that should be applied consistently to all leases.

We expect that the application of hindsight will be challenging in many cases and could in some cases result in a more complex transition process.

We believe hindsight extends only up until the effective date (e.g., 1/1/22 for a calendar year-end private company) and should not incorporate information that becomes available or events that occur after that date.

The hindsight practical expedient can only be used to refresh estimates or evaluations of contractual terms that exist as of the time of measurement. A reporting entity that chooses to adjust comparative periods at transition should not apply the hindsight practical expedient to push back a contractual modification in terms such as (1) the impact of an early termination when the option to terminate was not included in the original contract or (2) an extension of the term of the lease when that extension option was not already included in the original contract.

Similarly, for payments based on an index or a rate, a reporting entity that chooses to adjust comparative periods would not push back the index or rate at the effective date to measure the lease liability as of a prior date.

A reporting entity applying the hindsight practical expedient should consider the impact on its determination of whether a lease is a short-term lease. For example, a lease may have commenced 15 months prior to the effective date with an original lease term of 10 months with a renewal option for an additional 10 months. Assume exercise of the renewal option was not reasonably assured at lease commencement, but the company subsequently exercised the renewal option. This lease would not meet the definition of a short-term lease because the lease term as of its commencement date using hindsight is 20 months.

When applying hindsight for an operating lease with non-level rents, we believe a lessee or lessor should apply the updated lease term by starting at the lease commencement date and recalculating what the accrued/deferred rent balances would have been as of the application date of the new leases guidance if the lease term known as of the effective date had been known at commencement. The lessee or lessor should record any difference between the prior and adjusted accrued/deferred balances as of the application date as an adjustment to opening equity.

Question LG 9-5 and Question LG 9-6 discuss how to assess leases when electing the hindsight practical expedient for a lessee upon transition to ASC 842.

Question LG 9-5

Does the election of hindsight by a reporting entity require the entity to undertake a fresh assessment of the facts and circumstances that are relevant in determining the lease term even if there have been no triggering events?

PwC response

We believe a reporting entity should undertake a fresh assessment of the facts and circumstances when applying the hindsight practical expedient, taking into consideration all available information prior to the effective date that would be relevant in determining the term of the lease. For example, assume a calendar year-end private company adopts the leases standard on 1/1/2022 and has chosen to adjust the comparative period (1/1/2021 through 12/31/2021) in transition. The entity has a lease that commenced prior to 1/1/2021 and the lessee exercised an extension option on 3/1/2021. In this situation, we believe if the lessee elects hindsight at the time of adoption on 1/1/2022, the lessee should recognize a lease liability and a right-of-use asset on 1/1/2021 assuming the extended lease term.

This is the case even if the lessee's extension option was not exercisable in the look-back period (for example, if the extension option is only exercisable on or after 1/1/2021) but as of the effective date (i.e., 1/1/2022) it was reasonably certain that the lessee would exercise the extension option because of a change in facts and circumstances from the original assessment date. Thus, the extended lease term should be used.

Question LG 9-6

How does the use of hindsight interact with other practical expedients to either carryforward capital lease balances or to not reassess lease classification if electing the package of practical expedients?

PwC response

ASC 842-10-65-1(r)(1) prescribes transition guidance for a lessee that has a capital lease under ASC 840 that is classified as a finance lease under ASC 842. Under this guidance, the lessee should recognize a right-of-use asset and a leases liability at the carrying amount of the lease asset and the capital lease obligation under ASC 840 at the initial application date. A literal application of this guidance may result in an anomalous discount rate for a lessee that has a capital lease under ASC 840, especially if the lessee elects both the package of practical expedients and applies hindsight (to determine the lease term) when transitioning to ASC 842. The application of hindsight could result in a shortened (or lengthened) lease term because exercise of a renewal option may no longer be reasonably certain (or may have become reasonably certain). In this situation, the discount rate required to amortize the carrying value of the capital lease obligation (determined under ASC 840) to the appropriate amount by the end of the shortened (or lengthened) lease term may get significantly reduced (or increased).

This issue could occur whenever a lessee elects the package of practical expedients as well as the application of hindsight for its existing operating leases. In that case, the lessee would also need to apply the expedients to its existing capital leases. Because the lessee elected the package of practical expedients, it would not reassess lease classification.

Given the transition guidance in ASC 842-10-65-1(r)(1) states that the carrying amount of the capital lease asset and capital lease obligation under ASC 840 should be carried over into the right-of-use asset and lease liability, there are circumstances in which a literal application of that guidance in conjunction with hindsight would produce a materially distorted interest rate. This could result in a significant impact to subsequent expense recognition. Paragraph BC394 in the Basis for Conclusions of ASC 842 indicates that the Board intended for the application of the hindsight election to result in more accurate, updated information for financial statement users. Consequently, we believe a lessee may apply the following approach to transition existing capital leases when the lessee elects to apply hindsight:

- Apply hindsight at the lease inception date to determine the appropriate lease term and discount rate.

- Using such discount rate, recalculate the new capital lease asset and capital lease obligation balance (as well as any deferred initial direct costs balance) under ASC 840 using revised lease payments as of the initial application date as though the lease term was always the updated lease term based on hindsight.

- Any difference between the recalculated and existing balances at the initial application date should be recorded as an adjustment to opening equity. Note, however, that if the reporting entity has elected to adjust the comparative periods upon adoption and the lease commenced during the comparative periods, the adjustment should be reflected in earnings during the comparative periods.

The lessee should then follow the transition accounting in ASC 842-10-65-1(r) through ASC 842-10-65-1(t) using the recalculated balances.

Question LG 9-7 discusses how a lessor evaluates leases when electing the hindsight practical expedient.

Question LG 9-7

What is the lessor transition accounting model for a lease previously classified as a sales-type lease or direct financing lease under ASC 840 when a lessee elects the practical expedient of hindsight for purposes of adopting the leases standard?

PwC response

We believe that a principle similar to the one described in Question LG 9-6 would apply for lessors with sales-type leases and direct financing leases.

The transition guidance in ASC 842-10-65-1(x)(1) requires that a lessor continue to recognize a net investment in the lease at the carrying amount of the net investment under ASC 840. A literal application of ASC 842-10-65-1(x) could produce a materially distorted implicit interest rate in certain cases when a lessor also elects to apply hindsight. This could result in a significant impact to subsequent income recognition. Paragraph BC394 in the Basis for Conclusions of ASC 842 indicates that the Board intended for the application of the hindsight election to result in more accurate, updated information for financial statement users. Consequently, we believe a lessor may apply the following approach to transition existing sales-type and direct financing leases when the lessor elects to apply hindsight:

- Apply hindsight at the lease inception date to determine the appropriate lease term and implicit interest rate.

- Using such discount rate, recalculate the new net investment in the lease balance under ASC 840 using the revised lease payments as of the application date as though the lease term was always the updated lease term based on hindsight.

- Any difference between the recalculated and existing balances at the application date should be recorded as an adjustment to opening equity. Note, however, that if the reporting entity has elected to adjust the comparative periods upon adoption and the lease commenced during the comparative periods, the adjustment should be reflected in earnings during the comparative periods.

The lessor should then follow the transition accounting in ASC 842-10-65-1(x) using the recalculated balances.

9.3.1.3 *Land easements practical expedient*

An optional practical expedient is available that allows a reporting entity to choose to not apply the leases standard to certain existing land easements at transition. See LG 2.3.2.1 for additional information.

