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Preface

PwC is pleased to offer the first edition of our *Leases* guide. In February 2016, the FASB issued its standard on leases, ASC 842, which will replace today's leases guidance in 2019.

The chapters in this guide discuss both lessee and lessor accounting by topic. For example, LG 3 discusses lease classification for both lessees and lessors. 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. Finally, this guide contains chapters on the presentation and disclosure requirements, as well as the effective date and transition.

Locating guidance on particular topics

Guidance on particular topics can be located as follows:

- Table of contents—The table of contents provides a detailed listing of the various sections in each chapter. The titles of each section are intentionally descriptive to enable users to easily find a particular topic.
- Table of questions—The table of questions includes a listing of questions and PwC responses in numerical order, by chapter.
- Table of examples—The table of examples includes a listing of examples in numerical order, by chapter.

The guide also includes a detailed index of key topics.

References to US GAAP

Definitions, full paragraphs, and excerpts from the Financial Accounting Standards Board's *Accounting Standards Codification* are clearly designated, either within quotes in the regular text or enclosed within a shaded box. 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 chapters and sections in this guide

Where relevant, the discussion includes general and specific references to other chapters of the guide that provide additional information. References to another chapter or particular section within a chapter are indicated by the abbreviation "LG" followed by the specific section number (e.g., LG 2.3.2 refers to section 2.3.2 in chapter 2 of this guide).

References to other PwC guidance

This guide focuses on the accounting and financial reporting considerations for leases. It supplements information provided by the authoritative accounting literature and 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)*
- *Derivative instruments and hedging activities (DH)*
- *Fair value measurements (FV)*
- *Financial statement presentation (FSP)*
- *Financing transactions: debt, equity and the instruments in between (FG)*
- *Income taxes (TX)*
- *Stock-based compensation (SC)*
- *Transfers and servicing of financial assets (TS)*
- *Variable interest entities (VE)*

All references to the guides are to the latest editions noted in the PwC guide library. In addition, PwC's *Accounting and reporting manual* (the ARM) provides information about various accounting matters in US GAAP.

Copies of the other PwC guides may be obtained through CFOdirect, PwC's comprehensive online resource for financial executives (www.cfodirect.com), a subscription to Inform, PwC's online accounting and financial reporting reference tool (www.pwcinform.com), or by contacting a PwC representative.

Guidance date

As the environment continues to change, so will the content in this guide. This guide considers existing guidance as of March 31, 2016. Future editions will be released to keep pace with significant developments.

Certain events, such as the issuance of a new pronouncement by the FASB, a consensus (and ensuing endorsement by the FASB) of the Emerging Issues Task Force, or new SEC rules or guidance, may necessitate an update or supplement to the guide. Updates or supplements that may be in the form of other PwC communications can be found on CFOdirect (www.cfodirect.com) or Inform (www.pwcinform.com).

Other information

The appendices to this guide include guidance on professional literature, a listing of technical references and abbreviations, and definitions of key terms.

* * * * *

This guide has been prepared to support you in applying the leases accounting guidance. It 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.

We hope you find the information and insights in this guide useful. We will continue to share with you additional perspectives and interpretations as they develop.

Paul Kepple
US Chief Accountant

2016

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Chapter 1: Introduction

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.

Leasing guidance (before the issuance of ASU 2016-02) required lessees to classify leases as either capital or operating leases. Lessees recognized assets and obligations related to capital leases; expenses associated with capital leases were recognized by amortizing the leased asset and recognizing interest expense on the lease obligation. Many lease arrangements were classified as operating leases, under which lessees would not recognize lease assets or liabilities on their balance sheet, but rather would recognize lease payments as expense on a straight line basis over the lease term.

The leasing guidance was often criticized for not providing users the information necessary to understand a reporting entity's leasing activities, primarily because it did not provide users with a comprehensive understanding of the costs of property essential to a reporting entity's operations and how those costs were funded. Users frequently analyzed information from a reporting entity's lease-related disclosures to compare that reporting entity's performance with other companies. The user community and regulators frequently called for changes to the accounting requirements that would require lessees to recognize assets and liabilities associated with leases.

In 2008, the FASB and IASB (collectively, the "boards") initiated a joint project to develop a new standard to account for leases. Although many of the perceived problems with the previous leasing guidance related to a lessee's accounting for operating leases, the boards thought it beneficial to reflect on lease accounting holistically, and to consider lessor accounting while concurrently developing a proposal on revenue recognition (ASC 606, *Revenue from Contracts with Customers*, which was issued in May 2014).

The FASB issued ASU 2016-02 (the "leasing standard" or "ASC 842") in February 2016. Although the project began as a joint project, 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 lessee 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 adopted by the FASB.

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.

The following table includes a description of some of the most significant differences between the guidance in ASC 842 and IFRS 16.

Figure 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.
Lessor accounting	Under ASC 842, a sale and profit are recognized upon the commencement of a lease only when the arrangement transfers control of the underlying asset to the lessee. Under IFRS 16, selling profit is recognized on direct financing leases when performance obligations in IFRS 15, *Revenue from Contracts with Customers*, have been met.
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*.

Topic	Difference
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 when incurred, 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 requires a modified retrospective approach to each lease that existed at the beginning of the earliest comparative period presented in the financial statements, as well as leases entered into after that date. IFRS 16 allows a reporting entity to elect a full retrospective approach.
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, as described in FASB Concept Statement No. 6 (CON 6), 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 CON 6 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 formed 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 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.

The leasing standard does not require lessees to apply the guidance to arrangements with a lease term of 12 months or less. See LG 2.2.1 for additional information on this short-term lease exception. In addition, certain arrangements are outside the scope of the leasing 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. Lessors should continue to account for leveraged leases existing at the application date of the leasing standard using the guidance in ASC 840, *Leases*.

1.2.2 *Lessee classification*

As noted earlier, the FASB decided on a dual model, under which different types of leases have different accounting treatment subsequent to the initial recognition of leased 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 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*

The following table summarizes the significant differences between ASC 842 and the previous guidance in ASC 840.

Figure 1-2
Changes to lease accounting under ASC 842

Topic	ASC 842 guidance	Observations
Definition of a lease	An arrangement contains a lease only when such arrangement conveys the right to "control" the use of an "identified asset"	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. 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 life and whether payments represent substantially all of the asset's value is the 75% and 90% thresholds applicable in ASC 840.
	Lessees will recognize a right-of-use asset and a lease liability for virtually all leases	Putting nearly all leases on the balance sheet is the biggest change, and one of the key objectives of the guidance in ASC 842.

Topic	ASC 842 guidance	Observations
	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 interest expense 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.
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.	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, presuming payments are collectible, the lease is classified as a direct financing lease.

Topic	ASC 842 guidance	Observations
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. The right to use land is considered a separate lease component unless the accounting effect of doing so would be immaterial. A lessee may choose not to separate nonlease components from their related lease components. If this election is made, all cash flows associated with the nonlease component would be allocated to the related lease component.	Under ASC 840, property taxes and insurance are considered executory costs rather than minimum lease payments. 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 lease payments. 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.
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, recognition, and measurement are determined 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. Certain incremental costs previously eligible for capitalization will be expensed under ASC 842.
Build-to-suit arrangements	Ownership during construction period 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.

Topic	ASC 842 guidance	Observations
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 new revenue recognition standard, ▫ the leaseback is not a finance lease, and ▫ if there is a repurchase option, o the repurchase price is at the asset's fair value at the time of exercise and o 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. 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 as a sale under the new standard. However, sale and leaseback accounting applied for transactions executed prior to the effective date will not need to be reevaluated. Existing "failed" sales 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. 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 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.

Topic	ASC 842 guidance	Observations
Modification	A lease modification is a change to the contractual terms and conditions of a lease that was not part of the original lease and which results in a change in scope or consideration. 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.	Lease modifications under ASC 840 can be very 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 leasing 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 leasing standard requires disclosure of both qualitative and quantitative information about leases. See LG 9 for information on disclosures.

1.5 Transition and effective date

The leasing standard is applicable for most entities starting in 2019. Public business entities are required to apply the leasing standard for annual reporting periods (including interim periods therein) beginning after December 15, 2018. Certain not-for-profit entities, and employee benefit plans that file financial statements with the SEC, are also subject to the transition date applicable to public business entities. All other entities are required to apply the leasing standard for annual periods beginning after December 15, 2019. Earlier application is permitted for all entities as of February 25, 2016, the issuance date of the final standard.

The leasing standard is required to be applied to leases in existence as of the date of adoption using a modified retrospective transition approach; a full retrospective transition approach is not permitted. The transition guidance includes optional provisions intended to reduce the burden of the implementation of the leasing 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. For example, a reporting entity may not choose to reassess whether an existing arrangement contains a lease upon transition, but not reconsider the classification of existing leases. Lessee's may also apply hindsight with respect to judgments around lease renewal options and purchase options. See LG 10 for additional information about transition and the effective date of the leasing standard.

1.6 Implementation guidance

Topics addressed in the implementation guidance and illustrative examples accompanying the leasing standard include the following.

Figure 1-3
Topics addressed in the leasing 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 4.3.1.2
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	LG 6

Chapter 2: Scope

2.1 Chapter 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 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. Although not a lease in 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 plants and animals)

- Leases of inventory

- Leases of assets under construction

- Short-term leases for which a lessee has elected to apply the short-term lease exception (this exception only applies to lessees)

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.

2.2.1 *Short-term lease exception 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 exception, 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 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 exception when certain events occur. See LG 5.4 for information.

2.3 *Definition of a lease*

In a lease, one party obtains the right to use an asset legally owned by another party. 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).

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.

2.3.1.1 Explicitly identified asset

If a contract explicitly identifies the asset to be used, but contains contractual terms that allow the supplier to fulfill the contract without the use of the identified asset, the contract does not meet the requirement for use of an explicitly identified asset. Provisions that establish specific service levels or default clauses that permit an alternative means for fulfilling a contract under certain circumstances may indicate that the contract does not explicitly identify the asset to be used. 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 does not include an explicitly 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. The key consideration is whether the substitution right is substantive based on the facts and circumstances at inception of the contract.

Substitution rights that allow a lessor to replace an asset during the term of an arrangement under certain circumstances (e.g., if the specified asset becomes defective) are generally not considered substantive and would not preclude the arrangement from being considered a lease. Likewise, a provision that contractually permits or requires a seller to substitute other assets on or after a specified date does not preclude the arrangement from being considered to contain a lease prior to the substitution date. Please see LG 2.3.1.4 for additional information on substitution rights.

2.3.1.2 Implicitly identified asset

A contract that does not explicitly identify an asset to be used to fulfill the contract may implicitly identify the asset. When only one asset can be used to fulfill the contract (e.g., because of economic or legal factors or because the lessor has only one asset available to perform under the contract) then the asset is considered implicitly identified. In addition, a reporting entity should evaluate the feasibility of substituting one asset for another when the asset is physically on the lessee's site when contractual language permits such a replacement. An asset on the lessee's site may be implicitly identified due to the practical challenges of entering the customer's location and substituting equipment.

The following examples illustrate the identification of implicitly identified assets.

EXAMPLE 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 identify 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 equipment to be used to fulfill its contract and imposes restrictions on access and substitution for the duration of the contract.

Does the contract explicitly or implicitly identify an asset to be used to fulfill the contract?

Analysis

Yes. Although the assets used to fulfill the contract are not explicitly identified, the assets are implicitly identified as a result of the contractual requirements.

EXAMPLE 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 identify 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 explicitly or implicitly identify an asset to be used to fulfill the contract?

Analysis

Although the die is not explicitly identified in the arrangement, the contract is reliant on the die and therefore it is implicitly identified. While Supplier Corp is not contractually required to use a specific die, it is not feasible to utilize a different die. Therefore, the identified 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, but 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 ingress or egress, access to lavatories, etc.). 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 an intangible outside the scope of the leasing guidance.

Certain assets may lend themselves to use by more than one party. For example, a contract providing the use of a portion 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. However, if the customer contracts to use substantially all of the pipeline capacity, or a specified segment of the pipeline, then it may be considered physically distinct.

2.3.1.4 Substantive substitution rights

The existence of substantive substitution rights may result in the determination that a specific asset has not been identified.

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. Substantive substitution rights are likely to exist only in contracts with an explicitly identified asset. If an arrangement has an implicitly identified asset (i.e., no other assets are practically available to the supplier), it is doubtful substantive substitution rights exist.

Question 2-1

Is a substitution right that requires customer approval considered substantive?

PwC response

No. A contract that allows substitution rights only with customer approval is not considered substantive from the perspective of the supplier.

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 utilize the substitute asset and to be able 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.

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 attendant costs, 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.

To evaluate whether the substitution of an asset creates an economic benefit to the supplier, all relevant economic factors, such as those discussed below, should be considered together.

- The availability of other assets that can be used to satisfy the contract; whether the asset being used to fulfill the contract can be used more economically for another purpose

- Whether a similar asset that can be used to satisfy the arrangement is readily available in the market

- Any obstacles to substitution, such as cost or physical feasibility

For a lessee, this analysis is similar to how it might evaluate reasonably certain purchase and renewal options with respect to the economic factors considered. 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 (1) 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, (2) foregone production resulting from down time necessary to switch assets and other disruptions to the suppliers business, (3) excess operational costs to convert an asset that may not have produced identical output, and (4) 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 economic benefits should be for the supplier to have the right to substitute, 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 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 would be disregarded in the analysis. 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 may be unlikely to occur at inception. An example is a provision in a contract that allows the supplier to substitute the asset for new technology when it is available and the technology is not substantially developed at inception of the contract. This would not be considered a substantive substitution right. The analysis is performed at the inception of the arrangement and does not consider hypothetical or contingent changes, such as the development of future markets. 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 unlikely to be considered substantive substitution rights.

The following examples illustrate the effect of substitution rights on the identification of assets.

EXAMPLE 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 specifies that Manufacturing Corp's inventory will be stored in an identified 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 explicitly or implicitly identify an asset to be used to fulfill the contract?

Analysis

No. The asset is not identified because Warehousing Corp has a substantive substitution right. Warehousing Corp has agreed to provide a specific level of capacity within its warehouse but has the unilateral right to relocate Manufacturing Corp's inventory and can do so without significant cost.

EXAMPLE 2-4

Supplier without substantive substitution rights

Assume the same facts as Example 2-3 except that Manufacturing Corp specified in its contract that its materials must be stored at a specific temperature. 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 explicitly or implicitly identify an asset to be used to fulfill the contract?

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.

EXAMPLE 2-5

Supplier with substantive substitution rights

Aircraft Corp provides airplanes and services to commercial airlines and shipping companies on a multi-year basis. A typical contract stipulates that Aircraft Corp will provide the airplane, crew, maintenance, and insurance (ACMI) for the customer at any time during the term of the contract. Flight schedules are planned weeks in advance. Aircraft Corp has numerous planes in different locations and the legal right to provide any aircraft meeting the minimum requirements stipulated in the contract. The planes have various specifications, such as their size, fuel efficiency, and registration (i.e., which jurisdictions they can be flown in), interior layout (i.e., furniture and entertainment systems), or external paint color. Idle airplanes can be substituted for airplanes in use. Aircraft Corp's practice is to keep its airplanes flying as much as possible and, as a result, the airplane is rarely grounded for more time than is needed to service it for the next flight.

Aircraft Corp signs a multi-year ACMI contract with Customer Corp. The contract does not specify a particular airplane; only the model type and relevant characteristics of the airplane for a minimum of 400 hours each month. As such, the contract is silent to substitution rights. Aircraft Corp has several of this particular model in its airplane inventory.

Does the contract explicitly or implicitly identify an asset to be used to fulfill the contract?

Analysis

No. The airplane is not identified because Aircraft Corp has the ability to use any of its airplanes in fulfillment of the contract. Aircraft Corp is entitled to all revenue generated from the additional use of the aircraft and bears all associated costs – including repositioning or bringing in a new airplane when needed by Customer Corp. Any incremental costs associated with substituting the airplane are expected to be more than offset by the additional revenue that results from the substitution.

In Example 2-5, the airplane was not identified; however, some lessors may conclude that a similar arrangement is dependent on a specified asset because of the characteristics of the airplane required under the arrangement. For example, a customer with specific branding associated with its planes (e.g., seat layout, in-flight entertainment) may conclude that substitution is less likely because of the costs of branding and customization of an otherwise "generic" airplane in the event of a substitution.

2.3.2 Right to control the use of an identified asset over the period of use

Once a reporting entity concludes that the asset to be used is identified, the parties to the transaction must then evaluate whether it controls the use of that asset throughout the period of use. An arrangement is not a lease if it does not convey control of an asset. 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. Example 2-10 illustrates an arrangement in which control is obtained in nonconsecutive periods. In that example, 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.

2.3.2.1 The right to obtain substantially all of the economic benefits

The second 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. For example, if an electronic billboard is used by multiple advertisers it is likely that control rests with the billboard owner because none of the advertisers obtain substantially all of the economic benefits. 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 likely economic returns associated with these 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 when arriving at the likely economic benefits.

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. Solar facilities obtain significant economic benefit from RECs; 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 2-2

If a solar facility sells its energy production and RECs 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 do not prevent the customer from having the right to the economic benefits derived from the asset; they are 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.