ASC 842-10-65-1(gg)

An entity also may elect a practical expedient to not assess whether existing or expired land easements that were not previously accounted for as leases under Topic 840 are or contain a lease under this Topic. For purposes of (gg), a land easement (also commonly referred to as a right of way) refers to a right to use, access, or cross another entity's land for a specified purpose. This practical expedient shall be applied consistently by an entity to all its existing and expired land easements that were not previously accounted for as leases under Topic 840. This practical expedient may be elected separately or in conjunction with either one or both of the practical expedients in (f) and (g). An entity that elects this practical expedient for existing or expired land easements shall apply the pending content that links to this paragraph to land easements entered into (or modified) on or after the date that the entity first applies the pending content that links to this paragraph as described in (a) and (b). An entity that previously accounted for existing or expired land easements under Topic 840 shall not be eligible for this practical expedient for those land easements.

9.4 Lessee transition

The transition guidance for a lessee differs depending on the classification of the lease. Given that the practical expedients discussed in LG 9.3.1.1 allow reporting entities to avoid reconsidering lease classification, we expect that many lease arrangements will retain their original classification and therefore, the accounting for a change in classification is not discussed in this guide. Readers should refer to ASC 842-10-65-1 for guidance.

9.4.1 Lessee transition: operating leases

If a lease was classified as an operating lease under the guidance in ASC 840 and will continue to be classified as an operating lease under the leases standard, the lessee should recognize a right-of-use asset and lease liability at the application date of the leases standard. The application date for companies that choose to adjust comparatives periods is the later of: (1) the beginning of the earliest comparative period presented and (2) the commencement date of the lease. The application date for companies that choose to not adjust comparative periods is the effective date.

However, as discussed in LG 2.2.1, a lessee may elect not to recognize right-of-use assets and lease liabilities arising from short-term leases. If a lessee makes this election, it would not apply the transition guidance outlined in this section to such leases. Instead, the lessee should continue to recognize those lease payments on a straight-line basis and variable payments in the period in which the obligation for those payments is incurred.

For leases other than short-term leases when a lessee has made an election to not recognize a lease liability and right-of-use asset, the lease liability should be calculated as the present value of the sum of (1) the remaining minimum rental payments (as defined under ASC 840) and (2) any amounts probable of being owed by the lessee under a residual value guarantee.

A lessee should measure the operating lease right-of-use asset at an amount equal to the lease liability, adjusted for the following:

- Prepaid or accrued rent
- Remaining balance of any lease incentives
- Unamortized initial direct costs
- Any impairment
- The carrying amount of any liability related to the lease recognized in accordance with ASC 420, *Exit or Disposal Cost Obligations*

Unless the entity elects the package of practical expedients discussed in LG 9.3.1.1, unamortized initial direct costs remaining at the application date that would not have qualified for capitalization under the leases standard should be written off with an offsetting entry to equity (or earnings if the entity chooses to adjust comparative periods and the costs were incurred after the beginning of the earliest period presented).

Also, refer to LG 9.3.1.2 when the hindsight practical expedient is elected, regarding whether existing balances should be adjusted.

The transition guidance in ASC 842 does not explicitly discuss the treatment of sublease liabilities under ASC 840. These liabilities arise in certain sublease transactions when the underlying asset was subleased at a loss. Certain of these transactions are not in the scope of ASC 420 when the entity has not ceased use of the leased space for the term of the head lease. We believe it would be appropriate to analogize to the guidance for liabilities under ASC 420 in transition to ASC 842. Consequently, the right-of-use asset recognized at transition should be reduced (netted) by the carrying amount of the sublease liability. Alternatively, we would not object to a reporting entity writing off an existing sublease liability at the application date with an adjustment to opening equity at transition. In this latter case, the reporting entity should also perform an impairment test of the right-of-use asset at the application date. See LG 9.4.1.3.

Question LG 9-8

How should the lessee treat the excess of the carrying amount of the existing liability recognized in accordance with ASC 420, *Exit or Disposal Cost Obligations,* over **the right-of-use asset to be recorded at transition**?

PwC response

This situation is not specifically addressed in ASC 842; however, we believe that the lessee can elect to apply either of the follow methods:

- **Derecognize the excess ASC 420 liability through equity**: In this scenario, the lessee would debit the liability and credit equity for the amount in excess of the right-of-use asset (which is now zero). Subsequent to transition, losses resulting from the sublease would be reflected in the income statement as they are incurred (subsequent to the effective date).

- **Recognize the excess ASC 420 liability as a negative ROU asset (presented as a liability within the financial statements**): This treatment would preserve the liability, reducing future losses related to the sublease.

An entity should elect one method and apply it consistently to all leases impacted.

9.4.1.1 *Lessee: discount rates in transition*

The discount rate used to calculate the present value of the future payments should be determined at the application date as discussed in LG 9.3. For example, a calendar year-end private company adopting on January 1, 2022 that chooses not to adjust comparative periods would determine the rate as of January 1, 2022.

See LG 3.3.4.6 for information on determining the discount rate, including specific private company considerations. When a lessee uses its incremental borrowing rate as the discount rate at transition, the transition guidance does not specify whether the rate should be based on the original lease term or the remaining lease term. We believe that the selection of a rate that is based on either the original lease term or the remaining lease term is reasonable. The approach should be consistently applied.

9.4.1.2 Lessee: lease payments in transition

At transition, a lessee is required to measure a lease liability for leases classified as operating under current GAAP equal to the sum of the present value of (1) the remaining minimum rental payments (as defined in ASC 840), and (2) any amounts probable of being owed by the lessee under a residual value guarantee as defined under the leases standard. When lease classification has not changed, the lease payments used for measurement purposes should be based on the same data as under ASC 840. If the entity has not elected hindsight, the lease term used to determine the payments should be the same as what was used under ASC 840 at lease inception (or the latest reassessment of lease term if the lease had been modified).

Variable payments

ASC 840 requires that variable payments (contingent rentals) that are based on an index or rate be included in minimum lease payments based on the index or rate existing at lease inception (or as of the modification date if the lease has been modified). However, there is diversity in practice regarding how lessees treat rent payments based on an index or rate in their commitments footnote under ASC 840. Some lessees use the inception index or rate whereas others update the amount to reflect the current index or rate. The transition guidance in the new leases standard does not explicitly state whether the index or rate used to measure the lease liability for an operating lease should be as of the transition date or as of the inception of the lease.

We believe that if the lessee historically disclosed the amount of its commitments for operating leases using the index or rate as of the inception of the lease (consistent with the index or rate in effect under ASC 840 that was used to calculate the minimum rental payments), then that rate should be used in measuring the initial lease liability at transition for existing leases. If a lessee that previously used the inception index or rate in its commitment footnote wants to use the current index or rate to measure the lease liability at transition for existing leases, it would need to apply the guidance in ASC 250, *Accounting Changes and Error Corrections,* including an evaluation of preferability. Note that in evaluating preferability, the SEC staff has indicated that it may be reasonable to conclude that the use of a current index or rate better reflects the lease liability at transition.

We believe that if the lessee historically disclosed the amount of its commitments for operating leases with variable payments based on an index or rate using the current index or rate, the lessee may measure the initial lease liability for its existing leases at transition by either (a) using the current index or rate consistent with its existing policy for disclosures or (b) using the index or rate at the inception of the lease consistent with the definition of minimum rent payments in ASC 840. In this latter case, since the lessee is neither changing its recognition nor disclosure policies for operating leases, we do not believe that application of ASC 250 is required.

Separation of components in transition

Under the new leases guidance, a reporting entity is required to separate lease and nonlease components. However, for new leases on or after the effective date of ASC 842, a lessee may, as an accounting policy election by class of underlying asset, choose to not separate nonlease components from the associated lease components and instead account for each separate lease component and its associated nonlease components as a single lease component. The new leases transition guidance does not specify whether a lessee can make an accounting policy election to not separate lease and nonlease components for existing leases in calculating the lease liability at transition.

Under ASC 842, the measurement of the lease liability for an existing operating lease includes the present value of the remaining minimum rental payments ("as defined in ASC 840"). The term "minimum rental payments," however, is not actually defined in ASC 840 and the description of "minimum lease payments" is unclear. We believe that the treatment of lease and nonlease components in transition for existing leases depends on whether the lessee elects an accounting policy under ASC 842 to not separate nonlease components from the associated lease components (see LG 2.4.4.1).

Lessee does not elect to combine nonlease and lease components

A lessee must separate nonlease components (other than executory costs) from the associated lease components at transition for existing leases if the lessee has *not* made an accounting policy election to combine them under ASC 842 for new leases.

When a lease includes executory costs in the fixed rent payments (a gross lease), the guidance in ASC 840 with respect to accounting for those executory costs (such as insurance, maintenance, and property taxes) to be paid by the lessor is unclear. With respect to a lessee, ASC 840 says that minimum lease payments include minimum rental payments called for by the lease over the lease term and comprise payments the lessee is obligated to make in connection with the leased property. As such, it does not directly address the treatment of executory costs. In the minimum lease payments classification test, ASC 842 states that executory costs are excluded. As such, the new guidance could be read to imply that minimum lease payments include executory costs, hence the need to require their specific exclusion for purposes of the minimum lease payments classification test.

Since the guidance in ASC 840 is unclear, we believe there were two acceptable historical practices for a lessee to account for an operating gross lease:

- The lessee could have chosen to separate executory costs from the remainder of the minimum lease payments or

- The lessee could have chosen to include the fixed portion of executory costs within minimum lease payments

Note that in this section, "fixed" could also include payments based on an index or rate.

We believe that a lessee has asserted a policy with regards to including or separating the fixed executory costs based on what the lessee disclosed in its commitments footnote. Note that variable or contingent payments for executory costs would generally be excluded from minimum rental payments irrespective of the treatment of fixed executory costs. Therefore, we believe a lessee should transition its operating gross leases to ASC 842 consistent with its historical accounting policy as follows:

- If a reporting entity has a historical accounting policy to exclude executory costs from minimum lease payments under ASC 840, then executory costs should be excluded from minimum rental payments in transition. Therefore, the portion of payments attributable to these executory costs would not be included in the measurement of the initial lease liability.

- If a reporting entity has a historical accounting policy to include executory costs in minimum lease payments under ASC 840, then fixed executory costs should be included in minimum rental payments in transition. Therefore, the fixed portion of payments attributable to those executory costs would be included in the measurement of the initial lease liability.

If a lessee wants to change how executory costs are treated for existing leases, but is not electing to combine nonlease and lease components under ASC 842, it would need to apply the guidance in ASC 250, *Accounting Changes and Error Corrections,* including an evaluation of preferability. For example, if the lessee has historically included fixed executory costs in its commitments footnote and it wants to exclude these amounts from its lease liability at transition for existing leases, it would need to treat this as a change in accounting policy and consider whether such a change is preferable.

Question LG 9-9 considers how the treatment of executory costs at transition affects the units of accounting after transition.

Question LG 9-9

How does the treatment of executory costs at transition impact subsequent accounting in the event of a reassessment trigger or a modification that is not considered a new lease?

PwC response

We believe a lessee's separation (or non-separation) during transition creates a unit of accounting that should be carried forward on and after the effective date. For example, assume a gross lease has two nonlease components: maintenance (an executory cost) and ancillary services (not associated with maintenance) provided by the lessor. Assume the lessee chooses to separate nonlease components other than executory costs from the associated lease component during transition. If the lessee does not separate maintenance from the lease component in transition due to its existing accounting policy under ASC 840 but separates the ancillary services at transition, the two units of accounting established in transition would be (1) the lease component that includes maintenance and (2) the ancillary services nonlease component. These would remain consistent even in the event of a modification that is not a new lease or remeasurement on or after the effective date.

Lessee elects to combine nonlease and lease components

A lessee may choose to not separate nonlease components other than executory costs from the associated lease components for existing leases at transition if, and only if, the lessee makes an accounting policy election by class of underlying asset to not separate nonlease components from the associated lease components for new leases on and after the effective date. We believe a lessee that elects to combine lease and nonlease components under ASC 842 may also apply that election to existing leases at transition without applying ASC 250 *Accounting Changes and Error Corrections,* since the change arises from the adoption of a new accounting standard.

If a lessee elects to not adjust the comparative periods, we believe the lessee should present their comparative periods as they had before adopting ASC 842. We believe that the Board's intent in providing the optional transition method was to allow entities to continue to report leases for the comparative period as they had under ASC 840.

9.4.1.3 *Lessee: impairment in transition*

At transition, a lessee should consider whether adjustments are needed for any impairment when determining the amount of the right-of-use asset to record.

We believe that the FASB did not intend for lessees to adjust prior period impairment measurements or allocations to an asset group under ASC 360, *Property, Plant, and Equipment* upon adoption of the leases standard. If an asset group that includes an operating lease had been impaired under current GAAP, an allocation of the prior period asset group impairment should not be included in the measurement of the operating lease right-of-use asset upon adoption of the leases standard. Instead, a right-of-use asset for a lessee's operating lease should be assessed for impairment under current GAAP, for example, ASC 420, *Exit or disposal cost obligations* (if the entity has ceased use of the leased asset), or ASC 840 (if the lessee subleased the underlying leased asset at a loss) during the look-back period.

The impairment provisions of ASC 360 would apply only on or after the effective date of the new standard, unless the scenario in Question LG 9-10 applies.

Question LG 9-10

If previous impairments under ASC 360 in excess of the carrying value of long-lived assets within the asset group were identified prior to the effective date, but were not able to be expensed because the assets cannot be written down below fair value (an "unrecognized impairment"), is a lessee required to expense any additional impairment resulting from the recognition of the right-of-use asset as of the effective date?

PwC response

We believe that an "unrecognized impairment" should be recorded at the date that the right-of-use asset is initially recognized on the balance sheet. Therefore, if a reporting entity elects not to adjust comparative periods, the impairment should be recorded as either as a charge to income or an equity adjustment at adoption since the impairment is first recorded at the date of initial application (e.g., January 1, 2022 for a calendar year-end private company).

9.4.1.4 *Lessee: foreign currency in transition*

The transition guidance in the leases standard does not address how to treat the effects of foreign exchange rates in a lease that is denominated in a currency other than a reporting entity's functional currency. As a result, certain questions have arisen.

Question LG 9-11 and Question LG 9-12 discuss how leases denominated in a foreign currency should be accounted for in transition.

Question LG 9-11

In transitioning to ASC 842, what exchange rate should be used to determine lease payments for purposes of measuring a lessee's operating lease liability and right-of-use asset for existing operating leases?

PwC response

For leases that were classified as operating leases under ASC 840, a lessee should initially recognize a right-of-use asset and a lease liability at the application date described in LG 9.3

We believe it is reasonable to use the foreign exchange rate at the application date (rather than the commencement date) to determine lease payments for both the lease liability and the right-of-use asset. This is because the transition guidance in the leases standard requires the right-of-use asset to be initially equal to the lease liability adjusted for other items, which can only be accomplished by using the foreign exchange rate at the application date.

In addition, ASC 830-20-30-1 states: "At the date a foreign currency transaction is recognized, each asset, liability … shall be measured initially in the functional currency of the recording entity by use of the exchange rate in effect at that date." Consequently, the lessee should use the foreign exchange rate in effect at the date of initial recognition of the right-of-use asset and lease liability. For a calendar year-end nonpublic business entity with an effective date of January 1, 2022 choosing to adjust comparative periods, this would be (a) January 1, 2021 for an operating lease that commenced prior to January 1, 2021 or (b) the commencement date of the lease for a lease entered into during the comparative periods. For a calendar year-end nonpublic business entity choosing to not adjust comparative periods, this would be January 1, 2022.

Question LG 9-12

For a reporting entity that chooses to adjust comparative periods in transition, how should foreign currency gains or losses for a lessee's operating leases during the look-back period be accounted for after the initial application date?