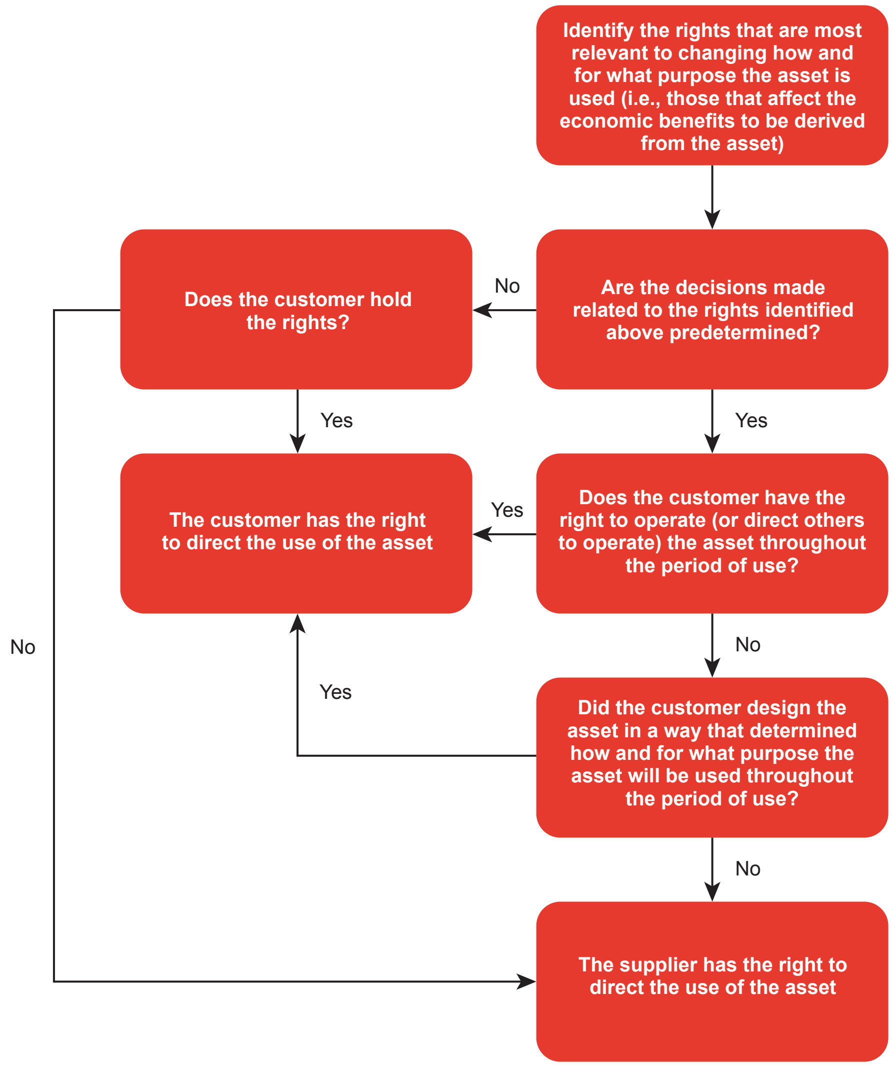
Agreements for the use of assets for which a customer cannot derive economic benefits on its own without other resources may still meet the definition of a lease if the customer meets the criteria necessary to direct the use of the asset. For example, a contract for the use of an asset of such a specialized 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.

2.3.2.2 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.

The following figure illustrates the analysis that should be used to determine which party has the right to direct the use of an identified asset.

Figure 2-1
Analysis of which party has the right to direct the use of an identified asset



The first step in the above analysis is focused on rights that provide the ability to determine or change how and for what purpose the asset is used. Examples of these rights are outlined in ASC 842-10-15-25.

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 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).

The right to determine how and for what purpose an asset is to be used is a strong indicator of which party directs the use of the identified asset because such rights determine the economic benefits that can be derived from using the asset during the period of use. Decisions regarding where and when the asset is to be used are likely to be more important than how those decisions are implemented. For example, if a customer outsources operation of an asset to an outside service provider, the outsourcing does not typically influence the economic benefits that can be derived from the asset.

In some arrangements, the decisions related to how and for what purpose an asset is used, as outlined in ASC 842-10-15-24, are already specified in the contract before the lease term commences. These decisions will need to be considered in conjunction with decisions made during the period of use to properly identify the party that directs the assets use. Simply specifying the output prior to the term does not, on its own, constitute the ability to direct the use.

It is important to consider the rights in total and how they interact with one another. Parties to the transaction must weigh the relevant factors in order to reach a conclusion based on the overall arrangement, the nature of the underlying asset, and the purpose for which the asset is to be used.

Direct operations during the period of use

When the decisions made about the operation of an asset are substantive, the ability to direct the operations is a strong indicator that the customer has the right to determine how and for what purpose the asset will be used and therefore directs the use of the asset. A customer that can direct the operation of an asset during the period of use is typically making the decisions that drive the economic benefits of the asset. If the supplier can change the operating instructions, then this right would be held by the supplier rather than the customer.

Change the use of the asset

The party that directs the operations of the asset before and during the period of use may not have the right to direct the use of the identified asset if the customer can unilaterally decide to change how and for what purpose the asset is used. In that circumstance, the customer will likely be deemed to direct the use that drives the economic benefits from the asset. These decision rights grant the customer the ability to affect the economics derived from the use of the asset during the period of use. However, the rights to direct the use have not been conveyed if the supplier and the customer must mutually agree to change how and for what purpose the asset is used (e.g., by amending the contract).

Specify the output

A customer's right to specify the terms of the output of the contract (i.e., the product itself and timing of delivery) does not necessarily determine whether the customer has the ability to direct the use of the underlying asset. A contract for the delivery of goods or services, even if reliant on an identifiable asset, is normally a supply arrangement and not a lease. However, when the ability to specify the output is combined with involvement in the design or decision making in the operation of an underlying asset, it may indicate that the customer is directing the use of the asset.

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 the purpose, then other 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:

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

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

If the supplier has the ability to alter the predetermined decisions, then the customer does not have the right to direct the use of the asset.

Design of the asset

In certain industries and with certain types of assets, the design of the asset 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 the supplier cannot have a significant impact on the economic benefits to be derived during the period of use (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 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.

If the customer's involvement in the design is limited to determining what will be produced (e.g., electricity), and the supplier's operational decisions determine when and how efficiently the output is produced (when to operate what number of turbines), then the ability to direct the use goes beyond the design of the asset and the supplier's operational decision making rights are likely to preclude the customer directing the use of the asset.

Design is expected to be a much more important indicator of the right to direct the use of the asset when the economics are effectively fixed in an arrangement prior to use. In assessing the significance of design, a reporting entity should consider how much variability is created during the operation of the asset that is not determined through its design.

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 — the right to control the use of an identified asset

The following examples illustrate the determination of which party has the right to control the use of an identified asset.

EXAMPLE 2-6

Contract to manufacture parts on a customer's property

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 equipment is 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, it does not have decision making rights over the asset during the period of use. This arrangement is a supply agreement, not a lease.

EXAMPLE 2-7

Contract to purchase electricity on an on-demand basis

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 plants' 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 2-6, Customer Corp is making decisions about the use of the asset during the period of use.

EXAMPLE 2-8

Contract to purchase electricity on a full-time basis

Assume the same facts as Example 2-7 except Customer Corp has contracted for power on a full-time basis, instead of on-demand.

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

Analysis

The contract is for full-time operation; therefore, how and when the asset is to be used was mutually predetermined by both parties. During the term of the contract, the economics are most influenced by the operational and maintenance decisions. Since the day-to-day operations are under the control of Supplier Corp, it has the ability to direct the use of the asset that most significantly impacts the economic benefits to be derived from the equipment. As a result, Supplier Corp controls the identified asset during the term of the contract.

EXAMPLE 2-9

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.

EXAMPLE 2-10

Contract for use of a grain storage facility

Customer Corp enters into a contract with Supplier Corp, which 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 they have 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.

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.

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 contracts are combined based on these criteria, 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 lease components.

2.4.1 Identifying 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. 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). This service is not related to securing the use of the truck. 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.

Costs that contribute to securing the asset (e.g., insurance, real estate taxes) should be included in lease payments (if they are included in the fixed payments due to the lessor) for purposes of classifying and measuring the lease. A lessee and lessor would generally treat payments made directly to the taxing authority and/or insurance provider as variable lease payments. This differs from the guidance in ASC 840-10-25-

5, which requires such payments to be excluded from minimum lease payments for purposes of classifying a lease.

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) regardless of whether they are embedded in fixed lease payments, paid by the lessee directly to the taxing authority or service provider, or paid by the lessor and subsequently reimbursed by the lessee. This will result in many lessors recording higher gross revenues and expenses than they do under the previous leasing guidance.

Arrangements that include both lease and nonlease elements 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 is not considered a cost of securing the office building and as such is considered a nonlease component. In other cases, costs incurred under an arrangement that are not related to the receipt of a good or service are not treated as nonlease components, but are part of the lease component, for example, reimbursement for the supplier's insurance, interest, taxes, or administrative costs. Such amounts are allocated to their lease and nonlease components following the guidelines described in LG 2.4.2 and LG 2.4.3.

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 provide products to be used on patients and disposed of following their use. Even if the equipment is considered a lease, the disposable product is a nonlease good because it is distinct (i.e., it is capable of generating an economic benefit separate from the lease of the equipment). See RR 3.3 for additional information.

2.4.2 Lessor allocation of consideration to lease and nonlease components

By satisfying a contract that contains lease and nonlease components, lessors generate revenue. Therefore, it is appropriate 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 2.4.4 for information.

2.4.3 Lessee allocation of consideration to lease and nonlease components

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 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. A monthly rental price with the same lease term, interest rates, and residual value may be a better indicator than the purchase price if the purchase price is not observable. However, if the terms underlying an observable input vary significantly, then another input (e.g., the purchase price) might be a better indicator. A good or service that is unique to a supplier may not have market comparisons. In this circumstance, a customer should gather as much information from the supplier regarding their basis for establishing the price in the arrangement. A supplier that sells (as opposed to leases) a similar or identical good or service to customers will have a sales price, which would be a good indicator of a standalone price.

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 consideration and the allocation of total consideration to the lease and nonlease components depends on the nature of the variable payments. See LG 2.4.4 for information.

2.4.3.1 *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 perform a pricing allocation, although it will increase the total lease liability to be recorded on its balance sheet.

This expedient is not available for lessors.

2.4.4 *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 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.

2.4.4.1 *Allocating variable consideration for lessors*

When allocating the consideration in the contract between lease and nonlease components, variable payments should be considered provided they relate solely to nonlease goods and services. If they do, the variable payments should be estimated and included in the consideration allocated to nonlease components consistent with ASC 606.

ASC 842-10-15-39 and 15-40 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 606-10-32-28.

ASC 842-10-15-40

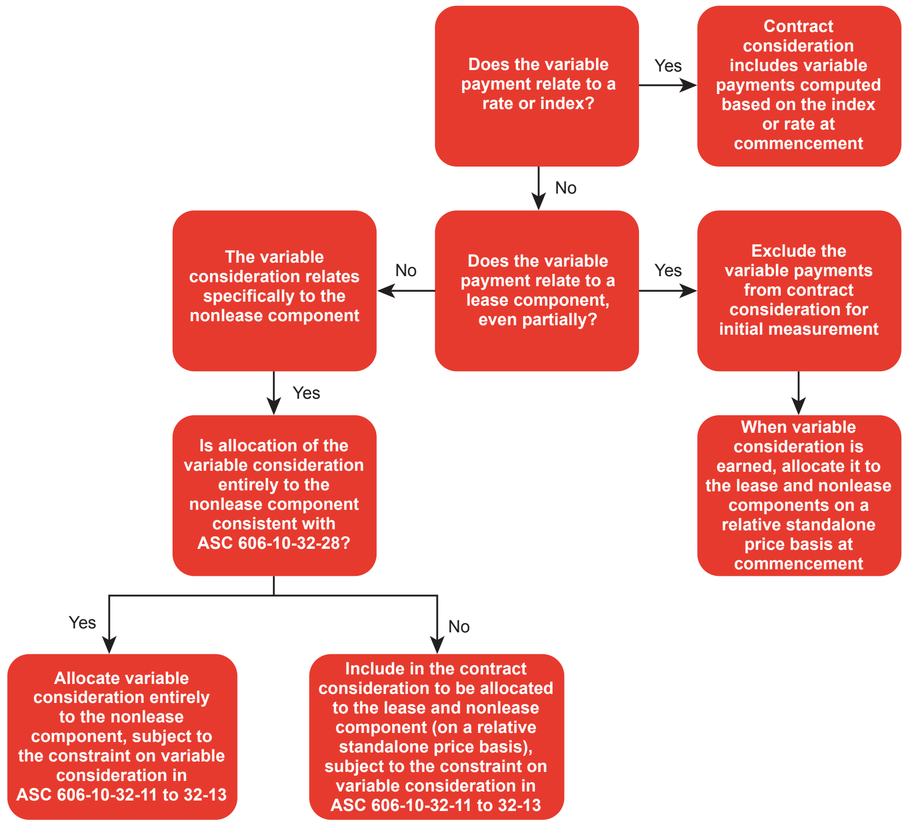
If the terms of a variable payment amount other than those in paragraph 842-10-15-35 relate to a lease component, even partially, the lessor shall recognize those payments as income in profit or loss in the period when the changes in facts and circumstances on which the variable payment is based occur (for example, when the lessee's sales on which the amount of variable payment depends occur).

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 analyze the factors that drive the variability of the payments. To practically analyze this, the factors that determine the amount and whether a 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 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 earned and then recognized in accordance with ASC 842-30-25-2(b) and ASC 606. Variable payments that are specifically 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 allocation objectives in ASC 606, the variable payment should be allocated entirely to the nonlease component; otherwise, 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. See Examples 2-11 through 2-13 for an illustration of these concepts.

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

Figure 2-2

Lessor allocation of variable consideration



The following examples illustrate how to allocate variable consideration between lease and nonlease components.

EXAMPLE 2-11

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

Customer Corp contracts with Supplier Corp to lease medical equipment over a five-year period and purchase related disposables used in the operation of the equipment. The disposables are designed to be used solely with the leased medical equipment; therefore, the amount of disposables purchased by Customer Corp will depend on the usage of the leased medical equipment.

There are no fixed lease payments or minimum disposable purchase requirements. Customer Corp will pay Supplier Corp $7 per disposable purchased. Supplier Corp estimates that Customer Corp will purchase 600 disposables per year over the five year term of the arrangement.

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 standalone selling price of the equipment is $15,000 (cost basis of $10,000) and the standalone selling price of each disposable is $2 (cost basis of $1).

The lease of the medical equipment is a sales-type lease since the lease term is for a major part of the useful life of the asset. The expected variable consideration each year is $4,200 (600 disposables × $7 contract price), which is not representative of the standalone selling price, which is $1,200 (600 disposables × $2 standalone selling price). For simplicity, discounting has been ignored in this example.

In the first year of the arrangement, Customer Corp purchases 600 disposables.

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

Analysis

The equipment lease and sale of disposables are separate lease and nonlease components, respectively. The variable payments do not depend on an index or rate. In addition, the variable payments should not be treated as contract consideration because the amount of disposables purchased by Customer Corp will depend on the usage of the leased medical equipment and the terms of the variable payment relate, at least partially, to the lease component. Therefore, the variable consideration should be excluded from the initial allocation of consideration used for initial measurement.

Since the lease is a sales-type lease, Supplier Corp would remove the asset from its balance sheet and record a receivable equal to the present value of the fixed lease payments (the expected residual is assumed to be zero) on the lease commencement date. Because variable payments are not included in contract consideration, they are not considered lease payments, so the value of the lease receivable is zero.

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

Dr. Loss	$10,000	
Cr. Medical equipment asset		$10,000

In the first year of the arrangement, we believe Supplier Corp would allocate the $4,200 variable lease payment based on the relative standalone selling price of the lease and nonlease components at lease commencement. Variable payments allocated to the medical equipment lease would be recognized using the guidance for variable income earned in ASC 842; variable payments allocated to the disposables would be recognized using the guidance in ASC 606.

Supplier Corp would allocate the variable lease payment of $4,200 (600 disposables × $7 per disposable) to the lease and nonlease components as follows:

	Standalone price (A)	Relative % (A / $21,000) = (B)	Payment (C)	Allocated lease payment (B × C)
Medical equipment	$15,000	71.4%	$4,200	$3,000
Estimated disposables sale over term of the contract (600 per year for 5 years)	6,000	28.6%	$4,200	1,200
Total	**$21,000**	**100%**		**$4,200**

In the first year of the arrangement, Supplier Corp would record the following entries.

Dr. Cash	$4,200	
Cr. Lease revenue		$3,000
Cr. Sales revenue		$1,200
To record receipt of the payment for the disposables and allocated revenue		

Dr. Cost of goods sold	$600	
Cr. Inventory		$600
To record the cost of the disposables purchased by Customer Corp		

EXAMPLE 2-12

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

Customer Corp contracts with Supplier Corp to lease medical equipment over a five-year period and purchase related disposables used in the operation of the equipment. The disposables are not essential to the operation of the medical equipment and can be used in operating either the leased medical equipment or other medical equipment owned by Customer Corp; therefore, the amount of disposables purchased by Customer Corp is unrelated to the usage of the leased medical equipment.

The lease includes an annual fixed payment of $3,300. There is no minimum disposable purchase requirement. Customer Corp will pay Supplier Corp $1.50 per disposable purchased. Supplier Corp estimates that Customer Corp will purchase 600 disposables per year over the five-year term of the arrangement.

The medical equipment has a useful life of five years and is not expected to have any residual value at the end of the lease term. The standalone sales price of the equipment is $15,000 (cost basis of $10,000) and the standalone sales price of each disposable is $2 (cost basis of $1).

The lease of the medical equipment is a sales-type lease since the lease term is for a major part of the useful life of the asset. The expected variable consideration each year is $900 (600 disposables × $1.50 contract price), which is not representative of the standalone selling price, which is $1,200 (600 disposables × $2 standalone selling price).

In the first year of the arrangement Customer Corp purchases 600 disposables.

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

Analysis

The equipment lease and sale of disposables are separate lease and nonlease components, respectively. The variable payments relate specifically to the nonlease component (sale of disposables) because the sale of disposables is not related to the usage of the leased medical equipment.