PwC response

The transition guidance in ASC 842-10-65-1(d) of the leases standard states that a reporting entity shall adjust equity and, if it elects to adjust comparative periods, the other prior period comparative amounts, as if the new leases guidance always applied.

For reporting entities that choose to adjust comparative periods, based on the general transition guidance in ASC 842-10-65-1(d), subsequent to the application date the comparative income statements presented should be adjusted to reflect the effect of foreign currency exchange rate movements on lease-related monetary assets and liabilities. These foreign exchange transaction gains or losses should be recognized in income during the comparative periods.

9.4.1.5 Lessee: subsequent recognition and measurement in transition

After initial recognition, a lessee should measure the lease liability and the right-of-use asset in accordance with the subsequent measurement guidance in the leases standard as described in LG 4.4.2.

9.4.2 Lessee: capital leases in transition

If a lease was classified as a capital lease under the guidance in ASC 840 and will be classified as a finance lease under the leases standard, the lessee should reclassify the existing capital lease asset as a right-of-use asset and the existing obligation as a lease liability for each period the lease was outstanding beginning with the earliest period presented (if the entity chooses to adjust comparative periods) or the effective date (if the entity chooses not to adjust comparative periods). That is, the initial right-of-use asset and lease liability will be based on the guidance in ASC 840 for capital lease assets and capital lease obligations. However, refer to LG 9.3.1.2 and Question LG 9-6 when the hindsight practical expedient is elected.

If the entity elects the package of practical expedients discussed in LG 9.3.1.1, it does not reassess unamortized initial direct costs. If a reporting entity does not elect the package of practical expedients, costs that do not qualify for capitalization under the leases standard should be written off with an offsetting entry to equity unless the entity chooses to adjust comparative periods and the costs were incurred after the beginning of the earliest period presented, in which case they should be written off to earnings in the comparative period. Any unamortized initial direct costs that meet the definition of initial direct costs under the leases standard should be included in the right-of-use asset established at transition.

For reporting entities that choose to adjust comparative periods presented before the effective date, a lessee should measure the right-of-use asset and liability in accordance with the subsequent measurement guidance in Topic 840 during the comparative periods.

Beginning on the effective date, a lessee should measure the right-of-use asset and lease liability in accordance with the subsequent measurement guidance in the leases standard (see LG 4.4.1). A lessee should not, however, remeasure the right-of-use asset or lease liability for changes in the amount probable of being owed under a lessee-provided residual value guarantee. For leases that were capital leases under ASC 840, in cases when remeasurement of the lease liability is required for any reason, the lessee should continue to measure the residual value guarantee it provides on the basis of the stated amount, not the amount probable of being owed. See LG 5 for information on lease remeasurement.

9.4.3 Lessee: modifications during the look-back period

Generally, when there is no change in lease classification, a lessee that elects to adjust comparative periods will apply the modification guidance in ASC 840 for modifications that occur during the comparative periods presented. If the lease classification changes, the lessee should use the modification model in ASC 842 irrespective of whether the modification took place during the comparative periods or after the effective date. Absent a modification, a lessee should not reassess or remeasure leases during the comparative periods under the leases standard.

Question LG 9-13 and Question LG 9-14 discuss how a lessee should account for lease modifications during the look-back period.

Question LG 9-13

If the lessee chooses to adjust comparative periods upon transition, what is the accounting for an operating lease that is modified during comparative periods and the lease remains an operating lease?

PwC response

When a lease classified as an operating lease under ASC 840 continues to be classified as an operating lease under ASC 842, the transition provisions require application of a hybrid model. The lessee would recognize a lease liability and a right-of-use asset under ASC 842 for such a lease using the amounts calculated under ASC 840 at the application date. The transition provisions in ASC 842 further prescribe that the lessee should apply the modification and remeasurement guidance in ASC 842 should such a lease be modified after the look-back period. However, there is no guidance that addresses the accounting when a lease is modified during the comparative periods. In such a scenario, we believe a hybrid model should be applied as follows:

- The lessee should use the model for modifications in ASC 840 to determine the accounting for the modified operating lease.

The lessee should use the guidance in ASC 842 to recognize the modification, i.e., measure payments based on ASC 840 but use the guidance in ASC 842 to adjust the lease liability and the right-of-use asset.

Question LG 9-14

What is the accounting model when a capital lease under ASC 840 (classified as a finance lease under ASC 842) is modified during the look-back period?

PwC response

The new leases guidance requires the modification guidance under ASC 842 to be followed when a capital lease under ASC 840 (classified as a finance lease under ASC 842) is modified after the look-back period. There is no guidance when such a lease is modified during the look-back period. We believe the lessee should follow the modification guidance in ASC 840 to account for a modification during the look-back period since there was no change in the lease classification.

9.4.4 Remeasurement events other than modifications

As discussed in LG 5.3, even if a lease is not modified, a lessee is required to remeasure lease payments and the lease liability in certain circumstances. This includes cases in which lease payments and term would not be required to be reassessed under ASC 840. One example of such a triggering event is a significant event or a significant change in circumstances that is within the control of the lessee that directly affects whether the lessee is reasonably certain to exercise or not to exercise an option to extend or terminate the lease or to purchase the underlying asset.

In these scenarios, when a lessee recognizes a lease liability at transition, it should evaluate how the initial lease liability should reflect the remeasurement triggering event based on its transition elections.

As discussed in LG 9.4.1, at transition for an operating lease, the lessee's lease liability should be calculated as the present value of the sum of (1) the remaining minimum rental payments (as defined under ASC 840) and (2) any amounts probable of being owed by the lessee under a residual value guarantee.

As discussed in LG 9.4.2, for capital leases, the lessee should reclassify the existing capital lease asset as a right-of-use asset and the existing obligation as a lease liability.

When a company does not elect to use hindsight, it should continue to use the old lease payment data under ASC 840 as required by ASC 842-10-65-1(l)(1) and ASC 842-10-65-1(r)(1) in transition unless and until a remeasurement triggering event occurs after the date of adoption of the leases standard (1/1/2022 for a private calendar year-end company).

Figure LG 9-2 shows how a lessee should consider the occurrence of a triggering event that occurs prior to the effective date of the leases guidance in the transition for an operating lease. For purposes of the dates in the table, assume a private calendar year-end company is adopting the standard on 1/1/2022.

Figure LG 9-2

Triggering events that occur prior to the effective date (private calendar year-end company with an effective date of January 1, 2022)

Triggering event occurs on 12/31/2021 or earlier	**Hindsight practical expedient is not elected**	**Hindsight practical expedient is elected**
The entity chooses to not adjust comparative periods	At transition on 1/1/2022, calculate the transition lease liability and right-of-use asset based on the old lease payment data under ASC 840. Refer to LG 9.4.1 and LG 9.4.2 for transition accounting for operating and capital leases, respectively. Differences between the lease liability and the right-of-use asset not otherwise specified would be recorded in opening equity.	At transition on 1/1/2022, calculate the transition lease liability and right-of-use asset based on revised information considering the triggering event. Refer to LG 9.3.1.2, LG 9.4.1, and LG 9.4.2. Differences between the lease liability and the right-of-use asset not otherwise specified would be recorded in opening equity.
The entity chooses to adjust comparative period (2021)	At transition, adjust the comparative period as follows: □ As of 1/1/2021, calculate the transition lease liability and the right-of-use asset based on the old lease payment data under ASC 840. Refer to LG 9.4.1 and LG 9.4.2 for transition accounting for operating and capital leases, respectively. Differences	At transition, adjust the comparative period as follows: □ As of 1/1/2021, calculate the transition lease liability and the right-of-use asset based on revised information considering the triggering event. Refer to LG 9.3.1.2, LG 9.4.1, and LG 9.4.2. Differences between the lease liability and the right-of-use asset not otherwise

Triggering event occurs on 12/31/2021 or earlier	Hindsight practical expedient is not elected	Hindsight practical expedient is elected
	between the lease liability and the right-of-use asset not otherwise specified would be recorded in opening equity (as of 1/1/2021). □ Roll the amounts forward for 2021 following the subsequent measurement requirements in the leases guidance with adjustments, if any, recorded to the P&L in the comparative period (refer to LG 9.4.1.5 and LG 9.4.2).	specified would be recorded in opening equity (as of 1/1/2021). □ Roll the amounts forward for 2021 following the subsequent measurement requirements in the leases guidance with differences, if any, recorded to the P&L in the comparative period (refer to LG 9.4.1.5 and LG 9.4.2).

Note that for remeasurement triggering events that occur after the effective date of the leases guidance (for example, an event on January 2, 2022 for a private calendar year-end company) a lessee should follow the leases guidance discussed in LG 5.3.

9.5 Lessor transition

The transition guidance for a lessor differs in some respects depending on the classification of the lease. Given that the practical expedients discussed in LG 9.3.1.1 allow reporting entities to avoid reconsidering lease classification, we expect that many lease arrangements will retain their original classification and therefore, the accounting for a change in classification is not discussed in this guide. Readers should refer to ASC 842-10-65-1 for guidance.

9.5.1 Lessor: operating leases in transition

If a lease was classified as an operating lease under the guidance in ASC 840 and will continue to be classified as an operating lease under the leases standard, the lessor should continue to recognize the carrying amount of the underlying asset and any lease assets or liabilities (for example, prepaid or deferred rent) at the same amounts previously recognized in accordance with ASC 840. However, refer to LG 9.3.1.2 when the hindsight practical expedient is elected.

If the entity elects the package of practical expedients discussed in LG 9.3.1.1, it does not reassess unamortized initial direct costs. If a reporting entity does not elect the package of practical expedients, unamortized initial direct costs that do not qualify for capitalization under the leases standard should be written off with an offsetting entry to opening equity unless the entity chooses to adjust comparative periods and the costs were incurred after the beginning of the earliest period presented. In this case, they should be written off to earnings in the comparative period. Unamortized initial direct costs that qualify for capitalization under the leases standard (see LG 4.3.1.2) should remain capitalized and continue to be expensed over the lease term.

9.5.2 *Direct financing and sales-type leases in transition*

If a lease was classified as a direct financing or sales-type lease in accordance with ASC 840 and will be classified similarly under the leases standard, the lessor should continue to recognize its net investment in the lease at the later of the earliest period presented or lease commencement. The net investment amount is the same as the carrying amount measured using the guidance in ASC 840 immediately before that date. However, see LG 9.3.1.2 and Question LG 9-7 when the hindsight practical expedient is elected.

For a direct financing lease, the net investment in the lease should include any unamortized initial direct costs capitalized in accordance with ASC 840. The transition guidance in the leases standard does not require lessors to write off initial direct costs that do not meet the definition of initial direct costs under the new guidance even if the entity does not elect the package of practical expedients.

For lessors that choose to adjust comparative periods presented before the effective date, a lessor should account for the lease in accordance with the subsequent measurement guidance in ASC 840 during the comparative periods. Beginning on the effective date, a lessor should account for the lease in accordance with the recognition and measurement guidance in the leases standard. See LG 4.5.1 for information.

9.5.3 *Leveraged leases in transition*

Leases that commenced before the effective date of the leases standard that were previously classified as leveraged leases, may continue to be accounted for as leveraged leases by the lessor. Lessors should apply the guidance in ASC 842-50, which is consistent with legacy leveraged lease accounting guidance. New leases (or leases not previously classified as leveraged leases) and leveraged leases modified on or after the effective date cannot be classified as leveraged leases but will need to be classified using the new standard. See LG 7 for more information regarding leveraged leases.

9.5.4 *Separation and allocation of components*

Under the leases guidance, a reporting entity is required to separate lease and nonlease components and allocate consideration in the contract to each component. However, a lessor may, as an accounting policy election by class of underlying asset, choose to not separate nonlease components from the associated lease components and instead account for each separate lease component and its associated nonlease components as a single lease component provided certain conditions are met. See LG 2.4 for more information.

Question LG 9-15 discusses contract consideration reallocation upon adoption of the revenue recognition standard.

Question LG 9-15

Is a reporting entity required to reallocate contract consideration between revenue components and lease components when adopting the revenue standard (ASC 606)?

PwC response

This question arises in the context of a reporting entity adopting the new revenue recognition standard before the leases standard.

If a reporting entity adopts the new revenue standard and the leases standard at the same time and also elects the package of practical expedients in the leases standard, the entity is not required to reassess the accounting for lease components, including the allocations between lease and nonlease components in contracts restated under the new revenue standard.

However, the transition guidance in the new revenue standard does not explicitly provide any relief from the requirement to separate lease and nonlease components if a reporting entity adopts the new revenue standard before the leases standard.

The FASB explained in a Board meeting on June 21, 2017 that it did not intend for a reporting entity to revisit the allocation of contract consideration to lease components within the scope of the existing leases guidance when the entity adopts the new revenue standard.

Similarly, if an element were an executory cost under ASC 840, it would not need to be separated until the adoption of ASC 842. Also, a lessor can elect to not separate certain nonlease components under the leases standard in certain cases as described in LG 2.4.

9.5.4.1 Presentation of tenant reimbursements

Lessors of real estate frequently pass the costs of insurance, maintenance, and property taxes (collectively, executory costs) on to their lessees for reimbursement, and present the tenant reimbursements in a separate income statement line item under ASC 840. Executory costs as defined under ASC 840, however, are accounted for differently under ASC 842. Under ASC 842, property taxes and insurance are not separate components in an arrangement (i.e., they are neither lease components nor nonlease components; they are additional consideration in the contract), whereas maintenance is a nonlease component that should be accounted for under ASC 606. (See LG 2.4.1 for additional information on identifying lease and nonlease components.) These changes may lead to questions as to how lessors should present these recovered costs for existing leases upon adopting ASC 842.

We believe that upon adopting ASC 842, lessors that elect the package of practical expedients described in LG 9.3.1.1 may continue (prospectively) to present existing leases in a consistent manner with how they had done so previously. Because this differs from the accounting under ASC 842 that will apply to new or modified leases, lessors should disclose the difference in presentation of their existing leases. Alternately, we believe that it would be acceptable to conform the presentation of existing leases to the presentation of leases entered into or modified after the effective date of ASC 842.

As described in LG 2.4.4.1, lessors may also elect, by class of underlying assets, to combine lease and nonlease components. Per ASC 842-10-65-2, this election applies to “all new and existing leases.” Accordingly, a lessor that elects to not separate lease and nonlease components must also combine such components for existing leases (for the applicable class of underlying asset) upon adoption, and it would no longer be appropriate to present the nonlease maintenance component (or the reimbursable insurance and property taxes) in a separate tenant reimbursement income statement line item after the effective date of ASC 842.

As for the comparative periods prior to adopting ASC 842, we believe that lessors that have elected the transition method to not adjust prior periods should present their comparative periods as they had before adopting ASC 842. We believe that the Board's intent in providing the optional transition method was to allow entities to continue to report leases for the comparative period as they had under ASC 840.

9.5.5 Lessor: modification during comparative periods

Generally, when there is no change in lease classification, a lessor that elects to adjust comparative periods will apply the modification guidance in ASC 840 for modifications that occur during the comparative periods presented. If the lease classification changes, the lessor should use the modification model in ASC 842 irrespective of whether the modification took place during the comparative periods or after the effective date.

Question LG 9-16 discusses how lessors should account for lease modifications during the look-back period.

Question LG 9-16

Assume a lessor elects the package of practical expedients upon adoption of the leases standard and chooses to adjust comparative periods. What is the accounting if an operating or sales-type or direct financing lease under ASC 840 is modified during the look-back period?