In this example, we are assuming that Supplier Corp allocates the variable payments to the lease and nonlease components. However, if a lessor believes that allocating the variable consideration entirely to the nonlease component is consistent with the allocation objective in ASC 606-10-32-28, then it should do so. See RR 5 for information on allocating variable consideration.

Since the lease is a sales-type lease, Supplier Corp would remove the asset from its balance sheet and record a receivable equal to the present value of the lease payments. The lease receivable is $15,000, calculated as ($16,500 total fixed payments + $4,500 estimate of variable consideration) × ($15,000 selling price of equipment ÷ $21,000 combined selling price of equipment and disposables). For simplicity, discounting has been ignored in this example.

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

Dr. Lease receivable	$15,000	
Dr. Cost of sales	$10,000	
Cr. Revenue		$15,000
Cr. Medical equipment asset		$10,000

In the first year of the arrangement, Supplier Corp would allocate the $4, 200 lease payment ($3,300 fixed lease payment + $900 disposable purchase price [600 disposable × $1.50]) based on the relative standalone selling price of the lease and nonlease components at lease commencement.

	Standalone price (A)	Relative % (A / $21,000) = (B)	Payment (C)	Allocated lease payment (B × C) = D
Medical equipment	$15,000	71.4%	$4,200	$3,000
Estimated disposables sale over term of the contract (600 per year for 5 years)	6,000	28.6%	$4,200	1,200
Total	**$21,000**	**100%**		**$4,200**

In the first year of the arrangement, Supplier Corp would record the following entries.

Dr. Cash	$4,200	
Cr. Lease receivable		$3,000
Cr. Sales revenue		$1,200
To record receipt of the payment for the disposables and allocated revenue		

Dr. Cost of goods sold	$600	
Cr. Inventory		$600
To record the cost of the disposables purchased by Customer Corp		

EXAMPLE 2-13

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

Customer Corp contracts with Supplier Corp to lease medical equipment over a five-year period and purchase related disposables used in the operation of the equipment. The disposables are not essential to the operation of the medical equipment and can be used in operating either the leased medical equipment or other medical equipment owned by Customer Corp; therefore, the amount of disposables purchased by Customer Corp is unrelated to the usage of the leased medical equipment.

The lease includes an annual fixed payment of $3,000. There is no minimum disposable purchase requirement. Customer Corp will pay Supplier Corp $2 per disposable purchased. Supplier Corp estimates that Customer Corp will purchase 600 disposables per year over the five-year term of the arrangement.

The medical equipment has a useful life of five years and is not expected to have any residual value at the end of the lease term. The standalone sales price of the equipment is $15,000 (cost basis of $10,000) and the standalone sales price of each disposable is $2 (cost basis of $1).

The lease of the medical equipment is a sales-type lease as the lease term is for a major part of the useful life of the asset. The expected variable consideration each year is $1,200, which is representative of the standalone selling price of the disposables.

In the first year of the arrangement Customer Corp purchases 600 disposables.

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

Analysis

The equipment lease and the sale of disposables are separate lease and nonlease components, respectively. The variable payments relate solely to the nonlease component (sale of disposables) because the payment is not based on the usage of the medical equipment and it approximates the standalone selling price of the disposables. Further, the variable payments relate specifically to the nonlease component (sale of disposables) because the sale of disposables is not related to the usage of the leased medical equipment.

In this example, we are assuming that Supplier Corp allocates the variable payments entirely to the nonlease component (sale of disposables) because doing so would be consistent with the allocation objective in ASC 606-10-32-28.

Since the lease is a sales-type lease, Supplier Corp would remove the asset from its balance sheet and record a receivable equal to the present value of the lease payments. The lease receivable is $15,000, calculated as $3,000 fixed payment × 5 years. For simplicity, discounting has been ignored in this example.

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

Dr. Lease receivable	$15,000	
Dr. Cost of sales	$10,000	
Cr. Revenue		$15,000
Cr. Medical equipment asset		$10,000

In the first year of the arrangement, Supplier Corp would allocate the $3,000 fixed lease payment entirely to the medical equipment lease and the $1,200 variable payment to the sale of disposables; the sale of disposables would be recognized using the guidance in ASC 606.

In the first year of the arrangement, Supplier Corp would record the following entries.

Dr. Cash	$4,200	
Cr. Lease receivable		$3,000
Cr. Sales revenue		$1,200
To record receipt of the payment for the disposables and allocated revenue		

Dr. Cost of goods sold	$600	
Cr. Inventory		$600
To record the cost of the disposables purchased by Customer Corp		

2.4.4.2 *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 components based on their relative standalone prices at lease commencement. 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.

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. A key consideration is whether the supplier will use multiple assets, or a group of assets that work together, to fulfill the arrangement. 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's a lease. Conversely, if the assets covered by the 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.

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.

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 one 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 these arrangements, 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.

The following example illustrates how to evaluate components within an arrangement and whether those components are lease or nonlease components.

EXAMPLE 2-14

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 common area 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 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.

To properly account for the lease components, Customer Corp will need to determine the standalone selling price of the use of the building assets, 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 the lease elements based on the relative standalone selling prices.

2.5.1 *Portfolio exception*

A reporting entity may elect to utilize a portfolio approach, under which it does not have to consider the 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 contract level. In addition to the materiality restriction, 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.

A lessor should only reallocate consideration when there is a contract modification that is not accounted for as a separate, new contract.

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

3.1 Chapter overview

Prior to the issuance of ASC 842, lease classification determined not only how lease expense was recorded in the income statement, but also whether a lessee was required to record an asset and a liability associated with its obligations under the lease. Classification was based on a number of criteria, including specific bright lines and numerous interpretations. Lessees often preferred operating leases because recognition of the underlying asset and associated lease liability was not required and rent expense was recognized on a straight-line basis over the lease term. A capital lease required the lessee to reflect an asset and corresponding lease liability equal to the present value of the future lease payments.

A lessor always reflected lease-related assets on its balance sheet; for operating leases, the lessor recorded the asset under lease, for leases classified as either sales-type or direct financing, the lessor would derecognize the leased asset and record its net investment in the lease (equal to the present value of the lease payments expected to be received over the lease term and the present value of the unguaranteed estimated residual value of the asset at the end of the lease term).

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. 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. Leveraged leases were eliminated in the new standard, but the standard grandfathered leveraged leases that exist at the adoption date of the new standard.

The following figure summarizes the accounting by lessees for the different types of leases.

Figure 3-1
Overview of lease accounting by lessees

	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

The following figure summarizes the accounting by lessors for the different lease types (excluding leveraged leases, which are discussed in LG 7).

Figure 3-2
Overview of lease accounting by lessors

	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

Question 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.

3.2.1 Lease commencement

ASC 840 required classification to be determined at lease inception. ASC 842 only 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.

The FASB believes that recognition of right-of-use assets and lease liabilities at lease commencement is appropriate 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 a lessee has the unfettered right to enter the property, whether the asset is complete, the nature of any improvement work being performed on the asset as well as lessee responsibility for a loss due to casualty damages impacting the asset. The commencement date specified in the lease contract or the date when lease payments are due are not typically strong indicators of when a lessee has obtained control of the leased asset.

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. If so, 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.

3.2.2 Lease components

A reporting entity must first 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.

3.3 Lease classification criteria

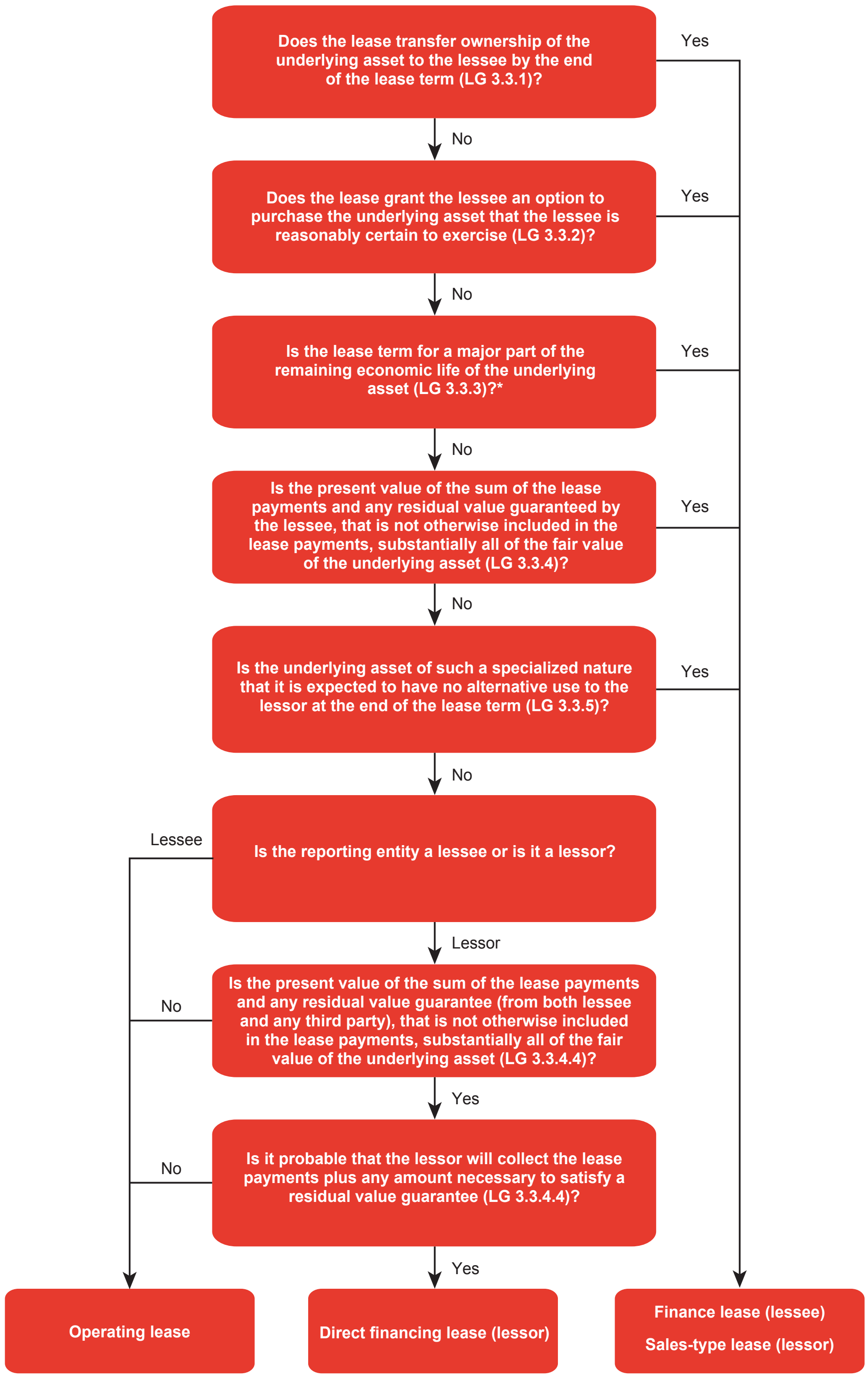
Lease classification is governed by five criteria. Although the guidance considers whether a lease is economically similar to the purchase of a nonfinancial asset from the perspective of control, rather than on the basis of risks and rewards of ownership (as used in ASC 840), the classification approach 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 842-10-25-3 are met. All other leases should be classified as an operating lease by both the lessee and lessor.

Although lessors are 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.

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 exception.

The following figure provides the lease classification criteria contained in ASC 842-10-25-2 and 25-3.

Figure 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 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.

Question 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 3-4

Do the lease classification criteria in ASC 842-10-25-2 and 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 25-3. Consequently, long-term leases of land may be classified as finance leases by lessees. As discussed in LG 3.3.4.6, lessors use the rate implicit in the lease as the discount rate when determining lease classification. As the unguaranteed residual value of land at expiration of a lease is considered when deriving the rate implicit in the lease, a lessor might classify a land lease as an operating lease even if the lessee classifies it as a finance lease.

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.

3.3.2 Option to purchase the underlying asset is reasonably certain of exercise

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. Which may occur, for example, if 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 is for the major part of the remaining economic life of the asset

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. Although the FASB did not include bright lines in ASC 842, it has indicated that 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.

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.

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 lessee could be obligated to extend a lease, the lessee and lessor must include that extension period in determining the lease term. This could be the case when the renewal option is controlled by the lessor.

ASC 842-10-30-1

An entity shall determine the lease term as the noncancelable 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.

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.

Question 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 indicate that certain arrangements may include asset, entity, or market-based 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.

We believe that a lease that is cancelable only upon the occurrence of a remote contingency should be considered a noncancelable lease term 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 noncancelable for any periods in which the penalty exists.

Question 3-6

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 noncancelable?

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.

The following examples illustrate the effect of renewal options on the lease term.

EXAMPLE 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 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.

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.

The following examples illustrate how to determine the estimated economic life.

EXAMPLE 3-3

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.

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 (i.e., the lower end of the range).

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 3-4

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.

3.3.3.3 *Determining the estimated economic life of a lease component with multiple underlying 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 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 *Present value of the lease payments amounts to substantially all of the fair value of the underlying asset*

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 the 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, they 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 3-7

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 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 3-8

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

PwC response

Yes. Since these payments are incurred by the lessee to remove the lessor's assets, these costs would generally be considered 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 (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.

The following example illustrates how to determine the fixed lease payments.

EXAMPLE 3-5

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 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 3-7 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 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 significant 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, which is 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 it 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.

The estimated loss incurred by the lessor, if any, represents a lease incentive, which should be included as a reduction to fixed lease payments by both the lessee and lessor when classifying the lease and measuring the right-of-use asset and lease liability.

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 should evaluate the nature of the improvement and 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, reimbursement for an improvement that is a lessor asset is not a lease incentive; it should be recorded as a reimbursement to the lessee for the cost of the lessor asset (e.g., as a reduction to prepaid rent).

If a lessor agrees to pay a fixed or formula-based amount to the lessee once the lessee provides evidence of the expenditures (regardless of their nature), 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 specific improvements, judgment will be required to determine whether the improvements represent lessee or lessor assets.

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 that depend on an index or a rate meet the definition of an asset (for the lessor) and a liability (for the lessee) because they are unavoidable and therefore economically similar to fixed lease payments. At lease commencement, the lessor has a present right to receive those payments and the lessee has a present obligation to make those lease payments. As such, the only uncertainty associated with variable lease payments that depend on an index or a rate relates to the measurement of the asset or liability that arises from those payments and not the existence of the asset or 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.

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

The following examples illustrate when to include variable lease payments in the calculation of lease payments when classifying a lease.

EXAMPLE 3-6

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

EXAMPLE 3-7

Lease payments – variable lease payments

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 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 the real estate taxes, they are costs Lessor Corp would owe regardless of whether the underlying asset is leased; therefore, the payments represent a reimbursement of Lessor Corp's costs, which are associated with the right to use the office building. However, since real estate taxes vary on an annual basis, 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 3-5, real estate taxes do not represent a separate lease component. See LG 2.4 for additional information on identifying lease and nonlease components.

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 unavoidable (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, we believe that the total payment should be considered a variable lease payment and excluded from the lease payments.

The following examples illustrate how to determine if variable lease payments are considered in substance fixed lease payments.

EXAMPLE 3-8

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 allocation of consideration and measurement of lease payments are not addressed in this example.

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

Analysis

The lease payments for purposes of classifying the lease include 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 million regardless of its consumable use, the $1 million minimum payment is an in substance fixed lease payment.

EXAMPLE 3-9

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 3-10

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.

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). This requirement 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.

Question 3-9

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 a lease, but 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.

Loan guarantees and loans to the lessor

Similar to ASC 840-10-25-5(b), 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 provides a description of a portfolio level guarantee.

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.

Generally, a lessor should not include residual value guarantees as a lease payment 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. Under limited circumstances, if the following characteristics exist, we believe it may be acceptable to consider a pooled residual value guarantee in the assessment of the lease payments criterion:

- 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

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 values of these 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, regardless of whether the lessor is expected to realize the tax credits, they 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 842-10-55-3 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).

See PwC's *Fair value measurements* guide for further discussion of fair value measurements.

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

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.

When evaluating the lease payments criterion, a lessor should not defer initial direct costs if, at the lease commencement date, the fair value of the underlying asset is different from its carrying amount.

Often times, the lessee will not have enough information to determine the rate implicit in the lease. 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; however, such information is rarely available to a lessee. While a lessee might be able to reasonably estimate these items, it is not required to do so; it may use its incremental borrowing rate for purposes of discounting lease payments.

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.

A lessee's incremental borrowing rate inherently considers its creditworthiness for a lending period similar to the term of the lease and the standard lending practices related to such loans. For real estate, for example, it may reflect the loan to value ratio and any covenant restrictions.

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. The following example demonstrates this concept.

EXAMPLE 3-11

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

Since the underlying assets are similar, have similar lease terms, and the value and range of lease payments do not vary greatly, 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.

Private company considerations

ASC 842-20-30-3 provides a practical expedient for nonpublic business entities, which allows the use of 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 lower interest expense. Use of a risk-free rate is an accounting policy election, and once elected must be utilized consistently for all leases.

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 a 75% to 80% 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 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, the pipeline has no alternative use beyond the lessee's need to transport gas; as such, the lessor would be expected to price the lease to ensure a return during the noncancelable 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% to 80%. 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.

3.5.1 Finance leases

EXAMPLE 3-12

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 leased 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 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% because the rate charged in the lease is not readily determinable) 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 4-2 for an illustration of the initial recognition and measurement of this type of lease.

EXAMPLE 3-13

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	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 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

How should Lessee Corp classify the lease?

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

Criteria	Analysis
	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 4-3 for an illustration of the initial recognition and measurement of this type of lease.

3.5.2 *Operating lease*

EXAMPLE 3-14

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 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.

Criteria	Analysis
	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.
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 25-3 have been met.

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

EXAMPLE 3-15

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 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.
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% because the rate charges in the lease is not readily determinable) 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 25-3 have been met.

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

EXAMPLE 3-16

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 leased equipment	7 years
Purchase option	None
Annual lease payments	The first annual payment is $1,500. The annual payment increases each year by an amount equal to $1,500 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 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 inception. The total payments are $6,275 (see below for a schedule of payments). The present value of the lease payments (discounted at Lessee Corp's incremental borrowing rate of 8% because the rate charges in the lease is not readily determinable) 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 25-3 have been met.

See Example 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.

3.6.1 Sales-type lease

EXAMPLE 3-17

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 leased 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 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.

Criteria	Analysis
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 4-7 for an illustration of the initial recognition and measurement of this type of lease.

EXAMPLE 3-18

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 leased 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 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

Criteria	Analysis
	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 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 4-8 for an illustration of the initial recognition and measurement of this type of lease.

3.6.2 Operating lease

EXAMPLE 3-19

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	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 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 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.

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 (discounted at the rate Lessor Corp charges in the lease of 8%) is $16,062. Therefore, the present value of the lease payments amounts to approximately 54% of the fair value of the leased asset ($16,062 / $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 25-3 have been met.

See Example 4-9 for an illustration of the initial recognition and measurement of this type of lease.

Chapter 4: Accounting for leases

4.1 Chapter 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 shorter than 12 months. A reporting entity can elect an accounting policy not to record such short-term leases on the balance sheet. See LG 2.2.1 for information on the short-term lease exception.

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 before lease commencement. As discussed in LG 3.3.4, there are six components 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 before the commencement date), whereas only the remaining payments due should be used to measure the lease liability

- 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 made at or before the commencement date, less lease incentives received*

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. The following figure provides examples of costs included and excluded from initial direct costs.

Figure 4-1
Examples of costs included and excluded from initial direct costs

Included	Excluded
▫ Commissions (including payments to employees acting as selling agents)	▫ Employee salaries
▫ Legal fees resulting from the execution of the lease	▫ Internal engineering costs
▫ Lease document preparation costs incurred after the execution of the lease	▫ Legal fees for services rendered before the execution of the lease
▫ Certain payments to existing tenants to move out	▫ Negotiating lease term and conditions
▫ Consideration paid for a guarantee of a residual asset by an unrelated third party	▫ 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 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.

4.2.2.3 Examples – measuring the right-of-use asset

The following examples illustrate the measurement of a right-of-use asset and a lessee's accounting for leases.

EXAMPLE 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, 20X6:

- The lease commencement date is February 1, 20X6.
- 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, 20X6.

Lessee Corp calculated the initial lease liability as the present value of the 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 and record this lease?

Analysis

Lessee Corp would calculate the right-of-use asset as follows:

Initial measurement of lease liability	$900,000
Lease payments made to Lessor Corp at or before the commencement date	10,000
Lease incentives received from Lessor Corp	(50,000)
Initial direct costs	1,000
Initial measurement of right-of-use asset	$861,000

On January 1, 20X6 (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 upon lease commencement		

Dr. Cash	$50,000	
Cr. Lease incentive		$40,000
Cr. Prepaid rent		$10,000
To record receipt of the lease incentive from the lessor.		

On February 1, 20X6 (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	$40,000	
Cr. Right-of-use asset		$40,000
To reclassify the lease incentive 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 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. The following table summarizes information about the lease and the leased assets.

Lease term	5 years, no renewal option
Economic life of the leased 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

Lessee Corp determines that the lease is a finance lease as discussed in Example 3-12.

How would Lessee Corp measure and record this lease?

Analysis

Lessee Corp would first calculate the lease liability as the present value of the annual fixed lease payments of $1,100 discounted at Lessee Corp's incremental borrowing rate of 7%; this amount is $4,825.

The right-of-use asset is equal to the lease liability because there is no adjustment required for initial direct costs incurred by Lessee Corp, lease payments made on or before the commencement date, or lease incentives received prior to 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		$4,825

See Example 4-10 for an illustration of the subsequent measurement and recognition for this fact pattern.

EXAMPLE 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. 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 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 (see schedule of lease payments below).
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 readily determine 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 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 is shown below.

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 determines that the lease is a finance lease as discussed in Example 3-13.

How would Lessee Corp measure and record this lease?

Analysis

Lessee Corp would first calculate the lease liability as the present value of the annual lease payments, less the lease incentive paid in year 2, plus the exercise price of the purchase option using the rate implicit in the lease of approximately 9.04%.

PV of lease payments, less lease incentive	$3,737,510
PV of purchase option at end of lease term	1,262,490
Total lease liability	$5,000,000

The right-of-use asset is equal the lease liability because there is no adjustment required for initial direct costs incurred by Lessee Corp, lease payments made on or before the lease commencement date, or lease incentives received prior to the lease commencement date.

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

Dr. Right-of-use asset	$5,000,000	
Cr. Lease liability		$5,000,000

See Example 4-11 for an illustration of the subsequent measurement and recognition for this fact pattern.

EXAMPLE 4-4

Lessee operating lease recognition – automobile lease

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

Lessee Corp determines that the lease is an operating lease as discussed in Example 3-14.

How would Lessee Corp measure and record this lease?

Analysis

Lessee Corp would first calculate the lease liability as the present value of the monthly fixed lease payments discounted at Lessee Corp's incremental borrowing rate of 6%; this amount is $16,518.

The right-of-use asset is equal to the lease liability because there is no adjustment required for initial direct costs incurred by Lessee Corp, lease payments made on or before the commencement date, or lease incentives received prior to the lease commencement date.

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

Dr. Right-of-use asset	$16,518	
Cr. Lease liability		$16,518

See Example 4-12 for an illustration of the subsequent measurement and recognition for this fact pattern.

EXAMPLE 4-5

Lessee operating lease recognition – copier with lease and nonlease components

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 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
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.

As discussed in Example 3-15, Lessee Corp determines that the lease is an operating lease. In addition, the allocated annual lease payment is \$432.

How would Lessee Corp measure and record this lease?

Analysis

Lessee Corp would first calculate the lease liability as the present value of the annual allocated lease payment amount of \$432 discounted at Lessee Corp's incremental borrowing rate of 5.5%; this amount is \$1,229.

The right-of-use asset is the sum of the lease liability and the initial direct costs paid by Lessee Corp; this amount is $1,329 ($1,229 + $100). There is no adjustment required for lease payments made on or before the commencement date or lease incentives received prior to the lease commencement date.

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

Dr. Right-of-use asset	$1,329	
Cr. Lease liability		$1,229
Cr. Cash		$100

EXAMPLE 4-6

Lessee operating lease recognition – lease payments tied to an index

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 leased equipment	7 years
Purchase option	None
Annual lease payments	The first annual payment is $1,500 The annual payment increases each year by an amount equal to $1,500 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 by .25% each year (i.e., the Prime Rate is expected to be 3.25% at the beginning of year 2). The expected lease payments are:

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

As discussed in Example 3-16, Lessee Corp determines that the lease is an operating lease.

How would Lessee Corp measure and record this lease?

Analysis

Lessee Corp would first calculate the lease liability as the present value of the 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 $5,595.

The right-of-use asset is equal to the lease liability because there is no adjustment required for initial direct costs incurred by Lessee Corp, lease payments made on or before the commencement date, or lease incentives received prior to the lease commencement date.

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

Dr. Right-of-use asset	$5,595	
Cr. Lease liability		$5,595

4.3 Initial recognition and measurement – lessor

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.

When a lease is not a sales-type lease but meets the criteria to be classified as a direct financing lease, 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. 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. In a sales-type lease, the lessor transfers control of the underlying asset to the lessee. At lease commencement, the lessor should derecognize the leased asset and record its net investment in the lease (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 a 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

b. The unguaranteed residual asset at the present value of the amount the lessor expects to derive from the underlying asset following the end of the lease term that is not guaranteed by the lessee or any other third party unrelated to the lessor, discounted using the rate implicit in the lease.

The lessor should recognize any profit or loss arising from the sale of the underlying asset (through the lease).

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 Selling profit / selling 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 4-7 for an illustration of how to calculate selling profit when a lease contains an unguaranteed residual value.

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 LG 9.3.2.1 for information on the presentation of selling profit or loss in the statement of comprehensive income.

4.3.1.2 *Initial direct costs*

The guidance for identifying initial direct costs is the same for a lessor as it is for a lessee. 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 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 *When collectibility is not probable at the commencement date for a sales-type lease*

ASC 842-30-25-3 to 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 collection 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.

4.3.1.4 Examples – lessor accounting for sales-type leases

The following examples illustrate a lessor's accounting for a sales-type lease.

EXAMPLE 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. 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
Economic life of the leased 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

As discussed in Example 3-17, Lessor Corp determines that the lease is a sales-type lease.

How would Lessor Corp measure and record this lease?

Analysis

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 lease payments discounted at 7.04%; this amount is $4,822.

- The present value of the unguaranteed residual asset discounted at 7.04% is $178.

- Lessor Corp's net investment in the lease is $5,000 (the sum of the lease receivable ($4,822) 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, if lower) and the carrying amount of the underlying asset net of any unguaranteed residual asset. Since the present value of the lease receivable ($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	$4,822
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 ($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	$4,822	
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 4-13 for an illustration of the subsequent measurement and recognition for this fact pattern.

EXAMPLE 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. 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 leased 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 (see schedule below).
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

The schedule of lease payments is shown below.

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 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 LG 9.3.2.1 for information on the presentation of selling profit or loss in the statement of comprehensive income.

As discussed in Example 3-18, Lessor Corp determines that the lease is a sales-type lease.

How would Lessor Corp measure and record this lease?

Analysis

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 $5,000,000. This is the present value of the 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 $5,000,000 (the sum of the lease receivable ($5,000,000) and the unguaranteed residual asset ($0)). This is equal to the commencement date fair value of the asset under lease.

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

Dr. Lease receivable	$5,000,000	
Cr. Property, plant and equipment (leased asset)		$5,000,000

4.3.2 *Direct financing lease*

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. Selling losses should not be deferred; they should be recognized using the impairment guidance for inventory or property, plant, and equipment, as applicable.

4.3.2.1 *Initial measurement of net investment in the lease*

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 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, these costs are expensed as incurred. In a direct financing lease, the initial direct costs are deferred and amortized over the term of the lease, reducing interest income earned under the arrangement.

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.

4.3.3 Operating lease

An operating lease is neither a sale nor financing of an asset. The lessor should keep the asset underlying the lease on its balance sheet and continue to depreciate the asset based on its useful life. Rental revenue 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). A lessor should record an unbilled rent receivable, which is the cumulative amount by which straight-line rental revenue exceeds rents currently billed in accordance with the lease.

4.3.3.1 When collectibility is not probable at the commencement date for an operating lease

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 useful life. However, subsequent to initial recognition, a lessee'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).

4.3.3.2 Examples – lessor accounting for operating leases

The following example illustrates a lessor's accounting for an operating lease.

EXAMPLE 4-9

Lessor operating lease recognition – automobile lease

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	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 Lessee Corp □ Lessor Corp does not provide any incentives

As discussed in Example 3-19, Lessor Corp determines that the lease is a sales-type lease.

How would Lessor Corp measure and record this lease?

Analysis

Since the lease is classified as an operating lease, no asset or liability would be recorded at lease inception. Lessor Corp would keep the automobile on its books as an asset and depreciate it in accordance with its normal depreciation policy.

See Example 4-14 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. The following figure describes how these amounts are recognized.

Figure 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

The following example illustrates the subsequent measurement of a right-of-use asset and lease liability.

EXAMPLE 4-10

Finance lease subsequent measurement and recognition – non-specialized digital imaging equipment lease (lessee)

This example is a continuation of Example 4-2.

The lease is classified as a finance lease as the lease payments represent substantially all of the fair value of the asset. The right-of-use asset and lease liability are $4,825.

How would Lessee Corp measure the right-of-use asset and lease liability over the lease term?

Analysis

Lessee Corp would amortize the right-of-use asset on a straight-line basis over the lease term because the economic life is greater than the lease term.

	Amortization	Right-of-use asset
Commencement		$4,825
Year 1	$965	3,860
Year 2	965	2,895
Year 3	965	1,930

	Amortization	Right-of-use asset
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)
Commencement					$4,825
Year 1	$1,100	$1,100	$ –	$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
	$5,500	**$4,825**	**$675**	**$675**	

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. The following example illustrates the application of this guidance.

EXAMPLE 4-11

Finance lease subsequent measurement and recognition – real estate lease with a purchase option (lessee)

This example is a continuation of Example 4-3.

The lease is classified as a finance lease because it grants Lessee Corp the option to purchase the asset underlying the lease and Lessee Corp is reasonably certain to exercise that purchase option. The right-of-use asset and lease liability are $5,000,000.

How would Lessee Corp measure the right-of-use asset and lease liability over the lease term?

Analysis

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 4-3 for a schedule of payments.

	Payment	Principal paid	Interest paid	Interest expense	Lease liability (end of year)
Commencement					$5,000,000
Year 1	$500,000	$500,000	—	$406,840	4,906,840
Year 2	315,000	-91,480	406,840	415,143	5,006,983
Year 3	530,450	115,307	415,143	404,718	4,881,251
Year 4	546,364	141,646	404,718	391,912	4,726,800
Year 5	562,754	170,842	391,912	376,466	4,540,511
Year 6	579,637	203,171	376,466	358,098	4,318,972
Year 7	597,026	238,928	358,098	336,497	4,058,443
Year 8	614,937	278,440	336,497	311,323	3,754,829
Year 9	633,385	322,062	311,323	282,206	3,403,650
Year 10	652,387	370,181	282,206	248,737	3,000,000
Year 10[1]	3,000,000	2,751,263	248,737	—	—
	$8,531,940	**$5,000,000**	**$3,531,940**	**$3,531,940**	

[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*

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 following components, divided by the lease term:

- The initial amount of the lease liability, plus
- Any lease payments made at or before the lease commencement date, plus

- Any initial direct costs incurred by the lessee, less
- Any lease incentives received

In Example 4-12, 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.

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, plus
- Any prepaid or accrued lease payments, plus
- Any unamortized initial direct costs, minus
- The remaining balance of any lease incentives received, amortized on a straight-line basis (unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the right-of-use asset)

Both of these approaches result in the same balance for a right-of-use asset.

EXAMPLE 4-12

Lessee operating lease subsequent measurement and recognition – automobile lease

This example is a continuation of Example 4-4.

This lease is classified as an operating lease as none of the criteria for finance lease classification are met. The right-of-use asset and lease liability are $16,518.

How would Lessee Corp measure the right-of-use asset and lease liability over the lease term?

Analysis

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	Principal paid	Interest paid	Interest expense	Lease liability
Commencement					$16,518
Year 1	$6,000	$5,236	$764	$820	11,338
Year 2	6,000	5,472	527	500	5,838
Year 3	6,000	5,809	191	162	—
	$18,000	**$16,518**	**$1,482**	**$1,482**	

The amortization of the right-of-use asset is calculated as the difference between the straight-line lease expense and the interest expense 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**	

4.5 Subsequent recognition and measurement – lessor

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.

In operating leases, lessors record lease income on a straight-line basis over the lease term.

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. 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.

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 residual asset is recorded at its present value and accreted to its final expected value at the expiration of the lease term.

The following example illustrates the application of this guidance.

EXAMPLE 4-13

Sales-type lease subsequent measurement and recognition – non-specialized digital imaging equipment lease (lessor)

This example is a continuation of Example 4-7.

The lease is classified as a sales-type lease as the lease payments represent substantially all of the fair value of the asset. The net investment in the lease is $5,000 (lease receivable of $4,822 plus an unguaranteed residual asset of $178). Since control has been deemed to have transferred to Lessee Corp, profit is recognized by Lessor Corp at lease commencement.

How would Lessor Corp account for the leasing transaction after lease commencement?

Analysis

Lessor Corp would first schedule out the cash flows on the lease receivable as shown in the following table.

	Payment	Principal received	Interest received	Interest income	Lease receivable
Commencement					$4,822
Year 1	$1,100	$1,100	$ —	$262	3,984
Year 2	1,100	838	262	203	3,087
Year 3	1,100	897	203	140	2,127
Year 4	1,100	960	140	73	1,100
Year 5	1,100	1,027	73	—	—
	$5,500	**$4,822**	**$678**	**$ 678**	

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
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.

The following example illustrates the application of this guidance.

EXAMPLE 4-14

Lessor operating lease subsequent measurement and recognition – automobile lease

This example is a continuation of Example 4-9.

This lease is classified as an operating lease as none of the criteria for sales-type or direct financing lease treatment have been met. As this is an operating lease, Lessor Corp does not record a net investment, retains the automobile in property, plant, and equipment on its balance sheet, and continues to depreciate the asset.

How would Lessor Corp account for the leasing transaction after lease commencement?

Analysis

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 BC 10 for further guidance on impairments of tangible and intangible assets.

4.6.1 Finance leases

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 Operating lease

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 has a higher risk of impairment. 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.

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

4.7.1 Sales-type and direct financing leases

A lessor should apply the loan impairment guidance in ASC 310 to the net investment in the lease (i.e., receivable, residual asset, and deferred profit) recorded in a sales-type or direct financing lease. When determining the loss allowance for a lease receivable, a lessor should consider the collateral relating to the net investment in the lease. The collateral is the cash flows that the lessor expects to derive from the underlying asset during the remaining lease term, including the cash flows that the lessor would expect to derive from the underlying asset that it recovers from the lessee.