PwC response

The transition provisions in ASC 842 do not provide any guidance on the accounting in this scenario. We believe the lessor should follow the modification guidance in ASC 840 should there be a modification of the lease during the look-back period. Modification guidance under the leases standard should be followed for a modification after the look-back period.

9.6 Sale and leaseback in transition

A transaction previously accounted for as a sale and leaseback under ASC 840 should not be reassessed to determine whether it would have qualified as a sale (or purchase) under the guidance in ASC 606. Lessees and lessors should account for the lease in any transaction that qualified as a sale and leaseback in accordance with the lessee and lessor transition requirements. ASC 842-10-65-1 also provides guidance on the accounting for any deferred gain or loss balance after transition.

ASC 842-10-65-1(dd)

If a previous sale and leaseback transaction was accounted for as a sale and capital leaseback in accordance with Topic 840, the transferor shall continue to recognize any deferred gain or loss that exists at the later of the beginning of the earliest comparative period presented in the financial statements and the date of the sale of the underlying asset (if an entity elects the transition method in (c)(1)) or that exists at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph (if an entity elects the transition method in (c)(2)), as follows:

1. If the underlying asset is land only, straight line over the remaining lease term.

2. If the underlying asset is not land only and the leaseback is a finance lease, in proportion to the amortization of the right-of-use asset.

3. If the underlying asset is not land only and the leaseback is an operating lease, in proportion to the recognition in profit or loss of the total lease cost.

ASC 842-10-65-1(ee)

If a previous sale and leaseback transaction was accounted for as a sale and operating leaseback in accordance with Topic 840, the transferor shall do the following:

1. Recognize any deferred gain or loss not resulting from off-market terms (that is, where the consideration for the sale of the asset is not at fair value or the lease payments are not at market rates) as a cumulative-effect adjustment to equity unless the entity elects the transition method in (c)(1) and the date of sale is after the beginning of the earliest period presented, in which case any deferred gain or loss not resulting from off-market terms shall be recognized in earnings in the period the sale occurred.

2. Recognize any deferred loss resulting from the consideration for the sale of the asset not being at fair value or the lease payments not being at market rates as an adjustment to the leaseback right-of-use asset at the later of the beginning of the earliest comparative period presented in the financial statements and the date of the sale of the underlying asset (if an entity elects the transition method in (c)(1)), or at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph (if an entity elects the transition method in (c)(2)).

3. Recognize any deferred gain resulting from the consideration for the sale of the asset not being at fair value or the lease payments not being at market rates as a financial liability at the later of the beginning of the earliest comparative period presented in the financial statements and the date of the sale of the underlying asset (if an entity elects the transition method in (c)(1)), or at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph (if an entity elects the transition method in (c)(2)).

A sale and leaseback transaction previously accounted for as a failed sale and leaseback transaction in accordance with ASC 840 should be reassessed under the leases standard to determine whether a sale would have occurred (1) at any point on or after the beginning of the earliest period presented in the financial statements under the guidance in ASC 842 (if a reporting entity elects to adjust comparative periods) or (2) at the effective date (if a reporting entity elects to not adjust comparative periods). See LG 6 for information on sale and leaseback accounting. If a sale would have occurred, the sale and leaseback transaction should be accounted for using the lease transition guidance in ASC 842-10-65-1 on a modified retrospective basis from the date a sale is determined to have occurred.

Question LG 9-17 discusses application of sale and leaseback transition guidance for leases that existed prior to the effective date of the leases standard.

Question LG 9-17

Must lessors apply sale and leaseback transition guidance under the leases standard to failed sale and leaseback transactions under ASC 840 that existed prior to the effective date of the leases standard?

PwC response

We do not believe that a buyer-lessor should reassess a successful purchase under the new standard.

The transition provisions require that transactions that "failed" sale-leaseback accounting under ASC 840 through the effective date be reassessed under the leases standard to determine if they would qualify as a sale during the look-back period. Since the sale-leaseback model under ASC 840 did not apply to lessors, but the sale and leaseback model in the leases standard does, it is unclear whether the transition guidance in the leases standard for previous failed sale and leaseback transactions applies to lessor accounting.

We believe a buyer-lessor should not reassess a successful purchase with respect to a previous sale and leaseback transaction that did not qualify for sale-leaseback accounting under ASC 840. Instead, for successful purchases, buyer-lessors should account for the leaseback in accordance with the normal lessor transition guidance.

9.7 Build-to-suit leases in transition

The leases standard provides transition guidance for certain existing build-to-suit arrangements.

ASC 842-10-65-1(u)

A lessee shall apply a modified retrospective transition approach for leases accounted for as build-to-suit arrangements under Topic 840 that are existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements (if an entity elects the transition method in (c)(1)) or that are existing at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph (if an entity elects the transition method in (c)(2)) as follows:

1. If an entity has recognized assets and liabilities solely as a result of a transaction's build-to-suit designation in accordance with Topic 840, the entity shall do the following:

    i. If an entity elects the transition method in (c)(1), the entity shall derecognize those assets and liabilities at the later of the beginning of the earliest comparative period presented in the financial statements and the date that the lessee is determined to be the accounting owner of the asset in accordance with Topic 840.

    ii. If an entity elects the transition method in (c)(2), the entity shall derecognize those assets and liabilities at the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph.

    iii. Any difference in (i) or (ii) shall be recorded as an adjustment to equity at the date that those assets and liabilities were derecognized in accordance with (u)(1)(i) or (ii).

iv. The lessee shall apply the lessee transition requirements in (k) through (t) to the lease.

2. If the construction period of the build-to-suit lease concluded before the beginning of the earliest comparative period presented in the financial statements (if the entity elects the transition method in (c)(1)) or if it concluded before the beginning of the reporting period in which the entity first applies the pending content that links to this paragraph (if the entity elects the transition method in (c)(2)), and the transaction qualified as a sale and leaseback transaction in accordance with Subtopic 840-40 before that date, the entity shall follow the general lessee transition requirements for the lease.

For lessees that choose to adjust comparative periods in transition, the lessee should follow the build-to-suit transition guidance for derecognition of assets and liabilities and account for the lease transaction during the look-back period as if the lease had not been accounted for in accordance with the build-to-suit guidance.

Questions LG 9-18 and LG 9-19 discuss accounting for existing build-to-suit transactions under the new leases guidance.

Question LG 9-18

Should lessees account for build-to-suit transactions that existed at transition under the new build-to-suit guidance?

PwC response

The leases standard does not specifically address how the new build-to-suit model in ASC 842 should be applied to build-to-suit transactions that exist at transition. We believe the accounting will depend on the stage of the project.

- If there are no assets and liabilities recognized by the lessee as a result of a completed construction project on the effective date (i.e., the lessee was either not the owner during construction under ASC 840 or the transaction qualified as a sale-leaseback), we believe the lessee should follow the normal lease transition requirements for the lease at the effective date.

- If construction is complete as of the effective date and assets and liabilities have been and still are recognized by the lessee as a result of the construction project as of the effective date, we believe the lessee should derecognize assets and liabilities record solely as a result of the build to suit arrangement pursuant to ASC 842-10-65-1(u)(1). Any difference should be recorded as an adjustment to equity. The lessee would then follow the normal lease transition guidance. Also refer to the response to Question LG 9-19 for additional guidance on these transactions.

- If construction is still in progress as of the effective date, we believe the transaction should be reassessed under the control-based build-to-suit model in the leases standard.

    - If the lessee was deemed to be the accounting owner under ASC 840 and is not deemed to control the asset under the new leases standard, the lessee should derecognize the asset under construction and the liabilities recorded solely as a result of applying build to suit lease accounting. Any difference should be recorded as an adjustment to equity. The lessee would then follow the normal lease transition guidance. Also, refer to the response to Question LG 9-18 for additional guidance.