4.7.2 Operating leases

Lessors should follow the guidance in ASC 360 regarding the impairment of long-lived assets for assets subject to an operating lease. See BC 10 for further guidance on the impairment of tangible and intangible assets.

Chapter 5: Modification and remeasurement of a lease

5.1 Chapter overview

This chapter addresses the accounting for modifications, including termination, of a lease contract. It also addresses the accounting for lease remeasurements for events that are not modifications.

Depending on the facts and circumstances, a lease modification may be accounted for by the lessee and lessor as (1) two leases – the original lease and a separate new lease, or (2) one modified 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:

- A triggering event that changes the certainty of a lessee exercising an option to renew or terminate the lease, or purchase the underlying asset

- 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 that those payments become fixed

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 renegotiate 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).

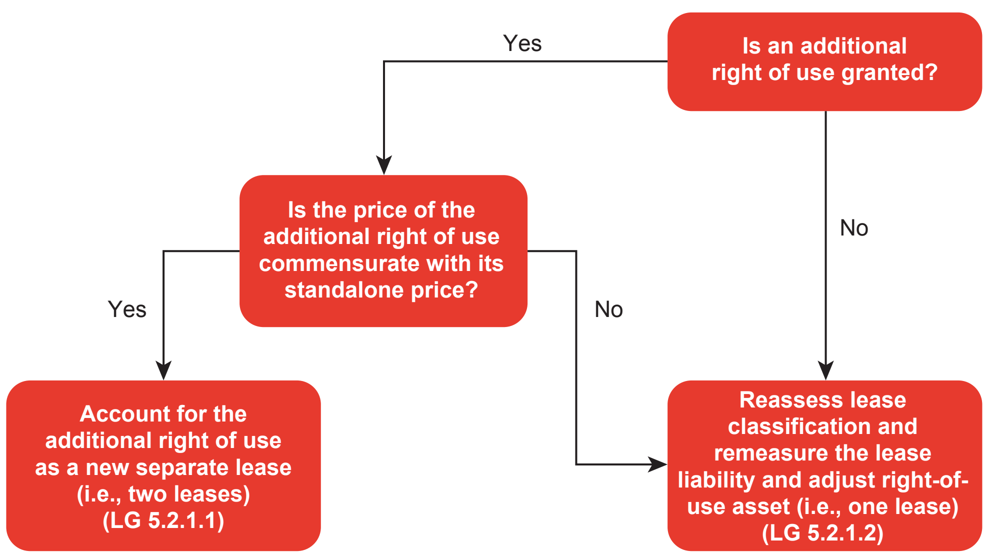
The following are examples of lease modifications that may be negotiated after the lease commencement date:

- 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 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 lease that is accounted for separate from the original lease or a single modified lease.

Figure 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.

5.2.1.1 *Separate new lease*

ASC 842-10-25-8 provides guidance on whether a lessee should account for a lease modification as a new lease (separate from the existing lease).

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 lease

When a lessee concludes that a lease modification should be accounted for as a new lease that is separate and apart from the original lease, the accounting for the original lease is not changed as a result of the modification. Accordingly, 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.

The following example illustrates a lessee's accounting for a modification as a separate new lease.

EXAMPLE 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 pays 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.

How should Lessee Corp account for this lease modification?

Analysis

Lessee Corp should account for the lease modification as a separate lease 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. Therefore, on the new lease's commencement date, Lessee Corp would have two separate leases:

- The original lease for 2,000 square feet for five 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. Beginning on the effective date of the modification, Lessee Corp would have two separate leases, each of which contains a single lease component – the original, unmodified lease and the new lease.

5.2.1.2 Modified lease

If a lease modification is not accounted for as a separate lease, a lessee should reassess the lease classification, remeasure the lease liability, and adjust the right-of-use asset. 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 5.3.2 and LG 5.3.3.

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.

5.3 Accounting for lease remeasurement – lessee

As discussed in LG 5.1, a lessee should reallocate the contract consideration between 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 net income. 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

- Reassess the lease classification
- Update the discount rate used to remeasure the lease liability

The following table provides an overview of the circumstances that could lead to the above consequences.

Figure 5-2
Accounting for a lease remeasurement

	Reassess contract (LG 2)	Reassess classification (LG 3)	Reallocate contract consideration (LG 2.4.3)	Remeasure the lease liability and adjust the right-of-use asset (LG 5.3.2 and LG 5.3.3)	Update discount rate (LG 3.3.4.6)
Lease contract is modified in such a way that the combined contract is accounted for as one lease (LG 5.2)	●	●	●	●	●
An event occurs that gives the lessee a significant economic incentive to exercise, or not exercise, a renewal option (LG 5.3.1)		●	●	●	●
An event occurs that gives the lessee a significant economic incentive to exercise, or not exercise, a purchase option (LG 5.3.1)		●	●	●	●
A contingency on which variable payments are based is met such that the variable payments become fixed (LG 5.3.1)			●	●	
Amounts owed under a residual value guarantee become probable (LG 5.3.1)			●	●	

When reassessing lease classification upon a modification, 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 terms of the contract are changed.

5.3.1 Lease remeasurement for a change in lease payments or the probability of exercising an option

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.

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 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. As CPI increases, should lease payments be adjusted to include the impact of the increase to date?

PwC response

No. 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 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.

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 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., a change in the price to lease or 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 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. See LG 2.4.3 for information regarding the allocation of consideration.

ASC 842-20-35-4 and 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 inception already reflected the options. For example, if a lessee with a five-year lease with a three-year renewal option used a discount rate at lease commencement assuming exercise of the three-year renewal option, the discount rate already reflects the renewal option and does not need to be adjusted.

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 recorded lease liability should be recorded at the remeasured amount with an adjustment to the right-of-use asset.

5.3.3 Right-of-use asset adjustment

Generally, the right-of-use asset will need to be adjusted upon a full or partial termination of the lease (i.e., a reduction to a right-of-use). See LG 5.5 for information on lease terminations.

For all other changes (e.g., those that give an additional right of use, increase or decrease 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.

5.3.4 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.

5.3.4.1 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 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.

5.3.4.2 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:

$$\frac{\text{Future undiscounted cash flows + (the right-of-use asset – the lease liability at the remeasurement date)}}{\text{Remaining lease term}}$$

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.

5.3.5 *Illustrative examples of lease remeasurement*

The following examples illustrate how to remeasure a lease for a lease modification or other event.

EXAMPLE 5-2

Remeasurement of an operating lease with variable lease payments

On January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease property to be used as a retail store.

The lease has the following terms:

Lease commencement date	January 1, 20X1
Initial lease term	5 years
Renewal option	3 years
Annual lease payments for the initial term	$100,000
Annual lease payments for the renewal option	$110,000
Lease increase based on changes in the Consumer Price Index (CPI)	The annual lease payment 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.
Payment date	Annually on January 1
Initial direct costs	$10,000

Lessee Corp determines that the lease is an operating lease. Lessee Corp's incremental borrowing rate at the lease inception date is 5% (this rate does not reflect the renewal option). The CPI at lease commencement is 120.

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.

Since Lessee Corp is now reasonably certain that it will exercise its renewal option, it is required to remeasure the lease in the first quarter of 20X4.

Lessee Corp reassesses the lease classification and determines that it is still an operating lease.

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%
CPI available 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

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%. As shown in the table, the revised lease liability is $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

Income statement impact

The single lease expense would be recalculated using the following formula.

$$\frac{\text{Future undiscounted cash flows at the remeasurement date + (the right-of-use asset – the lease liability immediately before the remeasurement)}}{\text{Remaining lease term}}$$

$$\frac{\$551{,}200 + (\$199{,}238 - \$195{,}238)}{5} = \$111{,}040 \text{ single lease expense}$$

The annual single lease expense of $111,040 would be recognized for the remaining term of the lease.

EXAMPLE 5-3

Remeasurement of finance lease for a change in expected purchase option exercise

On January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease manufacturing equipment.

The lease has the following terms:

Lease commencement date	January 1, 20X1
Lease term	5 years with no renewal option
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 determines that the lease is a finance lease. Lessee Corp's incremental borrowing rate at the lease inception date is 5% (this rate does not reflect the purchase option).

At the lease commencement date, it was not reasonably certain that the 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 contractual modification to the manufacturing facility lease 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. Since Lessee Corp is now reasonably certain that it will exercise its purchase option, it is required to reassess and remeasure the lease on January 1, 20X3 (the beginning of year 3 of the lease).

Lessee Corp reassesses the lease classification and determines that it is still a finance lease.

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%
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

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 updated discount rate of 3% because the initial discount rate did not include this option) plus the purchase option. The following table shows the future lease payments including the payment of $30,000 at the end of the lease to exercise the purchase option. As shown in the table, the revised lease liability is $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

Income statement impact

Lessee Corp would calculate the interest expense on the lease liability from the remeasurement date as follows.

Year	Remaining cash payments	Discount	Annual lease payment	Liability balance after annual payment	Interest expense
3	$330,000	$11,199	$100,000	$218,801	$6,564
4	$230,000	$4,635	$100,000	$125,365	$3,76
5	$130,000	$874	$100,000	$29,126	$874

The revised straight-line amortization 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 estimated useful life at the remeasurement date	5 years
Recalculated annual right-of-use asset amortization	$61,123

EXAMPLE 5-4

Remeasurement of a finance lease for a change in the probability of payment for a residual value guarantee

On January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease manufacturing equipment.

The lease has the following terms:

Lease commencement date	January 1, 20X1
Lease term	5 years with no renewal option
Economic life of the equipment	6 years
Annual lease payments	$100,000
Payment date	Annually on January 1

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.

Lessee Corp determines that the lease is a finance lease. Lessee Corp's incremental borrowing rate at the lease inception date is 5%.

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. Since Lessee Corp now determines that it is probable that it will have to make a payment under the residual value guarantee, it is required to remeasure the lease on the date of the change in the amount probable of being paid (January 1, 20X3).

Lessee Corp does not need to reassesses the lease classification based on the guidance in ASC 842-10-25-1.

The following table summarizes information pertinent to the lease remeasurement.

Remeasurement date	January 1, 20X3
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

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 is $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

Income statement impact

Lessee Corp would calculate the interest expense on the lease liability from the remeasurement date as follows.

Year	Remaining cash payments	Discount	Annual lease payment	Liability balance	Interest expense
3	$310,000	$15,421	$100,000	$194,579	$9,729
4	$210,000	$5,692	$100,000	$104,308	$5,215
5	$110,000	$476	$100,000	$9,524	$476

The revised straight-line amortization 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 estimated useful life at the remeasurement date	3 years
Recalculated annual right-of-use asset amortization	$93,798

EXAMPLE 5-5

Accounting for a modified operating lease that extends the lease term classified as an operating lease

On January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease property to be used as a retail store.

The lease has the following terms:

Lease commencement date	January 1, 20X1
Initial lease term	5 years with no renewal option
Annual lease payments	$100,000
Payment date	Annually on January 1
Initial direct costs	$10,000

Lessee Corp determines that the lease is an operating lease. Lessee Corp's incremental borrowing rate at the lease inception date is 5%.

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. As the modification does not grant an additional right of use, Lessee Corp concludes that the modification is not a separate new lease, but rather that it should reassess and remeasure the entire modified lease on the effective date of the modification.

Lessee Corp reassesses the lease classification and determines that it should still be classified as an operating lease upon modification.

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%
Right-of-use asset immediately before the modification	$199,238
Lease liability immediately before the modification	$195,238

How would Lessee Corp account for the lease modification?

Analysis

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% (because the original discount rate for the lease did not already reflect that the lessee had an option to extend the lease). 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 is $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

Income statement impact

Lessee Corp would recalculate the single lease expense using the following formula.

$$\frac{\text{Future undiscounted cash flows at the remeasurement date + (the right-of-use asset - the lease liability immediately before the remeasurement)}}{\text{Remaining lease term}}$$

The amounts are as follows:

$$\frac{\$550{,}000 + (\$199{,}238 - \$195{,}238)}{5} = \$110{,}800 \text{ singe lease expense}$$

Lessee Corp would recognize annual single lease expense of $110,800 for the remaining term of the lease.

EXAMPLE 5-6

Accounting for a modified operating lease with a decrease in lease term

On January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease property to be used as a retail store.

The lease has the following terms:

Lease commencement date	January 1, 20X1
Initial lease term	5 years with no renewal option
Annual lease payments	$100,000
Payment date	Annually on January 1
Initial direct costs	$10,000

Lessee Corp determines that the lease is an operating lease. Lessee Corp's incremental borrowing rate at the lease inception date is 5%.

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. Since there is a not an additional right of use granted, Lessee Corp should reassess and remeasure the lease as of the effective date of the modification date.

Lessee Corp reassesses the lease classification and determines that the lease should continue to be classified as an operating lease upon modification.

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%
Right-of-use asset immediately before the modification	$380,325
Lease liability immediately before the modification	$372,325

How would Lessee Corp account for the lease modification?

Analysis

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% because the original discount rate for the lease did not already reflect that the lessee has an option to extend the lease. The modified lease liability is $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.

Lease liability	$158,551	
Right-of-use asset		$158,551

Income statement impact

The single lease expense should be calculated as illustrated in Example 5-5.

EXAMPLE 5-7

Accounting for a change in consideration in an operating lease

On January 1, 20X1, Lessee Corp enters into a contract with Lessor Corp to lease property to be used as a retail store.

The lease has the following terms:

Lease commencement date	January 1, 20X1
Initial lease term	5 years (includes a termination option available after year 3 with a termination penalty)
Annual lease payments	$100,000
Payment date	Annually on January 1
Initial direct costs	$10,000

Lessee Corp determines that the lease is an operating lease. Lessee Corp's incremental borrowing rate at the lease inception date is 5%.

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 to $90,000.

Lessee Corp determines that the lease should continue to be classified as an operating lease upon modification.

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 December 31, 20X3	4%
Lease liability immediately before the modification	$195,238

How would Lessee Corp account for the lease modification?

Analysis

Lessee Corp would remeasure the lease as of the modification date.

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 is $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

Income statement impact

The single lease expense should be calculated as illustrated in Example 5-5.

5.4 Lessee reassessment of short-term lease exception

A lessee should reassess whether a short-term lease continues to qualify for the short-term lease exception when either of the following events occur:

- The lease term changes (e.g., because the lessee elects to 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 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 exception, 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 exception.

5.5 Accounting for a lease termination – lessee

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 net income 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 termination of the original lease. In some cases, it may be treated as a modification.

A decrease in lease term is not a partial termination event; it should be accounted for as a lease modification. See LG 5.2 for information on accounting for a lease modification.

5.5.1 Accounting for a partial lease termination

A modification or reassessment 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 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 net income.

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 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 for an example of lessee accounting for a partial lease termination.

5.5.2 *Purchase of a leased asset during the lease term*

A lessee's accounting for the purchase of an underlying asset is described in ASC 842-20-40-2.

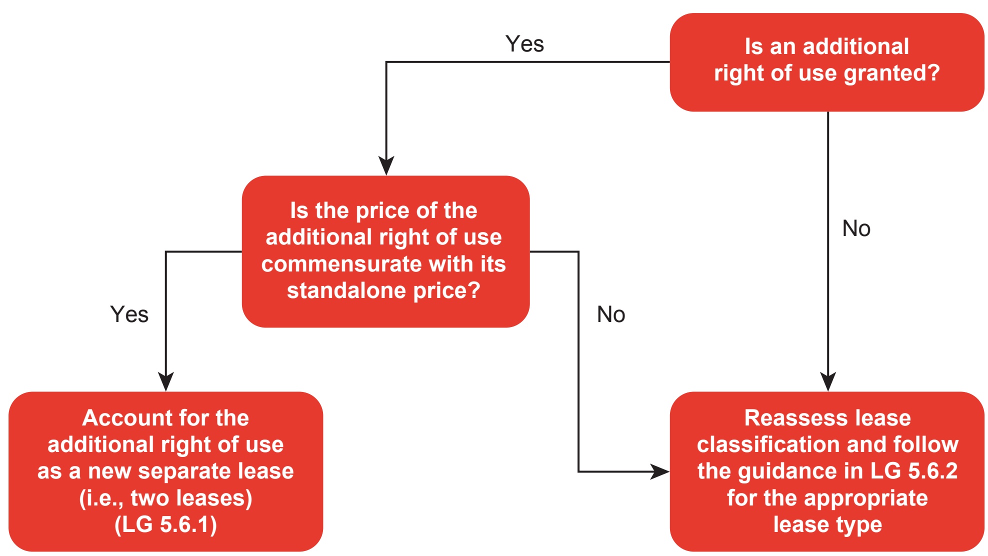
ASC 842-20-40-2

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*

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 lease (i.e., accounted for separate from the original lease) or a new modified lease. The following figure illustrates the steps to determine the accounting for a change made to a lease.

Figure 5-3
Lessor's accounting for a lease modification



5.6.1 *Separate new lease*

A lessor should apply the same accounting as a lessee for a modification that results in a separate new lease. See LG 5.2.1.1 for more information on a lessee's accounting for a separate new lease.

5.6.2 *Modified lease*

If a lease modification is not accounted for as a separate new lease, it should be accounted for as a modified lease; that is, it should be accounted 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. See LG 3 for information on lease classification. The accounting treatment depends on the lease type before and after the modification.

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. The following table summarizes the accounting for the modification of a direct financing lease.

Figure 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.	Example 5-8
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.	Example 5-9

Modified lease classification	Lessor accounting	Example
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.	Example 5-10

The following examples illustrate the accounting for the modification of a direct financing lease.

EXAMPLE 5-8

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 assets at lease inception.

Lease term	5 years, no renewal option
Economic life of the leased equipment	10 years
Purchase option	None
Annual lease payments	$195,000
Payment date	Annually on January 1
Fair value of the leased equipment	$1,200,000
Lessor Corp's carrying value of the leased equipment	$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
Interest rate charged in the lease	5.0%
Other	Title to the asset remains with Lessor Corp upon lease expiration

At lease commencement, Lessor Corp concludes that the lease is not a sales-type lease because none of the criteria in ASC 842-10-25-2 are met. Lessor Corp concludes 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. Therefore, Lessor Corp initially recognized a net investment in the lease of $1,200,000 and derecognized the carrying value of the equipment of $1,200,000.

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 components at the modification date are 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	Annually on January 1
Fair value of the leased equipment	$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.

How would Lessor Corp account for the lease modification?

Analysis

Determine if the lease modification is a separate new lease

Since the change in pricing of the lease is not commensurate with the standalone price and there is no additional right-of-use asset, Lessor Corp would not account for the modification as a new lease, separate from the original five-year 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

Lessor Corp would base its lease reassessment on the equipment fair value as of the modification date and discount rate implicit in the modified lease (6.75%). The lease is not a sales-type lease because none of the criteria in ASC 842-10-25-2 are met. Lessor Corp would 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 5-9

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 assets at lease inception.

Lease term	5 years, no renewal option
Economic life of the leased equipment	10 years
Purchase option	None
Annual lease payments	$195,000
Payment date	Annually on January 1
Fair value of the leased equipment	$1,200,000

Lessor Corp's carrying value of the leased equipment	$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
Interest rate charged in the lease	5.0%
Other	Title to the asset remains with Lessor Corp upon lease expiration

At lease commencement, Lessor Corp concludes that the lease is not a sales-type lease because none of the criteria in ASC 842-10-25-2 are met. Lessor Corp concludes 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. Therefore, Lessor Corp initially recognized a net investment in the lease of $1,200,000 and derecognized the carrying value of the equipment of $1,200,000.

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 components at the modification date are 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	Annually on January 1
Fair value of the leased equipment	$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.

How would Lessor Corp account for the lease modification?

Analysis

Determine if the lease modification is a separate new lease

Since the change in pricing of the lease is not commensurate with the standalone price and there is no additional right-of-use asset, Lessor Corp would not account for the modification as a new lease, separate from the original five-year 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

Lessor Corp would 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.

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 5-10

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 assets at lease inception.

Lease term	5 years, no renewal option
Economic life of the leased equipment	10 years
Purchase option	None
Annual lease payments	$195,000
Payment date	Annually on January 1
Fair value of the leased equipment	$1,200,000
Lessor Corp's carrying value of the leased equipment	$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
Interest rate charged in the lease	5.0%
Other	Title to the asset remains with Lessor Corp upon lease expiration

At lease commencement, Lessor Corp concludes that the lease is not a sales-type lease because none of the criteria in ASC 842-10-25-2 are met. Lessor Corp concludes 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. Therefore, Lessor Corp initially recognized a net investment in the lease of $1,200,000 and derecognized the carrying value of the equipment of $1,200,000.

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 components at the modification date are shown in the following table.

Modification date	January 1, 20X2
Remaining modified lease term	6 years, no renewal option
Remaining economic life	7 years
Purchase option	None
Annual lease payment	$190,000

Payment date	Annually on January 1
Fair value of the leased equipment	$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 2 years of the lease)
Estimated residual value	$700,000
Residual value guarantee	$350,000 residual value guarantee is provided by a third party unrelated to Lessee Corp or Lessor Corp
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.

How would Lessor Corp account for the lease modification?

Analysis

Determine if the lease modification is a separate new lease

Since the change in pricing of the lease is not commensurate with the standalone price for the additional right-of-use asset, Lessor Corp would not account for the modification as a new lease, separate from the original five-year 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

Lessor Corp would classify 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.

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

The accounting for the modification of an operating lease will depend on how the lease is classified after it is modified. The following table summarizes the accounting for the modification of an operating lease.

Figure 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.	
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.	Example 5-12
Operating lease	No gain or loss is recognized as a result of the modification. A new straight-line lease expense is calculated based on the remaining payments adjusted for any prepaid or accrued rent at the date the modification is recorded.	Example 5-11

The following examples illustrate the accounting for the modification of an operating lease.

EXAMPLE 5-11
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 assets at lease inception.

Lease commencement date	January 1, 20X1
Initial 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	Annually on January 1
Accrued rent asset	$8,000
Economic life of the asset	40 years

Fair value of the asset	$7,000,000
Other	Title to the asset remains with Lessor Corp upon lease expiration

Lessor Corp classified the lease as an operating lease because it does not meet any of the criteria to be classified as a sales-type lease or as a direct financing lease.

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 revised annual lease payments are $507,000 for the next two years and $509,000 for the three years added to the term. The increase in lease consideration is at a discount to the current market rate for the additional term for this particular lease contract.

How would Lessor Corp account for the lease modification?

Analysis

Determine if the lease modification is a separate new lease

Since the change in pricing of the lease is not commensurate with the standalone price and there is no additional right-of-use (increase in lease term is not considered an additional right of use), Lessor Corp should not account for the modification as a new lease, separate from the original five-year 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

Lessor Corp would classify 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 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, 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	($8,000)
Net payments	$2,533,000

Lessor Corp would recognize annual straight-line income of $506,600 ($2,533,000 ÷ 5 years).

EXAMPLE 5-12

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 assets at lease inception.

Lease commencement date	January 1, 20X1
Initial 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	Annually on January 1
Economic life of the leased asset	10 years
Carrying value and fair value of the equipment at lease inception	$1,300,000

At lease inception, Lessor Corp determines that the lease is an operating lease because none of the criteria in ASC 842-10-25-2 are met. Lessor Corp calculates a straight-line rental revenue amount of $162,490 annually.

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 or purchase option
Purchase option	None
Annual lease payments	$173,000
Payment date	Annually on January 1
Accrued rent asset	$19,229
Remaining economic life	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.

How would Lessor Corp account for the lease modification?

Analysis

Determine if the lease modification is a separate new lease

Since the change in pricing of the lease is not commensurate with the standalone price and the change in lease term is not an additional right-of-use asset, Lessor Corp would not account for the modification as a new lease, separate from the original five-year 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

Since the modified lease is for a major part of the remaining economic life of the equipment, the lease is a sales-type lease.

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	(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. The following table below summarizes the accounting for the modification of a sales-type lease.

Figure 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.	The accounting is the same as shown in Example 5-8
Sales-type lease	Same as a direct financing lease	The accounting is the same as shown in Example 5-8

Modified lease classification	Lessor accounting	Example
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.	The accounting is the same as shown in Example 5-10

5.7 *Accounting for a lease termination – lessor*

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 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.

Chapter 6: Sale and leaseback transactions

6.1 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 LG 9 for information on the disclosure requirements for sale and leaseback transactions by both seller-lessees and buyer-lessors.

6.2 Sale and leaseback transactions

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 Determining whether a sale has occurred

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"), when the buyer-lessor is a customer or ASC 610-20, *Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets* (which references the control guidance in the revenue standard), when the buyer-lessor is not a customer.[1]

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.

6.3.1 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.

[1] For ease of reference, the remainder of the chapter will refer to the "revenue standard" regardless of whether the buyer-lessor is a customer.

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 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 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 Indicators that control of an asset has been obtained

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 transfer of control indicators in the revenue standard. According to the revenue standard, the five indicators that a customer has obtained control of an asset 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 RR6 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 Seller-lessee has a present right to payment (or buyer-lessor has a present obligation to make 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 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.

6.3.2.3 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. 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 the 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 *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 *Impact of a prospective lessee obtaining control of an underlying asset prior to lease 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.

The following examples illustrate the assessment of whether a lessee has obtained control of the underlying asset prior to lease commencement.

EXAMPLE 6-1

Sale and leaseback transaction – lessee obtains control prior to lease commencement

Contractor Corp wants to lease a new construction 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 sales 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 6-2

Sale and leaseback transaction – lessee obtains title, but not control prior to lease commencement

Assume the same facts as Example 6-1 except that the manufacturer arranges for the lease between Contractor Corp and the bank. For tax reasons, Contractor Corp and the bank agree that legal title will momentarily transfer from the manufacturer to Contractor Corp and then Contractor Corp will immediately transfer the title to the bank.

Should Contractor Corp account for the transaction as a sale and leaseback?

Analysis

Contractor Corp should account for the transaction as an operating 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.

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.

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.

If a lessee obtains control of an underlying asset under construction before the lease commencement date, 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. Unless, and until, the lessee transfers control of the underlying asset to the lessor, the lessee is deemed to be the accounting owner of the underlying asset.

A 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 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*. A lessor should not recognize the asset under construction.

A lessee and lessor should determine when, if ever, control transfers from the lessee to the lessor and the transaction qualifies as a sale and a leaseback. Generally, once a lessee has obtained control of an underlying asset under construction, it is unlikely that the transaction will qualify for sale and leaseback accounting before construction of the underlying asset has been completed.

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.

The following examples 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 55-44 for additional examples.

EXAMPLE 6-3

Sale and leaseback transactions – 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. 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 as a financial liability.

Symmetrical 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 6-4

Sale and leaseback transactions – 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 *Construction costs incurred by a lessee*

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.

The following example illustrates the application of this guidance.

EXAMPLE 6-5

Sale and leaseback transactions – construction costs incurred by a lessee that does not obtain control of construction in process (real estate)

Assume the same fact pattern as Example 6-4.

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.

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 seller-lessee classifies a leaseback as a finance lease, 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 not a lease, so the leaseback would represent a repurchase of the underlying sold asset. See LG 3 for information on the criteria for classification as a finance lease. See LG 6.5 for information on the accounting for failed sale and leaseback transactions.

6.3.5 Repurchase rights and obligations in a sale and leaseback transaction

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 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 accounted for 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 Seller-lessee has a repurchase option or the transaction is subject to a forward

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.

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 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

Generally, if the underlying asset is real estate, the transaction would fail to meet the second criteria because each location is unique; therefore, alternative real estate assets that are readily available in the marketplace will not be considered substantially the same as the underlying real estate asset. Judgment may be required to determine whether other types of assets are considered substantially the same as the underlying asset.

If a repurchase option or obligation precludes a seller-lessee from accounting for the transaction as a sale, both the seller-lessee and buyer-lessor should account for the contract as a financing arrangement. See LG 6.5 for further discussion of how to account for a failed sale and leaseback transaction.

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.

6.4 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 below.

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.

The following examples illustrate how a seller-lessee would account for a gain or loss on sale generated from a sale and leaseback transaction.

EXAMPLE 6-6

Sale and leaseback transactions – 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 6-7

Sale and leaseback transactions – loss on sale

Assume the same fact pattern as Example 6-6 except the seller-lessee's net carrying amount of the asset at the date of sale is $25 million.

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 6-8. 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 for information on debt issuance costs.

6.4.4 Accounting for sale and leaseback transactions entered into at off-market terms

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 any 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.

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 accounting for a 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.

The following example illustrates the seller-lessee's accounting when the stated sale price of an underlying asset is less than its fair value.

EXAMPLE 6-8

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 end 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.

The following example illustrates the accounting by the seller-lessee when the sale price of an underlying asset is greater than its fair value.

EXAMPLE 6-9

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%.

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 accounting for a 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 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 to the seller-lessee separate from the lease liability. The buyer-lessor should record the underlying asset at its fair value.

The following example 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 6-10

Sale and leaseback transaction – buyer-lessor buys an underlying asset for an amount greater than fair value

Assume the same fact pattern as Example 6-9.

The buyer-lessor's interest rate implicit in the leaseback, which was not known to the seller-lessee in Example 6-9, 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. Receivable	$2,000,000	
Cr. Cash		$30,000,000

Each annual leaseback payment of $1,000,000 would be allocated between the lease and the receivable. 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.

Repayment of principal	$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 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 *Transaction is not accounted for as a sale (failed sale and leaseback)*

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 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 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 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 Accounting by a seller-lessee when the buyer-lessor obtains control of the asset after lease commencement

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 initially classifying the lease and measuring the right-of-use asset and lease liability.

The following examples 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 6-11

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
- The buyer-lessor does not obtain control of the underlying asset prior to the end of the leaseback term
- 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 does not qualify for sale accounting. It 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 6-12

Failed sale and leaseback – buyer-lessor does not obtain control of the underlying asset prior to the end of the leaseback term

Assume the same fact pattern as Example 6-11 except that the annual leaseback payment is $75,000.

How should the seller-lessee account for the sale and leaseback of the building?

Analysis

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

Period	Net carrying amount	Asset value	Accumulated depreciation	Financial liability	Increase of liability	Interest expense
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 6-13

Failed sale and leaseback – buyer-lessor does not obtain control of the underlying asset prior to the end of the leaseback term

Assume the same fact pattern as Example 6-11 except that the annual leaseback payment is $200,000.

How should the seller-lessee account for the sale and leaseback of the building?

Analysis

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
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 6-14

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

Assume the same fact pattern as Example 6-11 except that 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

At the end of the third year, 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, 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. At that time, the seller-lessee would determine the lease classification and measure the right-of-use asset and lease liability.

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.

The following example 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 6-15

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 described above 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 note 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 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.

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.

The following examples 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 6-16

Failed sale and leaseback – buyer-lessor obtains control of the underlying asset at the end of the leaseback term

Assume the same fact pattern as Example 6-11. In addition, 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 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 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 6-17

Buyer-lessor obtains control of the underlying asset prior to the end of the leaseback term

Assume the same fact pattern as Example 6-11 except that 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. In addition, 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

At the end of the third year, 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.

Chapter 7: Leveraged leases

7.1 Chapter 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 10 for information on effective date and transition.

ASC 840 and ARM 4650.54 provide guidance for grandfathered leveraged leases. This chapter supplements the guidance in ARM 4650.54 and discusses how to account for changes in leveraged lease arrangements that occur after a lessor adopts ASC 842.

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

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).

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

See ARM 4650.54 for additional guidance on the classification criteria for leveraged leases.

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 *Financial statement presentation of leveraged leases and income recognition*

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 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.

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.

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.

7.3 Changes to a leveraged lease arrangement

Once a lessor adopts ASC 842, it may only continue to apply leveraged lease accounting to grandfathered leveraged leases. 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 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 of a leveraged lease

As noted in LG 7.2.1, 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 *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 *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 *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)

- 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 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 6.5.2.1 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 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. See ARM 4650.54 for further information regarding the effects of a change in the projected timing of income tax-related cash flows.

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

  This includes changes resulting from a change in enacted income tax rates, as well as those that result from a change in state apportionment factors.

- 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. See ARM 4650.54 for additional information.

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. See ASC 842-50-55-27 through 55-33 for an illustration. See ARM 4650.55, BCG 4.3.4.7, and TX 2.3.2.1 for additional information on the accounting for leveraged leases acquired in a business combination.

Chapter 8: Other topics

8.1 Chapter overview

This chapter discusses the following topics:

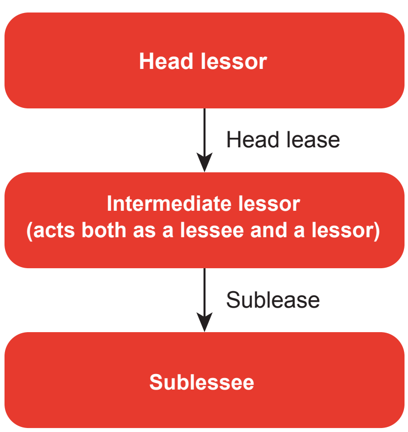
- Subleases
- Sales of leased assets
- Sales of lease receivables and unguaranteed residual assets
- Sales of equipment with guaranteed minimum resale amount
- Business combinations

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 and equity method of accounting* guide for more information.

8.2 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 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. The following figure illustrates a typical sublease arrangement.

Figure 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.

See LG 9.2.4, LG 9.2.5, and LG 9.3.2.3 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. 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.

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 Accounting for the arrangement when the intermediate lessor is not relieved of its primary obligation under the head lease

ASC 842-20-35-14 discusses the accounting for a sublease when the intermediate lessor is not relieved of its primary obligation under the head lease. The following figure 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 8-2

Accounting for subleases when the intermediate lessor is not relieved of its primary obligation under the head lease

Lease classification	Intermediate lessor accounting treatment
Both the head lease and sublease are classified as operating leases	□ 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) 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 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 an operating lease	□ ASC 842 does not address this scenario. □ We believe the intermediate lessor should continue to account for the head lease as before commencement of the sublease. □ A change in the manner of use of the underlying asset could be an indicator that the right-of-use asset under the head lease is impaired and should be tested for impairment in accordance with ASC 360-10-35-21. See 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 derecognition guidance for sales-type lease/direct financing lease 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.

Lease classification	Intermediate lessor accounting treatment
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 derecognition guidance for sales-type lease/direct financing lease 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 right-of-use asset would be evaluated for impairment prior to derecognition using the guidance in ASC 360. 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. In addition, because the sublease met one of the conditions in ASC 842-10-25-2 and the head lease did not, the intermediate lessor should evaluate whether the original assumptions relating to the head lease have changed.

8.2.1.2 Intermediate lessor is relieved of its primary obligation under the head lease

ASC 842-20-40-3 provides guidance on accounting for a 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.

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.

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 of 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 this arrangement involves 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. 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.

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. 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 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 Accounting for the sale of an unguaranteed residual asset in a direct financing or a sales-type lease

There is no 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. 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 should be derecognized, the lessor should apply the guidance in:

- ASC 606-10-25-1 through 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 Accounting for the purchase of an interest in the residual value of a leased asset

Residual assets may be guaranteed or unguaranteed.