- If the lessee was not previously the accounting owner but is deemed to control the asset under construction under the new leases standard, the lessee should recognize the asset under construction and a liability (A) at the later of (1) the earliest period presented or (2) the date control over the asset under construction was established if the entity chooses to adjust comparative periods or (B) at the effective date if the entity chooses to not adjust comparative periods. A lessee that controls the asset being constructed under the leases standard would also need to assess the transaction under the sale and leaseback provisions of the leases standard upon completion of construction.

- The liability and asset under construction should remain on the balance sheet if the lessee was previously the accounting owner and is deemed to control the asset under the leases standard. A lessee that controls the asset being constructed under the leases standard would also need to assess the transaction under the sale and leaseback provisions of the leases standard upon completion of construction.

Question LG 9-19

Must lessees apply sale and leaseback transition guidance under the leases standard to failed sale and leaseback transactions under ASC 840 that existed prior to the effective date of the leases standard when these transactions resulted from failed build-to-suit transactions under ASC 840?

PwC response

Under ASC 840 and the leases standard, a lessee that is deemed to be the owner of a construction project due to a failed build-to-suit transaction must evaluate the transaction upon construction completion to determine if it qualifies for sale-leaseback accounting.

The transition guidance in the leases standard does not explicitly address the transition for a transaction that failed the sale and leaseback guidance under ASC 840 once construction was completed (either prior to or during the look-back period) because the transaction failed the build-to-suit guidance under ASC 840. We believe that in such instances, since the reason for the failed sale-leaseback was due to a failed build-to-suit under ASC 840, the lessee should apply the transition guidance applicable to the failed build-to-suit (i.e., the lessee would not have to apply the sale and leaseback transition guidance for a failed sale and leaseback transaction). Instead, the lessee would derecognize the assets and liabilities recorded solely as a result of transaction's build-to-suit designation and record any difference as an adjustment to equity (1) at the later of the beginning of the look-back period and the date the lessee was determined to be the accounting owner under ASC 840, if a reporting entity chooses to adjust comparative periods, or (2) at the effective date, if the entity chooses not adjust comparative periods. After such date, the lessee would follow the lessee transition requirements for the lease and record a right-of-use asset and lease liability for the lease.

It is not uncommon for a lessee to capitalize costs due to the application of build to suit that would have also been capitalized were the lessee not the accounting owner. For example, the lessee may have funded part of the construction costs on behalf of the lessor. These costs would be considered prepaid rent and should be reflected as such in transition. Payments for leasehold improvements are another common example of assets that should remain on the lessee's balance sheet after build to suit assets and debt are removed in transition. Prepaid rent and leasehold improvements would be reflected on the balance sheet at cost (amortized cost when the asset has been placed into service prior to transition.) If the lessee chooses to adjust comparative periods, then we believe the adjustments in those comparative periods would include reversing the income statement effects of the recognition of any imputed ground rent expense recorded during the construction period as well as the interest expense and depreciation expense recognized after construction was complete.

The methodology used for lease classification of the lease recorded upon adoption varies depending on whether or not the lessee elects the package of practical expedients (discussed in LG 9.3.1.1).

- **Lessee did not elect the package of practical expedients**: In this case, the lessee is reassessing lease classification for all existing leases under ASC 842. Therefore, we believe the lessee should also apply ASC 842 to determine lease classification. The lessee can elect to use either of the following dates to classify the lease:
  - Lease commencement date
  - the later of (1) the lease commencement date and (2) the date that the lessee first recognizes the lease on the balance (i.e., the ASC 842 application date)
- **Lessee elects the package of practical expedients**: In this case, the lessee is not reassessing lease classification for all existing leases (i.e., lease classification is based on ASC 840). Therefore, we believe that in addition to the two options listed above, the lessee can also elect to use ASC 840 lease classification guidance and determine lease classification using the lease inception date and the terms and conditions of the lease at that time.

The options listed above should be elected as an accounting policy and must be applied consistently.

9.8 Amounts previously recognized in business combinations

ASC 842-10-65-1 provides guidance for reporting entities that have previously recognized an asset or a liability related to favorable or unfavorable terms of an operating lease under the business combination guidance in ASC 805.

ASC 842-10-65-1(h)

If an entity has previously recognized an asset or a liability in accordance with Topic 805 on business combinations relating to favorable or unfavorable terms of an operating lease acquired as part of a business combination, the entity shall do all of the following:

1. Derecognize that asset and liability (except for those arising from leases that are classified as operating leases in accordance with Topic 842 for which the entity is a lessor).
2. Adjust the carrying amount of the right-of-use asset by a corresponding amount if the entity is a lessee.

3. Make a corresponding adjustment to equity if assets or liabilities arise from leases that are classified as sales-type leases or direct financing leases in accordance with Topic 842 for which the entity is a lessor. Also see (w).

9.8.1 *Transition for certain leasehold improvements*

Under ASC 840, leasehold improvements that are installed significantly after lease inception or acquired in a business combination can have an amortization period greater than the lease term used for accounting purposes. This is because the lessee must use the shorter of the useful life of the assets, or a term that includes required lease periods and renewals that are deemed to be reasonably assured at the date that the leasehold improvements are purchased for amortization purposes, while the lease term for accounting purposes is not updated in these cases. However, ASC 842 does not permit this treatment. Instead it includes the following guidance:

Amortization of Leasehold Improvements

ASC 842-20-35-12: Leasehold improvements shall be amortized over the shorter of the useful life of those leasehold improvements and the remaining lease term, unless the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, in which case the lessee shall amortize the leasehold improvements to the end of their useful life.

ASC 842-20-30-13: Leasehold improvements acquired in a business combination or an acquisition by a not-for-profit entity shall be amortized over the shorter of the useful life of the assets and the remaining lease term at the date of acquisition.

ASC 842 does not have specific transition provisions for leasehold improvements. Therefore, questions have arisen about whether the amortization period of these leasehold improvements should be shortened to conform to the lease term used for accounting purposes upon adoption of ASC 842. We believe that unless hindsight is elected, the amortization period for the leasehold improvements should not be changed. However, based on informal discussions with the FASB staff, a lessee could alternatively adjust the amortization to conform with the lease term either on a prospective basis or as a cumulative catch-up adjustment through equity.

9.9 *Transition disclosure*

Lessees and lessors should provide the transition disclosures required by ASC 250, *Accounting Changes and Error Correction,* except that the information described in ASC 250-10-50-1(b)(2) and ASC 250-10-50-3 is not required.

Additionally, if a reporting entity uses any of the transition practical expedients discussed in LG 9.3.1, it is required to disclose the use of such expedients.

Excerpt from ASC 250-10-50-1

An entity shall disclose all of the following in the fiscal period in which a change in accounting principle is made:

a. The nature of and reason for the change in accounting principle, including an explanation of why the newly adopted accounting principle is preferable.

b. The method of applying the change, including all of the following:

1. A description of the prior-period information that has been retrospectively adjusted, if any.

2. [Not required]

3. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.

4. If retrospective application to all prior periods is impracticable, disclosure of the reasons therefore, and a description of the alternative method used to report the change (see paragraphs 250-10-45-5 through 45-7).

c. If indirect effects of a change in accounting principle are recognized both of the following shall be disclosed:

1. A description of the indirect effects of a change in accounting principle, including the amounts that have been recognized in the current period, and the related per-share amounts, if applicable

2. Unless impracticable, the amount of the total recognized indirect effects of the accounting change and the related per-share amounts, if applicable, that are attributable to each prior period presented. Compliance with this disclosure requirement is practicable unless an entity cannot comply with it after making every reasonable effort to do so.

Financial statements of subsequent periods need not repeat the disclosures required by this paragraph. If a change in accounting principle has no material effect in the period of change but is reasonably certain to have a material effect in later periods, the disclosures required by (a) shall be provided whenever the financial statements of the period of change are presented.