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 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. If the residual is guaranteed after the lease commencement date, it is considered the same as an unguaranteed residual asset 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 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 Sales of equipment with guaranteed minimum resale amount accounted for as an operating lease

ASC 842-30-55-6 through 55-9 describe the accounting for the sale of equipment with a guaranteed minimum resale amount that is classified as 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 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 a guaranteed minimum resale agreement to determine whether it contains an embedded derivative

Although leases are not in the scope of the guidance in ASC 815, *Derivatives and Hedging,* a lease may contain an embedded derivative that should be separated. For example, a residual value guarantee grants the holder a put right, which may be an embedded derivative.

An embedded derivative should be separated from its host contract if (1) it is not clearly and closely related to its host instrument and (2) it would be considered a derivative within the scope of ASC 815, if it were a separate instrument. A residual value guarantee that requires delivery of the underlying asset does not meet the definition of a derivative because it is not readily convertible to cash. Some residual value guarantees may meet the definition of a derivative; however, they would likely meet the scope exception for residual value guarantees in ASC 815-10-15-80.

8.6 Business combinations

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. 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.

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 exception 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 exception, BCG 4.3.4.5 for information on favorable and unfavorable contracts, and BCG 4.3.4.7 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.

8.6.2 *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 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 4.3.4.7 for more information.

Chapter 9: Presentation and disclosure

9.1 Chapter overview

The leases standard provides guidelines for presenting and disclosing lease arrangements. This chapter provides an overview of those requirements for both lessees and lessors.

The objective of the disclosure requirements in the leases standard is to enable financial statement users to understand the amount, timing, and uncertainty of cash flows arising from leases. To achieve this objective, lessees and lessors are required to disclose qualitative and quantitative information about their leases, the significant judgments made in applying the lease guidance, and the amounts recognized in the financial statements related to those leases. Reporting entities should provide the appropriate level of detail so that the information provided is meaningful to financial statement users.

9.2 Lessees

Although a lessee is required to present assets and liabilities for all leases in a similar manner, presentation of expenses and cash flows will differ based on how a lease is classified.

9.2.1 Balance sheet presentation

As discussed in ASC 842-20-45-1, a lessee should separately present a right-of-use asset and lease liability.

ASC 842-20-45-1

A lessee shall either present in the statement of financial position or disclose in the notes all of the following:

a. Finance lease right-of-use assets and operating lease right-of-use assets separately from each other and from other assets

b. Finance lease liabilities and operating lease liabilities separately from each other and from other liabilities.

Right-of-use assets and lease liabilities shall be subject to the same considerations as other nonfinancial assets and financial liabilities in classifying them as current and noncurrent in classified statements of financial position.

9.2.1.1 Right-of-use asset

Financial statement users may view right-of-use assets differently than other assets; therefore, finance lease and operating lease right-of-use assets should either be presented separately from each other and other assets on the balance sheet or disclosed in the notes to the financial statements along with the balance sheet line items in which those assets are included.

Although ASC 842-20-45-1 seems to permit disclosure in the notes in lieu of separate presentation on the balance sheet, ASC 842-20-45-3 prohibits combining finance lease and operating lease right-of-use assets on the balance sheet.

As noted in LG 4.2.2.2, initial direct costs should be included in the initial measurement of the right-of-use asset.

9.2.1.2 Lease liability

Finance lease and operating lease liabilities should be presented separately from each other and other liabilities on the balance sheet or disclosed in the notes to the financial statements along with the balance sheet line items in which those liabilities are included.

Although ASC 842-20-45-1 seems to permit disclosure in the notes in lieu of separate presentation on the balance sheet, ASC 842-20-45-3 prohibits combining finance lease and operating lease liabilities on the balance sheet.

9.2.2 Statement of comprehensive income

ASC 842-20-45-4 discusses lessee presentation in the statement of comprehensive income.

ASC 842-20-45-4

In the statement of comprehensive income, a lessee shall present both of the following:

a. For finance leases, the interest expense on the lease liability and amortization of the right-of-use asset are not required to be presented as separate line items and shall be presented in a manner consistent with how the entity presents other interest expense and depreciation or amortization of similar assets, respectively.

b. For operating leases, lease expense shall be included in the lessee's income from continuing operations.

9.2.2.1 Finance lease

Separate presentation of interest expense on the lease liability and amortization of the right-to-use asset is not required for a finance lease because it is economically similar to the acquisition of assets on a financed basis. Interest expense should generally be presented with other interest expense in the income statement.

9.2.2.2 Operating lease

A lessee should present the lease expense of an operating lease as a single operating expense in income from continuing operations. As noted in LG 4.4.2, lease expense should be calculated on a straight-line basis. Although a lessee is not required to provide the components of lease expense, financial statement users will be able to derive certain information from the quantitative disclosures, including the weighted average discount rate. See LG 9.2.5 for further discussion.

9.2.3 *Statement of cash flows*

The following subsections address how a lessee should present cash payments for finance and operating leases in the statement of cash flows.

9.2.3.1 *Finance lease*

A lessee should classify cash payments with respect to finance leases as follows:

- Cash payments for the principal portion of the lease liability arising from a finance lease should be classified as financing activities
- Cash payments for the interest portion of the lease liability arising from a finance lease should be classified as operating activities
- Variable lease payments and short-term lease payments not included in the lease liability should be classified as operating activities

9.2.3.2 *Operating lease*

A lessee should generally classify cash payments arising from operating leases within operating activities. The exception to this relates to lease payments associated with the cost to bring another asset to the condition and location necessary for its intended use that are capitalized as part of the cost of the asset. For example, certain lease payments incurred while building property, plant, or equipment would be capitalized and should be classified as investing activities rather than operating.

9.2.4 *Qualitative disclosure*

ASC 842-20-50-3 requires a lessee to disclose the following qualitative items.

ASC 842-20-50-3

A lessee shall disclose all of the following:

a. Information about the nature of its leases, including:

1. A general description of those leases.

2. The basis and terms and conditions on which variable lease payments are determined.

3. The existence and terms and conditions of options to extend or terminate the lease. A lessee should provide narrative disclosure about the options that are recognized as part of its right-of-use assets and lease liabilities and those that are not.

4. The existence and terms and conditions of residual value guarantees provided by the lessee.

5. The restrictions or covenants imposed by leases, for example, those relating to dividends or incurring additional financial obligations.

   A lessee should identify the information relating to subleases included in the disclosures provided in (1) through (5).

b. Information about leases that have not yet commenced but that create significant rights and obligations for the lessee, including the nature of any involvement with the construction or design of the underlying asset.

c. Information about significant assumptions and judgments made in applying the requirements of this Topic, which may include the following:

1. The determination of whether a contract contains a lease (as described in paragraphs 842-10-15-2 through 15-27)

2. The allocation of the consideration in a contract between lease and nonlease components (as described in paragraphs 842-10-15-28 through 15-32)

3. The determination of the discount rate for the lease (as described in paragraphs 842-20-30-2 through 30-4).

For more information about the significant assumptions and judgments noted in paragraphs ASC 842-20-50-3(c)(1) through 50-3(c)(3), see LG 2.3, LG 2.4, and LG 3.3.4.6.

Lessees should disclose the election of the short-term lease exception (see LG 2.2.1). Additionally, if the short-term lease expense for the period does not reasonably reflect the lessee's ongoing short-term lease commitments, a lessee should disclose that fact and the amount of its short-term lease commitments.

Question 9-1

When a lessee discloses information about leases that have not yet commenced, but that create significant rights and obligations for the lessee based on the guidance in ASC 842-20-50-3(b) should it also consider the guidance in ASC 450, *Contingencies*?

PwC response

Yes, we believe a lessee should consider the implications of ASC 450 in this circumstance. See ARM 5360 for information on contingencies.

9.2.5 Quantitative disclosure

The leases standard also requires a lessee to disclose certain quantitative items as discussed in ASC 842-20-50-4.

ASC 842-20-50-4

For each period presented in the financial statements, a lessee shall disclose the following amounts relating to a lessee's total lease cost, which includes both amounts recognized in profit or loss during the period and any amounts capitalized as part of the cost of another asset in accordance with other Topics, and the cash flows arising from lease transactions:

a. Finance lease cost, segregated between the amortization of the right-of-use assets and interest on the lease liabilities.

b. Operating lease cost determined in accordance with paragraphs 842-20-25-6(a) and 842-20-25-7.

c. Short-term lease cost, excluding expenses relating to leases with a lease term of one month or less, determined in accordance with paragraph 842-20-25-2.

d. Variable lease cost determined in accordance with paragraphs 842-20-25-5(b) and 842-20-25-6(b).

e. Sublease income, disclosed on a gross basis, separate from the finance or operating lease expense.

f. Net gain or loss recognized from sale and leaseback transactions in accordance with paragraph 842-40-25-4.

g. Amounts segregated between those for finance and operating leases for the following items:

1. Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows

2. Supplemental noncash information on lease liabilities arising from obtaining right-of-use assets

3. Weighted-average remaining lease term

4. Weighted-average discount rate.

The amount of lease cost will not always be the same as the lease expense recognized. Lease cost may include items not recognized as lease expense (e.g., amounts capitalized as part of the cost of inventory).

A lessee should also disclose a maturity analysis of its finance lease and operating lease liabilities, separately showing:

- The undiscounted cash flows on an annual basis for a minimum of each of the next five years

- The sum of the undiscounted cash flows for all years thereafter

- A reconciliation of the undiscounted cash flows to the discounted finance lease liabilities and operating lease liabilities recognized in the statement of financial position

ASC 842-20-55-53 provides an example of this disclosure requirement.

9.3 Lessors

Lessors are required to classify leases as sales-type, direct financing, or operating leases.

9.3.1 Balance sheet presentation

A lessor's presentation of its leased asset is dependent on how the lease is classified.

9.3.1.1 Sales-type and direct financing leases

In a sales-type or direct financing lease, the lessor derecognizes the leased asset and recognizes a lease investment on its balance sheet as discussed in LG 4.3.1. A lessor's aggregate net investment should be presented separate from other assets on the lessor's balance sheet.

Lease assets should be classified as current or noncurrent. See FSP 2 for information on balance sheet classification.

9.3.1.2 Operating lease

A lessor should classify assets subject to operating leases as property, plant, and equipment (e.g., within buildings) or as a separate line item on the balance sheet (e.g., assets subject to operating leases). As with other fixed assets, property subject to operating leases may be presented net of accumulated depreciation on the balance sheet, but the accumulated depreciation should be shown on the face of the balance sheet or disclosed in the notes to the financial statements.

For operating leases with rents that change over time, the requirement to recognize rental income on a straight-line basis may generate a rent receivable or deferred rent revenue on the lessor's balance sheet. A lessor may also need to recognize a prepaid asset on the balance sheet arising from initial direct costs that the lessor will recognize as an expense over the lease term. Lessors should present a rent receivable, deferred rent, or prepaid initial direct costs with items of similar maturities on a classified balance sheet; for example, with other prepaid items associated with long-term contracts.

9.3.2 Statement of comprehensive income

The following subsections address how a lessor should recognize income based on the classification of its leases.

9.3.2.1 *Sales-type and direct financing leases*

ASC 842-30-45-3 provides guidance on a lessor's presentation of sales-type and direct financing leases in the statement of comprehensive income.

ASC 842-30-45-3

A lessor shall either present in the statement of comprehensive income or disclose in the notes income arising from leases. If a lessor does not separately present lease income in the statement of comprehensive income, the lessor shall disclose which line items include lease income in the statement of comprehensive income.

A lessor in a sales-type lease will recognize a selling profit or loss (as well as the initial direct costs) at lease commencement. The profit or loss recognized should be presented in a manner that best reflects the business model associated with the leased asset. For example, a manufacturer that leases assets as a means of realizing value from goods it would otherwise sell may present the revenue and cost of goods sold on a gross basis. Alternatively, if a lessor leases assets to generate revenue by providing financing, it may be appropriate to present the net profit or loss in a single line item.

A lessor in a direct financing lease should defer the selling profit and initial direct costs, both of which are included in the net investment of the lease. In accordance with ASC 835-30-45-3, amortization of the initial direct costs should be recorded as a reduction of interest income rather than as an expense.

9.3.2.2 *Operating lease*

A lessor should present rental income from an operating lease net of the amortization of rent receivables, deferred rent, or prepaid initial direct costs.

A lessor should continue to measure the underlying asset subject to an operating lease in accordance with other GAAP. Depreciation of the underlying asset should be presented gross and should not offset rental income.

9.3.2.3 *Subleases*

ASC 842 requires that an intermediate lessor (i.e., a sublessor) disclose sublease income on a gross basis, separate from the finance or operating lease expense.

9.3.3 *Statement of cash flows*

A lessor is required to classify cash receipts from all lease payments, regardless of lease classification, as operating activities.

9.3.4 *Disclosure*

ASC 842-30-50-3 and 50-7 requires a lessor to disclose the following qualitative items.

ASC 842-30-50-3

A lessor shall disclose both of the following:

a. Information about the nature of its leases, including:

1. A general description of those leases

2. The basis and terms and conditions on which variable lease payments are determined

3. The existence and terms and conditions of options to extend or terminate the lease

4. The existence and terms and conditions of options for a lessee to purchase the underlying asset.

b. Information about significant assumptions and judgments made in applying the requirements of this Topic, which may include the following:

1. The determination of whether a contract contains a lease (as described in paragraphs 842-10-15-2 through 15-27)

2. The allocation of the consideration in a contract between lease and nonlease components (as described in paragraphs 842-10-15-28 through 15-32)

3. The determination of the amount the lessor expects to derive from the underlying asset following the end of the lease term.

ASC 842-30-50-7

A lessor shall disclose information about how it manages its risk associated with the residual value of its leased assets. In particular, a lessor should disclose all of the following:

a. Its risk management strategy for residual assets

b. The carrying amount of residual assets covered by residual value guarantees (excluding guarantees considered to be lease payments for the lessor, as described in paragraph 842-30-30-1(a)(2))

c. Any other means by which the lessor reduces its residual asset risk (for example, buyback agreements or variable lease payments for use in excess of specified limits).

9.3.4.1 Sales-type and direct financing leases

In addition to the general disclosures discussed above, ASC 842-30-50-9 and 50-10 require additional disclosures for sales-type and direct financing leases. We do not believe it is necessary to present these disclosure separately for sales-type and direct financing leases.

ASC 842-30-50-9 requires a lessor to disclose significant changes in the balance of its unguaranteed residual assets related to both sales-type and direct financing leases. It also requires a lessor in a direct financing lease to disclose the amount of deferred selling profit.

ASC 842-30-50-10

A lessor shall disclose a maturity analysis of its lease receivables, showing the undiscounted cash flows to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessor shall disclose a reconciliation of the undiscounted cash flows to the lease receivables recognized in the statement of financial position (or disclosed separately in the notes).

A lessor is also required to disclose its lease income in a tabular format in each annual and interim reporting period. For sales-type and direct financing leases, this tabular disclosure should include the following:

- Profit or loss recognized at the commencement date, disclosed on either a gross or net basis based on its business model (as determined in LG 9.2.2.2)
- Interest income, either in aggregate or separated by components of the net investment in the lease
- Lease income relating to variable lease payments not included in the measurement of the lease receivable

A lessor should also disclose the components of its aggregate net investment in sales-type leases and direct financing leases including:

- The carrying amount of its lease receivables
- Its unguaranteed residual assets
- Any deferred selling profit in direct financing leases (which is a reduction to the net investment)

9.3.4.2 Operating lease

In addition to the general disclosures discussed above, a lessor should disclose the following with respect to operating leases:

- A maturity analysis of lease payments, showing the undiscounted cash flows to be received on an annual basis for a minimum of the next five years and the total lease payments to be received in the remaining years. The maturity analysis for operating leases should not be combined with the maturity analysis for sales-type and direct financing leases

- The property, plant, and equipment disclosures required by ASC 360 separate from owned assets held and used by the lessor

A lessor is also required to disclose its lease income in a tabular format for each annual and interim reporting period. For operating leases, this tabular disclosure should include lease income relating to lease payments, including lease income relating to variable lease payments.

9.4 Sale and leaseback transactions

Both the buyer-lessor and seller-lessee in a sale and leaseback transaction should disclose the terms and conditions of the transactions. The seller-lessee should also disclose any gains or losses arising from the transaction separate from gains or losses on disposal of other assets.

9.5 Leveraged leases

If leveraged leasing is a significant part of a lessor's business activities (based on revenue, net income, or assets), the components of the net investment balance in leveraged leases should be disclosed. Those components include the following:

- Rentals receivable
- Investment-tax-credit receivable
- Estimated residual value of the leased asset
- Unearned and deferred income

Lessors are required to provide additional disclosures about their financing receivables pursuant to ASC 310. See FSP 8.3 for further discussion.

If accounting for leveraged leases creates a variation from the customary relationship between income tax expense and pretax accounting income, and the reason for that variation is not otherwise apparent, the lessor should disclose the reason for the variation.

9.6 Related party leases

Related party lessees and lessors should apply the disclosure requirements for related party transactions in ASC 850. See FSP 26 for information.

9.7 Transition disclosures

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) is not required.

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.

Chapter 10: Effective date and transition

10.1 Chapter overview

The leases standard is applicable for most public business entities starting in 2019. Adopting the leases standard could be a significant undertaking. Some reporting entities will need several years 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. See LG 9 for details regarding transition related disclosures.

10.2 Effective date

The following table summarizes the effective dates for adopting the leases standard. Early adoption is permitted for both public and nonpublic business entities.

Figure 10-1
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 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
Other	Fiscal years beginning after December 15, 2019 and interim periods within fiscal years beginning after December 15, 2020

The effective date for public business entities, certain not-for-profit entities, and employee benefit plans requires calendar year-end reporting entities to adopt the leases standard on January 1, 2019. These entities will first report leases in accordance with the leases standard in their 2019 interim and annual financial statements, unless they choose early adoption. If adopted in 2019, this would generally require application of the leases standard to the comparative financial statements for fiscal years 2018 and 2017.

Other entities have an additional year to comply with the leases standard. In addition, they may present their interim financial statements using legacy guidance in the year of adoption. These entities will first report leases in accordance with the leases standard in their 2020 annual financial statements and 2021 interim financial statements, unless they choose early adoption.

10.3 Transition

Upon adoption of the leases standard, lessees and lessors are required to apply a modified retrospective transition approach to each lease that existed at the beginning of the earliest comparative period presented in the financial statements, as well as leases entered into after that date. Application of the modified retrospective transition approach to each lease type is discussed in the following sections.

The leases standard provides the option to elect a package of practical expedients, which are discussed in LG 10.3.3. Although lessees with operating leases that adopt the 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.

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. 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 discussed in LG 10.3.3 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. Users should refer to ASC 842-10-65-1 for guidance.

10.3.1 Lessee transition

The transition guidance differs in some respects depending on the classification of the lease.

10.3.1.1 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 new leases standard, the lessee should recognize a right-of-use asset and lease liability at the later of the (1) earliest period presented or (2) the lease commencement date.

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. The discount rate used to calculate the present value should be determined at the later of (1) the earliest period presented or (2) the commencement date of the lease. See LG 3.3.4.6 for information on determining the discount rate, including specific private company considerations.

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 that would have qualified for capitalization under the leases standard
- Any impairment
- The carrying amount of any liability related to the lease recognized in accordance with ASC 420, *Exit or Disposal Cost Obligations*

Unamortized initial direct costs remaining at the later of (1) the earliest period presented or (2) the lease commencement date that would not have qualified for capitalization under the leases standard should be written off with an offsetting entry to equity. See LG 10.3.3 for practical expedients that may result in different accounting for unamortized initial direct costs.

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 lease payments on a straight-line basis and variable payments in the period in which the obligation for those payments is incurred.

10.3.1.2 Capital leases

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. 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.

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. Costs that do not qualify for capitalization under the new leases standard should be written off with an offsetting entry to equity. However, see LG 10.3.3 for practical expedients that may result in different accounting.

Subsequent to 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). A lessee should not, however, remeasure the right-of-use asset or lease liability for changes in the amount probable of being owed under residual value guarantees unless otherwise required due to a subsequent modification. See LG 5.

10.3.1.3 Build-to-suit leases

The leases standard does not contain specific guidance for build-to-suit arrangements, but does provide transition guidance for existing arrangements. These leases should be accounted for using the modified retrospective transition approach at the earliest period presented or lease commencement date as discussed in ASC 842-10-65-1.

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 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 should 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. Any difference should be recorded as an adjustment to equity at that date. The lessee shall apply the lessee transition requirements in (k) through (s) 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 and the transaction qualified as a sale and leaseback transaction in accordance with Subtopic 840-40 before the date of initial application, the entity shall follow the general lessee transition requirements for the lease.

A lessee should consider whether it is the owner of the leased asset based on the guidance in the leases standard. If it is not the accounting owner, a lessee should adjust opening equity and follow the lessee transition guidance as if the lease had not been accounted for in accordance with the build-to-suit guidance.

10.3.2 Lessor transition

The transition guidance differs in some respects depending on the classification of the lease.

10.3.2.1 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 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.

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. Unamortized initial direct costs that do not qualify for capitalization under the leases standard should be written off with an offsetting entry to equity at the later of the earliest period presented or the commencement date of the lease. See LG 10.3.3 for practical expedients that may result in different accounting.

10.3.2.2 Finance leases

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 reclassify the 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. For a direct financing lease, the net investment in the lease should include any unamortized initial direct costs capitalized in accordance with ASC 840.

A lessor should subsequently account for the lease in accordance with the recognition and measurement guidance in the leases standard. See LG 4.5 for information.

10.3.2.3 Leveraged leases

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.

10.3.3 Practical expedients

ASC 842-10-65-1 provides a group of practical expedients that must be elected as a package and must be applied by a reporting entity to all of its leases regardless of whether they are the 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 (that is, 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.

In most cases, reporting entities that choose not to apply these practical expedients will reach the same conclusions as they did under prior GAAP. In the limited circumstances where differences exist, the guidance in ASC 842 is likely to result in a nonlease conclusion where previous GAAP would have concluded a contract was (or contained) a lease. The practical expedients should not be applied to grandfather incorrect assessments determined under prior GAAP.

Because a reporting entity is not required to reassess lease classification for existing leases, we believe that a lessee with a build-to-suit lease that elects the practical expedients may apply the build-to-suit lease transition guidance in LG 10.3.1.3.

A reporting entity with unamortized initial direct costs that do not qualify for capitalization under the leases standard guidance 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.

Upon transition, a reporting entity is also permitted to elect to use hindsight with respect to determining the lease term (i.e., they may consider the actual outcome of lease renewals, termination options, and purchase options) and in assessing any impairment of right-of-use assets for existing leases. This provision may be elected separately or in conjunction with the practical expedients in ASC 842-10-65-1(f), but represents a policy election that should be applied consistently by a reporting entity to all of its leases (including both when it is the lessee and lessor).

A reporting entity is required to disclose the use of either of the practical expedients.

10.3.4 Sale and leaseback

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 (as required by the leases standard). 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 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 or the date of the sale of the underlying asset 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 at the later of the date of initial application (to equity) or the date of sale (to earnings of the comparative period presented).

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 date of initial application.

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 date of initial application.

A sale and leaseback transaction previously accounted for as a failed sale and leaseback transaction in accordance with ASC 840 should be reassessed to determine whether a sale would have occurred at any point on or after the beginning of the earliest period presented in the financial statements under the guidance in ASC 842. 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 guidance in ASC 842-10-65-1, on a modified retrospective basis from the date a sale is determined to have occurred.

10.3.5 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 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 operating leases 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 at the beginning of the earliest comparative period presented if assets or liabilities arise from leases classified as sales-type leases or direct financing leases in accordance with Topic 840 for which the entity is a lessor.

Appendices

Appendix A: Professional literature

The PwC guides provide in-depth accounting and financial reporting guidance for various topics, as outlined in the preface to this guide. The PwC guides summarize the applicable accounting literature, including relevant references to and excerpts from the FASB's *Accounting Standards Codification* (the Codification). They also provide our insights and perspectives, interpretative and application guidance, illustrative examples, and discussion on emerging practice issues. The PwC guides supplement the authoritative accounting literature. This appendix provides further information on authoritative U.S. generally accepted accounting principles.

Professional literature

The Codification is the primary source of authoritative U.S. financial accounting and reporting standards (U.S. GAAP) for nongovernmental reporting entities (hereinafter referred to as "reporting entities"). Additionally, guidance issued by the SEC is a source of authoritative guidance for SEC registrants.

Updates and amendments to the Codification arising out of the FASB's standard-setting processes are communicated through Accounting Standards Updates (ASUs). The Codification is updated concurrent with the release of a new ASU, or shortly thereafter. PwC has developed a *FASB Accounting Standards Codification Quick Reference Guide,* which is available on CFOdirect. The quick reference guide explains the structure of the Codification, including examples of the citation format, how new authoritative guidance is released and incorporated into the Codification, and where to locate other PwC information and resources on the Codification. The quick reference guide also includes listings of the Codification's "Topics" and "Sections" and a list of frequently referenced accounting standards and the corresponding Codification Topics where they now primarily reside.

In the absence of guidance for a transaction or event within a source of authoritative U.S. GAAP (e.g., the Codification and SEC guidance), a reporting entity should first consider accounting principles for similar transactions or events within a source of authoritative U.S. GAAP for that reporting entity and then consider non-authoritative guidance from other sources. Sources of non-authoritative accounting guidance and literature include:

- FASB Concepts Statements
- AICPA Issues Papers
- International Financial Reporting Standards issued by the International Accounting Standards Board
- Pronouncements of other professional associations or regulatory agencies

- Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids

- PwC accounting and financial reporting guides

- Accounting textbooks, guides, handbooks, and articles

- Practices that are widely recognized and prevalent either generally or in the industry

While other professional literature can be considered when the Codification does not cover a certain type of transaction or event, we do not expect this to occur frequently in practice.

SEC guidance

The content contained in the SEC sections of the FASB's Codification is provided for convenience and relates only to SEC registrants. The SEC sections do not contain the entire population of SEC rules, regulations, interpretative releases, and staff guidance. Also, there is typically a lag between when SEC guidance is issued and when it is reflected in the SEC sections of the Codification. Therefore, reference should be made to the actual documents published by the SEC and SEC staff when addressing matters related to public reporting entities.

Appendix B: Technical references and abbreviations

The following tables provide a list of the technical references and definitions for the abbreviations and acronyms used within this guide.

Technical references

ASC 250	Accounting Standards Codification 250, *Accounting Changes and Error Corrections*
ASC 310	Accounting Standards Codification 310, *Receivables*
ASC 340	Accounting Standards Codification 340, *Other Assets and Deferred Costs*
ASC 350	Accounting Standards Codification 350, *Intangibles – Goodwill and Other*
ASC 360	Accounting Standards Codification 360, *Property, Plant, and Equipment*
ASC 606	Accounting Standards Codification 606, *Revenue from Contracts with Customers*
ASC 610-20	Accounting Standards Codification 610-20, *Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets*
ASC 740	Accounting Standards Codification 740, *Income Taxes*
ASC 805	Accounting Standards Codification 805, *Business Combinations*
ASC 835	Accounting Standards Codification 835, *Interest*
ASC 840	Accounting Standards Codification 840, *Leases*
ASC 842	Accounting Standards Codification 842, *Leases*
ASC 850	Accounting Standards Codification 850, *Related Party Disclosures*
ASC 930	Accounting Standards Codification 930, *Extractive Activities – Mining*
ASC 932	Accounting Standards Codification 932, *Extractive Activities – Oil and Gas*

Technical references	
CON 6	FASB Statement of Financial Accounting Concepts No. 6 – *Elements of Financial Statements*
IFRS 16	International Financial Reporting Standards 16, *Leases*

Abbreviation / acronym	Definition
ARM	Accounting and Reporting Manual
ASC	Accounting Standards Codification
ASU	Accounting Standards Update
BCG	Business combinations guide
EITF	Emerging Issues Task Force
FASB	Financial Accounting Standards Board
FSP	Financial statement presentation guide
GAAP	Generally Accepted Accounting Principles
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
LG	Leases guide
RR	Revenue recognition guide
SEC	U.S. Securities and Exchange Commission
TX	Income taxes guide

Appendix C: Key terms

The following table provides definitions for key terms used within this guide.

Term	Definition
Agent	A person appointed by the principal who acts on the behalf of the principal and can bind the principal into a contract
Bargain purchase option	An option in a lease agreement that allows the lessee to purchase the leased asset, which, when considering the circumstances in place at the commencement date (or when classification or measurement must be reassessed), the lessee is reasonably certain to exercise
Call option	A seller-lessee's right to repurchase the property it sold to a buyer-lessor
Commencement date of the lease	The date on which a lessor makes an underlying asset available for use by a lessee
Direct financing lease	A lease in which a lessor does not transfer control of the underlying asset to the lessee, and when: □ the sum of the present value of the lease payments and any residual value guaranteed by a third party unrelated to the lessor equals or exceeds substantially all of the fair value of the underlying asset, and □ it is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee
Discount rate for the lease (rate the lessor charges the lessee)	For a lessee, the rate implicit in the lease unless that rate cannot be readily determined. In that case, the lessee should use its incremental borrowing rate For a lessor, the discount rate for the lease is the rate implicit in the lease
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
Fair value	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

Term	Definition
Finance lease	For lessees, a lease is a finance lease if the lessee effectively obtains control of the underlying asset, by meeting any of the following five criteria: □ The lease transfers ownership of the underlying asset to the lessee by the end of the lease term □ The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise □ The lease term is for a major part (generally 75%) of the remaining economic life of the underlying asset □ The sum of the lease payments and the present value of any residual value guaranteed by the lessee amounts to or exceeds substantially all (generally 90%) of the fair value of the underlying asset □ The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term
Identified asset	An asset that could be the subject of a lease. An identified asset may be either explicitly or implicitly identified. An asset would not be an identified asset if the supplier has the right and practical ability to substitute the asset and could economically benefit from exercising that right.
Implicit rate (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 initial direct costs of the lessor
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
Initial direct costs	Incremental costs of a lease that would not have been incurred if the lease had not been obtained
Lease	A contract, or part of a contract, that conveys the right to control the use of property, plant, or equipment (underlying asset) for a period of time in exchange for consideration

Term	Definition
Lease commencement date	See Commencement date of the lease
Lease liability	A lessee’s obligation to make lease payments arising from a lease, measured on a discounted basis
Lease modification	A change to the contractual terms and conditions of a lease that was not part of the original terms and conditions of the lease that results in a change in the scope of or the consideration for the lease
Lease payments	Payments required from a lessee to a lessor relating to the right to use an underlying asset, consisting of the following: □ Fixed payments, including in substance fixed payments, less any lease incentives received or receivable from the lessor □ Variable lease payments that depend on an index or a rate, based on the index or rate on the lease commencement date □ The exercise price of a purchase option if the lessee is reasonably certain to exercise that option □ Payments for penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease □ Amounts probable of being owed under residual value guarantees □ Fees paid by the lessee to the owner of the special purpose entity for structuring the transaction Lease payments do not include payments allocated to nonlease components of a contract except when the lessee elects to combine nonlease and lease components and account for them as a single lease component.

Term	Definition
Lease term	The noncancellable period for which a lessee has the right to use an underlying asset, together with all of the following: □ Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option □ Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option □ Periods covered by an option to extend (or not terminate) the lease in which exercise of the option is controlled by the lessor
Leasehold improvements	An improvement made by a lessee to leased property. The leasehold improvement is owned by a lessee.
Lessee	An entity that enters into a contract to obtain the right to use an underlying asset for a period of time in exchange for consideration
Lessor	An entity that enters into a contract to provide the right to use an underlying asset for a period of time in exchange for consideration
Leveraged lease	Leveraged lease classification applies only to lessors. 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 and subsequently rises during the lease term
Net investment in the lease	For a sales-type lease, the sum of the lease receivable and the unguaranteed residual asset For a direct financing lease, the sum of the lease receivable and the unguaranteed residual asset, net of any deferred selling profit

Term	Definition
Nonrecourse debt	Associated with a leveraged lease; debt for which the only source of repayment is from unremitted rents, a residual value guarantee from the lessee, variable rents, or liquidation of the underlying asset
Not-for-profit entity	An entity that possesses the following characteristics in varying degrees, that distinguish it from a business entity: (a) contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return, (b) operating purposes other than to provide goods or services at a profit, and (c) the absence of ownership interests like those of business entities
Operating lease	A lease in which a lessor transfers the use of an asset to a lessee for a period of time but does not effectively transfer control of the underlying asset
Penalty	Economic detriments that could be incurred by a lessee, either directly or indirectly, under the terms of a lease agreement or by factors outside the lease agreement. Such detriments would include requirements to disburse cash, assume a liability, perform services, or suffer an economic loss or forego an economic benefit
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
Principal	The main party to a transaction, acting as either a buyer or seller for his/her own account and risk
Private company	An entity other than a public business entity, a not-for-profit entity, or an employee benefit plan within the scope of Plan accounting

Term	Definition
Public business entity	A public business entity is a business entity that meets one of the following criteria: (a) It is required by the SEC to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing) (b) It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC (c) It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer (d) It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market (e) It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare US GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods)
Put option	A buyer-lessor's right to require a seller-lessee to repurchase the property
Reasonably certain	In practice, reasonably certain generally connotes a probability of 75 – 80%
Residual asset	The amount the lessor expects to derive from the underlying asset following the end of the lease term
Residual value guarantee	A guarantee made to a lessor that the value of an underlying asset returned to the lessor at the end of a lease will be at least a specified amount
Right-of-use asset	An asset that represents a lessee's right to use an underlying asset for the lease term
Sale and leaseback transaction	In a sale and leaseback transaction, a seller-lessee sells property that it owns to a buyer-lessor and concurrently leases back all or a portion of the property sold
Sales-type lease	A lease in which a lessor effectively transfers control of an underlying asset to a lessee

Term	Definition
Short-term lease	A lease that, at the commencement date, has a lease term (as defined above) of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise
Sublease	A transaction in which an underlying asset is re-leased by the original lessee (or intermediate lessor) to a third party, and the lease (or head lease) between the original lessor and lessee remains in effect
Underlying asset	An asset that is the subject of a lease for which a right to use that asset has been conveyed to a lessee. The underlying asset could be a physically distinct portion of a single asset
Unguaranteed residual asset	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 a third party
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

PwC's National Accounting Services Group

The Accounting Services Group (ASG) within the Firm's National Quality Organization leads the development of Firm perspectives and points of view used to inform the capital markets, regulators, and policy makers. ASG assesses and communicates the implications of technical and professional developments on the profession, clients, investors, and policy makers. The team consults on complex accounting and financial reporting matters and works with clients to resolve issues raised in SEC comment letters. They work with the standard setting and regulatory processes through communications with the FASB, SEC, and others. The team provides market services such as quarterly technical webcasts and external technical trainings, including our alumni events. The team is also responsible for sharing their expert knowledge on topics through internal and external presentations and by authoring various PwC publications. In addition to working with the US market, ASG also has a great deal of involvement in global issues. The ASG team has a large global team that is deeply involved in the development of IFRS, and that has developed a strong working relationship with the IASB. The team of experienced Partners, Directors, and Senior Managers helps develop talking points, perspectives, and presentations for when Senior Leadership interacts with the media, policy makers, academia, regulators, etc.

About PwC

At PwC, our purpose is to build trust in society and solve important problems. PwC is a network of firms in 157 countries with more than 208,000 people who are committed to delivering quality in assurance, advisory and tax services. Find out more and tell us what matters to you by visiting us at www.pwc.com/US.