9.9.1 Lessee's transition disclosure for index or rate-based rent

There is diversity in practice in how lessees prepare their footnote disclosures under ASC 840 when rent payments in an operating lease depend on an index or rate. ASC 840 defines minimum lease payments as being based on the index or rate in effect at lease inception (unless there has been a modification to that lease, in which case the index or rate at the modification date should be used). Lessees are required to base straight-line rent expense accruals for operating leases on this definition.

Some lessees prepare their ASC 840 footnote disclosures consistent with the required recognition model, others update the inception date index or rate to reflect the current index or rate. For purposes of transitioning operating leases under ASC 840 to the new leases standard, a lessee should measure lease liabilities at the applicable date using the "remaining minimum rental payments," as defined under the current leases guidance. Given the diversity in practice, the issue is whether the index or rate in rent payments should be the index or rate at inception date of the lease or updated to reflect the current index or rate.

In addressing the diversity in practice, we understand the SEC staff would allow lessees to use an index or rate for transitioning operating leases to ASC 842 that is consistent with the policy used for footnote disclosures under ASC 840. The SEC staff noted that a lessee may choose to change the policy it is currently using for ASC 840 operating lease footnote disclosures purposes for transitioning such leases to the new leases standard. However, this would be a change in accounting policy and the lessee would be required to apply ASC 250, *Accounting Changes and Error Corrections,* which would require a determination that the new policy is preferable. The SEC staff observed that it was reasonable to conclude that the use of a current index or rate better reflects the lease liability and would therefore be preferable.

As a result of the SEC staff's views, for leases classified as operating leases under ASC 840, we believe a lessee may measure the opening lease liability under the new leases standard in the following manner at transition:

- If a lessee uses the current date index or rate in its ASC 840 operating lease financial statement disclosures, the lessee could either (a) use the current date index or rate; or (b) use the lease inception date index or rate consistent with how minimum rent payments are recognized.

- If a lessee uses the inception date index or rate in its ASC 840 operating lease financial statement disclosures, the lessee could either (a) use the current date index or rate but apply the change in accounting guidance in ASC 250; or (b) continue to use the lease inception date index or rate.

9.10 Five-year selected financial data table

We believe that the selected financial data table required by Regulation S-K Item 301 should follow the transition provisions of the new leases guidance. Adjustments would only be required to those periods in the financial data table that correspond to the periods adjusted in the registrant's financial statements included in the relevant filing. For example, a calendar year-end SEC registrant that is neither an emerging growth company nor a smaller reporting company will have a Form 10-K for the year ending December 31, 2019 that will include financial statements for each of the three years in the period ending December 31, 2019 and selected financial data for each of the five years in the period ending December 31, 2019. Assume that the entity elects to adjust comparative periods presented. January 1, 2017 is the beginning of the earliest comparative period presented in the financial statements. Accordingly, the registrant would only apply the new standard to 2019, 2018, and 2017 in the selected financial data table. The selected financial data for 2016 and 2015 are not considered comparative financial statements and therefore do not change the date of initial application of the new leasing standard for purposes of GAAP. The 2016 and 2015 information included in the selected financial data table will be prepared using the prior lease accounting model.

Similarly, if a reporting entity chooses not to adjust comparative periods, the four prior years in the selected financial data table would not be adjusted.

In either case, consistent with Instruction 2 to Regulation S-K Item 301, the registrant must provide disclosure regarding the lack of comparability of the data presented in the selected financial data table (if applicable and material).

9.11 *Effective date and transition for ASU 2021-05*

On July 19, 2021, the FASB published ASU 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, which upon adoption requires a lessor to classify a lease with variable lease payments (that do not depend on a rate or index) as an operating lease on commencement date if classifying the lease as a sales-type or direct financing lease would result in a selling loss.

Figure LG 9-3 summarizes the effective dates for adopting ASU 2021-05. Early adoption is permitted for both public and nonpublic business entities.

Figure LG 9-3
ASU 2021-05 effective dates

Type of entity	Effective date
Public business entities A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or over-the-counter market An employee benefit plan that files or furnishes financial statements to the SEC	▫ Fiscal years, and interim periods within those fiscal years, beginning after December 15, 2021
All other entities not included above	▫ Fiscal years beginning after December 15, 2021 and interim periods within fiscal years beginning after December 15, 2022

Entities that have not yet adopted ASC 842 on or before the issuance of ASU 2021-05 (i.e., July 19, 2021) should adopt ASU 2021-05 at the same time as ASC 842 and use the same transition method used to adopt ASC 842 (i.e., adjust comparative periods with the cumulative effect of transition recognized at the beginning of the earliest period presented, or with the cumulative effect of transition recognized at the beginning of the period of adoption and no adjustment of comparative periods). See LG 9.3 for transition methods available for ASC 842.

Entities that have adopted ASC 842 on or before the issuance of ASU 2021-05 (i.e., July 19, 2021) should apply ASU 2021-05 either (1) retrospectively to leases that commenced or were modified (where the modification is not accounted for as a separate contract under ASC 842-10-25-8) on or after the adoption of ASC 842, or (2) prospectively to leases that commence or are modified (where the modification is not accounted for as a separate contract under ASC 842-10-25-8) on or after the date that an entity first applies the ASU.

9.12 *Effective date and transition for ASU 2021-09*

On November 11, 2021, the FASB published ASU 2021-09, *Leases (Topic 842): Lessors—Discount Rate for Lessees That Are Not Public Business Entities*, which upon adoption provides nonpublic business entity lessees with a practical expedient to elect, as an accounting policy, to use a risk-free rate as the discount rate by class of underlying asset. ASU 2021-09 requires the use of the rate implicit in the lease when readily determinable regardless of the election to otherwise use a risk-free rate for a class of underlying asset.

Figure LG 9-4 summarizes the effective dates for adopting ASU 2021-09.

Figure LG 9-4
ASU 2021-09 effective dates

Type of entity	Effective date
Nonpublic business entities that have not adopted ASC 842 as of November 11, 2021	□ The same as ASC 842, i.e., fiscal years beginning after December 15, 2021 and interim periods within fiscal years beginning after December 15, 2022
Nonpublic business entities that have adopted ASC 842 as of November 11, 2021	□ Fiscal years beginning after December 15, 2021 and interim periods within fiscal years beginning after December 15, 2022. Early adoption is permitted.

Nonpublic business entities that have not yet adopted ASC 842 on or before the issuance of ASU 2021-09 (i.e., November 11, 2021) should adopt ASU 2021-09 at the same time as ASC 842 and use the same transition method used to adopt ASC 842 (i.e., adjust comparative periods with the cumulative effect of transition recognized at the beginning of the earliest period presented, or with the cumulative effect of transition recognized at the beginning of the period of adoption and no adjustment of comparative periods). See LG 9.3 for transition methods available for ASC 842.

Upon adoption of the ASU, nonpublic business entity lessees that have already adopted ASC 842 on or before the issuance of ASU 2021-09 (i.e., November 11, 2021) should:

- Adjust the lease liability using the discount rate calculated based on the remaining lease term of leases that exist at the beginning of the fiscal year of adoption of ASU 2021-09 and recognize the amount of change in the lease liability as an adjustment to the corresponding right-of-use asset.
    - If the adjustment would reduce the right-of-use asset to below zero, the lessee should reduce the right-of-use asset to zero and recognize the remaining amount of the adjustment to retained earnings at the beginning of the fiscal year of adoption of the ASU.
    - If the adjustment would increase a right-of-use asset that was previously impaired, the lessee should recognize the adjustment to retained earnings at the beginning of the fiscal year of adoption of the ASU.
- Not consider the adoption of the ASU as an event that would cause remeasurement and reallocation of the consideration in the contract (including lease payments) or reassessment of lease term or lessee option to purchase the underlying asset or classification.

Choose to apply or discontinue using the risk-free rate for any class of underlying asset.